

Regulation of Proxies by the Securities and Exchange Commission

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NOTES AND COMMENT

REGULATION OF PROXIES BY THE SECURITIES AND EXCHANGE COMMISSION.

A proxy to vote shares of stock is an authority given by a shareholder, who has the right to vote, to another to exercise this right.¹ At common law it was held that the shareholder had no implied right to vote by proxy.² This was based on the theory that the corporation was entitled to have the intelligent action of its individual shareholders, so that the latter were bound to vote in person and could not validly delegate this right.³ In New York, however, the right to vote by proxy could have been conferred by a by-law.⁴ Today, such right is universally recognized by statute,⁵ with the result that voting by proxy has become a common practice.

Necessity for Regulation.

Proxy-voting, as a device for securing corporate control, is not of recent origin.⁶ Within each envelope containing notice of a shareholders' meeting, a request is usually extended to the shareholders to execute and return the proxy-form enclosed therein. The form of proxy, in most instances, will designate as proxies one or more per-

¹ *Manson v. Curtis*, 223 N. Y. 313, 119 N. E. 559 (1918); 13 AM. JUR. (1938) 533.

² 5 FLETCHER, CYCLOPEDIA OF CORPORATIONS (perm. ed. 1931) 167; PRASHKER, CASES AND MATERIALS ON THE LAW OF PRIVATE CORPORATIONS (1937) 640; 14 C. J. (1917) 907; 13 AM. JUR. (1938) 534.

³ This rule developed because of reasons peculiarly applicable to municipal and charitable corporations wherein membership is devoid of pecuniary considerations, so that the theory that the right to vote was a personal trust committed solely to the personal discretion of the members was justified. *Walker v. Johnson*, 17 App. Cas. 144, 162 (D. C. 1900); 14 C. J. (1917) 907. This is reflected in N. Y. GEN. CORP. LAW § 19 which even today excludes mention of religious corporations in setting forth the right to vote by proxy. Such a view, however, can have no application to a modern business corporation. *Walker v. Johnson*, *supra*.

⁴ *Phillips v. Wickham*, 1 Paige Ch. 590, 598 (N. Y. 1829).

⁵ POPE, DIGEST OF STAT. OF ARK. § 2189; REV. CODE OF DEL. § 2049; FLA. COMP. GEN. LAWS ANN. § 6012; ILL. REV. STAT. c. 32, § 157.28; BURNS, IND. STAT. ANN. § 25-207; ANN. LAWS OF MASS. c. 156, § 32; MANSON'S MINN. STAT. § 7492-25; MISS. CODE § 4147; MO. REV. STAT. § 4530; NEV. COMP. LAWS § 1628; N. J. REV. STAT. tit. 14, c. 10, § 9; N. Y. GEN. CORP. LAW § 19; OKLA. STAT. § 9766; PURDON'S PA. STAT. ANN. (perm. ed.) tit. 15, §§ 108, 109; R. I. GEN. CORP. LAW § 23; REMINGTON'S COMP. STAT. OF WASH. § 3812; WIS. STAT. § 182.15.

The UNIFORM BUSINESS CORPORATION ACT 28, par. IV also sanctions the use of proxies.

⁶ See 19 FLETCHER, *op. cit. supra* note 2, at 195; STEVENS, PRIVATE CORPORATIONS (1936) 468; ROERLICH, LAW AND PRACTICE IN CORPORATE CONTROL 47; WORMSER, FRANKENSTEIN, INC. (1931) 158.

sons who represent the existing management and control. The mechanical return⁷ (in the self-addressed stamped envelope enclosed for such purposes⁸) of these proxies, without reflection on the shareholder's part, obviously results in the continuance and retention of the soliciting management's policies and control. Of course, in some cases, the shareholder fails to return the proxy, either because he lacks the initiative and interest, or because he suspects that the proxy was requested for the sole purpose of insuring the perpetuation of the existing management. Again—all proxies being revocable in New York⁹—the shareholders will occasionally retract their proxies, either by express act or by implication, as where a new proxy is given to another. The latter usually results when an "opposition proxy committee", organized by complaining shareholders, undertakes to solicit proxies opposed to those solicited by the existing management. Instances of such committees may be found in the renowned proxy-warfares occurring in the Rockefeller-Stewart controversy,¹⁰ the Youngstown-Bethlehem merger,¹¹ and the retention of Mr. Childs as president of Childs Co. of New York.¹²

The use of proxies, however, is not restricted to obtaining control. The majority of shareholders in a large corporation, who are dispersed over various parts of the country, rarely, if ever, personally participate in corporate activities.¹³ Consequently, if it were not for

⁷ As aptly stated by ROHRlich, *loc. cit. supra* note 6: "The proxy ordinarily runs in favor of one or more persons selected by the board of directors. The return is almost automatic."

