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## From Legitimacy to Logic: Reconstructing Proxy Regulation

Jill E. Fisch

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# From Legitimacy to Logic: Reconstructing Proxy Regulation

Jill E. Fisch\*

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## I. INTRODUCTION

On October 16, 1992, after a comprehensive review of its system of proxy regulation and after two separate amendment proposals that

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drew more than 1700 letters of comment from the public,<sup>1</sup> the Securities and Exchange Commission (the "Commission" or the "SEC") voted to reform the federal proxy rules. The reforms were "intended to facilitate shareholder communications and to enhance informed proxy voting, and to reduce the cost of compliance with the proxy rules for all persons engaged in a proxy solicitation."<sup>2</sup> The SEC explained the amendments by stating that the rules were "impeding shareholder communication and participation in the corporate governance process" and were "run[ning] exactly contrary to the best interests of shareholders."<sup>3</sup> SEC Chairman Richard Breeden further described the amendments as effectuating the shareholder's constitutional right to free speech.<sup>4</sup>

The October 1992 amendments are but the latest in a series of changes to proxy rules that began in 1935 as a simple list of disclosure requirements.<sup>5</sup> Since that time, the federal proxy rules have generated frequent criticism.<sup>6</sup> The October 1992 revisions are no exception. From

1. Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, 1992 SEC LEXIS 2470, \*7 (Oct. 16, 1992) ("Proxy Rule Release").

2. Regulation of Communications Among Securityholders, Exchange Act Release No. 30,849, 1992 SEC LEXIS 1296, \*1 (June 24, 1992).

3. Proxy Rule Release, 1992 SEC LEXIS at \*8 (cited in note 1).

4. *Adoption of Proxy Rule Revisions Likely Without Significant Change, Breeden Says*, 24 Sec. Reg. & L. Rep. (BNA) 1023 (July 10, 1992) (quoting the speech delivered by SEC Chairman Richard Breeden to the Annual Conference of the American Society of Corporate Secretaries on June 30, 1992).

5. The SEC's first proxy rules were adopted in 1935. See Exchange Act Release No. 378, 1935 SEC LEXIS 378 (Sept. 24, 1935). Subsequent amendments are too numerous to recount. For a detailed history of the federal proxy rules, see Staff of the SEC Div. of Corporation Finance, Report on Corporate Accountability, 96th Cong., 2d Sess. (1980); Susan W. Liebeler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 Ga. L. Rev. 425 (1984) (focusing on the history of SEC Rule 14a-8).

6. Recent scholarship includes Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 Wis. L. Rev. 1071; Bernard S. Black, *Disclosure, Not Censorship: The Case for Proxy Reform*, 17 J. Corp. L. 49 (1991); Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 Cath. U. L. Rev. 37 (1990); George W. Dent, Jr., *Proxy Regulation in Search of a Purpose: A Reply to Professor Ryan*, 23 Ga. L. Rev. 815 (1989); Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 Ga. L. Rev. 97 (1988); George W. Dent, Jr., *SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y. L. Sch. L. Rev. 1 (1985); Liebeler, 18 Ga. L. Rev. 425 (cited in note 5); Frank H. Easterbrook and Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & Econ. 395 (1983); Henry G. Manne, *Shareholder Social Proposals Viewed by an Opponent*, 24 Stan. L. Rev. 481 (1972); Melvin Aron Eisenberg, *Access to the Corporate Proxy Machinery*, 83 Harv. L. Rev. 1489 (1970).

Commentators have criticized the proxy rules since their inception; a sampling of early commentary evaluating and criticizing the rules includes David C. Bayne and Frank D. Emerson, *The Virginia-Carolina Chemical Corporation Proxy Contest: A Case-Study of the SEC's New Rule 240.14a-11 and Schedule 14B*, 57 Colum. L. Rev. 801 (1957); David C. Bayne, et al., *Proxy Regulation and the Rule-Making Process: The 1954 Amendments*, 40 Va. L. Rev. 387 (1954); Frank D. Emerson and Franklin C. Latham, *SEC Proxy Regulations: Steps Toward More Effective Stockholder Participation*, 59 Yale L. J. 635 (1950); Daniel M. Friedman, *SEC Regulation of Corporate Proxies*, 63 Harv. L. Rev. 796 (1950); Sheldon E. Bernstein and Henry G. Fischer, *The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy*, 7 U. Chi. L. Rev. 226

the outset of the three-year process that resulted in the adoption of these reforms, the business and legal communities have criticized the changes effectuated by the amendments as, alternatively, going too far and replacing a system that was working properly; not going far enough and frustrating the exercise of shareholder democracy; and embodying principles of political compromise rather than a cohesive vision of corporate governance.<sup>7</sup>

Whatever the ultimate business response to the latest SEC attempt to improve its proxy rules, the 1992 revisions cannot be seen as the final step in the reform process.<sup>8</sup> The amendments neglect areas of substantial concern to investors and commentators; even the proposing releases acknowledge the need for further review and action. What explains this difficulty in articulating a set of standards for proxy regulation? Why, in this area, is the Commission repeatedly buffeted back and forth between various players in the corporate governance arena but apparently adrift from any predetermined course of its own?

The answer stems from the SEC's troubled mandate to exercise its rulemaking powers in connection with the solicitation of proxies. The statutory language and legislative history are ambiguous as to whether the SEC is authorized to enact rules with a substantive effect on corporate governance or simply to implement disclosure requirements. This ambiguity, together with the SEC's reluctance to take a position on the

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(1940); Arthur H. Dean, *Non-Compliance with Proxy Regulations: Effect on Ability of Corporation to Hold Valid Meeting*, 24 Cornell L. Q. 483 (1939).

Members of the business community as well as scholars have objected to the operation of the rules. See, for example, Martin Lipton and Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. Chi. L. Rev. 187 (1991); Nell Minow, *Proxy Reform: The Case for Increased Shareholder Communication*, 17 J. Corp. L. 149 (1991); Nell Minow, *Shareholders, Stakeholders, and Boards of Directors*, 21 Stetson L. Rev. 197 (1991). Recently several institutional investors communicated their concerns about the rules to the SEC. See Letter from Richard H. Koppes, CalPERS General Counsel, to Linda C. Quinn, Director, Division of Corporation Finance, SEC (Nov. 3, 1989), reprinted in *Institutional Investors: Passive Fiduciaries to Activist Owners* 454 (Practising Law Institute, Corporate Law and Practice Course Handbook Series Number 704, 1990); Letter from United Shareholders' Association to Edward H. Fleischman, Commissioner, SEC (Mar. 20, 1990).

7. See, for example, *SEC Adopts Proxy Reform Package After Long Study, Intense Debate*, 19 Pension Reporter (BNA) 1799 (Oct. 19, 1992) (describing industry reactions to the amendments); *Shareholder Communication Proposals Produce Second Tidal Wave of Comments*, 24 Sec. Reg. & L. Rep. (BNA) 1516 (Sept. 25, 1992) (describing the reaction by various industry groups to the second amendment proposal).

8. The Council of Institutional Investors has already announced its intention to request the SEC to review the shareholder proposal rules and to change its regulations to purely procedural requirements, such as limiting the number of proposals. *Institutional Investors To Ask SEC To Look at Shareholder Proposal Rule*, 24 Sec. Reg. & L. Rep. (BNA) 1743 (Nov. 13, 1992). This approach has been endorsed by one influential commentator. See John C. Coffee, Jr., *Blocking Bias via Proxy*, Wall St. J. at A14 (Feb. 2, 1991) (criticizing SEC interference with the ability of shareholders to impose normative restrictions on their corporations' activities).

limitations of its mandate, has led to experimental rulemaking in a vacuum. The SEC has failed to articulate its own theory of the proper role of shareholder participation in corporate governance, presumably because of uncertainty as to the agency's right to formulate such a theory. Accordingly, the history of the SEC's rulemaking has reflected political compromise between the pressures of various interest groups. The frequent amendments to the proxy rules further demonstrate the inability of the SEC, based on its lack of standards, to judge the success of the structure it has developed.

This Article argues that, before the proxy rules are once again evaluated, criticized, and ultimately amended, the SEC's role in regulating proxy solicitation should be reexamined. After reviewing the dual system under which shareholder voting is regulated, which includes both the federal proxy rules and state corporation law, the Article focuses on shareholder access to the proxy. It demonstrates that the SEC has, through its rulemaking, fashioned a federal common law of access to the voting mechanism. The Article inquires into the operation and implications of the SEC's standards, as well as the legitimacy of their claimed origins in state law.

The Article then questions whether the existing regulatory structure is consistent with the SEC's authorization to regulate the solicitation of proxies.<sup>9</sup> Because the language of Section 14(a) of the Securities Exchange Act of 1934 (the "Exchange Act") contains little guidance as to the nature of the SEC's mandate,<sup>10</sup> this Article examines the extent to which the legislative history of that statute dictates the appropriate role for the SEC in affecting substantive issues of corporate governance through the regulation of proxy voting.

The Article concludes that the legislative history of Section 14(a) is ambiguous, and that the statute can be read to support either the theory that Congress intended to limit the SEC's authority to compel disclosure or the theory that Congress intended a broader mandate. Congressional consideration of the abuses to which the federal securities laws were addressed, however, reveals a strong objective to protect shareholders from practices by corporate insiders that limit the effec-

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9. This is fundamentally a question of statutory interpretation as to the scope and nature of the SEC's rulemaking authority under § 14(a). Recent developments in the theory of statutory interpretation inform this analysis. See Philip P. Frickey, *From the Big Sleep to the Big Heat: The Revival of Theory in Statutory Interpretation*, 77 Minn. L. Rev. 241 (1992) (describing the resurgence of theoretical approaches to statutory interpretation and explaining the dominant theories).

10. Thus, a textual approach is of limited value. See Nicholas S. Zeppos, *Legislative History and the Interpretation of Statutes: Toward a Fact-Finding Model of Statutory Interpretation*, 76 Va. L. Rev. 1295, 1296-97 (1990) (describing the textualist approach). Compare notes 244-60, 275-79 and accompanying text (discussing the significance of statutory text).

tiveness of shareholder voting.<sup>11</sup> This Article contends that as early as 1934, Congress intended federal proxy regulation to respond to its concern that shareholder control over corporate governance was weakening. This congressional objective should set the standard for evaluating the SEC's proxy rules.

Using this standard, the final Part of this Article evaluates the effect of the SEC's rules on shareholder participation in corporate governance and the broader effect that the exercise of the Commission's regulatory authority has had on the development of state law under the dual regulatory systems. Although critics have questioned whether shareholder voting actually can operate effectively—to choose efficient governance structures, to select competent management, and to effect value-maximizing decisions<sup>12</sup>—the Article argues that shareholder vot-

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11. Voting is one of the few ways in which shareholders can control the conduct of the managers who run the corporation on their behalf. Other monitoring mechanisms include the derivative suit, in which a shareholder brings suit on behalf of the corporation to challenge conduct that has injured it, and the securities market, whereby a shareholder dissatisfied by management's conduct may sell his or her stock. Derivative suits seek to penalize wrongdoing directly by imposing liability on managers who breach their duties to the corporation. The markets discipline managers indirectly by causing the stock price of a poorly managed corporation to decline in value. Many commentators believe that the market for corporate control also functions as a means of monitoring management by allowing the replacement of unsatisfactory management. See Jill E. Fisch, *Frankenstein's Monster Hits the Campaign Trail: An Approach to Regulation of Corporate Political Expenditures*, 32 Wm. & Mary L. Rev. 587, 637 n.260 (1991) (describing the division in the academic community over the effectiveness of the market for corporate control).

12. Many commentators have argued that current corporate governance structures do not operate properly to encourage efficient corporate decisionmaking and the protection of shareholder interests. See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, 526-29 (1990) (summarizing the explanations for shareholder passivity). Commentators often attribute this failure to collective action problems, which prevent voting from serving as an effective tool for monitoring and controlling corporate management. See, for example, Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. Chi. L. Rev. 119, 136 (1987) (stating that "[i]n most cases, the collective action problem faced by dispersed shareholders renders voting relatively ineffective as a monitoring mechanism"); *Voting Rights Listing Standards—Proposed Disenfranchisement Rule*, Exchange Act Release No. 24,623, 38 SEC Docket 917 (June 22, 1987) (recognizing that the "collective action" limitations on shareholder voting make voting an ineffective tool for shareholders to resist management proposals).

The developing participation of institutional investors offers a potential solution to the collective action problem. For investors with large holdings, the cost/benefit analysis of participation in corporate governance is more favorable. Recent evidence suggests that institutional investors are no longer entirely passive and are making greater use of, among other things, the proxy machinery. See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811, 814 (1992); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. Rev. 895, 926-27 (1992). The actions of CalPERS and the United Shareholders' Association in proposing revisions to the proxy rules are indicative of this development. See Part V of this Article. If it is true that institutional investors have the incentives and ability to intervene in corporate governance, legal rules that interfere with that participation justifiably may be attacked as imposing real restrictions on the process. But compare Lipton and Rosenblum, 58 U. Chi. L. Rev. at 205-13 (cited in note 6) (criticizing the short-term orientation of institutional investors).

ing has been prevented from working properly.<sup>13</sup> Indeed, the SEC has affirmatively impeded the effectiveness of the shareholder voting process both through its adoption of rules that interfere with shareholder democracy and through its failure to adopt rules to address deficiencies in the process. Both shortcomings render the proxy rules inconsistent with the SEC's mandate. The Article concludes that under a dynamic view of statutory interpretation,<sup>14</sup> the SEC has both the authority and the obligation to promulgate rules that enhance the effectiveness of the shareholder voting process.

## II. STATE CORPORATION LAW AND THE REGULATION OF VOTING

The primary rules governing shareholder voting are supplied by state corporation law.<sup>15</sup> State law requires that corporations be managed by a board of directors<sup>16</sup> and that the directors be elected by the shareholders.<sup>17</sup> State law also determines which issues, in addition to board election, require shareholder approval<sup>18</sup> and specifies the procedures governing the voting process.<sup>19</sup> Specifically, state law generally requires corporations to hold an annual shareholders meeting at which shareholders elect the directors.<sup>20</sup> At common law, it was necessary for shareholders to attend the annual meeting personally in order to exercise their voting rights. The development of large, widely held corporations rendered this requirement problematic and led to the development of the proxy voting process.<sup>21</sup>

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13. For a broader look at rules that affect effective shareholder voting, see Black, 89 Mich. L. Rev. 520 (cited in note 12).

14. See William N. Eskridge, Jr., *Dynamic Statutory Interpretation*, 135 U. Pa. L. Rev. 1479 (1987) (developing a model of dynamic statutory interpretation).

15. See generally Edward Ross Aranow and Herbert A. Einhorn, *Proxy Contests for Corporate Control* (Columbia U., 2d ed. 1968) (summarizing state law governing voting and conduct of annual meetings).

16. See, for example, 8 Del. Code Ann. § 141 (Michie, 1991) (providing that corporations shall be managed "by or under the direction of a board of directors").

17. See, for example, 8 Del. Code Ann. § 211(b) (Michie, 1991) (providing for an annual meeting of stockholders to elect the directors).

18. See, for example, 8 Del. Code Ann. § 242 (Michie, 1991) (requiring a shareholder vote to amend the charter); 8 Del. Code Ann. § 251 (Michie, 1991 & Supp. 1992) (requiring a shareholder vote to approve a merger); 8 Del. Code Ann. § 275 (Michie, 1991) (requiring a shareholder vote for liquidation).

19. These procedures include the concepts of a record date and a quorum, as well as the principle that a shareholder's voting rights are determined by the number of shares held. See, for example, 8 Del. Code Ann. § 212(a) (Michie, 1991) (granting shareholders one vote per share unless the charter provides to the contrary); 8 Del. Code Ann. § 213 (Michie, 1991) (authorizing the board of directors to fix the record date); 8 Del. Code Ann. § 216 (Michie, 1991) (stating quorum requirements).

20. See, for example, 8 Del. Code Ann. § 211(b) (Michie, 1991).

21. For a description of the historical development of proxy voting, see Leonard H. Axe, *Corporate Proxies*, 41 Mich. L. Rev. 38 (1942).

The proxy process allows a shareholder to vote without being physically present at the annual meeting. Proxy voting is governed by agency principles that permit a shareholder to authorize another person to vote on his or her behalf.<sup>22</sup> A proxy can either give the shareholder's nominee discretionary authority or specify the manner in which the shares are to be voted. Although state law originally restricted the use of proxies,<sup>23</sup> their use grew necessary as corporations became unable to secure sufficient shareholder presence to meet the quorum requirements. Eventually, state statutes addressed proxy voting and expressly protected the right of shareholders to vote by proxy.<sup>24</sup>

Under modern practice most shareholders vote by proxy, and personal attendance at the annual meeting is a rare and primarily symbolic gesture. Typically, management will distribute to shareholders a form of proxy that authorizes a corporate official to vote the shareholders' shares in accordance with their instructions together with the notice of the annual meeting that is required by state law. This process is generally used whether or not the election is contested.<sup>25</sup>

The main reason corporations solicit proxies is to satisfy the quorum requirement. Under state law, business may not be conducted at an annual meeting unless holders of a certain percentage of the stock are present.<sup>26</sup> A national corporation may have shareholders spread over fifty states and abroad, making it impossible for many shareholders to attend the annual meeting. Without state law provisions that allow shareholders to be present "by proxy," it would be difficult for the corporation to secure the quorum necessary to conduct business. Shares represented by proxy at the annual meeting are explicitly defined by statute to satisfy the quorum requirement.<sup>27</sup>

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22. The term proxy, under agency law, refers to the person to whom voting authority is given. With the advent of federal proxy regulation, the term has come to refer to the written voting authorization, which may also be called the proxy card. See, for example, Rule 14a-4, 17 C.F.R. § 240.14a-4 (1992) (describing the requirements as to the form of proxy). The term has also been used to refer to the proxy voting mechanism, as in "improving shareholder access to the proxy."

23. See Dean, 24 Cornell L. Q. at 487-88 (cited in note 6) (explaining that no right to vote by proxy existed at common law; the right of shareholders to vote by proxy was provided by state corporation acts).

24. See *id.* (describing early statutory provisions allowing shareholder voting by proxy). An example of a modern statutory provision is 8 Del. Code Ann. § 212 (Michie, 1991), which expressly entitles a shareholder to "authorize another person or persons to act for him by proxy" and which sets out the procedures and conditions for executing a valid proxy.

25. In a contested election, shareholders may receive proxies from two or more competing slates of candidates and may choose to authorize either the company official or a representative of a challenger group as their proxy.

26. See, for example, 8 Del. Code Ann. § 216 (Michie, 1991).

27. See *id.*



Modern state law permits, but does not require, the use of proxies. Moreover, under state law, a corporation is not required to provide a proxy mechanism for shareholders who cannot attend the annual meeting, although a shareholder may make private arrangements to be represented by proxy. In addition, state law does not specify disclosure requirements or procedural rules in connection with proxy solicitation and voting.<sup>28</sup>

These gaps in state law lead to a further complication. Presence at the annual meeting carries with it certain common-law rights, such as the right to nominate a candidate for the board of directors or to propose resolutions or transactions within the authority of the shareholders, such as a shareholder resolution or bylaw amendment. These rights originally were viewed as property rights, based on the status of the shareholder as partial owner of the corporation and the shareholder's right to share in the control of this asset. As corporate law developed prior to the passage of the federal securities laws, courts recognized a general philosophy of shareholder rights based on ownership.<sup>29</sup> These rights included preemptive rights, requirements of approval, or in some circumstances, unanimous consent, over certain extraordinary transactions, and inspection rights.<sup>30</sup>

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28. The SEC explained in its 1944 annual report the disclosure requirements that existed prior to the development of the federal proxy rules:

Prior to the development of the Commission's proxy rules, the average shareholder received annually from his company a proxy card in small type which he was urged to sign and return. Ordinarily, the proxy authorized some person or persons to vote the stockholders' shares to elect a board of directors and to take any other action which was considered desirable. Too frequently the owner of the shares was given no assurance that the items mentioned in the notice of meeting were the only ones which the management expected to bring up for consideration at the meeting. The stockholder was merely invited to sign his name and return his proxy without being furnished the information essential to the intelligent exercise of his right of franchise.

10 SEC Annual Rep. 51 (1944). See Comment, *Regulation of Proxy Solicitation by the Securities and Exchange Commission*, 33 Nw. U. L. Rev. 914, 916 n.11 (1939) (recognizing that state statutory provisions merely provided for notice of meetings and "did not require adequate disclosure of the financial condition of the corporation, questions of policy in issue, and details about matters on which the stockholder must vote").

29. See David C. Bayne, Jr., *The Basic Rationale of Proper Subject*, 34 U. Detroit L. J. 575, 581-82 (1957) (describing early corporate law based on the conception of the shareholder as owner).

30. *Id.* An example was state law regulation of mergers, which, as fundamental changes in the corporation, were strictly limited under the common law and required unanimous shareholder approval. See Harry G. Henn and John R. Alexander, *Laws of Corporations and Other Business Enterprises* 517 (West, 3d ed. 1983) (stating that at common law, unanimous shareholder approval was required for extraordinary matters, including mergers, charter amendments, and dissolution). The requirement that a substantial majority of shareholders, usually three-quarters or two-thirds, approve a merger persisted until the 1960s in most states. See Lewis D. Solomon, Donald E. Schwartz, and Jeffrey D. Bauman, *Corporations, Law & Policy* 943 (West, 2d ed. 1988).

The role of the shareholder as an owner of the corporation underwent a dramatic change in the first half of the twentieth century.<sup>31</sup> Although shareholders originally had ultimate authority to control the corporation, this power was taken from them through a variety of means, such as disappearance of the common-law right of shareholders to remove directors at will,<sup>32</sup> reduction of the number of transactions that required unanimous shareholder approval,<sup>33</sup> increased judicial deference to directors' business judgment and a refusal to permit shareholder challenges to the exercise of that judgment,<sup>34</sup> and a growing view that shareholders had more or less permanently delegated managerial power over the corporation<sup>35</sup> and could not exercise such power directly.<sup>36</sup>

The reason for this change is not obvious but it may be explained by the adoption of modern state corporation statutes directing that the business of the corporation be managed by a board of directors. These statutes can be interpreted as giving the board of directors unlimited control over corporate affairs and removing this control from the share-

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31. See generally Adolf A. Berle, Jr. and Gardner C. Means, *The Modern Corporation and Private Property* 138-41 (CCH, 1932) (describing the weakening of shareholder control over corporate decisionmaking).

32. See *id.* at 139-40 (describing the change from the common-law principle that shareholders had the right to remove directors at will); Bayne, 34 U. Detroit L. J. at 582 (cited in note 29) (noting the rarity of the "early common law" right of shareholders to remove a director at will).

33. See Berle and Means, *The Modern Corporation and Private Property* at 140-41 (describing the increased discretion given to the board and the evolution away from requiring unanimous consent of shareholders for many transactions).

34. See, for example, *Merrill v. Davis*, 225 S.W.2d 763 (Mo. 1950) (holding that a decision to litigate is part of corporate powers that are exclusively vested in the board of directors); *Leggett v. Missouri State Life Ins. Co.*, 342 S.W.2d 833 (Mo. 1960) (same).

35. A leading treatise explained the rule as follows: "Where, as is customary, the management and control of the corporation is vested by a statute or the charter, not in the stockholders or members, but in a board of directors and trustees, their action in regard to the affairs of the corporation is *controlling and exclusive*, and the stockholders or members cannot control the directors or trustees in the exercise of the judgment vested in them by the charter." William M. Fletcher, 5 *Fletcher Cyclopedia of the Law of Private Corporations* § 2104 at 531 (Callaghan, 1952) (emphasis added). See also *Saigh ex rel. Anheuser-Busch v. Busch*, 396 S.W.2d 9, 16 (Mo. Ct. App. 1965) (noting that "[t]he management and control of the corporation being vested by statute in the board of directors, as we have pointed out, is not in the stockholders and the action of the board of directors in regard to the affairs of the corporation is controlling and exclusive and the stockholders cannot control the directors in the exercise of the judgment vested in them by the statute").

36. See, for example, *Charlestown Boot & Shoe Co. v. Dunsmore*, 60 N.H. 85 (1880) (striking down as void a shareholder vote choosing a committee to act with the directors in closing up the affairs of the corporation because the shareholders had no power to control the corporation this way and their action would impermissibly restrain the directors from exercising their statutory duties). See also *Saigh*, 396 S.W.2d at 16 (stating that "no individual stockholder has the authority to take over the duties of corporate management").

holders.<sup>37</sup> Alternatively, the evolution of the conventional corporation from a small business in which many of the investors were local and perhaps active owners to an enterprise owned by a large and widely dispersed group of investors with an ever-diminishing amount of involvement and control over their property may have prompted a change in the shareholders' role.<sup>38</sup>

This development, in particular, diminished the importance of shareholder voting as a means of supervising the management of the corporation because it hampered both the ability of shareholders to attend annual meetings and their ability to become informed about corporate affairs in order to exercise their franchise intelligently.<sup>39</sup> Although proxy voting developed as a means of giving dispersed shareholders an opportunity to vote, voting by proxy required shareholders to delegate their voting power to someone else—usually a nominee chosen by management.<sup>40</sup> This delegation further limited shareholders' effective participation in corporate governance.<sup>41</sup>

The disempowerment of the shareholder may have contributed to the abuses that predated the stock market crash of 1929. In assessing the abuses to which federal regulation should be addressed, Congress identified the ability of corporate insiders to use their power to take advantage of investors as a primary problem. Some of these practices became the explicit target of the federal legislation.

