

NEWS

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

(202) 755-4846



REMARKS TO
AMERICAN STOCK EXCHANGE-WHARTON SCHOOL
CONFERENCE ON MID-RANGE COMPANIES
WASHINGTON, D. C.
JUNE 5, 1979

"CORPORATE GOVERNANCE ISSUES
AND SMALL BUSINESS"

BY: ROBERTA S. KARMEL, COMMISSIONER*
SECURITIES AND EXCHANGE COMMISSION

1.

SINCE I BECAME A COMMISSIONER OF THE SECURITIES AND EXCHANGE COMMISSION, THE SEC AND THE BUSINESS COMMUNITY HAVE BEEN ENGAGED IN TWO IMPORTANT DIALOGUES. ONE IS ON THE SUBJECT OF CORPORATE GOVERNANCE. THE OTHER IS ON THE SUBJECT OF SMALL BUSINESS. SIGNIFICANTLY, DURING MY FIRST YEAR IN OFFICE, THE COMMISSION CONDUCTED SEPARATE NATION-WIDE PUBLIC HEARINGS ON EACH OF THESE TOPICS.

SUCH DIALOGUES OFTEN ARE THE IMPETUS FOR CHANGE IN THE BUSINESS WORLD, NOT ONLY BECAUSE THEY MAY FORM THE BASIS FOR SEC RULEMAKING, BUT ALSO BECAUSE THEY MAY INITIATE VOLUNTARY ACTION BY THE BUSINESS COMMUNITY. THE RELATIONSHIP BETWEEN BUSINESS AND GOVERNMENT IN OUR COUNTRY IS BOTH ADVERSARIAL AND COOPERATIVE. MY PERSONAL VIEW IS THAT LESS HOSTILITY AND MORE COOPERATION BETWEEN BUSINESS AND GOVERNMENT IS NECESSARY FOR U.S. BUSINESS TO COMPETE EFFECTIVELY IN WORLD WIDE MARKETS.

IN THIS CONTEXT, I WILL SUGGEST THAT SOME OF THE DIALOGUE BETWEEN THE SEC AND THE BUSINESS COMMUNITY CONCERNING CORPORATE GOVERNANCE HAS NOT BEEN AS CONSTRUCTIVE AS IT MIGHT BE, PARTICULARLY WITH RESPECT TO THE APPLICABILITY OF CERTAIN CONCEPTS TO SMALLER PUBLIC COMPANIES.

I BELIEVE THIS IS BECAUSE PARTICIPANTS IN THE PUBLIC DISCUSSION ABOUT THESE MATTERS HAVE FOCUSED TOO MUCH ON QUANTITATIVE AND MECHANICAL QUESTIONS, SUCH AS DEFINITIONS AND NUMBERS OF INDEPENDENT DIRECTORS, NAMES AND NUMBERS OF COMMITTEES OF DIRECTORS, AND THE MECHANISMS FOR IMPOSING RESTRICTIONS ON BOARD STRUCTURE AND COMPOSITION. WE HAVE NOT DEVOTED ENOUGH TIME AND ATTENTION TO DISCUSSING THE OBJECTIVES OF OUR CORPORATE GOVERNANCE EFFORTS, AND THE BEST WAYS FOR EFFECTING QUALITATIVE IMPROVEMENTS ON CORPORATE BOARDS. FURTHER, WE HAVE NOT FOCUSED ON THE DIFFERENCES AMONG BUSINESS CORPORATIONS, NOR ON THE SPECIAL PROBLEMS OF SMALLER COMPANIES.

THE SEC'S PRESENT CHAIRMAN, HAROLD M. WILLIAMS, SET FORTH THE OBJECTIVES OF IMPROVEMENTS IN BOARD STRUCTURE, AS FOLLOWS:

THE BOARD AND MANAGEMENT MUST BE SENSITIVE TO THE BURDEN ... TO DEMONSTRATE THAT THE EXERCISE OF CORPORATE POWER BOTH IS AND APPEARS TO BE ACCOUNTABLE TO SOME ORGAN WITH A BROADER PERSPECTIVE THAN EITHER SHAREHOLDERS OR MANAGEMENT ... BOTH MANAGEMENT AND DIRECTORS ALSO SHARE ANOTHER CLOSELY RELATED GOAL - - TO DEVELOP A BOARD WHICH CAN BRING THE BEST, MOST INFORMED, AND MOST OBJECTIVE ADVICE AVAILABLE TO BEAR IN SOLVING THE COMPLEX PROBLEMS WHICH CONFRONT THE ENTITY. 1/

