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THE S.E.C. AND SHAREHOLDER PROPOSALS:  
SIMPLIFICATION IN REGULATION

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SIMPLIFICATION IN REGULATION

Today I want to challenge one of the SEC's most notable regulatory successes -- the Commission's Shareholder Proposal Rule. Through this Rule, known to the cogniscenti as Rule 14a-8, the Commission mediates the delicate, often highly charged conflicts which can arise between 9,000 registered public companies and some of their more strong-willed shareholders. This area is a thicket of problems, ranging from arcane questions of state corporate law to delicate, far-ranging issues of intense social concern, such as the uses of nuclear power, environmental pollution, and apartheid. These questions often arise in an atmosphere characterized by mistrust and emotionalism, both on the part of corporate managers (who often feel the shareholder is abusing the process) and shareholder proponents (who often feel management is unresponsive to shareholder concerns).

The staff, guided by the current version of the Rule, has handled these problems well -- so well, in fact, that there is a general consensus that the area has been effectively regulated.

Why, then, would I select this tiny target for attack? The answer is two-fold.

First, as a regulatory experience, the administration of Rule 14a-8 holds valuable lessons on the use of Commission resources and the limits of regulation.

Second, on a more immediate level, I believe that, however effective we have been as referee in the family feuds between managers and owners of public companies, for the future our presence in that area should be minimal. Efforts expended on Rule 14a-8 contribute little to basic investor protection or to efficiency and fairness in the nation's securities markets -- the Commission's principal missions. Administering the Rule has entangled the staff in a parade of issues turning on state law, corporate policy, social engineering and political questions to which we, as regulators, can contribute little.

Today the Commission must husband every ounce of available resources. Even though the administration of this Rule is not a major staff effort, we must seek ways to create more self-executing rules so that our scarce resources can be applied where they are most needed and will have the widest effect.

Before expanding upon these views, however, I would like to touch upon some of the Rule's history and background.

### The Evolution of the Shareholder Proposal Rule

The Shareholder Proposal Rule may be seen as an outgrowth of the well-known separation of ownership from control of public companies in this country -- a phenomenon first documented by Berle and Means in 1932. In the "Dark Ages" before the federal securities laws, state law had already given the corporate shareholder not only the right to vote, in person or by proxy, but also the right to attend shareholder meetings, make appropriate proposals in person, and obtain a vote on them. These were the essential elements in the mechanism of shareholder control.

As shareholdings became more dispersed, corporate management often was tempted to use the proxy voting procedures as a barrier to realistic shareholder influence in corporate decisionmaking. Thus, by the 1920's, we find public companies soliciting proxies granting unlimited voting discretion with little or no disclosure of the matters to be voted on or the interest of management in those matters. In one notable case of behavior so outrageous it might almost be admired, a company printed proxies on the back of dividend checks -- thereby combining the endorsement function and proxy decision into one act.

It was at this point that Congress passed the Exchange Act, including, in its treatment of shareholder rights, a clear endorsement of corporate democracy and, in the legislative history, a mandate to the Commission to exercise some of its broadest powers -- under Section 14 of that Act -- to "prevent the recurrence of abuses which have frustrated the fair exercise of the voting rights of stockholders."

While federalizing the proxy voting process helped to avoid further erosion of basic voting rights, it was not until 1942 that the Commission addressed the other element of participatory corporate democracy -- shareholder proposals. In that year the Commission codified an earlier staff position with the first shareholder proposal rule, which required management:

- to include in its proxy materials any proposal by a "qualified security holder," of which management had "reasonable notice," and which was a "proper subject for action by the security holders;"
- to undertake to vote in accordance with each shareholder's wishes with respect to the proposal; and
- to include, if requested, the proponent's identity and a 100-word supporting statement for each proposal opposed by management.

In Congressional testimony on the Rule, Commissioner O'Brien said, in 1943, that the motivation behind the Rule was

"The desire to approximate the widely attended town meeting type of forum characteristic of the days when nearly all corporations were closely held and geographically limited..."

