REMARKS OF JAMES R. DOTY*
GENERAL COUNSEL, SECURITIES AND EXCHANGE COMMISSION

BEFORE THE ANNUAL MEETING
OF THE UNITED SHAREHOLDERS ASSOCIATION

Washington, D.C.
September 17, 1990

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Good morning, ladies and gentlemen. I appreciate the opportunity to appear before you this morning, with the distinguished speakers you have assembled, to discuss the role of shareholders in the 1990s.

Before beginning, however, I wish to emphasize that my remarks today are my own and do not necessarily reflect the views of the Securities and Exchange Commission or those of any member of the Commission or of its staff. A further disclaimer must also be made from the start. My view of this issue of the role of shareholders in the '90s is necessarily that of a simple, corporate securities lawyer, one who has for the past six months been in the service of the Commission.

Chairman Richard C. Breeden has described our equity markets as the "crown jewel" of the U.S. financial markets. 1/ If that analogy is apt -- and I believe it is -- then the Commission is chartered under the federal securities laws as the steward of that jewel. My remarks this morning are in some respects a brief accounting of certain, recent actions of the Commission in discharging that stewardship. In that regard, I want to focus on

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1/ It should surprise no one that our equities markets are the envy of the world. Of the 25 largest equities markets in the world, 11 are U.S. markets. The U.S. markets, aggregated, are as large as all the European markets and all the Asian markets put together.

certain arenas of controversy -- each of particular concern to your association -- where the Commission is playing a crucial and indeed, to my mind, courageous stewardship role. These arenas involve the protection of shareholders in continuing to enjoy rights and benefits that many believed could be taken for granted, chief among these being the shareholders' franchise and an honest trading market.

A brief yarn will illustrate my point. In a certain Eastern bloc country, a citizen consumer is buying a car. After establishing the base price, he then discovers a long list of "optional extras" -- things taken for granted here, such as windshield wipers and headlamps. Finally, he asks when he can pick-up the car. The answer: "December 15, 1995." The customer: "Morning or afternoon?" The answer: "Afternoon." The customer: "Oh, good! I've got the plumber coming in the morning!"

What is the story about? Not just the inefficiencies of state-planned economies. It also tells us a lot about how people can learn to live with something that is unsuitable, unworkable, even outrageous. Our society is now debating at the highest levels the decisions that will affect us for decades. It is incumbent upon us all to keep our perspective and our good will. But make no mistake about it, at stake in our debates over corporate governance and market regulation are decisions that will have a lot to do with whether our equity markets remain a crown jewel and the envy of the world.

1. <u>The Commission's Watch Over the Proxy Process</u>

My first theme, as you might expect, concerns the Commission's continuing watch over the proxy solicitation and voting process. The staff and the Commission have over the years demonstrated continuing concern for the efficacy of the proxy rules in furthering Congress' goal of ensuring a fair corporate suffrage. Both through its disclosure rules, and by procedural protections necessary to meaningful exercise of the franchise, the Commission has sought to assure shareholders an effective role in the corporations which they own.

Chairman Breeden has recently announced a re-examination of the proxy solicitation and voting process in light of the dramatic changes in institutional equity holdings and activities. This review is part of an ongoing evaluation of the proxy rules' efficacy in furthering fair corporate suffrage. Among the subjects that the staff and the Commission will consider are the issues that have been raised by you and others. Your own association's formal petition for rulemaking raises a range of issues, including (i) confidential voting and independent tabulation, (ii) expanding shareholder access to the proxy process, (iii) deregulation of certain intershareholder communications, and (iv) required shareholder votes on "greenmail," "golden parachutes" and "poison pills," among others. As such, it calls for "comprehensive revision to the federal proxy rules."

Now, I particularly urge that you not take any of my remarks as a comment on the merits of the proposals or the scope of any rule changes which might be proposed as a result of the staff's examination and report to the Commission. I do note that the proxy rules seem a bit like a highway system -- always under construction and never entirely satisfactory.

On the other hand, let me suggest that although various of your proposals and those of others are by any reasonable construction procedural, others of them, to use the words of the U.S. Court of Appeals for the D.C. Circuit in the Business Roundtable opinion "may lie in the murky area between substance and procedure." 2/ What does this mean, and what does it imply for revision of the proxy rules and for the role of shareholders in the '90s?

As you know, the Court agreed with the Business Roundtable that the Commission had exceeded its statutory authority in adopting Rule 19c-4 3/ -- the "one-share/one-vote rule". (That rule was intended to promote fair corporate suffrage by generally prohibiting securities exchanges and the NASD from listing equity securities of companies that restricted or disparately reduced the per share voting rights of their shareholders.) Now this rule was not altogether new: until 1986 a rule addressing

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2/ Business Roundtable v. SEC, No. 88-16151 (D.C. Cir., June 12, 1990), vacating the Commission's Rule 19c-4.

