NEWS

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SEC CORPORATE GOVERNANCE PROPOSALS: AN UPDATE

Address by

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American Society of
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I appreciate the opportunity to participate in this joint annual meeting at which issues of vital interest to corporations, investors, and the Securities and Exchange Commission will be discussed. Meetings of this type are beneficial because they help both of us to understand each other better and to develop a better working relationship. As all of us know, corporate accountability and the process by which corporations are governed are being subjected to intense scrutiny and corporations are being expected as never before to be responsive to the interests of investors, employees, consumers, governmental units and the general public. Although there are many well publicized instances in which expected standards have not been met, it is also important to recognize that either on the initiative of corporate management or in response to external pressures, corporate practices and accountability have been significantly improved over the last several decades. The Securities and Exchange Commission is among the external forces that have had a significant influence on corporate practices.

The federal securities laws, which are administered by the Commission, require public corporations to provide full and fair disclosure of the character and nature of their securities, to promote fair corporate suffrage, and to maintain

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a system of internal controls for safeguarding assets in order to facilitate strong capital markets and protect investors. Investors cannot be expected to entrust their funds to corporate management unless they believe that they will be dealt with fairly, that management is accountable for the use of corporate assets, and that the information on which they may make investment and corporate suffrage decisions adequately and appropriately describes the financial condition of the enterprise, and its operations, including the functioning of the board of directors. Congress has given the Commission the responsibility and broad authority to assure that public corporations fulfill these obligations.

In the accounting area, pursuant to the rule-making authority to prescribe the form, content, method of preparation, and certification of financial statements to be filed with the Commission, the Commission has established requirements and continues to consider ways to enhance the independence of external auditors of corporations. Individual Commissioners have discussed the importance of an independent internal corporate accounting staff which has front line authority for quality financial reporting, and the Commission's staff is presently exploring the desirability of proposing for comment a requirement for management to report on internal controls to help assure that corporate assets are being used only in accordance with management directives.

Pursuant to our disclosure authority, the Commission has required disclosure of questionable and illegal corporate payments and management remuneration including perquisites. In April of 1977, based on that same authority, the Commission commenced a re-examination of rules relating to shareholder communications, shareholder participation in the corporate electoral process and corporate governance generally. Following almost six weeks of public hearings throughout the United States and numerous written submissions, last July the Commission published for public comment proposals intended to increase the information available to investors concerning (1) the structure and operation of the boards of directors of publicly held companies; (2) resignations of directors; (3) director attendance at board and committee meetings; (4) voting policies and procedures of certain institutions subject to the Commission's proxy rules; and (5) the terms of settlement of proxy contests. The Commission also proposed a rule amendment which would give shareholder proposal proponents an opportunity to review and comment upon management's reply, if any, to their proposals.

It was the Commission's view that such disclosure would facilitate informed corporate suffrage by providing shareholders with information which would permit an evaluation of the quality and effectiveness of boards of directors and improve the operation of the shareholder proposal process. Our release also stated that the proposed requirements "would be conducive to the development of improved accountability mechanisms . . . [and that] the proposals . . . would be consistent with the evolution of stronger, more independent boards of directors, better equipped to discharge their fiduciary obligations and to represent the interests of the shareholders who elect them."

Despite the general support expressed in our corporate governance hearings for Commission action to strengthen the independence of corporate boards of directors, the overwhelming majority of the nearly 600 responses to our specific proposals were very critical. A significant number of the comments claimed that the proposals were designed primarily to require changes in the composition of corporate boards of directors and to otherwise influence corporate conduct rather than to provide useful information to investors, that this "is the worst sort of administrative legislation" and that the Commission "is going beyond its powers under the statutes which it administers."

The intensity of feeling with respect to our proposals is illustrated not only in the responses we received but in newspaper and magazine editorials such as one which asserted that the SEC has reached the "conclusion that corporate democracy is hopeless" and that "corporate governance can be made publicly accountable only by taking it out of the hands of the hoary cabal of managers, directors, and shareholders and placing it in the hands of independent directors."

