DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

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Subject: Processing Proxy Statements

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Mr. Bagley: Today's subject is the processing of proxy statements. As you know, proxy material deals with those matters for which the security holder's assent or vote is required. Prior to Section 14 of the Securities Exchange Act of 1934, such actions were treated as routine or mere formalities. If a matter was mentioned to come up at a meeting, it would be done in a single sentence. The proxy itself would be blanket authority and read "with all the authority as though I were present." It was in fact a "one way street." You either surrendered all your authority or threw the proxy in the waste basket.

The LA-5 Rules, which were the first rules promulgated under Section 14 of the Act, did not go much further. It provided that there be filed with the Commission whatever was sent to the security holder in soliciting his authority. However, on October 20, 1938, Regulation X-14 went into effect. These rules provided that not only must a proxy statement be furnished setting forth adequate disclosure with respect to the authority sought, but that the proxy contain means by which the security holder may express himself for or against the subject matter. The disclosures required in the proxy statement were, of course, minimum standards, the company being permitted to add anything else it wished so long as such additional information was not misleading or carried a misleading implication.

The rules have been amended from time to time since then and are now proving themselves quite workable. No longer is the security holder impotent, as in the past, to exercise his vote based on full and complete information. Justice Brandeis once said, in effect, that the security holder receives the rewards and benefits of our economic capitalistic system and, therefore, should assume the responsibilities that go with it. However, this was difficult for him to do when he was in the dark as to the corporation's business.

In getting into the processing of proxy material, we will start with the most simple situation -- the annual meeting where nothing is to come up but the election of directors. Of course, the proxy will contain discretionary authority to vote on any other matter or matters not presently known which may come before the meeting. There can be no restrictions as to proper matters that may come before and annual meeting. Therefore, the proxy rules permit management or others who may be soliciting proxies to include discretionary authority as to

matters not known which may be presented at the meeting, provided a statement is made in the soliciting material that they are not aware of any such matters to come before the meeting.

In the election of directors, the proxy material must be accompanied or preceded by an annual report to security holders. The reason for this is to permit a security holder to review the record of the directors' stewardship over the past year before he votes them back in office. Certain relief as to this requirement is given to management in a proxy contest where opposition has already begun soliciting.

The proxy statement itself must clearly present all required information. There is a rule covering this point which also deals with appropriate headings and presenting the information in tabular form where practical. Unlike certain other S.E.C. rules, the answer to an item in the negative may not necessarily be omitted. It may only be omitted if it is inapplicable, the reason, of course, being that an answer in the negative may be quite pertinent. The proxy statement must also meet certain legibility standards and may omit required information if such information has already been furnished the person solicited, in connection with the same meeting or subject matter, providing a clear reference is made in the proxy statement to the particular document containing such information.

The proxy statement, the form of proxy and other soliciting material furnished concurrently to the security holder must be furnished in triplicate. This is filed in preliminary from and the Commission has ten days to examine such material as to its compliance with its rules. In actual practice, the Commission staff has less than the allotted ten days since the company may mail its material after the tenth day. The note to the rule which states that the printing of the definitive material should await comment of the Commission's staff relates only to the ten day period and contemplates no extension of the period.

Required information with respect to the election of directors consists of naming each person who is to become a director, stating his term of office and all other positions with the company held by him. If he is not an officer of the company, then the proxy statement must show his principal occupation or employment, giving the name and principal business of any occupation or organization in which such employment is carried on. Should he be up for election for the first time for which proxies are being solicited pursuant to Regulation X-14, then all of his principal occupations or employment during the last five years must be stated. Those nominees who were previously directors must indicate the periods they so served.

