

NOTES

PROXY SOLICITATION REDEFINED: THE SEC TAKES AN INCREMENTAL STEP TOWARD EFFECTIVE CORPORATE GOVERNANCE

Suppose a corporation files a lawsuit that could have a significant impact on the value of its stock.¹ Naturally, the board of directors would feel obligated to inform the shareholders of the pending litigation. If the board of directors intends to issue a press release regarding the lawsuit, is it required to obtain government approval before issuing the release?²

Further suppose that a stockbroker, in an effort to sell a client's controlling interest in a failing corporation, talks to several prospective buyers.³ These conversations include discussion of the company's poor management and speculation regarding the possibility of a proxy fight.⁴ Must the stockbroker memorialize these conversations and report them to the government?⁵

1. This hypothetical is loosely based on *ConAgra, Inc. v. Tyson Foods, Inc.*, 708 F. Supp. 257 (D. Neb.), *vacated*, 716 F. Supp. 428 (D. Neb. 1989). See *infra* notes 79-80 and accompanying text for a discussion of *ConAgra*.

2. The issue in this hypothetical involves whether the corporation's actions constitute a proxy "solicitation" under Rule 14a-1(l), 17 C.F.R. § 240.14a-1(l) (1992), *amended by* Rule 14a-1(l)(2)(iv), 57 Fed. Reg. 48,276, 48,290 (1992) (to be codified at 17 C.F.R. § 240.14a-1(l)). In *ConAgra*, the corporation's analogous press release was deemed to be a solicitation under the pre-amendment version of Rule 14a-1(l). See *infra* note 7 for the text of former Rule 14a-1.

3. This hypothetical is loosely based on *Pantry Pride, Inc. v. Rooney*, 598 F. Supp. 891 (S.D.N.Y. 1984). See *infra* notes 84-88 and accompanying text for a discussion of *Pantry Pride*.

4. A proxy is "[a] document executed by a shareholder in order to authorize another person or persons to cast his votes at an annual or special meeting of shareholders." PAUL W. RICHTER, *PROXY CONTESTS HANDBOOK* glossary at 3 (1990). A "proxy contest" or "proxy fight" is "[a] solicitation of shareholders by a shareholder or shareholder group who are: 1) not affiliated with or part of the corporation's management; 2) are seeking shareholder approval or rejection of a matter submitted for shareholder approval (e.g., election of directors, amendment of the charter, approval of a merger agreement); and 3) are opposed to or by the corporate management." *Id.*

5. The defendant in *Pantry Pride* allegedly violated the so-called ten-person rule. Rule 14a-2(b)(1), 17 C.F.R. § 240.14a-2(b)(1) (1992), *amended by* Rule 14a-2(b)(2), 57 Fed. Reg. 48,276, 48,290 (1992) (to be codified at 17 C.F.R. § 240.14a-2(b)(2)). See *Pantry Pride*, 598 F. Supp. at 902. See also MICHAEL D. WATERS, *PROXY REGULATION* 32 (1992) (referring to Rule 14a-2(b)(1) as the "ten-person rule"). The rule requires shareholders to file proxy statements and mail them to any person whose proxy is solicited if the total number of solicited shareholders is more than ten. See *infra* note 7 for the text of the ten-person rule. See generally WATERS, *supra*, at 32-36; EDWARD R. ARANOW & HERBERT A. EINHORN, *PROXY CONTESTS FOR CORPORATE CONTROL* 109-11 (1968); International

Prior to the Securities and Exchange Commission's (SEC) 1992 amendments to its proxy rules,⁶ the actions of both the corporation and the stockbroker would have been deemed proxy solicitations under Rules 14a-1 and 14a-2.⁷ Therefore, each party would have been required to file a proxy statement with the SEC.⁸ However, the 1992 proxy rule amend-

Banknote Co. v. Muller, 713 F. Supp. 612, 622 (S.D.N.Y. 1989); Chris-Craft Indus., Inc. v. Independent Stockholders Comm., 354 F. Supp. 895, 906 (D. Del. 1973).

6. Effective October 22, 1992, the SEC adopted amendments to the old proxy rules. Rule 14a-1(l)(2), 57 Fed. Reg. 48,276, 48,290 (1992) (to be codified at 17 C.F.R. § 240.14a-1(l)(2)); Rule 14a-2(b)(1)-(3), 57 Fed. Reg. 48, 276, 48, 290 (1992) (to be codified at 17 C.F.R. § 240.14a-2(b)(1)-(3)); Rule 14a-3(a),(f), 57 Fed. Reg. 48,276, 48,291 (1992) (to be codified at 17 C.F.R. § 240.141-3(a),(f)); Rule 14a-4(a),(b),(d),(f), 57 Fed. Reg. 48,276, 48,291 (1992) (to be codified at 17 C.F.R. § 240.14a-4(a),(b),(d),(f)); Rule 14a-5(a)-(l), 57 Fed. Reg. 48,276, 48,291 (1992) (to be codified at 17 C.F.R. § 240.14a-5(a)-(l)); Rule 14a-7, 57 Fed. Reg. 48,276, 48,292 (1992) (to be codified at 17 C.F.R. § 240.14a-7); Rule 14a-11(b)-(f), 57 Fed. Reg. 48,276, 48,293 (1992) (to be codified at 17 C.F.R. § 240.14a-11(b)-(f)); Rule 14a-12(a),(b), 57 Fed. Reg. 48,276, 48,293 (1992) (to be codified at 17 C.F.R. § 240.14a-12(a),(b)) [hereinafter 1992 Amendments].

7. Prior to its 1992 amendment, Rule 14a-1(l) provided, in relevant part:

(l) *Solicitation.* (1) The terms "solicit" and "solicitation" include:

(i) Any request for a proxy whether or not accompanied by or included in a form of proxy[;]

(ii) Any request to execute or not to execute, or to revoke, a proxy; or

(iii) The furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding, or revocation of a proxy.

(2) The terms do not apply, however, to the furnishing of a form of proxy to a security holder upon the unsolicited request of such security holder, the performance by the registrant of acts required by [Rule 14a-7], or the performance by any person of ministerial acts on behalf of a person soliciting a proxy.

17 C.F.R. § 240.14a-1(l) (1991), amended by 57 Fed. Reg. 48,276, 48,290 (1992) (to be codified at 17 C.F.R. § 240.14a-1(l)). See also *infra* notes 39-43, 49-51 and accompanying text for additional discussion of Rule 14a-1(l):

Rule 14a-2(b)(1), the ten-person rule, provided:

(b) [Rules 14a-3 to 14a-8 and 14a-10 to 14a-14] do not apply to the following:

(1) Any solicitation made otherwise than on behalf of the registrant where the total number of persons solicited is not more than ten.

17 C.F.R. § 240.14a-2(b)(1) (1991), amended by 57 Fed. Reg. 48,276, 48,290 (1992) (to be codified at 17 C.F.R. § 240.14a-2(b)(2)).

As a practical matter, proxy solicitation has been described as "the process of systematically contacting shareholders and urging them to execute and return proxy cards which authorize named proxies to cast the shareholder's votes, either in a manner designated in the proxy card or according to the proxies' discretion." Melvin A. Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489, 1491 (1970). Proxy solicitations vary in complexity. For example, if a few people hold a significant portion of the corporations' stock, a solicitation may involve only a few phone calls or letters. *Id.* However, in a large public corporation with widely dispersed shareholders, "a more elaborate solicitation is required." *Id.* Generally, this involves "a widespread mailing of written materials to shareholders, and follow-up letters and phone calls to those who do not respond." *Id.*

8. Rule 14a-2 provides that the proxy rules "apply to every solicitation of a proxy with respect to securities registered pursuant to Section 12 of the Act" except for those specifically exempted in the

ments have arguably changed the result in the above two hypotheticals. The SEC has eased the regulatory burden on publicly broadcast statements.⁹ In addition, it now exempts statements made by persons who do not seek the power to act as proxy.¹⁰ Thus, the requirements imposed on the first example are now drastically reduced, and the second example is probably exempt from regulation entirely.

The broad scope of the pre-1992 definition of proxy solicitation sparked widespread debate about appropriate reforms to improve the proxy system.¹¹ In the late 1980s, the debate intensified due to the increasing use of the proxy contest over the tender offer as a means of effectuating

rule. See 17 C.F.R. § 240.14a-2 (1992). Thus, if a communication is deemed a solicitation under Rule 14a-1, Rule 14a-6 requires the solicitor to file a statement with the SEC. See 17 C.F.R. § 240.14a-6 (1992), amended by 57 Fed. Reg. 48,276, 48,291 (1992) (to be codified at 17 C.F.R. § 240.14a-6).

Rule 14a-6 was amended in 1992 to provide that soliciting persons were no longer required to preclear all soliciting materials. See Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, 57 Fed. Reg. 48,276, 48,284 (1992) [hereinafter Adopting Release]. Instead, under the amendment, only proxy statements and the proxy itself are subject to a prefiling requirement. *Id.* Other soliciting materials now may be filed at the time of the solicitation, whether before or after the circulation of the written proxy statement. *Id.*

The SEC noted that it amended this rule in response to comments suggesting that staff review prior to dissemination "did not significantly improve the communication." Adopting Release, *supra*, at 48,284. The Commission stated that some commentators "argued that staff comment reduced the substance and quality of the communications." *Id.* See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 824 (1992) (characterizing the SEC staff as "vigorous censors"). See also *infra* notes 145-47 and accompanying text for additional discussion of the SEC review process.

9. See Rule 14a-3, 57 Fed. Reg. 48,276, 48,291 (1992) (to be codified at 17 C.F.R. § 240.14a-3). Prior to its amendment, Rule 14a-3 would have required the company in the first hypothetical to furnish each person "solicited" by the press release with a definitive written proxy statement. As amended, Rule 14a-3's delivery requirement no longer applies to widely disseminated statements, as long as the solicitor files a definitive proxy statement with the SEC. See also Rule 14a-6, 57 Fed. Reg. 48,276, 48,291 (1992) (to be codified at 17 C.F.R. § 240.14a-6). Rule 14a-6 formerly provided that all soliciting materials had to be precleared with the SEC. As amended, Rule 14a-6 requires that only proxy statements and the proxy itself be filed with the SEC. See *supra* note 8. Taken together, these rules drastically reduce the regulatory burden on statements deemed a proxy solicitation. Even under the relaxed new proxy rule regime, the statement in the first hypothetical will likely be deemed a proxy solicitation. Although the board of directors in the hypothetical may not have issued the press release to garner proxies, the SEC now exempts statements made by persons not seeking proxy authority, see *infra* note 18. It specifically declined to apply that exemption to company directors. See Rule 14a-2(b)(1)(i), 57 Fed. Reg. 48,276, 48,291 (1992) (to be codified at 17 C.F.R. § 240.14a-2(b)(1)(i)).

10. See *infra* note 18. Assuming the stockbroker in the second hypothetical discussed the company's performance solely to market his client's shares, his statement is exempt from regulation under Rule 14a-2, as amended in 1992.

11. See WATERS, *supra* note 5, at 473, 478.

corporate change.¹² The growth of institutional investors¹³ also intensi-

12. The proxy machinery has existed for many decades. Klaus Eppler & Edward W. Scheuermann, *Overview of the History and Current Uses of Proxy and Consent Solicitation: Shareholder Challenges and Management Responses*, in PROXY CONTESTS, INSTITUTIONAL INVESTOR INITIATIVES, MANAGEMENT RESPONSES 9, 11 (Practicing Law Institute ed. 1990). Until the late 1960s, the proxy contest was essentially the exclusive means of achieving corporate reform. However, in the 1970s and 1980s, the corporate merger and acquisition explosion led to the proxy contest's virtual dormancy. See RICHTER, *supra* note 4, at 1. See also Eppler & Scheuermann, *supra*, at 12; Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 WIS. L. REV. 1071, 1072 (1992) (analogizing 1980s corporate takeover wars to a playground pick-up game, with proxy contests as "the kid who always got picked last"). Hostile takeovers facilitated most mergers and acquisitions, with the tender offer as the popular "weapon" among acquirers. In a tender offer, a bidder offers shareholders a premium above market price for their shares. See LEWIS D. SOLOMON ET AL., CORPORATIONS: LAW AND POLICY 1065 (2d ed. 1988). Using this strategy, the acquirer exchanged the uncertainty of a successful proxy contest for the near certainty of the tender offer's acceptance. For example, "[i]n a study of seventy-one proxy contests between 1962 and 1978, insurgents won a majority of the board in only eighteen cases[.]" Bainbridge, *supra*, at 1083. On the other hand, studies of tender offers estimate their success rate at 80%. *Id.* Once "junk bonds" and other tender offer financing methods were perfected, hostile bidders had the ability to acquire virtually any public corporation. RICHTER, *supra* note 4, intro. at 2.

