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I. INTRODUCTION

In the traditional model of corporate ownership, small shareholders (or "Individual Shareholders") are effectively disenfranchised as ownership disperses among an increasing number of shareholders.[1] Individual Shareholders have no means of economic benefit with respect to share ownership other than increases in the value of the shares owned. Large shareholders, or general partners of a limited partnership ("Control Shareholders"), on the other hand, have not been disenfranchised, and, along with management (together, "Control Persons"), can engage in and cause the company to engage in transactions and other activities that benefit the Control Persons ("Control Activities"), often to the detriment of other shareholders.

Institutional investors, particularly pension funds, dramatically change this mix. Because they own large amounts of equity,[2] pension funds in many cases will have voting power analogous to Control Shareholders. For various reasons, however, pension fund investors

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1. *See infra* notes 21-33 and accompanying text.
2. *See infra* notes 35-37 and accompanying text.

are unable to engage in Control Activities. Rather, pension fund investors will tend to have interests that are similar to those of Individual Shareholders.[3]

Nonetheless, the Securities and Exchange Commission's (the "SEC" or "Commission") proxy regulations[4] substantially restrict pension funds' ability to act in a manner that benefits Individual Shareholders. Institutions and other shareholders are restricted because the Commission regulates their communications among themselves. The Commission's regulations generally apply to communications, with respect to section 12[5] registered securities, that are deemed "solicitations" of proxies.[6]

Federal securities laws generally require that ten days prior to a "solicitation," specified information ("Schedule 14A Information" or "Schedule 14A Materials")[7] be filed with the Commission in the form of a proxy statement (together with other pre-dissemination filing requirements, the "Prefiling Requirement" or "Preclearance Requirement").[8] After ten days, or prior clearance by the SEC staff, the Schedule 14A Information must be given by the soliciting party (the "Solicitor") to those solicited (the "Solicitees") prior to or contemporaneously (the "Contemporaneous Requirement") with any communication deemed a "solicitation."[9] Traditionally, "solicitation" has been broadly defined by the Commission and the courts.[10] These onerous rules stifle communications that could ultimately benefit Individual Shareholders.

The Commission recognized the "significant change in securityholder demographics resulting in a concentration of institutional

3. *See infra* notes 38-48 and accompanying text.

4. Regulation 14A, 17 C.F.R. 240, 14a-1–14b-2.

5. 15 U.S.C. 78(l).

6. *See infra* notes 95-134 and accompanying text.

7. Schedule 14A Information includes general information regarding the solicitation, including the date, time, and place of the meeting; revocability of the proxy; dissenters' right of appraisal; person making the solicitation; interest of certain persons in matters to be acted upon; and voting securities and principal holders thereof. Depending upon the particular matter that is the subject of the solicitation, Schedule 14A may require disclosure of information concerning the registrant's directors and executive officers including compensation, past business experience, involvement in certain legal proceedings, transactions with the registrant, and indebtedness to the registrant; compensation plans; financial condition, including full financial statements, pro formas, and management's discussion and analysis; and detailed information concerning certain transactions. 17 C.F.R. § 240.14a-101 (1991).

8. *See infra* notes 82-89 and accompanying text for a discussion of exceptions to the general rule that Schedule 14A Information must be filed ten days prior to dissemination. *See infra* notes 89-90 and accompanying text for a discussion of other pre-dissemination filing requirements.

9. *See infra* notes 79-88 and accompanying text for a discussion of the Contemporaneous Requirement, including certain exceptions.

10. *See infra* notes 95-134 and accompanying text.

equity ownership and voting power,"[11] and responded in two releases[12] issued in June 1991[13] (the "1991 Release") and June 1992[14] (the "1992 Release").[15] Generally, these releases propose revisions to the Commission's proxy rules that would decrease the current restrictions imposed on securityholder communications, and request comment concerning such proposals.

This paper will consider whether proxy regulation of the following three types of communications should be modified: (1) preliminary communications that "test the waters"; (2) broad-based advocacy; and (3) third party commentary. This paper will argue that many preliminary communications that test the waters regarding various issues should not be regulated by the Commission's proxy rules. Thus, the definition of "solicitation" should be redefined to exclude communications to fifty or fewer shareholders, and to groups comprising sophisticated shareholders.[16]

Broad-based advocacy accompanied by a request for proxy, and communications leading up to such requests are properly defined as "solicitations" and should be subject to proxy regulation, including some form of the Prefiling and Contemporaneous Requirements. In many cases, however, the burdens of the current Contemporaneous Requirement outweigh the benefits. Therefore, shareholders should

11. Regulation of Securityholder Communications, Exchange Act, Release No. 34-29315, 56 Fed. Reg. 28,987 (June 25, 1991) [hereinafter "Release No. 34-29315 or the "1991 Release"].

12. *Id.* At various locations throughout this paper, the author will make note of the Commission's rulemaking proceedings. Because this article was written primarily while the author was employed by the Commission and restricted by the Commission's conduct regulations, the author has attempted not to characterize such proposed rules or rulemaking proceedings.

13. Release No. 34-29315, *supra* note 11, at 28,988.

14. Regulation of Communications Among Securityholders, Exchange Act, Release No. 34-30849, 57 Fed. Reg. 29,564. (July 2, 1992) [hereinafter "Release No. 34-30849," or the "1992 Release"].

15. Letter-writing campaign by issuers, issuer organizations, institutional shareholders, and organizations of such shareholders, and commentators urging or opposing proxy rule revisions was instrumental in causing the Commission to reassess its current proxy regulations: The 1991 Release noted that there were more than 40 submissions to the Commission, along with more than 500 letters submitted by individual members of the United Shareholders Association ("USA") supporting USA's rulemaking petition. Release 34-29315, *supra* note 11, at 28,988. *See also infra* note 24. All such submissions are available to the public in Commission Public File No. 4-353. The 1992 Release notes that the Commission received over 900 letters, available to the public in Commission File No. S7-22-91, commenting on the 1991 Release. Release No. 34-30849, *supra* note 14, at 29,564. Comments regarding the 1992 Release will be available in Commission File No. S7-15-92.

16. *See infra* notes 171-73 and accompanying text.

be permitted to communicate freely for the time period preceding thirty days before the meeting date or final date upon which proxies[17] must be received (hereafter, the "Meeting Date"). During this time, if the communicator does not request a proxy, he should not be required to provide Schedule 14A Information.[18] However, the Solicitor must comply with the Contemporaneous Requirement if and when he requests a proxy, provides a proxy card, or communicates within this thirty day period.[19]

The Prefiling Requirement should be amended in the following areas: only Schedule 14A Information should be required to be filed prior to dissemination; opposing proxy statements containing Schedule 14A Information should not be used prior to clearance by the staff, or the longer of (a) five calendar days after filing, or (b) ten calendar days after filing of the first party's proxy materials or the date of prior clearance of the first party's proxy materials by the staff; the proxy statement should be public when filed; and opposition Schedules 14B should be required to be filed contemporaneously with the Schedule 14A Information.[20]

Further, communications from third parties should not be defined as "solicitations" to the extent that the third party renders voting advice or commentary in the ordinary course of his business or other activities. Thus, communications from third party proxy advisors, and disinterested third party commentary would not be regulated by the Commission's proxy rules.[21]

II. THE TRADITIONAL MODEL OF CORPORATE OWNERSHIP AND CONTROL

A. *The Modern Corporation and Shareholder Disenfranchisement*

The traditional model of corporate control and ownership was set forth by Berle and Means in the classic book *The Modern Corporation and Private Property*.[22] Their thesis was that as the modern corporation develops, corporate ownership is separated from control.

> Economic power, in terms of control over physical assets, is apparently responding to a centripetal force, tending more and more to concentrate in the hands of a few corporate managements. At the same time, beneficial owner-

17. Unless otherwise noted, the term "proxy" will be defined as it is in rule 14a-1(f), 17 C.F.R. § 240.14a-1(f). Rule 14a-1(f) defines the term "proxy" to include "every proxy, consent or authorization within the meaning of section 14(a) [15 U.S.C. 78n(a)] of the [Securities Exchange] Act [of 1934]. The consent or authorization may take the form of failure to object or dissent." *Id.*

18. *See supra* note 5.

19. *See infra* note 184 and accompanying text.

20. *See supra* note 5.

21. *See infra* notes 69-70.

22. ADOLF BERLE JR., & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

ship is centrifugal, tending to divide and subdivide, to split into ever smaller units and to pass freely from hand to hand. In other words, ownership continually becomes more dispersed; the power formerly joined to it becomes increasingly concentrated; and the corporate system is thereby more securely established.[23]

The Berle and Means hypothesis flows from the notion that shareholders originally exerted corporate control through voting power. Through their power to vote, shareholders may sponsor initiatives for their benefit, install new boards of directors, or defeat proposals that are not in their interest. For example, shareholders might vote against management proposals to implement devices with an antitakeover effect, vote to amend the corporate bylaws to restrict antitakeover measures that benefit only entrenched management, or install boardmembers more sympathetic to shareholders' concerns. As the concentration of share ownership becomes more dispersed, however, the voting power controlled by each individual decreases and the power exerted by management increases. This effectively disenfranchises Individual Shareholders.[24]

The phenomenon of disenfranchisement of Individual Shareholders causes economic disincentives for such shareholders to communicate. Individual shareholders are unlikely to communicate among themselves because of the high cost of doing so. Because each shareholder owns only a small portion of the company, the marginal benefit that accrues to him by increased performance will justify only small expense to achieve such increased performance. Absent a change in management, corporate policies will only be changed by a majority vote of the dispersed shareholders. Advocating such a vote is costly, and generally will not justify the expense.

Because he is disenfranchised, the Individual Shareholder, unlike a Control Person, does not have the ability to engage in or cause the company to engage in Control Activities. Thus, an Individual Shareholder's primary interest is in receiving dividends or appreciation in the value of his shares.

B. Non-Modern Corporations

Many corporations have not evolved into the Berle and Means modern corporation. These corporations may be controlled by a ma-

23. *Id.* at 9.

24. *See* Rulemaking petition from United Shareholders Association Dated and Filed March 20, 1990 (the "USA Petition") Commission Public File No. 4-353. *See also supra* note 15. The USA Petition cites numerous commentators who have argued that the proxy system disenfranchises shareholders. *Id.* at 6. *See also* note 14.

jority shareholder or one or more large shareholders, or influenced by large shareholders who do not ultimately control all corporate decisions. Such majority and large shareholders are called "Control Shareholders," and together with management and general partners, are referred to as "Control Persons."

In the present model, the distinction between Control Persons and Individual Shareholders is that Control Persons potentially have goals that may be achieved at the expense of other shareholders. The interests of Control Persons often go beyond simply increasing corporate performance for the benefit of shareholders. Rather, Control Persons may engage in and may cause or influence a company to engage in transactions or other activities that benefit the Control Person at the expense of the Individual Shareholder.[25] The following are seven examples of Control Activities (transactions or other activities in which Control Persons may engage that are likely to harm other shareholders).[26]

First, a Control Shareholder may increase the percentage of his equity ownership through a transaction that requires a shareholder vote, such as a "roll-up" transaction[27] or merger. Or, the Control Shareholder may increase his equity ownership through a tender offer or other transaction that does not require a shareholder vote.[28] Because he already exerts control as a general partner or large shareholder, the Control Shareholder possesses superior information and the ability to foist the transaction upon other shareholders (including limited partners). Frequently, Control Shareholders will cause management to present the transaction to shareholders in a proxy statement. These transactions may, however, be hostile.[29] The desire to

25. Control Activities will not necessarily harm Individual Shareholders. Control Activities might include a situation where a large shareholder who is dissatisfied with an incompetent board seeks control of the company for the purpose of improving corporate performance. In this example, the Control Person's interests will be aligned with the interests of Individual Shareholders.

26. These transactions/activities may, but will not always involve communications that are subject to the Commission's proxy rules.

