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(202) 272-2650

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"EXPLORING THE LIMITS OF CORPORATE ACCOUNTABILITY"

Stephen J. Friedman
Commissioner
Securities and Exchange Commission

I would like to share with you some observations about the current phase of the movement to make our business institutions more responsive to social concerns. Briefly, there are five ideas I think deserve emphasis:

-- While concern about this subject is not new, the American experience in the '60's and '70's has given it special weight.

-- It is important to separate questions of shareholder participation and corporate governance from questions of corporate accountability, which deals with quite different matters.

-- The legal system that has been developed to govern the relationship of investors to corporations -- the corporate and Federal securities laws -- are not congenial or effective ways of dealing with problems of corporate accountability.

-- In particular, the attempt to have the corporate system internalize social goals carries a significant price tag and some hidden dangers.

-- At the same time, the underlying issues will not disappear. American business has made significant strides in responding to public concerns, but more needs to be done.

Recent History

The ambiguous reaction of Americans to concentrations of corporate wealth and power runs deep in our political history. President Jackson's attack on the Bank of the United States, the distrust of agrarian regions for the industrialized and moneyed Northeast -- those were the good old days in the Northeast -- trustbusting, and the flowering of economic regulation all sketch the landscape of this element of our past. In 1906 Arthur Twining Hadley, then president of

Yale University, wrote:

> "Industrial corporations grew up into power because they met the needs of the past. To stay in power, they must meet the needs of the present, and arrange their ethics accordingly.
>
> ... Those who fear the effect of increased government activity must prove by their acceptance of ethical duties to the public that they are not blind devotees of an industrial past which has ceased to exist, but are preparing to accept the heavier burdens and obligations which the industrial present carries with it."

And in a reverse echo of the comparisons one hears too often today between the size of large corporations and national states, another observer noted at about the same time that

> "U.S. Steel receives and expends more money every year than any but the very greatest of the world's national governments; its debt is larger than that of many of the lesser population, nearly as large as that of Maryland and Nebraska, and indirectly influences twice that number."

The post-World War II period, and especially the '50's and most of the '60's, brought a sharp divergence away from this concern. That was a time of great prosperity, seemingly endless growth, and a continuously rising tide that seemed destined to lift all boats indefinitely.

Beneath the surface the substructure of events continued to shift, however, and the resulting cracks and strains have brought to the surface many of the earlier basic questions about the role of large corporations in America:

-- Doubts about the efficacy of the "programs" of the '60's that were primarily concerned with equal opportunity have given new currency to income redistribution, affirmative action, quotas and other departures from market-based solutions to social problems.

-- The enormous transfer of wealth effected by OPEC oil price increases, coupled with the growth of inflationary pressures originating in the war years of the late 1960's have curtailed the rising economic tide, and each sector of our society has increasingly turned a sharp eye to its own interests -- the other eye being trained on the government as the source of help. There is substantially less confidence in the ability of the market system to solve our problems.

-- The growth of multinational corporations has, both in fact and in perception, created increasing doubts about the ability of the traditional national regulatory apparatus to deal with social problems -- the foreign payments problem and the difficulty of regulating eurodollar deposits are two clear examples.

-- The cumulative effect on society of a series of social costs external to the market system have only begun to be felt -- air and water pollution, chemical waste disposal, injuries to employees through exposure to trace chemical contamination over a long period of time, and similar effects on consumers. These problems have been seen by many as posing conflicts between social goals and the economic system that, in my judgment, are more apparent than real.

Predictably, the 1970's witnessed the construction of an ever-tightening web of laws and regulations designed to limit corporate discretion in many areas -- environmental protection, worker health and safety, equal employment opportunity and consumer protection.

I think the result has not been very satisfactory to anyone. There has developed a widespread aversion to the extent and detail of government regulation and an equally widespread concern about the impact of regulation on capital formation. In addition to the obvious costs of compliance, there are hidden costs: each time the government acts by fiat, an additional area becomes foreclosed to carefully-tailored voluntary solutions, flexible enough to accommodate later developments, yet economical enough not to make the cure more painful than the disease.

At the same time, I see little desire to abandon the social goals that gave rise to this regulatory pattern. The public perception continues that the accumulated wealth and power represented by business institutions is a matter of concern -- that even within the network of legal rules which has been erected, basic choices are made by our business institutions which greatly affect the lives of diverse groups of people in response to financial considerations that do not take into account the interests of those groups.

In response to these developments, two distinct currents are discernible. One represents an attempt to make the regulatory process more effective and flexible, to use tax policy to force the market system to incorporate some of the social costs, and to find a way for countervailing economic consideration to be weighed in the regulatory balance.

Another approach views corporate management, and particularly the Board of Directors, as critical points of access to decisions affecting many groups in our society. This approach seeks, in the end, to have the corporate system internalize the social goals of regulation. Although not always clearly articulated, it is that objective which is the informing principle of much of corporate governance and corporate accountability.

Consider the corporate governance and accountability proposals that have been generally discussed. They fall into three general categories:

-- those dealing with shareholder participation, including the flow of information to shareholders.

-- those dealing with the structure and composition of the Board of Directors.