In the late 1980s, several shifts in the economic and legal climate caused a decline in tender offers. RICHTER, *supra* note 4, intro. at 2. See also Bainbridge, *supra*, at 1084; Eppler & Scheuermann, *supra*, at 12-15. First, the general collapse of the junk bond market paralyzed hostile bidders' financing means. See RICHTER, *supra* note 4, intro. at 2; Eppler & Scheuermann, *supra*, at 12 ("[T]he relative collapse of the junk bond market severely limited the ability of would-be acquirers to raise the financing necessary for premium over market price tender offers."). Second, the "poison pill" and other takeover defenses became widespread. A poison pill results when the registrant provides for the issue of rights to existing shareholders. This allows them to acquire additional shares of the registrant's voting securities if a triggering event occurs, such as a bidder's acquisition of 25% of the registrant's voting securities. See WATERS, *supra* note 5, at 213. A research group called the Investor Responsibility Research Center found that as of August, 1990, 51% of large American companies were armed with poison pills. See John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1316 n.5 (1992). The third factor leading to the decline in the number of tender offers was the fact that state antitakeover statutes proliferated after the Supreme Court approved such statutes in *CTS Corp. v. Dynamic Corp.*, 481 U.S. 69 (1987). Eppler & Scheuermann, *supra*, at 13. Over 30 states had antitakeover statutes in 1990. *Id.* Finally, recent state court decisions favoring antitakeover measures also led to the tender offer's extinction. *Id.* A Delaware Supreme Court decision, *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989), was instrumental in upholding poison pills. See Bainbridge, *supra*, at 1086. In *Paramount*, the Delaware Supreme Court loosened the criteria for judging the legality of takeover defenses. *Id.* After *Paramount*, management takeover defenses will better withstand judicial scrutiny. Consequently, that decision renders the tender offer impractical. *Id.*

13. See *infra* part IIC. The term "institutional investor" refers generally to any corporate shareholder. There are, however, a wide variety of institutional investors. See A. A. Sommer, Jr., *Corporate Governance in the Nineties: Managers vs. Institutions*, 59 U. CIN. L. REV. 357, 361 (1990). Public and private pension funds are the largest. *Id.* In 1988, these groups held two-thirds of the equity capital of the 1000 largest corporations. *Id.* (citing Peter Drucker, *Management and the World's Work*, HARV. BUS. REV., Sept.-Oct. 1988, at 71). Other major institutional investor groups include open and closed-end investment companies, life and property/casualty insurance companies, bank non-pension

fied the debate, as such investors came to realize that a reformed proxy system afforded them a greater opportunity to participate actively in corporate governance matters.¹⁴

This debate led the SEC to examine¹⁵ and ultimately amend¹⁶ the proxy rules. Notably, these amendments narrowed the scope of the definition of proxy solicitation in Rule 14a-1¹⁷ and expanded the range of exemptions in Rule 14a-2.¹⁸ The net result is that shareholder communi-

trusts, and foundations and endowments. *Id.* at 363 (citing CAROLYN K. BRANCATO & P. GAUGHAN, *THE GROWTH OF INSTITUTIONAL INVESTORS IN THE U.S. CAPITAL MARKETS*, (Columbia University Center for Law and Economic Studies Institutional Investors Project ed. Nov. 1988)). *See also* Black, *supra* note 8, at 815; Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1140-41 (1991) (discussing various types of institutional investors).

Institutional ownership varies markedly from individual ownership. *See* Sommer, *supra*, at 360. Unlike most individual owners, institutional owners bear fiduciary duties. *Id.* The Employee Retirement Income Security Act of 1974 (ERISA) imposes fiduciary duties upon private plan sponsors, trustees, and others who act as fiduciaries. *See* James E. Heard, *A Critical Review of the Proxy System*, in *SHAREHOLDER ACTIVISM: THE EMERGING ROLE OF INSTITUTIONAL INVESTORS* 82 (Practicing Law Institute eds., 1987). ERISA is silent on proxy voting matters. However, United States Labor Department officials have indicated that voting is held to the same standard as any other investment activity. *Id.*

Institutions are gaining an increasingly large equity holding in American business. *See* Sommer, *supra*, at 360. A 1988 study showed that institutional investors held 52% of the equity of the 50 largest corporations, 53% of the top 100, and 47% of the top 1000. *Id.* at 361 (citing *The Role of Institutional Investors in Corporate Governance and Capital Markets, Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs*, 101st Cong., 1st Sess. 15 (1989)). *See also infra* note 153 and accompanying text for additional data on institutional investor equity holdings.

14. *See infra* part III.C.

15. *See* Adopting Release, *supra* note 8, at 48,277.

16. *See supra* note 7.

17. *See* Adopting Release, *supra* note 8, at 48,290. The new Rule 14a-1(l) provides in relevant part:

(2) The terms [of "solicitation"] do not apply, however, to:

(iv) A communication by a security holder who does not otherwise engage in a proxy solicitation (other than a solicitation exempt under § 240.14a-2) stating how the security holder intends to vote and the reasons therefor, provided that the communication:

(A) Is made by means of speeches in public forums, press releases, published or broadcast opinions, statements, or advertisements appearing in a broadcast media, or newspaper, magazine or other bona fide publication disseminated on a regular basis,

(B) Is directed to persons to whom the security holder owes a fiduciary duty in connection with the voting of securities of a registrant held by the security holder, or

(C) Is made in response to unsolicited requests for additional information with respect to a prior communication by the security holder made pursuant to this paragraph (1)(2)(iv).

Rule 14a-1(l), 57 Fed. Reg. 48,290 (1992) (to be codified at 17 C.F.R. § 240.14a-1(l)).

18. *See* Adopting Release, *supra* note 8, at 48,290. The text of the new definition retained the ten-person exemption rule and renumbered it as Rule 14a-(b)(2). *Id.* The amendment then added Rule 14a-2(b)(1), which provides in relevant part:

(b) Sections 240.14a-3 to 240.14a-6 (other than 14a-6(g)), 240.14a-8, and 240.14a-10 to 14a-

cation is less inhibited by regulatory impediments.¹⁹ A close examination of the amendments, however, reveals that the changes made were important but inadequate.²⁰ Further reform is necessary to effectuate the policies underlying the proxy rules.²¹

This Note focuses on the amendments to Rules 14a-1 and 14a-2 and concludes that while the amendments were an important step toward achieving effective corporate governance, additional reform is necessary. Part I discusses the legislative and judicial development of Rules 14a-1 and Rule 14a-2. Part II discusses the debate and criticism of the proxy rules prior to the SEC's adoption of the 1992 amendments. Part III discusses the SEC's response to this criticism in the form of its 1992 amendments to Rules 14a-1 and 14a-2. Finally, Part IV recognizes these amendments as an important step toward effective corporate governance, but proposes that the SEC take further measures to change Rules 14a-1 and 14a-2 to ensure that the rules meet Congress' intent of promoting "fair corporate suffrage."²²

14 do not apply to the following:

(1) Any solicitation by or on behalf of any person who does not, at any time during such solicitation, seek directly or indirectly, either on its own or another's behalf, the power to act as proxy for a security holder and does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization.

Rule 14a-2(b)(1), 57 Fed. Reg. 48,276, 48,290 (1992) (to be codified at 17 C.F.R. § 240.14a-2(b)(1)).

Additionally, the SEC adopted amendments to six other rules. *See supra* note 6. These amendments are beyond the scope of this Note, which will address only the amendments to the definition of solicitation in Rule 14a-1 and exempt solicitations in Rule 14a-2. Discussion of the other rules will be addressed only to the extent that they interact with Rules 14a-1 and 14a-2.

19. Given that a communication cannot be subject to the proxy rules until it is labeled a solicitation, *see supra* note 8, the definition of solicitation and its exemptions are the "gates" to the proxy requirements. In narrowing those "gates," shareholders have more freedom to communicate without having to comply with filing requirements. *See, e.g.,* Kevin J. Salwen, *SEC to Allow Investors More Room to Talk*, WALL ST. J., Oct. 14, 1992, at C1 (noting that new amendments will "loosen the muzzle on investors" to enable them to more effectively discuss corporate performance).

20. *See, e.g., SEC Adopts Proxy Reform Package After Long Study and Intense Debate*, SECURITIES LAW DAILY, Oct. 16, 1992, at 1 (quoting John Olson, Chairman of the ABA Federal Regulation of Securities Committee) ("The [proxy rule] changes made were evolutionary, not revolutionary."). *See also infra* part IV.

21. *See infra* part IV.

22. *See* J.I. Case v. Borak, 377 U.S. 426, 431 (1964) (quoting H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13 (1934)) (Stating that the proxy rules "stemmed from the Congressional belief that '[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange.'").

I. THE LEGAL ENVIRONMENT: LEGISLATIVE AND JUDICIAL DEVELOPMENT OF THE PROXY RULES

A proxy is essentially a written contract²³ in which the record owner²⁴ of stock grants another person²⁵ the authority to vote shares in his absence.²⁶ The proxy holder then becomes the shareholder's agent for voting purposes.²⁷ The shareholder may either grant the proxy holder unlimited voting discretion on any issue, or restrict voting authority only to certain issues.²⁸ Because many shareholders cannot physically attend shareholder meetings, the majority of shareholders vote by proxy.²⁹

23. See WATERS, *supra* note 5, at 9. For enforcement purposes, courts generally treat the proxy like to any other contract. *Id.* at 10.

However, the SEC's definition of proxy in Rule 14a-1(f), 17 C.F.R. § 240.14a-1(f) (1992), provides little substantive guidance as to what constitutes a proxy for purposes of the federal securities laws. It provides as follows:

(f) *Proxy.* The term "proxy" includes every proxy, consent or authorization within the meaning of section 14(a) of the Act. The consent or authorization may take the form of failure to object or to dissent.

17 C.F.R. § 240.14a-1(f) (1992).

This definition is brief, but has a deceptively broad scope. See WATERS, *supra* note 5, at 10 ("For example, the *failure* of a shareholder to object to or to dissent from the taking of action by consent is deemed to be the grant of a proxy."). Moreover, the proxy grant may be written or spoken. *Id.*

24. A record owner, generally a broker, keeps the shares on deposit for the beneficial owner, who is the true owner of the stock. See SOLOMON ET AL., *supra* note 12, at 519. The corporation knows the name of the record holder, but often does not know the beneficial owner's name. *Id.* Only the record owner formally votes. *Id.*

25. The proxy holder does not have to be a stockholder. However, he or she must have the legal capacity to act as an agent. See generally Leonard H. Axe, *Corporate Proxies: II*, 41 MICH. L. REV. 225 (1942).

26. See WATERS, *supra* note 5, at 9. Proxy votes generally are not confidential. See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 535 (1990).

27. See HARRY B. HENN & JOHN P. ALEXANDER, *THE LAW OF CORPORATIONS* 518 (3d ed. 1983).

28. See WATERS, *supra* note 5, at 10.

29. See *id.* at 9. See also Aleta G. Estreicher, *Securities Regulation and the First Amendment*, 24 GA. L. REV. 223, 276 (1990) ("The proxy system is, in effect, a long-distance substitute for the in-person shareholders meeting."); L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 449 (2d ed. 1988) ("Separation of ownership from management puts the entire concept of the stockholders' meeting at the mercy of the proxy instrument."); Eisenberg, *supra* note 7, at 1494 (citing Bernstein & Fisher, *The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy*, 7 U. CHI. L. REV. 226, 277 (1940)) (noting that the solicitation of proxies is, in effect, today's shareholder meeting).

Overwhelmingly, most shareholders vote by signing and returning proxy cards. Few shareholders personally attend annual meetings. One commentator has stated:

[In 1974] at Cities Service Company, the 77th largest corporation with 135,000 shareholders, 25 shareholders personally attended the meeting; El Paso Natural Gas, with 125,000 shareholders, had 50 attendees; at Coca-Cola, the 69th largest corporation, with 70,000

Because so many shareholders vote by proxy, corporate governance decisions often hinge upon which of two opposing sides can garner enough shareholder proxies to win a vote at a shareholders' meeting—hence the name “proxy contest.” Additionally, because the outcome of such contests is central to corporate governance, the process of proxy solicitation is heavily regulated under federal securities laws.

The use of proxy contests has grown exponentially since 1987.³⁰ In the first six months of 1988 alone, the number of proxy contests doubled the average annual number of contests occurring over the preceding two decades.³¹ In the past, proxy contests were waged almost solely to unseat a board of directors. Now, they are also used to eliminate management antitakeover measures and to gain support for shareholder proposals.³² The 1990s will likely continue to witness the renaissance of the proxy contest as a significant tool for achieving both policy objectives and control in the corporate environment.³³

Administrative and judicial treatment of the proxy rules prior to the 1992 changes culminated in what critics called the “discourage[ment] of responsible, long-term investors from playing a meaningful role in the governance of public corporations.”³⁴ Prior to the 1992 changes, SEC

shareholders, 25 shareholders attended the annual meeting. . . . Even “Campaign GM,” the most publicized shareholder challenge of the past 20 years, was unable to attract more than 3000 of General Motors’ 1,400,000 shareholders, or roughly two-tenths of one percent.