There must be included in the proxy statement the approximate amount of equity securities of the company and its subsidiaries owned directly or indirectly by each nominee for director. If he owns none, a statement to that effect must be made. You will appreciate that the size of a director's financial stake in the company or lack of a financial stake may well influence his decisions in a number of ways. If his interest is large, he may have a conservative attitude toward the dividend policy since the bulk of his dividends may for income taxes. This apparently was the case of Sewall Avery, president of Montgomery Ward, and you may recall that a proxy fight developed in this company. On the other hand, sizeable stock holdings may prompt a director to exercise restraint with respect to salaries, bonuses, options, pensions, etc.,

since all these costs can have a marked effect on the aggregate value of his holdings in the company. The nominee who has only nominal or no financial stake in the company warrants a second look by the stockholder as to why such individual is a candidate for directorship. It may be that he is an officer of a bank that loans the company large sums of money and the bank, therefore, wishes to be close to the situation. Or such nominee may be a seller to or purchaser from the company and, therefore, beholden to the top officers. Whatever the reason, the proxy rules attempt to bring the facts to the surface at the time they are up for election in one way or another. For instance, if a nominee for director is proposed to be elected pursuant to any arrangement or understanding with any other person or persons, except the directors or officers acting as such, the other persons to the arraignment must be named and the arrangement must be briefly described.

The proxy statement must reflect the complete management cost of running the business. In addition to showing the aggregate remuneration of all officers and directors, there must be a breakdown showing separately payments made to directors and certain officers where such amounts exceeded $30,000.00 and the capacities for which the remuneration was received. Other forms of remuneration such as deferred compensation, bonuses to be paid in the future, pensions, options, etc., must also be adequately disclosed.

Any material transaction which an officer or director had had with the company since the beginning of the last fiscal year must be briefly discussed even if the transaction was "at arms length." Likewise any indebtedness to the company by an officer or director must be disclosed if the amount exceeds $10,000.00 or 1% of the total assets, whichever is less.

From the above, I think you will agree that a base has been laid for the stockholder to get some opinion, if not complete, of the all-important factor -- management -- before he decides to vote his shares for their reelection. He is also informed of certain of his legal rights such as revoking his proxy, cumulative voting, etc., all of which must be properly set forth in the proxy statement. In processing the proxy material, it is the examiner's job to see that the facts are correctly stated according to the best of his available information.

The proxy rules run the entire gamut of corporate finance and are for the protection of the individual who already has invested his money in an enterprise subject to the proxy rules. The matters that may be submitted to stockholders for action extend all the way from a simple election of directors, which we have just covered, to recapitalizations, acquisitions, mergers, consolidations, voluntary reorganizations and liquidations. Efforts have been made to set forth in the various item in Regulation X-14 what the Commission deems to be adequate disclosure to enable a stockholder to form an intelligent opinion as to how to vote with respect to the above mentioned matters and such other matters as the selection of auditors, bonus and profit sharing plans, the granting of options, warrants or rights, charter amendments, by-law amendments, etc.

In the selection of auditors, the auditors must be named and a brief discussion given as to any direct financial interest or any material indirect financial interest in the company, or its parent or subsidiaries, all for the purpose of indicating whether the auditors are, in fact, independent.

As to bonus, profit sharing or other remuneration plans, the material features of the plan must be briefly described, identifying each class of persons who will participate, their number and basis of such participation. There must also be shown the amounts which would have been distributable under the plan had it been in effect during the last fiscal year to (1) officers and directors, and (2) other employees, stated separately. There is a further breakdown required in that the name and position of the top salaried officers must be stated and the amount each would have received for the last fiscal year had the plan been in effect. Existing bonus, profit sharing or other incentive plans must be described. And, lastly, if the plan may be amended, otherwise than by a vote of the stockholders, which would increase the cost to the company or alter the allocation of the benefits, the nature of such amendments must be clearly stated.