27. The term "roll-up" will be used in the same manner as used in Release No. 34-29315. The term will refer to a reorganization of two or more entities into a single publicly traded entity. Typically, the original entities are limited partnerships or real estate investment trusts. Investors in the original entities usually receive debt or equity or a combination of debt and equity. *See,* Release 34-29315, *supra* note 13, at 28,987 n.1.

28. Tender offers are not governed by the Commission's proxy rules, and will not be discussed in this paper.

29. Some commentators argue that hostile acquisitions benefit Individual Shareholders for two reasons: First, by providing a check on management that has been unable to realize the value of the company; and second, by allowing shareholders to capture unrealized value of their shares. Many commentators argue, however, that hostile takeovers are an inefficient and destructive method of disciplining management. Lipton and Rosenblum argue that such tender offers lead to an unhealthy focus on short term results and dangerous overleveraging. *See* Martin Lipton & Steven A.

acquire equity as cheaply as possible is common to all purchasers,[30] but the results are more likely to be harmful when the purchaser already has a large equity stake and better access to information concerning the issuer. In this situation Control Shareholders will often achieve their goals at the expense of other shareholders.

Second, Control Shareholders may engage in self-dealing with the company. For example, they may contract for sales of assets or initiate other favorable transactions, which benefit the Control Shareholder but not the company. This type of transaction might include a roll-up of a limited partnership where a general partner gains a more advantageous management contract.

Third, a Control Shareholder may purposely harm the company and other shareholders to cause them to act in certain ways. In many cases this third example interacts with the first; thus, a Control Shareholder might take action that harms other shareholders to force their hands in a roll-up, exchange offer, or merger. For example, a Control Shareholder (in this context, the general partner) of a limited partnership might force unitholders to agree to change the legal form to a corporation by causing the partnership to discontinue partnership distributions. This, in turn, may cause a precipitous drop in the market price of the units.[31] The distinction between this example and the first is that here the Control Shareholder takes action that affirmatively harms other shareholders, causing them to engage in a transaction in which the Control Shareholder will benefit.

Fourth, Control Shareholders are able to engage in greenmail.[32] This harms other shareholders because it dilutes the value of shares not purchased in the greenmail transaction.

Fifth, Control Persons may have a deleterious interest in personal

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Rosenblum, *A New System of Corporate Governance: the Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 213-14 (1991).

30. The Control Shareholder, of course, will want to pay as little as possible. The Control Shareholder will in some cases even want to see the price of each individual share decline in order to make his acquisition of additional shares less expensive. If the control person attempts to drive the price down, however, he will run afoul of federal securities market manipulation laws.

31. *See supra* note 30.

32. Greenmail is a defensive tactic used, for example, by target management and to prevent a successful tender offer by a hostile bidder, including a Control Shareholder. When utilizing the defense, target management repurchases shares from the hostile bidder at a premium. *See, e.g.*, Fry v. Trump, 681 F. Supp. 252 (D.N.J. 1988) (receiving greenmail is not a breach of fiduciary duty); *see generally* Note, *Greenmail: Targeted Stock Repurchases and the Management—Entrenchment Hypothesis*, 98 HARV. L. REV. 1045 (1985).

aggrandizement. The Control Shareholder may simply desire the notoriety that comes with controlling a company through ownership of a large block of shares. He may have no interest in running the day-to-day operations of the company and may devote little or no time to company matters, or he simply may be an incompetent manager. Thus, his interests may run contrary to the Individual Shareholder's desire to have competent management run operations efficiently in order to increase the value of the company and its shares.

Finally, management frequently has an incentive to engage in the five transactions identified above. In addition, management often desires to entrench itself,[33] pay itself large salaries, engage in a management buyout or otherwise benefit from the corporation at the expense of Individual Shareholders.

Not all Control Activities will involve shareholder communications subject to the Commission's proxy rules,[34] but many will. Thus, for example, a Control Person may present a roll-up or merger transaction, or management might submit a proposed anti-takeover device for shareholder vote. In such transactions, a Control Person will derive a greater marginal benefit from the communication, because he will receive the benefit associated with the Control Activity in addition to an increase in share price, where applicable. Further, the per-share cost of the communication is lower for the Control Shareholder than for the Individual Shareholder because, as before, the cost will be distributed among a greater number of shares. Moreover, if the transaction is one in which a Control Shareholder assumes control of the company, he will be in a position to force the company to reimburse his communication expense from corporate coffers. Management will, in fact, bear no expense in communicating, as the cost will be paid directly by the corporation. For these reasons, Control Person communications are more likely to occur than Individual Shareholder communications.

III. Pension Funds as Shareholders

In addition to the two categories of shareholders discussed above, a third, not contemplated by the Berle and Means model, is becoming

33. Such a communication, for example, might take the form of a proposal to insert anti-takeover devices into corporate articles or bylaws. A discussion of the benefits to shareholders of anti-takeover devices is beyond the scope of this article. In general, however, such devices may run contra to interests of Individual Shareholders to the extent that they deny shareholders the opportunity to receive true economic value for their shares by artificially depressing market prices. It does not necessarily follow, however, that takeovers benefit shareholders. *See supra* note 29.

34. In some cases, a transaction involving a communication may precede a Control Activity that does not involve a communication. For example, a Control Shareholder's disruptive proxy solicitations may motivate management to engage in a greenmail transaction with the Control Shareholder.

increasingly prevalent: institutional shareholders. Columbia University data indicates that pension funds held 20.4 percent of outstanding equities in 1986.[35] New York Stock Exchange ("NYSE") data indicates that at the end of 1988, pension funds owned stock (including stock in companies not listed on the NYSE) equivalent to 29.9 percent of the New York Stock Exchange total market value.[36] The Employee Benefit Research Institute reports that pension funds accounted for 26.1% of all equity in the United States.[37]

A. *Pension Funds and the Control Person versus Individual Shareholder Paradigm*

A previous section isolated several types of Control Activities that which Control Persons may use to the detriment of other shareholders. One reason why Control Persons are able to engage in these transactions is because they own large blocks of shares. One might expect that because pension funds control tremendous amounts of capital, they might try to acquire large blocks of equity in order to engage in these activities. For the following reasons, however, pension funds generally do not acquire large blocks of stock in individual companies and do not engage in Control Activities.

First, the Employee Retirement Income Security Act (ERISA),[38] creates tremendous incentives for pension funds to broadly diversify.[39] Professor Black notes that,

> Under ERISA, pension plan managers must act for the exclusive benefit of plan participants, or face civil and criminal liability. They are enjoined to ex-

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35. Carolyn K. Brancato, *The Pivotal Role of Institutional Investors in Capital Markets* in INSTITUTIONAL INVESTING: THE CHALLENGES AND RESPONSIBILITIES OF THE 21ST CENTURY 3, 18 (Arnold W. Sametz ed., 1991).

36. NEW YORK STOCK EXCHANGE INSTITUTIONAL INVESTOR FACT BOOK 1990, 6 (Jean E. Tobin ed., 1990). *See also* Bernard S. Black, *Shareholder Passivity Reexamined* [hereinafter Black *Shareholder Passivity*], 89 MICH L. REV. 520, 570-71 (1990).

37. Brancato, *supra* note 36, at 17-18 (citing *Pension Fund Holdings of Selected Financial Assets*: 1950-1989, EBRI Q. INVESTMENT REP. (Employee Benefits Res. Inst.), Mar. 1990, at 53.

38. 29 U.S.C. § 1001-1461 (1988 & Supp. 1991).

39. Black, *supra* note 36 at 553-56 (citing Betty L. Krikorian, FIDUCIARY STANDARDS IN PENSION AND TRUST FUND MANAGEMENT (1989); Betty L. Krikorian, *Fiduciary Standards: Loyalty, Prudence, Voting Proxies, and Corporate Governance* in INSTITUTIONAL INVESTING: THE CHALLENGES AND RESPONSIBILITIES OF THE 21ST CENTURY 257 (Arnold W. Sametz ed., 1991) (formerly Betty L. Krikorian, *Fiduciary Standards for Institutional Investors: Overview and Current Issues*)). Black notes that corporate and private pension funds are generally subject to the same rules. This is so because ERISA borrows heavily from the common law of trusts, and public pension fund fiduciaries will hesitate to act in a manner that violates specific ERISA fiduciary restrictions. *Id.* at 553 n.110.

ercise "the care, skill, prudence, and diligence . . . [of] a prudent man acting in a like capacity," and to "diversify[]. . . so as to minimize the risk of large losses, unless . . . it is clearly prudent not to do so." [29 U.S.C. § 1104(a)(1988)]. Diversifying widely, owning small percentage stakes in hundreds or even thousands of companies, is safe, since it is what others "in like capacity" are doing. In contrast, owning large stakes in a smaller number of companies . . . is risky because it isn't what others are doing, and doesn't minimize the risk of "large losses."[40]

These incentives discourage pension funds from accumulating large blocks of a single company's stock even though such accumulation might enable it to engage in Control Activities.

Second, the common law of trusts discourages certain types of Control Activities, such as mergers or roll-ups, which tend to be risky and may involve high levels of leverage, by requiring that all investments be prudent.[41] This rule applies to each share, and not the aggregate portfolio.[42] A fiduciary may not make a risky investment even if he successfully diversifies by balancing the increased risk with safer investments.[43]

Third, fiduciary standards discourage Control Activities by pension funds by restricting a pension fund's ability to actively manage an operating business.[44] Even if a pension fund acquired a large block of a company's shares, it would be prevented from operating the business in a manner that benefited itself at the expense of others; indeed, it would be prevented from operating the business at all.

Finally, ERISA fiduciaries are personally liable if they lose a fiduciary duty lawsuit.[45] In such an event, the fiduciary must pay for the total loss, including legal fees.[46] The pension fund cannot reimburse the fiduciary, nor can it insure against the costs.[47] This creates a powerful disincentive to engage in Control Activities if there is even a remote possibility that the activity may violate fiduciary standards. Moreover, fiduciaries who willfully violate ERISA face criminal liability.[48]

For these reasons, pension funds are unlikely to engage in the types of detrimental transactions that Control Shareholders and management are able to undertake. The following section will dis-

40. *Id.* at 553 (quoting 29 U.S.C. § 1104(a)) (1988 & Supp. 1991) (footnote omitted).

41. *Id.* at 554.

42. *Id.*

43. *Id.* at 553-54. Black notes, however, that the trend may be to apply the prudence standard to the entire portfolio rather than individual investments. *Id.* at 554.

44. *Id.* at 555. Black cites the second Restatement of Trusts, which states "the following are not proper trust investments: . . . employment of trust property in the carrying on of trade or business." *Id.* at 555 n.118 (citing RESTATEMENT (SECOND) OF TRUSTS § 227 Comment f (1959)).

45. *Id.* at 555.

46. *Id.*

47. *Id.*

48. *Id.* (citing 29 U.S.C. § 1311) (1988 & Supp. 1991). Black notes that the risk of criminal prosecution is low. *Id.*

cuss whether institutional investing may damage shareholders in manners not present in the traditional Individual Shareholder versus Control Shareholder dichotomy.

B. *Other Ways that Institutional Investors May Harm Individual Shareholders*

Issuers and issuer organizations argue that because relatively few pension funds control such a large amount of total equity, pension fund managers are likely to negotiate in "smoke-filled"[49] back rooms, in "secrecy"[50] in the "shadows of Wall Street."[51] This argument is put forth vociferously in the context of proxy revision, because to the extent communications are encouraged, these back-room negotiations allegedly will increase. This argument has an alarming sound to it, but, assuming such negotiations occur at all, the specific harms caused thereby are not easily identified unless institutions have interests that differ from Individual Shareholders. The primary distinctions put forth by issuers are that institutions have short term goals,[52] and tend to act in a herd-like manner that causes market volatility.[53] This conduct by institutions allegedly damages individual corporations and market efficiency.[54]

First, individual corporations allegedly are harmed because corpo-

49. *See, e.g.*, Letter from James P. Carty, Vice President, National Association of Manufacturers, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, p. 1, September 23, 1991 (on file in Commission Public File No. S7-22-91) [hereinafter NAM Letter]. The NAM Letter was written in response to the rules proposed by the Commission in Release No. 34-29315, *see supra* note 15.