It is interesting to note that the management, in sending out proxies may usually use corporate funds to meet the expense incurred in procuring stamps, envelopes, etc. *Lawyer's Advertising Co. v. Consolidated Ry. Lighting and Refrigerating Co.*, 187 N. Y. 395, 80 N. E. 199 (1907); 3 COOK, CORPORATIONS (8th ed.) 2685. However, if it clearly appears that the proxies were solicited in a mere contest over who should control the corporation, use of corporate funds is improper. *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 20 Del. Ch. 78, 171 Atl. 226 (1934).

⁸ In one case a minority shareholder succeeded in obtaining the control of a large corporation by merely enclosing stamped return envelopes with the proxies forms, as opposed to the enclosure of unstamped return envelopes which were sent out by the existing management. *THE AUTOBIOGRAPHY OF LINCOLN STEPFENS* (1931) 533.

⁹ N. Y. GEN. CORP. LAW § 19. In some states, if the proxy is coupled with an interest, it is irrevocable. *Mobile & O. R. R. v. Nicholas*, 98 Ala. 92, 12 So. 723 (1893); *Smith v. San Francisco & N. P. R. R.*, 115 Cal. 584, 47 Pac. 582 (1897); *Chapman v. Bates*, 61 N. J. Eq. 658, 47 Atl. 683 (1900); *Boyer v. Nesbitt*, 227 Pa. 398, 76 Atl. 103 (1910).

¹⁰ See 19 FLETCHER, *op. cit. supra* note 2, at 196; BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1933) 82; PRASHKER, *op. cit. supra* note 2, at 644.

¹¹ See Rohrllich, *Protective Committees* (1932) 80 U. OF PA. L. REV. 671.

¹² See (1936) 66 U. S. L. REV. 66.

¹³ Testimony in the current investigation of the Temporary National Economic Committee (Monopoly Probe) revealed that out of 27,000,000 policyholders of the Metropolitan Life Insurance Co. entitled to vote, only 437,000 of them personally cast their ballots in the 1937 election of directors. *Newsweek*, Feb. 20, 1939, p. 44.

the use of proxies, a quorum for a meeting of shareholders in such corporations would rarely be procured. In fact, in many instances, it becomes necessary for the secretary of the corporation to follow up a solicitation of a proxy with telegrams urging the shareholder to execute and return the form of proxy previously mailed to him, or in the alternative to attend the meeting in person¹⁴ in order to insure the presence of a quorum. Thus, the proxy in some instances becomes essential to the continuance of a corporation. Again, we have seen that the proxy—through the instrumentality of an opposition committee—may be used to protect the interests of a minority. But for the most part, the proxy is a mere utensil in the hands of the existing management, utilized as a medium for their self-perpetuation.

The real evil, however, arises not so much in the result achieved, *i.e.*, the concentration of power in a few, but in the means used for the attainment of such end. "Too often proxies are solicited without explanation of the real nature of the questions for which authority to cast his [the shareholder's] vote is sought."¹⁵ Prior to the Securities Exchange Act, a proxy could be validly solicited by a form which merely stated that the shareholder authorized the solicitor to vote for him at a certain meeting, even though no facts concerning the matters that might arise at the meeting were disclosed.¹⁶ Such a proxy would not only give the solicitor general discretion as to the manner of casting the vote,¹⁷ but would also give him general authority to vote on any ordinary matter which might arise at the meeting.¹⁸ In one case, the president of a corporation had solicited proxies for the ratification of certain transactions which he had executed. The letter requesting such proxies was entirely devoid of all important details which, if known to the shareholders, would have precluded the ratification. It failed to disclose the president's personal interest in an underwriting agreement made by the corporation, and that secret options in the corporation's stock had been previously granted. The result was that the solicitation was so successful that the corporation voted all proxies in favor of ratifying not only the transaction in discussion, but also all other acts previously executed by the directors and officers.¹⁹ Such practices made the regulation of the solicitation of proxies almost a necessary consequence. Again, the average shareholders of a large corporation do not even keep informed of corporate activities. Their disinterested attitude, coupled with the fact that they consider the weight of their vote practically negligible, seldom prompts the shareholders to make any substitutions or limitations in the proxy-forms.

¹⁴ See 19 FLETCHER, *op. cit. supra* note 2, at 195.

¹⁵ SEN. REP. No. 792, 73d Cong., 2d Sess. (1934) 12.

¹⁶ See proxy forms in FLETCHER, CORPORATION FORMS (1913) 1053 *et seq.*

¹⁷ See 5 FLETCHER, *op. cit. supra* note 2, at 181.

¹⁸ See 5 FLETCHER, *op. cit. supra* note 2, at 182. However, the proxy could not be used to vote on extraordinary matters, such as a voluntary dissolution, consolidation, or reorganization. 5 FLETCHER, *op. cit. supra* note 2, at 184.

¹⁹ SEN. REP. No. 792, 73d Cong., 2d Sess. (1934) 12.