-- those dealing with the goals to which the Board and management should be responsive and the interests or constituencies they should represent.

Shareholder Participation

A storm of debate has grown up around the kind of information which shareholders should be entitled to receive, the issues upon which they should be permitted to vote, and the like. As you know, the SEC has a special set of rules relating to those issues, and a significant amount of resources are consumed in the process of administering them.

My own views in this area are simple. The shareholders own the corporation. In general, they are entitled to receive information on any subject they desire and to set corporate policy on any issue they desire -- if they so desire.

The rub is that most holders of shares do not exhibit any desire to have a mass of information on matters of social concern or to set policies for the corporation, at least in those cases where management objects. For example, there is a serious debate about whether 6% of the outstanding shares is too high a threshold to use in determining the number of shares required to ask for a flow of information on some special subject. Part of the reason for this lack of interest is that the ownership of large companies is increasingly held in institutional hands -- hands in which the vote is effectively neutralized. But beyond that, it is probably true that many individual shareholders view themselves solely as beneficiaries of an income stream; they do not think of thenselves as owners of the company, only of its stock. They are simply not interested.

If that is the case, what accounts for the continuing -- and perhaps building -- pressure on these issues? In part it is the raised consciousness of certain institutional shareholders, particularly some religious groups, of the fact that their share ownership can be used to pursue non-economic ideals. But, more importantly, I think it is the pressure of those who seek to make corporations accountable for a broader range of issues and to a larger constituency than the shareholder group.

That goal alone is not surprising -- accountability is just what the Congress sought in enacting EPA and OSHA. The twist is in using the shareholder participation mechanism to achieve that end. I think that is not the right way to go about achieving these goals, for two reasons:

-- First, it does not work very well: the corporate electoral process is a very blunt instrument, and there is a great deal of evidence that shareholders, are not highly interested in becoming regulators.

-- Second, the result is to distort the process of corporate governance and proxy regulation. Do we really mean that the corporation must expend the time and money to inform its shareholders about a subject if the holders of only 6% of the shares want the information? Are the endless debates about which subjects relate to the day-to-day business of the corporation really a productive expenditure of time and effort?

At the same time, this is an area in which I think the lines of communication should be left open. If shareholders want to change the kind of information they get, or set policies for the company, they should be permitted to do so. There ought not to be structural barriers to that participation, even if the result is additional cost in the proxy process.

The Board of Directors

Questions relating to the composition and structure of the Board have received more attention than any other aspect of this problem, and I will pause on them for only a moment. I think it is worthwhile to ask ourselves about the purpose of these structural changes. What are they designed to accomplish?

It seems to me that they address to two concerns. The first is simply the effectiveness of the corporate mechanism to achieve its goals. There is a broad consensus that an active Board is an important part of a well-functioning company, and that the best-run companies recognize that fact and seek out the discipline that such a Board brings to corporate decision-making.

The second purpose deals with the responsiveness of the company to the broad concerns about the impact of business in our society. It recognizes that every Board has a wide range of discretion in pursuing corporate goals and that in making those decisions it should have the views of people who are sensitive to the interests of other parts of our society. This seems to me a wholly salutory development. All of us benefit from the different perspective and experience of others, and the Board of Directors is no exception. Hundreds of questions of timing, degree and judgment are decided one way or another depending upon the people and views represented at the table where the decision is made.

Accountability

Finally, I would like to turn to corporate accountability. I am using that term quite narrowly in the sense of seeking to compel corporations to internalize social goals -- not merely to take them into account, but to erect them as objectives which are, in fact or in law, of equal status with profitability.

This approach would sacrifice a degree of the efficiency which the market system brings for the enhanced achievement of social and political goals. Although much has been written in this area, the current legislative proposals do not explicitly adopt this approach. But it is apparent in proposals for constituency directors and provides the motive force behind much of the criticism of American business. Its logic goes well beyond trying to influence the exercise of discretion issues by the Board. It would, in effect, provide a legal basis for challenging Board decisions as a breach of a fiduciary duty owed to persons or interests other than shareholders -- employees and local residents, for example. It goes a step beyond saying that shareholders, dissatisfied with the response of the directors to matters of social concerns, can put them out of office and get new directors. In the end, this approach to corporate accountability must find a way to remove directors or hold them liable even if the shareholders are satisfied.

It is useful to contrast this approach with the traditional paradigm of business accountability. Our society looks principally to the government to establish overall rules of conduct and, within those rules, to leave the broadest possible scope of discretion to the individual citizen -- corporate or otherwise -- to order his affairs as he sees fit. It is those rules that establish the corporation's obligation to account. Within the scope of discretion afforded corporate directors, only one other legal requirement generally limits them -- their fiduciary obligations to the company's investors. Thus the director has duties of care and loyalty to the shareholders which serve as guideposts in his exercise of discretion. The sole yardstick against which the director's performance is measured under his fiduciary duties is one of economic effect.