50. *See, e.g.*, Letter from H.B. Atwater, Jr., Chairman of the Task Force on Corporate Governance, The Business Roundtable, to Linda C. Quinn, Director, Division of Corporation Finance, Securities and Exchange Commission, p. 5, Dec. 17, 1990 (on file in Commission Public File No. 4-353) [hereinafter 1990 BRT Letter]. The 1990 BRT Letter was written in response to letters submitted to the Commission requesting that the Commission revise its proxy rules, *see supra* note 15.

51. *See e.g.*, NAM Letter, *supra* note 49, at 1.

52. *See e.g.*, Letter and memorandum from Clifford L. Whitehill, Chairman, Legal Advisory Committee of the Corporate Governance Task Force of The Business Roundtable, to Linda C. Quinn, Director, Division of Corporation Finance, Securities and Exchange Commission, p. 5, BRT September 18, 1991 (on file in Commission's public File No. S7-22-91) [hereinafter 1991 BRT Letter]. The 1991 BRT Letter was written in response to the rule proposed by the Commission in Release No. 34-29315, *see supra* note 15.

53. Jonathon Jones, Kenneth Lehn, and J. Harold Mulherin, *Institutional Ownership of Equity: Effects on Stock Market Liquidity and Corporate Long-Term Investments*, in INSTITUTIONAL INVESTING: THE CHALLENGES AND RESPONSIBILITIES OF THE 21ST CENTURY 115-16 (Arnold W. Sametz, ed., 1991) [hereinafter, Jones, Lehn, and Mulherin].

54. *See, e.g.*, 1990 BRT Letter, *supra* note 50, at 5.

rate managers must principally be concerned with current returns. If current returns decline, institutions rush to the market and sell large blocks of the company's shares.[55] In turn, critics argue, this causes a disincentive to invest in research and development, which produces long-range returns.[56]

Second, stock markets allegedly are injured because of the volatility resulting from institutions' herd-like behavior.[57] Small increases in share price cause myopic institutions to buy large blocks of the company's shares, intent on capturing the short-term trend. Small declines result in institutions selling off large blocks,[58] intent on avoiding short-term declines. Institutions allegedly act in a herd-like manner in this regard, and therefore magnify market swings.[59] Critics argue that this herd-like trading decreases liquidity by frustrating market-makers' ability to provide continuous trading.[60] Market-makers thus increase their bid-ask spreads, and individual investors are required to pay higher transaction costs in trading stock.[61]

There is a dearth of quantitative evidence supporting the above hypotheticals. In fact, a recent study by Jonathan Jones, Kenneth Lehn, and J. Harold Mulherin, formerly financial economists at the Office of Economic Analysis, U. S. Securities and Exchange Commission, presents empirical evidence that the these fears are misplaced.[62] The Jones, Lehn, and Mulherin study ("JLM Study") analyzed data from two samples of firms. One sample consisted of firms with low institutional ownership ("LIO"), the other sample of firms with high institutional ownership ("HIO"). For each of the two samples, the JLM Study collected data for 1982, the year in which index futures were introduced, and 1988.[63]

The JLM Study involved two experiments. The first experiment tested critics' argument that the purported increases in volatility caused by institutional trading conduct decreases market liquidity for shares of companies with large institutional ownership.[64] The results showed that this was not the case. In the period between 1982 and 1988, stock price volatility decreased for both LIO and HIO stock, but the decrease was greater for HIO stocks.[65] Further, the bid-ask

55. Jones, Lehn, and Mulherin, *supra* note 53, at 116. *But see infra* note 68.

56. Jones, Lehn, and Mulherin, *supra* note 53, at 116.

57. *Id.*

58. *Id. But see infra* note 68.

59. Jones, Lehn, and Mulherin, *supra* note 53, at 116.

60. *Id.* at 121.

61. *Id.* at 117.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.* at 122.

spreads decreased for HIO and increased for LIO stocks.[66] Thus, transaction costs for all investors may actually have decreased because of institutional investing. These results indicate that the liquidity of a particular stock increases and volatility decreases as the amount of institutional ownership increases.

The second experiment considered whether the increase in institutions' investing caused a decrease in long-term corporate investment in research and development. The study found that institutions tended to invest in firms with higher research and development expenditures.[67] Thus, in the JLM Study, institutional investing appears to correspond to increased corporate research and development.

The JLM Study showed that the traditional concerns regarding institutions' "short-termism" may be misplaced. Assuming that institutions engage in short term investing,[68] the JLM Study shows that this conduct does not have the negative impact on corporate management and the markets that critics would have us believe. In fact, corporations with large institutional ownership appear to be more likely to engage in long-term research and development, and stock markets appear to actually benefit from the stabilizing influence of institutions.

C. Pension Fund Communications

For the reasons set forth above, pension funds have interests similar to those of Individual Shareholders. On the other hand, their resources will be similar to those of a Control Person. Accordingly, pension funds are more likely to communicate among themselves and otherwise exert influence to achieve goals that benefit Individual Shareholders. These communications should be fostered.

66. *Id.* at 118.

67. *Id.* at 123-24.

68. Whether or not institutions engage in short-term investment may be open to question. Because of the tremendous amount of total equity controlled by institutions, pension funds are likely to find it difficult to liquidate their holdings in particular companies. Such illiquidity may cause large institutional investors to retain their investments for long periods. California Public Employees' Retirement System (CalPERS) estimates that on the average it holds stocks for between six to ten years. *See* Letter from Richard H. Koppes, General Counsel, California Public Employees' Retirement System, to Linda C. Quinn, Director, Division of Corporation Finance, Securities and Exchange Commission, November 3, 1989 (on file in Commission's Public File No. 3-453) [hereinafter 1989 CalPERS Letter], *see supra* note 15.

IV. Third Party Communications

A. *Third Party Proxy Advisors*

Another type of communicator that, for purposes of this discussion, falls under the rubric of institution communications, are third party advisors. Third party advisors in this category are generally financially supported by institutions. Because of the economies of scale, institutions are willing to incur large expense not only in communicating and advocating, but also in research. This research includes not only traditional research into advisability of investing in a particular stock, but also ways to increase the value of an investment in a particular company's stock. This research may take the form of advice from third parties with respect to voting issues, both how to vote and whether to sponsor shareholder initiatives. Such third parties are likely, in most cases, to be acting at the behest of institutions, as such investors are the only shareholders who are likely to have sufficient funds to pay for the research. These third party communications will have the same goals as those of the institutions themselves. Thus, these third parties will generally reflect the interests of Individual Shareholders.[69]

B. *Third Party Commentators*

One final type of communicator defies categorization into the types described above. This is the disinterested financial or corporate commentator, including editorial writers in financial and business periodicals, and public interest groups. These communicators will often have interests that parallel shareholders in general, as, by definition, they will not engage in Control Activities. Restraint of these communications presents the most compelling constitutional problems.[70]

V. Communication Patterns

The sections that follow will isolate three specific patterns of communications and consider whether each specific pattern should be encouraged. After determining whether each pattern of communication should be encouraged, we will briefly consider whether federal securities laws regulate each particular pattern. In short, federal securities regulations are triggered by "solicitations" of proxies.[71] We will consider whether each pattern of communication is a "solicitation."

69. These third party proxy advisors must be distinguished from third party agent proxy solicitors. The agent solicitors communicate with shareholders on behalf of the principal. Such communications are properly viewed as communications of the principal itself.

70. First Amendment issues are beyond the scope of this paper.

71. *See infra* notes 95-134 and accompanying text.

The first of the three patterns is advocacy to large numbers of shareholders prior to or contemporaneously with an actual request for a proxy. This category includes all broad-based solicitations of shareholders, including management's solicitation concerning the annual meeting of shareholders, solicitations regarding Control Activities by management or Control Shareholders, solicitations in support of shareholder proposals required by rule 14a-8 to be included in management's materials, and solicitations contesting any of the aforementioned types of solicitations. Under federal securities laws, broad-based advocacy accompanied by a request for a proxy, and communications leading up to such requests, are solicitations subject to the proxy rules.[72]

We have seen that, for economic reasons, Individual Shareholders are unlikely to engage in broad-based solicitations, and are not able to protect their interests when opposing parties engage in such solicitations. Pension funds, however, are able to engage in such solicitations. Moreover, pension funds, in acting in their own interest, will protect Individual Shareholders' interests. For this reason, the proxy rules should be relaxed for broad-based shareholder communications.

The second pattern occurs where a shareholder "tests the waters" with small numbers of shareholders.[73] This pattern occurs when a shareholder communicates with a small sample of other shareholders regarding issues common to such shareholders. In this type of communication the shareholder will probe to determine whether other shareholders share the same concerns, and if so, to discuss alternatives to achieve desired results.[74] These communications usually address problems perceived by the communicator, and are initiated only when he is dissatisfied. It follows that these communications will al-

72. *Id.*

73. The American Bar Association refers to a similar concept of "idea testing," and argues that such communications should be permitted by an additional safe harbor from the definition of solicitation for "preliminary non-public communications among a limited number of shareholders or between the registrant and a limited number of shareholders." *See* Letter from James H. Cheek, III, Chairman, Committee on Federal Regulation of Securities, and Robert Todd Lang, Chairman, Subcommittee of Proxy Solicitations and Tender Offers, to Linda C. Quinn, Director, Division of Corporation Finance, U. S. Securities and Exchange Commission, p. 7 [hereinafter the "ABA Letter"] American Bar Association April 27, 1990 (on file in Commission's Public File No. 4-353). The ABA Letter was written and submitted to the Commission in response to the 1989 CalPERS Letter, *see supra* notes 15 and 68.

74. The ABA Letter describes the safe-harbor for "idea-testing" as "both practical and desirable: true dialogue—a communication flowing back and forth among the participants—is not effectively regulated by rigid item-by-item disclosure requirements or by preliminary filing of proxy materials." *See* ABA Letter, *supra* note 73, at 7.

most invariably shade into advocacy, and thus will be solicitations subject to the Commission's proxy rules.

A distinguishing feature of the testing the waters communication is that it may probe to determine mutual interests. As discussed previously, Individual Shareholders and pension funds will generally have a common, singular interest in increasing the economic value of their shares. Thus, this type of communication is likely to suit the needs of Individual Shareholders and pension funds.

This type of communication is less likely to precede Control Activities. In such activities, the benefit usually inures to a single individual or entity who, for example, enters into the transaction with the company. There is little reason to poll other shareholders to determine their opinion regarding a transaction that will benefit only the polling party. However, Control Persons may communicate with small numbers of shareholders in an effort to gain greater control by forming a Control Person block. This type of communication is similar to testing the waters because it is with a small number of shareholders. It is distinguishable, however, in that it is unlikely to occur among more than a few Control Persons; too large of a group would tend to be unwieldy. Further, section 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act"), and rule 13d-5(b)(1) discourage the formation of such "groups."[75]

Because institutions will be more likely to test the waters, and because such communications are likely to benefit Individual Shareholders, this type of communication should be encouraged. In the following sections we will look at current federal securities laws, which generally define these communications as solicitations.

The third pattern of communications are those originating from disinterested third party commentators. Third party commentators will have their own goals unrelated to Control Activities; for example, they may want respect for writing thoughtful, well-reasoned stories, or they may want the notoriety that comes with startling editorials. Both types of editorials benefit Individual Shareholders; although the latter type may cause panic or other impulsive actions, it is a tenet of our society that robust uninhibited debate is beneficial to readers, or, here, investors. Finally, the key feature of these communications is that by definition, they will not originate from parties

75. Section 13 and rules promulgated thereunder require, generally, that a "person" who acquires beneficial ownership of more than 5% of a section 12 registered equity security file with the Commission and distribute to the issuer an information schedule stating, among other things, the purpose of the transaction pursuant to which the person acquired the securities. 17 C.F.R. § 240.13d-101 (1991). "Person" is defined to include a "group" of persons who agree to act together for the purpose of "acquiring, holding, voting or disposing of equity securities of an issuer." 17 C.F.R. § 240.13d-5(b)(1) (1991).

with an interest in the transaction. For these reasons, such communications should be encouraged. In the following sections we will look at current federal securities laws, which are very unclear in this area. This murkiness inappropriately chills communications from third party commentators.