"If stockholders refuse or neglect to protect themselves; if conditions are such as to make it difficult or impossible for them to do so, the State must take up the cudgels in their behalf."²⁰ Though in various states statutory regulation was present in some form,²¹ it was of limited application. Statutes merely prohibited the issuance of proxies for a consideration,²² but did not attempt to minutely regulate their solicitation. Federal legislation, therefore, was almost inevitable.

Statutory Provisions.

"Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange. Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies. Insiders having little or no substantial interest in the properties they manage have often retained their control without an adequate disclosure of their interest and without an adequate explanation of the management policies they intend to pursue. Insiders have at times solicited proxies without fairly informing the stockholders of the purposes for which the proxies are to be used and have used such proxies to take from the stockholders for their own selfish advantage valuable property rights. Inasmuch as only the exchanges make it possible for securities to be widely distributed among the investing public, it follows as a corollary that the use of the exchanges should involve a corresponding duty of according to the shareholders' fair suffrage * * *"²³ With this purpose in mind, Congress, in 1934, passed Section 14 of the Securities Exchange Act.²⁴ Subdivision (a) of this section makes it unlawful for any person to solicit proxies by the use of the mails, or any instrumentality of interstate commerce, or any facility of a registered exchange in contravention of the rules and regulations of the Securities and Exchange Commission, while subdivision (b) thereof prohibits any member of a registered exchange, or any dealer or broker who transacts business through such a member, to give a proxy in violation of the rules of the Commission.

The Securities and Exchange Commission, pursuant to Sections 11(g)²⁵ and 12(e)²⁶ of the Public Utility Holding Company Act of 1935, also regulates the solicitation of proxies in respect to holding companies and their subsidiaries. Under Section 12(e) of this Act, the solicitation of a proxy regarding any security of a registered hold-

²⁰ WORMSER, *op. cit. supra* note 6, at 156.

²¹ See 5 FLETCHER, *op. cit. supra* note 2, at 171 for a discussion of state statutory restrictions on proxy-voting.

²² See N. Y. PENAL LAW § 668.

²³ H. R. REP. No. 1383, 73d Cong., 2d Sess. (1934) 13, 14.

²⁴ 48 STAT. 895, 15 U. S. C. A. § 78n (Supp. 1935).

²⁵ 49 STAT. 820, 15 U. S. C. A. § 79k (Supp. 1935).

²⁶ 49 STAT. 823, 15 U. S. C. A. § 79l (Supp. 1935).

ing company or subsidiary thereof must comply with the rules of the Commission. Section 11(g) thereof prohibits the solicitations of proxies with respect to any reorganization of a registered holding company unless the plan of reorganization has either been approved by the Commission or submitted to it by a person having a *bona fide* interest²⁷ therein, and further, unless the solicitation, which must be accompanied or preceded by a report of the Commission on the plan, complies with all rules and regulations as prescribed by the Commission.²⁸

It will be noted that in neither case did Congress outline the exact procedure to be followed in order to have a valid solicitation of a proxy, but it left the actual regulation to the Securities and Exchange Commission,²⁹ so that the latter may vary its rules as often as changing conditions require. An examination of such rules, therefore, becomes necessary in order to determine what must be done when a proxy is solicited.

²⁷ "Bona fide interest" is defined in the rules adopted by the Commission as: "(1) Such company [seeking reorganization], any creditor or stockholder thereof, any receiver or trustee of such company and any duly authorized representative of any of said persons; (2) Any trustee under a mortgage, deed of trust or indenture pursuant to which there are outstanding securities which have been issued, guaranteed or assumed by such company; (3) Any State commission having regulatory jurisdiction over the company undergoing reorganization, or any person authorized to prepare a plan by any court, officer or agency before which a reorganization proceeding is pending; and (4) Any other person who is declared by the Commission, in connection with an order for a hearing on an application filed by such person, or otherwise, to have a bona fide interest in such reorganization, including (but without limitation) consumers, officers, directors, or employees of such company, labor unions, associations and other representations of such employees." RULE U-12E-1(e).

²⁸ Section 11(g) provides: "It shall be unlawful for any person to solicit or permit the use of his or its name to solicit, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, any proxy, consent, authorization, power of attorney, deposit, or dissent in respect of any reorganization plan of a registered holding company or any subsidiary company thereof under this section for the divestment of control, securities, or other assets, or for the dissolution of any registered holding company or any subsidiary company thereof, unless—(1) the plan has been proposed by the Commission, or the plan and such information regarding it and its sponsors as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers has been submitted to the Commission by a person having a bona fide interest (as defined by the rules and regulations of the Commission) in such reorganization; (2) each such solicitation is accompanied or preceded by a copy of a report on the plan which shall be made by the Commission after an opportunity for a hearing on the plan and other plans submitted to it, or by an abstract of such report made or approved by the Commission; and (3) each such solicitation is made not in contravention of such rules and regulations or orders as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers. Nothing in this subsection or the rules and regulations thereunder shall prevent any person from appearing before the Commission or any court through an attorney or proxy."