1/ "CORPORATE ACCOUNTABILITY--ONE YEAR LATER," ADDRESS TO SIXTH ANNUAL SECURITIES REGULATION INSTITUTE, SAN DIEGO, CALIFORNIA, JANUARY 18, 1979, PP. 30-31.

THE SEC HAS NO DIRECT OR SPECIFIC MANDATE TO STRUCTURE OR ALTER THE STRUCTURE OF CORPORATE BOARDS. PERSONALLY, I HAVE NEVER SERVED AS A DIRECTOR OR OFFICER OF ANY PUBLIC CORPORATION, AND I AM NOT SANGUINE ABOUT MY ABILITY OR EXPERTISE AS A GOVERNMENT OFFICIAL TO GENERALLY REGULATE CORPORATE BEHAVIOR. NEVERTHELESS, THE SEC IS RESPONSIBLE FOR INCREASING CORPORATE ACCOUNTABILITY TO INVESTORS AND STOCKHOLDERS THROUGH COMPLIANCE WITH THE FEDERAL SECURITIES LAWS. AND AS RECENTLY POINTED OUT BY THE U.S. SUPREME COURT, THE SECURITIES LAWS DO NOT NARROWLY FOCUS ON INVESTOR PROTECTION TO THE EXCLUSION OF CERTAIN MACRO-ECONOMIC CONCERNS. 2/

IT SEEMS TO ME THAT THE PRIMARY OBJECTIVES OF THE SEC'S CORPORATE ACCOUNTABILITY PROGRAM SHOULD BE: (1) THE PREVENTION AND SUPPRESSION OF FRAUD BY PUBLIC ISSUERS UPON STOCKHOLDERS AND INVESTORS; (2) THE IMPROVEMENT OF SHAREHOLDER COMMUNICATIONS, GENERALLY AND PARTICULARLY IN THE CORPORATE ELECTORAL PROCESS; AND (3) THE ACHIEVEMENT OF SYSTEMS OF INTERNAL ACCOUNTING CONTROL. FURTHER, WE SHOULD KEEP IN MIND THAT THE PURPOSE OF THESE EFFORTS IS

2/ UNITED STATES V. NAFTALIN, SUP. CT. NO. 78-561
(MAY 21, 1979).

TO ENHANCE THE PERFORMANCE OF PUBLIC COMPANIES SO AS TO CREATE A CLIMATE OF INVESTOR CONFIDENCE HOSPITABLE TO CAPITAL FORMATION. WHILE THERE MAY BE OTHER VERY WORTHWHILE OBJECTIVES OF BOTH CORPORATE GOVERNANCE AND GOVERNMENT REGULATION, I DO NOT BELIEVE IT IS APPROPRIATE TO USE THE SECURITIES LAWS AS INSTRUMENTS TO ACHIEVE GENERAL ECONOMIC OR SOCIAL REFORM.

AN INCREASING NUMBER OF COMMENTATORS ARE CONCLUDING THAT GOVERNMENT REGULATION OF BUSINESS SHOULD PROCEED BY DISCLOSURE RATHER THAN STANDARD SETTING. THE SEC IS FORTUNATE IN THAT DISCLOSURE HAS BEEN THE PREDOMINANT REGULATORY MECHANISM GIVEN TO US BY CONGRESS. INDEED, THE COMMISSION'S PRESENT PROGRAMS FOR BOTH CORPORATE ACCOUNTABILITY AND SMALL BUSINESS ORIGINATE FROM THE 1977 REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SEC.