V. PROXY COMMUNICATION RULES

Authority for the Commission's proxy rules is conferred by section 14(a) of the Exchange Act.[76] Section 14(a) provides, generally, that it is unlawful to use the mails or any other instrumentality of interstate commerce to "solicit any proxy or consent or authorization" in respect to any security registered under section 12 of the Exchange Act in contravention of rules and regulations prescribed by the Commission.[77] The Commission's rulemaking authority extends to rules that are necessary or appropriate in the public interest or for the protection of investors.[78]

Pursuant to its rulemaking authority, the Commission requires that with certain exceptions, prior to or contemporaneously with any solicitation,[79] Schedule 14A Information[80] must be given to shareholders (hereinafter, the "Contemporaneous Requirement"). Generally, the Schedule 14A Information must be filed with the Commission ten calendar days before it is given to shareholders.[81]

76. Section 14(a) provides as follows:

> It shall be unlawful for any person, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section [12] of this title.

15 U.S.C. § 78n(a) (1982).

77. *Id.*

78. *Id.*

79. 17 C.F.R. § 240.14a-3 (1991).

80. *See supra* note 7.

81. 17 C.F.R. § 240.14a-6 (1991). "Plain vanilla" proxy statements need not be filed preliminarily. "Plain vanilla" proxy statements may not comment upon or refer to solicitations in opposition, but may include comments that relate only to the following:

> an annual (or special meeting in lieu of the annual) meeting, or for an investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a-1 *et seq.*] or a business development company, if the solicitation relates to any meeting of securityholders at which the only matters to be acted upon are: (1) the election of directors; (2) the election, approval or ratification of accountant(s); (3) a security holder proposal included pursuant to Rule 14a-8 [17 C.F.R. § 240.14a-6]; (4) with respect to an investment company registered

The exceptions to the Contemporaneous Requirement include "stop, look and listen" material in the case of election contests[82] and preemptive solicitations by opposing parties in non-election situations.[83] These communications may inform shareholders that a solicitation is imminent and alert them to the issues to be addressed. These materials must be filed five business days before use.[84] Thereafter, Schedule 14A Information must be sent or given to securityholders "at the earliest practicable date."[85] With the following exceptions additional soliciting material used after the original proxy statement must be filed two business days before its use.[86] The exceptions include: copies of speeches, press releases and scripts, which need only be filed or mailed for filing on the date such material is used or published;[87] and personal soliciting material and instructions, which must be filed five calendar days before use.[88] In the case of election contests, insurgents must file Schedules 14B five business days prior to commencement of a solicitation.[89] Management must file Schedules 14B five days after the registrant's solicitation.[90] The requirement that certain information be filed with the Commission ten, five, or two days before its use will be referred to as the "Preclearance Requirement." During this time, the staff reviews and comments upon the material.

Two exceptions allow solicitations without providing Schedule 14A

> under the Investment Company Act of 1940 or a business development company, a proposal to continue, without change, any advisory or other contract or agreement that previously has been the subject of a proxy solicitation for which proxy material was filed with the Commission pursuant to this rule; and/or (5) with respect to an open-end investment company registered under the Investment Company Act of 1940, a proposal to increase the number of shares authorized to be issued.

Id.

82. 17 C.F.R. § 240.14a-11(d) (1991).

83. 17 C.F.R. § 240.14a-12(a) (1991). In non-election situations, the stop, look and listen solicitation may be made only in opposition to a prior solicitation, invitation for tenders, or other publicized activity, which if successful, could effectively defeat the action proposed to be taken at the meeting. *Id.* at (a)(1).

84. 17 C.F.R. § 240.14a-11(e) (1991); 17 C.F.R. § 240.14a-12(b) (1991).

85. 17 C.F.R. § 240.14a-11(d)(4) (1991); 17 C.F.R. § 240.14a-12(a)(4) (1991).

86. 17 C.F.R. § 240.14a-6(b) (1991).

87. 17 C.F.R. § 240.14a-6(h) (1991).

88. 17 C.F.R. § 240.14a-6(d) (1991).

89. 17 C.F.R. § 240.14a-11(c) (1991). Schedule 14B must be filed by each "participant" in a solicitation regarding an election contest. Information required in Schedule 14B includes the participant's identity and background; interests in securities of the registrant, including beneficial and record ownership, dates of recent purchases, funds borrowed to purchase securities, contracts and arrangements or understandings with respect to the registrant's securities; circumstances in which such person became a participant; nature of activities as a participant; certain relationships and transactions with the registrant; arrangements or understandings with respect to future employment by the registrant, and future transactions with the registrant; and total amount contributed or proposed to be contributed in furtherance of the solicitation if such amount exceeds $500. 17 C.F.R. § 240.14a-102 (1991).

90. 17 C.F.R. § 240.14a-11(c) (1991).

Information at all. The first exception occurs where the total number of Solicitees is ten or fewer, and the solicitation is not made on behalf of the issuer.[91] The second exception is for the furnishing of proxy voting advice by an advisor to another party with whom the advisor has a business relationship.[92] There are four requirements that must be satisfied to fall within the advisor exception,[93] the most important for present purposes is that the advisor render financial advice in the ordinary course of his business.[94]

The above rules and exceptions are applicable when there is a "solicitation." The term "solicitation" was interpreted in a line of cases that form the basis for the Commission's current definition. The original proxy rules, promulgated in 1935, defined "solicitation" to include, "the communication of any request or application to a security holder for a proxy, consent, or authorization."[95] In the early years a "solicitation" was not found unless there was an actual request for a proxy.[96] When a "solicitation" occurred the Commission's rules regarding fraudulent statements[97] and furnishing of prescribed information were triggered.[98] Filing was required no later than the date

91. 17 C.F.R. § 240.14a-2(b)(1) (1991).

92. 17 C.F.R. § 240.14a-2(b)(2) (1991).

93. A person falls within the "advisor" exception if:

(i) The advisor renders financial advice in the ordinary course of his business;

(ii) The adviser discloses to the recipient of the advice any significant relationship with the registrant or any of its affiliates, or a security holder proponent of the matter on which the advice is given, as well as any material interests of the advisor in such matter[;]

(iii) The advisor receives no special commission or remuneration for furnishing the proxy voting advice from any person other than a recipient of the advice and other persons who receive similar advice under this subsection; and

(iv) The proxy voting advice is not furnished on behalf of any person soliciting proxies or on behalf of a participant in an election subject to the provisions of Rule 14a-11.

17 C.F.R. § 240.14a-2(b)(2)(i) - (iv) (1991).

94. 17 C.F.R. § 240.14a-2(b)(2)(i) (1991).

95. *Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency*, 73d Congress, 2d Sess. 1 [hereinafter Exchange Act Release No. 378] (1935), "solicitation" was 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."

96. *See generally* Securities and Exchange Commission v. Okin, 132 F.2d. 784 (2d Cir. 1943); Exchange Act Release No. 378, *supra* note 95.

97. *See* Exchange Act Release No. 378, *supra* note 95, ("no proxy may be solicited by means of any communication or statement which is false or misleading with respect to any material fact").

98. *See* Exchange Act Release No. 378, *supra* note 95, (prescribing disclosure including information concerning who initiated the solicitation and the amount of securities owned by such person, whether any person was compensated for soliciting or

of the solicitation.[99]

The Commission's early proxy rules allowed liberal shareholder communications, yet protected shareholders at the commencement of what might be a Control Activity. The rules permitted unregulated shareholder communications, including those of Individual Shareholders and Control Persons, prior to the time of the request for a proxy. When a proxy was actually requested, however, the Commission determined that Individual Shareholders needed the protection of laws requiring certain information be disclosed so that the investor could make an informed decision in giving his proxy.[100]

Under the rules of 1935, statements made in shareholder communications prior to a request for a proxy were not covered by any federal law, including federal securities antifraud laws. Further, this was so even if a "solicitation" or an actual request for a proxy was imminent. The first extension of the definition of "solicitation" occurred out of necessity to regulate false and misleading material mailed to shareholders.

A. *Securities and Exchange Commission v. Okin*[101]

Defendant Okin mailed a materially false and misleading letter to the shareholders of Electric Bond and Share Company. The letter asked the shareholders to prevent a quorum at an upcoming meeting by not signing proxies for the company, and revoking any which they might already have signed. The complaint alleged that if he were successful in preventing a quorum, Okin intended thereafter to solicit proxies.

Federal securities antifraud rules did not cover pre-solicitation communications. Thus, the court needed to find that the communication was a solicitation of a "proxy, power of attorney, consent or authorization" in order to find that the Commission had jurisdiction to regulate the communication.

The court hesitated at finding the letter to be a solicitation, but found that the Commission had authority that extended beyond the power to regulate solicitations of proxies.[102] The Court determined that because Okin intended to follow up by "actually soliciting proxies," the Commission could regulate the communication under its

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recommending the execution of proxies and if so the name of the person on whose behalf such solicitation or recommendation was made; the matters to be considered in the exercise of the proxy, and action proposed to be taken by the grantee of the proxy).

99. *Id.*

100. Unfortunately, the early rules did not require that any information be provided in the case of Control Activities that took the form of tender offers.

101. 132 F.2d 784 (2d Cir. 1943).

102. *Id.* at 786.

power to regulate proxies.[103] The Commission's new authority included the power to regulate "writings which are part of a continuous plan ending in solicitation and which prepare the way for its success."[104]

This first extension of the proxy solicitation rules was essential, as no other federal securities antifraud laws were triggered absent a purchase or sale. The court noted the need for regulation in this area:

> We have no doubt that the [proxy regulation] power extends to such writings; were it not so, an easy way would be open to circumvent the statute; one only need spread the misinformation adequately before beginning to solicit, and the Commission would be powerless to protect shareholders.[105]

Okin demonstrates the compelling need for Commission antifraud regulation of pre-solicitation communications. The court recognized the need and correctly applied the prohibitions against fraudulent solicitations to communications that lead up to the solicitation.

The ruling retained the same definition of "solicitation" for both antifraud and disclosure purposes. This was not essential to the decision; the court could have distinguished the time at which a solicitation occurred for purposes of, on the one hand, antifraud rules, and on the other, prescribed disclosure and filing rules. Remember, the court took judicial liberty in applying solicitation rules to communications that the court admitted were not solicitations but rather presolicitation communications.[106] The effect of *Okin* was to expedite the time at which a solicitation was deemed to occur.

Okin specifically addressed the first of the three types of communications identified earlier. *Okin* held that broad-based advocacy prior to a request for proxies is, in all cases, a "solicitation."

The significance of *Okin* with respect to the second category, testing the waters with a small number of shareholders, is not as clear. Dicta suggests that the court was prepared to find a solicitation in early communications: "The early stages in the execution of such a continuous purpose must be subject to regulation, if the purpose of Congress is to be fully carried out."[107]

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103. *Id.*
104. *Id.*
105. *Id.*
106. The court noted that solicitations of a proxy, power of attorney, consent, or authorization regarding any security are subject to the Commission's regulations, but noted that "it would be going too far to say that the letter in controversy was a solicitation of any of these." *Id.*
107. *Id.*

Under the *Okin* test, the third type of communication, those of third party proxy advisors or disinterested commentators, probably would not be solicitations. The court appeared to apply a subjective test to determine whether there was a solicitation. The court required a "plan" on the part of the communicator, that was to culminate in an actual request, apparently by the communicator, for the giving or withholding of a proxy.[108] Disinterested or minimally interested third party commentators or proxy advisors may plan to influence shareholders, but by definition they will not request that proxies be given to themselves.

