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Securities

"STOCKHOLDERS AND CORPORATE MANAGEMENT"

ADDRESS

OF

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Commissioner, Securities and Exchange Commission

before

THE CONFERENCE BOARD

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I am very glad to join with you today to discuss the subject of stockholders and corporate management. It is a particular pleasure for me to be here because you men work with the basic materials in the field, and the problem of the relationship of stockholders to management is one which concerns you every day in the routine, so to speak, of your duties. The subject of discussion is very broad in scope. Indeed, it encompasses all points of contact between management as such and the stockholders group. It includes, to one degree or another, most of any corporation's activities. I do not propose, however, in the short space of these remarks, to deal with all phases of this relationship. I shall limit my discussion to the legal framework in which the relationship is cast and the actual practices which have developed.

The relation of managements to their shareholders has varied through the years and has been affected to a large extent by the provisions of state laws and by the requirements of regulatory bodies where applicable. However, the broad, general framework of this relationship has, in theory at least, been clear. In theory, the stockholders are the owners of the corporation. The corporate management consists of representatives selected by the shareholders and responsible to them. The shareholders have the right to prescribe the rules under which the corporate management shall operate the business except as to ordinary management functions. The stockholders retain the power to change the management.

In earlier days the actuality followed the theory rather closely. An enterprise was incorporated locally and the shares were subscribed locally. Annually the management reported to its shareholders. The shareholders met and elected their management from among themselves. They expressed their views on the conduct of the business and made suggestions, all of which were fully discussed and voted on at the meeting.

The diffusion of ownership of corporations among widely scattered investors, many with small holdings, made the physical congregation of shareholders impossible. As a result, the character of the corporate meeting changed. Instead of a congregation of the owners of a corporation, the corporate meeting became a collection of proxies. The actual meeting lost its deliberative character and the approval of proposals became a mere formality. Policy was no longer made by the shareholders. It was made by management. Management devised a program of action and submitted it for rubber-stamping. The body of shareholders, by and large, came to be regarded as a hurdle to be cleared rather than a helpful member of the corporate community.

It was inevitable that the average shareholder, having little reason to feel himself an essential part of the corporate workings, should become apathetic. Typically, he received from his company a generalized annual report from which it was difficult to comprehend the progress of his corporation. He also received, sometimes before the annual report, sometimes after it, a proxy card in small type which he was urged to sign and return. Ordinarily, the proxy card gave blanket authority to elect a board of directors and take any other action the proxies considered desirable. Too often there was no explanation of the necessity for the action the shareholder was asked to authorize, and there was no assurance that the proposals mentioned in the notice of meeting were the only ones proposed by the management. The stockholder was merely accorded the opportunity to sign his name and mail back the proxy. Comment or criticism was not invited, and opposition could be expressed only by expensive counter-solicitation directed to removal of the management. Meetings often were held at inaccessible places, and shareholders who survived the obstacles and attended the meetings were often received as interlopers. Undoubtedly, managements faced real difficulties in the transition from

compact group ownership to widespread ownership of corporate shares in maintaining shareholder relations. But those difficulties were too often used to justify curtailment of a proper and effective stockholder participation in corporate matters. In retrospect, it is difficult to conceive of methods better designed than some quite widely followed in the past to induce stockholder indifference and unresponsiveness to management proxy solicitation. Many stockholders fell in the habit of consigning proxies to the wastebasket. Managements found it increasingly difficult to secure quorums and resorted to lowering quorum requirements and to hiring special solicitors.

Much thought was given to devising means to satisfy the legal requirement of an annual meeting of shareholders. Little thought was given to the discovery of means to energize stockholder participation in corporate affairs. I believe the wrong road has been followed. It will be better to retrace some of the steps and to strike a new point of departure. It seems to me that the heart of the problem lies in the failure of corporate practice to reproduce through the proxy medium an annual meeting substantially equivalent to the old meeting in person. I know that the old-fashioned meeting cannot be revived. Admittedly, that is impossible. It is not impossible, however, to utilize the proxy machine to approximate the conditions of the old-fashioned meeting. The proxy machine can be used to afford to the stockholders a means of communicating with each other, to give them the opportunity to submit proposals to their fellow stockholders, and to secure the collective judgment of those stockholders on their proposals. Accordingly, our regulations have for sometime been designed to provide the shareholder with an opportunity for a more active participation in the affairs of his corporation. They require the management to include in its proxy statements all the proposals it intends to make and to give the stockholder an opportunity to