Joel Seligman, *The Securities and Exchange Commission and Corporate Democracy*, 3 U. DAYTON L. REV. 1, 4 (1978).

30. See Eppler & Scheuermann, *supra* note 12, at 15-22 (discussing the “renaissance” of the proxy contest in the late 1980s); Bainbridge, *supra* note 12, at 1090. While proxy contests grew at a rapid rate, tender offer activity fell dramatically. *Id.*

31. Bainbridge, *supra* note 12, at 1090.

32. See WATERS, *supra* note 5, at 211-15; RICHTER, *supra* note 4, intro. at 3. Rule 14a-8 governs shareholder proposals. 17 C.F.R. § 240.14a-8 (1992). It allows shareholders to submit to the company a resolution that they will introduce at the shareholders’ meeting so that the company may include it in the proxy material sent to all of the shareholders. SOLOMAN ET AL., *supra* note 12, at 515.

33. See Eppler & Scheuermann, *supra* note 12, at 21.

34. Letter from Richard H. Koppes, General Counsel, California Public Employees’ Retirement System (CalPERS), to Linda C. Quinn, Director, Division of Corporation Finance, SEC (Nov. 3, 1989), in 1 22ND ANNUAL INSTITUTE ON SECURITIES REGULATION 298, 304 (Practicing Law Institute eds., 1990) [hereinafter Letter from CalPERS]. See also John Pound, *Proxy Contests: The SEC Rewrites the Rules*, AM. ENTERPRISE, Sept.-Oct. 1991, at 58-59 (stating that proxy rules diminish already weak incentive that dispersed shareholders have to gather, discuss information, and seek corporate change, and that rules essentially require each shareholder to assess voting issues and make decisions in isolation from other shareholders). *But see* Letter from Richard H. Troy, Chairman, American Society of Corporate Secretaries, to Linda C. Quinn, Director, Division of Corporation Finance, SEC 5 (Sept. 12, 1991) [hereinafter Letter from American Society of Corporate Secretaries] (stating that the system did not need revision).

regulations generally expanded the class of activities to be regulated and monitored as proxy solicitations. Courts addressing these regulations tended to ameliorate some of the stifling effects of the SEC's extensive reach, although the regulations remained quite pervasive.

A. Administrative Development

The SEC derives its authority to promulgate rules regarding proxy solicitation from Section 14(a)³⁵ of the Securities and Exchange Act of 1934. This section does not contain substantive regulations.³⁶ Instead, it simply delegates rulemaking power to the SEC.³⁷

Regulation 14A³⁸ sets forth the SEC rules promulgated pursuant to Section 14(a) and defines the term "proxy solicitation" in Rule 14a-1.³⁹

35. 15 U.S.C. § 78n(a) (1988 & Supp. 1993).

36. See WATERS, *supra* note 5, at 7; Bainbridge, *supra* note 12, at 1073.

37. See WATERS, *supra* note 5, at 7. See also S. REP. NO. 1455, 73d Cong., 2d Sess. 77 (1934) ("Mindful that security holders are entitled to information and a voice in the major policy decisions made pursuant to the proxy voting process, the Committee recommends that the solicitation and issuance of proxies be left to regulation by the Commission."). The SEC has traditionally claimed very broad powers under Section 14(a). See Bainbridge, *supra* note 12, at 1073. Congress enacted Section 14(a) to deter management or others from receiving shareholder votes through deceptive or insufficient disclosure in proxy solicitation. See *J.I. Case v. Borak*, 377 U.S. 426, 431 (1964). The section was intended to abate pervasive abuse of the proxy process. *Id.* See also H. REP. NO. 1383, 73d Cong., 2d Sess. 13 (1934) [hereinafter HOUSE REPORT]; *SEC v. Transamerica Corp.*, 163 F.2d 511, 518 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948) ("It was the intent of Congress to require fair opportunity for the operation of corporate suffrage. The control of great corporations by a very few persons was the abuse at which Congress struck in enacting section 14(a)."). For example, a 1934 congressional report cited a case in which a corporation's shareholders ratified a transaction at the annual meeting although no shareholders were present—all of the solicited shareholders had granted their proxies to corporate employees. S. REP. NO. 792, 73rd Cong., 2d Sess. 12 (1934). However, the soliciting letter failed to mention that one officer had a significant personal interest in the transaction. *Id.* This recurrent practice led Congress to conclude that insiders were using the proxy system to further their own "selfish advantage." HOUSE REPORT, *supra*, at 14. See also Estreicher, *supra* note 29, at 306 n.347 (noting that before passage of Section 14(a), "the stockholder was merely invited to sign his name and return his proxy without being furnished the information essential to the intelligent exercise of his right of franchise"). Therefore, in Section 14(a), Congress granted the SEC authority to prevent further abuse. See RICHTER, *supra* note 4, at 1-3 to 1-4.

38. 17 C.F.R. §§ 240.14a-1 to 14a-14 (1992). Regulation 14A contains the proxy rules.

These rules apply to companies which have a class of securities listed on a stock exchange, pursuant to § 12(b) of the 1934 Act, or have a class of securities registered with the SEC under § 12(g) of the Act, where the securities are owned by 500 or more holders of record and the issuer has \$5,000,000 or more of assets.

SOLOMON ET AL., *supra* note 12, at 513.

39. See *supra* note 7 for text of the pre-amendment definition of solicitation. See *supra* note 17 for text of the post-amendment definition of solicitation. The SEC amended the rule three times within the first 22 years of its existence. See Adopting Release, *supra* note 8, at 48,277. The rule then remained unchanged from 1956 until the 1992 amendment. *Id.* Regulation 14A also establishes the

The SEC's original definition of solicitation in 1935 reflected the principal focus of the proxy rules, which was to ensure that management and others who solicited proxies fully disclosed to shareholders critical voting information.⁴⁰ The narrowly tailored definition limited the reach of proxy rules to direct proxy solicitation only.⁴¹ In 1940, the SEC changed the definition of solicitation to include any attempt to secure proxies, whether or not couched expressly in terms of solicitation.⁴² Shareholders received substantially more information, though as a result, the SEC monitored more corporate communication.

In 1942, the SEC further expanded the definition of solicitation to cover not only affirmative attempts to secure proxies, but also attempts to prevent a shareholder from executing a proxy.⁴³ However, the SEC did not wish to deter the initial, "grass roots" efforts dissident shareholders might take before soliciting proxies.⁴⁴ It reasoned that if a shareholder could not gauge a certain level of support, the shareholder might drop altogether any organizational efforts.⁴⁵ Thus, in 1942, the SEC also added what is known as the ten-person rule.⁴⁶ The rule exempts shareholder proxy solicitations in which the number of solicited shareholders does not exceed ten.⁴⁷ In so doing, the SEC sought to allow dissident shareholders to appraise the initial level of support for their views without having to comply with filing requirements that might serve to deter their actions.⁴⁸

procedural rules governing the proxy solicitation process. See WATERS, *supra* note 5, at 8. The regulation contains rules governing what information will be disclosed and how it will be presented, proxy form procedures, the SEC filing procedures, procedural safeguards aimed at shareholder protection, proxy contest procedures, and an antifraud provision. See Rule 14a, 17 C.F.R. § 240.14a (1992).

40. *Id.* See Exchange Act Release No. 178, at 1 (Sept. 24, 1935) ("Solicitation" is defined to include any communication or request for a proxy, consent, or authorization, or the furnishing of any form of proxy, whether or not the form is in blank.").

41. Adopting Release, *supra* note 8, at 48,277.

42. *Id.*

43. *Id.*

44. See ARANOW & EINHORN, *supra* note 5, at 110.

45. *Id.*

46. See Exchange Act Release No. 3347, 7 Fed. Reg. 10,655 (Dec. 18, 1942). At that time, the rule was designated as Rule X-14A-8(a). *Id.* The 1992 amendments retained the ten-person rule in its substantive form and renumbered it as Rule 14a-2(b)(2).

47. See *supra* notes 5, 7.

48. See ARANOW & EINHORN, *supra* note 5, at 110-11. The SEC recognized that before a stockholder undertook a solicitation opposing management, the stockholder must first assess the potential for support from other shareholders. *Id.* at 110. If a shareholder were required to meet filing requirements in connection with those initial communications, the shareholder might choose not to undertake the solicitation. *Id.* The ten-person rule was designed to encourage and facilitate such "grass

Finally, in 1956, the SEC dramatically expanded the scope of "solicitation" to include any communication to shareholders under circumstances reasonably calculated to result in the securing or withholding of a proxy.⁴⁹ The SEC provided little guidance as to what circumstances would trigger the requirements imposed by the new definition.⁵⁰ Consequently, the courts were left to interpret the definition.⁵¹

B. Judicial Development

Traditionally, the courts, like the SEC, have interpreted the term "solicitation" broadly.⁵² In 1943, the Second Circuit foreshadowed the SEC's expansive 1956 amendment when it broadly interpreted the word. In *SEC v. Okin*,⁵³ the defendant shareholder sent a letter to fellow shareholders in connection with an annual meeting asking them not to sign any proxies for the company. He also asked the shareholders to revoke any proxy that they might have already signed.⁵⁴ The court held that the defendant's actions constituted a proxy solicitation.⁵⁵ The SEC later relied upon the court's definition of "solicitation":⁵⁶ "any . . . writings which are part of a continuous plan ending in solicitation and which prepare the way for its success."⁵⁷

The *Okin* court's broad definition of solicitation applied to a letter sent to shareholders opposing actual management solicitation of proxies for an upcoming scheduled meeting.⁵⁸ Going one step further, the Fifth Circuit in *Sargent v. Genesco, Inc.*,⁵⁹ found that a letter which management sent to shareholders was a solicitation, even though no meeting was sched-

roots" efforts. *Id.* at 111.

49. Exchange Act Release No. 5276, 21 Fed. Reg. 577, 578 (Jan. 17, 1956) [hereinafter 1956 Release].

50. *Id.* at 577 (discussing amendment's scope). *But cf.* Adopting Release, *supra* note 8, at 48,277 n.22 (interpreting the SEC's purpose in enacting the amendment).

51. *See infra* part I.B.

52. *See* WATERS, *supra* note 5, at 12.

53. 132 F.2d 784 (2d Cir. 1943).

54. *Id.* at 786.

55. *Id.* *Okin* involved a solicitation under the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1988 & Supp. 1993). However, the *Okin* definition has served as a benchmark for other courts and the SEC in their interpretation of "solicitation" under the 1934 Act. *See* WATERS, *supra* note 5, at 13 n.27.

56. WATERS, *supra* note 5, at 13.

57. *Okin*, 132 F.2d at 786.

58. *See* WATERS, *supra* note 5, at 14. *See also Okin*, 132 F.2d at 786.

59. 492 F.2d 750 (5th Cir. 1974).

uled.⁶⁰ In *Sargent*, management sent its shareholders a letter explaining the corporation's recent financial difficulties and endorsing the terms of a refinancing plan.⁶¹ The letter did not expressly call for a shareholder vote on the issue.⁶² Nevertheless, the court deemed the letter a solicitation,⁶³ holding that what constitutes a solicitation is a question of fact that depends upon both the nature of the communication and the circumstances under which it was transmitted.⁶⁴ According to the court, the purpose of this letter was to prevent shareholders from opposing the proffered refinancing plan.⁶⁵

On the other hand, courts have been less likely to find a solicitation in "circumstances" involving a shareholder communication that merely seeks to comment on corporate performance.⁶⁶ In *Chris-Craft Industries v. Independent Stockholders Committee*,⁶⁷ dissatisfied shareholders criticized the poor performance of the corporation and asked some major shareholders to prepare letters of support for their positions.⁶⁸ Because the shareholder group initially concluded that a proxy fight was not feasible,⁶⁹ and because a considerable amount of time passed between the group's meetings and the actual proxy contest,⁷⁰ the court found that the initial communications were not "reasonably calculated to result in securing a

60. *Id.* at 767.

61. *Id.* at 755-56. Management mailed to the corporation's shareholders and debenture holders a letter briefly explaining the financial difficulties that had developed and summarizing the terms of the refinancing plan. *Id.* at 768. The letter also stated that if the corporation were to implement the plan, the book value of the corporation's common stock would ultimately increase. Consequently, the letter stated, the company would obtain needed working capital. *Id.*

62. *Id.* at 768. At the date of the letter's September 1968 mailing, the 1968 annual stockholders' meeting had not been held. Moreover, no such meeting was held until August 1969. *Id.*

63. 492 F.2d at 767.

64. *Id.* (citing 29 Fed. Reg. 341 (1964)).