The strength and utility of the existing concept of a director's fiduciary duty lies in its peculiar combination of narrowness and breadth. On the one hand, the rules are flexible enough to encourage imagination and innovation in developing business strategies to cope with unpredictable situations. On the other hand, the standards defining what is outside the scope of discretion are quite narrow so they can clearly be applied both to define the goals which the director must pursue and measure his success in doing so. Thus, the sin lies in deviating from the specified path -- and the director risks liability to the shareholder for any loss incurred. Once again, this liability analysis should not be confused with the continuing right on the part of the shareholders to change fiduciaries -- whether or not the director's actions have been proper and even in the face of extraordinary economic success -- if that is the shareholders' choice.

Many proponents of change find this paradigm inadequate. They see American business as insufficiently constrained by the network of laws and regulations -- and as not adequately accountable for their actions. Now, there is little doubt that changing the groups and interests to which directors owe their allegiance would have a profound effect on their behavior. It would make them more likely to actively promote other values. But it would do so at a very high price.

We have a great deal to lose if the rules are redrawn to create new corporate goals which are elevated in importance to the level of a director's current fiduciary duty. That step will inevitably foster divided loyalties and internal conflicts in the process. It will reduce the drive to efficiency that our system generates, possibly have significant effects on the capital allocation mechanism and, in a perverse way, generate less accountability.

When managers are given a variety of goals to pursue, it is often the case that they pursue none of them very well. That phenomenon is seen most clearly in government credit programs, in which the tension between the fact that the government has assumed a risk the private credit markets would not assume at an acceptable interest rate, and the political goals of both lowering the interest rate and avoiding undue losses, leads to a continuing state of ambivalence.

Changing the goals of the game may also have a profound effect on the process of allocating and raising capital. If you accept the notion that most investors are primarily interested in the returns available from their invested capital, than the problem of investing in institutions that are required to pursue non-economic goals becomes infinitely complex.

Moreover, if it becomes clear the the law will no longer enforce the expectations of investors that profit is the primary goal of the corporation, the distortions in the process of capital formation could be significant. Investors (and particularly those who are fiduciaries themselves) may search elsewhere for their investment opportunities.

Another serious fallout from creating new corporate goals is an inevitable loss of accountability. If the corporate director serves two masters he cannot truly be said to be accountable to either. If the corporation is, through special constituency directors, required to pursue a multiplicity of goals, it cannot legally be faulted for failing to achieve any of them. Moreover, as we move away from the economic sphere, alternative methods of measuring performance are simply not as useful. Consider, for example, a corporation with a legal mandate to serve the interests of the environment. In the absence of regulatory standards, how is success or failure to be measured? If goals cannot be identified or placed in an order of priority, if the corporation owes duties of care and loyalty to more than one group, or if the yardstick to measure peformance is blurred, then accountability itself suffers.

Accordingly, I believe there is a clear point beyond which we should not go to modify our present corporate institutions in a search for accountability. We should not require any change in the system which would compel the corporate director -- at the risk of violating his fiduciary responsibilities -- to pursue any social goal in preference to profitability for the benefit of any constituency other than its shareholders.

It would be a fundamental mistake to force upon our business institutions the responsibility for implementing social or political goals in the absence of governing legal standards. Of course, when we believe that cars should be safer, that rivers should be cleaner or that communities should have a voice in corporate decisions, those are the proper subjects for lawmakers to formalize and impose as legally enforceable duties. And disclosure may well be an appropriate enforcement mechanism in many cases -- but that is not <u>shareholder</u> disclosure, it is <u>public</u> disclosure.

This is not to say that the corporate director should honor the lowest permissible legal standard and then pursue only profit regardless of the social cost. We have always expected -- and generally have received -- more from business than minimum standards of conduct. Our system is sufficiently flexible to permit serious observers to conclude that the best companies are often the most socially responsible.

Finally, I fear that the process of building social goals into American corporate objectives could have a dark side as well. The proponents of social consciousness on the part of business say that profitability is not a sufficient guide to the conduct of powerful institutions. Thus, corporations are urged to take the interests of shareholder groups into account. The managers of pension funds and other sources of institutional money are urged to consider effecting social goals in their investment policies. Financial institutions are urged, by our staff among others, to formulate a policy on the exercise of the voting power that comes with their investments. And the United States Supreme Court, in a recent decision, has overturned a Massachusetts statute that barred corporations from political activity on issues unrelated to their business, pointing to the First Amendment.

These developments rest on objections to a market system that responds to return on investment and is neutral with respect to other social values. While the retreat from neutrality has significant advantages in the way of a higher level of social consciousness, it also raises the spectre of the active involvement in the political process of those whose power and influence derive from their management of other people's assets. Many who urge this think in terms of business adopting the social goals they urge. But that is not a necessary result. And many others are uncomfortable with a system in which large business and financial institutions would play an even larger role in the political process than they do today or, more importantly, use their economic power to effect their own notions of social and political goals.

In my view, the present system is fundamentally sound and our efforts to make business more responsive socially should not yet include changes in the allocation of corporate power, massive additional intervention by the Federal government or basic changes in the fiduciary obligations of the corporate actors.

Nevertheless, if that system is to survive in essentially its current form, it must continue to evolve. Particularly in what I have called the area of discretionary behavior by the Board, the actions of corporations must be sufficiently responsive to social concerns to be broadly perceived as responsible conduct.