3/ 17 C.F.R. 240.19c-4 (1990).

disparate voting rights was on the books of, and enforced by, the New York and American Stock Exchanges.

While acknowledging that disclosure is not the sole subject of Section 14 of the Exchange Act, indeed acknowledging a Congressional purpose in the Exchange Act to ensure fair corporate suffrage, the Court nevertheless suggested that the primary means available to the Commission for fulfillment of that purpose were so limited as to leave Rule 19c-4 without statutory support. The Commission had stepped "beyond control of voting procedure and into the distribution of voting power." As such, "the SEC's assertion of authority directly invades the 'firmly established' state jurisdiction over corporate governance and shareholder voting rights."

To state that Rule 19c-4 "invaded" firmly established state jurisdiction, is, I respectfully suggest, to "paper over" the problem which the opinion serves up. Rule 19c-4 did not allocate voting power or prohibit states from permitting alternative corporate structures; it prohibited the listing of certain types of equity securities on the national securities exchanges and on NASDAQ.

The Commission would not I think consider -- and the <u>Business Roundtable</u> opinion will not support a conclusion -- that the limits of the Commission's rulemaking power may be expressed by a pat denomination of "procedural" and "substantive" rules. Nor should anyone plan to dance on the grave of other rules based on the assumption that whatever may be deemed a "corporate governance" matter is left to the states.

Exchange Act Section 19(c) provides that: "The Commission, by rule, may * * * add to * * * the rules of a self-regulatory organization * * * as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization * * * or otherwise in furtherance of the purposes of this title." 4/ This is broad language. Where, one asks, does the Court find the limitations on Commission authority?

Unwilling to "read out" of the purposes of the Exchange Act the protection of the fairness of corporate suffrage, the Court expressed itself in terms of the means whereby the Commission achieves that purpose. But under the broad sweep of Exchange Act Section 19(b), the regulated exchanges have long proposed and adopted rules, many of which, the Court acknowledges, "dealt with matters of internal corporate governance." As the case of these exchange-proposed rules demonstrates, the permitted scope of the Commission's rules cannot be limited to those which are not deemed in some conclusory fashion to "invade" or affect the substantive areas of internal corporate governance.

In short, the Business Roundtable decision, although important, does not provide the road map by which future Courts

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4/ Securities Exchange Act of 1934 ("Exchange Act") section 19(c).

will decide the scope of Commission rulemaking authority in its regulation of the proxy process.

Moreover, it would appear that one-share/one-vote -- or, more accurately, protection against corporate disenfranchisement -- may survive the Business Roundtable decision. Legislation has been introduced in the Senate, 5/ and in the House, Energy and Commerce Committee Chairman Dingell has said he is considering introducing such legislation. The NASD has proposed its own rule that would institute a corporate disenfranchisement rule for the more active over-the-counter stocks listed on NASDAQ. The Commission has published that rule proposal for comment, and has granted temporary accelerated approval to the proposed rule change for a 90-day period. 6/ The New York Stock Exchange had, before the court's decision, adopted voting standards based on Rule 19c-4. 7/ I am hopeful that the NYSE will maintain its rule.

2. Arbitration Provisions in Corporate Charters

Another legal issue for those concerned with the role of shareholders in the '90s -- and one which could affect the ability of shareholders to hold management accountable -- relates

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5/ S. 1794, "A bill to amend the Securities Exchange Act of 1934 with respect to mergers and corporate tender offers, and for other purposes," was introduced by Senator Specter on October 25, 1989.

6/ See SEC Rel. Nos. 34-28276, 34-28277 (July 27, 1990).

7/ See SEC Rel. No. 34-27554 (Dec. 20, 1989), approving new NYSE Listed Company Manual § 313.00(A).

to the inclusion of mandatory arbitration covenants in corporate charters. This involves a recent attempt by a Pennsylvania corporation to include a provision in its corporate documents that generally would have required all present or former shareholders to submit their claims against the corporation or its management to arbitration under the Federal Arbitration Act.

The arbitration provision would have applied to both direct and derivative claims, whether against the corporation, in the corporation's name, or otherwise, relating to acts or omissions by the corporation or its officers, directors, or other related persons. The provision also would have applied to any claim brought by the corporation against any present or former shareholder.

The existence of the arbitration provision came to the Commission's attention when the company filed a registration statement for its initial public offering. The Commission staff notified counsel for the issuer that if a request to accelerate the effectiveness of the registration statement was filed, the staff would decline to exercise delegated authority to grant acceleration. The issuer then deleted the arbitration provision from its corporate governance documents in order to move forward with its offering.

