NEWS

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CORPORATE CHECKS AND BALANCES

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During the past several years, the activities of American corporations have been subjected to an unprecedented degree of public scrutiny and criticism. The modern corporate system has been so successful in utilizing economic resources to produce desired goods and services efficiently that corporate influence frequently transcends national borders, and the resources and revenues of some corporations even exceed those of many governments. This economic success, however, has resulted in justifiable concern and some cynicism as to how individuals who manage vast corporate resources and as a result are able to wield substantial economic and political power, can be held accountable to their employees, consumers, investors, the general public, and to the laws and policies of those jurisdictions under which their corporations were organized and in which they operate. While concern over the accountability of corporate management to various constituencies may have increased recently, it is certainly not a new issue.

In 1932, Professors Berle and Means in their landmark study, The Modern Corporation and Private Property, documented the then-startling proposition that the ownership and control of Corporate America had been divorced. In his preface, Professor Berle stated:

> Accepting the institution of the large corporation (as we must), and studying it as a human institution, we have to consider the effect on property, the effect on workers, and the effect upon individuals who consume or use the goods or services which the corporation produces or renders. . . .
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> When these subjects are thought through there will still remain the problem of the relation which the corporation will ultimately bear to the state--whether it will dominate the state or be regulated by the state or whether the two will coexist with relatively little connection. In other words, as between a political organization of society and an economic organization of society which will be the dominant form? This is a question which must remain unanswered for a long time to come.
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> It is obvious that the corporate system not only tends to be the flower of our industrial organization, but that the public is in a mood to impose on it a steadily growing degree of responsibility for our economic welfare.

Over forty-five years later, these statements are still valid because in a dynamic economy and society, there are no final answers to these issues. The basic dichotomy between ownership and control not only remains with us, but has probably been exacerbated by the growing role of institutional investors, the increased mobility of a professional corps of corporate managers, the frenetic pace of technological development, and many other socio-economic factors. The impact of the corporation on property, workers, and consumers continues to deserve serious consideration, as does the relationship of the corporation to the state.

I do not intend to comment on the relationship of the corporation to its employees or consumers. I would, however, like to offer some thoughts on how the potentially disparate interests of stockholders, who legally own Corporate America, and the executives and managers, who in fact control Corporate America, can be reconciled. In so doing I will also offer some views on what I consider to be the most appropriate role of the Federal Government in such a reconciliation.

When Congress established the Securities and Exchange Commission in 1934, it had the benefit of studies describing how the corporate proxy mechanism, which was virtually unregulated by state corporate laws, had been frequently abused by corporate managements who solicited proxies from shareholders without furnishing any information whatsoever regarding board nominees or other matters to be voted on at shareholder meetings. While the legislative history of the Securities Exchange Act of 1934 emphasizes that disclosure was to be the primary regulatory tool for correcting abuses of the past, it also specifies that the SEC was intended to restore corporate democracy and protect shareholders' suffrage.

Under the Exchange Act today, the SEC is broadly authorized to prescribe whatever rules are "necessary or appropriate in the public interest or for the protection of investors" in connection with the solicitation of proxies relating to most large, publicly-owned corporations.

Currently, the Commission's proxy regulations consist of twelve rules and twenty-seven separate disclosure items. Generally, the proxy regulations call for the filing and distribution of a proxy statement which describes the issues to be voted on at stockholders' meetings, including information about candidates for election as directors and about management, and for the distribution of an annual report to stockholders containing financial statements and other pertinent information. There is a rule which permits shareholder proponents to place proposals and supporting statements in managements' proxy statement if such proposals are proper subjects for shareholders' action under state law and comply with certain other requirements. There is also a rule prohibiting false and misleading statements in connection with proxy solicitation.

The importance of the SEC's proxy regulation should not be underestimated. As the Supreme Court recently recognized, the SEC's proxy powers embody "a pervasive legislative scheme * * *" "clearly [reflecting] an intrusion of federal law into the internal affairs of corporations * * *." In his treatise on Securities Regulation, Professor Loss states, possibly with minor hyperbole, that the corporate proxy is:

> . . . a tremendous force for good or evil in our economic scheme. Unregulated, it is an open invitation to self-perpetuation and irresponsibility of management. Properly circumscribed, it may well turn out to be the salvation of the modern corporate system.

Because of the significance of our proxy regulations, they should be constantly re-examined to assess their continued effectiveness.

