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CORPORATE ACCOUNTABILITY: A PARTICIPATORY PROCESS

ADDRESS

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and the Corporate Secretary"
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I am pleased to be with you this evening as a participant in this conference on corporate governance issues and the corporate secretary. In the best American tradition, this conference is providing the opportunity to hear from critics as well as defenders of our corporate system in a continuation of the dialogue that started with the development of the corporation as an economic institution in the last part of the the eighteenth century.

To remain viable, the corporate system must be perceived by the general public as a mechanism which produces goods and services in accord with other social goals. There are those, of course, who believe that the system itself is faulty and that a different economic structure should be established. Most critics, however, support the system and offer constructive criticism in order to preserve and strengthen it. Most defenders also recognize that important improvements can and should be made. Virtually everyone agrees that corporate management must be accountable for its stewardship. There are strong differences of opinion, however, as to whom and for what, corporate officials should be held accountable and how that accountability can best be maintained.

In the concluding chapter of their study entitled, The Modern Corporation and Private Property, published in 1932, Professors Berle and Means stated that: "By tradition, a corporation belongs to its shareholders, or, in a wider sense, to its security holders, and theirs is the only interest to be recognized as the object of corporate activity." Certainly, a primary objective of corporate activity is to serve the interests of shareholders but in doing that, other interests must also be recognized.

The end purpose of all economic systems is to provide a means by which limited resources of land, labor, and capital can be used efficiently to produce and allocate desired goods and services. In our private enterprise system the goal is to maximize the quality of economic life primarily through single proprietorships, partnerships, and corporations. The corporate form of business has important advantages. It provides limited liability for its owners, and is able to attract large amounts of capital, provide employment for a large number of workers, and obtain highly qualified management. These essential factors of production can be attracted, however, only if their participation brings satisfactory rewards. If investors do not receive a satisfactory net return for the funds they provide, they will not continue to invest and there will be insufficient capital to maintain and improve corporate productive capacity and competitiveness. But this is only one factor. Employees must also receive what they believe to be adequate compensation for their labor or they will seek alternative employment. The

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same is true of corporate management. There is an interdependence among these groups. None can achieve its goals without the vital contribution of the others. Yet, at the same time each desires to maximize the benefits it receives. Within reasonable bounds, these self-interests are the driving force behind successful corporate activity. But if they get too unbalanced, that is, if one group receives an inordinate share of the corporate stream of income, all participants will eventually suffer.

Corporate activity also has an impact on the interests of others in addition to shareholders, employees and management. Customers, for example, must receive quality products at competitive prices or they will shift to other alternatives and the economic benefits to be shared by shareholders, employees and management will decline or cease altogether. Moreover, corporate activity can have positive and negative effects on the local community and the general public. During the past half century, and particularly in recent years, increasing demands have been made on corporations to give greater consideration to the interests of various groups such as consumers, suppliers, the local community, and the general public in addition to the interests of corporate management, employees, and those who own corporate securities. In some way all of these interests must be taken into consideration. Professors Berle and Means concluded that, "It is conceivable, --indeed it seems almost essential if the corporate system is to survive,--that the 'control' of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each, a portion of the income stream on the basis of public policy rather than private cupidity."

Actually, in a free market system based on self-interest and competition, the shares going to various groups cannot be determined so simply. I do not believe that the control group of corporations can be expected to be a neutral technocracy, nor is it necessarily in a position to determine public policy with respect to the claims of various groups on the corporate income stream. Corporate management and the board of directors by law have fiduciary responsibilities to shareholders. Thus, I suppose, we would all agree that they should not be permitted to use their positions to act contrary to the interests of shareholders or to use corporate assets without being accountable to shareholders for their actions.

I believe there would also be a consensus that management, shareholders and employees, who are the immediate participants in corporate activity, should not have the ability to obtain greater benefits by transferring to others in society some of the costs of production such as a lack of safety standards or proper disposal or elimination of pollutants. Yet can the management of a company which is in competition with others be expected voluntarily to determine to expend corporate

funds for processes or facilities or standards of production that do not enhance the quality or quantity of the firm's output or its competitive position unless other firms are held to the same requirements? To some extent, socially responsible business attitudes and practices can have a beneficial effect on corporate operations and income, but the interests of corporate executives, employees, and investors are not necessarily always consistent with those of other interest groups or of the general public.