²⁹ See SECURITIES EXCHANGE ACT § 23(a), 49 STAT. 1379, 15 U. S. C. A. § 78w (Supp. 1935); PUBLIC UTILITY HOLDING COMPANY ACT § 20, 49 STAT. 835, 15 U. S. C. A. § 79t (Supp. 1935).

Rules and Regulations.

A complete revision of the rules and regulations relative to the solicitation of proxies with respect to securities registered on a national exchange has recently been effected by the Securities and Exchange Commission.³⁰ The new rules, known as "Regulation X-14", which became effective October 1, 1938,³¹ repeal rules LA1 through LA7.³² These regulations do not attempt to limit the type of matters for which a proxy may be solicited, but they provide for a just and complete disclosure of important details to the shareholders whose proxies are solicited, so that they may act with some judgment with reference thereto. Disclosure is made available by requiring that a "proxy-statement", which must conform with certain standards of legibility,³³ be previously or concurrently furnished to each person whose proxy is solicited.³⁴ "Solicitation" is defined as including any request for a proxy, whether or not such request is accompanied by or included in a written form of proxy.³⁵ Three copies of the proxy-statement must be filed with the Securities and Exchange Commission not later than at the time the solicitation begins; one copy of the statement must also be filed with each exchange on which is listed the security with respect to which the solicitation is made.³⁶ The proxy-statement must set forth:

(a) *The shareholders' power to revoke the proxy, and rights of dissenting shareholders.* Not only must the shareholders' power to revoke the proxy be stated, but if any express conditions qualifying this right exist, a brief summary of such conditions must be included.³⁷

³⁰ The text of Regulation X-14 is found in S. E. C., SECURITIES EXCHANGE ACT OF 1934, RELEASE No. 1823, Aug. 11, 1938.

³¹ S. E. C., SECURITIES EXCHANGE ACT OF 1934, RELEASE No. 1823, Aug. 11, 1938, p. 3. However, compliance with the previous rules is sufficient in the case of a solicitation made after Oct. 1, 1938, with respect to any subject matter or meeting as to which the first solicitation was made prior to such date. S. E. C., SECURITIES EXCHANGE ACT OF 1934, RELEASE No. 1823, Aug. 11, 1938, p. 14.

³² The text of these old rules is found in S. E. C., SECURITIES EXCHANGE ACT OF 1934, RELEASE No. 378 (Class A) Sept. 24, 1935 as amended by S. E. C., SECURITIES EXCHANGE ACT OF 1934, RELEASE No. 1497, Dec. 20, 1937. The distinguishing feature between these old rules and the current Regulation X-14 is that the latter makes the amount of information to be made available to the solicited shareholder more comprehensive.

³³ RULE X-14A-3 provides: "Every printed proxy statement and form of proxy, and all related printed material furnished to the persons solicited in connection with any solicitation subject to Section 14(a) of the Act, other than documents not prepared in connection with the solicitation, shall be set in type not smaller than 10-point roman, at least 2-point leaded; except that financial statements may be set in type not smaller than 8-point roman, if necessary for convenient presentation."

³⁴ RULE X-14A-1.

³⁵ RULE X-14A-9(b).

³⁶ RULE X-14A-4. The new rules make no provision for a "waiting period" after the filing of the proxy-statement with the Commission.

³⁷ SCHEDULE 14A—Item 1(a) and (b). S. E. C. SECURITIES EXCHANGE ACT OF 1934, RELEASE No. 1823, Aug. 11, 1938.

If any matter to be acted upon pursuant to the proxy carries with it a statutory right of appraisal to a dissenting shareholder, the proxy-statement must briefly summarize or quote the provisions of the statute, as well as any charter or other provision relative thereto.³⁸ Thus, if the solicitation concerns the consolidation³⁹ or the merger⁴⁰ of the corporation, or the voluntary sale of the franchise or property of the corporation,⁴¹ or the sale of the remaining property on a voluntary dissolution of the corporation,⁴² or the issuance of stock to employees,⁴³ the shareholders' right of appraisal must be explained. Few shareholders are even aware that in certain instances they have a right of appraisal—this provision not only informs them of such right, but it also enables them to ascertain whether or not their right of appraisal under the circumstances would warrant their dissenting.

(b) *Plan of compensation, if any, and expenses for solicitation.* Although there is usually no general plan of compensation in the ordinary case of the solicitation of proxies, in some instances the corporation will procure the services of those who are especially engaged in the business of soliciting proxies. While the rules of the Commission do not attempt to eliminate such practices, they do provide for a full disclosure of the agreement between the corporation and such persons. Thus, the general plan itself, plus the amount of compensation, directly or indirectly, paid or to be paid, must be stated. In any case, whether there is a general plan of compensation or not, the proxy-statement must reveal all other expenses incurred, such as the cost of envelopes, postage, printing, etc.⁴⁴ These provisions, of course, do not sanction the compensation of a shareholder for his proxy, but, on the contrary, any payment for the proxy in New York will not only vitiate the proxy,⁴⁵ but will subject the shareholder to criminal liability as well.⁴⁶

(c) *The identification of the persons soliciting the proxy.* This enables the shareholder to determine whether the proxy is solicited in behalf of the existing management. If such is the case, a clear statement to that effect must be made.⁴⁷ Further, if a director has given written notice to the corporation that he is not in favor of the action to be taken and that he intends to solicit proxies in opposition thereto, such fact must also be stated.⁴⁸ If the solicitation is not made by the management or the corporation, the names of the persons

³⁸ SCHEDULE 14A—ITEM 2.