Even though it was always more symbolic than real, pursuit of this goal paved the way for more and more shareholder proposals as the decades went by.

In the 1940's, shareholder proposals averaged less than 50 per year, or about one for every 44 listed companies. During the 50's and 60's, proposals increased in both absolute and relative terms, until by 1969 there were over 220 proposals submitted, or one for every 12 public companies.

In the 1970's, the field exploded, perhaps as a reflection of generally increased social activism, as well as the dramatic effects of Campaign GM in 1971. For the ten years ending with 1979, an average of 650 proposals per year were submitted.

In the 1980-81 proxy season, according to the American Society of Corporate Secretaries, 991 proposals were submitted. Of this most recent group, almost 55% were submitted by no more than seven individual or coordinated group proponents. About half the proposals were submitted by the owners of 100 shares or less.

With this background, I will focus more closely on two fundamental questions:

First: Should the Commission regulate shareholder proposals at all; and

Second: If so, how?

### The Utility of Shareholder Proposals Today

Shareholder proposals generate a curious hostility among some corporate officials. The numbers tell us that today, as a result of multiple proposals received by some companies, only one out of every 24 public companies ever faces even one proposal in a given year. Of those received, over 20% are eventually withdrawn or excluded under the current Rule. Moreover, shareholder proposals opposed by management are rarely adopted and typically receive less than 10% of the votes cast. Indeed, the Commission's staff can remember only two instances where proposals received a majority vote without management's endorsement: one, an effort to open end a closed end fund, and the other, a case in which management failed to obtain discretionary authority on its proxies and thus could not vote in opposition. The latter result was overwhelmingly reversed the next year.

On the basis of these statistics, then, one might assume that corporate managers would have better things to occupy their energies. However, the volume of writing on this topic, both popular and legal, assures us that such is not the case.

Surely the numbers tell less than the whole story. Something peculiar to this process touches a corporate nerve. Perhaps the answer lies in the perspective which the typical corporate executive brings to the situation. From the corporate viewpoint, the overriding truth is that, without management support, shareholder proposals practically never attract a majority vote, yet they still demand the time and personal attention of corporate officials and attorneys. The distaste of management thus engendered is sharpened by the fact that traditional management prerogatives are often challenged and social concerns promoted through the process. Management tends to be portrayed in an unfavorable light -- an acutely distressing result when one remembers that management is people, with egos, sensitivity and human concerns.

To this injury, add the insult that a company is forced, at its own expense, to dignify proposals by including them in its proxy materials. Management knows that the proxy statement

places these proposals squarely on the desks of the top management of corporate fiduciaries holding stock in the company, and attracts their careful attention. It could not be otherwise, since proxy voting, as one of the bundle of rights accorded to stockholders, must be carried on by fiduciaries with due care.

Add the rare, but popularized instances where shareholders have clearly abused the process to attempt to harass or blackmail a company, and the feelings of management become more comprehensible.

Few commentators are willing to carry management's banner to the extreme length of suggesting that the Rule -- and, thereby, the proposals themselves -- be abolished. In truth, however, a narrow, objective analysis of the economic benefits and burdens involved might well support repeal, since the benefits are rather evanescent, in comparison to hard dollar costs. The difficulty in attacking the Rule was eloquently put by one observer as follows:

"The rule is believed by the writer to stem from one of those lovely theories of democracy which enjoy such a surface veneer of probity as to be difficult of effective criticism even though in application undesirable results are produced."

The argument can also be made that the sum of our efforts under the Rule is simply to perpetuate the thread of a fiction that lost its vitality 50 years ago. Under this view, whatever it once may have been, the corporation is not, and should not be, a democracy or society in microcosm -- it is a pile of capital organized and managed solely for profit.

This approach leads to the conclusion that shares of stock are simply a commodity, to be bought and sold in expectation of gain. The institutional investor, pension trust, and other large holder has ways, other than the Rule, to make its views heard in the Board Room. Moreover, many large holders are sufficiently worried about the implications of their economic power and are so paralyzed by their fiduciary responsibilities that they seldom seek to influence management. The shareholder proposal rule, so the argument goes, fails to honor this reality and thus operates principally to offer

a soapbox to special interest groups with nonbusiness concerns -- a means for the lunatic fringe to play out their fantasy of pushing around someone vastly bigger than they are.

