DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

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Subject: Proxy Contests

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MR. HELLER: Most of the state corporation laws require that an annual meeting of the stockholders be held for the purpose of electing a board of directors. Under most state corporation laws the board of directors is charged with the management of the business of the company. In our modern economic society, with very many large corporations, it is virtually impossible for all of the stockholders to be present at the annual meeting. So the lawyers devised a document known as a proxy, which is a piece of paper signed by the stockholder authorizing another to attend the meeting and vote for him as though he were there himself. That piece of paper is called a proxy.

A proxy contest is simply a battle between the management and another group to get from the stockholders as many proxies as possible in the hope they will be sufficient to elect a majority of the board of directors. That is all it amounts to. It is a device for getting control of the company by getting the stockholders to vote a particular way. This is less expensive than buying a majority of the stock, as you can do it for less if you have a good enough case against the management in the opposition group. The expenses of doing this are probably deductible for tax purposes, and if you are fortunate enough to win, you may persuade the stockholders to reimburse you for your expenses and get them all back and be in control of the company.

The next problem is how do we get into it? The Congress got us into it by putting into the Securities Exchange of a provision that no one can solicit a proxy of any stockholder holding a listed security in contravention of rules and regulations prepared by this Commission. We had for years, up to as recently as January 1956, rules which did not specifically deal with proxy contests and we simply improvised and twisted and bent the rules that we had to fit the situation. We got a result, and last year we simply crystallized our previous practices in the form of specific rules. We thing now that these deal adequately with proxy contests as we know them.

The proxy rules relate, generally speaking, only to corporations whose securities are listed on securities exchanges. Over-the-counter companies are not subject to our rules. And I can tell you that many a manager of an over-the-counter company, when confronted with a proxy contest, has immediately registered its securities under the Securities Exchange Act and listed them on an exchange for the sole purpose of getting the benefit of the general fairness of the rules and the application of the rules to the opposition so that they can have some hope that the opposition will be dealing withing fairly defined limits of truth. Investment companies and

public utility holding companies are subject to the rules whether or not listed on exchanges. That is because of the particular provisions of the Investment Company Act and the Public Utility Holding-Company Act. By and large the important rules are those under the 1934 Act. Proxy fights are primarily held for control of industrial corporations, and I know of virtually no case where a proxy fight was held for control of a holding company--perhaps one. Nor have I ever heard of one for an investment Company.

The question is, now, why do they arise? As to that I can say this: A proxy contest, in essence, is an applied security and financial analysis, and is in part an outgrowth of the Act itself. The Securities Exchange Act requires every listed corporation to file reports with this Commission which set forth the results of its operations, the character of its business, its financial position, and makes it possible to compare the company's operating and management performance with other companies in the same business. This enables experts financial experts, security analysts, and others-- to make determinations as to the merits of the management, in the first place; and in the second place, the probabilities that they can be defeated in a proxy contest-- a very important consideration. The last consideration is probably uppermost. The first requirement that an opposition **looks** for is a management with very little stock. That is first. That requirement was not met in the Fairbanks-Morse case. The management there had 35% of the stock. The result was that Silverstein lost-- he just couldn't buck that much stock. The next requirement is that the security value must be a good one. I have never seen an opposition group in a proxy fight which did not believe that the security was a good one and was undervalued in the market because of acts of the management or for other reasons. That money can be put to work: you can increase the earnings, you can use it to buy outstanding stock, thereby decreasing the shares and increasing the earnings for the remaining shares. These are things which men think of--the financial experts. Again, you can find a corporation, for example, which is not paying out much of its earnings as dividends. Such a case was the New York Central.

There are also possibilities of merger or consolidation with companies that the opposition have which may result in economy to them or to one or other of the companies through use of a single sales force instead of two, etc.

Our experience has been that the company selected is a secondary company in the industry. In other words, it is not doing as well as the big companies in the industry and a plausible case can be made by comparing the financial statements of the two and showing that the management of this company is not as good as the other--invalid, perhaps, by strict logic-- but the sort of thing that is done. The courts have indicated that comparison, by and large, should be left alone by the Commission so long as the facts stated are fairly accurate and the figures are correct. The inferences to be drawn from them are a matter of argument by the parties which can best be answered by them and evaluated by stockholders rather than by a government agency. That is what the Courts have ruled. There is some doubt whether the Court of Appeals agreed with that, either, but we a pursuing a course somewhere midway between what the Court said and what we think is probably accurate. That takes you through the reasons why this is done.