B. 1956 Amendments

The early to mid-1950s saw a tremendous preoccupation with the increasing number of proxy contests. One writer of the period described the climate as follows:

> During the past two years the advent of the large-scale "proxy contest" has treated the American public to a revealing view of the business community. Perhaps never before has the layman felt as keen an interest in business, for the nationwide proxy contest has provided a natural set of emotion-packed attractions. When the public is served liberal portions of football coaches' and movie stars' views of the corporate management, multi-page stories on the campaigns of the "ins" and "outs" on Life magazine, and full-page advertisements in newspapers throughout the country, the campaign takes on all the flavor of a "World Series of Business." The proxy contest has truly caught the American fancy.[109]

The Commission, in its rulemaking authority, responded by crafting a rule that specifically mandated the *Okin* result; prescribed disclosure must be made much earlier in the course of a solicitation. The rule continued to require disclosure at the time of a solicitation, but the statutory definition of solicitation was expanded to include "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."[110]

The Commission's response was prudent in view of the business climate. As the above quote demonstrates, a great deal of communication was occurring. But the communications were, generally, quite expensive. An Individual Shareholder was not likely to hire a movie star to advocate on his behalf because the marginal benefit to be received would be overwhelmed by the expense.

The Commission's rule did not focus on the number of solicitees, but made clear that the first category of communications, broad-

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108. The court noted that "[i]f the complaint had not alleged that the defendant intended to follow up [the letter] by actually soliciting proxies . . . we should indeed have great doubt about whether it stated a cause of action." *Id.*

109. Broehl, Wayne G., *The Proxy Battle*, (the Amos Tuck School of Business Administration) (1955).

110. 17 C.F.R. § 240.14a-1(l) (1991).

based advocacy, are solicitations even if a proxy is not specifically requested. The rules did little to clarify whether testing the waters with a small number of shareholders is a solicitation. By essentially codifying the *Okin* decision, however, the 1956 amendments probably captured such communications.

In the 1956 amendments the Commission went beyond *Okin*, and established an objective standard for the "solicitation" determination. The purported Solicitor's intent to eventually solicit proxies himself was irrelevant, the rule looked to whether the communication was "reasonably calculated" to result in the procurement, withholding or revocation of a proxy. This rule and subsequent caselaw can operate to bring within their ambit disinterested independent commentators and third party proxy advisors.[111]

The new rule particularly stifled communications from disinterested commentators. One commentator notes that

> Prior to 1956, the market for private information and opinions, particularly in proxy contests, was robust and becoming stronger with the growing size of proxy campaigns. In major pre-1956 campaigns, nationally prominent newspapers often took explicit editorial positions. Value Line, a leading source of retail-level investment analysis for small investors, made explicit voting recommendations in many major contests. These recommendations were sufficiently important and respected that they were often reported in the New York Times and the Wall Street Journal.[112]

After the 1956 amendments, however, the market for private analysis and third party recommendations on proxy voting issues "ceased to exist."[113]

C. *Studebaker Corporation v. Gittlin*[114]

Gittlin was one of the first important cases that tested the amended rules. A New York state law gave shareholders access to shareholder lists only if the requesting party submitted authorizations from five percent of the shareholders. Gittlin, on behalf of himself and forty-two other shareholders who had given Gittlin written authorizations, requested access to Studebaker's stockholders list. Gittlin wanted Studebaker management to agree to certain changes in its board, and he announced his intention to solicit proxies for the

111. *See infra* notes 135-43 and accompanying text.

112. John Pound, *Proxy Voting and the SEC: The Case for Deregulation* at 24 (December, 1989) (unpublished paper by Assistant Professor of Public Policy, Kennedy School of Government, Harvard University, on file with the PEPPERDINE LAW REVIEW).

113. *Id.* at 23-24.

114. 360 F.2d 692 (2d Cir. 1966).

forthcoming annual meeting if his request was not granted. Studebaker alleged that because he had not filed proxy materials, Gittlin must have obtained the authorizations in violation of Commission rules prohibiting proxy solicitations prior to filing.[115]

The court found that Gittlin's solicitation of authorizations was subject to the Commission's proxy regulation because it was "part of 'a continuous plan' intended to end in solicitation and to prepare the way for its success."[116] The court found that such a continuous plan should be covered by proxy regulation because "[p]resumably the stockholders who gave authorizations were told something and, as Judge L. Hand said in *Okin*, 'one need only spread the misinformation adequately before beginning to solicit, and the Commission would be powerless to protect shareholders.' "[117]

Gittlin is important in the present discussion for three reasons. First, the court followed the *Okin* line of cases and found a solicitation in the initial stages of a "continuous plan" intended to culminate in a request for proxies.

Second, *Gittlin* failed to equate the self-interests of Control Persons and management. As such it was the precursor of proxy regulation that has tilted the playing field in favor of management.[118] The court assumed that management will have the interests of the corporation at heart. The court's trusting belief that management acts strictly for the benefit of the corporation contrasted with its distrust of non-management groups:

> The legislative history shows that Congress anticipated protection from "irresponsible outsiders seeking to wrest control of a corporation away from honest and conscientious corporate officials,". . . and the Proxy Rules are shot

115. At the time of Gittlin, the definition of the Commission's proxy regulation power specifically included "authorizations." Rule 14a-1. Gittlin argued that the Commission's proxy regulation power only extended to proxies, authorizations, or consents with respect to a *vote* by securityholders. The Commission's view was that requesting an authorization is a proxy solicitation, whether or not it is "a step in a planned solicitation of proxies." 360 F.2d at 695. The Commission stated that section 14(a) should be construed to include all "situations in which a stockholder is requested to permit another to act for him, whatever may be the purpose of the authorization." *Id.* at 696 n.2. The court specifically declined to accept the Commission's broad interpretation of section 14(a) and rule 14a-1. *Id.* at 696.

116. *Id.* at 696.

117. *Id.*

118. Although such a tilt has not occurred with respect to the definition of "solicitation," management has advantages in that it may mail "plain vanilla" proxy statements contemporaneously with filing, *see supra* note 81, and may file Schedules 14B five business days *after* it makes a solicitation subject to rule 14a-11. Rule 14a-11(c)(2). In the case of "plain vanilla" proxy statements pertaining to elections of directors, the Commission's staff permits management to mail the soliciting materials to securityholders without prefiling even if insurgents have announced that they intend to conduct an opposing solicitation. Management's soliciting materials may not refer to the opposing solicitation, and such failure to refer to the opposing solicitation may not cause management's materials to be false or misleading. Release 34-29315, *supra* note 11, at 28,992 n.51.

> through with provisions recognizing that in contests for control the management has a role to play as such and not merely insofar as the managers are stockholders.[119]

The third point in *Gittlin* may be the most significant, for it was not a mere affirmation of earlier rules. *Gittlin* implies that testing the waters with, or advocating to, small numbers of shareholders are solicitations. The court found it unnecessary to address whether Gittlin solicited all of Studebaker's shareholders. The fact that he held authorizations from forty-two shareholders meant that he had solicited forty-two shareholders, and was regulated by the proxy rules. Thus, by 1966, it had become clear that the number of persons (in excess of ten) with whom a shareholder tests the waters or advocates is irrelevant for purposes of determining whether there is a solicitation.[120]

D. *Recent Cases*

1. Testing the waters

After *Gittlin*, it is clear that advocacy to a large number of shareholders prior to the request for a proxy is a solicitation. Cases have also demonstrated that the number of Solicitees is irrelevant as long as the safe harbor for solicitations of ten or fewer shareholders is unavailable.

More recent cases shed little light on the factors that distinguish testing the waters on one hand, and advocating or soliciting on the other. One case frames the question as determining the "fine line between gauging the market pulse and drumming up support."[121]

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119. 360 F.2d at 695.

120. Note that this result is implicit in the Commission's exemption for solicitations of ten or fewer shareholders, which existed as rule 14a-2(a) at the time of *Gittlin*.

121. Pantry Pride, Inc. v. Rooney, 598 F. Supp. 891, 902 (S.D.N.Y. 1984). This case involved a proxy contest for control of Pantry Pride, Inc. ("Pantry Pride"). The court acknowledged that defendant Patrick Rooney "straddled the fine line between gauging the market pulse and drumming up proxy support," but ultimately determined that Rooney's contacts with Arthur Goldberg, Philip Devon and eight institutions "were designed to merely assess possible reactions to a proxy fight," and that there was "no hard evidence of [Rooney's] untimely solicitation of more than ten shareholders." *Id.*

A discussion of the facts of *Pantry Pride* would be lengthy and unhelpful. The case details Rooney's contacts with Goldberg, Devon and one or two institutions. But the court specifically finds only that Rooney did not solicit more than ten persons. The only relevant facts concern the contacts with the eleventh person who may have been solicited. The court's discussion of these contacts is limited to the following cursory description of the conversations in which the eleventh solicitation would have occurred:

> In his role as stockbroker, Rooney also spoke with representatives from many of Pantry Pride's largest institutional shareholders during September and Oc-

Although the number of Solicitees appears to be irrelevant, courts that are called upon to determine whether a solicitation has occurred usually address a solicitation of a small sample of shareholders. Typically, broad-based communications are understood to be solicitations and the Solicitor prefiles and circulates a proxy statement. Communications to smaller numbers of shareholders, however, typically involve multiple nonwritten communications. It is in the latter case that courts are called upon to determine whether a solicitation has occurred; not so much because of the numbers as because of the multiple nonwritten nature of the communication. These cases are necessarily fact driven, as it has proved impossible to establish a bright line test.

Cases have found that communications to the financial community and the press, intended to "influence shareholder opinion," may be a solicitation if the standards of *Okin* and *Gittlin* are satisfied.[122] Further, the filing of information that is required to be filed with the Commission is not necessarily a solicitation, but it may be a solicitation if the filing attempts to "influence" shareholders in a planned proxy battle by including information not required to be filed.[123] Finally, one case found that by definition all participants in a section 13(d) group,[124] whose purpose is to conduct a proxy contest for control, must have been solicited.[125]

One interesting case concerns communications among members of a dissident committee. In *Calumet Industries Inc. v. MacClure*[126] the court found that *Okin* does not compel an interpretation that solicitation includes "any communication which may eventually influence the giving of proxies when they are actually requested."[127] The court went on to find that organizational communications among members

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> tober. Some of these conversations in October concerned the poor performance of Pantry Pride management and the possibilities of a proxy fight.

Id. at 895.

122. Trans World Corp. v. Odyssey Partners, 561 F. Supp. 1315, 1322 (S.D.N.Y. 1983). In this case defendant shareholders presented a non-binding shareholder resolution that Trans World Corporation ("TWC") spin-off or sell certain of its subsidiaries. The resolution was to be presented and voted upon at the annual shareholders meeting. Plaintiff TWC sued, alleging that defendant solicited prior to filing and without presenting prescribed disclosure. The case came before the court on a motion to dismiss for failure to state a claim. The court found that a section 14(a) claim was sufficient where defendants were charged with communicating to the financial community in an effort to influence shareholder opinion.

123. *Id.* at 1320.

124. *See supra* note 75.

125. Cook United, Inc. v. Stockholders Protective Committee of Cook United, Inc., 1979 WL 1209 (D.C.N.Y.) [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,875 at 95,579 (S.D.N.Y. May 21, 1979) (not reported in F. Supp., but available on Westlaw and LEXIS).

126. 464 F. Supp. 19 (N.D. Ill. 1978).

127. *Id.* at 32. *But cf.*, Long Island Lighting Co. v. Barbash, 779 F.2d 793, *infra* notes 137-43 and *Trans World Corp. v. Odyssey Partners*, 561 F. Supp. 1315, *supra* note

and supporters of a dissident committee did not constitute a solicitation. *Calumet* is difficult to analyze. First, the court did not enunciate the criteria for its finding. Second, the factual determination is unclear: as in *Pantry Pride*, plaintiff alleged that more than ten shareholders were solicited, but the court's broad finding implies that not even one solicitation occurred pursuant to the organizational communications.

In *Scott v. Multi-Amp Corporation*[128] management of Multi-Amp Corporation ("M-A") undertook a management buyout. Plaintiffs sued management alleging, among other things, that the buyout price was grossly inadequate and that management used materially false and misleading proxy solicitation material. Management's counterclaim argued that plaintiffs' communications with other shareholders opposing the transaction amounted to a solicitation. In the present context the case is important because of the court's decision in the counterclaim that the shareholder communications were not solicitations.