I disagree.

In my view, the shareholder proposal process serves a worthwhile purpose -- valuable enough to justify the rather minimal burdens involved.

Here are my reasons.

-- The estrangement of the public shareholder, so well articulated by Berle and Means 50 years ago, continues today. Ownership of public companies has become broader and even more dispersed than in 1932. Control has correspondingly become more safely lodged in the hands of management. Although large shareholdings may be more common today than in 1932, they are in the hands of bank trust departments, pension funds, ESOPs, insurance companies and mutual funds. These types of institutions seem restrained, like Gulliver in Lilliputia, by the threads of thousands of concerns which prevent them from seeking an active role in management. Public companies and their managers are thus cut off from the sources of their legitimacy -- the corporate owners for whom they act. As the connection grows more tenuous, any mechanism which fosters accountability becomes more important in helping to avoiding the final, unacceptable conclusion that public companies exercise unchecked power in our society. If, rightly or wrongly, that perception becomes accepted as true, society may be expected to react by imposing mandatory restraints on management's discretion. Witness the fate of business monopolies, utility holding companies, and even charitable foundations over the past 100 years. Each grew in power to a point beyond the checks and balances so basic to our our society; each was eventually reined in by legislation.

- Corporate managers should accept, and indeed embrace, the proposition that shareholder proposals challenge not the authority of management, but only its judgment. They do not threaten management, but only force management to defend its policies in response to issues of shareholder concern. By contributing to a more effective dialogue between management and the shareholders and stimulating a healthy reappraisal of existing positions, the Shareholder Proposal Rule can be viewed less as a torment than an opportunity.
  
- Proposals on matters of social interest are no real enemy. While they may not clearly comport with the business interests of a company, viewed narrowly, that is not important. What is crucial is that some shareholders care about them -- and that fact alone makes them important. If special interest groups may occasionally twist the corporate forum to air political issues or otherwise abuse the system, this is a small price to pay for the legitimizing effects of the larger process.
  
- Finally, in evaluating the costs and benefits of the Rule, we should keep in mind that the real economic costs need not be unduly great, and are largely within the control of management. As for the benefits, we must take into account the hard-to-measure fact that, even if not legally forced to do so, management takes these proposals seriously. Witness the number of changes made in response to proposals which were never pressed to conclusion, or which received quite small percentages of the vote. Note the careful consideration almost always found in management's responsive statement. Without this avenue, the disaffected shareholder's chief option is to "vote with his feet" -- the Wall Street Rule -- by liquidating his investment. This option can be painful to the shareholder and unattractive even to management.



Although I believe some shareholder proposal rule is worth preserving -- that it contributes to issuers and shareholders alike far more than it costs -- I also feel that the approach used in regulating this area can be modified to improve the process even more.

First, I would like to discuss several problems I see with the existing Rule.

### Problems with the Current Shareholder Proposal Rule

Most of you are familiar with Rule 14a-8. In broadest terms, the Rule requires public companies to include in their proxy materials any shareholder proposal (together with a limited supporting statement) which:

- (1) is submitted on a timely basis by a record or beneficial shareholder who commits to present the proposal at the shareholders meeting;
- (2) meets certain technical requirements as to length; and
- (3) does not fit within one or more of thirteen exclusionary categories.

I have no quarrel with the first two types of requirements. Any game needs some rules, and these are reasonably precise, self-administering and predictable.

I take a different view, however, of the complex of rules, law and lore surrounding the thirteen standards for excluding a proposal from a company's proxy materials. In contrast to the pleasantly bright lines of the technical requirements, these standards turn upon rather imprecise concepts like

- "a personal claim ... or grievance;"
- "not significantly related to the issuer's business;"
- "beyond the issuer's power to effectuate;" and
- "ordinary business operations of the issuer."