We have the authority under the Statute to devise rules and regulations with respect to the solicitation of proxies. I have construed that to mean not much more than to get an adequate

disclosure suitable to the particular circumstances. In proxy fights we try to do just that. We have taken this factual background as to what has happened and tried to fit the rules over it so as to bring out as clearly as possible to the stockholders what the motivation of the opposing sides are, what they are seeking to do, what they are going to do with the company's assets if they succeed.

Before we get to the precise rules, what happens generally is that a lot of stock is being purchased on the market by the opposition group and the management finds out about it (which is rather easy--they look at the transfer books and the stock is piling up in brokerage accounts when previously it was all held by investors), and there follows a moment of disquietude in the management. They generally go to the brokerage houses, seeking out the reasons for these purchases. At that point there is an announcement by the one side or the other that somebody else is trying to get control. The opposition is immediately branded with the trade name the management uses for these people: "Raider." The word simply means that a group is trying to get control of the management and take the management emoluments away from them.

Ordinarily our rules provide that no one can solicit a proxy--solicit is a word of art that means many things. It means not just sending someone a piece of paper and getting him to sign it. It means more than that. It means getting out literature to him, or making statements which will be disseminated widely which suggest to him how to vote or induce him not to vote for one side as against the other. Those things are classified by the Statute and the courts as solicitations, too. Every time there is an outcry by the management or the opposing group we have in effect a solicitation because their outcries are made though all modern channels of communication: the press, radio, television, etc. The outcries are managed by public relations men. These men, in my opinion, have become the predominant figures in the proxy fights today, superseding the lawyer. Their job is to see how they can prejudice these people by skirting as close to the truth as possible without quite being too truthful.

Our rules generally, as I said, prohibit solicitations that do not comply with the requirements of the Act. Once the stockholder has received a formal proxy statement, we believe that he has been given the essential facts. Once he gets that, we think that he is then in a position to evaluate all the statements, etc., and is then equipped to form a judgment as to the rest of the material that comes out.

In proxy contests, however, because of the fact that they are contests and that there is a social value to the stockholders in getting as much information to them over as long a period as possible, we permit under the rules a pre-proxy statement solicitation **within** certain limits. They have to tell you who they are and how much stock they own, but the rest of the material we think in the course of the contest will get out as to why they are there and what they want. Sometimes it will burst upon one suddenly because the management has been asleep and hasn't watched the transfer books. It will be started by Mr. Young putting an ad in the paper which says that he would like to get nominations for a new ownership board of directors. We said that was solicitation of a proxy.

These fights are conducted with the aid of public relations men. They appeal to prejudice and use various devices that are attractive to stockholders. They use the press, the radio and

television. Because they use these media of communication, and because there is a First Amendment in our Constitution that says Congress cannot abridge the freedom of the press and freedom of speech, the Commission has taken the position that prepared press releases handed to newspapers are prepared speeches for delivery to groups of stockholders, security analysts, and others, are solicitations material, but need not be filed with this Commission before they are delivered. But they must not be misleading and they must be filed after they are delivered. And if they in fact contain misleading statements, they must be corrected in future literature that goes out to stockholders.

To get more specifically to what the rules do. The job of the rules, as I have said, is to get disclosure. The stockholder should get information which will enable him to make an accurate and intelligent appraisal of the people who want to manage his company. To do that, what we have done is this: We have set up a category called "participants". There are the people who we think are the prime movers in the proxy fight on both sides--management and opposition. First, there is the management; second, members of groups who are opposed to the management or who are supporting the management, other than the management. They are groups gotten up for the purpose of soliciting proxies or financing or otherwise aiding in a proxy contest. We define it to include any person who solicits on behalf of either side. We define it to include any person who finances either side, which means helping them to buy the stock, either to keep control or to get control. We have included people who make contributions to the solicitation expenses, if they are $500 or more. To all such persons we have said, "The stockholders are interested in you--who you are and why you are doing this."

We require those people, in the case of the opposition group, withing five days prior to any solicitation by them to file with this Commission a schedule, called Schedule 14B of Regulation X-14, and that schedule requires these people to set forth their names, their addresses, their business experience for the last ten years, their criminal records, if any, their participation in other proxy fights (which is rather important because it will establish whether they are "pros" or whether they are engaged in a financial adventure of some sort for their own benefit, or whether they are genuinely disturbed by the conduct of the affairs of the company). We ask them to set forth their beneficial ownership of stock. It is obvious the stockholder is concerned in knowing how much stock these people have. If they acquired the stock within the last two years, we want to know how they acquired it, what financing was used if it was other than a brokerage or bank financing. In that way we get possible inklings as to other participants. We ask them to tell per this schedule what jobs they hope to get with the company if they win, or if they have them, if they are going to change them or put in a long-term contract, etc. We ask them what transactions they have had or are going to have with this company. That will gather information as to whether they are going to sell things to, or buy things from, the company, or merge the company into another company. That information is then required to be distilled into the proxy statements of both sides. That will give the stockholder a clear-cut definition of who the parties are and what they want. The he can determine whether what they want matches what he wants.