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37. See Bayne, 34 U. Detroit L. J. at 585 (cited in note 29) (describing corporation statutes that vest exclusive control in the board of directors).

38. See Berle and Means, *The Modern Corporation and Private Property* at 47-64 (cited in note 31) (describing the growth in the number and dispersion of shareholders during the early 1900s). During the 30 years from 1901 to 1931, for example, the number of shareholders in AT&T grew from 10,000 to 642,180. *Id.* at 55.

39. *Id.* at 139.

40. See *id.* (describing a proxy nominee as a "dummy" chosen either by management or the opposition and the proxy machinery as the means by which the shareholder's "power is separated from him").

41. To a large extent, shareholder democracy was replaced by the "Wall Street Rule," under which those shareholders unhappy with governance decisions would vote with their feet by selling their holdings. See, for example, John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277, 1287 (1991) (describing the Wall Street Rule); Barnard, 40 Cath. U. L. Rev. at 45 (cited in note 6) (describing the same). To the extent this process causes stock prices to decline, it can result in a form of indirect monitoring of governance decisions through the takeover market. See, for example, Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251 (1977). The effectiveness of the stock market in monitoring corporate governance is limited, however, both because individual governance decisions may have a marginal effect on stock price and because of the costs and dislocations associated with takeovers. See, for example, Black, 89 Mich. L. Rev. at 526 (cited in note 12); John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 Colum. L. Rev. 1145, 1150 (1984). Commentators have recently observed that changes in the nature of institutional investment have made employment of the Wall Street Rule more difficult. Coffee, 91 Colum. L. Rev. at 1277-79; Barnard, 40 Cath. U. L. Rev. at 83.

## III. THE FEDERAL PROXY RULES

Congress entered the regulation of corporate voting by passing the federal securities laws. Section 14 of the Securities Exchange Act of 1934 establishes federal regulation of the proxy voting process. Rather than legislating specific laws to deal with proxy voting, Congress delegated the rulemaking function to the SEC. Section 14(a) does not impose any substantive requirements in connection with a proxy solicitation; it simply makes the solicitation of proxies without complying with the SEC rules unlawful.<sup>42</sup>

The legislative direction Congress gave the SEC to develop a system of proxy regulation—delegation paralleled in a number of other areas in the Exchange Act—has been described as a political compromise.<sup>43</sup> Industry insiders who testified in the hearings preceding the adoption of the Exchange Act were concerned about the burdens imposed by federal regulation.<sup>44</sup> They believed that the newly created SEC would be more responsive to the concerns of corporate America and the stock exchanges.<sup>45</sup> Accordingly, broad delegation of rulemaking authority to the SEC in place of substantive legislation decreased their opposition to the legislation.

Section 14(a) of the Exchange Act authorizes the SEC to make rules governing the solicitation of proxies “in the public interest or for

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42. Rule 14a-1(l) defines a proxy solicitation as any request for a proxy; any request “to execute or not to execute or revoke a proxy”; or “[t]he 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.” 17 C.F.R. § 240.14a-1(l) (1992). The definition of a solicitation has been given a broad interpretation by the courts. See, for example, *Long Island Lighting Co. v. Barbash*, 779 F.2d 793 (2d Cir. 1985); *Studebaker Corp. v. Gittlin*, 360 F.2d 692 (2d Cir. 1966); *SEC v. Okin*, 132 F.2d 784 (2d Cir. 1943).

43. See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 Stan. L. Rev. 385, 456-60 (1990) (describing the delegation to the SEC as allowing Congress to avoid conflict over specific statutory reforms); Joel Seligman, *The Transformation of Wall Street* 82-100 (Houghton Mifflin Co., 1982) (describing political processes leading to enactment of the Securities Exchange Act of 1934).

44. Congress held a series of hearings before the Senate Committee on Banking and Currency and the House Committee on Interstate and Foreign Commerce regarding the regulation of securities trading and exchange practices in March and April of 1934, which culminated in the adoption of the Securities Exchange Act of 1934. See “Stock Exchange Practices,” Hearings before the Senate Banking and Currency Committee, 73d Cong., 2d Sess. (1934) (“Senate Hearings”); “Stock Exchange Regulation,” Hearings before the House Interstate and Foreign Commerce Committee, 73d Cong., 2d Sess. (1934) (“House Hearings”). The legislative history of the 1934 Act, including the Senate and House Hearings, is reprinted in Jack S. Ellenberger and Ellen P. Mahar, comps., *Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934* (F.B. Rothman, 1973) (11 vols.) (“*Legislative History*”).

45. In particular, exchange leaders feared the Federal Trade Commission, which had previously administered the federal securities laws, because they perceived that it was under the control of the pro-enforcement drafters of the federal legislation. See Seligman, *The Transformation of Wall Street* at 97 (cited in note 43).

the protection of investors."<sup>46</sup> The SEC has exercised this authority by promulgating extensive regulations. The federal proxy rules require anyone soliciting proxies under this provision to make certain required disclosures, to follow specified procedures, and to abstain from making false or misleading statements. These burdens increase if the proxy solicitation concerns the election of directors.

Rule 14a-3 of the Commission's proxy rules requires anyone soliciting a proxy, with certain exceptions,<sup>47</sup> to furnish the shareholder with a written proxy statement prior to or concurrent with the solicitation.<sup>48</sup> The proxy statement must include a description of the subject of the solicitation, a list of parties interested in the solicitation, a description of the person or entity making the solicitation, and an explanation of the rules and procedures governing the proxy process.<sup>49</sup> The rules require disclosure tailored to the issue for which proxies are being solicited. For example, if the issue is election of directors, Schedule 14A requires information about the nominee and incumbent directors, including a description of the nominees, the composition of the board of directors, a description of the attendance by incumbent directors at board meetings during the prior fiscal year and a summary of their committee service, and a description of director compensation.<sup>50</sup>

The proxy statement must be pre-filed with the SEC before it may be used to solicit proxies. Rule 14a-6 provides for a ten-day waiting period after the proxy statement is filed before it may be distributed to shareholders. Distribution of the proxy statement or solicitation of proxies before the proxy statement has been "cleared" by the SEC is known as "gun-jumping" and is a violation of the proxy rules.

Special rules apply to solicitation of proxies in connection with the election or removal of directors. Rule 14a-11 requires the identification

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46. Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1988) ("Section 14(a)"). The SEC is authorized only to regulate proxy solicitation with respect to securities registered under Section 12 of the Exchange Act—that is, securities listed on a national exchange and securities issued by large publicly held corporations. 15 U.S.C. § 78l(b) & (g) (1988 & Supp. 1992).

47. The circumstances under which a proxy statement must be delivered have been substantially reduced by the recent amendments to the proxy rules. See Part V (describing the recent amendments).

48. 17 C.F.R. § 240.14a-3 (1992).

49. Regulation 14A and Schedule 14A, 17 C.F.R. § 240.14a-101 (1992), specify the information required in the proxy statement.

50. If proxies are solicited for an annual or special meeting at which directors will be elected, the issuer must also send shareholders an annual report prior to or together with the proxy statement. Rule 14a-3(b), 17 C.F.R. § 240.14a-3(b) (1992). See, for example, *Ash v. GAF Corp.*, 723 F.2d 1090, 1094 (2d Cir. 1983) (holding that a corporation that sent its annual report by third class mail four days before a proxy did not reasonably guarantee that shareholders would receive the annual report at the same time or before the proxy materials). The annual report must include selected information from the 10-K, including audited financial statements for the two most recent fiscal years. See Rule 14a-3(b) (setting forth the information required in an annual report).

of all participants in an election contest, both in the proxy statement and in solicitations made prior to delivery of the written proxy statement. Participants include the issuer, its directors, nominees for the position of director, and anyone soliciting proxies or financing the solicitation of proxies. The Rule further requires detailed disclosure relating to all such participants. Participants must disclose their occupation and relationship to the issuer, their ownership and other interests in the securities of the issuer, including sources of funds for any securities purchased with borrowed funds, their criminal record, if applicable, a description of their proposed activities in the proxy contest, and any contribution they have made or will make in furtherance of the solicitation.

The proxy rules also regulate shareholder access to the proxy mechanism. Rule 14a-7 protects the shareholder's ability to oppose management's position through the proxy process. The Rule provides any shareholder who wishes to solicit in opposition to management with the right either to obtain a list of shareholders from management or to have management mail the insurgent's proxy materials to the shareholders. The Rule gives management the option to mail the materials or to provide the list, and if management elects to do the mailing, the shareholder must pay the costs.<sup>51</sup>

Rule 14a-8 gives a shareholder who meets certain threshold requirements the right to require management to include his or her proposal in management's proxy statement.<sup>52</sup> This "shareholder proposal rule" is the rule most fundamentally concerned with shareholder access to the ballot and is considered in more detail below.

Finally, Rule 14a-9 is a general antifraud provision that bars the use of false or misleading statements in connection with the solicitation of a proxy.<sup>53</sup> The Rule applies to all communications, oral or written, that are part of a solicitation subject to Section 14(a) and bars both affirmative misstatements and omissions.<sup>54</sup> The federal courts have implied a private right of action under Rule 14a-9; most litigation under the federal proxy rules is based on this provision.

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51. Rule 14a-7 was recently amended. See notes 191-92 and accompanying text (describing the amendments to Rule 14a-7).

52. The Rule provides that management may exclude a shareholder proposal that falls within any of thirteen specified categories, including a proposal that deals with "a matter relating to the conduct of the ordinary business operations of the registrant" or a proposal that "relates to an election to office." 17 C.F.R. § 240.14a-8 (1992). See Part IV.C.

53. See generally *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) (describing the scope of the proxy antifraud provision).

54. This Rule is similar in structure to Rule 10b-5, the general antifraud provision. See 17 C.F.R. § 240.10b-5 (1992).

## IV. FEDERAL REGULATION OF BALLOT ACCESS

Federal law affects shareholder access to the ballot in connection with both issue voting and election contests. To understand this effect, it is necessary to explore further both the federal proxy rules relating to shareholder access and the evolution of those rules.

A. *Evolution of Federal Regulation and Rule 14a-8*

The SEC's rulemaking under Section 14 initially reflected a perception that the SEC's role would be limited to addressing the problems introduced into the voting process by the replacement of personal attendance with proxy solicitations. In adopting early proxy rules, the SEC described its mission as an attempt to replicate the old-style annual meeting that was personally attended by shareholders.<sup>55</sup> Commissioner Robert H. O'Brien explained:

It seems to me that the heart of the problem lies in the failure of corporate practice to reproduce through the proxy medium an annual meeting substantially equivalent to the old meeting in person. I know that the old-fashioned meeting cannot be revived. Admittedly, that is impossible. It is not impossible, however, to utilize the proxy machinery to approximate the conditions of the old-fashioned meeting.<sup>56</sup>

The proxy rules were designed to enable shareholders to retain, while voting by proxy, the same state and common-law rights of corporate governance that they had exercised previously through attendance and participation at the annual meeting. SEC Chairman Ganson Purcell explained:

[T]he rights that we are endeavoring to assure to the stockholders are those rights that he has traditionally had under State law, to appear at the meeting; to make a proposal; to speak on that proposal at appropriate length; and to have his proposal voted on.<sup>57</sup>

The proxy rules reflect this deference to state law. The earliest version of the rules simply required a minimal degree of disclosure and prohibited false and misleading statements.<sup>58</sup> Almost immediately, how-

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55. See Brief for SEC at 17, *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947) (indicating the SEC goal, through proxy rules, of duplicating as closely as possible the conditions for effective self-governance that prevailed at the type of annual meeting that shareholders attended in person), cited in Friedman, 63 Harv. L. Rev. at 807 n.45 (cited in note 6).

56. SEC Commissioner Robert H. O'Brien, Address Before the Conference Board 3 (Jan. 21, 1943), quoted in Donald E. Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 Mich. L. Rev. 419, 438 n.88 (1971).

57. Security and Exchange Commission Proxy Rules, Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 before the House Committee on Interstate and Foreign Commerce, 78th Cong., 1st Sess. 172 (1943) (statement of SEC Chairman Ganson Purcell).

58. Even the provision against false and misleading statements promptly acquired a substantive overtone as the SEC used it to redress insider attempts to gain shareholder approval of unfair practices by depriving shareholders of full information about the transactions. See, for example,

ever, the SEC found that these requirements forced it to consider the issue of ballot access.

Although the right of shareholders to make proposals at annual meetings predated the passage of the federal securities laws, the replacement of personal attendance with proxy voting made it difficult for a shareholder to inform other shareholders of his or her intention to raise such a proposal. Shortly after the SEC had adopted the first proxy rules, the Bethlehem Steel case forced the SEC to consider how its regulation of the proxy voting process impaired shareholder-initiated proposals.<sup>59</sup>

A shareholder of the Bethlehem Steel Corporation informed the management, shortly before the company's annual meeting, of his intention to make a motion at the meeting to amend the bylaws to provide that the shareholders would choose the company's auditors. Management made no mention of the proposed motion in the proxy solicitation materials that were distributed to shareholders. The shareholder complained to the SEC that management's failure to mention the proposed motion made its proxy solicitation false and misleading in violation of the SEC's new proxy rules. Bethlehem responded that it was under no obligation to solicit proxies for a shareholder proposal.

The SEC decided that failure by a company to mention in its solicitation materials an issue that it knew would be raised at the annual meeting rendered the materials false and misleading.<sup>60</sup> It is not clear, however, that this position was supported by existing law, particularly in cases in which the shareholder proposal was completely unrelated to the subject for which management was soliciting proxies.<sup>61</sup> The federal rules did not require management to solicit proxies at all. Arguably,

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Note, *Corporate Recapitalization by Charter Amendment*, 46 Yale L. J. 985 (1937) (describing the solicitation for shareholder approval of a recapitalization plan for Consolidated Film Industries and SEC objections to the solicitation on the basis that it violated the new rules prohibiting false and misleading statements in proxy solicitations).

59. The description of the Bethlehem Steel proxy contest is taken from Dean, 24 Cornell L. Q. at 503-06 (cited in note 6).

60. The SEC took this position in a number of individual cases during the 1938 and 1939 proxy seasons. Robert B. von Mehren and John C. McCarroll, *The Proxy Rules: A Case Study in the Administrative Process*, 29 L. & Contemp. Probs. 728, 740-41 (1964). See, for example, 5 SEC Annual Rep. 62 (1939) (finding it misleading for management to omit a shareholder proposal from a proxy statement). The SEC appeared concerned about the practical problems imposed on the voting process when management, knowing of a proposed motion, used its control of the proxy process to disenfranchise shareholders with respect to that motion. See Bernstein and Fischer, 7 U. Chi. L. Rev. at 233-37 (cited in note 6) (discussing the implications of partial management solicitation).

61. See Bernstein and Fischer, 7 U. Chi. L. Rev. at 234 n.35 (cited in note 6).



under both state and federal law, management could select the issues upon which it sought shareholder voting authority.<sup>62</sup>

To remedy this problem, the SEC amended its proxy rules. The first amendment, enacted in 1940, required solicitation materials to disclose "any matters which the persons making the solicitations are informed other persons intend to present for action at such meeting."<sup>63</sup> Subsequently, in 1942, the SEC amended the rules<sup>64</sup> to require management to include in its proxy statement any proposed shareholder resolution that was "a proper subject for action by the security holders."<sup>65</sup>

The SEC took the position that the shareholder proposal rule simply implemented the shareholder's rights to ballot access under state law.<sup>66</sup> In other words, state law rather than the federal proxy rules was to define the substantive relationship between shareholder and management in governing the corporation. State law would determine the right of a shareholder to nominate a candidate for the board of directors; state law also would determine the proper subjects for a shareholder proposal.<sup>67</sup>

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62. See Dean, 24 Cornell L. Q. at 515-16 (cited in note 6) (arguing that management cannot be required to refer to proposals it does not intend to raise at a meeting on the basis that omission of a shareholder motion renders the material false and misleading if management's proxy material states that "the management does not intend to bring anything in addition to the matters enumerated above before the meeting").

63. Exchange Act Release No. 2376, 1940 SEC LEXIS 37, \*6 (Jan. 12, 1940) (amending Schedule 14A to require the person making a proxy solicitation to identify, in item 16, any other matters he is aware will be raised at the meeting and his proposed disposition of the proxies solicited with respect to those matters).

64. This provision was originally adopted as Rule X-14a-7 in Exchange Act Release No. 3347 (Dec. 18, 1942). It was subsequently renumbered as Rule 14a-8.

65. A contemporary scholar described this limitation as follows:

Where, under the law of incorporation, the charter or the by-laws, certain matters must be initiated by the board of directors, a stockholder, by advising the management he intends to make a motion on such matters, cannot compel the management to insert in the notice of the meeting a statement that certain matters are to be acted upon, when it rests within the discretion of the board whether or not such matters should be initiated. For example, if a board of directors has the right to initiate the reduction of capital and a stockholder writes in and states that he proposes to make a motion that the capital be reduced, it would seem that such a motion may properly be declared out of order. . . .

Dean, 24 Cornell L. Q. at 516 (cited in note 6).

66. Courts have determined that the proxy rules supplement shareholders' state law rights and that state corporation law does not require a corporation to distribute a shareholder proposal to other shareholders. See, for example, *Dyer v. SEC*, 266 F.2d 33, 41 (8th Cir. 1959) (stating that "Rule [14a-8] affords a privilege, which does not otherwise ordinarily exist in favor of stockholders"); *Carter v. Portland General Elec. Co.*, 362 P.2d 766 (Or. 1961) (holding that state law did not require a corporation to submit information on a shareholder's proposal to other shareholders, nor to permit a shareholder motion in an annual meeting, when the corporation in question was not subject to the SEC's proxy rules).

67. See Opinion of Baldwin B. Bane, Director of the Division of Corporation Finance, Exchange Act Release No. 3638, 1945 SEC LEXIS 233, \*2 (Jan. 3, 1945) (stating that "[s]peaking generally, it is the purpose of Rule X-14A-7 [now Rule 14a-8] to place stockholders in a position to

It soon became clear, however, that state statutory or decisional law had not fully defined proper subjects for shareholder action.<sup>68</sup> In *SEC v. Transamerica Corp.*,<sup>69</sup> the SEC brought suit against Transamerica under Rule 14a-8, seeking to compel the company to include certain shareholder proposals in its proxy materials.<sup>70</sup> Because the Rule required inclusion of shareholder proposals only if they concerned a "proper subject for shareholder action," management sought to exclude the proposals on the grounds that they did not deal with subjects proper under Delaware law.

On appeal, the parties focused on the issue of what constituted a proper subject for shareholder action.<sup>71</sup> Delaware corporation law permitted a corporation to include, as part of its charter, provisions that limited, regulated, and defined the respective powers and functions of the shareholders and the board of directors. The Transamerica charter gave the board of directors the exclusive authority to decide whether to submit proposed bylaw amendments for a shareholder vote. Management claimed that this provision was permitted by state law and, therefore, a shareholder proposal to amend the bylaws was not a proper subject for shareholder action unless approved by management.

The SEC argued that Transamerica's reading of proper subject was too narrow. The court agreed, holding that a corporate bylaw could not be used to frustrate "[t]he power conferred upon the Commission by

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bring before their fellow stockholders matters of concern to them as stockholders in such corporation; that is, such matters relating to the affairs of the company concerned as are proper subjects for stockholders' action *under the laws of the state under which it is organized*" (emphasis added). The courts have accepted that the question of proper subject is determined by state law. See *SEC v. Transamerica Corp.*, 67 F. Supp. 326, 329 (D. Del. 1946), *aff'd in part, rev'd in part*, 163 F.2d 511 (3d Cir. 1947) (stating that the inquiry as to whether shareholder proposals are proper matters for action by shareholders at an annual meeting is to be answered "not by federal but by Delaware law").

68. See Bernstein and Fischer, 7 U. Chi. L. Rev. at 235 n.38 (cited in note 6) (explaining that "[v]ery little case law exists as to what a stockholder may properly raise from the floor [of an annual meeting]"); John G. Ledes, *A Review of Proper Subject Under the Proxy Rules*, 34 U. Detroit L. J. 520 (1957) (addressing the question of what constitutes a proper subject for shareholder action under the federal proxy rules).

69. 163 F.2d 511 (3d Cir. 1947).

70. The proposals, offered by shareholder John J. Gilbert, were (1) to have the company's auditors elected by the shareholders; (2) to amend the bylaws to eliminate the requirement that notice of proposed bylaw amendments be included in the notice of meeting; (3) to change the annual meeting from Wilmington to San Francisco; and (4) to require that a post-meeting report be sent to shareholders. *Transamerica*, 163 F.2d at 513. For a detailed discussion of the *Transamerica* case, see Frank D. Emerson and Franklin C. Latchan, *The SEC Proxy Proposal Rule: The Corporate Gadfly*, 19 U. Chi. L. Rev. 807, 809-11 (1952).

71. The court observed that most of the briefs and arguments were devoted to the issue of what constituted a proper subject for shareholder action, so as to compel inclusion of the proposals under the Rule. *Transamerica*, 163 F.2d at 515.

Congress. . . .”<sup>72</sup> The court, however, did not expressly find that Congress had authorized the SEC to override a charter provision or bylaw that had been adopted in compliance with state law.<sup>73</sup> In addition, the court did not explain whether its conclusion that Transamerica’s position was “overnice” and “untenable”<sup>74</sup> was based on its interpretation of Delaware law and, if so, what the basis was for that interpretation.<sup>75</sup>

Management concerns about abuse of the shareholder right to ballot access compounded the difficulties in determining and applying this ambiguous state law concept of proper subject. Management claimed that shareholder proposals could result in management liability, render the solicitation material libelous, and cause needless expense to the corporation. In the absence of clear state law, the SEC felt an obligation to engage in rulemaking, both to clarify the rights of shareholders to ballot access and to prevent the potential abuses feared by management.

Accordingly, the SEC began exercising its rulemaking power to set forth the circumstances under which shareholders would be entitled to ballot access.<sup>76</sup> Starting with an opinion by the SEC Director of the

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72. *Id.* at 518.

73. Nor did it explain how this finding, which appears implicit in the court’s conclusion, could be squared with the view that federal law deferred to the states to determine what issues were proper subjects for a shareholder vote.

74. *Transamerica*, 163 F.2d at 518.

75. The Oregon Supreme Court’s decision in *Carter v. Portland General Elec. Co.*, 362 P.2d 766 (Or. 1961), provides an interesting contrast to *Transamerica*. Portland General Electric was not subject to the SEC’s proxy rules. Accordingly, when shareholders sought to introduce a shareholder proposal at an annual meeting, the corporation ruled the motion out of order. It subsequently refused to include information on the shareholder proposal in its proxy materials. The court held that the SEC’s proxy rules went beyond the shareholders’ rights under state law, and that it could not extend the rules to corporations that were not within the regulatory coverage. *Id.* at 767-68.

The shareholders also sought to have the court declare their motion—an advisory proposal dealing with the construction of a hydroelectric dam—a proper matter for a shareholder vote. The shareholders cited *Transamerica* for the proposition that the issue proposed was a proper subject. *Id.* at 768-69. The court refused, distinguishing *Transamerica* as involving the enforcement of an SEC rule and stating that it had no basis upon which to decide whether a shareholder motion was a proper subject. The court stated, “[I]f we adopt the rule it would be without limitation. It would apply to any stockholder of any corporation. Nor does there exist any administrative body to make any preliminary determination that a stockholder’s proposal is a ‘proper’ one. In simple reality we would be acting in a void.” *Id.* at 769. After *Carter*, it is difficult to ascertain what state law (at least in Oregon) the SEC can rely on to determine proper subject.

76. At the time the SEC began this undertaking, little evidence existed to support management’s concerns about abuse of the shareholder proposal processes. Early studies showed that the process was seldom used, and that most proposals related to corporate governance and the shareholders’ role. For example, a study of the four year period from 1948 to 1951 indicated that proposals most commonly addressed cumulative voting, selection of auditors, location of the annual meeting, and post-meeting reports. See Emerson and Latcham, 19 U. Chi. L. Rev. at 813-30 (cited in note 70).

Division of Corporation Finance<sup>77</sup> and continuing in a series of amendments to SEC Rule 14a-8,<sup>78</sup> the SEC articulated the limits to a shareholder's right to free ballot access.<sup>79</sup> The current version of Rule 14a-8 contains thirteen bases upon which management can exclude a shareholder proposal from the proxy statement as an improper subject.<sup>80</sup>

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77. Exchange Act Release No. 3638, 1945 SEC LEXIS 233, \*2 (Jan. 3, 1945) (stating the opinion of Baldwin B. Bane, Director of the Division of Corporation Finance, interpreting the phrase "proper subject for action" in Rule 14a-8 to include proposals that relate directly to the affairs of the particular corporation and not proposals that deal with general political, social, or economic matters. "[I]t is the purpose of Rule [14a-8] to place stockholders in a position to bring before their fellow stockholders matters of concern to them as stockholders in such corporation; that is, such matters relating to the affairs of the company concerned as are proper subjects for stockholders' action under the laws of the state under which it is organized)."