If a pension or retirement plan is to be voted upon, it must likewise be briefly but adequately described, identifying each class of persons who will be entitled to participate, indicating the approximate number of persons in each such class and the basis of their participation. Since a retirement plan could hardly be inaugurated without giving some recognition to past services, the plans invariably make some provision. Therefore, the total amount necessary to fund the past services, the period of time over which it is to be paid, and the annual payments necessary to liquidate the past service costs all must be stated. The estimated current cost must also be shown and the total annual payment of past and current costs must then be broken down as between (1) directors and officers and (2) other employees. Specific estimated benefits to be received by certain top salaried officers upon retirement must be shown as well as its annual cost. Then, as previously stated in discussing bonus plans, there must, of course, be adequately described, all plans presently in effect as to the various forms of remuneration now being paid, and the nature of any amendments which may increase the cost to the company or alter the allocation of the benefits.

A few years ago, the Congress amended the income tax law so as to permit corporations to issue options to purchase common stock to their officers and employees without any tax liability until the options are exercised and the stock thereafter sold. If the stock is held for more than six months, the profit upon sale is taxable as long term capital gain and not at the ordinary income tax rates. The purpose of the amendment, according to the legislative history, was to further a financial interest in the company by officers and employees. This tax advantage caused an epidemic of option plans to be submitted to stockholders for approval. It is fair to say that many of the stock option plans are designed to give management increased remuneration rather than to further their ownership in the business. Many companies state that they find option plans necessary to hold good men because their competitors have resorted to the practice.

When these plans are submitted for stockholder action, there must be stated in the proxy material the title and amount of securities to be optioned, the prices, expiration dates and other material conditions with respect to the options, the consideration received or to be received by the company and the market value as of the latest practicable date.

The specific amount of options any one person may receive must be stated and if, as usual, top salaried officials are included, then there must also be briefly set forth all other forms of remuneration such individuals are currently receiving and will receive upon retirement.

If any reports of directors, officers, committees or minutes of any meetings are up for action by stockholders, there must be a clear cut statement as to whether such action constitutes approval or disapproval of any of the matters referred to in such reports or minutes. There must then be identified each of such matters to be approved or disapproved and adequate information must be furnished with respect to each such item in order that the stockholder may intelligently vote as to each matter. Of course, there is also furnished a ballot with respect to each matter. You will note that the proxy rules do not provide for blanket approval of such things as reports, minutes, annual reports, etc. I understand that the Supreme Court has also ruled that "blanket approval" is no approval. Occasionally, a matter is submitted to stockholders which the proxy statement states need not be approved by the stockholders since the directors have authority to act on the matter without stockholder approval. Under such circumstances, the proxy material must also state what action is intended to be taken by the management in the event the stockholders vote "no" on the matter.

Whenever amendments to the charter, by-laws or other documents are submitted to stockholders for their vote, the reasons and general effect must be given briefly and the vote needed for approval. Too frequently, the material will state as the reason that the "directors deem it to be of the best interest for the company and stockholders." That impresses us as being too vague to constitute a reason.

When the question of acquisition or disposition of property is submitted to stockholders, the proxy statement must disclose the general character of the property, its location, the name and address of transferor or transferee, as the case may be, and the nature of any material relationship between such persons. In addition, the material features of the contract must be stated as well as the nature and amount of consideration to be paid or received, and the facts bearing on the fairness of the consideration.

Required stockholder vote with respect to capitalization comes up in many ways. It may be the increasing of the authorized common stock or the creating of a new preferred stock, or even the creating of debt securities. It may involve the modification or exchange of securities. Whatever it is, there must be full, fair and adequate disclosure so that the stockholder may make an intelligent determination as to how he wishes to vote. Where authorization is sought to increase the capital of a company, the proxy material must state the title and amount of securities to be authorized or issued; a complete description of the securities, except for common when only the preemptive rights need be stated; the nature and amount of the consideration to be received on issuance of the new securities and how the proceeds are to be used. If it involves an exchange, the material differences between the outstanding securities and the new securities must be made clear; the reason for the proposed modification or exchange; the general effect upon the rights of existing security holders; and the vote needed for approval. If the plan is set forth in a written document, it must be filed with the preliminary material. Except for a straight authorization of an increase in common stock, there must be included in the proxy material, certified financial statements compiled in accordance with generally accepted accounting principles.