65. *Id.*

66. See WATERS, *supra* note 5, at 15-16 (noting that courts occasionally grant flexibility to those who seek to communicate with shareholders regarding corporate performance, and that courts respect shareholders' needs to carry out organizational activities without subjecting themselves to the proxy requirements).

67. 354 F. Supp. 895 (D. Del. 1973).

68. *Id.* at 904.

69. *Id.* at 903. The group decided that it did not have the financial resources to wage the battle. *Id.* For a general discussion of proxy costs, see *infra* part II.B.1.

70. The first meeting was in February 1970. 354 F. Supp. at 901. The proxy contest began in November 1971 and lasted until January 1972. *Id.* at 905. See also WATERS, *supra* note 5, at 16 (noting that the *Chris-Craft* court may have relied on the timing involved).

proxy," and hence, were not a solicitation.⁷¹ *Chris-Craft* and its progeny⁷² suggest that some courts were struggling to circumvent the broad application of the term solicitation and recognize the shareholders' need to communicate and organize free from the restrictions of the proxy rules.⁷³

Courts have also struggled to balance the tension between SEC disclosure policies and the filing requirements, which often stifle prompt disclosure of important information.⁷⁴ For example, in *Smallwood v. Pearl Brewing Co.*,⁷⁵ a company solicited shareholder approval of a merger. One month before mailing the proxy statement, the company sent shareholders a letter stating that the board favored the merger's approval.⁷⁶ In a decision seemingly motivated by policy considerations, the court held that the management communication was not a proxy solicitation.⁷⁷ Strict compliance with the proxy rules, the court reasoned, must be balanced against the need to encourage prompt disclosure of material corporate information.⁷⁸ However, what constitutes "material corporate information" remains unclear, and courts disagree on the definition. Arguably, "material corporate information" was at stake in *ConAgra, Inc. v. Tyson Foods, Inc.*⁷⁹ in which a federal district court held that a management press release announcing that the corporation had just filed a significant lawsuit

71. 354 F. Supp. at 907. The court noted:

[T]he interest in obtaining the letters of support was to demonstrate to the management of *Chris-Craft* that [the defendant] had considerable shareholder support for his merger proposals and was not intended to prepare the way for a proxy solicitation. Thus, the second part of the *Okin* test was not met and the communications were not in violation of [the proxy rules].

Id.

72. See, e.g., *Calumet Indus. v. MacClure*, 464 F. Supp. 19, 32 (N.D. Ill. 1978) ("The evidence does not support the plaintiff's claim that the organizational communications which went on among members of the Committee and its supporters constituted proxy solicitation."). Cf. *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715 (8th Cir. 1974) (holding that shareholder's attempt to create a voting trust was a solicitation), *cert. denied*, 419 U.S. 1107 (1975).

73. See *WATERS*, *supra* note 5, at 16.

74. See *SOLOMON ET AL.*, *supra* note 12, at 523.

75. 489 F.2d 579 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974).

76. *Id.* at 586.

77. *Id.* at 601.

78. The court further noted:

While we cannot overlook the capacity of such a communication to affect later shareholder voting, it is reasonable to conclude that statements describing an event that has just occurred should be examined under a less powerful glass than similar statements made after a period sufficient for careful study and reflection has passed.

Id.

79. 708 F. Supp. 257 (D. Neb.), *vacated*, 716 F. Supp. 428 (D. Neb. 1989).

was a solicitation.⁸⁰

The ten-person rule, like the definition of solicitation, has also been the subject of extensive litigation.⁸¹ Courts have not applied it literally.⁸² Rather, in cases of incidental violations, courts have often failed to grant relief.⁸³ In *Pantry Pride, Inc. v. Rooney*,⁸⁴ a dissident stockholder had several conversations with institutional stockholders in order to assess possible reactions to a proxy fight.⁸⁵ Although the dissident had contacted more than ten shareholders,⁸⁶ the court denied the plaintiff recovery because he could not show that anyone was misled by the solicitation of the "eleventh shareholder."⁸⁷ This minor violation, the court reasoned, did not warrant the "drastic" injunctive relief the shareholder sought.⁸⁸

Similarly, in *International Banknote Co. v. Muller*,⁸⁹ a shareholder solicited at least ten, and possibly twelve, people in an attempt to organize a shareholders' committee to remove incumbent management.⁹⁰ The court ruled for the defendant, holding that this "de minimis" violation of the ten-

80. In *ConAgra*, the parties to the action were engaged in a "spirited corporate contest" over the acquisition of Holly Farms Corporation, a processing company. *Id.* at 259. Pursuant to that contest, Holly Farms heard proposals from both ConAgra and Tyson at a board meeting. Tyson and Holly Farms reached an agreeable proposal at the close of the meeting. The details, however, were to be worked out later among their respective attorneys. *Id.* The attorneys reached an impasse on their agreement, and in an effort to overcome the standoff, Tyson suggested that Holly Farms and Tyson issue a joint press release. *Id.* Although no agreement was reached, Tyson released a statement declaring it had acquired Holly Farms. Holly Farms issued a statement denying that claim. *Id.* Tyson issued another press release indicating that negotiations were favorable between the two companies. *Id.* at 261. Holly Farms ultimately rejected Tyson's proposal, but in the meantime, Tyson's stock rose. *Id.* ConAgra then filed a lawsuit against Tyson, claiming its actions violated the securities laws. It also issued a press release pursuant to that lawsuit. *Id.* It was this press release that the court ultimately deemed a solicitation [of Holly Farms stockholders]. *Id.* at 268. See *supra* note 1 for a hypothetical variation on this case. *But see* *Mills v. Sarjem Corp.*, 133 F. Supp. 753, 768 (D.N.J. 1955) (finding letters to shareholders informing them of proposed merger not to be a solicitation). For further discussion of *ConAgra*, see Norman Feit, *SEC Proxy Reforms: Boon for Free Expression or Back Room Deals?*, N.Y. L.J., October 13, 1992, at 11 (stating that *ConAgra* has "done little to narrow the scope of solicitations," particularly regarding press statements).

81. See WATERS, *supra* note 5, at 33.

82. *Id.*

83. *Id.*

84. 598 F. Supp. 891 (S.D.N.Y. 1984). See also *supra* text accompanying note 2 for a hypothetical based on *Pantry Pride*.

85. 598 F. Supp. at 894.

86. *Id.* at 902.

87. *Id.*

88. *Id.*

89. 713 F. Supp. 612 (S.D.N.Y. 1989).

90. *Id.* at 622. The evidence was unclear as to how many shareholders were actually solicited. At least ten individuals had been solicited, and possibly two others. *Id.*

person rule did not justify the plaintiff's recovery.⁹¹

As the *Pantry Pride* and *Muller* decisions illustrate, under the pre-amendment versions of Rules 14a-1 and 14a-2, courts wrestled with the facts of each case in order to balance the competing concerns of the shareholders' need to organize and communicate with the need for full disclosure sought by the proxy requirements.⁹²

II. PRE-AMENDMENT DEBATE AND CRITICISM

The SEC did not independently decide to engage in a three-year examination of the proxy rules.⁹³ Rather, the considerable criticism of legal commentators and corporate shareholders coerced the SEC into action.⁹⁴ Commentators argued that the SEC's old system was flawed because: (1) proxy solicitation rules unconstitutionally regulated commercial speech that was protected by the First Amendment; (2) both the financial and opportunity costs associated with adhering to the SEC proxy regulations made solicitations prohibitively expensive in many situations; and (3) the former system stifled the ability of institutional investors, the largest shareholders, to play an effective role in corporate governance.

A. First Amendment Debate

Although traditionally the proxy rules were believed to be unquestionably constitutional, a series of Supreme Court and Second Circuit decisions in the 1970s and 1980s raised doubts.⁹⁵

91. *Id.* The court noted that even if the evidence clearly showed that more than ten persons had been solicited, the violation of the ten-person rule still would not justify the "drastic remedy" of injunctive relief. *Id.*

92. See SOLOMON ET AL., *supra* note 12, at 523.

93. See WATERS, *supra* note 5, at 473-74 (discussing criticism and debate surrounding the proxy rules in late 1980s).

94. *Id.*

95. See Harvey M. Spear et al., *Do Proxy Clearance Procedures Violate the First Amendment?*, NAT'L L.J., Sept. 19, 1983, at 29 (noting that "for decades" the common belief has been that the proxy rules comport with the First Amendment). See also Estreicher, *supra* note 29, at 223 ("The received wisdom for fifty years has been that the First Amendment is inapplicable to speech relating to operation of securities markets."). Accordingly, a leading 1961 treatise dispensed of the issue in two sentences and a single footnote. Spear et al., *supra*, at 29 (quoting 2 L. LOSS, SECURITIES REGULATION 871 (2d ed. 1961)). Furthermore, litigation on the issue was all but nonexistent. *Id.* In 1956, the Second Circuit upheld the constitutionality of both Section 14(a) and Regulation 14A in *SEC v. May*, 229 F.2d 123 (2d Cir. 1956). The *May* court did not address the First Amendment issue. Spear et al., *supra*, at 29 ("[T]he briefs [submitted] in *May* can hardly be said to have represented the First Amendment issue squarely and it is understandable that the *May* opinion made no specific reference to the First Amendment."). However, *May* put the First Amendment issue to rest until the 1980s. *Id.* (stating that

The Supreme Court first addressed the First Amendment constitutionality of the proxy rules in dictum in a 1978 case, *Ohralik v. Ohio State Bar Ass'n*.⁹⁶ In *Ohralik*, a commercial speech⁹⁷ case involving attorney advertising,⁹⁸ the Court discussed the types of regulated communication that do not offend the First Amendment.⁹⁹ The Court placed corporate proxy statements in this category.¹⁰⁰ However, the proxy cases cited did not mention the First Amendment.¹⁰¹

In another 1978 case, the Supreme Court further advanced the view that corporate speech is protected under the First Amendment. In *First National Bank of Boston v. Bellotti*,¹⁰² the Court struck down a Massachusetts statute that prohibited certain corporations from making any expenditures to influence or affect a vote¹⁰³ and held that the First Amendment fully protects public corporate speech.¹⁰⁴ The defendant corporation was

May represents the only First Amendment challenge to the proxy rules from their inception in 1934 until 1983).

96. 436 U.S. 447 (1978).

97. The Supreme Court has defined commercial speech as "expression related solely to the economic interests of the speaker and its audience" and alternatively as "speech proposing a commercial transaction." See Michael E. Schoeman, *The First Amendment and Restrictions on Advertising of Securities Under the Securities Act of 1933*, 41 BUS. L. 377 (1986) (quoting *Central Hudson Gas & Elec. Corp. v. Public Serv. Comm'n*, 447 U.S. 557, 561 (1980) and *Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447, 455-56 (1978)). Cf. *Estreicher*, *supra* note 29, at 224 ("The term commercial speech is a counterpane concealing a disorderly bed. There appears to be no agreement even on what it is."). Some criteria for determining when speech is "commercial" and thus entitled to less constitutional scrutiny include: "(1) there is no expressive interest on the part of the speaker; (2) the promotion seeks to induce behavior over which government has plenary authority; and (3) the [F]irst [A.]mendment value of the message is limited to its informational value to the audience." *Id.* at 227.

Notwithstanding its flexible approach, however, the Court appears to believe that commercial speech should be afforded less protection than other forms of protected expression. *Id.* at 225. In fact, Justice Powell noted in *Ohralik* that commercial speech merits some protection but is of less constitutional moment than other forms of speech.

98. In *Ohralik*, an attorney contacted the parents of an accident victim after learning about the accident from an outside source. *Id.* at 449. The attorney then contacted both the injured driver and passenger of that accident. *Id.* at 449-50. He persuaded them both to sign contingent fee agreements. *Id.* at 451. Ultimately, both clients discharged the attorney. *Id.* at 452. After doing so, they filed complaints with the county bar grievance committee regarding the attorney's behavior. *Id.*

99. *Id.* at 456.

100. *Id.* The court noted that "numerous examples [of regulated communications] could be cited" that do not offend the First Amendment, such as the exchange of information about securities and corporate proxy statements. *Id.* (citing *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968) and *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970)).

101. *Spear et al.*, *supra* note 95, at 29.

102. 435 U.S. 765 (1978).

103. *Bellotti*, 435 U.S. at 768.

104. *Id.* at 783.

charged with violating the Massachusetts statute after it publicly announced its opposition to a proposed state law.¹⁰⁵ The Court found the statute unconstitutional,¹⁰⁶ stating that the legislature may not proscribe the subjects about which people can speak or who may address an issue in public.¹⁰⁷

In 1980, the Supreme Court identified a test for determining the extent of protection afforded commercial speech by the First Amendment in *Central Hudson Gas & Electric Corp. v. Public Service Commission of New York*.¹⁰⁸ In *Central Hudson*, the Court held that commercial speech is afforded First Amendment protection when the regulation suppressing it does not directly relate to the asserted government interest, or is more extensive than necessary to protect that interest.¹⁰⁹ Commentators questioned whether the proxy regulations comported with that test.¹¹⁰

The Supreme Court later examined the securities laws under the First Amendment in the 1985 case, *Lowe v. SEC*.¹¹¹ Although *Lowe* did not involve the proxy issue,¹¹² it did suggest the possibility of extending First Amendment protection to SEC commercial speech.¹¹³ In *Lowe*, the Supreme Court held that the Investment Advisors Act of 1940 (IAA) did

105. *Id.* at 784-85.

