BANKING ON CORPORATE

BY NEILL MAY

The trouble with backdoor proxy regulation

What if food safety regulations were embedded in a regulatory framework for the licensing of food vendors? Or if highway traffic laws were embodied in the system developed for regulation of car rental agencies, or auto dealerships? Almost nobody would argue (when I was younger I would start sentences like this by saying that nobody would argue, but I have learned the hard way that there's always somebody to argue anything) the public interest is not well served by legal restrictions on the contents of food, and on driving. The regulation of those activities through the back door, however, would be curious at best.

Yet that type of backdoor regulation is precisely what is happening in the context of shareholder votes, an issue of significantly increasing importance as the incidence of contested public issuer votes continues to grow. Corporate and securities laws are focused on the solicitation of proxies, specifically on the disclosures that must be provided by a party (whether it's management of the issuer itself, or another party such as a dissident shareholder) that is seeking to vote other shareholders' shares on their behalf.

Like the regulation of food vendors, car rental agencies, and auto dealerships, there is an obvious benefit to proxy regulation in its own right. Many holders of publicly traded securities cast their votes by proxy, and ensuring those securityholders understand who the proposed proxyholders are, how they intend to vote, and whether they have conflicts of interest, among other things, is important. A party seeking a proxy from a securityholder is creating a relationship of trust, seeking to carry the right to exercise the securityholder's voting rights, and (depending on the terms of the proxy sought) to exercise discretion if something changes — the proxy rules support the creation of that relationship by mandating disclosure.

However, that system has, over time, effectively become the framework that governs "political campaigns" for publicly traded issuers. A dissident securityholder seeking to effect a change in direction or policy at a publicly traded issuer (for example, replacement of directors) not only has to deal with the proxy rules in seeking to get proxies (the right to cast votes) from other securityholders, but also has to deal with those rules in stating its case generally as to the merits of its proposed change in direction or policy. The dissident, even if not seeking a proxy, has to abide by the proxy rules even if it simply wants to make a public statement as to its views, such as in the example mentioned, the benefits of electing its proposed nominees to the board.

One of the causes of this phenomenon is the sheer breadth of the proxy rules, and their conservative interpretation (note if I express comments like this passively, as if someone else other than securities lawyers like me were providing these conservative interpretations, I can escape blamelessly). The proxy rules apply to any "solicitation" of a proxy, which includes communicating with securityholders under circumstances reasonably calculated to result in the holding or revocation of a proxy. So even if the dissident securityholder is not actually seeking proxies, and is not focused on having securityholders revoke proxies given to other parties, the dissident could be said to be encouraging securityholders to not give proxies to others simply by speaking to the wisdom of its vision.

Just how "political campaigning" for votes in the publicly traded issuer arena should be regulated is not clear. Intuitively, encouraging dialogue, and a marketplace of ideas for the direction of publicly-traded issuers, are valuable objectives, dictating in favour of few limitations on such campaigning. And in some ways there is movement in favour of liberalizing rules toward more of a *caveat emptor* approach such as the crowdfunding proposal about which I have written previously, trusting consumers to protect themselves. But there are limits. There are benefits too in having some order and responsibility in the marketplace, and traditional concepts such as potential civil liability (statutory or otherwise) for public misrepresentations might not work well in this context, where dissidents or other commentators may be, or organize themselves to be, somewhat judgment proof. And the complexities of the information are profound. For example, understanding the motivations of parties vocalizing their votes is made more difficult in an era where voting rights may be separated from economic interests.

My barometer for testing my sense of these issues is to see if my explanations can be absorbed at all by two randomly selected teenagers who happen to live at my address. It's a useful test of the comprehensibility and logic of an argument, though the narcoleptic responses are a bit discouraging. The test yielded predictable results — regulation of securityholder campaigning through the mechanisms of a system designed to address proxies doesn't make sense.

Like food ingredients, and the technicalities of highway traffic rules, many likely take the mechanics of securityholder voting rules for granted — until there's a problem. But the absence of a framework that directly addresses the issue creates inefficiencies that (except possibly for apparently sleep-deprived adolescents) are troubling. CL

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