The need for re-examination has been underscored by recent events. During the past decade we have witnessed the perpetration of massive corporate frauds, such as Penn Central, Stirling Homex, Equity Funding and other cases where directors and officers were either unwilling or unable to carry out their fiduciary responsibilities. Just during the past few years there have also been revelations of illegal and questionable payments and practices by several hundred U. S. corporations. As the Commission stated in its May, 1976 Report on Questionable and Illegal Payments and Practices to the Senate Committee on Banking, Housing and Urban Affairs:

> The almost universal characteristic of the cases reviewed to date by the Commission has been the apparent frustration of our system of corporate accountability which has been designed to assure that there is a proper accounting of the use of corporate funds and that documents filed with the Commission and circulated to shareholders do not omit or misrepresent material facts. Millions of dollars of funds have been inaccurately recorded in corporate books and records to facilitate the making of questionable payments. Such falsification of records has been known to corporate employees and often to top management, but often has been concealed from outside auditors and counsel and outside directors.

Based in part on the SEC Report, the Foreign Corrupt Practices Act of 1977 was signed into law and became effective on December 20th.

Concurrent with, or possibly as a result of, these breakdowns in the corporate accountability system, there has been increased investor interest in many non-traditional areas of corporate activity. The SEC's hearings on disclosure by corporations of environmental, equal employment, and other socially significant matters are illustrative of the new level of investor consciousness. Many interested persons and groups participated in those proceedings and more than 100 areas of social information were identified by witnesses as being significant enough to mandate disclosure. Another topic about which investors have become increasingly vocal is the level of management remuneration and the apparent widespread receipt of certain personal benefits, frequently referred to as perquisites, by select members of management.

Against this background of events and trends, the Commission in April of last year formally announced a re-examination of its proxy rules relating to three principal subjects. First, the Commission determined to examine the subject of how shareholders should be able to communicate with other shareholders on various types of corporate policies and activities under the Commission's proxy rules; what criteria and limitations, if any, should be applied to them;

and whether some mechanism should be provided whereby shareholders would be able to present their views on management proposals. Second, the Commission decided to consider whether rules or legislation to increase shareholders' opportunities to participate meaningfully in corporate governance and the corporate electoral process were necessary or appropriate. Among other matters, consideration was to be given to providing shareholders with access to management's proxy soliciting materials for the purpose of nominating persons of their choice to serve on the board of directors, and requiring that in situations involving conflicts of interest, affiliates or other persons must vote their securities with the majority, or in proportion to the votes of shareholders who do not have such conflicts of interest in some or all matters affecting the substantive rights of shareholders. And, finally, the Commission determined to re-examine its existing disclosure requirements applicable to solicitations of proxies to determine whether the disclosure of certain information which presently is not expressly required to be disclosed might assist shareholders in evaluating the quality of corporate management and in making informed voting decisions. Specifically, consideration was to be given to requiring disclosures of the process used by management to select nominees for directorships; what qualifications they must have; what corporate matters incumbents have dealt with during the previous fiscal year; and whether

any directors have resigned from the board during the year, and, if so, why. The Commission made it clear, however, that:

> [t]he issues being studied transcend the proxy rules in significance, and include the broader and more fundamental questions of how corporations can best be made more responsive to their shareholders and the public at large.

The active participation of many persons and organizations in the hearings held last fall in Washington, D.C., Los Angeles, Chicago, and New York is evidence of the deep interest in the issues being explored.

To me, one of the more interesting aspects of the hearings was the broad spectrum of views which were articulated. Many witnesses representing corporate management generally believed the present system of corporate accountability was working quite well. This position seemed to be held most strongly by witnesses for the American Society of Corporate Secretaries, who expressed opposition to nearly all of the possible reforms described in the Commission's release announcing the hearings and concluded that "the present system is working and there is no need to make any significant changes at this time." At the other end of the spectrum were many academicians, attorneys, members of Congress, representatives of consumer interest organizations, and interested shareholders who strongly advocated various significant changes to increase the accountability of management to its various constituencies and to improve the ability of shareholders to participate in

corporate decisionmaking. There were, of course, representatives of a number of companies who explained the progressive measures they are already taking to improve communication with shareholders, encourage shareholder participation in corporate governance and assure management accountability to shareholders and the public.

It is apparent, at least to me, that despite various statutes and SEC regulations, shareholder democracy today is much more an appealing concept than an operating reality. Although it is possible to document the current lack of shareholder involvement in corporate affairs, it is a far more difficult task to gauge precisely the degree to which this lack of participation is reflective of general apathy or of frustration with an inadequate corporate governance system. Even though many will disagree, it is my opinion that most shareholders are primarily, if not almost exclusively, interested in a return on their investment through dividends and capital appreciation, and that they do not or cannot devote the time, energy or resources necessary to become involved in the governance of corporations which they, in part, own.