106. *Id.* at 795.

107. *Id.* at 785.

108. 447 U.S. 557 (1980). In *Central Hudson*, the Public Service Commission of New York ordered electric utilities in New York State to cease all public utility advertising because the Commission believed there was not a sufficient fuel supply to meet all consumer demand. *Id.* at 558. Three years later, after the fuel shortage ended, the Commission solicited public comment on whether it should continue the ban. *Id.* Ultimately, the Commission decided to continue it. *Id.* *Central Hudson* brought suit against the Commission, opposing the ban on First Amendment grounds. *Id.*

109. *Id.* at 566. The "more extensive than necessary" and the "direct relation" language represent two prongs of a four-part test set forth by the Supreme Court in *Central Hudson*. That test, in its entirety, is as follows: (1) The speech in question must concern lawful activity and not be misleading; (2) the government must have a substantial interest in regulating the speech; (3) the regulation must directly advance this interest; and (4) the regulation must be no more extensive than necessary. *Id.* at 569.

110. See, e.g., Elizabeth J. Holland, Note, *Proxy Preclearance and the First Amendment: The Unconstitutionality of Rule 14a-6*, 9 CARDOZO L. REV. 1555, 1574 (1988) (arguing that the proxy rules were more extensive than necessary to protect the government interest).

111. 472 U.S. 181 (1985).

112. *Lowe* involved a claim under section 203(c) of the Investment Advisors Act of 1940 (IAA). *Id.* at 183. *Lowe* was the president and principal shareholder of Lowe Management Corporation, which was registered as an investment adviser under the IAA. *Id.* *Lowe* was convicted of misappropriating a client's funds, tampering with evidence to protect a client, and stealing from a bank. *Id.* As a result, the SEC revoked the registration of *Lowe's* corporation, and ordered *Lowe* not to associate with other investment advisers. *Id.*

113. See NICHOLAS WOLFSON, CORPORATE FIRST AMENDMENT RIGHTS AND THE SEC 53-54 (1990).

not reach publishers of investment newsletters.¹¹⁴ The lower court had convicted Lowe of securities fraud. The SEC sought to enjoin him from publishing under the IAA.¹¹⁵ The district court held that although the SEC's argument was statutorily correct, First Amendment considerations required that the defendant be allowed to publish.¹¹⁶

The Supreme Court ultimately took great pains to impute its decision to Congressional intent, and avoid the constitutional issue.¹¹⁷ In a concurring opinion, however, Justice White attacked the IAA as violative of the First Amendment.¹¹⁸ Justice White accused the majority of interpreting the IAA with a "thinly disguised conviction" that the Act was unconstitutional.¹¹⁹ *Lowe* is significant because it suggests that securities laws are not immune from constitutional scrutiny.¹²⁰

In another 1985 case, the Second Circuit squarely addressed the First Amendment constitutional issue and seems to have disagreed with the Supreme Court's trend of protecting commercial speech. In *Long Island Lighting Co. (LILCO) v. Barbash*,¹²¹ a shareholder newspaper advertisement criticized privately-owned LILCO's management and advocated that a state-run authority be created to replace it.¹²² The advertisement did

114. 472 U.S. at 211.

115. *Id.* at 184.

116. *Id.* at 186.

117. See Clark A. Remington, Note, *A Political Speech Exception to the Regulation of Proxy Solicitations*, 86 COLUM. L. REV. 1453, 1459 (1986). See also Estreicher, *supra* note 29, at 298 (arguing that majority opinion in *Lowe* avoided constitutional issues through "strained statutory interpretation"). A noted scholar criticized the Court's decision in *Lowe* as engaging in "statutory gymnastics" rather than confronting the difficult and inevitable constitutional questions. *Id.* at 298 n.315 (citing Alfred C. Aman, Jr., SEC v. *Lowe: Professional Regulation and the First Amendment*, 1985 SUP. CT. REV. 93, 96).

118. *Lowe*, 472 U.S. at 239 (White, J., concurring) ("At some point, a measure is no longer a regulation of a profession but a regulation of speech or of the press; beyond that point, the statute must survive that level of scrutiny demanded by the First Amendment."). See also Estreicher, *supra* note 29, at 298, for a discussion of Justice White's concurrence.

119. 472 U.S. at 226 (White, J., concurring). Justice White argued that the Act was invalid because the SEC sought to enjoin offenders from publishing any future advice, whether or not such advice is fraudulent. *Id.* at 234-35. Therefore, he reasoned, the Act was more extensive than necessary to serve the SEC's interest of preventing fraud on investors. *Id.* at 235.

120. See WOLFSON, *supra* note 113, at 54 (arguing that *Lowe* indicates that "much of SEC-regulated speech may not comfortably fit the rubric of commercial speech").

121. 779 F.2d 793 (2d Cir. 1985). LILCO was a New York electric company that served two Long Island, New York counties. *Id.* at 794.

122. *Id.* The defendant, John Matthews, ran unsuccessfully for County Executive in a 1985 election. *Id.* During the campaign, he voiced his opposition to LILCO and its operation of a nearby nuclear power plant. *Id.* As a shareholder in the company, he waged a proxy contest to unseat LILCO's incumbent management. *Id.* Meanwhile, another defendant, the Citizens Committee to

not mention proxies or an upcoming shareholder meeting.¹²³ However, LILCO sought to enjoin the advertisement as a proxy solicitation that failed to comply with the SEC filing requirements. The district court stated that SEC regulations could not prevent such advertisements without violating fundamental free speech rights under the First Amendment.¹²⁴ The Second Circuit reversed, finding that the advertisement fit within the definition of solicitation of a proxy.¹²⁵ The Second Circuit claimed not to express an opinion on the First Amendment issue.¹²⁶ However, the dissent disagreed, arguing that the case raised a constitutional issue of the "first magnitude."¹²⁷ *LILCO* thus shows that political speech may not be protected if it can be defined as commercial.¹²⁸

The *LILCO* case illustrates the dilemma of characterizing proxy speech that is at the margin between political and commercial.¹²⁹ No court has definitively held that the proxy rules violate the First Amendment.¹³⁰ However, tension apparently existed between the *Bellotti* decision and the former proxy rules.¹³¹ Moreover, Justice White's concurrence in *Lowe* suggests that the former proxy rules were on tenuous constitutional ground.¹³² In fact, the SEC noted First Amendment concerns in its release pursuant to the 1992 amendments.¹³³ The questionable constitutionality of the old proxy rules was an impetus for the SEC's 1992 changes.

B. Prohibitive Costs of Solicitation

In its release accompanying the 1992 proxy rule amendments, the SEC noted that if the pre-amendment proxy rules applied to a communication,

replace LILCO, was formed to challenge LILCO's construction of the plant. *Id.* They placed ads in the local media urging citizens to support their views and replace LILCO. *Id.* In its complaint, LILCO alleged that Matthews had conspired with the committee to publish the ads. *Id.* at 797.

123. *Id.*

124. *LILCO v. Barbash*, 625 F. Supp. 221, 226 (E.D.N.Y. 1985), *rev'd*, 779 F.2d 793 (2d Cir. 1985).

125. *LILCO*, 779 F.2d at 795.

126. *Id.* at 796.

127. *Id.* at 798 (Winter, J., dissenting). The dissenting judge cited *Lowe* for the proposition that the federal regulations did not apply to the newspaper editors. *Id.*

128. Remington, *supra* note 117, at 1460.

129. See WOLFSON, *supra* note 113, at 55.

130. See *supra* notes 97-107 and accompanying text.

131. See WOLFSON, *supra* note 113, at 55.

132. See *supra* note 118-19 and accompanying text.

133. An intrusive regulatory scheme "would raise serious questions under the [F]ree [S]peech [C]ause of the First Amendment." Adopting Release, *supra* note 8, at 48,279.

“the effect [could] be very costly.”¹³⁴ Prior to the amendments, the prohibitive cost of solicitation, in terms of both financial and opportunity costs, resulted in a substantial “chilling effect” that inhibited shareholder communication.¹³⁵

1. *Financial*

From a financial standpoint, shareholders were in a far worse position than management to meet the costs of compliance when the SEC deemed their actions a solicitation under the proxy rules.¹³⁶ Although courts allowed incumbent management to tap into corporate funds to finance proxy solicitations, shareholders had to pay for their solicitations out of their own pockets.¹³⁷ If a shareholder unwittingly “solicited” other shareholders under the broad definition of solicitation, he or she was required under the proxy rules “to prepare a proxy statement and mail it to every shareholder of the company who [was] deemed solicited.”¹³⁸ The cost of this mailing requirement alone often made such communication prohibitively expensive.¹³⁹ Consequently, the threat of an extensive financial burden made shareholders acutely aware of their communica-

134. *Id.* at 278. See generally Seligman, *supra* note 29; Stephen H. Schulman, *The Costs of Free Speech in Proxy Contests for Corporate Control*, 20 WAYNE L. REV. 1 (1973); Leonard S. Machtinger, *Proxy Fight Expenditures of Insurgent Shareholders*, 19 CASE W. RES. L. REV. 212 (1968); Edward R. Aranow & Herbert A. Einhorn, *Corporate Proxy Contests: Expenses of Management and Insurgents*, 42 CORNELL L.Q. 4 (1956).

135. See Adopting Release, *supra* note 8, at 48,279. The SEC also stated that “to correct this distortion of the purposes of the proxy rules, [i.e., the high cost of solicitations] . . . the Commission [has] proposed several revisions to the proxy rules[.]”

136. See *infra* notes 137-40 and accompanying text.

137. See WATERS, *supra* note 5, at 251-52. See also Bainbridge, *supra* note 12, at 1078 (“In theory, incumbent directors do not have unbridled access to the corporate treasury. In practice, however, incumbents rarely pay their own expenses. . . . [On the other hand,] [i]n surgents have no right to reimbursement out of corporate funds.”). Shareholders may only receive reimbursement for their proxy contest expenses if they win the contest. See WATERS, *supra* note 5, at 252; Schulman, *supra* note 134, at 10-12. Beyond this limited instance, shareholders are not entitled to be reimbursed for actions deemed to be “solicitations.” WATERS, *supra* note 5, at 152.

By contrast, some jurisdictions have ruled that there are virtually no limits on the amount management may spend on a proxy contest. In a New York case, *Rosenfeld v. Fairchild Engine and Airplane Corp.*, 128 N.E.2d 291 (N.Y. 1955), management was allowed to use corporate funds to pay for entertainment expenses, chartered airplanes and limousines, and public relations counsel as part of the contest. *Id.* at 295 (VanVoorhis, J., dissenting).

138. Adopting Release, *supra* note 8, at 48,278.

139. *Id.* See also Seligman, *supra* note 29, at 7 (discussing proxy solicitation costs).

tions.¹⁴⁰

2. *Opportunity Costs*¹⁴¹

Even if a shareholder had the financial means to engage in a communication that was likely to be deemed a solicitation, the onerous regulatory process also served to deter shareholders who were not ultimately seeking proxies from discussing corporate performance or voting matters.¹⁴²

Prior to the 1992 amendments, a shareholder wishing to engage only in voting communications would have been required to register with the Commission, file a proxy statement, and file "a voluminous disclosure about finances, intentions, and personal history."¹⁴³ Shareholders also had to register all subsequent communications before submitting them to investors.¹⁴⁴

The SEC staff then screened each communication before it was disseminated to the public.¹⁴⁵ The staff made editorial comments on what it perceived as false or misleading to the average shareholder and ordered the disseminators to remove such misinformation.¹⁴⁶ The SEC scrutinized the submitted proxy statements in sharp detail.¹⁴⁷

140. See Adopting Release, *supra* note 8, at 48,278 (stating that due to the potential cost, "shareholders can be deterred from discussing management and corporate performance by the prospect of being found after the fact to have engaged in a proxy solicitation.").

However, not only shareholders are deterred from engaging in a potential solicitation. John Pound, Associate Professor of Public Policy and Director of the Corporate Voting Research Project at the Kennedy School of Government at Harvard University, stated that he was advised not to publish a written commentary on an AT&T-NCR proxy fight because such an article could potentially be deemed a "solicitation." See Pound, *supra* note 34, at 58-59. Because Pound did not want to "incur several thousand dollars of legal costs in order to discuss [his] opinion on that contest," he chose not to publish. *Id.*

141. Opportunity cost is the value of the foregone time and effort spent on an activity. See PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 32 (13th ed. 1989).