³⁹ N. Y. STOCK CORP. LAW § 87.

⁴⁰ *Id.* § 21.

⁴¹ *Id.* § 21.

⁴² *Id.* § 105a.

⁴³ *Id.* § 21.

⁴⁴ SCHEDULE 14A—ITEM 3.

⁴⁵ N. Y. STOCK CORP. LAW § 47.

⁴⁶ N. Y. PENAL LAW § 668.

⁴⁷ SCHEDULE 14A—ITEM 4(a).

⁴⁸ *Id.* ITEM 4(c).

actually making the solicitation and the approximate amount of securities owned either beneficially or of record by such persons and their associates⁴⁹ must be stated.⁵⁰ In either case, whether it is solicited in behalf of the management or not, the proxy-statement must contain information as to any substantial interest of any director, officer or associates in any matter to be acted upon pursuant to the proxy.⁵¹

(d) *The matters to be acted upon pursuant to the proxy.* Under this heading the rules prescribe specific requirements for each different type of matter concerned.⁵² Thus, where the proxy is to cover the election of directors, information as to each candidate for whom the solicitor intends to vote must be included. The information called for will enable the shareholder solicited to determine the nominee's interest in property acquired by the corporation not in the ordinary course of business, the security holdings of the nominee, and the relationship between the nominee and the person or persons primarily responsible for his original designation as a candidate.⁵³ Similarly, where the solicitation relates to the acquisition or disposition of property by the corporation, specified information as to the character of the property, the fairness of the consideration, and the relationship of the transferor or transferee to the corporation, is required.⁵⁴ If the matter to be acted upon is not specifically included in the rules, then information of the same substantial character as is required in the other items must be furnished.⁵⁵

The exact order of these items is not required to be followed.⁵⁶ In fact, literal adherence, without regard to the purpose of the rule, may result in making the proxy-statement misleading and thus viola-

⁴⁹ "Associate" is defined as: "(1) any corporation or organization (other than the issuer) of which such person owns of record or beneficially 10% or more of any class of voting securities, (2) any firm of which such person is a partner, and (3) any relative or spouse of such person having the same home as such person." RULE X-14A-9(e).

⁵⁰ SCHEDULE 14A—ITEM 5(a) and (b).

⁵¹ *Id.* ITEMS 4(b), 5(c). But no statement need be made as to any interest arising solely by his being a director, officer, or associate of the solicitor; nor need any statement be made by reason of his security holdings unless the matter to be acted upon involves the issuance, modification or exchange of any class of securities. *Id.* ITEM 4(b).

⁵² The rules divide the matters to be acted upon and provide for specific information relating to each as follows: (1) election of directors or other officials; (2) plan providing for remuneration of any director, officer, or employee; (3) amendment of charter, by-laws, or other document; (4) authorization or issuance of securities, otherwise than in exchange for outstanding securities of the issuer; (5) plan for the modification of any class of securities, or the issuance of issuer's securities in exchange for its outstanding securities; (6) plan involving the merger, consolidation, or sale of assets; (7) acquisition or disposition of any property; (8) action to be taken with respect to any report or minutes; (9) other matters. SCHEDULE 14A—ITEMS 6 to 14.

⁵³ SCHEDULE 14A—ITEM 6.

⁵⁴ *Id.* ITEM 12.

⁵⁵ *Id.* ITEM 14.

⁵⁶ RULE X-14A-1(a).

tive of Rule X-14A-5.⁵⁷ The rules, in recognition of the fact that general questions are occasionally submitted to the shareholders before the complete terms and conditions thereof can be determined, further provide that any information required to be disclosed, but which is neither known nor reasonably available to the solicitor, may be omitted, provided that a brief statement of the circumstances making such information unavailable be included in lieu thereof; nor need matters to occur or to be determined in the future be stated other than in terms of present intention, so long as the limit of the authority intended to be conferred concerning such matters be set forth to the fullest extent practicable.⁵⁸