Before any democracy, whether political or corporate, can be effective, a significant proportion of the electorate must be well informed, have meaningful alternatives, and choose to exercise their franchise. It is questionable whether an effective corporate democracy is an achievable goal.

Nevertheless, I believe that reasonable opportunities for shareholder participation in corporate decisionmaking should be provided and am confident that such opportunities will, to an extent, improve management accountability.

However, even if universal shareholder participation could be obtained, true corporate accountability would not be assured because shareholder interests do not always coincide with the interests of other groups to which the corporation is accountable. Accordingly, alternative methods of making corporations accountable must be considered.

Another approach which has received substantial support, is the enactment of a federal corporate chartering statute to preempt state corporate laws which tend to be too protective of incumbent management and provide less than satisfactory shareholder rights and protections. The Federal Government has enacted many public interest laws and established government agencies dealing with matters that impact corporate conduct, such as equal employment, environmental protection, fair trade practices, and product and employee safety. Perhaps it will prove necessary to extend this federal regulatory approach to deal with the organization, structure and internal operations of every major corporation. But that approach carries the danger, and perhaps even the assurance, of stifling private initiative, of reducing the role of our private institutions and professions in responsible decisionmaking, and of weakening the crucial ability of our corporations to

operate in a flexible and efficient manner. In my opinion the proper role of government is to foster an environment, and provide necessary incentives, for private decisionmaking that coincides with the public interest. Thus, increased government intervention in corporate decisionmaking should occur only if efforts to encourage appropriate private action are unsuccessful.

Probably because of my economics background and my firm belief in the disclosure philosophy and self-regulatory approach of the federal securities laws, I believe corporate management can be made more accountable to shareholders, as well as to the public, without a radical restructuring of the corporate governance system. In my view, the most promising and least disruptive way to enhance corporate accountability is for corporate boards of directors to fulfill their fundamental responsibility of representing shareholders and assuring that management acts in conformance with existing legal and ethical standards. Each director is a fiduciary and is under a duty of loyalty and care to stockholders. The board of directors' role is to establish corporate objectives, to select competent top management executives, and to monitor their performance.

It is essential that corporate boards become more vigilant and more vigorous than they have been in the past. Far too often directors have been chosen by, and dominated by,

corporate management. And far too often well qualified individuals have accepted directorships as honorary positions or in order to protect the interests of the corporation's bank, major customer or major supplier. In my judgment, directors cannot monitor management performance effectively or assure management accountability unless the board is truly independent of management.

Accordingly, I believe that at least a majority of the members of every board of directors must be independent of management. Because boards operate primarily through committees, it is important that the executive committeee, the audit committee, the compensation committee, the nominating committee and all other committees in which serious conflicts of interest between management and shareholders are likely, be dominated by outside directors. And, because the chairman of the board controls the agenda for board meetings and has other prerogatives, it is appropriate that he too be independent of management.

There can be no doubt that the SEC has neither the authority nor the disposition to resolve all of the major issues I have mentioned. Changes will come in these areas and, as in the past, they will be the result of interaction between government actions and private initiatives. The fundamental approach to achieve better corporate accountability is to build better "checks and balances" into the corporate

system. The Commission has already started down this path, and should continue to follow it by facilitating the independence of directors as well as the independence of outside accountants.

Our staff is currently reviewing the extensive record in the Commission's Corporate Governance Proceedings. It is my understanding that recommendations will be made to the Commission early this Summer; and presumably the Commission will then publish its proposals for public comment by interested persons. I cannot predict what actions the Commission will take. But I believe it is appropriate to consider additional disclosure requirements with respect to management's qualifications, performance, and remuneration, and to permit more communication among interested shareholders with respect to shareholder proposals and other matters not involving a change in control. Finally, because the current corporate electoral process is generally perceived as not being fair, I would anticipate amendments to our proxy regulations, including the development of a shareholder nomination process for directors.

The changes I have mentioned may seem radical to some of you. They are, however, really quite modest in comparison with those which I believe will be imposed upon you in the event voluntary reform is unsuccessful. I assure you the SEC will continue to carry out its statutory mandate

and be active in this area. You should not perceive our activities as threats, but should realize that they present opportunities for improving the corporate system.