THIS COMMITTEE RECOMMENDED THAT THE COMMISSION DEVELOP A PACKAGE OF DISCLOSURE REQUIREMENTS TO STRENGTHEN THE ABILITY OF BOARDS OF DIRECTORS TO OPERATE AS INDEPENDENT, EFFECTIVE MONITORS OF MANAGEMENT PERFORMANCE AND TO PROVIDE INVESTORS WITH A REASONABLE UNDERSTANDING OF THE ORGANIZATION AND ROLE OF THE BOARD. THE ADVISORY COMMITTEE ALSO SUGGESTED A RE-EVALUATION OF THE IMPACT OF SEC DISCLOSURE PROVISIONS ON THE GROWTH AND DEVELOPMENT OF SMALL BUSINESS.

IN DECEMBER 1978 THE SEC ADOPTED AMENDMENTS TO ITS PROXY RULES WHICH REQUIRE MORE COMPREHENSIVE DISCLOSURES THAN PREVIOUSLY ABOUT THE COMPOSITION AND STRUCTURE OF BOARDS OF DIRECTORS. THESE AMENDMENTS REQUIRE ISSUERS TO DISCLOSE CERTAIN BUSINESS OR PERSONAL RELATIONSHIPS WHICH A DIRECTOR OR NOMINEE HAS TO A CORPORATION OR ITS MANAGEMENT. THEY ALSO REQUIRE THE CORPORATION TO DISCLOSE WHETHER IT HAS STANDING AUDIT, NOMINATING AND COMPENSATION COMMITTEES, AND TO IDENTIFY THE MEMBERS OF SUCH COMMITTEES. CERTAIN NEW INFORMATION ABOUT DIRECTOR ATTENDANCE AND RESIGNATIONS IS ALSO REQUIRED.

ORIGINALLY, THE COMMISSION HAD PROPOSED RULES WHICH WOULD HAVE REQUIRED GREATER DISCLOSURE ABOUT THE FUNCTIONS OF BOARD COMMITTEES. IN REJECTING SUCH PROPOSALS, THE COMMISSION SHOWED A SENSITIVITY TO THE NEEDS OF SMALLER COMPANIES, AND THE COMMENTATORS WHO FELT THAT "A DEFINITION OF FUNCTIONS CUSTOMARILY PERFORMED BY AUDIT, NOMINATING AND COMPENSATION COMMITTEES WOULD NOT ALLOW FOR NEEDED FLEXIBILITY."

ANOTHER RECENT CORPORATE ACCOUNTABILITY REGULATION OF THE COMMISSION IS THE REVISED DISCLOSURE REQUIREMENTS ABOUT MANAGEMENT REMUNERATION ADOPTED IN DECEMBER, 1978.

IN THIS AREA, THE COMMISSION HAS ALSO SHOWN A SENSITIVITY TO THE NEEDS OF SMALLER COMPANIES. THE FORM S-18, A SIMPLIFIED REGISTRATION FORM FOR SMALLER COMPANIES WAS ADOPTED BY THE COMMISSION IN APRIL OF THIS YEAR. AMONG OTHER THINGS, THE S-18 SIGNIFICANTLY RELAXES FOR USERS OF THE FORM THE MANAGEMENT REMUNERATION DISCLOSURE NOW OTHERWISE REQUIRED.

BEFORE PROCEEDING TO FURTHER POSSIBLE RULEMAKING RELATING TO CORPORATE GOVERNANCE, THE COMMISSION HAS DIRECTED THE STAFF TO ENGAGE IN TWO IMPORTANT PROJECTS. ONE IS A PROGRAM FOR MONITORING THE OPERATION AND EFFECTS OF THE COMMISSION'S NEW CORPORATE ACCOUNTABILITY RULES. THE OTHER IS THE PREPARATION OF A REPORT ON THE COMMISSION'S CORPORATE GOVERNANCE HEARINGS.

THE STAFF IS COLLECTING AND COLLATING DATA FROM PROXY STATEMENTS FILED THIS YEAR RESPECTING THE PREVALENCE OF THE DIRECTOR RELATIONSHIPS REQUIRED TO BE DISCLOSED UNDER THE SEC'S NEW RULES, THE EXISTENCE, COMPOSITION AND FUNCTIONS PERFORMED BY KEY STANDING COMMITTEES AND OTHER RELATED INFORMATION. THE STATISTICAL STUDY WILL INCLUDE ANALYSES FOR DIFFERENT CATEGORIES OF COMPANIES CLASSIFIED ACCORDING TO VARIOUS RELEVANT CRITERIA. THESE WILL INCLUDE TRADING MARKET CENTER AND SIZE OF ASSETS.

