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Washington, D. C. 20549
(202) 755-4846

S.E.C.'S CONCERN WITH CORPORATE GOVERNANCE

BY
PHILIP A. LOOMIS, JR.
COMMISSIONER
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C.

FINANCIAL EXECUTIVES INSTITUTE
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I propose to talk today about the S.E.C.'s concern with corporate governance because I think there have been some misconceptions about that and some suggestions that we are exceeding our jurisdiction or even meddling in something which is none of our business.

I want to assure you that I am not going to talk about corporate governance as such. That is a very large issue involving such questions as whether there is a problem relating to corporate governance, and if so, what that problem is and what should be done about it, and by whom. A great deal has been said about this matter in the last few years, much of it very interesting and valuable. All I want to say about it now is that there is a live and genuine issue which is being studied and discussed by businessmen and business organizations such as the Business Roundtable, the Conference Board and others, by professional organizations such as the American Institute of Certified Public Accountants and organs of the American Bar Association, and by academics and scholars as well as public interest groups. Committees of the Congress, such as Senator Metzenbaum's Subcommittee on Stockholder's Rights and Responsibilities, have interested themselves, some bills

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were introduced and others almost certainly will be. The basic question seems to involve corporate accountability. There is a perception, whether you agree with it or not, that corporate management has very considerable power but, as a practical matter limited accountability. Shareholders are scattered and unorganized, state corporation laws are permissive, and consequently a question arises as to how accountability can be established or improved.

Where does the S.E.C. come in on all this? We are very interested and I hardly think we could avoid being interested. We have several areas of responsibility which either are affected by, or relate quite directly to, issues of corporate governance. There are three principal areas of this kind. In the first place we are responsible for the system of reporting by publicly-owned corporations to their shareholders and to the investing public. This entails a responsibility to do what we can to assure that such reports are accurate, adequate and not misleading. We must rely primarily upon the companies themselves to accomplish this since only the company, and perhaps its auditors, can know what all the facts are and, therefore, whether they are properly reported. There are some 10,000 reporting companies and obviously we cannot investigate the disclosures of more than a small fraction of them. The integrity of this reporting system therefore depends in large measure on the integrity of the process by which the reports are prepared.

The problems we have had with what were referred to as improper or questionable payments in foreign countries vividly illustrate this aspect of the matter. The companies involved in these activities did not report them in the ordinary course of operations, on the contrary they were usually concealed both from the auditors and from the board of directors itself. Something went wrong here in accountability and in the system of internal control which is an aspect of governance, and, as a result the reports filed with us were neither accurate nor adequate.

Another area of our responsibility which relates directly to corporate governance is the area of proxy regulation. The Commission is given very broad authority with respect to the solicitation of proxies. Section 14(a) of the Securities Exchange Act of 1934 simply says that w it shall be unlawful for any person to solicit any proxy or authorization with respect to the securities of a reporting company

> ". . . in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. . . ."

While the Commission has implemented this provision primarily by establishing disclosure requirements, the statutory provision is by no means limited to disclosure

nor have we so limited it. We have, for example, provided Marquis of Queensberry Rules for proxy fights and procedures for the submission of stockholders proposals.

Proxy solicitation is an essential element of the process of corporate governance in publicly-owned corporations. It is this process by which members of the board of directors are chosen. The legislative history of Section 14(a) indicates that the section was intended to provide for "fair corporate suffrage." Thus, there are a good many things which we could do under the proxy provisions which would impact upon corporate governance, and I will refer to some of them later on.

There is a third area which may not look as if it has much to do with corporate governance but which has become relevant to it. This is the area of accounting and auditing. The Securities Act of 1933 requires that registration statements under that Act include financial statements certified by "an independent public or certified accountant." The Securities Exchange Act of 1934 authorizes a similar requirement for statements and reports thereunder. You will note that the statutes require an "independent" accountant. The Commission has always regarded independence as a basic requirement for auditors. It is probably the main reason why an outside auditor is brought in at all, rather than simply relying on the company's accounting

staff, and the public looks to the independent auditor to authenticate the company's financial statements. Since what the auditor audits is the financial statements produced by management, he must be independent of management.

Independence is a state of mind but it can be influenced by the environment in which the auditor operates. As early as 1940 the Commission recommended the establishment of an audit committee composed of non-management directors as a means of strengthening the independence of auditors. If this committee has a responsibility for the selection of the auditor, and if the auditor reports to it, and can refer disagreements with management to it, then the environment supports auditor independence. But the creation of such an audit committee is an aspect of corporate governance and thus I suppose the Commission's 1940 recommendation, which has been repeated and emphasized over the years, is the first example of our intervention in a question of corporate governance. This also indicates that our concern with aspects of corporate governance is not a new development, attributable to the foreign payments problem.