78. See Liebeler, 18 Ga. L. Rev. 425 (cited in note 5) (recounting the history of Rule 14a-8).

79. The real issue of shareholder access under Rule 14a-8 is the question of who pays for the distribution of a shareholder proposal. If the proposal is included under the Rule in management's proxy statement, the corporation pays for the costs of distribution. The rationale is that shareholder proposals are not personal to the proposing shareholder, but relate to the concerns of all shareholders with the governance of their corporation.

80. Rule 14a-8(c) provides:

The registrant may omit a proposal and any statement in support thereof from its proxy statement and form of proxy under any of the following circumstances:

(1) If the proposal is, under the laws of the registrant's domicile, not a proper subject for action by security holders.

NOTE: Whether a proposal is a proper subject for action by security holders will depend on the applicable state law. Under certain states' laws, a proposal that mandates certain action by the registrant's board of directors may not be a proper subject matter for shareholder action, while a proposal recommending or requesting such action of the board may be proper under such state laws.

(2) If the proposal, if implemented, would require the registrant to violate any state law or Federal law of the United States, or any law of any foreign jurisdiction to which the registrant is subject, except that this provision shall not apply with respect to any foreign law compliance with which would be violative of any state law or Federal law of the United States.

(3) If the proposal or the supporting statement is contrary to any of the Commission's proxy rules and regulations, including Rule 14a-9 [§ 240.14a-9 of this chapter], which prohibits false or misleading statements in proxy soliciting materials;

(4) If the proposal relates to the redress of a personal claim or grievance against the registrant or any other person, or if it is designed to result in a benefit to the proponent or to further a personal interest, which benefit or interest is not shared with the other security holders at large;

(5) If the proposal relates to operations which account for less than 5 percent of the registrant's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the registrant's business;

(6) If the proposal deals with a matter beyond the registrant's power to effectuate;

(7) If the proposal deals with a matter relating to the conduct of the ordinary business operations of the registrant;

(8) If the proposal relates to an election to office;

(9) If the proposal is counter to a proposal to be submitted by the registrant at the meeting;

(10) If the proposal has been rendered moot;

*B. Exclusion of Shareholder Proposals Under Rule 14a-8*

Many of the restrictions in Rule 14a-8 appear both sensible and within the SEC's power to impose. Few commentators would argue with the propriety of permitting management to exclude proposals that are false and misleading<sup>81</sup> or that call for the corporation to violate state or federal law.<sup>82</sup> Only the first basis for exclusion, however, which requires that the proposal deal with a matter that is a proper subject for shareholder action under state law, is strictly true to the SEC's original premise that proper subject is determined by state law.<sup>83</sup>

Moreover, many of the bases for exclusion are not grounded directly in state law. Under Rule 14a-8(c)(13), for example, the SEC permits exclusion of shareholder proposals dealing with dividends.<sup>84</sup> This restriction could be based upon the traditional state corporate law doctrine that declaration of dividends is a matter within the discretion of the board of directors.<sup>85</sup> This principle arises, however, in the context of litigation accusing directors of acting improperly and violating their duty of care to the corporation. These challenges are limited by the business judgment rule, which posits that directors should have a wide degree of discretion in implementing business decisions without being

(11) If the proposal is substantially duplicative of a proposal previously submitted to the registrant by another proponent, which proposal will be included in the registrant's proxy material for the meeting;

(12) If the proposal deals with substantially the same subject matter as a prior proposal submitted to security holders in the registrant's proxy statement and form of proxy relating to any annual or special meeting of security holders held within the preceding five calendar years, it may be omitted from the registrant's proxy materials relating to any meeting of security holders held within three calendar years after the latest such previous submission: *Provided, That*—

(i) If the proposal was submitted at only one meeting during such preceding period, it received less than three percent of the total number of votes cast in regard thereto; or

(ii) If the proposal was submitted at only two meetings during such preceding period, it received at the time of its second submission less than six percent of the total number of votes cast in regard thereto; or

(iii) If the prior proposal was submitted at three or more meetings during such preceding period, it received at the time of its latest submission less than 10 percent of the total number of votes cast in regard thereto; or

(13) If the proposal relates to specific amounts of cash or stock dividends.

17 C.F.R. § 240.14a-8 (1992).

81. Rule 14a-8(c)(3), 17 C.F.R. § 240.14a-8(c)(3) (1992).

82. Rule 14a-8(c)(2), 17 C.F.R. § 240.14a-8(c)(2) (1992).

83. Compare *Grimes v. Centerior Energy Corp.*, 909 F.2d 529, 533 (D.C. Cir. 1990) (holding that the "development of enumerated exemptions in Rule 14a-8(c) serves to define the 'proper subjects' for 'shareholder action under applicable state law'").

84. For a description of early shareholder proposals addressing payment of dividends, see Emerson and Latham, 19 U. Chi. L. Rev. at 819-21 (cited in note 70).

85. See Ryan, 23 Ga. L. Rev. at 110 n.50 (cited in note 6) (suggesting this as a basis of exclusion).

subject to *judicial attack*.<sup>86</sup> A shareholder vote that attempts to set or change corporate dividend policy is quite different from litigation challenging a board decision as improper.<sup>87</sup>

Similarly, Rule 14a-8(a)(1) imposes minimum ownership requirements and holding period qualifications upon shareholders who seek inclusion of a proposal under Rule 14a-8. No uniform state or common-law principle requires that a shareholder hold one percent or one thousand dollars worth of a corporation's stock for a minimum of one year before making a motion at a shareholders' meeting.<sup>88</sup> No state law bars a shareholder from making the same motion or proposal in successive years, yet Rule 14a-8(c)(12) limits a shareholder's ability to do so. Additionally, state law does not restrict shareholders to dealing with issues concerning more than five percent of the corporation's total assets or extraordinary business matters.<sup>89</sup> The SEC, however, has imposed these limits on shareholder democracy.

Many of the restrictions imposed by the proxy rules can be attributed to a pragmatic effort by the SEC to limit the number of shareholder proposals and to restrict use of the proxy statement to issues of general importance to shareholders. Although such limits may be desirable, they have no foundation in state or common-law restrictions re-

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86. See, for example, *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (describing the business judgment rule).

87. Indeed, it seems quite reasonable to permit shareholders to play a role in determining corporate policy but also to allow the board of directors the freedom to exercise its discretion without judicial supervision. See *Hinton v. B.F. Goodrich Co.*, C.A. No. 7624, slip. op. (Ohio Ct. App. May 7, 1975) (finding shareholder desire to communicate with fellow shareholders regarding the amount of dividends paid by the corporation to be a proper purpose for access to the shareholder list). The court stated, "The shareholders have a legitimate concern as to the policy of the directors with respect to the portion of the earnings to be paid in dividends and the portion to be retained in the business." *Id.*

88. This requirement is analogous, however, to state corporate law provisions that require minimum shareholdings for access to the shareholder list or for relief from the security-for-expenses requirement in derivative suits. See, for example, N.Y. Bus. Corp. Law § 624 (McKinney, 1986) (requiring a shareholder to own at least 5% or own stock for six months to inspect the shareholder list); Cal. Corp. Code § 1600 (West, 1990) (requiring a shareholder to own 1% of voting shares to inspect the shareholder list); N.Y. Bus. Corp. Law § 627 (McKinney, 1986) (requiring security for expenses in a shareholder derivative suit unless the plaintiffs hold 5% of the company).

89. Presumably this threshold represents the SEC's cost/benefit analysis and its determination that the costs of distributing and permitting a vote on a shareholder proposal are not justified for proposals related to less than 5% of the corporation's business. This conclusion is hardly compelling, given the total size of many large public companies' business operations. Moreover, as the SEC itself has recognized, a proposal cannot automatically be considered trivial because it involves a small dollar amount. See Proposed Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, Exchange Act Release No. 19,135, 1982 SEC LEXIS 691, \*51-52 n.45 (Oct. 14, 1982) (interpreting the exclusion to provide that proposals that fail to reach the specified economic threshold will be included "if a significant relationship to the issuer's business is demonstrated on the face of the resolution or supporting statement").

garding proper subjects to be raised at a shareholders' meeting. The SEC's authority to impose these restrictions on the use of the proxy mechanism is therefore unclear.

Apart from pragmatic concerns, the SEC's restrictions appear to stem primarily from the general principle that state law vests management, rather than shareholders, with the authority to run the corporation. State corporation statutes generally provide that the corporation shall be managed by or under the direction of the board of directors.<sup>90</sup> This common provision suggests that a shareholder proposal affecting the management of the corporation's affairs may improperly interfere with the board's authority.<sup>91</sup>

The absence of modern judicial decisions voiding shareholder action on the basis of these statutes suggests that their limitation on shareholder activity is, at best, minimal. Additionally, it would seem that framing the proposal as a shareholder recommendation rather than an attempt to bind the board would address any limitation the statutes impose.<sup>92</sup> Although the SEC has been more receptive to shareholder proposals framed as recommendations, it has, in many cases, allowed management to exclude precatory proposals under Rule 14a-8(c)(5).<sup>93</sup>

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90. See, for example, 8 Del. Code Ann. § 141(a) (Michie, 1991) (stating that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors"); Cal. Corp. Code § 300(a) (West, 1990) (stating that "the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board"); N.Y. Bus. Corp. Law § 701 (McKinney, 1986) (stating that "the business of a corporation shall be managed under the direction of its board of directors").

91. See, for example, Aranow and Einhorn, *Proxy Contests for Corporate Control* at 287-88 (cited in note 15) (describing the difficulty of determining whether management statutes limit the types of issues shareholders may properly submit). In *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970), vacated as moot, 404 U.S. 403 (1972), counsel for the Dow Chemical Company argued that the ordinary business exclusion prevented shareholders from challenging the operations of their company:

It is my opinion that the determination of the products which the company shall manufacture, the customers to which it shall sell the products, and the conditions under which it shall make such sales are related to the conduct of the ordinary business operations of the Company and that any attempt to amend the Certificate of Incorporation to define the circumstances under which the management of the Company shall make such determinations is contrary to the concept of corporate management, which is inherent in the Delaware General Corporation Act under which the Company is organized.

Id. at 679.

92. See, for example, *Auer v. Dressel*, 306 N.Y. 427, 118 N.E.2d 590 (1954) (upholding the right of shareholders to vote on a nonbinding resolution endorsing the reinstatement of the petitioner as president of the corporation). It appears that Louis Loss was primarily responsible for the idea of framing shareholder proposals in precatory or advisory form. Louis Loss, 2 *Securities Regulation* 908-11 (Little, Brown, 2d ed. 1961). See Manne, 24 *Stan. L. Rev.* at 486 (cited in note 6) (crediting Loss with popularizing this approach).

93. See Part IV.C.2 (discussing the ordinary business exclusion).

Little explicit state law addresses the question of what constitutes a proper subject for shareholder action.<sup>94</sup> Although the SEC alludes to state law principles, few state statutes or judicial decisions expressly forbid shareholder action on a particular subject. Professor Louis Loss has explained that a judicial decision striking down shareholder efforts to address corporate business as contrary to state statutory delegation of corporate decisionmaking authority to management would be "highly unusual."<sup>95</sup> Accordingly, both in determining appropriate criteria for excluding shareholder proposals and in applying those criteria, the SEC does not replicate passively the annual meeting process by applying state law principles, but creates a federal common law as to what constitutes a proper subject for shareholder action.<sup>96</sup> The SEC has thereby thrust itself<sup>97</sup> into the role of determining the proper balance of power between management and shareholders.<sup>98</sup> The next Part demonstrates that the SEC has done so without any guiding principle. The following

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94. The one viable source of state law concerns access to shareholder lists and other corporate documents. Many state statutes provide a right of access "for a proper purpose," and courts have developed a body of law concerning what constitutes a proper purpose entitling a shareholder to such access. See, for example, *The Food and Allied Service Trades Dep't, AFL-CIO v. Wal-Mart Stores, Inc.*, Civ. Act. No. 12551, 1992 Del. Ch. LEXIS 108 ([Del.] Chancery Ct. New Castle County, May 19, 1992) (upholding a shareholder's right to inspect the list for the purpose of soliciting proxies in support of a resolution submitted solely for political and moral reasons); *Credit Bureau Reports, Inc. v. Credit Bureau of St. Paul, Inc.*, 290 A.2d 691 (Del. 1972) (ruling that an inspection for the purpose of communication with fellow shareholders is proper, regardless of the subject of communication); *Hinton v. B.F. Goodrich Co.*, C.A. No. 7624, slip. op. (Ohio Ct. App. May 7, 1975) (upholding shareholder access for the purpose of communicating with fellow shareholders regarding the amount of dividends paid by the corporation). The state law decisions regarding proper subject matter are, in general, broader than the federal common law developed by the SEC. See Part IV.C. But see *State ex. rel. Pillsbury v. Honeywell, Inc.*, 191 N.W.2d 406 (Minn. 1971) (holding that communication regarding the company's munitions policy based on a shareholder's political philosophy is an improper purpose for access to corporate documents).

95. Louis Loss, *Fundamentals of Securities Regulation* 537-38 (Little, Brown, 1983).

96. See *id.* at 538 (stating that "[i]nvariably the Commission (normally its staff), while purporting to find and apply a generally nonexistent state law, has been building a 'common law' of its own as to what constitutes a 'proper subject' for shareholder action").

97. Rule 14a-8 provides the SEC with continuing supervision over the question of ballot access by installing the SEC staff as the tribunal for applying the Rule. Thus, the SEC does not merely legislate the regulatory bases upon which management may exclude a shareholder proposal; it also interprets the regulations in particular cases and resolves disputes between management and the proposing shareholder. This procedure is set out in Rule 14a-8(d), which provides that if management seeks to exclude a shareholder proposal under Rule 14a-8, it must notify the SEC of its intention and the basis for the exclusion. After reviewing submissions from both management and the proponent, the SEC staff will either direct management to include the proposal or will concur in management's decision that the proposal may properly be omitted from the proxy statement.

98. See 24 Sec. Reg. & L. Rep. (BNA) at 1743 (cited in note 8) (quoting Sarah Teslick, Executive Director of the Council for Institutional Investors, criticizing the SEC's substantive exclusions under Rule 14a-8(c) as "controlling thought processes" of shareholders).



Part examines whether legislative history can be used as a source for a uniform theory to guide SEC rulemaking under Section 14(a).

### C. Operation of the Power to Exclude Under Rule 14a-8(c)

The operation of the SEC's proxy rules substantively impacts corporate governance. Specifically, the rules affect the balance of decision-making authority between management and shareholders. These consequences can be illustrated by examining the evolution of shareholder activism and the SEC response in two specific areas: social responsibility proposals and executive compensation.

#### 1. Social Responsibility Proposals

In the 1950s and 1960s, shareholders began to display increasing concern over the corporation's relationship to society at large. Issues such as the Vietnam War, the civil rights movement, and environmentalism became important not merely on the political agenda, but also on the corporate agenda. Shareholders began to use the corporate proxy to debate these issues. Some shareholders viewed the proxy as a vehicle for airing their views before a large audience. Others felt that social responsibility represented a legitimate corporate concern, and that corporations should act responsibly, rather than merely emphasizing accumulation of profits. Arguably one factor relevant to a shareholder's investment decision was the social and political philosophy of the company in which the investment was made.<sup>99</sup>

Although scholars today debate the extent to which corporations should respond to social and political concerns,<sup>100</sup> rather than focusing exclusively on the economic goal of wealth maximization, most people accept the place of social concerns in corporate decisionmaking.<sup>101</sup> Issues of corporate social responsibility directly affect corporate profits; for example, many in the corporate world refuse to do business with firms that operate in South Africa. The extent to which a corporation should consider social questions—such as plant closings, environmental concerns, and dangerous products—that may limit its profitability to

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99. See Loss, *Fundamentals of Securities Regulation* at 539-40 (cited in note 95) (describing the development of the "ethical investor" movement).

100. For a recent examination of the role of the corporation in the political process, see Fisch, 32 *Wm. & Mary L. Rev.* 587 (cited in note 11).

101. See, for example, David L. Engel, *An Approach to Corporate Social Responsibility*, 32 *Stan. L. Rev.* 1 (1979); Edwin M. Epstein, *Societal, Managerial, and Legal Perspectives on Corporate Social Responsibility—Product and Process*, 30 *Hastings L. J.* 1287 (1979). But see Alfred Rappaport, *Let's Let Business Be Business*, *N.Y. Times* § 3 at 13 (Feb. 4, 1990) (arguing that corporate participation is an inefficient way to solve social problems and that "[t]he corporation's only social responsibility [should be] to increase its value to 'stakeholders'").

shareholders presents a fundamental corporate governance issue. Corporations have been criticized for a lack of social responsiveness, and investors, as well as consumers, increasingly seek corporations that meet particular social or political agendas.<sup>102</sup>

In the 1950s and 1960s, however, corporate management viewed shareholders' efforts to focus corporate decisionmaking on issues of social and political concern as inappropriate; management opposed the use of the proxy statement to debate such issues. The SEC, which had previously allowed management to exclude shareholder proposals made "primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes," supported management's view.<sup>103</sup> In 1951, the SEC used Rule 14a-8(c) to permit the Greyhound Corporation to exclude a shareholder proposal to abolish segregated seating on its buses.<sup>104</sup> The court in *Greyhound* deferred to the SEC's decision to permit exclusion of the proposal.<sup>105</sup>

The SEC's position regarding social action proposals persisted and resulted in fairly limited use of the shareholder proposal rule until the late 1960s. In 1969, the SEC interpreted the Rule to permit the Dow Chemical Company to exclude a shareholder proposal requesting the board of directors to "consider the advisability of adopting a resolution setting forth an amendment to the composite certificate of incorporation of the Dow Chemical Company that the company shall not make napalm."<sup>106</sup> In the now-famous case of *Medical Committee for Human Rights v. SEC*, the Second Circuit indicated, albeit in dictum, its strong disapproval of the SEC's interpretation: "Our own examination of the issue raises substantial questions as to whether an interpretation of Rule 14a-8(c)(2) which permitted omission of this proposal as one motivated primarily by general political or social concerns would conflict with the congressional intent underlying Section 14(a) of the Act."<sup>107</sup> The court explained that the controversy surrounding the manufacture of napalm demonstrated that its continued manufacture was a matter of great economic as well as social significance to the company. Warning

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102. An example is the development of "politically correct" mutual funds, which permit shareholders to restrict their investment to companies with whom they agree on social issues. The TIAA-CREF Social Choice Account allows investors to restrict their investment to companies that, among other things, do not have economic ties to South Africa, produce nuclear energy, or produce and market either alcoholic beverages or tobacco. See TIAA-CREF, *Charting TIAA and the CREF Accounts* 12 (Winter 1991-92).

103. Exchange Act Release No. 4775, 1952 SEC LEXIS 121 (Dec. 11, 1952). The provision allowing exclusion of social action proposals was Rule 14a-8(c)(2), 17 C.F.R. § 240.14a-8(c)(2).

104. *Peck v. Greyhound Corp.*, 97 F. Supp. 679 (S.D.N.Y. 1951).

105. *Id.*

106. *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659, 662-63 (D.C. Cir. 1970), vacated as moot, 404 U.S. 403 (1972).

107. *Id.* at 680.

that "[t]he proper political and social role of modern corporations is, of course, a matter of philosophical argument extending far beyond the scope of our present concern," the court suggested that it was a subject upon which the shareholders were entitled to input.<sup>108</sup>

No reason has been advanced in the present proceedings which leads to the conclusion that management may properly place obstacles in the path of shareholders who wish to present to their co-owners, in accord with applicable state law, the question of whether they wish to have their assets used in a manner which they believe to be more socially responsible but possibly less profitable than that which is dictated by present company policy.<sup>109</sup>

While the Second Circuit in *Medical Committee for Human Rights* was expressing its disapproval of the SEC's approach to social policy proposals, another similar battle was underway. The Campaign GM proxy contest involved an effort by a group of shareholders to improve the social responsibility of General Motors. The shareholder group, which called itself the Project on Corporate Responsibility, submitted nine shareholder proposals for inclusion in the General Motors proxy statement. These included proposed bylaw amendments to add public-interest directors and to form a Shareholders Committee for Corporate Responsibility, and specific reforms dealing with air pollution, employee safety, and other issues.<sup>110</sup> Although the SEC required General Motors to include two of the proposals, it permitted, without detailed explanation, exclusion of the other seven.<sup>111</sup>

The SEC's more receptive treatment of the Campaign GM proposals may have been due, in part, to its recognition that Congress had concerns about its approach to social and political proposals. Shortly after the General Motors annual meeting in April 1970, Senator Edmund S. Muskie proposed a bill to prevent corporations from excluding shareholder proposals on the grounds that they dealt with social or political issues. On June 23, 1970, Senator Muskie introduced the Corporate Participation Bill,<sup>112</sup> which was designed to allow shareholders to direct their corporations not only to increase profits but also "to advance the general welfare."<sup>113</sup> At a minimum, the bill indicated a belief on the part of some members of Congress that social responsibility issues represented a proper matter of shareholder concern.

The SEC responded by amending Rule 14a-8 in 1972. As redrafted, the Rule permitted the exclusion of social action proposals only when

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108. Id. at 681.

109. Id.

110. See Schwartz, 69 Mich. L. Rev. 419 (cited in note 56) (describing Campaign GM).

111. Id. at 451-62.

112. S. 4003, 91st Cong., 2d Sess. (June 23, 1970) in 116 Cong. Rec. 9547 (1970).

113. 116 Cong. Rec. 9547 (1970) (remarks of Senator Muskie).

those proposals were not significantly related to the issuer's business.<sup>114</sup> Although the SEC continued to view social action proposals with disfavor and to find, in many cases, that the proposals could be excluded on other grounds,<sup>115</sup> the SEC staff eventually came to accept many such proposals as proper.

Management's continued opposition to the inclusion of social action proposals resulted in further modifications to Rule 14a-8. The SEC responded to management predictions that Rule 14a-8 would open floodgates and overwhelm corporations with social action proposals by adopting procedural restrictions to ballot access. Although social action proposals could not be eliminated on the basis of their content, they could be discouraged by imposing minimum ownership requirements, limiting each shareholder to a single proposal, and barring resubmission of proposals unless they garnered a specified percentage of affirmative votes.

Finally, the effect of the SEC's opposition, lasting over twenty-seven years, to the introduction of social action proposals by shareholders prevented shareholders from exploring, through the voting process, the philosophical question of the degree to which corporate social responsibility is necessary or appropriate. This development was thwarted during a time when corporate growth and the increasing dominance of American business should have brought the issue to the forefront.

## 2. Executive Compensation and the Ordinary Business Exclusion

The provision of Rule 14a-8 that allowed management to exclude social action proposals is closely related to a current exclusion. Rule 14a-8(c)(5) permits management to omit proposals that relate to the ordinary business operations of the issuer. The SEC explained the rationale behind this exclusion<sup>116</sup> to Congress as follows:

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114. Adoption of Amendments to Proxy Rules, Exchange Act Release No. 9784, 1972 SEC LEXIS 155 (Sept. 22, 1972).

115. Social action proposals are commonly excluded under Rule 14a-8(c)(5) as relating to ordinary business operations. Recently, for example, the SEC staff has determined that shareholder proposals dealing with corporate charitable contributions may be excluded on this basis. See, for example, *Exxon Corp.*, SEC No-Action Letter, 1992 SEC No-Act. LEXIS 209 (Feb. 19, 1992); *Pacific Telesis Group*, SEC No-Action Letter, 1992 SEC No-Act. LEXIS 214 (Feb. 20, 1992). In addition to the difficulties of applying the ordinary business operations exclusion to proposals that raise substantial policy questions, see note 120 and accompanying text, the staff's position hinders shareholder control of the corporation's political and social speech. See *First Nat'l Bank of Boston v. Bellotti*, 435 U.S. 765, 792 (1978) (referring to mechanisms available to shareholders, under state corporation law, to monitor and control corporate political speech with which they disagree).

116. This exclusion was added to the rule in 1954. Adoption of Amendments to Proxy Rules, Exchange Act Release No. 4979, 1954 SEC LEXIS 38 (Jan. 6, 1954).

The policy motivating the Commission in adopting the rule . . . is basically the same as the underlying policy of most State corporation laws to confine the solution of ordinary business problems to the board of directors and place such problems beyond the competence and direction of the shareholders. The basic reason for this policy is that it is manifestly impracticable in most cases for stockholders to decide management problems at corporate meetings.<sup>117</sup>

Attempts by shareholders to dictate minute details of corporate operations, even if legal under state law, would presumably interfere with the board's statutory mandate to oversee the operation of the company.<sup>118</sup>

The extent to which state corporation law compels adoption of the ordinary business exclusion is questionable at best. The incongruity in the SEC's position is particularly clear with respect to proposals for charter amendments, as most state corporation statutes explicitly grant shareholders the right to amend the corporate charter.<sup>119</sup> Additionally, it would seem that shareholder proposals addressing business operations would more appropriately relate to the shareholders' financial interests in the corporation than would social policy proposals.