142. See, e.g., Letter from James E. Heard, President, and Nell Minow, Board Member, Institutional Shareholder Services, Inc., to Jonathan C. Katz, Secretary, 5 (Oct. 22, 1991) (quoting Sarah Teslik, Chairman, Council of Institutional Investors) ("I have personally seen Council members dismiss without further study perhaps 95 percent of the actions that they have contemplated that could require filings under the shareholder communication rules—precisely *because* they require such filings.") (emphasis added).

143. See Pound, *supra* note 34, at 58.

144. *Id.*

145. *Id.*

146. *Id.*

147. See Black, *supra* note 34, at 77-85 (providing examples of SEC pre clearance censorship). See also ARANOW & EINHORN, *supra* note 5, at 121-22; Black, *supra* note 8, at 824 (characterizing the SEC preclearance staff as "vigorous censors"); Black, *supra* note 26, at 539 (stating that practitioners often complain about the SEC staff's "extensive nitpicking"). Because of the filing burden, several

The potential monetary and opportunity costs of engaging in a solicitation created a "chilling effect" on shareholder communication regarding corporate performance and voting matters.¹⁴⁸ Because it was so difficult to gauge whether a communication was in fact a solicitation under the proxy rules, a lawyer's advice to shareholders was always, "file first."¹⁴⁹ However, if a shareholder could not afford the time or money to do so, the shareholder simply would not undertake the communication.¹⁵⁰ Consequently, commentators questioned whether the cost of complying with the proxy rules was inhibiting the goal of keeping shareholders fully informed.¹⁵¹

C. *The Role of Institutional Investors*

In recent years, institutional investors have become more active in corporate governance issues.¹⁵² Institutional share ownership and concentration increased dramatically in the 1980s.¹⁵³ Historically, shareholders expressed discontent with management by selling their shares and were generally apathetic to effecting corporate change.¹⁵⁴ However, because of the staggering growth in their holdings, institutional investors now have a long-term stake in their investments.¹⁵⁵ As a result, such investors no longer have the flexibility to "vote with their feet"¹⁵⁶ and sell their shares in a corporation when dissatisfied with management.

groups, such as Institutional Shareholder Services, Analysis Group, and United Shareholders Association, had chosen not to preclear their materials, hoping someone would sue, thereby allowing these groups to challenge the law in court. *See* Black, *supra* note 34, at 55-56.

Although technically Rule 14a-9, which grants the SEC power to amend submitted materials, prohibits any false or misleading material fact, the SEC did not use "materiality" as a standard in making its changes. *See* Harvey M. Spear et al., *Applying the First Amendment to the Rules of Proxy Contests*, N.Y. L.J., Sept. 26, 1983, at 22. For example, in one case, the staff required a shareholder group to delete its assertion that its nominees for director were "highly regarded" because the group failed to provide evidence of the statement. *See* Pound, *supra* note 34, at 58.

148. *See* Adopting Release, *supra* note 8, at 48,278.

149. *See* Black, *supra* note 34, at 54.

150. *See supra* note 142.

151. *See* Adopting Release, *supra* note 8, at 48,278.

152. *See supra* notes 13-14 and accompanying text. *See also* Eppler & Scheuermann, *supra* note 12, at 22-26.

153. In the late 1980s, institutional assets comprised over 18% of the total financial assets in the United States. Matheson & Olson, *supra* note 12, at 1354-55. The fifty largest institutions owned 27% of the stock market. *Id.* at 1355. In 1990 alone, institutional investor ownership of corporate equity swelled from 45% to 53%. *Id.*

154. *See* Eppler & Scheuermann, *supra* note 12, at 22.

155. *See* Letter from CalPERS, *supra* note 34, at 295.

156. *See* Eppler & Scheuermann, *supra* note 12, at 22.

Institutional investors thus have greater incentive to become more active and invest time and resources toward improving corporate performance.¹⁵⁷

With the demise of the tender offer as a means of effecting corporate change, institutional investors turned to the proxy machinery as the vehicle for their recent activism.¹⁵⁸ For example, institutions became more active in shareholder proposals pertaining to corporate governance issues.¹⁵⁹ Because institutional investors realized that a deregulated proxy system would afford them the ability to communicate more freely, thus enhancing their efforts, these investors lobbied the SEC for proxy rule reform in the late 1980s.¹⁶⁰

Notwithstanding this intense lobbying by institutional investors, business groups and some commentators still contended that institutional shareholders could not effectively monitor corporate performance.¹⁶¹ These commentators claimed that institutional investors were more concerned with

157. This activism is reflected in the recent efforts of institutional shareholders to act together as an organized whole. See Robert D. Rosenbaum & Michael E. Korens, *Trends in Institutional Shareholder Activism: What the Institutions are Doing Today*, in 1 22ND ANNUAL INSTITUTE ON SECURITIES REGULATION 441 (Practicing Law Institute eds., 1990). For example, the Council of Institutional Investors was formed and has encouraged many institutional investors to assume a more aggressive role with respect to management. *Id.* at 442. In addition, sophisticated advisers, such as Institutional Shareholder Services, "have urged and assisted the recasting of the role of institutional investors." *Id.* See also Matheson & Olson, *supra* note 12, at 1356 (noting that the Council of Institutional Investors has been a "nucleus" for institutional investor mobilization). A similar organization, Analysis Group, performs economic and financial analysis for institutional investors. *Id.* It created the Institutional Voting Research Service "to evaluate the governance and economic performance of large corporations." *Id.*

158. See generally Black, *supra* note 26, at 570-75; Matheson & Olson, *supra* note 12, at 1356-60.

159. See Matheson & Olson, *supra* note 12, at 1357. The number of such proposals increased over 30% from 1989 to 1990, and the proposals received all-time high levels of support. *Id.*

160. See Eppler & Scheuermann, *supra* note 12, at 23-24. The California Public Employees Retirement System (CalPERS), the largest public pension fund in the United States, led the way for reform of the SEC proxy rules. See WATERS, *supra* note 5, at 473 (stating that the initial letter from CalPERS "commenced a vigorous debate about the efficacy of the . . . proxy rules and the ways in which those rules [could] be improved."); Linda Grant, *SEC's Proposals on CEO Pay Win Praise*, L.A. TIMES, June 24, 1992, at D3 (noting that CalPERS "initiated the movement for liberalized shareholder communications"); Barbara Franklin, *SEC Seeks Freer Speech; Shareholder Communications Proposal Debated*, N.Y. L.J., July 2, 1992, at 5 (noting that CalPERS has been "among the leaders" pushing for proxy rule reform). In 1989, CalPERS sent the SEC a letter outlining forty-eight proposals for reforming the proxy rules and containing a general request to commence a "comprehensive review of the proxy system." See Letter from CalPERS, *supra* note 34, at 298. Shortly thereafter, other institutional shareholders sent similar letters to the SEC. See WATERS, *supra* note 5, at 473-74.

161. See, e.g., Rosenbaum, *supra* note 34, at 176-82. But see generally Black, *supra* note 8; Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992).

short-term profit maximization than long-term corporate performance.¹⁶² They asserted that reforming the proxy rules to allow these institutional investors to communicate more freely could be harmful.¹⁶³ These commentators believed that freer communication would lead to "secret back-room" negotiations, leaving out small shareholders and their beneficiaries.¹⁶⁴ These critics also argued that institutional investors would not appropriately represent the interests of either small shareholders or their beneficiaries in their efforts to serve their own financial and political agenda.¹⁶⁵ Despite these counterarguments, the SEC cited the need for institutional investors to communicate with one another as an impetus for the proxy rule amendments.¹⁶⁶

III. THE SEC RESPONSE

The SEC released its first set of proposed rules in June 1991¹⁶⁷ and

162. See Rosenbaum, *supra* note 34, at 178-79.

163. See, e.g., Letter from Clifford L. Whitehill, Business Roundtable, to Jonathan G. Katz, Secretary, SEC 1 (Sept. 18, 1991) [hereinafter Letter from Business Roundtable]. Referring to the broader exempt solicitation proposal, this letter stated:

[This proposed exemption] would be used primarily by advocates for one side or the other on controversial matters put to a shareholder vote to influence the 25 to 100 institutional investors whose votes would be determinative at most major companies. Because such solicitations would be free from any regulation under the proxy rules, shareholder voting decisions would likely be infected with the very sort of misinformation, rumor and innuendo that the current proxy rules were designed to preclude.

Id.

See also Rosenbaum, *supra* note 34, at 182 ("[T]he SEC should therefore resist [external lobbying efforts] to amend the [proxy] rules in ways which would permit undisclosed solicitations of the key votes of large institutional investors."). Rosenbaum is general counsel to the Business Roundtable.

164. Letter from Business Roundtable, *supra* note 163, at 1.

165. See Rosenbaum, *supra* note 34, at 176-79. See also Letter from Business Roundtable, *supra* note 163, at 2 (stating that institutional investors are merely intermediaries with political objectives and pressures antithetical to small shareholders).

166. See Regulation of Security Holder Communications, Exchange Act Release No. 29,315, 56 Fed. Reg. 28,987 (1991) [hereinafter 1991 Proposing Release].

167. 1991 Proposing Release, *supra* note 166. The text of the proposed amendment was as follows:

(b) Sections 240.14a-3 to 240.14a-6 [other than 14a-6(g)], 240.14a-6 and 240.14a-10 to 14a-14 do not apply to the following:

(1) Any solicitation by or on behalf of a person who:

- (i) Does not have, and is not acting on behalf of a person who has, a material economic interest in the matters to be acted upon, other than as a security holder of the registrant;
- (ii) Does not seek, and is not acting on behalf of a person who seeks, either directly or indirectly through representatives, the power to act as a proxy for a security holder; and
- (iii) Does not furnish or otherwise request, and is not acting on behalf of a person who furnishes or requests, a consent or authorization of a security holder for delivery to the registrant.

Id. at 28,993.

adopted its final amendments in 1992 following two years of revised proposals and vigorous debate.¹⁶⁸ The SEC amended Rule 14a-1(l) to provide that a security holder's public announcement of how he or she intends to vote is explicitly excluded from the definition of proxy solicitation.¹⁶⁹ Moreover, the SEC amended Rule 14a-2(b)(1) to state that any communication by or on behalf of any person who does not seek the power to act as proxy is exempt from the proxy regulations.¹⁷⁰ However, the SEC did not completely deregulate communications made by persons not soliciting proxy authority. Amended Rule 14a-6(g) provides that written communications exempt under Rule 14a-2(b)(1) must be filed with the SEC within three days of dissemination.¹⁷¹

In its release pursuant to the amendments, the SEC elaborated on the rationale behind the changes. The SEC stated that it contracted the definition of solicitation in order to provide certainty, reduce costs, and eliminate First Amendment concerns.¹⁷² However, the Commission failed

In June 1992, the SEC released its second set of proposals. Regulation of Communications Among Securityholders, Exchange Act Release No. 30,849, 57 Fed. Reg. 29,564 (1992) [hereinafter 1992 Proposing Release].

168. Adopting Release, *supra* note 8, at 48,276. See also *supra* note 6. The 1992 amendments to the rules were actually the third set of changes the SEC proposed. In 1991, the SEC first proposed changes and sought commentary from industry. See 1991 Proposing Release, *supra* note 166. In June of 1992, the SEC released a second set of proposals in response to the comments. See 1992 Proposing Release, *supra* note 167. The amendments to Rules 14a-1 and 14a-2 differed little from the June 1992 proposal.

169. Adopting Release, *supra* note 8, at 48,290.

170. *Id.* at 48,290-91.

171. Rule 14a-6(g), 57 Fed. Reg. 48,276, 48,292 (1992) (to be codified at 17 C.F.R. § 240.14a-6(g)) provides, in relevant part, as follows:

(g) Solicitations subject to § 240.14a-2(b)(1). (1) Any person who:

(i) Engages in a solicitation pursuant to § 240.a-2(b)(1), and

(ii) At the commencement of that solicitation owns beneficially securities of the class which is the subject of the solicitation with a market value of over \$5 million,

Shall furnish or mail to the commission, not later than three days after the date the written solicitation is first sent or given to any security holder, five copies of a statement containing the information specified in the Notice of Exempt Solicitation (§ 240.14a-103) which statement shall attach as an exhibit all written soliciting materials.

Thus, if an institutional investor wishes to send out a mass mailing that qualifies as an exempt solicitation under Rule 14a-2(b)(1), it must still comply with the notice requirement set forth in Rule 14a-6(g).