Because of this diversity of interests, in our system it has been decided that government, which should represent a consensus of the population, has a responsibility to maintain an environment in which corporations can function to provide necessary or desired goods and services, and at the same time assure that this is done in a manner consistent with other social policy goals. There are a number of ways by which this corporate accountability can be promoted by government. Direct standard-setting by law is one way to establish standards of conduct required by public health and safety needs, and there are many examples of such legal standards. Certain powers to establish regulatory requirements, however, can best be delegated to government agencies in order that requirements may be adjusted to changing needs. The danger, of course, is that in trying to assure that everyone's interests are being taken care of, there tends to be a proliferation of regulatory agencies and their requirements represent an important cost burden on economic activity. I, along with many other citizens, seriously question whether the degree of regulation that now exists requiring corporations to be accountable to many agencies for many things is actually necessary in the public interest.

The Securities and Exchange Commission is involved in the corporate accountability process because of the responsibility given to us to protect investors and the public from fraudulent and unfair practices in our securities markets. I believe our approach to regulation, which depends heavily on disclosure and industry self-regulation, provides the maximum opportunity for private organizations and the public generally to help determine corporate activities, thus reducing the degree to which direct government regulation is necessary.

Accountability to shareholders and the public is enhanced by requiring corporations to disclose their activities and financial condition. In addition to requiring disclosure of corporate operations and financial condition, Congress also intended for the Commission to protect the rights of investors to have a voice in corporate decision making. The legislative history of Section 14 of the Securities Exchange Act of 1934 ("Exchange Act"), which empowers the Commission to regulate solicitation of the proxies of the owners of securities registered under the Exchange Act, indicates that Congress expected the Commission's rules to achieve "fair corporate suffrage" by assuring adequate disclosure of information and by preventing misuse of corporate proxies by insiders. Because most shareholders do

not attend annual meetings, or have direct contact with corporate officers or directors except by means of written communications, the proxy solicitation process is the cornerstone of effective shareholder participation in corporate affairs.

In April of 1977, following the collapse of several large publicly owned corporations and the disclosure that hundreds of companies had made questionable or illegal payments which in many instances were not adequately recorded in corporate books and records nor known to the affected company's board of directors, the Commission initiated a broad reexamination of its proxy rules. In announcing this action, the Commission acknowledged the widely held perception that existing proxy rules did not provide shareholders with adequate opportunities to participate meaningfuly in the corporate electoral process --the primary means by which corporate directors who oversee management as fiduciaries for shareholders are held to account for their stewardship.

Our analysis of the comments received in hearings held across the country during the fall of 1977, along with other information, supported the conclusion that a strong board of directors, independent of management, is one of the most reliable mechanisms for strengthening the corporate accountability process. Accordingly, during 1978, the Commission adopted changes in the proxy rules to require disclosure of information concerning the affiliations of individual directors and their performance. In 1979, in order to complement the 1978 disclosure initiatives, shareholders were afforded the opportunity to express their views on individual candidates for directors by means of a revised proxy card format. It is still too early to tell, but the Commission is anxious to see whether there is a measurable increase in the quantity or quality of shareholder participation as a result of this rulemaking program.

The lengthy Staff Report on Corporate Accountability, which was released in September, is an indication that the Commission will continue to monitor the efficacy of our past efforts and consider the desirability of new methods to enhance the accountability process. The staff report concludes that companies have made a number of positive changes in the structure, composition and operation of boards of directors. That conclusion is supported by other studies and surveys. The most recent I have seen is a survey of 1300 of the largest corporations in the country by the executive-search consulting firm, Heidrick & Struggles. According to this survey, in August of this year, outside directors constituted a majority on the boards of 87.6 percent of the responding companies as compared with 64.4 percent in 1971. In addition, in an article published earlier this month, John E. Lohnes, of Korn/Ferry International concludes that, "Present trends in director selection . . . seem certain to bring about . . . boards which are clear meritocracies, pluralistic in their make up, impersonal in their selection and the way they function."