The SEC has fashioned a test for determining when a proposal falls within the exclusion for ordinary business operations that examines the "policy implications" of each proposal. A proposal that addresses substantial policy concerns will not be excludable under Rule 14a-8(c)(5).<sup>120</sup> Thus, the current position of the SEC appears to be directly contrary to its pre-1972 posture that social policy concerns were not properly addressed through the proxy process.<sup>121</sup>

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117. *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659, 678 (D.C. Cir. 1970), vacated as moot, 404 U.S. 403 (1972), (citing Hearings on SEC Enforcement Problems before a Subcommittee of the Senate Committee on Banking and Currency, 85th Cong., 1st Sess., pt. 1 at 118 (1957) (statement of SEC Chairman J. Sinclair Armstrong)).

118. Shareholder participation in decisions about employee compensation also raises the issue of whether this constitutes impermissible interference with the directors' control of the corporation. See notes 90-93 and accompanying text.

119. See, for example, *Grimes v. Centerior Energy Corp.*, 909 F.2d 529 (D.C. Cir. 1990) (allowing exclusion of a shareholder proposal to amend the charter to limit the company's capital expenditures as relating to ordinary business operations).

120. See Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12,999, 1976 SEC LEXIS 326, \*31-32 (Nov. 22, 1976) (stating that proposals "which have significant policy, economic or other implications inherent in them" will not be excluded by Rule 14a-8(c)(7) because this Rule only excludes "proposals that deal with truly 'ordinary' business matters . . . that are mundane in nature and do not involve any substantial policy or other considerations"). See also *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416, 426 (D.C. Cir. 1992) (describing the distinction between ordinary business operations and matters involving substantial policy considerations for purposes of the Rule 14a-8(c)(7) exemption); *Grimes*, 909 F.2d at 531-32.

121. In *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970), vacated as moot, 404 U.S. 403 (1972), Dow Chemical Company sought to omit a shareholder proposal alternatively on the grounds that it was a social action proposal and excludable under Rule 14a-8(c)(2) or that it related to ordinary business operations and was excludable under Rule 14a-8(c)(5). The

The application of the ordinary business operations exclusion demonstrates the problems created by leaving the determination of proper subject matter to the SEC staff. Indeed, the issue is so difficult that the SEC frequently reverses its original staff position regarding what constitutes a proper subject.<sup>122</sup>

Two recent shareholder proposals highlight the difficulty in determining which issues are proper proxy concerns. A shareholder recently submitted a proposal requesting the Cracker Barrel company's board of directors to implement nondiscriminatory hiring policies relating to sexual orientation and to incorporate such policies in the company's employment policy statement.<sup>123</sup> In light of the current attention paid to hiring policies regarding sexual orientation—such as the debate over the military exclusion of homosexuals<sup>124</sup> and the controversial Amend-

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court observed that this argument attempted to place the proponent of the proposal in a catch-22 situation. The court stated:

[I]t is also apparent that the two exceptions which these rules carve out of the general requirement of inclusion can be construed so as to permit the exclusion of practically any shareholder proposal on the grounds that it is either "too general" or "too specific." Indeed, in the present case Dow Chemical Company attempted to impale the Medical Committee's proposal on both horns of this dilemma: in its memorandum of counsel, [Dow] argued that the Medical Committee's proposal was a matter of ordinary business operations properly within the sphere of management expertise and, at the same time, that the proposal clearly had been submitted primarily for the purpose of promoting general political or social causes.

Id. at 679.

122. See, for example, *Pacific Telesis*, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 104 (Feb. 2, 1989) (reinterpreting the ordinary business operations exclusion as inapplicable to shareholder proposals regarding plant closings); *Adoption of Amendments Relating to Proposals by Security Holders*, Exchange Act Release No. 12,999, 1976 SEC LEXIS 326, \*31-32 (Nov. 22, 1976) (reversing an earlier interpretation that proposals dealing with the construction of nuclear power plants constituted an ordinary business concern and stating that "[i]n retrospect, it seems apparent that the economic and safety considerations attendant to nuclear power plants are of such magnitude that a determination whether to construct one is not an 'ordinary' business matter"). See also *Pacific Telesis Corp.*, SEC No-Action Letter, 1992 SEC No-Act. LEXIS 214 (Feb. 20, 1992) (allowing the corporation to exclude a shareholder proposal dealing with charitable contributions to Planned Parenthood as dealing with a matter that relates to the company's ordinary business operations. The SEC stated that staff positions taken in earlier letters, requiring inclusion of similar proposals, "were in error."); *Mimow*, 21 *Stetson L. Rev.* at 236 (cited in note 6) (describing the reversal of an SEC no-action position regarding exclusion of shareholder tobacco proposals); *Roosevelt*, 958 F.2d at 428 (describing the Commission's reversal of staff policy regarding whether proposals that request preparation of reports to shareholders are excludable).

123. *Cracker Barrel Old Country Store, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 76,418 (Oct. 13, 1992). The proposal requested the Cracker Barrel board to "1) implement nondiscriminatory policies related to sexual orientation, and 2) add explicit prohibitions against such discrimination to the Company employment policy statement." Letter Inquiry dated July 13, 1992, Fed. Sec. L. Rep. at 77,285.

124. See, for example, *Associated Press, Judge Says Navy Can Discharge Gay Sailor*, N.Y. Times § A at 20 (Feb. 11, 1993); *Jeffrey Schmalz, Gay Groups Regrouping for War on Military Ban*, N.Y. Times § A at 26 (Feb. 7, 1993); *Adam Clymer, G.O.P. Threatens Filibuster To Force Vote on Gay Ban*, N.Y. Times § A at 17 (Feb. 3, 1993).

ment 2 in Colorado<sup>125</sup>—one might think that the Cracker Barrel proposal clearly presented the “substantial policy considerations” that remove it from the category of proposals excludable because they relate to ordinary business matters.<sup>126</sup> Nonetheless, the SEC staff determined that the proposal properly could be excluded as an ordinary business matter. The Commission affirmed the staff position.<sup>127</sup>

The SEC staff took a markedly different position with respect to a proposal by an Eli Lilly & Company shareholder. The Lilly proposal requested the board of directors to adopt a price restraint policy by November 1, 1993.<sup>128</sup> When Lilly sought to exclude the proposal under Rule 14a-8(c)(7), claiming that drug pricing decisions related to the company’s ordinary business, the shareholder argued that media attention to the issue of fairness in drug pricing had made it a “crucial national issue.”<sup>129</sup> Although corporate pricing decisions would seem to fall within the core of business decisions delegated to management rather than to shareholders, the SEC staff refused to permit exclusion of the proposal.<sup>130</sup>

The SEC staff’s response to proposals addressing executive compensation provides a particularly egregious example of the difficulty in determining what constitutes a proper subject for a shareholder proposal. For many years, the SEC considered employee compensation, including compensation of the company’s officers, to be a matter of ordinary business operations.<sup>131</sup> Accordingly, the SEC upheld manage-

125. Amendment 2 to the Colorado Constitution prohibits the Colorado state legislature and other municipalities from passing laws that specifically protect homosexuals from discrimination. Amendment 2 represents a grass-roots effort to restrict state and local governments in Colorado from protecting homosexuals from discrimination. For further descriptions of Amendment 2 and public reactions to its passage, see Dirk Johnson, *A Ban on Gay-Rights Laws Is Put on Hold in Colorado*, N.Y. Times § A at 6 (Jan. 16, 1993); Editorial, *Don't Boycott Colorado, but Help Fight Back*, N.Y. Times § A at 24 (Jan. 8, 1993); Dirk Johnson, *Colorado Homosexuals Feel Betrayed*, N.Y. Times § 1 at 38 (Nov. 8, 1992).

126. See Coffee, Wall St. J. at A14 (Feb. 2, 1991) (cited in note 8) (arguing that the Cracker Barrel decision demonstrates the inability of the SEC staff to “draw any intellectually valid line” regarding which proposals present a proper subject for shareholder action).

127. *Cracker Barrel Old Country Store, Inc.*, SEC No-Action Letter, 1993 SEC No-Act. LEXIS 51 (Jan. 15, 1993).

128. *Eli Lilly & Co.*, SEC No-Action Letter, 1993 SEC No-Act. LEXIS 317, \*13 (Feb. 25, 1993).

129. The shareholder cited both President Clinton’s discussion of drug pricing during the presidential debates and feature stories on drug pricing by the Wall Street Journal and ABC Prime Time Live as evidence of the substantial policy concerns implicated by drug pricing. *Id.* at \*3.

130. The staff explained, “The proposal, which relates to the Company’s fundamental business strategy with respect to its pricing policy for pharmaceutical products, involves issues that are beyond matters of the Company’s ordinary business operations.” *Id.* at \*1.

131. In 1954, the SEC amended Rule 14a-8 by adding subsection (c)(5), which allowed management to exclude matters relating to ordinary business operations. *Solicitation of Proxies, Ex-*

ment attempts to exclude shareholder proposals dealing with executive compensation from the proxy statement.<sup>132</sup>

This position was ironic because Congress had specifically identified excessive management compensation as an abuse to which the federal securities laws, including Section 14(a), were addressed. Representative Lea's statement during the floor debate on the bill is illustrative:

[I]n recent years we have seen the directors of corporations, without the knowledge of their stockholders, voting themselves vast bonuses out of all proportion to what legitimate management would justify. We have had revelations of salaries paid to directors and officers of great corporations which showed shameful mismanagement; which showed that the men in charge of some of these corporations were more concerned in managing its affairs for their own benefit than for the benefit of the stockholders. The history of the past few years has revealed that in a number of instances these unconscionable bonuses and unconscionable salaries exacted from the stockholders were continued notwithstanding the fact that dividends were cut, and notwithstanding the fact that in some cases the common-stockholders were deprived of any dividends.<sup>133</sup>

Other members of Congress viewed the legislation as an effort to "make the integrity of the conduct of large business corporations increasingly a matter of national rather than local concern. . . ." <sup>134</sup> Congress was particularly concerned about shareholders' inability to

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change Act Release No. 4979 (Jan. 5, 1954). The SEC immediately interpreted this provision to allow exclusion of shareholder proposals dealing with employment compensation. See Aranow and Einhorn, *Proxy Contests for Corporate Control* at 293 (cited in note 15) (describing the SEC's approval, under the amended Rule, of AT&T's effort to exclude a shareholder proposal regarding employee benefits); *Curtin v. American Tel. & Tel. Co.*, 124 F. Supp. 197, 198 (S.D.N.Y. 1954) (deferring to the SEC's determination that pensions are "matters that primarily are the responsibility and concern of the corporate management and its directors rather than that of its stockholders").

132. See, for example, *General Elec. Co.*, SEC No-Action Letter, 1990 SEC No-Act. LEXIS 136 (Jan. 31, 1990) (ruling a proposal regarding incentive compensation excludable because it concerned employee compensation); *Newport Pharmaceuticals Int'l Inc.*, SEC No-Action Letter, 1984 SEC No-Act. LEXIS 2507 (Aug. 10, 1984) (holding a proposal regarding the formation of a special committee to investigate the compensation of management personnel excludable as a matter relating to the conduct of the company's ordinary business); *Scott Paper Co.*, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 1242 (Dec. 27, 1989) (holding a proposal requiring that director compensation be in the form of company common stock excludable because it dealt with a matter relating to the conduct of the company's ordinary business); *American Tel. & Tel. Co.*, SEC No-Action Letter, 1988 SEC No-Act. LEXIS 1618 (Dec. 8, 1988) (holding a proposal to impose a cap on the amount of compensation and benefits paid by the company properly excludable).

133. Debate in the U.S. House of Representatives on H.R. 9323, 78 Cong. Rec. 7861-62 (1934), reprinted in Ellenberger and Mahar, 4 *Legislative History* (cited in note 44) ("House Debate") (statement of Representative Lea). Representative Lea concluded that the bill went far beyond regulating national security exchanges, but would protect investors against fraud and imprudent investments by giving integrity to management of large corporations in which ownership was separated from control. *Id.*

134. House Debate, 78 Cong. Rec. at 7922 (statement by Representative Mapes (quoting *Rogers v. Guaranty Trust Co.*, 288 U.S. 123, 149-50 (1932) (Stone, J., dissenting))).



monitor and to control excessive executive compensation.<sup>135</sup> Congress clearly indicated that federal regulation of the proxy solicitation process was designed to curb excessive compensation abuses by enhancing shareholder control.<sup>136</sup> Early shareholder proposals responded to this objective, and many specifically addressed executive compensation,<sup>137</sup> until the SEC, determining that excessive compensation was not a proper subject for shareholder action, removed the issue from shareholder consideration.<sup>138</sup>

Additionally, executive compensation represents an area of per se conflict of interest between management and shareholders, a conflict particularly difficult to address through other shareholder monitoring mechanisms. Traditionally, executive compensation has been poorly disclosed and difficult for shareholders to evaluate. Although courts have allowed shareholders to attack excessive executive compensation as waste through derivative suits,<sup>139</sup> such litigation is too blunt an instrument to address the problem effectively, and the courts have proven themselves poorly equipped to assess such challenges.<sup>140</sup>

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135. See House Debate, 78 Cong. Rec. at 7922-23 (statement of Representative Mapes) (describing compensation excesses and abuses in connection with the American Tobacco litigation). Executive compensation at the American Tobacco Company was quite generous. For example, in 1931, the president of the company received compensation totalling over two million dollars. The compensation plan was attacked in several shareholder suits, and although parts of the compensation were held excessive, several courts refused to strike down the plan because it had been approved by the shareholders. Moreover, no court ordered the executives to repay part of their compensation as excessive, although the compensation arrangement was modified in some respects. For further discussion of the compensation arrangements and litigation, see *Rogers v. Guaranty Trust Co.*, 288 U.S. 123, 133 (1933) (Stone, J., dissenting); William L. Cary and Melvin Aron Eisenberg, *Corporations Cases and Materials* 617-20 (Foundation, 6th ed. 1988).

136. See House Debate, 78 Cong. Rec. at 7961 (statement of Representative Dirksen) (identifying the American Tobacco Company case as an "historic example" of abuse of the proxy process and empowering the SEC through Section 13 to deal with compensation abuses); Comment, 33 Nw. U. L. Rev. at 930-32 (cited in note 28) (recounting abuses of the American Tobacco compensation plan and the resulting proxy regulation response). See also Report [To accompany H.R. 9323], H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934), reprinted in 5 *Legislative History*, Item 18 (cited in note 44) ("Rayburn Report") (citing principles of fair corporate suffrage as a means of controlling unfair practices by corporate insiders).

137. See Emerson and Latcham, 19 U. Chi. L. Rev. at 821-25 (cited in note 70) (describing shareholder proposals on executive compensation during the 1948-51 proxy seasons).

138. See, for example, *Transamerica Corp.*, SEC No-Action Letter, 1990 SEC No-Act. LEXIS 46 (Jan. 10, 1990) (stating that "[t]he Division's existing position regarding proposals dealing with compensation arrangements is that such matters relate to the conduct of a registrant's ordinary business operations and may be excluded pursuant to rule 14a-8(c)(7)"). Accord *Int'l Remote Imaging System, Inc.*, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 684 (May 24, 1989); *The Centennial Group, Inc.*, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 955 (Sept. 7, 1989); and *Manville Corp.*, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 342 (March 3, 1989).

139. See, for example, *Rogers v. Hill*, 289 U.S. 582, 590-92 (1933) (finding that bonus payments to executives under corporate bylaws had "become so large as to warrant investigation").

140. See, for example, *Heller v. Boylan*, 29 N.Y.S.2d 653, 679 (Sup. Ct. 1941), aff'd, 263 A.D. 815, 32 N.Y.S.2d 131 (1941). The *Heller* court noted:

Finally, in 1991, the SEC decided that executive compensation had become an issue of such public significance that compensation decisions no longer could be deemed a matter of ordinary business operations. In May 1991, Linda C. Quinn, Director of the SEC's Division of Corporation Finance, gave early indications of the SEC's forthcoming reversal by stating that shareholder proposals "aimed at reforming the compensation process or setting criteria for executive and director pay . . . would most likely be approved by the SEC staff in 1992."<sup>141</sup> The SEC formally implemented this policy reversal in response to a series of no-action requests during the 1992 proxy season.<sup>142</sup> The SEC's statement in *Reebok International Ltd.*<sup>143</sup> is illustrative:

In view of the widespread public debate concerning executive and director compensation policies and practices, and the increasing recognition that these issues raise significant policy issues, it is the Division's view that proposals relating to senior executive compensation no longer can be considered matters relating to a registrant's ordinary business. Eventually the SEC concluded that executive compensation was so important that it substantially amended and expanded its requirements for disclosure of executive compensation in proxy statements and other periodic reports under the Exchange Act.<sup>144</sup>

Unfortunately, both the SEC's original position and its recent change of heart missed the point. Procedures for determining executive compensation have been faulted for inhibiting productivity and hampering the ability of U.S. corporations to compete globally. The operation of the proxy rules has limited shareholder voice in this area, thereby frustrating the ability of shareholders to introduce executive compensation monitoring procedures. In effect, the SEC's rules have impeded the ability of the corporate structure to evolve to address the

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Yes, the Court possesses the *power* to prune these payments, but openness forces the confession that the pruning would be synthetic and artificial rather than analytic or scientific. Whether or not it would be fair and just, is highly dubious. Yet, merely because the problem is perplexing is no reason for eschewing it. It is not timidity, however, which perturbs me. It is finding a rational or just gauge for revising these figures were I inclined to do so. No blueprints are furnished. The elements to be weighed are incalculable; the imponderables, manifold. To act out of whimsy or caprice or arbitrariness would be more than inexact—it would be the precise antithesis of justice; it would be a farce.

Id. (emphasis in original). See also Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. Corp. L. 231 (1983).

141. Corporate Governance Highlights, Investor Responsibility Research Center, Vol. 2, No. 24 (May 16, 1991).

142. See Executive Compensation Disclosure, Exchange Act Release No. 30,851, 1992 SEC LEXIS 1297, \*5-6 (June 23, 1992) (describing the SEC's reversal in position and listing companies for which the SEC required inclusion of proposals on executive compensation).

143. *Reebok Int'l Ltd.*, SEC No-Action Letter, 1992 SEC No-Act. LEXIS 376, \*1 (Mar. 16, 1992).

144. See Executive Compensation Disclosure, Exchange Act Release No. 31,327, 1992 SEC LEXIS 2468 (Oct. 16, 1992) (substantially revising the rules governing disclosure of executive compensation to improve shareholder understanding of the nature and extent of this compensation).

problem of excess compensation. The proxy process is designed to enable shareholder debate and voting to bring developing issues to the attention of the shareholders.<sup>145</sup> In order to effect changes in the corporate structure, shareholders must be able to anticipate and to initiate public debate, instead of awaiting SEC staff recognition<sup>146</sup> that the issues have developed into a significant policy matter.

#### D. Nomination of Directors

Closely related to the issue of shareholder ballot access with respect to policy issues is access with respect to director elections. Indeed, the area of director elections seems to be one in which shareholder participation is most legitimate because state corporation statutes vest in the shareholders the authority to elect the board of directors.<sup>147</sup> In spite of congressional concern in 1934 that corporate insiders controlled the election process, a concern to which the proxy regulations appear to be addressed,<sup>148</sup> insider domination of the election process remains pervasive today.<sup>149</sup>

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145. See Minow, 21 Stetson L. Rev. at 227-29 (cited in note 6) (describing recent efforts by institutional investors to use shareholder proposals to affect corporate governance issues).

146. The SEC staff determination as to when an issue is proper for shareholder action was, until fairly recently, immune from challenge even in court. See, for example, *Peck v. Greyhound Corp.*, 97 F. Supp. 679 (S.D.N.Y. 1951) (refusing to enjoin proxy solicitation after the SEC upheld a management decision to omit a shareholder proposal on the grounds that the shareholder had failed to exhaust his administrative remedies or to demonstrate irreparable harm). Compare *Rauchman v. Mobil Corp.*, 739 F.2d 205, 207 (6th Cir. 1984) (expressing "substantial reservations concerning the existence of an implied private cause of action based upon a violation of rule 14a-8"). Although the Supreme Court has not addressed the issue, the most recent circuit court decision upheld a private right of action. See *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416 (D.C. Cir. 1992).

Even when courts nominally have permitted a shareholder to challenge the SEC's judgment, they frequently defer to the agency's expertise in interpreting its own rules. See, for example, *Roosevelt*, 958 F.2d at 426 (deferring to the SEC's interpretation of "ordinary business operations"); *Curtin v. American Tel. & Tel. Co.*, 124 F. Supp. 197 (S.D.N.Y. 1954) (deferring to the SEC's interpretation of its own rule to permit exclusion of a shareholder proposal concerning pension issues as relating to ordinary business operations on the grounds that the SEC had interpreted its rules after full consideration of the matters involved, and its decision was not "clearly erroneous"); *Dyer v. SEC*, 266 F.2d 33, 38 (8th Cir. 1959) (deferring to the SEC decision to allow exclusion of two shareholder proposals under the ordinary business operations doctrine even though "[w]e think there would be room to differ with the Commission's judgment in respect to the propriety and desirability of permissibly allowing these two proposals . . ."). See also *New York City Emp. Ret. Sys. v. Dole Food Co.*, 969 F.2d 1430, 1435 (2d Cir. 1992) (Pollack, J., concurring) (stating that the SEC's interpretation that a proposal may be excluded under Rule 14a-9(c)(7) is "entitled to great weight").

147. See Eisenberg, 83 Harv. L. Rev. at 1505 (cited in note 6) (arguing that shareholders are entitled to nominate candidates for directorships as a corollary of their right to elect the board).

148. See Part VI.B.3.

149. See, for example, Minow, 21 Stetson L. Rev. at 227 (cited in note 6) (describing management control of the process of electing directors). As Ms. Minow observes, the typical director election involves the submission by management to shareholders of a single management-chosen

The continued ability of corporate insiders to control director elections can be attributed, in part, to deficiencies in the federal proxy rules. The proxy rules both have failed to provide affirmative access for shareholders to participate in the nomination process and have thwarted shareholder attempts at participation.

The most obvious omission from the federal proxy rules is a mechanism for shareholders to access the nomination process. The SEC took a few tentative steps toward providing such access in the early 1940s.<sup>150</sup> At the same time that the SEC began to address ballot access for shareholder proposals, it considered the extent to which shareholders should have direct access to the corporate ballot in connection with director elections. In 1942, the SEC proposed a rule that would have required corporations to include shareholder-nominated director candidates in the corporation's proxy statement.<sup>151</sup> Corporate management criticized the rule on the grounds that it was unworkable; shareholders might nominate unqualified candidates or create ballot confusion by nominating too many candidates. These interferences with effective corporate management could prove costly in connection with the wartime effort.<sup>152</sup> Ultimately the SEC abandoned its efforts to pass the rule.<sup>153</sup>

The SEC has also interpreted other aspects of its rules to prevent direct shareholder participation in the nomination process through use of the proxy to debate election issues. For example, since the 1947 amendments, Rule 14a-8 has allowed management to exclude shareholder proposals that relate to elections for office.<sup>154</sup> Ironically, the exclusion originated with a 1942 SEC proposal that would have permitted

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slate of director candidates. Current law does not even permit shareholders to vote against a director nominee—shareholders are limited to withholding a vote in favor of the nominee. As Professor Eisenberg has observed, it is not clear under state law that management is entitled to use the proxy machinery to designate director candidates. Eisenberg, 83 Harv. L. Rev. at 1506 (cited in note 6).

150. Exchange Act Release No. 3347, 1942 SEC LEXIS 44 (Dec. 18, 1942).

151. *Id.*

152. Barnard, 40 Cath. U. L. Rev. at 54 (cited in note 6); J.A.C. Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 Hofstra L. Rev. 183, 214 (1979).

153. See also Security and Exchange Commission Proxy Rules, Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 before the House Committee on Interstate and Foreign Commerce, 78th Cong., 1st Sess. (1943).

Although commentators have continually called for a rule permitting shareholders direct access to the ballot to nominate candidates for the board of directors, the SEC has never re-proposed such a rule. See, for example, Lipton and Rosenblum, 58 U. Chi. L. Rev. 187 (cited in note 6); Robert N. Schwartz, Note, *A Proposal for the Designation of Shareholder Nominees for Director in the Corporate Proxy Statement*, 74 Colum. L. Rev. 1139 (1974); Mortimer M. Caplin, *Shareholder Nominations of Directors: A Program for Fair Corporate Suffrage*, 39 Va. L. Rev. 141 (1953).