Any competent lawyer can spin the ambiguities inherent in these concepts into an endless web of rhetoric, argument and counter-argument. One of my favorite examples is the female proponent last year who filed a proposal requiring one public company to report on its programs for stimulating the hiring of men for positions such as secretary and telephone operator. The company's lawyers dutifully sought to exclude the proposal as a "personal grievance," submitting detailed evidence purporting to show that the proponent was prejudiced against women. The reaction was, of course, predictable -- a counter barrage of evidence from the proponent designed to prove lack of prejudice and management's ill will. Now this may be diverting -- I'm even ready to concede the issues have some social significance. But it is just not the type of issue the Commission ought to be struggling to resolve.

My quarrel, however, goes beyond the exclusions themselves. The delicate shadings, precise balancing and sophistication of these standards all betray an assumption that, given enough care, thought and attention to detail, a totally fair and just regulatory balance can be drawn between the interests of the company and that of its shareholders. This is a fallacy common not only to regulators but to law in general. The Commission has not been immune to America's love affair with fairness. There is no way for us to write our rules with the surgical precision that preserves solely the values we desire, while foreclosing all possible abuse or inefficiency. Fairness always exacts a price; sometimes the incremental cost of a fairness more perfectly expressed far exceeds the benefits thus derived.

Experience has taught us that greater precision and more complex involvement by the Commission in the process does not necessarily result in more perfect regulation -- just more regulation, together with greater cost and even uncertainty for the private sector.

Equally troublesome, the unavoidable result of approaching the shareholder proposal process in this way is to put the Commission's staff in two uncomfortable positions. First, they are forced to step into the middle of squabbles between two of the Commission's most important constituencies -- public companies and public investors. As regulators charged, directly and indirectly, with protecting the interests of both groups, we would do well to avoid where possible the inevitable conflicts which this umpiring function engenders.

The second uncomfortable position is closely related to the first. We steadfastly claim, time and again, that the staff's

no-action positions under the Rule are not final or legally binding, but are merely practical enforcement judgments based on unique facts. In reality, however, expense, time and other practical constraints usually preclude testing these positions in a lawsuit prior to the meeting. After the meeting, litigation is no less expensive, but may now also be pointless, since the damage, if any, has been done. Moreover, the courts have held that the staff's no-action positions are not "agency action" and thus are not reviewable unless specifically blessed by the full Commission.

In this respect, then, the Rule has effectively invested our staff with the power to decide complex issues of law, fact and policy without any real possibility of outside, objective appellate review.

In short, the current regulatory structure, although premised on the sound notion that a process should be provided to facilitate shareholder proposals, has gone too far down the regulatory road in pursuit of that goal. The Commission could usefully back off somewhat, reducing its regulatory presence in the area, while preserving an acceptable process.

At the same time, we should remember that many of the exclusionary rules were added to protect public companies from demonstrated instances of abuse and harassment. That concern must also be taken into account in redesigning the regulatory structure.

The strategy, which I hold to be a useful regulatory principle generally, is to take advantage of the natural forces operating in the real world, establish regulatory lines that are as simple and bright as possible and recognize that trade-offs are inevitable, since the goals of total justice and complete fairness cannot be achieved at an acceptable cost.

Here is what I would suggest.

#### Suggested Approach to the Regulation of Shareholder Proposals

The basic approach should be that all public companies must include in their proxy materials any shareholder proposal which is proper under state law. Only two categories of proposals ought to be excludable because of their subject matter: those which state law would exclude (even after they have been expressed in the most acceptable language) and those which relate to the nomination of directors.

This approach embraces the concept that shareholder proposals represent a good thing -- they benefit the company, the shareholder and the public interest, and they ought to be preserved. The elimination of the detailed exclusionary rules would make the process simpler and more predictable; it would also eliminate substantially all of our staff's involvement.