MUCH OF THIS INFORMATION IS NOT NOW READILY AVAILABLE. IT IS OBVIOUSLY RELEVANT TO AN EVALUATION OF THE OPERATION OF THE SEC'S NEW RULES AND OUR CONSIDERATION OF ANY FURTHER RULEMAKING INITIATIVES. FOR EXAMPLE, A CHICAGO-AREA STUDY IN MAY AND JUNE 1978 BY ARTHUR YOUNG & COMPANY SHOWED THAT THE SIZE OF OTC AND AMEX COMPANIES WITH AUDIT COMMITTEES VARIES WIDELY. THE SMALLEST, IN THAT STUDY, HAD SALES OR OPERATING INCOME IN 1976 OF \$10 MILLION, WHILE THE LARGEST HAD SALES OF \$908 MILLION. OUT OF 53 COMPANIES IN THE STUDY WHICH HAD SALES OR OPERATING INCOME OF \$40 MILLION OR LESS, 19 HAD AUDIT COMMITTEES AND 34 DID NOT. OF THE 48 CHICAGO-AREA AMEX COMPANIES SURVEYED, 30 HAD AUDIT COMMITTEES AND 18 DID NOT.

THE COMMISSION HAS REPEATEDLY ENDORSED THE FORMATION OF AUDIT COMMITTEES AS A CORPORATE ACCOUNTABILITY MECHANISM. IN ORDER TO ACHIEVE FURTHER PROGRESS IN THIS REGARD, I THINK WE NEED THE KIND OF STATISTICAL INFORMATION SET FORTH IN THE ARTHUR YOUNG & COMPANY STUDY, PARTICULARLY FOR MID-RANGE COMPANIES, ON A MORE CURRENT AND A NATION-WIDE BASIS. FURTHER, WE NEED TO UNDERSTAND SOME OF THE REASONS WHY THOSE COMPANIES WHICH DO NOT HAVE AUDIT COMMITTEES HAVE CHOSEN NOT TO FORM THEM, AND IF COST IS AN IMPORTANT CONSIDERATION.

THE MONITORING PROGRAM WHICH THE STAFF IS CONDUCTING WILL GENERATE STATISTICAL INFORMATION ABOUT AUDIT AND OTHER COMMITTEE SYSTEMS, AS WELL AS DIRECTOR RELATIONSHIPS. I HOPE THAT THE COMMISSION WILL THEN BE ABLE TO PUBLISH THIS DATA, WHICH SHOULD CONTRIBUTE TO THE DIALOGUE BETWEEN THE COMMISSION AND THE BUSINESS COMMUNITY ON CORPORATE GOVERNANCE. RETURNING TO AN EARLIER STATEMENT, HOWEVER, I WOULD NOT WANT US TO BECOME BOGGED DOWN IN ARGUMENTS ABOUT STATISTICS AND MECHANICS. OUR OBJECTIVES ARE QUALITATIVE.

AUDIT COMMITTEES, FOR EXAMPLE, HAVE BECOME INCREASINGLY IMPORTANT BECAUSE OF THE ENACTMENT OF THE INTERNAL CONTROL PROVISIONS OF THE FOREIGN CORRUPT PRACTICES ACT OF 1977. HOWEVER, THE EXISTENCE OF AN AUDIT COMMITTEE DOES NOT INSURE ADEQUATE OR EFFECTIVE INTERNAL ACCOUNTING CONTROL OF AN ISSUER. AND I AM SURE THAT SOME COMPANIES WHICH DO NOT HAVE AN AUDIT COMMITTEE NEVERTHELESS HAVE AN ADEQUATE SYSTEM.

THE STAFF REPORT ON THE SEC'S CORPORATE GOVERNANCE HEARINGS WILL COVER A NUMBER OF TOPICS. I AM INFORMED BY THE STAFF THAT THE REPORT WILL DISCUSS THE DESIRABILITY OF BOARD COMMITTEE SYSTEMS, THE ROLE OF THE SELF-REGULATORY ORGANIZATIONS IN PROMOTING CORPORATE ACCOUNTABILITY, THE LIABILITY OF THE SHAREHOLDER PROPOSAL RULES AND SHAREHOLDER PARTICIPATION IN THE CORPORATE ELECTORAL PROCESS. FURTHER, THE STAFF INTENDS TO FOCUS ON THE ROLE OF INSTITUTIONAL INVESTORS.