154. Adoption of Revised Proxy Rules, Exchange Act Release No. 4037, 1947 SEC LEXIS 424 (Dec. 17, 1947).

shareholders to nominate director candidates directly.<sup>155</sup> The unfavorable public response to that proposal led to a staff interpretation that Rule 14a-8 did not permit shareholder proposals in support of a slate of challengers. Subsequently, the SEC amended the text of the Rule to exclude proposals relating to director elections explicitly.<sup>156</sup>

Although the SEC has not interpreted the exclusion to bar general proposals relating to election procedures, such as cumulative voting rights and general qualifications for directors,<sup>157</sup> the provision prevents a shareholder from using Rule 14a-8 to nominate or advocate the election of a particular director.<sup>158</sup> Furthermore, the SEC has allowed management to rely on the exclusion to bar any proposal that could be viewed as interfering with election of existing directors or director slates.<sup>159</sup> An example of the SEC's acquiescence to management is its response to Mobil's recent exclusion of a shareholder proposal seeking to amend Mobil's bylaws to prevent citizens of OPEC countries from serving on the board of directors.<sup>160</sup> Mobil argued that the proposal would have the effect of barring a sitting director, who was an OPEC citizen, from re-election.<sup>161</sup> The SEC staff agreed that the proposal could be excluded under Rule 14a-8(c)(8) as relating to an election.<sup>162</sup> Mobil's exclusion of the proposal was upheld by the courts.<sup>163</sup>

Lacking direct ballot access under Rule 14a-8, the shareholder's only alternative is a counter-solicitation as governed by Rule 14a-11.<sup>164</sup>

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155. See notes 150-53 and accompanying text.

156. See note 80; Ryan, 23 Ga. L. Rev. at 113 n.60 (cited in note 6).

157. See Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12,999, 1976 SEC LEXIS 326, \*34-35 (Nov. 22, 1976) (explaining the scope of the exclusion).

158. See, for example, *SCI Systems, Inc.*, SEC No-Action Letter, 1992 SEC No-Act. LEXIS 875 (Aug. 14, 1992) (permitting exclusion of a proposal nominating director candidates); *CMT Investment Co.*, SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3382 (Mar. 27, 1981) (applying Rule 14a-8(c)(8) to nominations for election to the board of directors).

159. See, for example, *Tylan Corp.*, SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2530 (Sept. 25, 1987) (allowing exclusion of a proposal that would increase representation, on the directors slate, of certain groups, including minorities). The SEC staff has explained that even proposals relating to general director qualifications, which would otherwise be proper, may be excluded if they relate to or would interfere with the election of current nominees. See, for example, *Chicago Milwaukee Corp.*, SEC No-Action Letter, 1992 SEC No-Act. LEXIS 961 (Sept. 23, 1992).

160. See *Rauchman v. Mobil Corp.*, 739 F.2d 205, 206-07 (6th Cir. 1984) (describing the SEC review of and response to the shareholder proposal).

161. *Id.* at 206.

162. The SEC staff advised Mobil that the "proposal and supporting statement call into question the qualifications of Mr. Olayan for reelection and thus the proposal may be deemed an effort to oppose management's solicitation on behalf of the reelection of this person." *Id.* at 207.

163. *Id.*

164. A counter-solicitation occurs when a group of shareholders propose their own slate of candidates and conduct a solicitation in which they seek proxy authority to vote in favor of their slate rather than the slate nominated by management. See Rule 14a-11(a).

Under Rule 14a-11, a shareholder wishing to nominate a director, to criticize an existing director, or to propose changes in director qualifications that would disqualify a member of the current board is relegated to many of the same hurdles faced by a shareholder seeking control of the company.<sup>165</sup>

Thus, although the SEC rules do not prevent a shareholder from nominating a candidate or slate of candidates in opposition to management's choices, they impede the ability of a shareholder to do so. Even with the recent amendments, the rules continue to inhibit the ability of a challenger seeking minority board representation as much as the rules, inhibit shareholders seeking control of the company.<sup>166</sup> The rules also impair a corporation from experimenting with the nomination and election process. For example, the SEC has permitted exclusion of shareholder proposals seeking to implement procedures for direct shareholder nomination of directors.<sup>167</sup> Even if a corporation's charter or bylaws allowed shareholders to nominate director candidates directly, it is likely that such nominations, if communicated to other shareholders, would constitute solicitations under Rule 14a-1 and would require compliance with the proxy rules.

## V. THE RECENT AMENDMENTS TO THE PROXY RULES

The SEC most recently amended the federal proxy rules on October 16, 1992.<sup>168</sup> The amendments were adopted after a "comprehensive review" of the proxy rules undertaken by the SEC<sup>169</sup> in response to

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165. See *Union Elec. Co.*, Pub. Utility Holding Company Act Release No. 13,962, 1959 SEC LEXIS 730, \*5-6 (March 26, 1959) (finding that a shareholder proposal "which would censure all of the present members of Union's board of directors, who are also management nominees for re-election at the 1959 meeting, and declare all of them disqualified for re-election to office" constitutes "a solicitation in opposition to the election of directors within the meaning of Rules 14a-1 and 14a-11 and therefore could be made only by use of a proxy statement" and requires compliance with the rules pertaining to election contests).

166. See notes 185-87 and accompanying text (discussing the bona fide nominee rule).

167. See, for example, *Amoco Corp.*, SEC No-Action Letter, 1990 SEC No-Act. LEXIS 242 (Feb. 14, 1990) (allowing exclusion under Rule 14a-8(c) of a proposal to allow large shareholders to nominate director candidates on a common ballot with management).

168. See Proxy Rule Release, 1992 SEC LEXIS 2470 (cited in note 1).

169. The 1992 amendments were not the first comprehensive attempt by the SEC to re-evaluate the federal system of proxy regulation. In 1977, the SEC commenced what it termed a "Corporate Governance Proceeding" for the purpose of "re-examin[ing] its rules relating to shareholder communications, shareholder participation in the corporate electoral process, and corporate governance generally." SEC Staff Report on Corporate Accountability at 7 (cited in note 5). This proceeding culminated in an 800 page report, prepared by the SEC staff, that attempted to evaluate the system of proxy regulation in terms of current issues in corporate governance, corporate accountability, and shareholder rights.

Following submission of the report to Congress, the SEC developed three alternative proposals, two of which would have substantially revised shareholder access to the ballot. The proposals were introduced in Proposed Amendments to Rule 14a-8, Exchange Act Release No. 19,135, 1982

complaints that the rules were inefficient,<sup>170</sup> frustrated shareholder democracy,<sup>171</sup> and interfered with free speech.<sup>172</sup> Following this review, the SEC published two sets of proposed rule changes<sup>173</sup> that generated an enormous amount of controversy,<sup>174</sup> ranging from criticism that the rule changes did not go far enough in removing impediments to share-

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SEC LEXIS 691 (Oct. 14, 1982). Proposal I, a modification of existing procedures under Rule 14a-8, imposed requirements that a shareholder own a specified percentage of securities for a minimum time period before submitting a proposal and limited all shareholders to one proposal per annual meeting. Proposal II would have retained the existing proxy rules but would permit issuers to "opt out" and develop their own procedures for ballot access. Proposal III would have substantially diminished SEC involvement by eliminating management's power to exclude a shareholder proposal other than for improper subjects under state law and director election proposals.

Although the modifications were proposed with the stated objective of increasing shareholder democracy, a divided SEC retreated from this principle and adopted Proposal I. Amendments to Rule 14a-8, Exchange Act Release No. 20,091, 1983 SEC LEXIS 1011 (Aug. 16, 1983). Commissioner Bevis Longstreth publicly dissented from this decision, which he criticized as a sharp restriction of shareholders' rights. *Id.* at \*35. Many commentators agreed. One thing was clear: the SEC's rule changes as adopted represented neither a wholesale attempt to eliminate the obstacles imposed by the proxy process on corporate democracy nor an attempt to retreat from refereeing the tension that the proxy access issue generated between shareholder democracy and protection of corporations and their management from harassment and undue expense.

170. See, for example, Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. Corp. L. 163, 169-74 (1991) (identifying and evaluating criticisms that the proxy rules were unduly burdensome).

171. According to the United Shareholders' Association, the proxy rules have "evolved into a regulatory boia constrictor squeezing the power out of shareholder voting as a tool for holding corporate officers and directors accountable." *Shareholder Communication Proposals Produce Second Tidal Wave of Comments*, 24 Sec. Reg. & L. Rep. (BNA) 1516, 1517 (Sept. 25, 1992).

172. In 1989, the California Public Employees' Retirement System ("CalPERS") wrote to the SEC proposing a comprehensive revision of the proxy rules designed to facilitate the participation of institutional investors in corporate governance. Letter from Richard H. Koppes, CalPERS General Counsel, to Linda C. Quinn, Director, Division of Corporation Finance, SEC (Nov. 3, 1989), reprinted in *Institutional Investors: Passive Fiduciaries To Activist Owners* 454 (Practising Law Institute, Corporate Law and Practice Course Handbook Series Number 704, 1990). CalPERS's letter contained a variety of proposals as well as observations regarding the effect of the current proxy rules on shareholder communications and corporate democracy. CalPERS's letter was followed by a similar request for reform from the United Shareholders' Association ("USA"). See Letter from United Shareholders' Association to Edward H. Fleischman, Commissioner, SEC (Mar. 20, 1990). USA's letter, in particular, pinpointed flaws in the proxy rules that operate to limit shareholder access to the proxy machinery. The SEC responded to the requests by initiating a comprehensive review of its proxy rules and the proxy voting process.

173. See Regulation of Securityholder Communications, Exchange Act Release No. 29,315, 1991 SEC LEXIS 1204 (June 17, 1991) (containing the first proposed amendments to the proxy rules); Regulation of Communications Among Securityholders, Exchange Act Release No. 30,849, 1992 SEC LEXIS 1296 (June 24, 1992) (containing the second proposed amendments).

174. See generally *Symposium on the Proposed Proxy Rule Amendments*, 17 J. Corp. L. 1 (1991).

holder democracy<sup>175</sup> to arguments that the existing regulatory system functioned properly and did not require amendment.<sup>176</sup>

The amendments modify the federal proxy rules in four primary areas: (1) filing requirements in connection with proxy solicitations; (2) the "bona fide nominee" rule; (3) access to a shareholder list; and (4) "bundling" of management proposals.<sup>177</sup> The SEC justified the changes in the first two areas as being required by the prior rules' undue interference with shareholder democracy.<sup>178</sup> The remaining changes address problems involving the relationship between the federal proxy rules and state law. All four changes, as enacted, reflect a compromise between provisions that would have directly remedied the identified problem and concerns raised by corporate commentators about potential abuse.<sup>179</sup> As a result of this compromise, each of the four provisions is more complicated and provides more limited reform than earlier proposals and suggestions.

The most highly publicized change was the SEC's decision to exempt many solicitations<sup>180</sup> from the filing requirements<sup>181</sup> of Section 14(a).<sup>182</sup> As amended, the proxy rules exempt all oral solicitations by persons who do not seek proxy authority and who do not have an inter-

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175. Among the important issues the SEC proposal did not address were shareholder access to the proxy statement, nomination of directors, and confidential voting. Minow, 17 J. Corp. L. 149 (cited in note 6).

176. See, for example, Rosenbaum, 17 J. Corp. L. at 165 (cited in note 170) (arguing that "the present system is essentially functioning quite well for shareholders").

177. The amendments also address several more technical matters. They require greater disclosure of the results of previous shareholder votes and of procedures for vote tabulations, reduce the filing requirements in connection with election contests, provide circumstances in which solicitation will be permitted prior to the delivery of a proxy statement to shareholders, and modify public access to preliminary proxy filings. See Proxy Rule Release, 1992 SEC LEXIS 2470 at \*43-59, \*69-70 (cited in note 1).

178. See *id.* at \*22-23 (acknowledging that the "chilling effect" and cost of compliance with filing rules may limit shareholder discussion of management performance and other corporate issues); *id.* at \*73-74 (describing the proxy rules as having "erected unnecessary impediments" to shareholder voting for a partial slate of opposition director candidates).

179. See Roberta S. Karmel, *Can We Talk? A Greater Voice for Investors*, N.Y. L. J. 9 (Dec. 7, 1992) (describing the new proxy rules as "a political compromise between reform of the proxy rules, supported by institutional investors, and the status quo, supported by public corporations").

180. See Proxy Rule Release, 1992 SEC LEXIS 2470 at \*20-34 (cited in note 1) (describing the exemption).

181. The exemption was the SEC's response to criticism of the definition of proxy "solicitation" to include virtually any communication to shareholders intended to influence their opinions about the company. See *id.* at \*12-15. Rather than taking the obvious step of narrowing the definition of solicitation, the SEC retained the definition but exempted most shareholders who were not seeking control or financially involved in an election contest from the regulatory requirements associated with solicitation. The SEC also exempted shareholder announcements of their voting decisions and the reasons for those decisions by adopting a safe harbor exclusion for such announcements. See *id.* at \*40-43.

182. Any applicable filing requirements under § 13(d) continue to apply. See *id.* at \*17.



est in the subject of the solicitation from filing and pre-filing requirements.<sup>183</sup> Written solicitations under similar circumstances are also exempt from filing, except that beneficial owners of more than five million dollars of the issuer's securities must submit copies of written solicitations contemporaneously to the SEC.<sup>184</sup>

The old "bona fide nominee" rule, Rule 14a-4(d), prohibited an opposition shareholder from including management's director candidates on a proxy without the candidate's consent.<sup>185</sup> Because shareholders can submit only one valid proxy in connection with an election,<sup>186</sup> this Rule limited the ability of a shareholder to split his or her ticket between management-sponsored nominees and opposition candidates. This Rule also prevented challengers who sought to nominate only a partial opposition slate from offering shareholders the opportunity to exercise full voting rights. Thus, the Rule directly limited shareholder choice in connection with the election of directors.<sup>187</sup>

Although the SEC faced pressure to adopt a general proposal to allow shareholder choice among different slates of director candidates, it refused.<sup>188</sup> Instead, the SEC's amendment to Rule 14a-4(d) is a model of unnecessary confusion in the name of political compromise.<sup>189</sup> Opposition shareholders are instructed that they can neither include the names of company nominees on their proxy nor provide an opportunity for shareholders to write in the names of company nominees to "round out" a short slate. Challengers can, however, solicit general authority to

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183. Interestingly, the exemption includes officers and directors of the issuer who engage in solicitations at their own expense. See *id.* at \*30 (explaining that this exemption will further the interests of shareholders by providing more discussion of matters presented for a vote).

184. See *id.* at \*35-40 (describing the notice requirement). This provision was a response to corporate commentators who argued that institutional investors could conduct "secret" solicitation campaigns against management proposals. See *id.* at \*25. It is unclear why the SEC viewed this as an abusive practice.

185. See *id.* at \*74 (describing the operation of the rule).

186. *Id.* at \*73.

187. For a more detailed discussion of how the bona fide nominee rule acted as a barrier to minority representation on the board, see Ronald J. Gilson, Lilli A. Gordon, and John Pound, *How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors*, 17 J. Corp. L. 29 (1991).

188. See Proxy Rule Release, 1992 SEC LEXIS 2470 at \*75 (cited in note 1). The SEC described proposals for a universal ballot as "appealing since the shareholder could make such a selection if he or she attended the annual meeting in person." It decided nonetheless to limit its attention to the "more limited problem caused solely by its own rules." *Id.*

189. The SEC's response to competing interest groups with respect to Rule 14a-4(d) is perhaps the most blatant example of its rulemaking approach: political expediency at the sacrifice of principled goals. The description used by Judge Posner in criticizing a recent FCC compromise rule is appropriate: "The impression created is of unprincipled compromises of Rube Goldberg complexity among contending interest groups viewed merely as clamoring supplicants who have somehow to be conciliated." *Schurz Communications, Inc. v. FCC*, 982 F.2d 1043, 1050 (7th Cir. 1992).

vote the proxies in favor of company nominees and can specify, or ask solicitees to specify, nominees for whom the proxy will not be voted.<sup>190</sup>

The amendments also reflect a compromise position with respect to the provision of shareholder lists. The SEC did not return to its original position of federalizing the right of access to a shareholder list.<sup>191</sup> Instead, the SEC retained its previous system under which an issuer can elect to provide a list or to mail materials on behalf of a shareholder. As amended, Rule 14a-7 includes more detailed procedures governing both the shareholder's request for a shareholder list and the corporation's response to the request. It also requires a corporation that chooses to mail the shareholder's materials to do so more promptly. The provision falls far short, however, of guaranteeing shareholders information equivalent to that which the issuer possesses.<sup>192</sup>

Finally, the amendments incorporate the requirement that management "unbundle" groups of issues by permitting shareholders to vote on each matter separately.<sup>193</sup> Under amended Rule 14a-4(a), the form of proxy provided to shareholders must permit a separate vote on each issue for which voting authority is solicited. The Rule, however, has a

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190. See Proxy Rule Release, 1992 SEC LEXIS 2470 at \*79-83 (cited in note 1). The amendment creates substantial potential for confusion. Because the soliciting shareholder cannot include the names of management's nominees, it cannot disclose its preferred selections for candidates to round out the short slate. No single proxy can contain the names of all director candidates, so shareholders must compare the company slate with those of the opposition to choose their preferred candidates and must modify the opposition's proxy to indicate these choices. Moreover, as the model form of proxy contained in the release is drafted, shareholders are not instructed to write in their *choices*, but to write in the names of nominees for which they do *not* want their proxy to be voted. See *id.* at \*82.

191. The SEC noted that many commentators had objected that shareholders' state law rights of access were inadequate because companies routinely "abuse shareholder rights by denying requests on insubstantial grounds," forcing shareholders to litigate enforcement of their rights. *Id.* at \*61. The cost of a lawsuit may be sufficient to bar access to the list. See, for example, Robert A.G. Monks, *My Run for the Sears Board*, *Legal Times* 20 (Aug. 12, 1991). Corporate commentators questioned the SEC's authority to adopt proposed amendments expanding shareholder state law rights of access. *Id.*; Karmel, N.Y. L. J. 9 (Dec. 7, 1992 (cited in note 179)).

192. As Professor Bernard Black explains, Rule 14a-7 can best be described as a "non-access" rule. "It doesn't obstruct shareholder action, but neither does it level the playing field. . . ." Black, 17 *J. Corp. L.* at 57 (cited in note 6).

193. Previously it was possible for management to "bundle" multiple issues together. This practice allowed management to obtain shareholder ratification of measures that, if submitted separately, might have been defeated. Professor Jeffrey Gordon describes how bundling works. For example, a proxy might require shareholders to cast a single vote for a package including both a wealth-reducing proposal, such as an unfavorable amendment to the charter, and a "sweetener" such as a dividend payment. Shareholders thus would be required to approve a provision that they really did not want in order to obtain the sweetener. Jeffrey N. Gordon, *Ties that Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 *Cal. L. Rev.* 1, 47-49 (1988). The American Tobacco Company used increased dividends as sweeteners to obtain shareholder approval of its stock allotment compensation plans for executives. See *Rogers v. Guaranty Trust Co.*, 238 U.S. 123, 138 (1933) (Stone, J., dissenting).

limited effect on the ability of management to engage in strategic behavior<sup>194</sup> because it does not prevent management from conditioning approval of a proposal on the adoption of one or more other proposals. Thus, management can still coerce shareholders into supporting an unfavorable proposal by tying it to adoption of a proposal likely to garner shareholder support.

The amendments are also significant for what they failed to do. First, the SEC did not respond to CalPERS's request that the Commission mandate confidential voting.<sup>195</sup> Second, the SEC did not consider questions of ballot access; indeed, the SEC neither amended Rule 14a-8 nor addressed proposals regarding direct shareholder nomination of directors.<sup>196</sup> Third, the SEC did not provide for a universal proxy, which would give shareholders access to a single document listing all candidates for director positions and allow shareholders to vote their preferences without writing in names or comparing two or more separate lists. Fourth, the amendments did not address any substantive limitations on the role of shareholder voting, such as state law limitations on a shareholder's right to put a corporate governance question to a vote. Finally, the SEC did not address the potential chilling effect of Rule 13(d) on collective action by shareholders in connection with voting.

## VI. THE LEGITIMACY OF THE SEC'S PROXY RULES

As the preceding discussion demonstrates, the SEC's proxy rules are not passive attempts to implement shareholders' state law rights in an increasingly large and impersonal voting system. Instead, the rules change the voting process, both by determining issues upon which shareholder democracy is appropriate and by structuring the way in which such democracy can be exercised. The proxy rules' substantive impact on shareholder voting, a subject traditionally relegated to state corporation law, distinguishes them from much of the system of federal securities regulation, which focuses primarily on disclosure.

The dominance of state law with respect to shareholder voting raises the question of whether the proxy rules are a legitimate exercise of the SEC's rulemaking authority—ultimately a question of statutory

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194. See Gordon, 76 Cal. L. Rev. at 47-55 (describing bundling and "chicken" as examples of management strategic behavior).

195. See Minow, 17 J. Corp. L. at 152-53 (cited in note 6) (describing a confidential voting proposal).

196. See, for example, *id.* at 153 n.11 (describing proposals by NL Industries, Inc., and United Shareholders' Association for direct nomination of directors).

interpretation.<sup>197</sup> The broad language of Section 14(a)<sup>198</sup> makes it difficult to derive limitations on the SEC's power from an examination of the text of the rule. Nonetheless, such limitations do exist. An administrative agency can act only under "specific, well-defined grants of power."<sup>199</sup> "Neither pursuit of the public interest nor the 'broad purpose' of a statute can support a rule not justified by the statutory language. . . ." <sup>200</sup>

As the Supreme Court has explained: "The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is 'the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.'"<sup>201</sup> The Court has further explained that courts are to determine the will of Congress by examining the language and legislative history of the authorizing legislation.<sup>202</sup>

Although many commentators have debated the merits of the SEC's proxy regulations,<sup>203</sup> they have rarely questioned the SEC's authority to promulgate the rules.<sup>204</sup> In evaluating recent criticisms of the proxy rules, including criticism of the most recent amendments, and

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197. The SEC, as an administrative agency, can only make rules within the scope of the statutory authority delegated to it. See, for example, *Bd. of Governors of the Fed. Reserve Sys. v. Dimension Fin. Corp.*, 474 U.S. 361, 373 n.6 (1986) (holding that an administrative agency, in this case the Federal Reserve Board, only has the power "to police within the boundaries of the Act" and not "to expand its jurisdiction beyond the boundaries established by Congress").

198. Section 14(a) simply authorizes the SEC to make such rules as are "necessary or appropriate in the public interest or for the protection of investors." Section 14(a) (cited in note 46).

199. George W. Dent, Jr., *Dual Class Capitalization: A Reply to Professor Seligman*, 54 *Geo. Wash. L. Rev.* 725, 727 (1986).

200. *Id.*

201. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213-14 (1976) (citations omitted).

202. See *id.* at 214 (looking at the language and legislative history of the Exchange Act to determine the scope of the SEC rulemaking authority under § 10(b)). The Court seemingly has authorized the use of both dominant theoretical approaches to statutory interpretation: the textualist approach and the legislative history approach. For a detailed analysis of the extent to which the Supreme Court actually utilizes various theories of statutory interpretation in deciding cases, see Nicholas S. Zeppos, *The Use of Authority in Statutory Interpretation: An Empirical Analysis*, 70 *Tex. L. Rev.* 1073 (1992). But compare Zeppos, 76 *Va. L. Rev.* at 1295 (cited in note 10) (criticizing both textualist and legislative history methods and proposing an alternative fact-finding model of interpretation).

203. See note 6. Most criticism is directed to the merits of the proxy rules. See, for example, Manne, 24 *Stan. L. Rev.* 481 (cited in note 6) (arguing against allowing shareholder social-action proposals). Several commentators have questioned whether the proxy rules are desirable. See, for example, Dent, 30 *N.Y. L. Sch. L. Rev.* 1 (cited in note 6) (arguing that Rule 14a-8 wastes corporate resources and should be rescinded); Liebeler, 18 *Ga. L. Rev.* 425 (cited in note 5) (same).

204. Two recent commentators have analyzed the legislative history of § 14 to evaluate the legitimacy of the proxy rules. See Ryan, 23 *Ga. L. Rev.* 97 (cited in note 6) (concluding that even though the rules are substantive, they are consistent with congressional intent); Bainbridge, 1992 *Wis. L. Rev.* 1071 (cited in note 6) (concluding that the rules should be limited to disclosure and procedural issues).

determining whether further reform of the proxy rules is necessary, the legitimacy of the rules remains unresolved. Moreover, a recent decision by the Court of Appeals for the District of Columbia provides a fresh basis for questioning the SEC's authority to promulgate the existing rules.

A. *The Business Roundtable Decision*

*The Business Roundtable v. SEC*<sup>205</sup> concerned Rule 19c-4,<sup>206</sup> which prohibits national securities exchanges and national securities organizations from listing the stock of any corporation that "disenfranchised" its shareholders.<sup>207</sup> The Rule had the effect of limiting the ability of a listed corporation to modify or reduce the voting rights of common shareholders from a one share-one vote structure.

The Business Roundtable claimed that the SEC lacked the statutory authority to promulgate Rule 19c-4. In defense of the Rule, the SEC argued that one source of its authority was Section 14 of the Exchange Act, which authorized the SEC to make rules for the purpose of promoting fair corporate suffrage.<sup>208</sup> The court reviewed the legislative history and purposes of the Exchange Act and concluded that the SEC's rulemaking authority under Section 14 could not be construed so broadly.<sup>209</sup>

According to the court, Congress authorized the SEC to regulate the proxy process primarily to ensure that shareholders could exercise their votes on an informed basis. Although the court acknowledged the SEC's authorization to enact regulations to promote "fair corporate suffrage," the court stated that Congress intended the regulations to bear "almost exclusively on disclosure" as the means of promoting fair suffrage.<sup>210</sup>

The court analyzed the operation of Rule 19c-4 and concluded that the rule regulated the distribution of voting power in a corporation.<sup>211</sup> This regulation, said the court, directly interfered with corporate voting, control of which Congress had left to state law.<sup>212</sup> The court said that Section 14(a) did not authorize the SEC to decide which issues

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205. 905 F.2d 406 (D.C. Cir. 1990).