On the other hand, our staff found that "the private sector has ignored, for the most part, the possibility of enhanced shareholder participation" in the selection of directors. Under state laws, shareholders have the right to select directors and under federal law, the Commission has the authority to require that shareholder nominations be included in proxy statements. As early as 1942, the Commission's staff proposed amendments to the proxy rules to require the inclusion of shareholder nominations in corporate proxy materials. For various reasons, the proposal was not adopted then, and there is still a serious question whether such a rule would provide sufficient benefits to warrant the expense of implementing it.

A possible alternative approach is an independent nominating committee which would provide an objective means to foster the selection of directors independent of management, to evaluate the performance of the board generally, and to consider recommendations made by shareholders. However, information contained in a sample of 1200 proxy statements, which was representative of all companies filing proxy information with the Commission in 1979, showed that only 29 percent of the companies had nominating committees, and most of these had very limited or perfunctory responsibilities. Our staff is studying 1980 proxy statement disclosures to determine the prevelance of independent nominating committees which, at least, consider shareholder nominations. If the information available does not indicate a substantial increase, the staff has stated that it will request Commission authorization to develop a rule requiring companies to adopt a procedure for considering shareholder nominations. It seems to me that as a matter of good investor relations, companies would want to encourage, and indeed some are encouraging, responsible shareholders to submit recommendations to a nominating committee.

The Commission is aware that there are a number of problems in trying to encourage shareholder participation. One of these, which I am sure is troublesome to corporate secretaries, is the increasing practice of holding stock in street or nominee name. This trend is basically desirable since it facilitates more efficient and less costly stock transfer, but it also complicates the relationship between the issuer and the true beneficial owner of the stock. Under Commission rules, issuers must target proxy soliciting materials toward the beneficial owners of stock held in street name. On the other hand, under state law the stockholder of record possesses the rights of ownership, and transfer agents are expected to record only information about the holder of record. Thus, a circuituous system for communicating with beneficial owners has developed. All shareholder communications from the issuer reach beneficial owners only through the assistance of the holder of record who must also execute proxies that beneficial owners direct to the issuer.

It is understandable that many issuers are concerned because they cannot identify their beneficial owners and directly

communicate with them. Occasionally, the obstacles to direct communication delay necessary corporate action because of the inability to obtain a quorum. This communications process is not satisfactory to all shareholders either, because, in some instances, they receive proxy materials too late and do not receive other informal communications at all.

There have been, and continue to be, efforts in the private sector to deal with shareholder communication problems, and naturally the Commission supports those efforts. In addition, however, our staff concludes in the Corporate Accountability Report that the time is ripe for a thorough re-thinking of the process by which issuers communicate with beneficial owners of their stock. To begin this process, steps are currently being taken at the Commission to establish a Shareholder Communications Advisory Committee, composed of representatives of all affected parties, for the purpose of designing a system allowing issuers to identify their beneficial owners and to explore the possibilities of a uniform system for distributing proxy material and other corporate communications to all shareholders. I expect that corporate secretaries will be represented, directly or indirectly, on the Committee because of their responsibilities to supervise communications with shareholders and their familiarity with the process and the technical requirements of any viable alternative to present approaches.

The Commission is also very much aware that opportunities for increased shareholder participation can be abused. Disruptive behavior at an annual meeting, attempted misuse of the shareholder proposal process, the potential for irresponsible shareholder nominations and other possible abuses must be fully considered when attempting to fashion policy concerning corporate democracy. Of course, shareholder participation in corporate governance should not foster inefficiencies or unnecessarily disrupt management of the corporation. But we should not allow occasional abuses or potential transgressions to deter us from seeking the benefits of enhanced accountability. If shareholder participation is a desirable goal, we must strive to develop methods to attain that objective while minimizing abuse.

We also recognize that the Commission's determinations regarding disclosure to shareholders can have effects that are far reaching and may extend beyond the confines of financial decision-making. It is incumbent upon the Commission, to assess these effects in relation to the nature of our mandated responsibility to protect investors. Indeed, the Commission struggled with such an assessment in the middle 70's as we considered the issue of illegal and questionable corporate payments.

Some argued at that time that the Commission was embarking on a moral crusade against business practices it believed to be wrong and that the disclosure rationale was

simply subterfuge. Others, including myself, believed that this was and is a proper area for the exercise of Commission authority because the existence of the unrecorded or improperly recorded use of corporate assets, the demonstrated ignorance of the board of directors in many instances regarding the use of company assets, and the non-disclosure to shareholders and the public of the activities and the potential contingent liabilities represented direct evasions of accountability mechanisms established by law.