172. *Id.* at 48,277-79. However, the SEC made a marked change from the original 1992 proposal in Rule 14a-7, regarding access to shareholders lists. *Id.* at 48,285. In its June 1992 release, the SEC proposed that the rule be amended to allow shareholders access to the list upon request. See 1992 Proposing Release, *supra* note 167, at 29,566. However, the final amendment to the 1992 proposal only allowed such access in roll-up transactions or merger transactions. In all other transactions, the SEC retained the rule that management had discretion to send the list to shareholders or send the

to explain why the definition applied only to a shareholder's public announcement of voting intent.¹⁷³

The SEC also explained its rationale for requiring the filing of exempt written communications. The SEC stated that written communications are longer and more complex than spoken communications,¹⁷⁴ that written communications can be republished, while oral communications cannot,¹⁷⁵ and that the burden of filing and memorializing an oral communication is greater than that for a written communication.¹⁷⁶ As a result of these factors, the SEC has also elected to classify "scripts" of phone calls as written solicitations.¹⁷⁷

The 1992 amendments also include a "safe harbor" in the definition of solicitation to provide for public communications on how to vote.¹⁷⁸ The safe harbor does not provide for private voting communications. Yet, in effect, some private voting communications are nevertheless exempt. For example, mere conversations between shareholders are exempt under 14a-2(b)(2) as oral communications not intended to solicit proxies.¹⁷⁹ However, if an institutional investor sends a mailing to shareholders, stating how it intends to vote, it must still comply with notification requirements.¹⁸⁰

IV. A PROPOSAL FOR FURTHER PROXY RULE REFORM

The SEC's decision to deregulate the proxy rules was a step toward achieving effective corporate governance.¹⁸¹ The contraction of the definition of solicitation and the expansion of exempt solicitations will ameliorate First Amendment concerns, lower costs, and facilitate institutional investment in corporate governance. Consequently, the amendments are

shareholders' proxy statement to all the shareholders. See Adopting Release, *supra* note 8, at 48,276.

173. See Adopting Release, *supra* note 8, at 48,282.

174. *Id.* at 48,280.

175. *Id.*

176. *Id.*

177. *Id.* at 48,282.

178. See Adopting Release, *supra* note 8, at 48,290. See also *supra* note 17 for text of amendment.

179. See Adopting Release, *supra* note 8, at 48,290. See also *supra* note 201 for text of amendment.

180. See *infra* note 171 for text of Rule 14a-6(g). The rule provides that written communications must be filed with the SEC within three days of dissemination.

181. See, e.g., Judith C. Dobrynski, *An October Surprise That Has Shareholders Cheering*, BUS. WK., Nov. 2, 1992, at 144 (quoting John C. Wilcox, Chairman of Georgeson and Co., a proxy soliciting firm) ("This is a huge psychological boost to shareholder activism and to the corporate governance reform movement.").

an important step in addressing the criticism that prompted the SEC to act.¹⁸² However, to maximize effective corporate governance, further proxy rule reform is warranted. Written communications should be exempted and treated the same as oral communications, private communications should be treated the same as public, and the ten-person rule should be changed to a percentage rule.

A. *The Rules Were a Step in the Right Direction*

Expanding the scope of communication that falls outside the definition of solicitation, and hence, is no longer subject to the proxy rule requirements, will ease First Amendment concerns. The proxy rules will now classify *LILCO*-type speech¹⁸³ that falls at the margin between political and commercial speech as an exempt solicitation under Rule 14a-2(b)(1).¹⁸⁴ Thus, the amendment will abate the concern that the proxy rules unconstitutionally stifle political speech. Also, because public corporate speech is exempt under the 1992 proxy rule amendments, *Bellotti*-type concerns¹⁸⁵ will diminish.

Moreover, because the amended 14a-2 exemption applies to communications that do not involve direct proxy solicitation,¹⁸⁶ the rule complies with the *Central Hudson* requirement that a commercial speech regulation "directly relate" to the governmental interest it intends to protect.¹⁸⁷ The SEC enacted the proxy rules to prevent abuses by persons actually soliciting proxy authority.¹⁸⁸ Because Rule 14a-2 now exempts a

182. See *supra* part II. The issues discussed in Part II centered around the need for increased shareholder communication. Freer speech would diminish First Amendment concerns. See *supra* part II.A. Moreover, cost concerns would decrease upon increased shareholder communication. See *supra* part II.B. Finally, allowing freer speech among shareholders would afford institutional investors a greater opportunity to hold management accountable for their actions. See *supra* part II.C.

183. *LILCO*-type speech refers to public announcements regarding management performance that do not mention proxies. See *supra* notes 121-28 and accompanying text.

184. See *supra* note 18 for text of Rule 14a-2(b)(1) (exempting from filing requirements published statements by persons not intending to solicit proxies).

185. See *supra* notes 102-31 and accompanying text.

186. See *infra* note 201.

187. See *supra* notes 108-09 and accompanying text.

188. See Adopting Release, *supra* note 8, at 48,277. The Adopting Release stated:

In adopting the sweeping 1956 definition, the Commission sought to address abuses by persons who were actually engaging in solicitations of proxy authority in connection with election contests. The Commission does not seem to have been aware, or have intended, that the new definition might also sweep within all the regulatory requirements persons who did not "request" a shareholder to grant or revoke or deny a proxy, but whose expressed opinions might be found to have been reasonably calculated to affect the views of other shareholders positively or negatively toward a particular company and its management or directors.

communication in which the speaker does not intend to solicit a proxy, the rule has a more direct relation to the SEC's interest in ensuring that actual proxy voting authority be conducted on a fair and informed basis.¹⁸⁹

Furthermore, a narrower definition of solicitation will inevitably decrease communication costs. From a financial standpoint, shareholders will no longer incur extensive mailing requirements when they communicate regarding voting matters.¹⁹⁰ From an opportunity cost standpoint, shareholders' time and effort will be reduced.¹⁹¹ Because the rule more explicitly defines what constitutes a "solicitation," shareholders will be more willing to communicate.¹⁹²

In addition, because institutional shareholders will be able to communicate more freely among themselves, chances are greater that they will be able to participate actively in corporate governance.¹⁹³ It is unlikely that institutional investors will abuse this increased ability to communicate by engaging in "secret back-room communications."¹⁹⁴ If institutional shareholders attempt to abuse the new amendments, potential victims are

Id. at 48,277-48,278.

189. *See id.* (expressing the SEC's interest as regulating the actual solicitation of proxies).

190. *See supra* notes 136-39 and accompanying text.

191. Moreover, even if shareholders are required to file, their time and effort will be less than before because the SEC also amended the filing requirements to make them less onerous. *See supra* note 8.

192. *See supra* notes 148-50 and accompanying text.

193. *See, e.g.,* Marlene Givant Star, *Westinghouse Actions Lauded; Stockholders Urged to Back Management*, PENSIONS AND INVESTMENTS, Dec. 21, 1992, at 2.

194. *See* Nell Minow, *Proxy Reform: The Need for Increased Shareholder Communication*, 17 J. CORP. L. 149, 158 (arguing that management group claims that proxy reform will result in "secret back-room negotiations" are so "deliberately inflammatory that they verge on misrepresentation"). SEC Chairman Richard C. Breeden stated:

Despite suggestions to the contrary, large institutional shareholders would not be allowed to form secret groups for collective action. Disclosure is required when shareholders act in concert with respect to voting power. Indeed, disclosure of such action is a primary purpose of the public filing mandated by Section 13(d) of the Exchange Act[.]

Shareholder Rights: Hearing Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, 102d Cong., 1st Sess., Oct. 17, 1991, at 85. Pursuant to Section 13(d), shareholder groups owning more than 5% of a corporation's stock must make a public filing if members of the group decide to work together. *See* Minow, *supra*, at 158. Such shareholders must file even if they only intend to "influence" management. *Id.*

The SEC articulated several arguments in its release in response to claims that deregulating the rules would lead to back-room negotiations. First, it noted that institutional investors are still required under 13(d) to file with the SEC if they act as a "group" on voting matters. *See* Adopting Release, *supra* note 8, at 48,278. Second, the SEC noted that business groups cited no specific cases to support these claims. *Id.* Third, the SEC also rhetorically questioned why investors wishing to gain support for their views would wish to keep their views secret. *Id.*

not without remedy. The beneficiaries may bring claims under ERISA or similar laws,¹⁹⁵ and small shareholders may have a cause of action under state fiduciary duty principles.¹⁹⁶ In any event, empirical evidence indicates that there is little chance that institutional shareholders will indeed abuse their increased ability to communicate under the new rules.¹⁹⁷ Ultimately, the need for change outweighs the speculative risk of abuse.¹⁹⁸

B. *More Reform is Necessary*

Through the amendments to the definitions of solicitation and exempt solicitations, the SEC has endorsed shareholder arguments in favor of removing regulatory barriers to flexible communication.¹⁹⁹ However, the SEC described its initial proposals as "modest," and its second proposals as a retreat from the first proposals.²⁰⁰ These comments indicate that the SEC undertook proxy rule reform in a piecemeal manner. A careful examination of the amendments indicates that additional reform is necessary. Written communications should be exempt when oral communications are exempt, private communications should be treated like public communications and the ten-person rule should be changed to a percentage rule.

195. See generally *The Institutional Investor's Duty Under ERISA to Vote Corporate Proxies*, Thomas Gilroy & Brien D. Ward, in *PROXY CONTESTS, INSTITUTIONS INVESTOR INITIATIVES MANAGEMENT RESPONSES* 853 (Practicing Law Institute ed., 1990). See also 1990 Letter from CalPERS, *supra* note 160, at 1. In making and managing investments, CalPERS is required by statute to "meet a 'prudent expert' fiduciary standard, a standard that is essentially the same as that applicable to trustees of private pension plans under 'ERISA.'" *Id.*

196. See, e.g., *Pepper v. Litton*, 308 U.S. 295 (1939); *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); *Jones v. H. F. Ahmanson & Co.*, 460 P.2d 464 (Cal. 1969) (cases recognizing that majority shareholders have a fiduciary duty to minority shareholders). See generally *SOLOMON ET AL.*, *supra* note 12, at 747-48.

197. See Black, *supra* note 161, at 898 (noting the absence of evidence that greater shareholder oversight is harmful).

198. See Black, *supra* note 34, at 51-52.

199. See *Adopting Release*, *supra* note 8, at 48,277 ("The amendments adopted today reflect a Commission determination that the federal proxy rules have created unnecessary regulatory impediments to communication among shareholders and others and to the effective use of shareholder voting rights.").

200. See *Shareholder Communication Proposals Produce Second Tidal Wave of Comments*, 24 Sec. Reg. & L. Rep. (BNA), at 1516 [hereinafter *Tidal Wave*] (quoting SEC Chairman Richard C. Breeden ("The revised proposals were scaled back somewhat in several areas from the 1991 proposals in response to criticisms from the business community.")).

1. Oral/Written Communications Distinction Pursuant to Rule 14a-2(b)(1)

The SEC's decision to require the filing of Rule 14a-2(b)(1) exempt written solicitations was a significant retreat from the 1991 proposals.²⁰¹ The new rule requires shareholders to file written, but not oral, communications.²⁰² The SEC should change the rule to exempt both oral and written communications not intended to solicit a proxy. Despite the SEC's justification, this qualification to Rule 14a-2(b)(1) still raises concerns regarding the three issues the SEC attempted to address. First, constitutional concerns are still problematic. Although the First Amendment applies equally to both written and oral commercial speech,²⁰³ Rule 14a-2(b)(1) does not treat both equally. The SEC, however, dismissed this issue in a brief footnote, stating that placing a notice requirement on oral communication would impose a greater burden than necessary to achieve statutory requirements.²⁰⁴ It further noted that the burden of filing a written requirement is minimal when compared with a requirement that oral conversations be memorialized and filed.²⁰⁵

Although it is likely that filing a letter is less burdensome than memorializing and filing an oral conversation, that fact is irrelevant to the *Central Hudson* commercial speech inquiry. *Central Hudson* requires that the regulation "directly relate" to the governmental interest.²⁰⁶ In its October 1992 release, the SEC expressly stated that its rules were only intended to regulate those who actually engage in proxy authority

201. See Adopting Release, *supra* note 8, at 48,280. The SEC conceded that the decision to require written solicitations to be filed was a major change from the original proposal that was the target of extensive opposition. *Id.* at 48,279-48,280. As initially proposed, persons exempt under Rule 14a-2(b)(1) would have been able to communicate freely in any manner without being subject to a filing requirement. *Id.* at 48,279. The SEC's second proposal and its final amendments retreated from this initial proposal in the form of Rule 14a-6(g), requiring shareholders to file exempt written communications within three days of dissemination. *Id.* at 48,292. The SEC received numerous letters from shareholders opposing this filing requirement. *Id.* at 48,280. Some shareholders called the requirement "overly intrusive." *Id.* Others were concerned about the "potential liability" a solicitor might incur in connection with the filing requirement. *Id.* On the other hand, corporate representatives strongly approved the filing requirement. *Id.*

202. See *supra* note 171 and accompanying text.

203. In its release, the SEC conceded that "[t]he First Amendment applies equally between written and oral communications." Adopting Release, *supra* note 8, at 48,280 n.38.