206. 17 C.F.R. § 240.19c-4 (1990). The SEC adopted the Rule on July 7, 1988, in connection with its supervision of self-regulatory organizations such as stock exchanges.

207. *Business Roundtable*, 905 F.2d at 407.

208. *Id.* at 410.

209. See *id.* (reviewing the legislative history to determine the legislative purpose of the Exchange Act and refusing to accept a broad generalization of congressional purpose, such as improving the operation of the capital markets).

210. *Id.*

211. *Id.* at 411.

212. *Id.* at 411-12.

should be subject to a shareholder vote or to interfere with traditional state law issues such as quorum requirements, independent directors, and shareholder approval for major corporate transactions.<sup>213</sup> It found no principled way to distinguish regulation of these issues from the SEC's one share-one vote rule; all were consistent with the goal of promoting fair corporate suffrage.<sup>214</sup> The court concluded that the SEC had exceeded its authority and impermissibly attempted to federalize corporate governance standards by "step[ping] beyond control of voting procedure and into the distribution of voting power. . . ." <sup>215</sup>

*Business Roundtable* did not directly address the legitimacy of the proxy rules. In reviewing the objectives of proxy regulation and the extent to which the SEC can affect corporate governance in the name of fair corporate suffrage, however, the court raised significant questions concerning the SEC's regulation of ballot access. In particular, the court observed that Rule 19c-4, like many of the proxy rules, was based on SEC concerns that disclosure and procedural requirements might not remedy all the problems of the shareholder voting process.<sup>216</sup> The court warned that Congress did not seek, through Section 14(a) or elsewhere in the federal securities laws, to regulate shareholders' choices. If the SEC was concerned about the substantive efficacy of shareholder voting, the court advised it to "turn to Congress."<sup>217</sup>

#### B. *The Legislative History of Section 14(a)*

Is *Business Roundtable* correct in finding that the objectives of Congress in enacting Section 14(a) were limited to furthering disclosure in connection with the proxy process? If so, the decision seems to compel the conclusion that the proxy rules, which affect substantive voting rights, are illegitimate.<sup>218</sup> Or does the legislative history support the contrary conclusion that the SEC has not taken advantage of the full extent of its congressional authorization to promote fair corporate suffrage?<sup>219</sup>

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213. Id. at 412.

214. Id.

215. Id. at 411.

216. Id.

217. Id.

218. This is the position taken by Professor Stephen Bainbridge. Bainbridge, 1992 Wis. L. Rev. at 1111 (cited in note 6).

219. Professor Patrick Ryan explains that although the proxy rules substantively affect corporate governance, they are consistent with congressional intent. See Ryan, 23 Ga. L. Rev. at 140, 146 (cited in note 6) (arguing that the legislative history indicates that Congress anticipated and intended that the proposed system of proxy regulation would significantly change the management-shareholder balance of power by increasing shareholder participation in corporate governance).

This Article disagrees with both views of the legislative history. Although the legislative history demonstrates a congressional concern with disclosure, it also shows that the drafters of the Exchange Act hoped to reform the management of business corporations. Increased shareholder participation in corporate governance represented one mechanism for achieving this reform. It is unclear, however, whether the legislation adopted by Congress retained that objective. The dearth of clear evidence regarding Congress's objectives in enacting Section 14(a) makes reliance on legislative history as a basis for evaluating the legitimacy of the proxy rules impossible. The following Part of this Article instead suggests that history represents but one part of a more dynamic interpretive model.<sup>220</sup>

### 1. The Argument that Section 14(a) Is Limited to Disclosure

Recognition that the regulation of proxies comprised a relatively minor component of the Securities Exchange Act provides a starting point in analyzing the legislative intent behind Section 14(a). Although the statute authorizes the SEC to make rules to regulate the solicitation of proxies and the legislative history, including the committee reports, floor debate, and hearings, contains references to shareholder voting,<sup>221</sup> the statute did not focus primarily on the proxy rules.

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220. Statutory interpretation is a central element of federal securities law. Although major advances have been made in analyzing issues of statutory interpretation, see, for example, Zeppos, 76 Va. L. Rev. 1295 (cited in note 10); Eskridge, 135 U. Pa. L. Rev. 1479 (cited in note 14); Frickey, 77 Minn. L. Rev. 241 (cited in note 9), these advances have rarely been used to examine the interpretation of the federal securities laws.

221. The record reflecting the legislative history of the Exchange Act includes prior versions of the legislation, transcripts of the hearings held by the Committee on Stock Exchange Practices, transcripts of the floor debate on the legislation, and various committee reports. The House and Senate bills are reprinted in volumes 10 and 11, respectively, of Jack S. Ellenberger and Ellen P. Mahar, comps., *Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934* (F.B. Rothman, 1973) (11 vols.) ("*Legislative History*"). The congressional committees charged with studying stock exchange legislation, the Senate Committee on Banking and Currency and the House Committee on Interstate and Foreign Commerce, held hearings to consider the proposed bills from February to April of 1934. The Senate hearing transcripts ("*Senate Hearings*") are reprinted in volumes 6 and 7 of *Legislative History*, and the House hearings ("*House Hearings*") are reprinted in volumes 8 and 9. The floor debate is reprinted in 4 *Legislative History*. The congressional reports prepared in connection with the 1934 Act are reprinted in 5 *Legislative History*. For a detailed description of the sources of legislative history available on the 1934 Act and an evaluation of their significance, see Ryan, 23 Ga. L. Rev. at 130-43 (cited in note 6). See also George A. Costello, *Average Voting Members and Other "Benign Fictions": The Relative Reliability of Committee Reports, Floor Debates, and Other Sources of Legislative History*, 1990 Duke L. J. 39 (questioning the value of traditional "sources" of legislative history as probative of congressional intent). For a deeper look at the political evolution of the Exchange Act and the individuals responsible for drafting the statute, see Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 Hastings L. J. 391, 457-83 (1991). See also Seligman, *The Transformation of Wall Street* at 73-100 (cited in note 43).

Rather, the main congressional concerns—and the issues generating the most controversy—were regulating margin transactions, freeing stock exchanges from the effect of pools and other manipulative devices, and instituting a system of securities disclosure that would provide information to investors both in connection with their initial purchase and on an ongoing basis.<sup>222</sup> Congress adopted a system that addressed many perceived abuses in the securities market through disclosure, a device viewed both as a desirable end in itself and as a means of deterring fraud.<sup>223</sup>

During the drafting process, Congress paid less attention to the federal regulation of proxy voting. The few extended references to this section of the bill referred almost exclusively to problems raised by early drafts of the legislation, which had mandated specific disclosure requirements. In its original form, Section 14(a) required anyone soliciting proxies to disclose: (1) the purpose of the solicitation; (2) any relationship the solicitor had with the issuer; (3) any interest the solicitor possessed in the subject security; (4) persons from whom similar proxies were being solicited; and (5) such further information as the SEC might require.

Many objections were raised to this form of the provision, particularly to the required disclosure of other shareholders from whom proxies were being solicited.<sup>224</sup> Industry experts noted that this requirement was tantamount to requiring an issuer, during a routine proxy solicitation, to send a complete shareholder list to each shareholder.<sup>225</sup> They testified that this requirement was unduly burdensome and would im-

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222. See Senate Hearings at 6466 (cited in note 221) (statement of Thomas Corcoran) (describing regulation in four general fields: (1) control of credit; (2) manipulation and evils in stock market machinery; (3) protection of investors in the market "from ignorance and from exploitation by corporate insiders;" and (4) over-the-counter or unlisted regulation). Compare remarks by Senator Duncan U. Fletcher to the U.S. Senate upon introduction of S. 2693, 73d Cong., 1st Sess. in 78 Cong. Rec. 2270-71 (Feb. 9, 1934) (describing the purposes of the bill as addressing manipulation, regulation of credit, disclosure by issuers, and a variety of other "misleading and law-avoiding devices" including "the abuse of proxies"). See also Report on Stock Exchange Practices, S. Rep. No. 1455, 73d Cong., 2d Sess. (1934) (describing the result of congressional investigation and the objectives of regulation).

223. See Bainbridge, 1992 Wis. L. Rev. at 1109-10 (cited in note 6) (describing the objectives of the disclosure system).

224. These objections were made even though Thomas Corcoran, one of the draftsmen of the provision, justified § 14(a) in terms of protecting shareholders from management abuse of control of the proxy process. As Corcoran explained, this provision "prevents the great mass of unorganized stockholders and bondholders from being at the mercy of a management which controls the lists of those to whom proxy solicitations can be sent." House Hearings at 138-42 (cited in note 221) (statement of Thomas Corcoran).

225. See, for example, House Hearings at 224-25 (written statement by Richard Whitney, President of the New York Stock Exchange) (observing that the proxy provisions will require an issuer to send each shareholder a complete shareholders' list as part of every proxy solicitation).



pose unnecessary printing and mailing costs upon corporations.<sup>226</sup> Testimony at the Senate hearings also suggested that the provision would lead to misuse of shareholder lists.<sup>227</sup> Finally, witnesses criticized the requirement as superfluous, noting that state law provided a procedure for disclosure of shareholder lists.

Many of those testifying before the congressional committees reminded the committee members that the proxy solicitation process had developed to enable shareholder voting to continue in national corporations that would be unable to hold annual meetings and to meet state law quorum requirements if personal attendance were required. Witnesses warned that if Congress imposed stringent requirements on the proxy solicitation process, corporations would be paralyzed.<sup>228</sup> At least one witness threatened that the proposed proxy regulation would have the untoward effect of maintaining existing management in office against the will of the shareholders because, under state law, the previous board would remain in office if a corporation did not obtain a quorum sufficient to elect a new board.<sup>229</sup>

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226. See House Hearings at 261 (statement of Eugene E. Thompson, President of Associated Stock Exchanges) (describing the "enormous expense burden" imposed on corporations by the requirement that they send a list of all shareholders to every shareholder before soliciting proxies); House Hearings at 427 (statement of R. V. Fletcher, General Counsel to Association of Railway Executives) (criticizing a proposal requiring corporations to send a shareholder list to all shareholders in connection with a proxy solicitation and describing a printed list of the shareholders of the Pennsylvania Railroad as "a book as big as the family Bible, almost"); House Hearings at 527 (statement of Representative Wadsworth) (citing a letter from Walter S. Gifford, President of American Telephone & Telegraph Company, which describes the AT&T shareholder list as "three volumes as large as the Washington Telephone Directory," which would cost the company \$950,000 to distribute to all shareholders); House Hearings at 666 (letter from The Merchants' Association of New York) (recommending elimination of the requirement of printing and distributing a shareholder list in connection with the distribution of proxies as "a considerable item of expense without compensating advantage in a great majority of cases").

227. See, for example, Senate Hearings at 7169 (cited in note 221) (statement by Arthur W. Sewall, President of General Asphalt Company) (criticizing the cost of mailing shareholder lists and warning of the risk that lists "would fall into the hands of unscrupulous persons who might use them for an endless number of extraneous and even nefarious purposes"); Senate Hearings at 7265 (written statement submitted by Sidney Blumenthal, chairman of Sidney Blumenthal & Company, Inc.) (warning that distribution of shareholder names would "permit abuse by those who have a mischievous purpose" such as the distribution of "propaganda based on irresponsible statements, innuendoes and a spreading of questionable information").

228. Senate Hearings at 6896 (cited in note 221) (statement of Richard G. Babbage of the Real Estate Board of New York) (stating that "[i]t is elementary that the purposes of the meeting are stated in the notice of meeting and that the proxies should enable persons holding them to vote for any question that can legally be brought before the meeting. It is necessary in order to obtain a quorum that some system of obtaining proxies should be adopted.").

229. See House Hearings at 494 (cited in note 221) (memorandum submitted by John M. Hancock, member of Lehman Brothers) (describing the cost of shareholder lists and the difficulty of securing sufficient proxies for a quorum). Mr. Hancock warned that if the Commission's regulations made it difficult to secure proxies, "[t]he result will be that no meetings can be held. Under the existing law if there is no meeting of shareholders to elect directors the present directors con-

The committees first attempted to deal with these concerns by modifying the distribution requirement so that corporations would only be required to file a shareholder list with the commission instead of being forced to mail one to each shareholder who was solicited.<sup>230</sup> This modification appeared to address most of the concerns raised by witnesses before the congressional committees and still permitted shareholders access to the list. Some critics, however, maintained that the list might be used improperly or, worse, that the filing requirement would unduly burden individual shareholders who wished to solicit proxies.<sup>231</sup>

Congress ultimately decided not to resolve the issue, leaving the SEC to develop disclosure requirements in connection with the solicitation of proxies.<sup>232</sup> This method of resolution was consistent with the eventual congressional approach to the federal securities laws, which forswore detailed statutory provisions in favor of allowing an industry-specific agency to develop, through its expertise and experience, regulations that would address the overall congressional objectives.<sup>233</sup> Section

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tinue in power. This point is cited because in the attempt to cover certain evils it seems quite possible that the bill is creating a different kind of evil. Certainly there is nothing to be gained by having management continue in power by default." *Id.*

230. *Id.* See Senate Hearings at 7054-55 (cited in note 221) (debating the efficacy of a requirement that a shareholder list be filed with the Federal Trade Commission); Senate Hearings at 7148 (statement of Senator Fletcher) (arguing that shareholders should have access to the list of fellow investors).

231. Senate Hearings at 7565-66 (statement by Roland L. Redmond, Attorney for the New York Stock Exchange) (criticizing the section of the bill regulating the solicitation of proxies):

I am aware of the fact that this provision was put in with the idea that it would facilitate minority stockholders getting in touch with each other in a possible contest for control, but, quite frankly, I think it is going to operate almost the other way around, because under this provision the first thing that a minority stockholder would have to do before he could solicit the other stockholders would be to get a complete list from the company and file it with the Federal Trade Commission, and the expense that would be imposed upon the minority stockholders by that provision might be so great as to prevent the soliciting of any proxies. Quite frankly, we feel that this provision has no part in a stock-exchange bill.

*Id.*

232. Interestingly, after the SEC promulgated its first regulations under § 14, a large number of corporations resisted the application of the regulations by refusing to solicit proxies from their shareholders in connection with annual meetings. From October 1, 1938, to April 1, 1939, approximately 70 New York Stock Exchange companies (nearly 10% of the then-listed companies) adopted the policy of not soliciting proxies. The boycott of the proxy regulations seemed to verify the concern that regulating the solicitation process in the name of shareholder protection could backfire. See Dean, 24 Cornell L. Q. at 487 n.8 (cited in note 6).

233. See House Debate, 78 Cong. Rec. at 7923 (cited in note 133) (statement of Representative Mapes) (describing the House Committee's decision to change the method of proxy regulation from the "definite" and "stringent" requirements of the original bill to a provision that simply "clothes the Federal Trade Commission with very broad discretionary powers"). Compare House Debate, 78 Cong. Rec. at 7929 (statement of Representative Cooper) (objecting to the broad discretion given by the statute to the Federal Trade Commission to "set up any rule or regulation that it desires regarding the solicitation of proxies" and commenting that "[t]his section . . . shows the

14(a), as adopted, simply makes it unlawful to solicit proxies in contravention of the SEC rules.<sup>234</sup>

Apart from the debate over the shareholder list, the legislative history materials contain only a few references to proxy regulation. The most detailed discussion is contained in the Report on Stock Exchange Practices (the "Fletcher Report").<sup>235</sup> The Fletcher Report devotes approximately three pages of discussion to the regulation of proxies.<sup>236</sup> According to the Fletcher Report, the objective of proxy regulation is to provide shareholders with greater information to assist them in the voting process—information about matters such as the financial condition of the company, the major questions of policy to be decided at shareholders' meetings, and the matters for which voting authority is sought through the proxy.<sup>237</sup>

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extent to which the bill goes in an endeavor to control the conduct of individuals in the moral and everyday business activities of life"); House Debate, 78 Cong. Rec. at 7931 (statement of Representative Beedy) (warning that "[t]his year the FTC might decide that one practice is correct, but next year their point of view might change, and changed regulations vitally affecting all interests concerned would seriously disturb business stabilization").

See also Senate Hearings at 7565-66 (cited in note 221) (statement of Roland L. Redmond) (describing the reaction of the New York Stock Exchange to the general delegation of authority to the FTC):

We do suggest, however, in the line that we have taken right straight through of making these provisions flexible, that if any provision is retained it should be made simply to the effect that it shall be unlawful to solicit . . . in contravention of such rules and regulations as the Commission may adopt for the protection of investors. That, at least, would allow the Federal Trade Commission to study the problem and to adopt rules and regulations, if it becomes necessary.

Id. See also Senate Hearings at 7583 (memorandum submitted by George A. Lambell, Chairman of Committee of Put and Call Brokers and Dealers in the City of New York) (recommending that the proxy regulation section be amended simply to prohibit proxy solicitations in contravention of such rules and regulations as the Commission may adopt and proposing language virtually identical to that in the final statute).

234. The delegation of rulemaking authority to the SEC has been described as a political compromise. Industry insiders believed that the newly created SEC would be more responsive than Congress to their concerns about regulatory burdens. Accordingly, the broad delegation of authority decreased their opposition to the Act. See Thel, 42 *Stan. L. Rev.* at 456-60 (cited in note 43) (discussing the compromise on regulation by the newly created SEC).

235. Report on Stock Exchange Practices, S. Rep. No. 1455, 73d Cong., 2d Sess. (1934), reprinted in 5 *Legislative History*, Item 21 (cited in note 221) ("Fletcher Report"). The Fletcher Report, which was published by the Senate Committee on Banking and Currency in June 1934, is a virtual treatise on the then-existing trading and operational practices in the securities and investment banking industries. The report contains both a summary of the problems revealed by the congressional hearings and the manner in which the new federal securities legislation had been drafted to address those problems.

236. Id. at 74-77.

237. The report stated, "In order that the stockholder may have adequate knowledge as to the manner in which his interests are being served, it is essential that he be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which are decided at stockholders' meetings. Too often proxies are solicited without explanation to the

This description in the Fletcher Report suggests that disclosure is the threshold concern of federal proxy regulation. The state law right to elect directors is meaningless unless the shareholders can evaluate the performance of the current board, hence the requirement that the corporation provide shareholders with information on the corporation's financial condition in connection with the voting process. Shareholders should also understand the nature of the authorization they are being asked to provide in the proxy card. The Report describes a proxy solicitation by American Commercial Alcohol Corporation as an example of a solicitation that fails to disclose to shareholders the nature of the transaction they are being asked to ratify.<sup>238</sup> Finally, the Fletcher Report states that shareholders should be informed as to "major questions of policy."<sup>239</sup> This language is susceptible of two interpretations: (1) it may suggest a role for shareholders as decisionmakers with respect to corporate policy, or (2) it may simply direct that shareholders receive information about corporate policies and objectives in addition to operating results.

The Fletcher Report explains that the SEC's rulemaking process can meet the objectives of proxy regulation. It does not, however, articulate the nature of the rulemaking to be undertaken, apart from a direction that the rules and regulations be designed to protect investors from the abusive use of the proxy process, both by corporate insiders and by third parties who thereby seek to obtain control of the company.<sup>240</sup> The Report, therefore, does not conclusively answer the question of whether the rules should be limited to disclosure requirements.

A second congressional report,<sup>241</sup> the Rayburn Report,<sup>242</sup> contains some of the most frequently quoted language concerning regulation of the voting process. In a section entitled "Control of Unfair Practices by

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stockholder of the real nature of the matter for which authority to cast his vote is sought." *Id.* at 74.

238. *Id.* at 75.

239. *Id.* at 74.

240. *Id.* at 77.

241. The other two major congressional reports prepared in connection with the Exchange Act do not illuminate the issue of proxy regulation. The final conference report, Conference Report [To accompany H.R. 9323], H.R. Rep. No. 1338, 73d Cong., 2d Sess. (1934), describes the reconciliation of the final House and Senate draft bills, but does not address proxy regulation directly. Nor is the Senate Report, Report [To accompany S. 3420], S. Rep. No. 792, 73d Cong., 2d Sess. (1934), reprinted in 5 *Legislative History*, Item 17 ("Senate Report"), worthy of independent analysis, as it was drafted by Senator Fletcher and contains an abridged version of the Fletcher Report's discussion of proxies.

242. Report [To accompany H.R. 9323], H.R. Rep. No. 1333, 73d Cong., 2d Sess. (1934), reprinted in 5 *Legislative History*, Item 18 (cited in note 221) ("Rayburn Report"). The Rayburn Report was prepared by Congressman Rayburn to accompany a version of the bill similar in form to the bill that Congress eventually enacted.

Corporate Insiders," the Report states: "Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange."<sup>243</sup> The Report goes on to describe these unfair practices. The Report explains that corporate insiders can perpetuate themselves in office by soliciting proxies to secure their re-election without disclosing to shareholders: (1) their interest in the corporation; (2) the management policies they intend to pursue; and (3) the purposes for which the proxies are to be used. Thus, although the language of the Rayburn Report indicates a broad concern with fair voting practices, the abuse articulated in the Report actually concerns disclosure.

Professor Stephen Bainbridge argues that the language of the Fletcher and Rayburn Reports supports the *Business Roundtable* conclusion that Section 14(a) is limited to disclosure and that Congress did not intend the SEC, in regulating the solicitation of proxies, to affect the substantive voting rights of shareholders.<sup>244</sup> Presumably recognizing that the Reports provide scant evidence of congressional intent regarding the regulation of shareholder voting, Professor Bainbridge further argues that statutory silence is itself evidence that Congress did not intend to regulate substantive aspects of shareholder voting. Congress could, after all, have enacted substantive regulation if it wished to do so.<sup>245</sup>

Indeed, Congress could have been much more straightforward if it intended the SEC to regulate substantive aspects of shareholder voting. Congress instead authorized SEC rulemaking solely with regard to the solicitation of proxies. Congress did not authorize the SEC to regulate shareholder voting in general.

Why did Congress draft the statute this way? In 1934, Congress was aware of substantive deficiencies in the voting process; a staffer at the Federal Trade Commission had prepared a draft bill that would have included federal regulation of issues such as cumulative voting, voting trusts, and composition of the board of directors.<sup>246</sup> Moreover, the separation of ownership and control in the large public corporation and the inability of shareholders to affect the operations of their corporations just recently had been identified by Adolf Berle, a member of the committee charged with developing the Stock Exchange legisla-

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243. *Id.* at 13.

244. Bainbridge, 1992 *Wis. L. Rev.* at 1112 (cited in note 6).

245. *Id.* at 1114-16.

246. For a more complete description of the draft bill and two different interpretations of its significance, see Thel, 42 *Hastings L. J.* at 466-67 (cited in note 221); Bainbridge, 1992 *Wis. L. Rev.* at 1115 (cited in note 6).

tion,<sup>247</sup> as a major problem in American business.<sup>248</sup> Why then did Congress limit its regulation to the proxy process?

Substantive regulation of voting clearly would have affected the balance of power between shareholders and management, as well as the overall structure of corporate governance. It would have, in effect, displaced at least part of state corporation law with federal standards. The drafters of the federal securities laws in fact considered the adoption of a federal corporation law.<sup>249</sup> President Roosevelt himself viewed federal securities regulation as an effort to redress problems caused by lax enforcement of state corporation law.<sup>250</sup> Richard Whitney, President of the New York Stock Exchange, suggested during the hearings that the inadequacy of state corporation laws caused the abuses about which Congress was concerned, and that a national incorporation law would solve the problem.<sup>251</sup>

Congress's failure to adopt a federal corporation law may reflect, in part, its perception that it lacked the power to do so.<sup>252</sup> Under contemporary theories of constitutional law, whether Congress could regulate corporations directly was questionable.<sup>253</sup> The constitutionality of the

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247. Thel, 42 Hastings L. J. at 464.

248. Berle and Means, *The Modern Corporation and Private Property* (cited in note 31).

249. See, for example, Report to Secretary of Commerce by the Committee on Stock Exchange Regulation at 4, reprinted as part of the Roper Report, 73d Cong., 2d Sess. (1934), in 5 *Legislative History*, Item 16 (cited in note 221) (recognizing that "perhaps the most effective way" to deal with perceived abuses in securities markets is "by the requirement of Federal incorporation for corporations engaged in interstate commerce").

250. Seligman, *The Transformation of Wall Street* at 42 (cited in note 43).

251. Mr. Whitney stated: "The apparent purpose of these provisions is to correct the abuses in corporate procedure which exist today because of the inadequacy of State laws. The remedy for this situation is a national incorporation law applicable to all companies doing business in interstate commerce. This should be accomplished by direct Federal legislation." Senate Hearings at 6583 (cited in note 221).