As a general matter, such an arbitration provision in a company's charter and bylaws is troubling, measured by the standard of what is in the best interests of the shareholders. Arbitration of complex legal and factual disputes frequently may not allow plaintiffs the same scope of discovery, the same injunctive relief, the same opportunity for class action, or the same opportunity to litigate in a convenient forum, as will actions filed in a district court. Arbitration decisions are subject to only narrow judicial review and arbitrators generally do not write full opinions. Moreover, the investing public has benefited from the development of judicial precedent under the federal securities laws. Arbitration proceedings would not necessarily contribute to this jurisprudence.

I also suspect that an arbitration provision in a corporate charter may be unenforceable. First, the anti-waiver provisions in Section 14 of the Securities Act and Section 29(a) of the Securities Exchange Act make void any requirement that a person "waive compliance" with the Securities Act or the Exchange Act. Some have argued that the Supreme Court's McMahon 8/ and Rodriguez 9/ decisions permit such arbitration provisions -- a conclusion based, I believe, upon a misinterpretation of those decisions.

Finally, there is a serious question whether a corporate charter provision can create a binding contractual waiver of access to a court. A charter provision is not properly analogous to the agreement between a customer and a broker. A court should

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8/ Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, reh'g denied, 483 U.S. 1056 (1987).

9/ Rodriguez v. Shearson/American Express, Inc., 109 S.Ct. 1917 (1989).

not be quick to hold an unwitting shareholder to a corporate charter provision requiring the shareholder to waive such an important right as redress to a judicial forum.

3. Intermarket Regulation

The third matter that I wish to discuss is intermarket regulation. As Chairman Breeden has frequently stated, our dual regulatory system for stocks, options, and stock index futures adversely affects our issuers and their shareholders in ways that are unique to this country. Dual regulation of our markets is a matter for shareholder concern.

This morning, I want to focus on one, major problem associated with this system of fragmented regulatory responsibility (and I shall try to avoid covering familiar ground).

In all of the discussions over the need for consolidated regulation of the equity and equity derivative markets, relatively less attention has been paid to our inability to see "both sides" (of the equity and the derivative markets) in a manipulative trading pattern and the effect that has on the Commission's oversight of equity markets. And yet no issue in this debate has greater potential impact on the confidence of public investors in these markets. One such problem is "frontrunning" -- a practice that can be only partially checked in the equity markets under the bifurcated system. It is a further example of the necessity of a long-overdue transition to the consolidated regulation of securities equity and derivative markets. To delay that process in the name of "competition" among regulators only delays the establishment of a system of regulation now enjoyed in other countries, which a single agency combining both sides of this market could bring.

In some quarters, questions have been raised about what the SEC has done to prevent "frontrunning" abuses. In fact, eleven years ago, the SEC required the national securities exchanges to adopt policies prohibiting frontrunning. Since then, all of the major securities self-regulatory organizations have maintained such policies, updating them when necessary to deal with new products or expanded markets. In 1985, for example, the securities SROs extended the frontrunning prohibitions to encompass options on OTC stocks and index options. More recently, they have moved to extend the prohibition to frontrunning in stock index futures.

I want to stress that this effort has involved more than just rule-writing. Under the Commission's auspices, the securities SROs created the Intermarket Surveillance Group, or "ISG," in 1981, specifically to address intermarket trading abuses such as frontrunning. Since the creation of the ISG, surveillance and investigatory techniques have been fine-tuned, and the securities exchanges have prosecuted two dozen frontrunning cases -- five in 1990 alone.

It is unfortunate that the current fragmentation of jurisdiction stands as an obstacle to more complete intermarket enforcement of the anti-fraud rules.

4. Conclusion

To conclude, the topic which you have aired today is broad and timely. As we embark upon the new decade, we can, I think, at least cast off some shibboleths and address new questions. The notion, for example, that the "Wall Street Walk" is an adequate remedy for a shareholder that is disenchanted with management is now seen as part of the problem. How do we create a productive partnership between management and public shareholders? That is, I believe, a question worth pursuing. What we must avoid is a legal structure that resolves the tension in this relationship by simply severing the means whereby shareholders can assert some control over management. The preeminence of our equity markets is at risk if our laws and our legal structure appear to insulate management from the consequences of their own actions and to nullify the accountability of management to shareholders.

I hope that I have suggested a few areas in which the Commission staff, by considering the long-range implications of its rulemaking, and in its review and enforcement activities, is continuing to contribute to the process whereby these major issues are addressed.