The court's reasoning in ruling on the counterclaim is curious. The court determined that the test for a solicitation applies the same considerations that determine whether a group has been formed under section 13(d).[129] The test to determine whether a group has been formed, triggering the Williams Act filing requirement, turns on whether two or more persons "*agree* to act together."[130] Under this test, the conduct of the purported Solicitor and the content of the solicitation are irrelevant; a solicitation occurs when a shareholder agrees with the proponent.

Nonetheless, the court made the following finding:

> This court does not believe that the term "solicitation" was intended to apply to communications from one stockholder, who is opposed to a transaction, to another, who is also opposed, or to meetings among shareholders who are of all the same mind that M-A's directors are acting unfairly in connection with the sale of assets and liquidation of the corporation. Persons who have invested money in a corporate entity should be free to express their mutual concern among themselves when there exists a plan to liquidate the corporation. The mere fact that these persons are shareholders does not raise such commu-

115 (which framed the issue as whether the communication was made "in an effort to influence shareholder opinion"). *Id.* at 1320.

128. 386 F. Supp. 44 (D.N.J. 1974).

129. The court stated, "[T]his court does not view the discussions between NSRC and other shareholders opposed to the transaction in question as substantial enough to trigger the filing requirements of the Williams Act. The same considerations apply with equal force to the proxy regulations." *Id.* at 73.

130. 17 C.F.R. § 240.13d-5(b)(1) (1991).

nications to the level of proxy solicitation.[131]

The justification for the court's holding is elusive. The court's holding cannot turn on the lack of an "agreement"[132] between the shareholders, because as the above quote demonstrates, the shareholders were "all of the same mind." The court also seems to imply that solicitations must be broad requests to all shareholders.[133] The case probably can be fairly read only to apply to its specific facts.

If the cases are clear on any point, it is that a shareholder can never be sure when his communications with other shareholders will be a solicitation. This is so even if he tries to test the waters; he contacts the eleventh shareholder at his peril.[134] Under the caselaw, it is difficult to imagine a case where a shareholder will not attempt to "influence" other shareholders when he discusses matters of concern or even states his own opinion.

2. Third Party Communications

As previously discussed, the language of the Commission's rules appears to reach communications from third party commentators. The question turns on whether these communications are "reasonably calculated to result in the procurement, withholding or revocation of a proxy."[135] This appears to be an expansion of *Okin*, which seems to require that the plan culminate with a request, by the original communicator, for a proxy.[136] The language of rule 14a-1(l) does not require that the Solicitor have any relationship with the individual making the ultimate request for a proxy.

The quintessential example of this type of communication is a commentator's editorial. "Reasonably calculated" seems to imply a plan, on the part of the communicator, to cause proxies to be given. Query whether one can have a plan unless he also has an interest in, or a reason for trying to obtain, the proxies. The typical interest is own-

131. *Scott v. Multi-Amp Corp.*, 386 F. Supp. at 73 (citations omitted).

132. *See supra* note 130 and accompanying text.

133. *See supra* note 131 and accompanying text, as well as the following statement: "There is evidence to indicate that these shareholders were contemplating litigation to forestall approval of the sale at the annual meeting. This, however, does not prove that a solicitation in opposition was in the offing." Scott v. Multi-Amp Corp., 386 F. Supp. at 73.

134. Note that where a shareholder solicits eleven or more shareholders, a violation occurs if the shareholder does not provide the Schedule 14A Information to the *solicited* shareholders and file it with the Commission. There is no specific requirement that unsolicited shareholders be given the Schedule 14A Information. If a solicited shareholder is not given the Schedule 14A Information, the Commission may file an injunctive action under rule 14a-9. There is almost certainly a private right of action under 14a-9 pursuant to J.I. Case Co. v. Borak, 377 U.S. 426 (1964) and progeny, for solicited shareholders who are damaged because they did not receive the Schedule 14A Information.

135. 17 C.F.R. § 240 (1991).

136. *See supra* note 108 and accompanying text.

ing shares. But third party commentators may also have an interest in causing shareholders to give or withhold proxies. An editorial that supports a proposed slate of dissident directors may be calculated to do more than express an opinion; it may be "calculated" to result in proxies being given for their election.

The very essence of an editorial is to advocate for one's position; to cause another to believe and act in the manner advocated. An editorial surely is calculated to result in the reader/listener acting as urged. In a strict interpretation of the language of rule 14a-1, an editorial is almost certainly a solicitation. The leading case in the area bears this out.

In *Long Island Lighting Company v. Barbash*,[137] Long Island Lighting Company ("LILCo") was entangled in a public controversy concerning the safety and construction cost of a nuclear power plant, electricity rates, and recent electricity service problems. Defendant Matthews was a political candidate whose platform centered on LILCo issues.[138] Defendant Citizens Committee to Replace LILCo (the "Committee") was formed for the purpose of challenging LILCo's construction of the nuclear plant and its service and rates, and replacing LILCo with a municipally owned utility company.

The Committee published newspaper advertisements that accused LILCo of mismanagement and attempting to pass through to ratepayers needless costs relating to the construction of the nuclear power plant. The ad at issue argued that ratepayers would be better off if LILCo were replaced with a state-run entity. The ad asked readers to join the Committee and give it financial support.[139]

LILCo alleged that the defendants acted in concert to publish the ad, and the ad was a proxy solicitation because its purpose was to influence the exercise of proxies by LILCo shareholders. LILCo asked for an injunction until the defendants filed Schedule 14A Information with the Commission and corrected alleged false statements in the ad. The court reversed the district court's summary judgment for the defendants, finding that proxy rules may cover communications appearing in publications of general circulation that are indirectly addressed to shareholders.[140]

137. 779 F.2d 793 (2d Cir. 1985).

138. A company controlled by Matthews requested a copy of LILCo's shareholder list for the purpose of communicating regarding the election of LILCo's board and proposed sale of LILCo to Nassau and Suffolk Counties.

139. 779 F.2d at 797 (Winter, dissenting).

140. 779 F.2d at 795.

The LILCo defendants are a hybrid of the commentator (with no economic interest as shareholder) and shareholder (with an economic interest in his shares) archetypes. On the one hand, one of the actors-in-concert held shares, but on the other hand, the communication was commentary concerning a public interest matter unrelated to shareholder interests.[141] The appellate court, however, addressed the issues with broad strokes. The court held that communications are solicitations where they may "indirectly accomplish" the furnishing, revoking, or withholding of a proxy.[142] The court stated: "The question in every case is whether the challenged communication, seen in the totality of circumstances, is 'reasonably calculated' *to influence* the shareholders' votes."[143]

LILCo further held that the question does not turn on whether the communication is "targeted directly" at shareholders.[144] Under the *LILCo* test, commentaries in widely circulated publications advocating a particular result in a contested matter are solicitations because they are aimed at influencing readers, including shareholders.

E. The Commission's Proposed Proxy Rule Revisions

In accordance with its stated goal of "informed proxy voting,"[145] the Commission, in June 1991, issued Release Number 34-29315,[146] (the "1991 Release") proposing several amendments to its proxy rules which were intended to "facilitate securityholder communications."[147] In July 1991 the forty-five-day comment period, originally scheduled to expire in August 1991 was extended through September 1991.[148] In November 1991 Commission Chairman Richard C. Breeden announced that the Commission's proposals put forth in the 1991 Release would be revised, and requested further public comment prior to going forward with final action on the initiatives.[149] On June 23, 1992, the Commission issued its long-awaited revised

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141. As the dissent points out, the Committee was "obviously disinterested" in the return on investment to LILCo's shareholders. *Id.* at 798 (Winter, dissenting).

142. *Id.* at 796.

143. *Id.* (emphasis added) (citations omitted).

144. *Id.*

145. Release No. 34-29315, *supra* note 13, at 28,987.

146. *Id.*

147. *Id.*

148. Regulation of Securityholder Communications, Release No. 34-29397, 56 Fed. Reg. 31,349 (1991).

149. Chairman Breeden stated:

> The Commission has received widespread comment on its proposals, and a number of useful suggestions for changes have been made. In addition, some commenters apparently misunderstood the fact that large institutional shareholders acting in concert would have remained under continuing disclosure obligations under the federal disclosure rules. Therefore, because of the importance of proxy issues to management, shareholders and the capital markets generally, we believe it would be best to revise the existing proposals to

proxy rule proposals (the "1992 Release").[150] The 1991 Release and the 1992 Release propose, among others, the following proxy rule revisions.

Under the 1991 Release, a "disinterested person's" communications with, or solicitations of securityholders would be exempt from all proxy solicitation rules except the antifraud provisions of rule 14a-9. To qualify as "disinterested," a person must not have a "material economic interest . . . , other than as a security holder of the registrant," in the matter concerning which he solicits; seek the power to act as proxy; or furnish or otherwise request a consent or authorization of a securityholder for delivery to the registrant. A person who acts on behalf of a person who fails to satisfy the "disinterested person" test would likewise not qualify as "disinterested." Securities ownership of any person engaged in a solicitation of proxies would not constitute a "material economic interest" unless the amount of securities owned gave rise to affiliate status. Mere employment by the registrant, other than as an officer or director, would likewise ordinarily not establish a disqualifying interest. Notes to the proposed rule set forth examples of relationships that would give rise to a presumption that the person had a disqualifying "material economic interest."[151]

The 1992 Release reproposed the "disinterested person" exemption, with some refinements. The revised proposal replaced the notes describing disqualifying relationships with a list of specific ineligible persons.[152] Additionally, the term "disinterested" used in the 1991

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reflect the public comments, and then to publish the revised proposals for further comment, prior to moving forward.

U.S. Securities and Exchange Commission press release (No. 91-68), November 20, 1991.

150. Release No. 34-30849, *supra* note 14. On the same day, the Commission issued Release No. 34-30851, 57 Fed. Reg. 29,582 (July 23, 1992), which proposed amendments to management compensation disclosure requirements in proxy statements, periodic reports and other filings with the Commission. The amendments are intended to give shareholders clearer, more concise information regarding management compensation and the directors' bases for making such compensation decisions. *Id.* at 29,582-83.

151. Release No. 34-29315, *supra* note 13, at 28,990-94.

152. Under the 1992 Release, the following solicitations would be exempt:

(1) Any solicitation by or on behalf of any person who does not 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, and does not act on behalf of a person who furnishes or requests, a consent or authorization for delivery to the registrant. *Provided, however*, that the exemption set forth in this paragraph shall not apply to:

(i) The registrant, an officer, director, affiliate, or associate of the registrant, or any person serving in a similar capacity;

(ii) An affiliate of a person ineligible to rely on the exemption set forth in this

Release to describe those eligible to use the rule was deleted from the title of the exemption in recognition of the fact that all shareholders have an economic interest in the subject matter of a vote. Finally, the 1992 Release proposes that those who rely on the exemption, in certain circumstances give public notice of their reliance on the exemption. The notice requirement, however, would not apply to oral solicitations.[153]

In the 1991 Release, the Commission proposed to eliminate preliminary filing requirements for all soliciting materials other than the proxy statement and form of proxy. These materials instead would be filed or mailed for filing at the time they are first used. Further, although the proxy statement and form of proxy must be filed ten days prior to use, the proxy statement and form of proxy would no longer be non-public, but would become public immediately upon filing in preliminary form. Because the proxy statement would be public, it could be used in preliminary form immediately upon filing, as long as the proxy card was not used prior to the shorter of ten days or clearance by the staff. The Commission specifically requested comment concerning the appropriateness of eliminating either of, or both, the preliminary filing requirement and confidential (*i.e.*, non-public) treatment in the context of the following three types of transactions: election contests and other contested solicitations, securityholder proposals subject to rule 14a-8, and mergers and other extraordinary transactions.[154]

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paragraph, and any officer, director or associate of such ineligible person, or any person serving in a similar capacity;

(iii) Any nominee for whose election as a director proxies are solicited;

(iv) Any person soliciting in opposition to a tender offer, merger, recapitalization, reorganization, sale of assets or other extraordinary transaction recommended or approved by the board of directors of the registrant who is proposing or intends to propose an alternative transaction to which such person or one of its affiliates is a party;

(v) Any person who is required to report beneficial ownership of the registrant's equity securities on Schedule 13D [17 C.F.R. 240.13d-101], unless such person has filed a Schedule 13D and has not disclosed pursuant to Item 4 thereto an intent, or reserved the right to, engage in a control transaction, including a contested solicitation for the election of directors;

(vi) Any person who receives compensation from an ineligible person directly or indirectly related to the solicitation of proxies;

(vii) Where the registrant is an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*), an "interested person" of that investment company, as that term is defined in section 2(a)(19) of the Act (15 U.S.C. 80a-2);

(viii) Any person who, because of a substantial interest in the subject matter of the solicitation, will receive a benefit from a successful solicitation that is not shared pro rata by all other holders of the same class of securities; and

(ix) Any person acting on behalf of any of the foregoing.