252. Indeed, in his opening testimony before the House Committee on Interstate and Foreign Commerce, James Landis, the draftsman of the 1934 Act, stated, "At the threshold of this question, there seems to me to lie the question of national power over the exchanges. I think this committee has to meet that and face that before it can go any further. *The question is not free from doubt.*" House Hearings at 16 (cited in note 221) (emphasis added).

253. See Thel, 42 Hastings L. J. at 457 (cited in note 221) (describing the constitutional debate). One of the most comprehensive treatments of the subject is a monograph dated Dec. 18, 1933, by Raoul E. Desvernine, Edward McGarvey, and Jackson S. Hutto, *The Extent of Federal Power To Regulate Stock Exchanges and Stock Exchange Firms* ("*Extent of Federal Power*") (available at the U. of Va. law library), which was apparently prepared during the drafting process. The study analyzes congressional power to regulate the stock exchanges under the Commerce Clause, the taxing authority, congressional authority over the mails and telephones, power over the banking industry, and power to regulate in connection with national emergencies. The study concludes that none of the foregoing theories provides a basis for regulation of the stock exchanges. As the authors state, "The only power under which Congress might exercise direct control over stock exchanges or stock exchange firms would probably be the power under the commerce clause, and the existence of any such right would be extremely doubtful." *Id.* at 68.

Exchange Act was vehemently challenged during the drafting process,<sup>254</sup> although the Act's sponsors eventually prevailed by defending the regulation based on congressional power over interstate commerce.<sup>255</sup> The concern about constitutional limitations on congressional power may explain the absence of language authorizing substantive regulation of voting; the drafters perhaps omitted such language either because they felt constrained in their ability to regulate corporate affairs directly or because they felt such language would unduly subject the statute to constitutional challenge.

In enacting the Exchange Act, Congress may have been responding to public concerns that the federal securities laws were intruding too deeply into the internal governance of the corporation. Congress was widely criticized for going overboard in response to stock exchange abuses by attempting to regulate internal corporate affairs. Critics viewed this as an improper attempt by Congress to interfere with private industry and warned that President Roosevelt's "brain-trusters" who drafted the statute were trying to "crack down" on big business.<sup>256</sup>

Congress responded to this criticism by minimizing the degree to which the statute imposed substantive requirements other than disclosure on corporations. The legislative history is replete with statements disavowing an intention to affect management of corporate internal affairs.<sup>257</sup> The Senate bill contained explicit language that persisted until

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254. See House Hearings at 518-23 (cited in note 221) (discussion between John Dickinson, Assistant Secretary of Commerce, and Congressman Huddleston) (discussing the constitutionality of the Exchange Act under the Commerce Clause); Brief on Behalf of New York Stock Exchange Upon the Constitutionality of S. 2693 and H.R. 7852, reprinted in House Hearings at 562-71 (arguing that the bills are unconstitutional); House Debate, 78 Cong. Rec. at 7920 (cited in note 133) (statement by Congressman Frear) (arguing that the proposed bill presents an issue of constitutionality that will have to be submitted to the Supreme Court). The New York Stock Exchange introduced a memorandum that James Landis, one of the primary drafters of the Exchange Act, had written while at Harvard Law School in support of its argument that the statute was unconstitutional. See Seligman, *The Transformation of Wall Street* at 91 (cited in note 43).

255. See, for example, House Hearings at 16-20 (statement of James Landis) (justifying regulation based on Congress's power over interstate commerce); Memorandum Submitted by Noel T. Dowling, *Concerning the Power of Congress, Under the Commerce Clause, To Regulate Security Exchanges*, reprinted in House Hearings at 917-39 (analyzing the scope of congressional power to regulate stock exchanges under the Commerce Clause).

256. See, for example, Seligman, *The Transformation of Wall Street* at 96 (cited in note 43); Thel, 42 Stan. L. Rev. at 434-35 (cited in note 43). One witness at the House hearings warned that government control of business would establish a "planned economy" and push the country "along the road from Democracy to Communism." House Hearings at 759-73 (cited in note 221) (statement of James H. Rand, Jr.). See also Senate Hearings at 6584 (cited in note 221) (statement of Richard Whitney) (warning that the Exchange Act would effect "a form of nationalization of business and industry"); Desvernine, et al., *Extent of Federal Power* at 8-9 (cited in note 253) (warning that legislative regulation of the stock exchanges might, because of its intrusion on business practices, "be more detrimental to the common good than the evils sought to be corrected").

257. See, for example, Senate Report at 10 (cited in note 241) (disclaiming any intention "to invest a governmental commission with the power to interfere in the management of corporations")

the final conference draft stating that “nothing in this title shall be construed as authorizing the Commission to interfere with the management of the affairs of an issuer.”<sup>258</sup> Legislators, however, deleted this language in conference as unnecessary.<sup>259</sup> This history suggests a deliberate refusal on the part of Congress to enact substantive legislation affecting corporate governance. It is consistent with the view that Congress intended to limit the federal securities laws to disclosure and chose to defer the issue of a federal corporation law for a later day.<sup>260</sup>

Post hoc reviews of the legislative history and drafting of the statute also support this characterization.<sup>261</sup> For example, in the 1943 House Committee on Interstate and Foreign Commerce hearings on the SEC proxy rules, Congressman Wolverton, who had been a member of the Committee during the drafting and adoption of the 1934 Act, described his understanding of the legislative purpose as follows:

Well, my whole thought with reference to the act and what power the Commission can exercise, is based very largely on the theory that the act was intended to be one of disclosure and to protect the rights of investors by full disclosure. If you could go back to the hearings that were held when the original act was before the committee for consideration, I think you would find that the proponents of that legislation were very definitely of the opinion that the act was not intended, nor

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and arguing that “the bill furnishes no justification for such an interpretation”); Senate Debate on S. 3420, 73d Cong., 1st Sess. (April 20, 1934), in 78 Cong. Rec. 8505 (1934), reprinted in 4 *Legislative History* (statement by Mr. Reynolds) (stating that “[t]he authors of the bill evidently have recognized the fact that the commission is to have no right whatsoever to interfere with the management of any corporation”).

258. S. 3420, 73d Cong., 1st Sess. § 13(d) (April 20, 1934). See Senate Debate, 78 Cong. Rec. 8505 (1934) (statement by Mr. Reynolds) (stating in reference to § 13(d) that “nothing in this act shall be construed as authorizing the Commission to interfere with the management of the affairs of an issuer”); (statement by Mr. Barkley) (observing that § 13(d) “was put in the bill by the committee in order to allay the fears of business men and corporations that the Government was to be authorized to manage their business” and remarking about the “great deal of difference between managing the business of a corporation and requiring information to be filed in a public place”).

259. Conference Rep. No. 1838, 73d Cong., 2d Sess. 35 (1934), in 78 Cong. Rec. 10,262 (1934) (acknowledging that “[t]he House bill does not contain a provision corresponding to that contained in subsection (d) of section 13 of the Senate amendment. . . . This provision is omitted from the substitute as unnecessary, since it is not believed that the bill is open to misconstruction in this respect.”).

260. See Seligman, *The Transformation of Wall Street* at 205-10 (cited in note 43) (describing enactment of a statute regulating corporate governance as the “chief unfinished business in the Roosevelt administration’s program of federal corporations law” and explaining the process by which this program was eventually abandoned).

261. See, for example, *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477-78 (1977) (stating that the Exchange Act is primarily concerned with full disclosure; substantive fairness of transactions is “at most a tangential concern”); *J. I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964) (finding that the “purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation”) (emphasis added).



would it have, an interference other than that based on disclosure. I remember very distinctly the hearings . . . .

Now, when we come down to an interpretation of that language in section 14 by the Commission, it seems to me that the Commission in many particulars in the rules that it has adopted has gone beyond that disclosure theory and has taken upon itself a sort of guardianship of the rights of a stockholder.

I am not condemning the desire to protect the stockholder, but *I am condemning an interpretation that was not intended by Congress in the passage of the act.*<sup>262</sup>

This statement alone, of course, does not prove that Congress intended to limit the SEC's rulemaking authority under Section 14(a) to making rules compelling disclosure.<sup>263</sup> Representative Wolverton's remarks merely demonstrate that the statute and legislative history are ambiguous.<sup>264</sup> Although some members of Congress and some participants in the hearings likely supported more extensive involvement either by Congress or the Commission in the regulation of shareholder voting rights, the legislative history does not reveal a consensus position.

How did the record become so muddled just nine years after the enactment of the Exchange Act? Representative Wolverton's statement suggests that the foregoing review of legislative history is incomplete, and that at least some support exists in the record for a broader view of Congress's delegation of rulemaking authority to the SEC.

## 2. The Argument Against the Disclosure Model

Although both the Fletcher and Rayburn Reports demonstrate a regulatory concern with disclosure that is consistent with the regulatory structure of the federal securities laws in general, do the Reports indicate congressional intent to regulate beyond disclosure?<sup>265</sup> The Rayburn Report in particular contains a broad reference to "fair corporate suffrage."<sup>266</sup> Does the use of that language suggest an intention on the part of Congress to inject goals of substantive fairness into the voting process beyond insuring the ability of a shareholder to exercise state law voting rights in an informed manner?

262. Security and Exchange Commission Proxy Rules, Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 before the House Committee on Interstate and Foreign Commerce, 78th Cong., 1st Sess. 236-37 (1943) (statement by Mr. Wolverton) (emphasis added) ("1943 Hearings").

263. See *Business Roundtable*, 905 F.2d at 411 and sources cited therein.

264. Representative Wolverton stated: "Section 14 has evidently created some uncertainty or doubt as to just what was intended by the language that was used." 1943 Hearings (cited in note 262).

265. Professor Patrick Ryan identifies "nascent images" of shareholder monitoring and decisionmaking in the reports and argues that they support the view that Congress intended proxy regulation to further shareholder participation in corporate governance. Ryan, 23 Ga. L. Rev. at 140-41 (cited in note 6).

266. See notes 242-43 and accompanying text.

Unfortunately, neither the Reports nor the Congressional debate answer the question. Even if Congress intended to authorize the SEC to address questions of substantive fairness, the Reports do not indicate what Congress meant by "fair." The argument that Congress intended the Exchange Act to regulate more than disclosure is bolstered, however, by examining more closely the problems to which the Act was addressed and the concerns raised during the hearings about insider domination of corporate decisionmaking.

For example, Thomas Corcoran, one of the principal drafters of the Exchange Act, had a broad view of the problems to which the proxy regulation was addressed. Corcoran believed that corporate insiders, through their control of the proxy process, were able both to perpetuate themselves in power and to use the voting process to further their private ends.<sup>267</sup> He viewed the abuse of power by corporate insiders as central to the objectives of federal regulation, explaining:

It is one of the big worries about the corporate form of doing business in this country, that the shareholders, nor really even the boards of directors do not actually run corporations, but coterie of a very few men on the inside. . . . You are tied up, sir, with a problem so big that this proxy solicitation touches only one edge of it.<sup>268</sup>

Other scattered references in the hearing transcripts describe the need for more active shareholder participation in corporate governance to redress the abuses perpetrated by insider dominance.<sup>269</sup> The references demonstrate that, in developing the Exchange Act, Congress was concerned about the abuses perpetuated by corporate insiders, through the proxy process and otherwise.<sup>270</sup> Regulation of the proxy process provided a partial solution to this concern about management overreaching.<sup>271</sup> Significantly, this concern was shared both by those who supported Section 14(a) and those who criticized the provision as drafted.<sup>272</sup> In other words, there was a widely held sentiment in Con-

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267. House Hearings at 138-42 (cited in note 221) (statement of Thomas Corcoran).

268. *Id.*

269. See Ryan, 23 Ga. L. Rev. at 141-42 (cited in note 6) (noting references in the hearing transcripts supporting the ideal of active and informed shareholders).

270. At the time of the hearings, the separation of ownership and control in the public corporation had been widely recognized as diminishing the ability of shareholders to monitor and to restrain management conduct. Adolf A. Berle, Jr., and Gardner C. Means had published the seminal work, *The Modern Corporation and Private Property* (CCH, 1932), and members of Congress were familiar with the concerns it raised about management control of business decisionmaking.

271. See John Pound, *Proxy Voting and the SEC*, 29 J. Fin. Econ. 241, 250-52 (1991) (describing congressional concern about investor protection as motivating the proxy regulation mechanism).

272. Indeed, some commentators criticized the legislation as not going far enough and called for a statute that would empower the shareholder more explicitly. See, for example, House Hearings at 6545 (cited in note 221) (statement by Senator Kean) (suggesting that the Exchange Act should "be drawn a little more in favor of the stockholder who wishes to protest against the man-

gress that corporate insiders were allowed to perpetuate themselves as management and reap other personal advantages through misuse of the voting process. Moreover, Congress generally perceived that increased empowerment and participation by shareholders would ameliorate this problem.<sup>273</sup>

Can one conclude from these indications of congressional concern with shareholder democracy that Congress intended Section 14(a) to confer substantive rulemaking authority on the SEC to enhance shareholder monitoring and decisionmaking? The scattered references in the legislative history to the need for shareholder democracy to remedy insider abuse do not establish this intention. Indeed, a diligent researcher can find support for virtually anything within the thousands of statements contained in the legislative history of the Exchange Act.<sup>274</sup> In light of the many explicit statements to the contrary, one cannot infer that such references demonstrate legislative intent.

Additional arguments can be made in favor of an expansive view of the Exchange Act.<sup>275</sup> Perhaps the strongest argument is that the broad

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agement of the company, rather than the way it is now drawn"). The most extensive statement on this point was made by witness Samuel Untermyer:

I respectfully submit that the provisions of [section 13(a)], they are the opposite of what they should be. The ability of security holders to join for their mutual protection against the management of corporations that are now largely controlled by those with no substantial financial interest in the corporation and to communicate freely with one another to that end and to protect one another should be encouraged rather than discouraged or made difficult.

Why should it be considered necessary or desirable in the public interest in the solicitation of proxies to continue or dislodge an existing management. . . . [A]s it now stands, anybody who wants to contest corporate control instead of being encouraged to do so and to have his voice heard, has got to go before the Commission and make a disclosure to the Commission and get the consent of the Commission to deal with his own property. . . . My suggestion is to facilitate the assertion of the rights of stockholders who are not controlled by the management, to give them a chance to come into their own.

House Hearings at 7711-17. The concern Untermyer expressed was also raised in the Senate debate on the bill. Senator Steiwer stated:

There is much to be said about the section requiring proxies. If I had my way, I would either change that section or eliminate it from the bill. The committee was told by men who are experts upon this subject, men like Mr. Untermyer, who, through busy lifetimes, have been endeavoring to protect the interest of stockholders in great corporations, that this proxy requirement will not help the minority groups; that it will not aid the weak or defenseless; but that probably it will aid those in power, those who control the corporation; that it will operate differently than was contemplated by the committee.

Senate Debate, 73d Cong., 2d Sess., in 78 Cong. Rec. 8279 (1934) (statement by Senator Steiwer).

273. See Ryan, 23 Ga. L. Rev. at 142-43 (cited in note 6) (describing congressional observations about shareholder democracy as a remedy for insider abuses). Even Professor Bainbridge admits that the hearings contain passages indicating a broader congressional concern than disclosure. Bainbridge, 1992 Wis. L. Rev. at 1112-13 (cited in note 6).

274. Bainbridge, 1992 Wis. L. Rev. at 1113 n.190.

275. One argument is that other provisions of the Exchange Act contradict the *Business Roundtable* reading of the Act as disclosure-oriented. For example, Professor Thel has described § 16 of the Exchange Act as reflecting congressional intent to influence corporate governance in a

Congressional delegations of power to the SEC were specifically designed to permit broader substantive regulation without raising the political and constitutional concerns that explicit substantive rules would have sparked. In other words, as Professor Thel has suggested, the drafters "may have been trying to hide their agenda."<sup>276</sup> If the drafters believed they were empowering the Commission with the authority to redistribute corporate power, little advantage could be gained by advertising that fact in light of the substantial political resistance to that policy.<sup>277</sup> Under this reading, congressional silence on substantive matters need not be read as a failure to act.<sup>278</sup>

In addition, although Congress remained silent with respect to the scope of the authority delegated, it made no affirmative attempt to constrain the SEC.<sup>279</sup> Congress certainly could have phrased the statutory mandate to require those soliciting proxies to "make such disclosure as the SEC shall require." If Congress intended the SEC merely to work out a series of disclosure provisions, its grant of rulemaking authority could have been worded much more narrowly. Under this reading, Professor Bainbridge's argument about Congress's failure to be more explicit proves too much.

Finally, it is possible that current views of congressional intent in enacting the Exchange Act have been colored by the nature of its predecessor statute, the Securities Act of 1933. Little question remains about the disclosure-oriented nature of the Securities Act. At least one commentator has observed that by enacting this statute first, Congress

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substantive way. See Thel, 42 *Hastings L. J.* 391 (cited in note 221). Professor Thel suggests that § 16 is designed to regulate management decisionmaking and to render it more efficient and more consistent with the interests of investors and the general public. To the extent that it is correct, this reading of § 16 contradicts the argument that the objectives of the federal securities laws are limited to disclosure.

276. *Id.* at 483.

277. See Comment, 33 *Nw. U. L. Rev.* at 922 (cited in note 28) (reading § 14(a) as providing broad delegation to the SEC to regulate certain aspects of corporate management but acknowledging that both the breadth and general nature of this delegation present constitutional questions).

278. This position is directly contrary to Professor Bainbridge's reading of congressional silence. See Bainbridge, 1992 *Wis. L. Rev.* at 1114-16 (cited in note 6) (arguing that congressional silence indicated a decision against substantive regulation of voting rights).

279. Indeed, the delegation subsequently, albeit unsuccessfully, was attacked as unconstitutionally broad. *SEC v. May*, 229 F.2d 123 (2d Cir. 1956). See also Legislation, *Delegation of Power Under the Securities Exchange Act of 1934*, 36 *Colum. L. Rev.* 974, 991 (1936) (arguing that delegation of power to the SEC under § 14(a) is unique because it pertains to a practice "not closely related to trading on the exchange" and that the delegation is therefore overbroad). The article observes, however, that "[t]he abuses which have grown up in connection with the proxy machinery are probably sufficiently notorious to convince a sympathetic tribunal that an adequate standard may be evolved with reference to it." *Id.* (footnote omitted).

may have influenced scholars to characterize all future federal securities legislation as disclosure-oriented.<sup>280</sup>

### 3. The Legislative History as a Source of Regulatory Theory

The foregoing analysis does little to establish clear congressional direction to the SEC to engage in substantive rulemaking. These statements suggest, however, that the legislative history is not as free from doubt as the *Business Roundtable* court states.<sup>281</sup> It is unclear why any ambiguity should be resolved in favor of broadening the SEC's powers, in light of the principles of statutory construction that argue for narrow interpretation of doubtful grants of rulemaking authority.<sup>282</sup>

One problem with interpreting the SEC's power narrowly is the limited value of this interpretation in determining the direction of future regulation. The federal proxy regulations have been accepted with little question for more than fifty years, and the development of both state and federal systems to regulate the voting process has been premised upon the active involvement of the SEC. Even if the objection to this involvement is well taken, it likely comes too late.

Because the text of Section 14(a) does not contain explicit guidance as to the limitations of the SEC's rulemaking authority, and the legislative history does not resolve the issue, the question of interpretation remains. By focusing the inquiry on whether the SEC has the authority to enact substantive regulation, previous discussion has masked a more critical line of analysis. Even if the SEC has the power to enact substantive regulations, it is not clear that the existing regulatory system is consistent with congressional direction about the role of proxy regulation in the shareholder-management relationship. In other words, does the legislative history reveal a congressional theory of shareholder participation in corporate governance and, if so, are the proxy rules consistent with that theory?

The preceding historical analysis can inform this inquiry. To conclude that the legislative history does not furnish a solution to the question of whether Congress intended proxy regulation to extend beyond

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280. *Thel*, 42 *Stan. L. Rev.* at 415-16 (cited in note 43).

281. The ambiguity of legislative history is one reason many commentators, most notably Justice Scalia, criticize judicial reliance on legislative history as a means of statutory interpretation. See, for example, *FAIC Sec., Inc. v. United States*, 768 F.2d 352, 361-62 (D.C. Cir. 1985) (Scalia, J.) (stating that even the "best legislative history" is but one "clue as to what the legislating 'party' had in mind").

282. See, for example, Homer Kripke, *The SEC and Corporate Disclosure: Regulation In Search of a Purpose* 28 (Harcourt Brace Jovanovich, 1979) (criticizing the SEC for "elaboration of its proxy rules to affect corporate governance" and describing those rules as "a frolic and detour for which it has no specific statutory authority and very dubious implied authority") (emphasis added).

disclosure does not render its examination irrelevant for evaluating the legitimacy of the proxy rules. Although previous analyses have stopped with the determination of whether Congress intended to authorize substantive regulation, the legislative history provides further guidance.

With respect to the first question, the legislative history provides some indications of a congressional theory of corporate governance. During the development of the statute, Congress focused on the abuses perpetrated by corporate insiders, not merely in connection with securities transactions, but in connection with misuse of the proxy machinery. Moreover, the record reveals a congressional desire to increase *shareholder* information and participation. This intention is significant because it is decidedly non-neutral. Although the Fletcher Report, for example, recognizes that the proxy process may be misused by both corporate insiders and by third parties,<sup>283</sup> no indication is given in the Fletcher Report or elsewhere that Congress was concerned about the effects of too much participation by shareholders in corporate decisionmaking.

This interpretation is consistent with the general objective of the federal regulatory scheme: protection of investors.<sup>284</sup> The federal securities laws were drafted in response to abuses against investors and shareholders. Congress initially did not attempt to render the corporate governance structure more efficient; reform the model of corporate decisionmaking; or determine the social, moral, or political role of the firm in society. Congress instead focused on fair corporate suffrage, recognizing that management interference with the voting process was depriving shareholders of their rightful voice in the management of their corporations and aggravating the effects of the Berle-Means separation of ownership and control.

In this light, fair corporate suffrage includes not simply the informed exercise of voting rights, but the unrestrained exercise of those rights. As the Rayburn Report explained, “[T]he proposed bill gives the [Commission] power to control the conditions under which proxies may

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283. Fletcher Report at 77 (cited in note 235). The Report stated:

It is contemplated that the rules and regulations promulgated by the Commission will protect investors from promiscuous solicitation of their proxies, on the one hand, by irresponsible outsiders seeking to wrest control of a corporation away from honest and conscientious corporation officials; and, on the other hand, by unscrupulous corporate officials seeking to retain control of the management by concealing and distorting facts. The rules and regulations will also render it impossible for brokers having no beneficial ownership interest in a security to usurp the franchise power of their customers and thereby deprive the latter of their voice in the control of the corporations in which they hold securities.

Id.

284. Even those who argue that legislative history is an inappropriate method of statutory interpretation recognize the legitimacy of looking to the structure and purpose of the statute as a whole for interpretive guidance. See Zeppos, 76 Va. L. Rev. at 1296 (cited in note 10).

be solicited with a view to preventing the recurrence of abuses which have frustrated the free exercise of the voting rights of stockholders."<sup>285</sup> The abuses to which the Report refers involve management misuse of the proxy machinery for selfish ends.

Congress modified the language of Section 14(a) during the drafting process to reflect this concern more clearly. Early versions of the bill authorized the Commission to promulgate such regulations as were necessary or appropriate "*in the interest of the issuer of such security* or for the protection of investors in the securities of such issuer."<sup>286</sup> The final statute deleted the reference to the interests of the issuer. Congress instead authorized the SEC to promulgate rules and regulations "*in the public interest or for the protection of investors.*"<sup>287</sup> The proxy provision thus evolved with an increased focus on protecting *shareholders'* voting rights. Removing the reference to the issuer may have reflected congressional recognition that it was precisely those who speak for the issuer that jeopardize shareholder rights. If Congress was concerned about protecting shareholders from abuses that were practiced by insiders in the name of the corporation, then the direction to the SEC should focus on protecting the interests of these investors, not the interests of the issuer that might be defended by corporate insiders as conflicting with those of the individual shareholders.

Contemporaneous views of the public corporation supplement the legislative history of the Exchange Act. Many people in the United States in the early 1900s were concerned about corporate power and corporate accountability.<sup>288</sup> The history of the corporate democracy movement indicates that shareholder activism was viewed as a means of limiting the power of corporate management.<sup>289</sup> This movement has been described as an effort "to make the corporation accountable to shareholders through the development of specific legal mechanisms that would give outside, nonmanagement groups more direct power in corporate affairs."<sup>290</sup> Empowering the shareholders diffused the concentration of power and monitored management's exercise of it. To the extent that

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285. Rayburn Report at 13 (cited in note 242).

286. For example, H.R. 9323, 73d Cong., 2d Sess. (Apr. 25, 1934) (emphasis added).

287. Section 14(a) (cited in note 46).

288. See, for example, *Liggett Co. v. Lee*, 288 U.S. 517, 548-49 (1933) (Brandeis, J., dissenting) (reviewing the historical distrust of the corporate form and its attendant aggregations of capital and power). See also Berle and Means, *The Modern Corporation and Private Property* (cited in note 31); A. A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 Harv. L. Rev. 1365 (1932); William O. Douglas, *Directors Who Do Not Direct*, 47 Harv. L. Rev. 1305 (1934) (calling for an independent organization to monitor management and to redress problems of absentee ownership).

