The SEC's Proposed Shareholder Nomination Rules: A Dialogue

*By Joseph McLaughlin**

Americans are traditionally wary of large aggregations of economic power. The antitrust laws are one means of expressing this wariness, but so are the federal securities laws. Any person that "controls" a public company has to pay a price in terms of disclosure and often in terms of having to accept certain disabilities and liabilities.

The SEC is entrusted with the administration of the federal securities laws, and for decades it has zealously enforced the "control" provisions of those laws. Regrettably, it has now dropped this guard in connection with its recent proposal to permit large shareholders to nominate their own directors by means of a company's own proxy statement.

The abuses that the "control" provisions seek to deter have not gone away, and the SEC's proposals offer no guarantees that the new proposals will not encourage such abuses. But the SEC's desire to achieve a policy objective close to the hearts of certain institutional investors—primarily public and union pension funds—has led it to pretend that those abuses won't arise.

"Control" in the Federal Securities Laws

A few years ago, a client named Fred came to visit us. Fred managed a hedge fund that owned just over 5% of a public company called Acme Widget. Acme's management had asked Fred to nominate one of his partners to serve as an independent member of the company's board. Fred wanted to know of any adverse securities laws consequences. We pointed out that there was a danger that the directorship plus the significant stock position might result in a finding that Fred's fund "controlled" Acme for securities law purposes.

"What would that mean?" asked Fred.

We explained that if a person "controls" a public company, that relationship triggers a number of consequences. The company is obligated to disclose the fact of such control. The control person may not sell any of its securities without relying on an exemption such as Rule 144. (Alternatively, it may ask—not require—the company to register the securities with the SEC for resale by means of a prospectus that meets SEC requirements.)

Also, Fred had so far not had to worry about reporting his fund's purchases and sales on a current basis or about forfeiting to Acme any short-term profits on such transactions. Section 16 of the 1934 Act imposes these obligations and liabilities only on persons who own 10% or more of a company's voting securities or who are directors or executive officers. But several cases suggest that an outsider will be treated as a director if it has "deputized" a person to act as a director.

If Fred were in control of Acme, he might also not be able to wait until year-end to file a statement reporting his position. Rather, he might have to file an immediate and more detailed statement and report material changes on a current basis.

"That's pretty serious," said Fred. "Is that all?"

No, we said. Both of the principal federal securities statutes contain provisions that make control persons equally liable with the controlled company for any liability under either statute. To avoid personal liability, the control person has to prove that it acted in good faith and did not participate in or know about the violation. In view of the "deputization" theory, the exculpatory defense might not be enough to get a complaint dismissed before trial. In addition, any information that the designated director received in his capacity as a director would be deemed to have been received in trust and confidence and could not be used by Fred as a basis for buying or selling Acme's stock.

"But of course we would set up a Chinese Wall arrangement," said Fred.

We pointed out that Chinese Walls essentially required one to prove the negative, i.e., that no information had changed hands, and that it was difficult these days to prove such a proposition to the public, regulators and the financial press.

"Well," said Fred, "I don't think I would control Acme even if we did ask one of our partners to act as a director. What do you mean by 'control' anyway?"

We explained that control is defined in SEC rules as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

"That's a mouthful," observed Fred. "What does it mean?"

We explained that the definition was designed to be broad in its application. It was not necessary that a person exercised the power to control; rather, it was sufficient to possess the power. Moreover, the power could be exercised directly or indirectly and by any means, with or without ownership of voting stock. Family or social ties, interpersonal relationships, patterns of assertion or deferral at board or committee meetings could all be relevant. Also, a person might himself not be in a control position, but he might be a member of a control group.

"But if I explain all that to you to your satisfaction, can you give me a legal opinion that we're not in control or part of a control group?"

Not necessarily, we cautioned. Control (or the absence of control) depended on all the facts and circumstances, most of which we could not verify for opinion purposes. The only situation in which we felt comfortable giving an opinion was where someone else—with whom Fred had no ties—was indisputably in control of Acme.

"That's not the case here," Fred responded. "We are one of the biggest holders, and we'd certainly be the largest holder represented on the board. Also, the CEO and I have been buddies for years. But I really can't imagine I would be in control of his company. Why doesn't the SEC do something to make the rules clearer?"

The SEC did propose some clarification a few years ago, we pointed out. In 1997, it proposed a definition that would have excluded any person not owning more than 10% of a company's voting stock and who was neither an officer nor a director of the issuer.[1] The definition was never adopted, but it would only have applied to whether or not a person's sales were covered by the SEC's Rule 144; it would not have applied to determinations whether or not a person was in control of a company for other purposes.

"But that wouldn't have helped me anyway," observed Fred, "since I suppose that 'deputizing' a director is the same as 'being' a director."

That's likely, we replied. But we'll never know since the rule was never adopted.

"Can I get one of those letters from the SEC? You know, a no-action letter?"

No, we explained. The SEC staff won't issue no-action letters on control questions because they are so fact-specific.

"I can't afford to have our position treated as illiquid," noted Fred, "and I can't expose our investors to the liabilities you mentioned. I think I'll pass on the invitation."

The SEC's Shareholder Director Nomination Proposals

Fred came back to see us last week. "I hear that the SEC wants to give us the ability to nominate a director in opposition to Acme's slate of directors."