specify how he wants his shares voted. Typically, this has taken the form of a ballot which the stockholder is privileged to fill in. Although this provision has been in effect only for the past five years, stockholders have grown accustomed to a ballot offering them an opportunity to express their views. Our experience shows that stockholders are eager to avail themselves of this privilege. They are beginning to feel that they have a part to play and they are willing to undertake it. Thus a test check made by one of our large corporations indicated that out of every 100 stockholders only 32 sent in proxies, but 75% of those sending in proxies marked their ballots for or against a management proposal. Considering the short space of time these regulations have been in effect, this is an encouraging showing, and one which may soon have its influence with the 68% who did not send in their proxies.

Another sign of the reawakening of shareholders to their interest in the affairs of their corporations is the fact that shareholders are coming forward with suggestions and proposals of their own. In this respect, they are using the proxy machinery as a means of communicating with their fellow stockholders. And the Commission's proxy rules have for the past five years recognized the right of stockholders to use the proxy machine for this purpose.

Some five years ago we came upon the first case of a security holder who desired to use the proxy machinery in this way. The shareholder had advised his company that at the annual meeting he proposed to make a motion to amend the bylaws in several respects. The management in soliciting its proxies was on notice of these proposals and intended to oppose them. It asked our advice. It seemed to us that security holders were entitled to know that the proposal would be made at the meeting and to direct the use to be made of their proxies when the proposal came up. We concluded that under the

circumstances the management's proxy material should set forth the stockholder's proposal, give a yes-no vote, and state that the management intended to vote its stock and the proxies it received against the proposal unless otherwise directed. This procedure was followed in numerous subsequent cases and it is to the credit of management generally that it has worked smoothly for the past five years. This procedure is in some measure a substitute for the opportunity personal assemblage of the shareholders would give each stockholder to submit a proposal to the meeting for discussion and vote.

Recently the Commission has broadened this privilege so that security holders may present a 100-word statement in favor of their proposals. While, admittedly, this is an inadequate substitute for the right to give a full explanation of such proposals at a shareholders' meeting, it is a step in the direction of placing the shareholder where he would be if it were physically possible to gather all stockholders at the annual meeting.

We have heard arguments made that this procedure invites participation by "crackpots." Our experience over the past five years indicates that the privilege of having proposals included in the management's material has, for the most part, been used with restraint and judgment by stockholders. A high percentage of the proposals have been well thought out and worthy of consideration. Many have been accepted by managements and others have secured respectable percentages of the total vote cast.

From my point of view, the results so far are encouraging. It seems to me that these provisions in our rules have to some degree revitalized the democratic process in the conduct of corporate activity. The Commission is constantly examining and reexamining its own rules and practices in this field to discover means of encouraging and fostering more substantial shareholder participation in corporate affairs. We realize that much remains to be done.

We realize that we can't do it all. Our recent circularization of proposed proxy rules evoked some very fine and constructive criticism. Many of the comments which were made upon the proposals were extremely useful to us in arriving at our final conclusions, as to the extent that revision ought to go at that time. On the other hand, it is my opinion that some of the proposals which we abandoned deserve further exploration and study. For instance, one proposal which the Commission circulated but rejected is directed to the practices of management in making disclosure to its security holders. I have in mind the annual report which has the capacity to be the most significant document the stockholder receives from his management. We all know, however, that the annual reports of corporations vary widely in the amount of information they give and in the clarity with which it is presented. They range all the way from a few pages of pictures of the company's products and an over-simplified balance sheet to a volume of substantial size. In addition, these reports vary greatly in the accuracy of the disclosure they make. A study by our Chief Accountant's office has revealed that the financial statements contained in annual reports to stockholders often differ in material respects from those officially filed with the Commission. In recognition of this variance, we circulated a suggestion designed to consolidate the annual report to stockholders, the proxy statement, and the annual report to our Commission in a single document. This suggestion caused much comment, both favorable and unfavorable. The difficulties which were pointed out persuaded us that it was undesirable at this time to adopt this provision. Nevertheless, it likewise seemed clear that the suggested proposal would permit a considerable saving in time and expense, as well as in paper work. Consequently, our present rules, although not adopting the original proposal, permit the use of the annual report to shareholders as a basic document to effect compliance with the annual report

requirements of stock exchanges, with our proxy rules, and with our annual report requirements. This enables corporations to conform their reporting requirements to a simpler and more desirable standard. I have every hope that those who make this choice will find compliance with their reporting obligations a very much simplified matter.