Unfortunately our proposals created the apparent perception that the SEC is seeking to mandate a change in the structure and functioning of corporate boards of directors. Consistent with the views of many business leaders and the pronouncements of major business and professional organizations, members of the Commission have expressed the view that corporate governance could be improved through the exercise of independent judgment by directors and greater involvement of corporate boards in corporate decision making. If our proposals bring about such beneficial effects, however, and I hope they do, it will occur because of a heightened sensitivity to corporate governance and corporate accountability issues and action by the business community on its own initiative or in response to public pressure or shareholder actions, and not because of Commission-mandated changes.

This is not an inappropriate use of the Commission's authority. From the inception of the federal securities laws, it has been recognized that disclosure can have an upgrading effect on conduct and can serve indirectly to deter undesirable behavior. This in part was the basis for incorporating the disclosure principle into the securities acts.

Having responded in a general way to criticism of our initiatives, I would like to turn now to the rule proposals in this area which we issued last July and discuss the comments we received on them and some revisions which the Commission might make prior to their possible adoption. You should be aware that I cannot tell you what the final Commission disposition of these proposals will be. Those decisions have not yet been made. I understand that the staff recommendations on these proposed rules will be sent to the Commission today and we expect to consider them formally sometime in mid-November. Although I have not seen the final staff recommendations, I have discussed these proposals and my remarks today with the staff and believe that my positions are consistent with what the staff is proposing.

In order to assist shareholders in distinguishing between outside directors who are completely unaffiliated with the registrant's management and those who are members of management or have certain business or professional relationships with the registrant corporation or its management, the Commission's July release proposed that publicly held corporations identify each nominee and each director as either a "management director," an "affiliated non-management director," or an "independent director" as those terms are defined in the release.

The use of the term "independent" when combined with the discussion in the release expressing views about the importance of a board of directors capable of exercising independent judgment and the desirability of certain standing committees, normally being composed entirely of persons independent of management, led many to the conclusion that the Commission was making a value judgment that a director meeting the Commission's definition of independence is not only preferable to a "management" director or an "affiliated non-management" director but is the only type of director capable of exercising the judgment which is required to function as an effective director. One commentator concluded that, "the underlying premise of the Commission's proposals, although unstated, is that any director having other types of association with a directorship company has a conflict of interest that is so likely to cloud his judgment on any issue . . . that he should be automatically excluded from the key councils of the company." The effect of the perjorative connotation of not being an "independent" director was that the proposal was perceived as being intended to force corporations to have only "independent" directors on the board.

Somewhat typical of the rationale in opposition to the proposal was the response submitted by the American Society of Corporate Secretaries that,

> Although an individual director may have a relationship with a corporation which would fall within one of the proposed categories other than "independent director," he or she may in fact have the independency of judgment and other attributes which make him or her truly "independent" and highly valuable to the board on which he or she sits and to the interests of the corporation and its shareholders. Furthermore, the proposed definitions denigrate through omission all other meaningful attributes of directors, such as intelligence, integrity, judgment and knowledge. Finally, disclosure by categorization on any basis tends to improperly limit the focus of shareholders when considering directors' qualifications to only one issue to the exclusion of other relevant matters.

I do not believe any of us at the Commission are under the misapprehension that titles determine actions. We are all well aware that board members who may have some affiliation with management may, in fact, act more independently than some who do not. We also know that some expertise in the operations of a business is necessary in order to ask meaningful questions and to fulfill an oversight role with respect to corporate activities. On the other hand, however, we all know that affiliations often can and do result in less objectivity, less searching inquiry, and greater willingness to go along with decisions that one might otherwise be inclined to question.