That's right, we confirmed. The SEC has proposed permitting any long-term holder of more than 5% of a company's voting stock to use the company's proxy statement to nominate a director in opposition to management's slate. But the procedure would be available only if shareholders withheld more than 35% of their votes from a management nominee at a previous meeting or if a majority of shareholders voted in favor of a shareholder proposal that the company adopt a shareholder nomination procedure.

"That's ridiculous," said Fred. "If they're doing their job right, Acme's nominating committee would have put together a slate of directors who have the background and experience that management needs on the board. I would just muck it up if I proposed someone else. And before I went into this business on a full-time basis, I used to vote against any director who owned less stock than I did. Who's to say why shareholders refuse to support a nominee? Maybe he got involved in a messy divorce after the proxy statement went out. Or maybe he's a Democrat."

"Also," Fred went on, "who's going to stand for election as a director if it can turn out to be a popularity contest and you can get defeated? Some good people just won't agree to be nominated."

That may be, we agreed. But the SEC has heard all of these arguments, and it appears determined to adopt the rules in some form. It has also proposed a third "triggering event," which is that management does not implement a shareholder proposal that gets more than 50% of the votes.

"You mean those shareholder proposals that take up more space in the proxy statement than the information about directors and the rest of it?" asked Fred. "They're a plague. Since when did special interest groups get the right to hijack the proxy statement? We pay for all that paper."

We know how much you love shareholder proposals, we noted. But they have been around for a long time even though the SEC appears determined to expand them.

"Wait a minute," said Fred. "Let's get back to the SEC's shareholder nomination proposal. Didn't you tell me a few years ago that if I nominated someone for Acme's board I could have a lot of trouble because someone might think that I controlled Acme?"

We did, we acknowledged. But the proposed rules say that you couldn't nominate yourself or someone who works for you.

"That's no problem. Remember my college roommate Gus? He's a professor at the business school, and I'm a big donor to his graduate program. He is looking to join some boards. He needs the money. I could nominate him, and he would see everything the way I see it. Would that still give me the control problem?"

It might, we cautioned. The proposed rules say that someone will not be deemed to be in control of the issuer "solely" as a result of nominating a person who is elected to the board, but there cannot be any "agreement or relationship" between the person nominating and the person who is elected.

"So this would take care of the problem you mentioned about my not being able to sell Acme stock on the NYSE without a prospectus?"

Right, we agreed.

"You mean they finally started drawing some bright-line rules on the control question? It's about time," Fred exclaimed. "Not that it's much of a bright-line test to say that I can't have any 'agreement or relationship' with someone. What does that mean?"

We don't know, we admitted. But it could be a problem if Gus is compensated indirectly through your contributions. There's not much help in the SEC's explanation of the proposed rules.

"But why would I nominate someone with whom I have no 'agreement or relationship,'" asked Fred. "The whole point of nominating someone would be to put pressure on management to do something specific, like getting rid of deadwood operations or putting a lid on management compensation. And there are arbitragers out there who are always agitating for companies to be sold or broken up. Why would anyone nominate a person to be a director without having some basis for thinking that he knew the person's position on specific issues?"

We can't disagree with you, we admitted.

"I'm still the largest holder of Acme," said Fred. "But there are a few 1% and 2% holders out there. Can they get together to nominate someone even if I don't?"

Yes, we responded. The proposed rules relax the proxy rules to permit investors to form groups without having to file and mail a proxy statement.

"It sounds as if the SEC really wants this to work," observed Fred. "But suppose the group has more than 10%? Do they have to report buys and sells on a monthly basis? And what about the 'deputization' theory you told me about?"

You are right that the SEC wants this to work, we agreed. They are bending quite a few rules to this end. For example, they say in the release that a group formed to nominate a director is not "the type of group that should be viewed as being aggregated together for purposes of …Section 16," so they propose amending the rules to exclude such a group from Section 16. They are quite frank in admitting that there would otherwise be a "disincentive" to take advantage of the new procedure. Also, the release rather cavalierly dismisses the "deputization" theory as not applicable because of the required "independence" of a nominee from the nominating shareholder. It doesn't propose any rule to this effect, however, so the courts are still free to come to a different conclusion.

"You know," said Fred after a long (for him) silence. The only people who really want this have to be the public pension funds and the unions. Everyone else is going to continue to rely on the boards to do the right thing and if necessary to lean on them once in a while. But what worries me is how I react if the politicians and the labor leaders get together to nominate someone I think is a flake. Can I talk to other holders in opposition to the flake and urge them to support management's slate?"

You can do whatever you can do now, we advised. There is no special exemption in the new rules for opponents of a shareholder nominee, but the existing rules permit you to talk to other holders so long as you don't request a proxy. You would have to be careful not to be seen as acting on behalf of management.

"Not exactly a two-way street, is it?"

Not really, we agreed.

"I can just imagine your enthusiasm for my trying to get involved in an election contest," Fred sighed. "But these rules really make no sense. You can nominate a person to be a director, get him elected and enjoy whatever comes next—having been careful of course to avoid any 'agreement or relationship.' And you can get away without having to bear the disclosure, disabilities and liabilities that usually come with having a representative on the board.

"Are you sure the Republicans won the last election?"

*Joseph McLaughlin is a partner in the New York office of Sidley Austin Brown & Wood. The opinions expressed herein are solely those of the author, and do not necessarily reflect the views of Sidley Austin Brown & Wood.

[1] Securities Act Release No. 33-7391 (February 20, 1997).