Release No. 34-30849, *supra* note 14, at 29,577.

153. *Id.* at 29,567-68.

154. Release No. 34-29315, *supra* note 11, at 28,990-94.

The 1992 Release reproposed the preliminary filing proposal in substantially the same form. In response to comments concerning the appropriateness of eliminating confidential treatment in the case of business combinations, the Commission proposed to grant, upon request, confidential treatment of consolidations, acquisitions, and similar matters that are subject to Item 14 of Schedule 14A and not yet public. Confidential treatment would not be granted to "going private" and roll-up transactions.[155] The Commission also noted that it is considering, and requests comment on, exempting from the preliminary filing requirement certain proxy statements, including those used in election contests by management and insurgents. Finally, the Commission proposed that a Schedule 14B be filed by both management and insurgents within the earlier of five business days following each party's commencement of a solicitation or five business days prior to the dissemination of a definitive proxy statement.[156]

In the 1992 Release the Commission did an about-face on the 1991 Release proposal that would have granted securityholders far greater access to lists of shareholders. In the 1992 Release, in most circumstances the registrant would continue to have the option of mailing securityholder soliciting material rather than providing a shareholder list. The registrant would be required to furnish a shareholder list only if the registrant had commenced a roll-up or going private transaction, or such a transaction had been disclosed.[157]

The 1992 Release also proposes that the proxy rules be revised to do the following:

1. Exclude from the definition of solicitation public announcements by shareholders of how they intend to vote and the reasons for such vote. This exemption would only be available if the shareholder was not otherwise soliciting proxies.[158]

2. Eliminate the separate exception for stop, look and listen solicitations in election and non-election contests. In addition, the proposed rules would eliminate the requirement that the solicitation be made in response to an opposing solicitation or other public activity that could frustrate a planned solicitation, and the requirement that the stop, look, and listen materials be filed five days before use.[159]

155. *I.e.*, transactions subject to rule 13e-3, 17 C.F.R. 240.13e-3, or item 901(c) of regulation S-K, 17 C.F.R. 229.901(c).

156. Release No. 34-30849, *supra* note 14, at 29,568-69.

157. *Id.* at 29,569-71, *see also supra* note 155.

158. *Id.* at 29,571-72.

159. *Id.* at 29,572, *see supra* note 83.

3. Except from the proxy statement delivery requirement solicitations in speeches, newspapers, magazines, press releases, and other publications or broadcasts. To come within the exception, a definitive proxy statement must be on file with the Commission at the time of the solicitation, and a proxy card may not be furnished in connection with the excepted solicitation. The exception would apply even if the communicating party had previously commenced a non-excepted solicitation.[160]

4. Require unbundling of proxy card proposals. Under this proposal individual related proposals must be set forth separately rather than in a group. Soliciting parties could, however, condition the effectiveness of any proposal on the adoption of any other proposal.[161]

5. Revise the "bona fide nominee" rule to permit persons soliciting proxies for minority board representation to round out their slates with management nominees.[162]

6. Require disclosure in the registrant's periodic reports of the number of votes cast for, against or withheld, or as abstentions, as well as non-votes, as to each matter presented for a shareholder vote. In addition, the registrant's proxy statement would be required to describe the manner in which proxy votes would be counted, including of the effect of abstentions and non-votes under state law and the registrant's organizational documents.[163]

Finally, in the 1992 Release the Commission also published for comment a proposal that is subject to a rulemaking petition by Edward V. Regan, Comptroller of the State of New York, that would permit certain large shareholders to include in the registrant's proxy statement a statement of such shareholder's views of the performance of the registrant, its management, and the board of directors. Shareholders' solicitations in support of the statement would be subject to the antifraud, but no other, proxy rules.[164]

VII. Proxy Regulation Proposals

The Commission's proxy regulations should be changed to encourage communications that are likely to benefit Individual Shareholders. The Commission should address the presence of pension funds by revising proxy rules on two fronts: First, where the communication merely tests the waters;[165] and second, where the communications occur prior to thirty days before the Meeting Date.

160. *Id.*
161. *Id.* at 29,573.
162. *Id.* at 29,573-74.
163. *Id.*
164. *Id.* at 29,574-75.
165. *See supra* notes 73 and 74 and accompanying text.

A. *Testing the Waters versus Advocacy*

The discussion has shown that it is virtually impossible to distinguish between advocacy on the one hand and "gauging the market pulse" on the other. This is particularly so when the numbers of potential Solicitees are few; the communications will frequently be multiple, nonwritten, and extremely difficult to reconstruct.

The Commission and courts look to sometimes inconsistent formulations. One court says that "any communication which may eventually influence the giving of proxies when they are actually requested" is not a solicitation.[166] However, the Commission and other courts say that solicitations include communications that are "part of a continuous plan,"[167] are "reasonably calculated to influence,"[168] or are "reasonably calculated to result"[169] in the giving of a proxy. Neither approach considers the Solicitee's need for the Schedule 14A Information.[170] When Solicitors test the waters, the solicitation test should consider the sophistication of the Solicitee in determining when he should receive the prescribed information.[171] The solicitation test for small numbers of Solicitees should incorporate the sophisticated investor standards developed by courts on cases involving section 4(2) of the Securities Act and regulation D.[172]

Solicitations should be categorized into three types: (1) solicitations of fifty or fewer shareholders; (2) solicitations only of sophisticated shareholders; and (3) broad-based solicitations of shareholders.

The Commission's current exemption for solicitations of ten or fewer shareholders should be expanded to fifty or fewer shareholders.[173] Communications with small numbers of shareholders are

166. *Calumet Industries Inc. v. MacClure*, 464 F. Supp. 19, 30 (N.D. Ill. 1978).

167. *See supra* notes 95-134 and accompanying text.

168. *See Trans World Corp. v. Odyssey Partners*, 561 F. Supp. 1315, 1320 (S.D.N.Y. 1983) and *Long Island Lighting Co. v. Barbash*, 779 F.2d 794, 796 (2d Cir. 1985).

169. 17 C.F.R. § 240.14a-1(l) (1991).

170. For example, Release No. 34-29315, *supra* note 9, states that "[w]hether a particular communication should be deemed part of a solicitation turns on 'the purpose for which the communication was published—*i.e.*, whether the purpose was to influence the shareholders' decisions,' as evidenced by the substance of the communications and the circumstances under which they were transmitted." The "audience to which [the communication] is directed" is only an objective factor to be used in determining the purpose of the communication. *Id.*

171. Others have proposed similar revisions. *See, e.g.*, CalPERS 1989 Letter, *supra* note 68 at 10; Elmer W. Johnson, *An Insider's Call for Outside Direction*, HARV. BUS. REV. 3, 6 (1990). The ABA Letter, however, argues against a "two tier[ed] rule" that favors "sophisticated" shareholders. ABA Letter, *supra* note 73, at 8.

172. *See* 17 C.F.R. § 230.506(b)(2)(ii) (1991).

173. Others have similarly requested that the Commission's ten-person safe harbor

likely to occur in the initial stages of shareholder proxy activity. At this stage, the communicator is more likely to incorporate ideas he receives from other shareholders, and the ultimate shareholder action is likely to address a greater number of shareholders' concerns. Moreover, if the communication is with a small number of shareholders, it is unlikely that the Solicitor would take the trouble to include unsophisticated investors, who are more likely to need Schedule 14A Information. The benefits of requiring that prescribed information be given to fifty or fewer solicited shareholders simply do not justify the burden of making the difficult determination of whether a solicitation has occurred, and if so, gathering, filing and disseminating the Schedule 14A Information to the fifty Solicitees.

There should be a second exemption for solicitations only of sophisticated investors. Such a Solicitee-focused exemption acknowledges that sophisticated investors probably already have the Schedule 14A Information, and if they do not have it, or have access to it, they will require the Solicitor to give it to them or refuse to cooperate with him. One advantage of this test is that it may be easier to determine whether an investor is sophisticated than whether the communication is a solicitation. Solicitations will generally be nonwritten and will need to be reconstructed. An investor's status as sophisticated, however, will continue after the solicitation.

In looking to the Solicitee, these proposals address the potential offense more directly than a Solicitor-focused test. The potentially offensive conduct is failure to provide Schedule 14A Information to the party being solicited. The test to determine whether such conduct is an offense should look to whether the solicited party is likely to be injured by the conduct.

B. *Broad-based Solicitations*

The proxy rules regarding broad-based solicitations should be relaxed to encourage solicitations. The test in this area should focus on both the Solicitors and the Solicitees. The Solicitee-focused inquiry considers the benefits to the Solicitee of receiving prescribed information at a particular time. The Solicitor-focused inquiry considers the burden imposed on the Solicitor in providing the prescribed information at a particular time.

The Solicitee benefits test should consider two factors: (1) what facts a shareholder needs to execute an informed proxy; and (2) when he should receive the information. Schedule 14A provides a practical guide to information that may be material to a particular

be increased. *See, e.g.*, CalPERS 1989 Letter, *supra* note 68 at 10; ABA Letter, *supra* note 70, at 8.

transaction,[174] and addresses the "what facts are necessary" factor. Schedule 14A Information should be given to shareholders at some time in the course of communications designed to lead to an actual solicitation of proxies. The question of when the facts should be presented will be discussed below.

1. The Contemporaneous Requirement

The benefits of the Contemporaneous Requirement[175] do not always outweigh its burdens. The benefit of the Contemporaneous Requirement is that, when it applies, it gets all the material information into the hands of shareholders before a Solicitor attempts to persuade him or shape his opinion.

It is particularly important to get information into the hands of shareholders at some point in the course of a solicitation regarding, for example, several of the types of transactions described earlier as Control Activities. As previously discussed,[176] these transactions are more likely to be undertaken by Control Persons and may be detrimental to Individual Shareholders. Frequently, complex financial calculations are at the core of the transaction. These financial calculations will often include historic and pro forma information and detailed information concerning securityholders' rights and management's interests.[177] Shareholders should receive this information a sufficient number of days before the Meeting Date to allow them to analyze it.

Frequently, however, the current Contemporaneous Requirement is burdensome. First, it requires great expense very early in the course of a solicitation, and effectively prevents a gauging of the market with more than ten shareholders. Gauging of the market is desirable because it fosters shareholder input into the matters for which a proxy is eventually solicited. For example, if a Solicitor communicates with all shareholders by means of something less than a full-blown proxy statement containing Schedule 14A Information, he is more likely to do so early, when he is still formulating his proposals, strategy, and plans. If he communicates with a broad base of shareholders at such a policy formulation stage, he is more likely to incorporate their suggestions and feedback into his ultimate proposals.[178]

174. *See supra* note 5.
175. *See supra* notes 76-83 and accompanying text.
176. *See supra* notes 33-34 and accompanying text.
177. *See* Release No. 34-29315, *supra* note 9, at 28,994.
178. *See supra* notes 73-74.