It is true that the Commission's proposal focused on the question of non-affiliation with corporate management without giving equal weight to other important qualifications. In seeking to minimize reporting burdens and yet provide a means through which investors could be made aware of possible conflicts of interest, we proposed that directors be categorized by using a set of objective criteria when the values with respect to which the Commission is seeking disclosure are the product of very complex human and institutional relationships that cannot be accurately measured or presented in such a simplistic fashion. As is usually the case, I believe the comment process has shown that our rulemaking proposals can be improved. Surely we can accomplish our purposes of providing disclosure to assist investors to evaluate corporate directors without an unintended inference that only those who have absolutely no business relationships with the corporation or affiliation with management can exercise disinterested oversight or independent judgment. We could do this by eliminating the labels altogether and requiring detailed disclosure of all relationships, although this might result in rather lengthy disclosure in some cases. Another solution would be to retain the labeling concept but replace the "independent" label with a term which does not convey the implication that those who do not fit within this category cannot in fact be independent of management. Directors could be categorized, for example, into "management," "related non-management," and "unrelated non-management." In the event such classifications are retained, I believe that on the basis of comments received it would be appropriate to narrow the breadth of the "related management director" definition to exclude persons whose relationship is not with corporate executive officers or is of such a nature as to present minimal conflicts with the interests of corporate shareholders and that such persons should be included in the "unrelated non-management" category.

Another of the proposals that was criticized as being too rigid and categorical relates to disclosure concerning committees of the board of directors. The Commission stated its belief that the development of effective committee systems can assist boards of directors to fulfill their management oversight responsibilities and that disclosure of the nonexistence or existence and functioning of these committees can be important to investors. We proposed that corporations be required to disclose whether or not there is a standing audit committee, compensation committee, or nominating committee of the board, and identify by director category the composition of these committees. A note to the item indicates that a statement that the issuer has any of the named committees connotes that its committees perform certain functions believed to be customarily performed by such committees. These functions are set forth in the note. If the corporation has a committee which does not perform the enumerated "customary functions," it would be required to identify those functions which its committee does not perform.

There was general agreement in the responses that some disclosures regarding committees and their functions would be desirable but that the enumerated criteria with respect to committee functions were unnecessarily arbitrary and restrictive. It was also evident from the comments that there is not a consensus with respect to the functions which committees should perform and that the Commission's proposed approach could discourage both experimentation and the evoluation of committee responsibilities. Commentators were concerned that a committee's failure to perform a defined customary function would be perceived as evidence that the committee was not fulfilling its responsibilities and could potentially affect committee members' liability. The American Express Company submission stated a widely shared view that,

> Requiring disclosure of the "customary" functions of a committee does not perform would be of limited usefulness to shareholders in evaluating a committee's performance and cumbersome for the company. The very nature of the information requested forces a company to take a defensive stance in order to counter the unwarranted negative impression created by the enumeration of "non-functions." Consequently a company will be obligated to fill a proxy statement with detailed, self-serving expositions justifying its committee's functions.

I can assure you that in supporting this proposal for comment it was not my intention, nor do I believe it was the intention of the Commission, to establish a rigid model for all committee operations. It was thought that the negative disclosure approach would be easier and less burdensome for reporting companies while still providing important information to investors. The comments lead me to conclude that corporations would prefer to disclose the functions that their committees actually perform. Since this would also provide more explicit information to investors, I believe the Commission should amend our proposal to require such affirmative disclosure.

A third modification which I expect in the proposals before final Commission approval is related to the proposed requirement that the corporation disclose the total number of meetings of the Board since the date of the last annual meeting and identify each incumbent director who since that date has attended fewer than 75 percent of the meetings of the board or fewer than 75 percent of the combined total of meetings held by all committees of the board on which he sits. While the commentators were fairly evenly split as to the usefulness of information on the frequency of meetings, most respondents indicated that the attendance reporting requirement was undesirable because directors may provide the board with valuable expertise without actually attending meetings. I believe that, generally speaking, the frequency of meetings and attendance are important indicators of proper board and committee functioning and are relevant criteria for evaluating the performance of directors. I do, however, agree with the suggestion of the Society and others that in light of the increasing emphasis on board committee activity, disclosure should only be required of those directors who attended fewer than 75 percent of the combined number of board and committee meetings.