THERE IS A DIFFICULT BALANCE THAT NEEDS TO BE STRUCK BETWEEN THE NEED TO PROMOTE CORPORATE ACCOUNTABILITY THROUGH SUCH MEANS AS SEC DISCLOSURE REQUIREMENTS, AND THE NEED TO ASSURE THAT APPLICABLE DISCLOSURE REQUIREMENTS ARE NOT UNNECESSARILY OR UNREASONABLY BURDENSOME SO AS TO IMPEDE CAPITAL FORMATION. IT SEEMS TO ME THAT THE COMMISSION IS MORE LIKELY TO STRIKE THE RIGHT BALANCE IF IT KEEPS IN MIND THE PLURALITY AND DIVERSITY OF AMERICAN BUSINESS.

BECAUSE I BELIEVE THAT THE DIFFERENCES BETWEEN BUSINESS ENTITIES IS ONE OF THE STRENGTHS OF OUR MIXED ECONOMY, LAST YEAR I OPPOSED THE LABELLING OF DIRECTORS BY WAY OF SEC DISCLOSURE REGULATIONS. INDEED, I AM SOMEONE WHO GENERALLY OPPOSES LABELLING AS NOT VERY INDICATIVE OF A PERSON'S VIEWS OR ABILITIES AND THEREFORE, I WAS SOMEWHAT BEMUSED WHEN THE CIRCULAR ADVERTISING THIS CONFERENCE BILLED ME AS THE COMMISSION'S MOST "CONSERVATIVE" MEMBER. I KNOW THAT THIS LABEL ORIGINATED IN A NEWSPAPER ARTICLE AND NOT THIS CONFERENCE'S PUBLICITY DEPARTMENT. HOWEVER, I BELIEVE THE LABEL IS MISLEADING AS APPLIED TO ME. I WOULD LIKE TO TAKE THIS OPPORTUNITY TO CORRECT THE RECORD, IF YOU WILL INDULGE ME BY USING THIS IDEA AS MY CONCLUSION. CALLING ME A "CONSERVATIVE" WOULD APPEAR TO PASS JUDGMENT ON MY OPINIONS BASED ON THE REACTIONS TO THEM OF THE BUSINESS COMMUNITY AND THE FEDERAL BUREAUCRACY RATHER THAN COMING TO TERMS WITH THE VERY VITAL ISSUE OF REGULATORY REFORM WHICH I CONSTANTLY STRESS.

THE APPROACH OF THE SEC TO REGULATION NEEDS AS MUCH CRITICAL SCRUTINY AND REFORM AS THE APPROACH OF THE CAB OR THE ICC. WE SHOULD APPROACH NEW IDEAS FOR FURTHER GOVERNMENT REGULATION, CONCERNING CORPORATE GOVERNANCE OR ANY OTHER SUBJECT, WITH MORE CAUTION THAN WE HAVE APPROACHED LAWMAKING IN THE PAST. AND SUCH REFORM SHOULD NOT BECOME A MONOPOLY OF "LIBERALS" OR "CONSERVATIVES." IT IS ESSENTIAL TO THE GENERAL WELFARE.

WHEN WE LOOK AT THE QUESTION OF HOW THE SEC'S CORPORATE GOVERNANCE INITIATIVES SHOULD BE APPLIED TO SMALLER PUBLIC COMPANIES, WE SEE SOME OF THE CONTRADICTIONARY POLICIES WHICH EFFECTIVE ECONOMIC REGULATION MUST RECONCILE. AS A LIFETIME "LIBERAL," I BELIEVE THAT THE VISION OF A BETTER SOCIETY FOR ALL AMERICANS, THROUGH GOVERNMENT INTERVENTION IN THE ECONOMY, WILL NOT BE ACHIEVED BY PUNITIVE STANDARD SETTING REGULATION WHICH FAILS TO ENCOURAGE MAXIMUM INNOVATION BY THE PRIVATE SECTOR.