Second, it ignores the reality that opposing Solicitors will likely quickly point out that certain material information has been omitted or twisted to serve the interests of the Solicitor. Ultimately the full-blown materials will discuss prescribed factors. The opposition will quickly point out if the full-blown proxy statement reveals that the Solicitor has been less than forthcoming in earlier communications.[179]

Finally, when combined with the Preclearance Requirement, it inhibits timely solicitations in opposition to management proposals. Frequently, an opposition Solicitor cannot effectively respond to management proposals.[180] Current rules allow "stop, look and listen" pieces to inform shareholders that information will follow,[181] but what good is this information if the Solicitor can only get full-blown responding materials to shareholders a few days before the Meeting Date?

For the above reasons, the burdens of the Contemporaneous Requirement outweigh the benefits, at least for the period prior to thirty days before the Meeting Date.[182] During this time, Solicitors should be allowed to communicate with other shareholders prior to providing a full-blown proxy statement.[183] If Solicitors wish to furnish proxy cards, they would be permitted to do so only subsequent

179. The Commission noted in Release 34-29315, *supra* note 11, that

> Contested solicitations relating to the election of directors or proposals sponsored by management or shareholders are argued by some to present the most obvious case for elimination of preliminary filing and review requirements, since the adversarial nature of the transaction itself is believed to serve as a policing mechanism .... Counsel for the competing camps may be in the best position to monitor not only the adequacy and truthfulness of its client's materials, in order to avoid understandable consequences of a court or Commission finding that the materials are misleading, but also the opponent's materials.

Id. at 28,993.

180. This will occur when management's materials are mailed within a short period of time before the Meeting Date. Only after management has cleared its proxy statement will dissidents have access to it in order to formulate opposition strategies. Thereafter, the dissidents must file their proxy statement and wait to mail until the shorter of ten days or clearance by the staff. Finally, dissidents must get the materials through multiple layers of record holders and into the hands of the beneficial holder. Black, *Shareholder Passivity*, *supra* note 36, at 539.

181. *See supra* notes 81-89, and 159 and accompanying text.

182. The ABA Letter notes that

> [t]he timing of a communication with respect to the next scheduled annual or special meeting may be relevant, although not conclusive, as to whether or not it is part of a solicitation. Communications which occur more than some extended period of time prior to a scheduled annual or special meeting are often less likely to be directed at the actual procurement of proxies than those occurring closer in time to such meeting.

ABA Letter, *supra* note 73, at 8.

183. Rule 14a-9 requires that solicitations not omit to state any material fact necessary in order to make the statements made in such solicitation not false or misleading. 17 C.F.R. § 240.14a.9 (1991). This would require, in some cases, certain minimum information concerning the identity of the sponsor, etc.

to, or contemporaneously with, the proxy statement containing Schedule 14A Information.[184] Shareholders should, however, be given a full-blown proxy statement within thirty days of the Meeting Date. No communications should be permitted within this thirty-day period unless Schedule 14A Information is given prior to or contemporaneously with the communication.

2. The Preclearance Requirement

The benefit of the Preclearance Requirement[185] is that the staff ensures that factors which may be material are addressed, and that the material does not contain any claim that is fraudulent on its face. The limitations, however, should be emphasized. First, the Preclearance Requirement does not ensure that all material information is disclosed, but only that certain factors are addressed. Moreover, the staff in many cases is unable to ensure that the Solicitor has not lied or attempted to mislead when addressing the prescribed factors.

Second, the Preclearance Requirement often creates delay, as there will often be several rounds of comments and responses. This is particularly a problem in the case of a solicitation in opposition to a management proposal. Frequently, management's materials will be mailed shortly before the Meeting Date. During this period, the opposing Solicitor must formulate his opposition strategy, preclear, and get the materials through multiple layers of record holders and into the hands of the beneficial holder.[186]

Third, commentators argue that the Preclearance Requirement is a more extensive regulatory scheme than necessary, and as such, violates the First Amendment.[187] Fourth, the Preclearance Require-

184. *Cf.* Release 34-29315, *supra* note 11, at 28,993. The Commission's Proposals would "permit the use of the preliminary form of the proxy statement" after it is filed but prior to its clearance by the staff. The Commission's Proposals would, however, "bar the transmittal or use of the form of proxy during the ten-day period or shorter period in the case of earlier clearance." *Id.* The 1992 Release, *supra* note 14, reproposed the preliminary filing proposal in substantially the same form. *See supra* notes 155 and 156 and accompanying text.

185. *See supra* notes 84-93 and accompanying text.

186. *See supra* note 180. Black notes that in the only recent proxy solicitation in opposition to a management proposal, the opponent's materials were cleared by the staff a mere seven days prior to the meeting. Black, *Shareholder Passivity*, *supra* note 36, at 539.

187. *See e.g.*, USA Petition *supra* note 24, at 36-38. *See also*, Release No. 34-29315 *supra* note 11, at 28,992. An analysis of commentators' arguments with respect to the First Amendment is beyond the scope of this paper.

ment is unnecessary because opponents of the solicitation will point out omissions, untruths, and misleading statements.[188] Fifth, the Preclearance Requirement is unfair to non-management proponents in cases where management's "plain vanilla" proxy statement is not subject to preclearance, but a solicitation in opposition to management's slate *is* subject to preclearance,[189] particularly where the "plain vanilla" proxy statement contains a statement opposing a shareholder proposal pursuant to rule 14a-8.[190]

In response to these problems, the Preclearance Requirement should be amended in the following areas:

1. Preclearance should be required only for the proxy statement containing Schedule 14A Information; use of all other soliciting material should be permitted on the date on which it is filed.[191]

2. The requirement that all proxy statements containing Schedule 14A Information be on file ten calendar days prior to being used should be revised to require that opposing proxy statements containing Schedule 14A Information could not be used prior to clearance by the staff, or for the longer of (a) five calendar days after filing, or (b) ten calendar days after filing of the first party's proxy materials or the date of prior clearance of the first party's proxy materials by the staff.

3. The proxy statement containing Schedule 14A Information should be public upon filing, but could not be given to shareholders by the registrant, its affiliates, or agents during the Preclearance period.[192]

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188. *See supra* note 174.

189. *See e.g.*, Letter from NL Industries, Inc. to Linda C. Quinn, Director, Division of Corporation Finance, Securities and Exchange Commission, p. 7 (Commission Public File No. 4-353) (August 8, 1990) [hereinafter NL Industries Letter]. The NL Industries Letter was written in response to letters submitted to the Commission requesting that the Commission review its proxy rules. *See supra* note 15; *see also*, Release 34-29315, *supra* note 11, at 28,992 n.51 (citing NL Industries Letter). The 1991 Release states that in the case of "plain vanilla" proxy statements pertaining to elections of directors, the Commission's staff permits management to mail the soliciting materials to securityholders without prefiling even if insurgents have announced that they intend to conduct an opposing solicitation. Management's soliciting materials may not refer to the opposing solicitation, and such failure to refer to the opposing solicitation may not cause management's materials to be false or misleading. *Id.* at 28,992.

190. As the CalPERS 1989 Letter, *supra* note 68, points out, management's statement in opposition is not subject to prefiling, but any solicitation in support of the shareholder proposal must be prefiled. *Id.* at 21. *See also*, Release 34-29315, *supra* note 11, at 28,992 n.52 (citing CalPERS 1989 Letter, *supra* note 68, at 21).

191. Release No. 34-29315, *supra* note 11, at 28,993, and Release No. 34-30849, *supra* note 14, at 29,568, proposes this revision as well. Unless an exception applied, however, the Commission's proposals would require that the Solicitor have provided, or contemporaneously provide, a proxy statement that has been precleared. The 1992 Release proposed additional exceptions to the Contemporaneous and Preclearance Requirements, and requested comment on others. *See supra* notes 152-64.

192. Release No. 34-29315, *supra* note 11, also proposes that the proxy statement containing Schedule 14A Information be public upon filing. The 1991 Release pro-

4. The requirement that dissidents' Schedules 14B be on file five days prior to commencement of a solicitation in opposition to management's slate of directors should be revised to require filing contemporaneously with the filing of the Schedule 14A.[193]

These revisions to the current rules would address the timing problem faced by those soliciting in opposition to another proposal. Those opposing a solicitation could obtain the Schedule 14A proxy statement when it is filed and, if such opposing solicitor is able to prepare and file his own proxy statement in five calendar days, mail a solicitation in opposition at the same time the original proponent mails his proxy statement.

C. Communications From Third Parties

Communications from third party proxy advisors acting at the behest of shareholders should not need to include Schedule 14A Information. If a shareholder pays an advisor for information regarding the voting of his shares, or otherwise has a business relationship with him, it makes no sense to require the third party advisor to give Schedule 14A Information to the principal. This is especially true because it is likely that only large sophisticated investors will pay for voting advice. The exemption for proxy voting advice furnished to persons with whom the advisor has a business relationship should not require that the advisor render "financial advice" in the ordinary course of his business.[194] The language should be amended to require that the advisor render "financial or voting advice" in the ordinary

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posed that such proxy statement may be distributed after filing but before the expiration of ten days or preclearance by the staff. The 1991 Release states that,

> [u]nder the proposed approach, preliminary proxy materials would be treated in a manner similar to registration statements required by section 5 of the Securities Act of 1933. Accordingly, the preliminary filing requirement would permit the use of the preliminary form of the proxy statement, but would bar the transmittal or use of the form of proxy during the ten-day period or a shorter period in the case of earlier clearance. The Commission requests comment on the likelihood that soliciting persons would choose to make the general distribution of the proxy statement following staff review and clearance of the form of proxy.

Id. at 28,993-94.

The 1992 Release proposes to grant, upon request, confidential treatment of preliminary soliciting materials in certain transactional filings. *See supra* note 155 and accompanying text.

193. Release No. 34-30849, *supra* note 14, proposes that Schedules 14B be required to be filed within five business days following the commencement of a solicitation in opposition in an election contest or five business days prior to the dissemination of the preliminary proxy statement, whichever is earlier. *Id.* at 29,568-69.

194. 17 C.F.R. § 240.14a-2(b)(2)(i) (1991).

course of his business.[195]

Second, a fourth exemption for disinterested third party commentary should be added to the fifty person and sophisticated Solicitee safe harbors, as well as the proxy advisor exemption. This should exempt advice or other commentary by advisors, commentators, or public interest groups who advise or comment in the ordinary course of their business or activities. To come within the exemption, the commentator may not have an interest in the matter commented upon, such as stock ownership or payment from a Solicitor for the commentary. This should encourage a robust public debate of corporate issues and the effect of such issues on all parties.[196]

VIII. CONCLUSION

Institutions are unable to engage in Control Activities, and as such have interests similar to Individual Shareholders. Federal proxy regulation should reflect that institutions will often act for the benefit of Individual Shareholders, and federal securityholder communication regulations should be revised to encourage communications among shareholders.

Shareholders should be able to test the waters concerning common shareholder issues. The Commission should adopt safe harbors from its solicitation rules for solicitations of fifty or fewer shareholders, and only of sophisticated investors.

Further, shareholders should be permitted to communicate more freely among themselves during the period prior to thirty days before a Meeting Date. During this period, in most circumstances, shareholders should be free to communicate without contemporaneously providing a proxy statement containing Schedule 14A Information.

The rules regarding communications from third parties should also be relaxed. Those who provide financial or proxy voting advice in the ordinary course of their business should not be required to comply with the Commission's solicitation rules. Advice or other commentary by advisors, commentators, or public interest groups who advise or comment in the ordinary course of their business or activities should also be exempt.

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195. CalPERS notes that:

> it is not clear why the safe harbor needs to be conditioned by clause (i) of the rule—i.e., that "the advisor renders financial advice in the ordinary course of his business." Although this condition seems on the surface to be acceptable, the staff has traditionally interpreted this provision as requiring the proxy voting advice to be given in the context of a relationship in which the role is primarily that of a financial advisor, separate and distinct from proxy voting.

CalPERS 1989 Letter, *supra* note 68, at 10-11.

196. *See* notes 152, 153, and 158-64 and accompanying text for the commission's proposals in this regard.