At the same time, in order to honor the equally valid interests of management and public companies in being protected against abuse of the process and unreasonable burdens, I would endorse the following procedural limitations:

- Proponent Eligibility. The proponent must have been the record or beneficial owner of a minimum number of shares of the company's stock -- say 50 -- for a given period -- say one year -- up to and including the day of the meeting. This limitation is intended to assure that shareholders seeking to use the process are indeed investors -- owners of shares -- rather than activists of one kind or another using a share of stock as the passkey to the proxy bullhorn. While these limitations are not airtight, they should block certain irritating fringe behavior from which corporate officials have the right to be protected. Setting the precise limits will be a challenge, however, since we must take into account the large percentage of small shareholders. For example, over half of the General Motors shareholders own 50 shares or less.
- Number and Length. Only one proposal per proponent would be permitted, with its length plus supporting statement not to exceed 500 words. Once again, this somewhat arbitrary cut-off tends to restrain harassment through the submission of large numbers of proposals or long-winded polemics. This behavior is rare, yet it has occurred and can be addressed in this way without doing violence to the rights of shareholders.
- Maximum Number of Proposals. I would suggest that a company not be required to include more than five proposals for any one meeting, plus one additional proposal for each two proposals received in excess

of five, with a maximum of, say, ten proposals included under any circumstances. It is important that public companies not be unreasonably burdened by the process. An absolute maximum seems an appropriate way to limit the burdens. The order of receipt of the proposals would be irrelevant; duplicate proposals would be considered as one; and all timely proposals received would be considered in one group. Where proposals exceed the maximum, selection would be by lot, with appropriate disclosure in the proxy statement as to the mechanism used.

I would favor retention of the current regulation which provides that management has no responsibility for the language or information in a shareholder proposal or its supporting statement, and that this responsibility lies solely with the proponent. Similarly, I favor retention of current Rule 14a-8(e), which requires management to respond to shareholder proposals in advance of the distribution of the proxy materials, in order to stimulate informal dialogue between the company and the proponent. I should emphasize that only in the most unusual circumstances would the staff intervene in a dispute. The purpose of this approach is to get us out of the referee business. We would enter a dispute only to redress the most egregious of conduct.

As you will have realized, what I am suggesting is neither revolutionary nor novel, since it harkens back closely to the approach originally taken in 1942. It may be useful, however, to discuss the specific reasons for eliminating substantially all of the current exclusions.

#### Grounds for Excluding Shareholder Proposals

My proposal incorporates only two of the 13 existing grounds for exclusion:

- the proposal is not a proper subject for action by shareholders under state law; and
- the proposal relates to the nomination of directors.

Each of these exclusions is quite narrow. In the first place, under state law, practically any shareholder proposal is proper as long as it is framed as a request or recommendation and

not a mandate or directive. The second exclusion is no broader than necessary to preserve the separate proxy contest machinery from the loophole of nominating directors in a shareholder proposal.

The eleven remaining grounds fall into three main categories: legal, factual, and technical.

#### 1. Legal Grounds

This group of exclusions includes proposals that would:

- require the company to violate any law;
- be contrary to the Commission's proxy rules; or
- involve matters beyond the company's power to effectuate.

The problem with these is that they are unnecessary. A company is not privileged to violate the law or the Commission's proxy rules simply because its shareholders vote to do so. The downside risk, then, of putting these proposals to a vote is that, in theory, the shareholders may vote to do the impossible and be frustrated in that desire.

That of course is the pure case -- and the rarest. What more typically happens is that the issue of whether a given action is illegal will be an unclear and arguable one, depending upon assumed facts, the state of the law and the phrasing and interpretation of the action itself. The staff is not particularly well-equipped or expert in deciding those questions -- they should be placed before the shareholders generally. If the action proposed violates some law or exceeds the company's legal authority, that is an excellent argument for management to make -- but it should be made to the shareholders, not the Commission.

The exclusion which relates to proxy rule violations has always seemed superfluous to me. Other rules limit this conduct directly and, in any event, management is not responsible for the content of a shareholder proposal or its supporting statement. The proponent is. If a dispute arises because of a claimed misstatement or violation, it should be discussed and corrected. If a compromise cannot be reached, and management still wishes to exclude an item because its misleading character is clear, I cannot imagine a court of equity objecting.