We have seen that a proxy ordinarily conferred general authority and discretion to the holder to vote upon any ordinary matter which might arise at the meeting.⁵⁹ The result was that in many instances the shareholder subsequently discovered that he had, through the medium of the proxy, voted in favor of a proposition of which he in fact disapproved. Though the shareholder could have limited the authority and discretion of the holder by expressly so providing,⁶⁰ he rarely did so. Today, under the rules of the Commission, the authority of the proxy-holder is necessarily limited inasmuch as the proxy-statement must specifically describe each item to be acted upon pursuant to the proxy, so that the authority of the solicitor is accordingly confined to such matters that are so disclosed. Furthermore, the rules provide for a method whereby the discretion of the proxy-holder can be controlled. This is accomplished by placing a specific duty on the solicitor to provide means whereby the shareholder solicited is given the opportunity to direct the manner in which his vote shall be cast on each of the items under consideration (other than the election of directors or other officials).⁶¹ Thus, if the shareholder does direct the way his vote shall be cast, the discretion of the proxy-holder will be limited thereby.⁶² But the shareholder must avail himself of this opportunity, else full discretion will be deemed to be conferred to the holder.

Under Section 14(b) of the Securities Exchange Act relative to the execution of proxies by brokers in whose name the customer's stock is held of record, the Commission has adopted no rules or regulations, so that in the absence thereof, there are no limitations imposed.

⁵⁷ RULE X-14A-5 provides: "False or misleading statements. No solicitation subject to Section 14(a) of the Act shall be made by means of any form of proxy, notice of meeting, or other communication containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or omits to state any material fact necessary in order to make the statements therein not false or misleading."

⁵⁸ RULE X-14A-1(b).

⁵⁹ See notes 17, 18, *supra*.

⁶⁰ 5 FLETCHER, *op. cit. supra* note 2, at 185.

⁶¹ RULE X-14A-2(a).

⁶² RULE X-14A-2(b).

However, it is to be remembered that the particular exchange of which the broker is a member usually imposes restrictions upon such solicitations.⁶³ Violation of these exchange rules, of course, imposes no criminal liability, but may subject the member to expulsion.

Under the Public Utility Holding Company Act, the Commission is given authority not only to regulate the solicitation of proxies regarding any security of a registered holding company or its subsidiary, but also the solicitation of proxies or other authorizations in connection with a reorganization plan of a registered holding company.⁶⁴ In the former case, the same rules apply as if the proxy solicited affected securities registered on a national securities exchange,⁶⁵ so that Regulation X-14 would be applicable. In the latter case, Rules U-12E-1 through U-12E-6 apply.⁶⁶ Under these rules a proxy with respect to a consent to or dissent from a plan of reorganization may not be solicited unless the plan has been submitted to the Commission and it has reported thereon.⁶⁷ If more than twenty-five owners of securities or claims are solicited for such a consent or dissent, a declaration under Rule U-12E-5 must also be filed.⁶⁸ However, a solicitation of a proxy or other authorization in connection with or in anticipation of a reorganization which does not constitute a consent or dissent is permissible, even though the Commission has not reported on the plan.⁶⁹ In such case, if not more than twenty-five owners of securities⁷⁰ are solicited, no material whatsoever need be filed with the Commission.⁷¹ If more than twenty-five owners are solicited,⁷² the solicitation must be accompanied or preceded by a statement containing the names, business connections, security holdings and interest in the plan of the persons making the solicitations and of each person on whose behalf such person is acting, and

⁶³ See RULES 770-775 of the NEW YORK STOCK EXCHANGE, p. C-465, effective Jan. 16, 1939.

⁶⁴ See notes 25, 26, *supra*.

⁶⁵ RULE U-12E-2. However, no documents need be filed with any national securities exchange unless the security is actually registered on such exchange.

⁶⁶ The text of these rules is found in S. E. C., PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, RELEASE No. 759, July 26, 1937.

These rules are not applicable to solicitations with respect to plans which have been commenced in good faith before registration, or where the plan has been approved by a court before Dec. 1, 1935. OPINION OF GENERAL COUNSEL TO COMMISSION, S. E. C., PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, RELEASE No. 41, Dec. 2, 1935, as modified by OPINION OF GENERAL COUNSEL TO COMMISSION, S. E. C., PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, RELEASE No. 1110, May 31, 1938.

⁶⁷ RULE U-12E-3(b)-(2).

⁶⁸ RULE U-12E-3(d).

⁶⁹ RULE U-12E-3(c).

⁷⁰ RULE U-12E-3(b) provides: "For the purpose of computing such number of owners, all persons having any legal or beneficial interest in any specific security or claim shall be counted as a single owner."

⁷¹ RULE U-12E-3(b)-(1).

⁷² However, the Commission may, for cause shown, increase the number of owners which may be solicited without the necessity of filing any material with the Commission. RULE U-12E-3(b)-(1).

the authorization must expressly provide that it is unconditionally revocable by the grantor, and that it does not constitute nor authorize any person to give a consent to or dissent from any plan of reorganization.⁷³ These solicitations would merely enable the solicitor to represent the grantor in the negotiation, formulation, or development of a reorganization plan or to appear in any proceeding in connection with such plan, but would not empower him to either consent to nor dissent from such plan. The obvious purpose of these rules is to insure that the shareholder solicited be provided with adequate information concerning the reorganization plan and the solicitor's interest therein; the rules further protect the shareholder by providing that in any case, whether any material is filed with the Commission or not, the proxy or other authorization must make adequate provision for the review by a disinterested person of all expenses and fees to be incurred, for the submission of periodic reports and statements of account to the grantor, and for the prohibition against dealing in the securities affected by the reorganization by the solicitor or his associates.⁷⁴

Exempted Solicitations.