204. See Adopting Release, *supra* note 8, at 48,281 n.38.

205. *Id.* at 48,280.

206. See *supra* note 109 and accompanying text.

solicitation,²⁰⁷ yet it still required that persons who do not intend to solicit proxies file their communication with the SEC if the communication is written. Because this filing requirement does not directly relate to the SEC's asserted interest, it raises concerns under the First Amendment.²⁰⁸

Second, cost concerns surround the new rule. Although the financial cost of the written filing requirement is small,²⁰⁹ the fear of inviting lawsuits under Rule 14a-9 might prevent a proposed mailing.²¹⁰ Thus, the written exemption may chill some communications that might otherwise have occurred.²¹¹

Moreover, what constitutes an "oral" or a "written" communication is uncertain. In its release, the SEC noted that written "scripts" made pursuant to a telephone communication must be filed.²¹² Furthermore, the SEC requires that press releases submitted to the media be filed if they are not published.²¹³ Although, in effect, these communications are spoken, the SEC nevertheless deems them subject to the written filing requirement. If a shareholder must file with the SEC a script used during a phone call, it is unclear whether he or she must file a script used during a speech, particularly if that speech never took place.²¹⁴ This uncertainty

207. See Adopting Release, *supra* note 8, at 48,277.

208. See *supra* note 109. See also Adopting Release, *supra* note 8, at 48,279 ("[a] regulatory scheme that inserted [itself] into every exchange . . . would raise serious questions under . . . the First Amendment, particularly where no proxy authority is being solicited by such persons.") (emphasis added).

209. See Notice of Exempt Solicitation, 57 Fed. Reg. 48,294-48,295 (1992) (to be codified at 17 C.F.R. § 240.14a-103). This form provides for the filing of the name of the registrant, the name of the person relying on the exemption, and the address of the person relying on the exemption. The written communication must also be attached to the form. *Id.*

210. See *Comments Support SEC Proposals on Communications, Compensation Disclosure*, Pen. and Ben. Daily (BNA), Sept. 22, 1992 ("[T]here is a danger that any information filed with a governmental agency will take on a quasi-official status that will invite lawsuits.") (quoting Letter from Sarah Teslik, Executive Director, Council of Institutional Investors to SEC (Sept. 23, 1991)).

211. See *Tidal Wave*, *supra* note 200, at 1516 ("The public notification requirement for certain written materials 'will substantially dilute the benefits that the Commission seeks' and will 'chill proxy-related communications.'") (quoting the United Shareholders Association (USA)).

212. See *supra* text accompanying note 177; Adopting Release, *supra* note 8, at 48,282.

213. See Adopting Release, *supra* note 8, at 48,282.

214. If an unpublished press release must be filed, it would seem to follow that a script written pursuant to a speech that never occurred would also be subject to the filing requirement. It would also seem to follow that visual aids in the form of graphs and charts pursuant to such a speech would be subject to the filing requirement. The SEC expressly noted its concern with complex "graphs and charts" in a written communication. See Adopting Release, *supra* note 8, at 48,280. Thus, in connection with these concerns, the SEC might potentially require that visual aids containing such complex charts be filed.

may create an additional “chilling effect” among shareholders.²¹⁵ Because of the above concerns, the Commission should change the present exemption in order to exempt both written and oral communications from filing requirements. In doing so, the SEC will alleviate the pre-amendment concerns.²¹⁶

2. *Public/Private Voting Communications: Rule 14a-1(l)(iv)*

Although the 1992 amendments explicitly exempt public, but not private, communications on how to vote, some private voting communications are, nevertheless, exempt. This result also fails to alleviate the three concerns that sparked change.

Again, the constitutionality of this result under the *Central Hudson* test²¹⁷ comes into question. As noted above,²¹⁸ regulating a mere voting communication simply because it is written and not spoken does not directly serve the SEC’s intent of addressing abuses in actual proxy solicitation.²¹⁹

Because written voting communications are subject to the notification requirement, the regulations are likely to have a chilling effect on written communications.²²⁰ Consequently, institutional investors may publish

215. See Barbara Franklin, *SEC Seeks Freer Speech; Shareholder Communications Proposal Debated*, N.Y. L.J., July 2, 1992, at 5. Franklin cites an incident in which the SEC contacted shareholder activist Ralph Whitworth after he published his advice on an issue and told him his actions amounted to a proxy solicitation, of which he was unaware. Whitworth refrained from any further communication, due to his uncertainty as to what actions would be subject to filing requirements. *Id.*

216. With respect to the need for institutional investors to communicate, this filing requirement is potentially detrimental. See *supra* note 211. The USA noted that the notification requirement even applies to companies that merely provide services to clients on proxy voting issues: “[The firms] fulfill an increasingly desirable market function in developing an independent source of corporate governance analysis and information.” *Tidal Wave*, *supra* note 211, at 1516 (quoting the USA).

217. See *supra* note 108-09 and accompanying text.

218. See *supra* notes 206-08 and accompanying text.

219. See Estreicher, *supra* note 29, at 314.

[T]he imposition of the regulatory scheme on expressive communications far removed from the SEC’s legitimate regulatory concern for the impact on shareholders [raises substantial first amendment concerns. For example,] regulating messages concerning corporate management and policy that are directed to the general public and make no mention of proxies, proxy contests or upcoming shareholder meetings [raises such concerns].

Id.

220. See *Tidal Wave*, *supra* note 211, at 1516 (citing the chilling effect in connection with the public notification requirement). The anti-fraud provisions of Rule 14a-9 apply to the exempt communications. This fact may cause shareholders to be wary of engaging in a written communication subject to the filing requirement:

[It is] critical that documents filed with the Commission under the newly created notice filing requirement with respect to certain written communications be exempted from the liability

their voting stances in the media or make phone calls.²²¹ However, this type of communication might not be as effective as a direct mailing.²²² The SEC's proffered rationale for contracting the definition of solicitation was to respond to fiduciaries' need to communicate with their beneficiaries on voting matters.²²³ To allow them to do so only publicly does not fully satisfy this need.²²⁴ For these reasons, the safe harbor in the definition of solicitation should cover all voting communications, whether public or private.

3. Ten-Person Rule: Rule 14a-2(b)(2)

The SEC retained the ten-person rule in the form of Rule 14a-2(b)(2).²²⁵ Consequently, those who wish to solicit proxies from ten or fewer shareholders are not required to file a proxy statement. The SEC did not explain why it retained the rule in its current form.²²⁶ However, for several reasons, it is clear that the ten-person rule, enacted in 1942, is now outmoded and unworkable. The revisions to Rules 14a-1 and 14a-2 that exempt most shareholder communications preliminary to a proxy solicitation²²⁷ partially obviate the need for the current rule. The SEC enacted the ten-person rule to enable shareholders who are contemplating a proxy solicitation to take initial steps, such as forming a stockholders' committee.²²⁸ Before the amendments to Rules 14a-1 and 14a-2, the SEC may have characterized this action as a solicitation.²²⁹ Now, however, that

standards imposed on other proxy related filings. . . . [These Notice Form 14 filings] would remain subject to other laws governing written communication, including libel laws. . . . These laws more properly balance the free speech, privacy, and accuracy concerns most appropriate to this type of filing.

Id.

221. See, e.g., Harvey Pitt et al., *Proxy Reform: A New Era of SEC Activism*, INSIGHTS, November 1992, at 2 (arguing that most shareholder groups will simply avoid the notice requirements by using oral solicitations alone).

222. A direct mass mailing is logically much more expedient in reaching a large group than individual phone calls. Moreover, it is much more certain to reach intended recipients than a publication, given that all members of the target group may not actively seek out a publication, while they inevitably will receive a direct letter.

223. See 1992 Proposing Release, *supra* note 167, at 29,571.

224. See *supra* note 222.

225. The rule was formerly embodied in Rule 14a-2(b)(1). See *supra* note 46. See *supra* note 7 for text of former Rule 14a-2(b)(2).

226. See Adopting Release, *supra* note 8, at 48,278 n.24 ("Since 1942, conversations among not more than 10 shareholders have been exempt solicitations.").

227. See *supra* notes 17, 201, and 178-80 and accompanying text.

228. See *supra* notes 44-48 and accompanying text.

229. See *supra* note 44 and accompanying text.

action would be exempt.²³⁰

Yet the SEC should not eliminate the rule entirely. In creating the rule, the SEC apparently intended to exempt some *de minimis* proxy solicitations.²³¹ The SEC has expressly recognized that such transactions bear little risk of abuse relative to the regulatory burden.²³² However, the current rule is inconsistent with that notion. In 1942, when the SEC enacted the rule, individual shareholders dominated the securities markets.²³³ Today, by contrast, institutional shareholders hold most of the equity.²³⁴ Actual solicitation of less than ten institutional shareholders does not necessarily constitute a small transaction.²³⁵ Conversely, solicitation of twelve or thirteen individual shareholders arguably carries little risk.²³⁶ As a result, the ten-person rule in its current form makes little sense in light of recent trends in shareholder ownership.²³⁷

Instead of exempting a certain number of actual shareholders from the filing requirements, the rule should exempt actual shareholder solicitations on the basis of percentage ownership of voting shares.²³⁸ Numerous securities laws currently employ this criterion. For example, Regulation 14D, which regulates tender offers, uses a percentage criterion.²³⁹ Moreover, a percentage criterion triggers the filing of forms under Section 13(d).²⁴⁰

230. See *supra* notes 17, 201, and 178-80 and accompanying text.

231. See Letter from American Society of Corporate Secretaries, *supra* note 34, at 21 (referring to the ten-person rule as having a “*de minimis* purpose”). See also Adopting Release, *supra* note 8, at 48,280 (noting that solicitations involving “smaller shareholders” raise fewer concerns).

232. Adopting Release, *supra* note 8, at 48,280. This recognition is reflected in numerous rules that carry a threshold percentage share requirement before they are triggered. See *infra* notes 239-40 and accompanying text.

233. See WATERS, *supra* note 5, at 475 (noting that even as recently as 1970, institutional shareholders controlled only nine percent of the public securities markets).

234. See *supra* note 153 and accompanying text.

235. See, e.g., Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 157-58 (1988). Ryan discusses a “near-successful” CalPERS active proxy solicitation campaign that was limited to large investors. The solicitations were not subject to the SEC proxy rules, however, because fewer than ten people were actually solicited. *Id.* at 158.

236. See *Pantry Pride*, 598 F. Supp. at 902. See also *International Banknote*, 713 F. Supp. at 622 (holding that solicitation of eleven or twelve shareholders is a minor infraction and does not violate the ten-person rule).

237. See Letter from American Society of Corporate Secretaries, *supra* note 34, at 21.

238. *Id.*

239. *Id.* See Rule 14d-3(a), 17 C.F.R. § 240.14d-3(a) (1992) (providing that a bidder must file a form with the SEC upon making a tender offer in which, when completed, the bidder will own over five percent of the class of the subject company’s securities).

240. *Id.* See Rule 13d-1(a), 17 C.F.R. § 240.13d-1(a) (1992).

In addition, modifying the ten-person rule to adopt a percentage criterion would reduce a significant amount of litigation.²⁴¹ Courts would no longer have to engage in tedious discovery to determine the exact number of persons solicited,²⁴² nor struggle to determine whether to impose a violation on a solicitation of eleven or twelve shareholders.²⁴³ A percentage criterion for determining exemption from the proxy rules would better comport with the SEC's intent of ensuring that the shareholders are "fully and fairly informed" regarding actual proxy solicitation.²⁴⁴

V. CONCLUSION

With the failure of the tender offer as a mechanism for achieving corporate reform,²⁴⁵ shareholders are now relying on the proxy to hold management accountable for its actions.²⁴⁶ As a result, the efficacy of the proxy rules emerged as a subject of debate. This debate resulted in the SEC's amendment of the proxy rules in 1992. The amendments were an important step toward achieving effective corporate governance.

However, close scrutiny of the rules reveals that the prior concerns that led up to the change have not been fully addressed, and that the changes are really more modest than they appeared. In order for the SEC to ensure that the proxy rules comport with their underlying purpose, the SEC should address the rules' shortcomings in the manner suggested in this Note.

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241. See *supra* notes 85-94 and accompanying text.

242. See, e.g., *Pantry Pride*, 598 F. Supp. at 891; *International Banknote*, 713 F. Supp. 612. In both cases, the evidence was unclear as to the actual number of persons solicited. This reflects the difficulty of determining an exact number of shareholders contacted.

243. See WATERS, *supra* note 5, at 35-36 (courts faced with the ten-person rule generally engage in a fact-specific balancing test instead of adhering to the rule literally).

244. See Adopting Release, *supra* note 8, at 48,277-48,278 & n.22.

245. See *supra* note 12 and accompanying text.

246. See *supra* notes 30-31, 158-60 and accompanying text.