We have now covered the most frequent matters which come up for stockholders' vote except mergers and consolidations. Mergers may be proposed for either of two reasons. The first is obvious enough: to combine two or more business entities into a single, larger corporation which will presumably effect economies in operations or result in competitive advantages. The other reason may be to effect a recapitalization of a company, e.g., to get rid of accumulated preferred dividends. A merger to accomplish this latter purpose is generally made with a corporate shell set up solely for this purpose. The resulting merger creates no larger business than existed before but does change the rights of stockholders. Under the various merger statutes dissenting stockholders have rights to demand payment of the fair market value of their stock which is generally determined by independent appraisal.

There is no easy guide to the processing of a proxy statement involving a merger which in effect is a recapitalization scheme and not a combination of business enterprises. What the security holder gives up and what he receives in lieu thereof must be clearly stated and supported by financial statements and tabulation. The reasons for the "give up" must be made clear; the dissenter rights and rights of appraisal must also be briefly described, including a statement as to who bears the cost. The officers' and directors' security holdings in the company must be shown. This enables the stockholder to check their outcome. For instance, in a merger which is nothing but a recapitalization if management holds substantial amounts of common stock, and the plan leans heavily in favor of the common stockholder, the preferred stockholders may wish to exercise their rights of appraisal. A merger for the purpose of recapitalization should follow all the principles of fairness enforced by a court in an involuntary reorganization.

In the case of a merger between two or more going businesses the proxy statement should give the same type of information that would appear in a prospectus for a new stock offering under the Securities Act of 1933. Although Commission Rule 133 treats a merger as not involving a sale of a security for purposes of registration under that Act, a proxy statement relating to a merger should be processed just as if it were a prospectus offering stockholders a new security. The proxy statement, therefore, should give all the applicable information required by a form S-1 registration statement including financial statements. In addition, there should be given the tangible book value per share of each company being merged in order that the stockholder may compare the investment contribution of each. The earnings per share over a sufficient period of years to enable the security holders to measure the "going value" should be clearly set forth. Under certain circumstances, pro forma figures of both book values per share and earnings per share of the surviving corporation are helpful. Finally, the market prices of all the shares over a reasonable period should be included in the proxy statement in order that the security holder may see the investment appraisal by the investing public of each company. Insiders' holdings and appraisal rights for dissenters must, of course, be given. Also, all the information required to be shown in an election of directors must be given if the merger agreement includes the election of a new board of directors.

There is another form of reorganization which should be touched on and that is what is known as a "quasi-reorganization." This is a situation where a company may be currently having profitable operations but has had such heavy losses in the past that payment of dividends would impair the company's capital and therefore be illegal under state law. To avoid this legal

problem, a company may restate its capital accounts to place the company in a position where it could resume dividends without impairing capital. This is accomplished by reducing the stated capital of the company, thereby creating a capital surplus into which the deficit is charged so that dividends can be paid from current earnings without impairing capital. A quasi-reorganization may be effected with or without stockholder approval. In this connection, you will find General Accounting Releases Nos. 15 and 16 dealing with each situation. If stockholder approval is being sought, then the nature of the reorganization must be stated, the date it is to become effective and the reasons for the selection of the particular effective date. There should also be shown in tabular form the name and amount of each account affected and the effect of the reorganization thereon.

So much for the management's side of the proxy statement. Now, if a stockholder intends to attend the meeting of stockholders coming up and submit a resolution for stockholder action, the management must set forth the proposal in the proxy statement and include a "yes" or "no" vote in the proxy, provided it is a proper subject to come before the meeting and provided he has met certain other conditions, all of which are set forth in Regulation X-14 under Rule X-14A-8. If the management opposes the resolution, the stockholder is then entitled to a one-hundred word statement in support of his resolution. In addition his name and address must be included in the proxy statement. This is for the purpose of making it possible for other stockholders to communicate with him should they desire further information relative to the proposal.

Proxy contests will be discussed at a subsequent session.