Although the rules and regulations as promulgated by the Commission under the Securities Exchange Act are generally applicable to any solicitation of proxies as well as to solicitations of other authorizations,⁷⁵ in certain instances the rules of the Commission will exempt specified solicitations from the inhibition of the Act. Thus, the proxy rules are not applicable to any solicitation made otherwise than by the use of the mails or by any means of instrumentality of interstate commerce or any facility of any national securities exchange.⁷⁶ Since the constitutionality of the Act is based on the power of Congress to regulate interstate commerce and its control over the mails,⁷⁷ this exemption is a logical consequence. So, too, in accordance with the general plan of the Act to exempt transactions already subject to governmental or judicial control,⁷⁸ solicitations of acceptances of a plan of reorganization under Chapter X of the Bankruptcy Act or of the authorizations to accept any such plan, are exempt if made subsequent to the entry of an order approving such plan pursuant to Section 174 of the Bankruptcy Act.⁷⁹ Similarly, any solicitation of a proxy evidenced by a certificate of deposit or any other security which

⁷³ RULE U-12E-3(c).

⁷⁴ RULE U-12E-3(a)-(3).

⁷⁵ OPINION OF GENERAL COUNSEL TO COMMISSION, S. E. C., SECURITIES EXCHANGE ACT OF 1934, RELEASE NO. 461, JAN. 21, 1936.

⁷⁶ RULE X-14A-7(a).

⁷⁷ See PRASHKER, *op. cit. supra* note 2, at 618, 625.

⁷⁸ *Id.* at 615.

⁷⁹ RULE X-14A-7(e).

is registered under the Securities Act of 1933 is also exempt.⁸⁰ The rules, therefore, would not apply to solicitations by a protective committee of the deposit of securities under an agreement whereby certificates of deposit are issuable, since such certificates are securities within the Act of 1933, and must be registered thereunder.⁸¹ The rules are also not applicable to solicitations by a person in respect to securities carried in his name or in the name of his nominees, or held in his custody, provided that he received no compensation for the solicitation, and further, that he furnished a copy of all soliciting material to the person whose proxy is solicited.⁸²

In addition to the exemptions specifically provided by Regulation X-14, further exemptions are provided by Rule JF4(b) to solicitations of proxies with reference to securities admitted to unlisted trading privileges but not listed as registered securities on a national exchange; by Rule AN18 with reference to securities of foreign issuers and American depository receipts; and by Section 11(f) of the Bankruptcy Act to solicitations with reference to certain proxies in connection with railroad reorganizations. The Commission, in its discretion, may further increase the types of solicitations which are exempt from its rules.

Enforcement of the Rules.

Persons who contemplate the solicitation of proxies falling within the scope of the Act, may obtain suggestions or informal opinions from the Commission in advance of the actual filing of the proxy-statement.⁸³ These consultations, which enable the solicitor to ascertain, before the actual solicitation, whether or not it will conform to the Commission's regulations, usually result in a satisfactory compliance with the proxy rules. But where an improper solicitation is brought to the Commission's attention, it may make investigations to determine whether any rule has been violated, and it may prosecute an action in any federal court to restrain violations of the Act or any of its regulations.⁸⁴ Accordingly, where the proxy-statement does not

⁸⁰ *Id.* 14A-7(d).

⁸¹ See OPINION OF GENERAL COUNSEL TO COMMISSION, S. E. C., SECURITIES EXCHANGE ACT OF 1934, RELEASE No. 461, Jan. 21, 1936.

⁸² RULE X-14A-7(b). Under the old RULE LA-2 the exemptions were not so broad, but included only solicitations by banks, dealers, brokers, nominees, custodians, and trustees.

⁸³ S. E. C., SECURITIES EXCHANGE ACT OF 1934, RELEASE No. 1823, Aug. 11, 1938, p. 2. Such persons are requested to present their questions as far in advance of the solicitation as is practicable. *Ibid.*

The Commission reports that there has been a substantial increase during the fiscal year of 1938 of occasions wherein material was submitted to the Commission for comment in advance of the actual solicitation. FOURTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION (1938) 70.