289. Pound, 29 J. Fin. Econ. at 245-46 (cited in note 271).

290. *Id.* at 246.

Congress held these concerns in 1934,<sup>291</sup> a broad delegation of authority to the SEC to address abuses of corporate power through proxy regulation offered a partial response.<sup>292</sup>

### C. Proxy Regulation and Federalism

The foregoing review suggests that the prevailing view in Congress at the time the federal securities laws were passed was that corporate insiders had too much power and were misusing this power at the expense of shareholders. The question this review does not answer concerns the extent to which Congress intended the federal securities laws to provide a substantive remedy to this problem.<sup>293</sup> One additional factor should be considered in determining whether proxy regulation is the appropriate remedy: the role of the federal securities laws in the federalist structure of corporate regulation.<sup>294</sup>

The relationship of the proxy rules to state law is frequently overlooked. Although the proxy rules do not preempt state corporation law, the two regulatory systems rest upon very different organizing principles. Corporate law varies from state to state, and for the most part, the organization and internal affairs of a corporation are subject only to the law of its state of incorporation. Additionally, corporate law is primarily enabling rather than mandatory.<sup>295</sup> Many statutes allow corporations to choose the extent to which the corporation will be subject to the "de-

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291. See, for example, Comment, 33 Nw. U. L. Rev. at 915 (cited in note 28) (viewing federal regulation as an effort to "re-establish" shareholder democracy, particularly through the SEC's supervision of the proxy solicitation process, which will enable "significant blocks of voters . . . to canalize corporate policy by well-directed opposition").

292. See *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416, 422 (D.C. Cir. 1992) (stating that "[i]t is obvious to the point of banality . . . that Congress intended by its enactment of section 14 . . . to give true vitality to the concept of corporate democracy") (quoting *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659, 676 (D.C. Cir. 1970)).

293. It is in making this connection that Professor Ryan's work is most clearly deficient. See Ryan, 23 Ga. L. Rev. at 146 (cited in note 6) (concluding that the legislative history shows Congress understood that the proposed proxy regulation power would "work significant changes in management-shareholder relationships").

294. Interpretive theory might deem this an evolutionist approach, reasoning that understanding of a statute may evolve to meet "new problems and societal circumstances." See William N. Eskridge, Jr. and Philip P. Frickey, *Statutory Interpretation as Practical Reasoning*, 42 Stan. L. Rev. 321, 378 (1990) (arguing that "[t]he history that should drive statutory interpretation is not just the original expectations surrounding the statute, but also the ongoing historical development of the statute as those historical expectations and policies are applied in new and unanticipated factual settings").

295. The statutes take different forms, but the general approach allows corporate constituencies, through the contractual provisions of the corporate charter, to adopt governance mechanisms that differ from traditional rules. For a detailed discussion of the merits of establishing corporate governance through enabling legislation and the contractual mechanism of the charter, see Symposium, *The Debate on Contractual Freedom in Corporate Law*, 89 Colum. L. Rev. 1395 (1989).



fault" rules of the governing statute through charter provisions modifying those rules.<sup>296</sup>

Federal law, on the other hand, applies to publicly held corporations wherever located, subject to certain thresholds on size, number of shareholders, or Exchange listing.<sup>297</sup> The federal regulations are mandatory; firms cannot, for example, adopt charter provisions exempting them from the federal proxy rules. Finally, federal law is administered through the SEC, a specialized agency that brings unique experience and perspective to the regulatory process.

Regulation of corporate issues is effected primarily by one system or the other. Federal law, for example, is the dominant force in the regulation of insider trading, the issuance of new securities, and periodic disclosure by corporations. State law supplies the rules governing directors' duties to their shareholders, the payment of dividends, and the shareholder's right to inspect corporate books and records and shareholder lists. In the area of shareholder voting, however, federal and state laws are highly interdependent because of the development of the proxy voting process. For more than fifty years, during which time the modern public corporation has undergone a substantial transformation in size, range of business, and role in society, both state and federal law have regulated shareholder voting.

The interdependence of the state and federal regulatory systems has several consequences. First, the mere existence of the federal proxy rules may have restrained the development of state corporation law in the area of voting regulation. A state statute that conflicted with the proxy rules might not be valid under the Supremacy Clause. Additionally, the federal rules subdue state motivation to legislate. State legislatures have become accustomed to leaving the regulation of the voting process to the SEC and defer to that agency's expertise. State and federal courts also have grown accustomed to viewing shareholder proxy rights as those rights defined by the SEC rules. In spite of the SEC's statements that its rules simply enable shareholders to realize state law rights, courts are loathe to recognize ballot access, information, or pro-

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296. Considering a corporation's selection of governance charter provisions a "choice" presumes an effective voting process. The corporate charter cannot be viewed as a contract between shareholders and management, however, unless shareholders are able to introduce value-increasing charter amendments and resist management efforts to enact value-decreasing amendments.

297. See Section 14(a) (cited in note 46) (applying federal proxy rules to solicitations in respect of any security registered under § 12 of the Securities Exchange Act of 1934). A few provisions of the statute even apply to privately held corporations, such as the antifraud provision of Rule 10b-5.

cedural rights that extend beyond those explicitly guaranteed by federal law.<sup>298</sup>

Federal law further constrains experimentation by individual corporations. Because the proxy rules do not contain an opting-out mechanism, a corporation cannot determine how to conduct its proxy solicitation process through charter provisions. Accordingly, the proxy rules affirmatively preclude corporations from choosing the third alternative of the SEC's 1980 Corporate Governance proposal—making their own decisions on the voting process and ballot access. Although the laboratory of the individual corporate charter may be an ideal place for experimentation in shareholder democracy, such experimentation is severely curtailed by the requirements and procedures imposed on voting by federal law.

At the same time, the existence of state corporation law has served as a restraint, and perhaps an excuse, limiting the scope of the SEC's rulemaking. The *Business Roundtable* decision illustrates the judicial response to SEC interference with the voting process;<sup>299</sup> the decision is premised on the view that the regulation of voting has traditionally

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298. Courts frequently evaluate shareholder rights to ballot access solely in terms of the access mandated by Rule 14a-8. See, for example, *Rauchman v. Mobil Corp.*, 739 F.2d 205 (6th Cir. 1984) (resolving a shareholder suit to compel inclusion of a shareholder proposal by finding that the proposal may be excluded under Rule 14a-8(c)(8)). Accord *Grimes v. Centerior Energy Corp.*, 909 F.2d 529 (D.C. Cir. 1990); *Austin v. Consolidated Edison Co.*, 788 F. Supp. 192 (S.D.N.Y. 1992). These decisions imply that shareholders have no right to access except that afforded by the Rule. Indeed, Grimes argued that Centerior's proxy materials were rendered misleading by omitting mention of the fact that Grimes would offer a major proposal at the shareholders' meeting. *Grimes*, 909 F.2d at 533. The court rejected this argument by concluding that Rule 14a-8(c) served to "define" proper subjects for shareholder action "under applicable state law." *Id.* Therefore, the court concluded that the issuer could not be required even to mention the proposal. *Id.*

299. The chilling effect of state corporate law on the SEC's proxy rules extends beyond regulation of the voting process. Apart from disclosure, the SEC has imposed no substantive restrictions on management conduct in connection with a proxy solicitation. For example, the SEC has not imposed any fiduciary standard on the exercise of management's obligations under the federal proxy rules. Thus, management can and does interfere with shareholder democracy by objecting to the inclusion of shareholder proposals, preparing proxy materials that recommend a vote against proposals the company is forced to include, and opposing shareholder solicitations. See Emerson and Latcham, 19 U. Chi. L. Rev. at 816-17 (cited in note 70) (observing that although "a powerful case can be made for management support of proposals to extend cumulative voting," they were invariably opposed by management") (quoting Charles M. Williams, *Cumulative Voting For Directors* 184 (Harvard U., 1951)). Management also may vote its own stock and the stock it controls, such as stock in employee stock option plans or company pension plans, against shareholder initiatives. In the absence of federally imposed standards on management conduct, shareholders have little opportunity to challenge it, regardless of whether management is acting in the best interests of the corporation. Although management's opposition to a shareholder proposal may be improper, management's actions generally will be protected by the business judgment rule and, therefore, immune from legal challenge in a state law derivative suit premised upon management's breach of fiduciary duty. Compare *United Paperworkers Int'l Union v. Int'l Paper Co.*, 985 F.2d 1190 (2d Cir. 1993) (finding that management's response to a shareholder proposal violated federal rules against false and misleading statements).

been relegated to state law. SEC rules that provide for direct nomination of directors, allow shareholders to initiate charter amendments, or require shareholder ratification for the adoption of management-driven corporate law reforms such as anti-takeover legislation are likely to generate a similar response.<sup>300</sup> Critics have even attacked proposed proxy rules imposing confidential voting requirements or a federal right of access to shareholder lists as improper intrusions into the traditional purview of state law.<sup>301</sup>

## VII. IMPLICATIONS AND CONCLUSIONS

The interdependence of federal and state regulation of shareholder voting plays an important role in a pragmatic or dynamic approach to interpreting the scope of delegation under Section 14(a) within which the SEC's proper actions must be evaluated.<sup>302</sup> Under modern theories of statutory interpretation—theories that previously have not been employed to examine securities regulation—one must consider the current social and political framework of shareholder voting to ascertain the appropriate role of the federal proxy rules.

The problem with the status quo system of regulation is that shareholder voting currently is neither fair nor effective.<sup>303</sup> Although voting

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300. This regulation would be the equivalent of a federally-imposed "opting-in" requirement.

301. See, for example, Letter from American Bar Association to Jonathan G. Katz 8 (Sept. 23, 1991) (stating that "we do not believe that [the SEC's rulemaking authority] extends to federalizing the existing body of state law with respect to the right of access to a securityholder list"); Comments of the Business Roundtable on Exchange Act Release No. 29,315 at 7 (Sept. 18, 1991) (observing that the shareholder list proposal "would inappropriately intrude into state regulation of corporate governance"). See also *Shareholder Communication Proposals Produce Second Tidal Wave of Comments*, 24 Fed. Sec. & L. Rep. (BNA) 1516, 1518 (Sept. 25, 1992) (describing the American Bar Association's opposition to a proposed amendment prohibiting bundling of issues on the basis that it impermissibly interfered with state law, under which directors were entitled to group proposals as they deemed appropriate).

302. This characterization is based on the work of William Eskridge and Philip Frickey in conceptualizing a dynamic theory of statutory interpretation. See, for example, Eskridge, 135 U. Pa. L. Rev. 1479 (cited in note 14); Eskridge and Frickey, 42 Stan. L. Rev. 321 (cited in note 294). Their approach has been described as not simply pragmatic in the practical sense, but "in the postmodern epistemological sense of recognizing that answers vary according to context and perspective and are at bottom social constructions." Peter C. Schanck, *Understanding Postmodern Thought and its Implications for Statutory Interpretation*, 65 S. Cal. L. Rev. 2505, 2591 (1992) (footnote omitted). A detailed discussion of dynamic statutory interpretation is, however, beyond the scope of this Article.

303. Studies showing that shareholders vote to approve management-sponsored proposals, even when those proposals are value-decreasing, demonstrate the problems with the shareholder voting process. See, for example, Gregg A. Jarrell and Annette B. Poulsen, *Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980*, 19 J. Fin. Econ. 127, 141-54 (1987) (examining shareholder approval of value-decreasing anti-takeover charter amendments); Gordon, 76 Cal. L. Rev. 1 (cited in note 193) (demonstrating that shareholders approve dual class common recapitalizations even though empirical evidence shows they significantly decrease shareholder wealth).

is the primary tool by which shareholders participate in corporate governance, shareholder voting does not work properly for reasons that include: (1) the separation of ownership and control;<sup>304</sup> (2) management domination of the proxy mechanism;<sup>305</sup> and (3) collective action problems in shareholder voting.<sup>306</sup>

The implications of these shortcomings are substantial. Economic theories of corporate governance justify differences in state corporation law on the theory that these differences provide healthy competition.<sup>307</sup> A corporation can choose the law that allows it to operate most efficiently.<sup>308</sup> If, however, shareholders do not have sufficient power through the voting process to participate in meaningful bargaining, the market will not operate to produce the best corporate decisions.

Thus, if shareholder voting does not reflect an accurate and informed expression of shareholder opinion, business decisions such as choosing management, selecting a new state of incorporation, engaging in a merger, or opting into an anti-takeover statute can be made in circumstances under which they are not value-increasing.<sup>309</sup> Moreover,

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304. For example, Berle and Means argue that because corporations are controlled not by their owners but by management, management control of the proxy process frustrates shareholders' only means of exercising power. Berle and Means, *The Modern Corporation and Private Property* at 246 (cited in note 31).

305. Other than shareholder proposals initiated under Rule 14a-8, management selects the issues submitted to the shareholders, including nomination of directors, initiation of charter amendments, and selection of auditors. Even when shareholders can propose issues, board approval is still required. See, for example, Cal. Corp. Code § 902(a) (West, 1990) (allowing shareholders to initiate a charter amendment but requiring board approval).

Management also may engage in strategic behavior, such as linking difficult proposals to a "sweetener" or promising shareholders a benefit if they approve a management proposal. See Gordon, 76 Cal. L. Rev. at 29-60 (cited in note 193) (describing management's strategic behavior to affect voting by such means as bundling wealth-reducing proposals with "sweeteners," playing chicken, using coercive tactics, and directly pressuring institutional investors). Management's use of such tactics clearly limits the ability of shareholder voting to reflect rational and informed shareholder choice. The new amendments address the issue of bundling by prohibiting linking of matters for shareholder vote. See notes 193-94 and accompanying text.

306. See note 12.

307. See, for example, Winter, 6 J. Legal Stud. 251 (cited in note 41); Frank H. Easterbrook and Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416 (1989); Roberta Romano, *Competition for Corporate Charters and the Lessons of Takeover Statutes*, 61 Fordham L. Rev. 843, 844 (1993).

308. See Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 Colum. L. Rev. 1703, 1704-08 (1989) (describing the economic basis of the contractual theory of the firm).

309. Recent literature in the area of takeover legislation illustrates these principles. States have experimented with different regulatory structures governing takeovers, and corporations, through reincorporation and opt-in or opt-out provisions, have been able to choose the regulatory regime in which to operate.

Although empirical evidence demonstrates a negative correlation between anti-takeover statutes and shareholder returns, adoption of such statutes is widespread. See Romano, 61 Fordham L. Rev. at 850-51 (1993) (cited in note 307). This negative correlation seems inconsistent with the

limitations on shareholder access to the proxy process prevent shareholders from initiating value-increasing changes in the governance structure of their corporation.<sup>310</sup> The market, which is expected to produce efficient business decisions, thereby fails.

Perhaps this market failure motivated congressional regulation of the proxy process.<sup>311</sup> Although Congress did not provide a definition of "fair corporate suffrage," this term may define a voting process in which shareholders are able to voice their concerns and objectives, communicate them to fellow shareholders, and implement them in corporate decisions. A dynamic interpretation of Section 14(a) considers the evolution of federal regulation of voting within the context of the modern corporation. The preceding discussion of legislative history suggests that this model of shareholder participation in corporate decisionmaking fairly achieves the congressional objectives articulated in 1934.

In particular, although the model supports a theory of regulation that extends beyond disclosure and operates substantively to empower shareholders at the expense of management, the theory is not inconsistent with congressional intent to steer clear of corporate internal affairs. State law can be relied upon to regulate corporate governance without generating a race to the bottom, as long as the choice of governance structures by shareholders is a real choice. Viewed in this light, substantive regulation of the proxy process does not preempt the operation of state corporate law, but rather enhances it.

This enhancement provides both a basis for evaluating the legitimacy of the SEC's proxy regulations and a blueprint for future regulatory activity. The foregoing suggests that, based on Congress's concern

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view that corporations will choose the anti-takeover rule that maximizes their value, and, if a state adopts a damaging statute, will opt out of the statute either by reincorporating in a state that does not have anti-takeover laws or by adopting a statutorily-provided exclusion. Deficiencies in the voting process that frustrate shareholder choice may explain the inconsistency. If, for example, a state adopted an anti-takeover statute with an opt-out provision, corporations that would be damaged by the statute would have to achieve an opting-out charter amendment by shareholder vote—a considerable hurdle given management control of ballot access and the voting process. See *id.* (describing barriers imposed by the proxy mechanism on shareholder choice regarding anti-takeover legislation).

310. For example, a corporation's ability to select favorable state law charter provisions is limited in many states because charter amendments can be proposed only by management. See, for example, 8 Del. Code Ann. § 242(b)(1) (requiring the board of directors to adopt a resolution proposing the amendment and then submit the issue for shareholder vote in order to amend the corporate charter). Shareholders thus are unable to initiate a charter amendment directly.

311. The ineffectiveness of shareholder voting as a check against value-decreasing changes in the corporate structure was identified as a problem as early as the 1930s. See, for example, Note, *Corporate Recapitalization by Charter Amendment*, 46 Yale L. J. 985 (1937) (describing unfair recapitalizations accomplished through charter amendments in which preferred shareholders, although gaining little and losing much, nonetheless voted in favor of the plans). The commentator observed that the problem might be attributed to inadequacies of the proxy system. *Id.* at 999.

with insider abuse, Congress intended to authorize the SEC to remove the barriers erected by management to shareholder participation in corporate governance. SEC rules designed to enhance shareholder participation, such as allowing shareholders access to the proxy mechanism, or to facilitate the ability of shareholders to communicate with each other thus are legitimate. Rules that curtail shareholder participation by limiting the number of proposals a shareholder can make, preventing shareholders from communicating freely or acting in concert to effect a change in corporate governance, or providing management the ability to control the voting agenda are not. Furthermore, the SEC has not been empowered to adopt a general theory of corporate governance. The SEC has neither the expertise nor the authorization to decide if corporations should respond to social policy concerns, or if shareholder-initiated proposals will unduly interfere with management discretion. Congress has reserved precisely those issues for state law.

This analysis also demonstrates that the SEC's progress in pursuit of fair corporate suffrage has been deficient. Regulation 14A, even with the SEC's recent amendments, does not go far enough in resolving the problems associated with the voting process. The SEC rules do not overcome management control of the agenda. Although the SEC has given shareholders an affirmative right to access the ballot through Rule 14a-8, this right is limited to a restricted class of primarily nonbinding, advisory proposals on corporate policy.<sup>312</sup> In addition, the SEC has otherwise burdened ballot access through restrictions on subject matter,<sup>313</sup> minimum stockholdings and holding periods, and limitations on the number of issues a shareholder can raise.

This analysis does not espouse increased use of the shareholder proposal process or defend the use of such proposals in the social-political area. It is beyond the scope of this Article to evaluate the merits of shareholder activism; yet if courts, commentators, and even institutional investors<sup>314</sup> cannot agree which subjects are appropriate for shareholder voice, the SEC has neither the ability nor the right to make

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312. The theory that shareholder proposals are improper if they interfere with management's role under state law directly counters the congressional view of the voting process as a means to reduce management dominance and to enable shareholders to participate in decisionmaking.

313. As has been described, two of the areas that the SEC has decided are inappropriate for shareholder action are payment of dividends and executive compensation. Writing in 1934, at the same time Congress passed the Exchange Act, commentators Benjamin Graham and David L. Dodd included these topics among those to which the shareholders' attention should be particularly focused because of the inherent conflict between the interests of shareholders and management. Benjamin Graham and David L. Dodd, *Securities Analysis* 510-11 (McGraw-Hill, 1934).

314. See, for example, Comments of Sarah Teslick, Executive Director of Institutional Shareholder Services, 1 Corp. Governance Advisor 5 (1993) (indicating dissatisfaction of private institutional investors with the use of shareholder proposals for non-monetary issues).

that decision. With the growing participation of institutional investors in corporate governance, the market is likely to select an efficient degree of shareholder democracy, absent SEC interference.<sup>315</sup>

Additionally, the SEC rules do not resolve collective action problems associated with the voting process; in fact, the rules aggravate these problems. Although the recent amendments eliminating the filing requirement for certain proxy solicitations address one particularly egregious<sup>316</sup> burden on shareholders who wish to act collectively, the amendments do not exempt institutional investors or investors seeking board representation—two classes of shareholders most likely to participate actively in corporate democracy.<sup>317</sup> Exempted shareholders who succeed in reaching and mobilizing a large number of their colleagues also may fall prey to the disclosure requirements of Section 13(d).<sup>318</sup> Moreover, recent amendments to two particularly problematic restraints on shareholder activity—"bundling" of proposals and the "bona fide nominee" rule—do not reflect a commitment to removing restraints on shareholder choice. Instead, these amendments reflect political compromise and offer more promise of shareholder confusion than participation.

The extent to which the federal proxy rules frustrate shareholder democracy has been chronicled extensively elsewhere.<sup>319</sup> Many of these

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315. See Easterbrook and Fischel, 26 J. L. & Econ. 395 (cited in note 6) (arguing that the market will select the most efficient role for shareholder voting in corporate governance in the absence of restrictive federal regulation).

316. During the hearings, one witness expressly argued that the filing requirements would negatively affect shareholders who wish to participate in corporate governance, contrary to the very purposes of the legislation. See Senate Hearings at 7711-14 (cited in note 221) (statement of Mr. Untermyer):

It does not give [the stockholder] any chance at all. It does the contrary. It embarrasses him. It requires him to make a whole lot of disclosures to the Commission before he can go and approach his fellow stockholders and ask their authority to act. . . . [I]t acquaints the management, too, and puts them on guard, so that the stockholders are much more embarrassed, and then it requires certain disclosures and it seems to me that it puts every stockholder who wants to protect his corporation and get a change of management in the position of a sort of a striker.

317. See note 12 and sources cited therein (addressing the role of the institutional investor in corporate democracy).

318. Section 13(d) requires shareholders who collectively own 5% or more of a company to disclose agreements to engage in collective action on Schedule 13D. See Black, 89 Mich. L. Rev. at 542-45 (cited in note 12) (describing the impact of § 13(d) on collective shareholder action). In addition to requiring disclosure, § 13(d) is frequently used as a litigation weapon by management. See Marc P. Cherno and Sandra F. Coppola, *Use of Litigation as a Takeover Defense*, Presentation at the 1988 ALI-ABA Securities Litigation Program 5 (Apr. 28-29, 1988) (describing strategic defensive use of § 13(d) litigation).

319. See, for example, Black, 17 J. Corp. L. at 58 (cited in note 6) (observing that the proxy rules "undercut the Congressional intent, reflected in Section 14(a) of the Securities Exchange Act, to preserve shareholder voting as a meaningful check on corporate managers"); Black, 89 Mich. L. Rev. at 536-42 (cited in note 12) (describing obstacles to shareholder action created by the proxy

issues were brought to the attention of the SEC by the CalPERS letter,<sup>320</sup> but the SEC chose not to address them. In spite of its continued re-examination of the regulatory system and its never-ending series of amendments, the SEC continues to limit shareholder participation in corporate governance both through sins of commission and omission in connection with its proxy rules.<sup>321</sup> Accordingly, the rules remain an unauthorized and misbegotten regulatory endeavor.

It is beyond the scope of this Article to determine the extent to which federal law can improve the voting process, or whether shareholder voting can or will improve monitoring and lead to higher productivity for U.S. corporations. Currently, however, fair corporate suffrage remains a mere ideal. By supplanting state law regulation of the voting process, the SEC has shouldered the responsibility for effecting fair corporate suffrage. To date, it has not lived up to this obligation.

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rules). See also Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 Colum. L. Rev. 10 (1991). See also Black, 17 J. Corp. L. 49 (describing the shortcomings remaining in spite of proxy reform proposals, including the availability of Rule 14a-9 to chill proxy solicitations through the threat of litigation). The rules have also been criticized because they allow management pre-access to shareholder proposals and an opportunity to respond, but do not allow shareholders to oppose management proposals except through the expense of a counter-solicitation, and because they permit management to charge its solicitation expenses to the company, but require dissidents to pay the costs of communicating with their fellow shareholders. See Lucian Arye Bebchuk and Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 Cal. L. Rev. 1071 (1990) (describing the legal rules governing allocation of expenses in proxy contests and the resulting effects on the contests' frequency and success). Management also may contact shareholders directly and exert pressure on their voting. Although the recent amendments responded to several of the concerns raised by CalPERS, they did not address any of these problems. See also Frank D. Emerson and Franklin C. Latham, *Further Insight Into More Effective Stockholder Participation: The Sparks-Withington Proxy Contest*, 60 Yale L. J. 429 (1951) (illustrating the failure of the proxy rules to operate even-handedly in connection with a control contest by describing abuses such as management offering shareholders inducements in exchange for their proxies, engaging in pressure solicitations, and taking advantage of professional contacts with broker-dealers, bankers, and other key players in a proxy contest).

320. See notes 172, 195-96 and accompanying text.

321. See, for example, Black, 17 J. Corp. L. at 53 (cited in note 6) (observing that "[i]f the Commission is to be criticized, it should be for not doing *enough* to deregulate proxy solicitation and level the playing field on access to shareholder lists") (emphasis in original).