To do so would be a perversion of the principle that the proxy rules are intended to protect and inform shareholders. While, in the close case, inclusion would probably be the prudent course, not only is the company protected from liability, it has the opportunity to correct the statement, if desired, in its response.

## 2. Factual Determinations

In this category, I would put each of the following:

- proposals "not significantly related to the issuer's business;"
- proposals relating to "ordinary business operations;"
- proposals embodying a "personal claim or grievance;" and
- proposals that are moot.

I won't quarrel, in theory, with any of these categories. They represent a catalogue of good reasons why a proposal might be excluded. My only problem is that they can seldom be applied without doubt, since the crucial standards are not precise enough. Much like the "legal" category, these concepts will almost always be arguable and the arguments should be made before the shareholders, not the Commission's staff. In this case, the staff is at an added disadvantage because the factual disputes will be argued under time constraints too sharp to permit an unhurried search for and review of the relevant evidence.

Simply to describe these cases is to underline the inappropriateness of investing our staff with the quasi-judicial responsibility of deciding them:

- In 1981, a company received a proposal requesting disclosure of the names of company employees who were on "loan" to any governmental, civic, charitable or business organizations. The company sought to exclude the proposal on the grounds that it was not significantly related to its business. In support of its position, the company indicated that

only two of its 22,800 employees currently served any of the organizations described in the proposal during workday hours and that it was not expected that the number would ever exceed six at any one time.

- In 1980, a media watchdog organization called Accuracy in Media submitted proposals to the parent companies for the major television networks recommending that in accordance with the recommendation of the President's Commission on Three Mile Island the networks hire and train specialists who have more than a passing familiarity with reactors and the language of radiation. The companies argued that the proposal related to their ordinary business because it involved the day-to-day staffing of their news departments.
- In 1980, a public company sought to exclude from its proxy materials a proposal to limit charitable contributions, submitted by a shareholder who also published a corporate newsletter. The company alleged the proposal was motivated by a desire to retaliate against the company for cancelling its subscriptions to the newsletter.

Wrestling with these issues is like pushing on a string -- it is difficult, time consuming and in the end unrewarding.

### 3. Technical Considerations.

This category covers the following:

- dividend proposals;
- counterproposals to a management proposal;
- duplicative proposals; and
- previously failed proposals.

In each case, I am sympathetic with the theory. Take, for example, the counter-proposal exclusion. I see the danger, in theory, of asking the shareholders two inconsistent questions in two different places. The risk, of course, is inconsistent answers. However, such a result is most likely an indication



that the shareholders are confused. In such a case, a resubmission is appropriate. Moreover, if the miniscule risk of inconsistency is simply intolerable, one must assume that there would be little if any legal exposure if the second proposal were omitted, and the supporting statement alone included. This approach would require a statement by management that the counter proposal was omitted, an explanation of why, and advice that a "no" vote on the included proposal is the equivalent of a "yes" vote on the omitted counterproposal. The proponent gets all he had really asked for and the company would still be protected from theoretically inconsistent results.

Duplicative proposals ought simply to be combined into one, with care taken not to exclude any separate supporting reasons. If they are not close enough to combine, they should be treated as separate. Here, disclosure is the key to protecting everyone's interests.

Previously failed proposals do not justify the existing elaborate regulatory mechanism. Their past history should simply be ignored.

Dividend proposals, if in acceptable form under state law, ought to present no problems. It has always struck me as ironic that, despite the dominant interest of shareholders in dividend payments, the Rule has prohibited them from addressing that interest except in a very limited way, and that only since 1977.

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In summary, I would repeat that the shareholder proposal process is an important element in what remains of shareholder democracy, and, thus, serves to validate the larger corporate system itself, resting as it does on the notion of shareholder ownership and control. The burden imposed by this process is slight in comparison to its benefits. Since shareholder proposals serve a valued function, they are worth preserving -- but with a pinch, not a handful, of regulation. Of course, the process should not be usurped for improper purposes. A return to the simple, bright line approach should protect the good, discourage the bad, and minimize the active, ongoing interference of federal mediators in the relationship between a company and its shareholders.