Further, the matter which has traditionally been the role of the common shareholder, namely, the election of the management, is under present practice largely an illusion. This practice proceeds under the guise of a democratic process through which the voters -- i.e., the shareholders -- may each year select the persons to whom is entrusted the conduct of the business. In actuality, the stockholders are presented each year with a single slate, which may be attractive or unattractive to them. But they have no choice. It is either that slate or none at all. In the latter event, because of the provisions of state corporation acts, the same management holds over. The proposal made last summer permitted stockholders to make their own nominations and required that they be included as a part of the soliciting material circulated among security holders by the management. However, the suggestion presented numerous technical difficulties, and we could find no satisfactory solution in the short period we had to consider the matter. We, therefore, did not adopt this proposal. I am not sure that the technical difficulties which perplexed us do not largely disappear when the problem is approached from the point of view of the management. In other words, it may be that the respective managements of corporations in this country are in a position to adopt procedures through which a real choice in the election of management is given to stockholders.

In that connection, I wish to say that we have observed that there is a large number of corporate managements who have shown that they are sensitive to



the problems inherent in the relationship between management and security holders. They have taken steps and have adopted practices which seem to me to be distinctly along the right lines. They have supplied their shareholders with complete and simplified annual reports. Some have solicited comment from their security holders by mail; others have facilitated stockholder attendance at meetings and have even held regional meetings to secure the views of their shareholders. Unfortunately, such managements find their counterpart in certain submarginal elements. For example, a number of corporations listed on our great exchanges do not even grant to their public security holders the courtesy of soliciting their proxies. Indeed, in some cases, managements find themselves perpetuated in office because, by reason of their own failure to solicit proxies, no quorum appears at the annual meeting. The problem of bringing such managements up to the level of their more responsible brothers is a problem for management itself, for our national securities exchanges, and for government regulatory bodies.

Before I conclude, I want to say a few words about the accountant who is an important factor in the relation between management and stockholders. In general understanding, the accountant is independent. It is assumed that the accountant is not affiliated with the management and recognizes an independent responsibility to the security holders of the companies he audits. In this capacity he examines the records of the company and reports to his principals, the stockholders, concerning the manner in which the company is being operated. In theory, the stockholders have the benefit of the independent scrutiny of management activities by men trained in financial and business practices. But here again reality has often strayed far from theory. For at times the accountant has been subservient to the wishes of management. The Commission's reports show many instances where accountants wittingly or unwittingly

participated in obscuring from investors facts of vital importance. Our McKesson & Robbins investigation revealed the widespread existence of practices in effect placing the auditors under the control of management to the exclusion of shareholders' interests. It is, therefore, not surprising to find that deviations from accepted standards have frequently occurred in connection with matters touching the relations between management and the business unit.

However, with the Securities statutes as support, the accounting profession is gradually bringing its members to a greater and greater observation of the responsibilities owed by them to shareholders. The Commission has at every opportunity lent its aid to such efforts and has sought through its opinions and rules to press home its concept of the proper functions of the independent accountant. As a result, accountants now are in a stronger position to resist pressure to deviate from those responsibilities. This development, along with the development of greater interest of stockholders in their companies, promises more healthy stockholder-management relations in our great corporations. It is significant that these two developments are not unconnected. For stockholders, once given a right to make their own proposals for action at annual meetings, chose as one of the early subjects of their concern the relationship of accountants to management and stockholders. Many companies, at the suggestion of shareholders, now have methods of stockholder selection of auditors. Auditors' certificates are frequently addressed to stockholders, and representatives of the auditors are generally present at the annual meeting to answer questions by stockholders. Managements which have opposed such suggestions have found substantial groups of stockholders voting in favor of them.

It is clear that clarification and strengthening of the position of the independent accountant as a representative of the stockholder will bring improvement in direct management-stockholder relations. But something more than a strengthening of the accountant's position is needed. There is a need for a resetting of the stockholder-management relationship in the framework of its origin so as to create an informed and active group of shareholders who have a voice in the councils of their own corporations. This is necessary to the preservation of a vigorous system of free enterprise. It is in this respect that management-stockholder relations have their deepest significance to those who believe in capitalism under democracy.