I have tried to point out certain fairly specific ways in which issues of corporate governance and corporate structure have an impact on matters for which we have a statutory responsibility. More broadly a specified objective to which many if not most of our activities are

directed is the protection of investors. Obviously the interests and the protection of investors, particularly stockholders, are involved and affected by the resolution of issues of corporate governance and management accountability. Thus we have to be and we are involved. I propose now to briefly outline some of the things we are doing in this area. Before getting down to particular proposals, I would venture two general observations.

In the first place I think that our concern with corporate governance and corporate accountability is a legitimate one. Large business corporations are an absolutely essential element in our economy and our society. Like other institutions, emphatically including government, they are far from perfect, and must change with the times. Although the stockholders are legally the owners of the business, they do not in fact exercise control over large corporations, nor, in most cases, do they even want to; they think of themselves as investors. Control gravitates to management. This in large measure is necessary in the interest of the efficient performance of the corporation's functions and purposes. But, in a free society, those who exercise power must be accountable to someone.

Legally, management is accountable to the board of directors. Often, however, management has dominated the board. Much of the concern, therefore, is to devise means of strengthening the position of the board.

Secondly I hope, and am inclined to believe, that corporations can make the necessary changes themselves without any major expansion of government control and regulation. I have been involved in the business of regulation for a good many years. It is often necessary, as I think securities regulation is, but it is expensive, often cumbersome, and sometimes misdirected. There has probably been too much reliance on regulation in recent years, and we should try to avoid more of it. If, however, what the society perceives to be a significant problem is not otherwise effectively dealt with, then more regulation is likely to result.

Returning from these philosophical generalities to the matter at hand, the Commission in April, 1977, announced a broad re-examination of its rules relating to shareholder communications, shareholder participation in the corporate electoral process and corporate governance generally. We deliberately made this examination wide ranging in order to obtain as much information and guidance as we could concerning a complex matter involving numerous inter-related issues. Because of the nature and importance of the subject, we not only solicited public comments

but held public hearings commencing in Washington on September 29, 1977 and continuing for five weeks with sessions being held in Los Angeles, New York and Chicago. More than three hundred persons and organizations including corporations, business associations, government officials, public interest and religious groups, law firms, bar associations, financial analysts, academics, accountants, and individuals submitted written comments or testified during the proceedings.

A great variety of views were expressed but there was something of a consensus that a strengthened board of directors, capable of exercising independent judgment, was a key factor in improving corporate governance.

The Commission determined to proceed with the matter in stages. The first stage was to formulate and propose amendments to the proxy rules which would be primarily designed to provide additional disclosure with respect to the composition and functioning of the board of directors, including the existence and functions of three important types of committees, an audit committee, a nominating committee and a compensation committee. Such rule proposals were proposed for public comment on July 18, 1978. These proposals received an enormous public response, almost 600 persons and organizations submitted comments. This is one of the largest responses we have ever received in connection with a rule proposal.

The most controversial element related to the composition of the board. As you know, most large corporations now have what are called "outside" or "independent" directors. Such directors are not officers or employees of the company but beyond that these terms are not defined and such directors may have a great variety of connections or relationships with the company or its management.

The proposals sought to bring this fact clearly to the attention of shareholders by classifying the non-management directors on the basis of the presence of certain relationships which might affect independence. Most of the commentators objected strongly. They thought that these classifications or labels drew invidious distinctions, reflected value judgments by the Commission, or went beyond disclosure and sought to improperly influence corporate structure or board composition. This was not our intention, we merely sought to provide meaningful disclosure in a simplified and understandable way. The Commission, which had proposed this approach with some misgivings, determined at its meeting on November 15, 1978, that since its objectives had been so widely misunderstood, it would drop the labels and rely on expanded disclosure under the existing requirements with respect to affiliations and transactions of directors. The proposed rules, as revised in this and some other respects, were adopted to be effective December 25, 1978.

The next stage in our consideration of corporate governance issues will be the publication of a comprehensive staff report on some of the more complicated questions which have been raised. After that report has been published and people have been given time to react to it, we will consider what further steps are called for.

This then is the position in which the Commission is now with respect to its concern for corporate governance. I have tried to explain why I believe we have a legitimate interest in this matter and how we got to where we are. I recognize that the issues presented extend considerably beyond the scope of the Commission's statutory responsibilities and, as I said earlier, I would hope that many of these questions will be resolved by the corporate community rather than by government action. We will continue to be concerned, and I suspect that Commissioners will continue to exercise their right of free speech, but I believe that as a Commission, we have been careful not to exceed the boundaries of our jurisdiction and that we will continue to respect those limitations. Many individuals and organizations are involved in this issue of corporate governance and are in a position to make a contribution towards improvement in this area. I hope that we will all be able to work together towards that end.