⁸⁴ SECURITIES EXCHANGE ACT § 23, 49 STAT. 1921, 15 U. S. C. A. § 78u (Supp. 1935); PUBLIC UTILITY HOLDING COMPANY ACT § 19, 49 STAT. 832, 15 U. S. C. A. § 79r (Supp. 1935).

adequately describe the matters to be acted upon pursuant to the proxy, the Commission may file a bill seeking an order restraining the use of such proxies. Generally, however, the Commission does not take such drastic action, but will require the solicitor to recircularize the shareholders with additional information supplementing and elucidating the original proxy-statement.⁸⁵ In such cases, the Commission will also require that a form of revocation or confirmation be sent to those solicited so that they can revoke or confirm their proxies on the basis of the full disclosure. Where the solicitor refuses to transmit additional information to the shareholders, the Commission, depending on the character of the particular case, will itself recircularize the shareholders with the necessary information.⁸⁶ Of course, only proxies obtained or confirmed on the basis of the additional information may be voted upon. While the willful violation of any rule of the Commission or the willful making of any false or misleading statement in connection with any solicitation will impose criminal liability on the solicitor,⁸⁷ the rules of the Commission expressly provide that such violations shall not invalidate any proxy pursuant to which action has actually been taken.⁸⁸

The procedure of the Commission can be best understood by examining the steps taken by it in investigating solicitations. In one case, the management solicited the approval of the proposed dissolution of the corporation. A letter, signed by the president, had been sent to those solicited, in which the president, stating that he owned more than six and one-half times as many shares of the common stock as he owned of preferred, urged the approval of the dissolution. The Commission, after examining the facts, concluded that the letter was misleading, since it failed to state that there were almost eight times as many shares of common stock as there were of preferred, so that the proportional interest of the president in the preferred shares was in fact greater than his interest in the common. The Commission further found that those whose proxies were solicited were not

⁸⁵ THE FOURTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION (1938) at p. 69 states: "In a substantial number of cases in which the soliciting material was either false or misleading in character deficient in the descriptive material called for by the proxy rules, communications containing information, clarifying or supplementing the original soliciting literature, were required to be sent to security holders. Depending upon the character of the particular case, either new proxies, consents, or authorizations were solicited or security holders were afforded an opportunity to revoke or confirm the proxies which they had been given. In other cases, in order to avoid the possibility of failure to comply with such rules, proxies were not voted upon matters which appeared either not to have been described or to have been inadequately described in the soliciting literature."

⁸⁶ See S. E. C., SECURITIES EXCHANGE ACT OF 1934, RELEASE No. 759, July 26, 1937.

⁸⁷ SECURITIES EXCHANGE ACT § 32, 49 STAT. 1379, 15 U. S. C. A. § 78f (Supp. 1935); PUBLIC UTILITY HOLDING COMPANY ACT § 16, 49 STAT. 829, 15 U. S. C. A. § 79p (Supp. 1935).

⁸⁸ RULE X-14A-8.

informed that upon dissolution there would probably be no funds available for distribution among the holders of the common shares. The Commission requested the corporation to circularize the shareholders with further information disclosing these facts, but the corporation at first refused. The Commission then made it apparent that it would take action to procure an order restraining the use of the proxies obtained. Thereupon, the management complied with the Commission's request by sending the additional information and by also sending a form of revocation or confirmation to the shareholders. Only proxies confirmed or obtained on the basis of the additional information were permitted to be voted upon.⁸⁹

Conclusion.

The purpose of the Act to eliminate the misuse of proxies by providing that full disclosure be made to the shareholder solicited has unquestionably been effectuated. The innumerable solicitations examined by the Commission during the fiscal year of 1938, and the many follow-up letters which were required to be sent to the shareholders in order to clarify the matters contained in the original soliciting material evince the benefits accruing to the shareholders.⁹⁰ In fact, the procedure of the Commission has been so efficacious that as yet no judicial proceeding to restrain the use of proxies obtained in violation of the rules has been instituted under Section 21 of the Securities Exchange Act. Undoubtedly, the notorious evils and the innocuous practices attending the solicitation of proxies have been substantially curtailed by the Act.

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ACCOUNTANTS' LIABILITY.

Accountants¹ are members of one of the most important² profes-

⁸⁹ FOURTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION (1938) 70.

⁹⁰ *Id.* at 69 states: "During the fiscal year, 2,232 solicitations of proxies, consents, or authorizations and 447 follow-up communications thereon were examined for compliance with the rules promulgated by the Commission under authority of Section 14(a) of the Securities Exchange Act of 1934."

¹ Auditors of accounts were mentioned as being important in the Statutes of Westminster in the reign of Edward I. ENCYC. BRIT. (13th ed. 1926) 123.

² See RICHARDSON, INFLUENCE OF ACCOUNTANT'S CERTIFICATES ON COMMERCIAL CREDIT (1913); Watson, *Compulsory Audits by Public Accountants* (1933) 56 J. Acc'y. 250; Kimball, *Accountant's Reports from a Banker's Viewpoint* (1937) 65 J. Acc'y. 267; Note (1931) 31 COL. L. REV. 867.

The Securities and Exchange Commission may require balance sheets and profit and loss statements contained in the registration statements and the annual reports of issuers of registered securities to be certified by independent account-