The management must do the same thing. Within five days after the solicitation against them is commenced, they must file these schedules involving all these people who are helping them.

In these fights invariably it gets to be more than the management and the opposition. There may be four committees in favor of the management, or two committees in favor of the opposition. Sometimes we get more 14Bs in here than we have annual reports on the company. It has been found to be quite useful on both sides. They, in many cases, get more of an idea of the background of the personalities involved than they would ever have gotten by their own independent research, which is (a) expensive, and (b) difficult in the comparatively short span of the proxy fight. We get the information quickly for the stockholders by these schedules.

Having done these things, then we have the painful job of sitting down and examining the literature which is filed almost daily by these people. A proxy contest might last ten weeks, three weeks of which are devoted to the pre-proxy soliciting material in which the general sparring begins and attempts are made at name calling (which we try to stop quickly because unsubstantiated name calling and charges of corporate misconduct will not go unless they can prove it). Then the proxy statement is filed, and for the next seven weeks you have a proxy statement type of solicitation supplemented by additional material. We see a great deal more of this literature than the stockholder eventually sees.

The primary problem, as I said before, is this: The type of argumentation generally falls into two categories: (1) the ad hominem attack of the management or on the opposition as being a bunch of crooks and thieves and they have done this and done that, most of which you can dispose of as not true; (2) then the real attack on what I call the statistical attack. That is, the attack on the managerial abilities of both sides. In many cases the opposition group are also managers of corporations. These really are wars of managers against managers. These are not wars by the 100 share stockholders against the management. So there is a crossfire of charges about the managerial abilities of the two parties, and those arguments are buttresses by particular figures which are derived largely from the reports filed with this Commission by the companies concerned. Our staff is peculiarly able to evaluate them and do it **quickly** because it must be done quickly. Under our rules, proxy statements can go out within 10 days after they are filed, and thereafter literature is filed with us not more than two days before it goes out. So we are dealing, after the proxy statement, with two-day periods--two business day periods. It requires the highest cooperation and skills of our accountants, our financial analysts, and our lawyers. The brunt of it falls on the financial analysts and the accountants.

These proxy contests deal fundamentally with statistical problems: with the problems of earnings per share; with the problem of what earnings are. Mr. Silverstein said, "We made $1,000,000 in 1955 and we made $7,000,000 last year. Look at us compared to poor Fairbanks-Morse which only ran its earnings up another $1,000,000." Then when you tell Mr. Silverstein that he can't say that because of the $7,000,000, $6,000,000 was made by the sale of real property to others at a profit, it doesn't represent an operating result or any index of your managerial ability to make and sell a product at a profit, he doesn't understand why he can't say it. He said his accountants told him they earned $7,000,000. But I pointed out that the accountants said "net operating income, $1,000,000; special items, non-recurring, $6,000,000." That is what I mean by analysis on the part of the accountant and financial analyst. They are supposed to detect that that $7,000,000 and $1,000,000 is misleading, which he will do by simply going through the financial statement of Penn-Texas and discovering what the accountant really said. In the New Haven fight Mr. McGinas found the New Haven management extremely

at fault in losing money by the simple device of throwing in the sinking fund charges on outstanding bonds of the company as operating expense, whereby he derived a loss. My accountants assure me that that is not sound accounting at all. That is the type of thing we get and have to deal with.

It is our position that our fundamental job is to get the information to the stockholders and not get ourselves placed in the position of declaring either side the winner by suing the other side for putting in misleading material. We have never used the injunction procedure which the statute authorizes except as a last resort when we don't think the material can be corrected and sent to the stockholders in time for them to make up their mind on the new information. We resist strenuously all attempts by everybody to get us in the middle of the thing--a device used by the lawyers. We are not here to decide who shall win or who shall lose. We see that the stockholders get the information in time to decide who shall win or lose. The highest talents of our staff are employed in this, particularly our financial analysts and our accountants.

In most of these cases you will find that after the fight is over, the financial analysis made at the beginning of the fight has been distilled into the proxy material and results in an increased market appreciation of the value of the company and its securities which benefits security holders. Generally, the management, if successful, is stimulated into doing things which are perhaps more dynamic then they have done in the past.

Adjourned.