The July release also included a proposal which would require a registrant to forward to a shareholder proponent any management statement in opposition to the proponent's proposal ten days prior to the filing of preliminary proxy material with the Commission. This proposal is intended to provide the shareholder with the opportunity to bring materially inaccurate statements to the attention of management and the Commission's staff. The amendment was proposed in part in response to Sisters of the Precious Blood v. Bristol-Myers where the court held in effect that there is no judicial remedy under Section 14(a) of the Exchange Act for materially inaccurate statements made by management in connection with shareholder proposals that request, rather than require that management take certain actions. Moreover, it only seems fair to permit the shareholders to review management's opposing statement and comment on any material inaccuracies.

Commentators generally feared that this new step in the shareholder proposal process would be burdensome and time consuming and would cause additional difficulties in complying with already tight deadlines. For example, it was noted that although advice may be received from the staff 20 days before the filing date, the advice is often that management may exclude the proposal unless the proponent amends the text. It was argued that in such a case it would not be possible to prepare a response to the shareholder submission and submit that response to the shareholder 10 days before filing the materials to the Commission. The concern was also expressed that because proponents will describe deficiencies in the management reply to the staff of the Commission, the staff will be drawn into disputes over social and political issues. It appears to me that the concerns expressed can be taken care of with minor changes in the present proposal.

With regard to the timing problem, I think it is necessary to revise the rule to provide a tighter timetable in those cases where the Commission staff indicates that the proposal need only be included if it is revised. I certainly agree that it is important to assure that the corporation is not delayed in filing its proxy material because of proponent delay in amending the proposal.

I understand from the staff that they do not expect any serious problems in handling proponents' comments. They do not expect to become involved in disputes as to the merits of the proposals submitted because proponents' comments are intended to be limited to identifying statements or omissions which might make the management statements false or misleading and not to addressing the merits of the proposals. Perhaps the rule should be revised to make this clear. Accordingly, a shareholder proponent's comment will be handled the same way as any other staff comment on proxy soliciting material. The proponent's comment will be discussed with the registrant and, generally speaking, a mutually satisfactory resolution will be achieved. If this proposal is adopted, I invite you to report back to the Commission or its staff as to how it operates in the upcoming season and what problems you perceive. If it does not work we can, of course, revisit it.

While I have not commented specifically on the proposals relating to director resignations, institutional voting, and disclosure of settlement of election contests, I would be pleased to try to answer any questions you might have concerning the possible disposition of these proposals during the discussion period which I understand will follow my remarks. As was indicated in our July release, this first set of proposals have been designated as having a high priority. It is our hope to have those of the proposals which the Commission determines to adopt in effect before next year's proxy season. To do this it will be necessary for the Commission to take action in the next week or two which would mean that whatever rules are adopted should be publicly available by the end of this month.

Next spring the Commission intends to publish a staff report addressing a broad range of corporate governance issues including such matters as shareholder remedies, directors' responsibilities and the respective roles of the private sector, the Commission, the self-regulatory organizations, and the Congress with respect to the corporate accountability issue. Following that report the Commission will consider what further action, if any, is appropriate in this area. This could include additional rule making or exploration of the possible need to recommend or support legislation relating to corporate governance. At the earliest, any additional rule making would not be effective before the 1980 proxy season.

With respect to possible legislation, you may know that following hearings last year, Senator Howard Metzenbaum of Ohio organized an advisory committee including representatives of business to formulate legislative proposals dealing with corporate governance. I understand that he will probably introduce legislation early in the next Congressional session. If hearings are held, no doubt the Society and the Commission will be among those who will be called upon to testify. The type of legislation that will eventually be enacted, if any, will no doubt be determined largely by whether Congress believes appropriate accountability and corporate governance will occur in the absence of federal standards.