Another example of the Commission's disclosure authority interfacing with broader social concerns arose in the context of the National Environmental Policy Act. That Act augments unrelated enabling statutes by requiring governmental agencies to conduct their activities, including decision-making, in a way that takes into account the promotion of environmental protection. Thus, the Commission has been compelled to consider the extent to which environmental information should be a part of a company's disclosure obligation.

The Supreme Court's decision in First National Bank v. Bellotti may force us further into the uncomfortable position of having to assess whether to require disclosure which may have a major impact beyond the realm of investment decision-making. In its 1978 decision, the Court ruled that a Massachusetts statute prohibiting corporate contributions for the purpose of influencing the outcome of a public referendum was unconstitutional. The Court held that corporations have first amendment rights, including the right to express their political views. Subsequently, the Supreme Court, in Consolidated Edison v. Public Service Commission (1980), found that the First Amendment gives state regulated private utilities, and presumably other types of corporations, the right to include a statement of their views on nuclear power or other public policy issues in customer billings.

It is important to note that the majority opinion in Bellotti was based, at least in part, on certain assumptions about shareholder participation in the corporate governance process. The Court stated that "ultimately shareholders may decide, through the procedures of corporate democracy, whether their corporations should engage in debate on public issues." In view of the Court's assumptions in Bellotti, and the concomitant increase in corporate political activities, existing proxy rule provisions may not be adequate to deal with the concerns of shareholders who seek to hold their companies accountable for the expenditure of corporate funds for political purposes, such as support of political action committees, contributions to referendum campaigns, and advocacy advertising.

At present very little is known about these kinds of corporate activities. The regulations of the Federal Election Commission do not require disclosure of the amount expended by corporations to organize and administer political action

committees. Corporate contributions to referendum campaigns can be made directly from the corporate treasury, and there is no readily available means for shareholders to discover the nature or extent of such spending. Detailed information about advocacy advertising also is not available.

In a related development, the Institute of Public Representation, affiliated with the Georgetown University's Law Center, filed a private rulemaking petition requesting the Commission to require in annual reports to shareholders "disclosure relating to corporate political contribution funds, otherwise, known as political action committees" ("PAC's"). The Petition notes that there are nearly 1,000 corporate PAC's and that spending by these organizations has increased four-fold since 1975. The petition requests disclosure of a broad range of information about corporate support for political action committees. For example, it requests disclosure of the extent of the board's involvement with the company's PAC, the criteria used to determine which candidates and committees will receive contributions from the PAC, the categories of persons (i.e., shareholders, executives, administrative personnel) solicited, and the amount attributable to the costs of soliciting contributions and administering the PAC.

When the Commission approved publication of the Staff Report on Corporate Accountability, I expressed special interest and concern about this issue, as did other members of the Commission. Therefore, I believe that in the near future we will direct the staff to prepare a concept release on this subject in order to begin the process of carefully considering the most appropriate reaction to the issues raised by the Bellotti decision. I hope that each of you will urge the companies you represent to participate in this process.

Corporations exist because they are an efficient institutional mechanism to provide desired goods and services. As with any business in a private enterprise system, profit to the owners is of prime importance and corporate management must be accountable to shareholders. In striving to maximize profits, however, management must comply with the law and also consider the impact of its activities on other participants in the system because in many instances, particularly in the long run, interests of shareholders and others coincide. To the extent they do not, government is the arbiter of what is in the public interest. I believe that corporate accountability can be maintained best without unduly burdening business initiatives and flexibility by the operation of investor, employee, and consumer decisions within a framework established by government to assure that each of these groups has access to information about the financial condition and activities of corporations and the ability to respond meaningfully to that information.

The Commission is responsible to assure that the interests of shareholders are protected. We try to do this by

requiring disclosure of corporate activities and financial condition and opportunities for shareholder participation in corporate governance. We do not know whether shareholders will take advantage of the new opportunities the Commission and corporations are providing. Obviously, we encourage shareholders to use these opportunities responsibly. However, if they do not exhibit an inclination to become more involved in the corporate accountability process, I, do not expect the Commission to be anxious to expand further the avenues for meaningful participation. In my opinion, this would be unfortunate, because I believe it is in the public interest for corporate democracy rather than government regulation to play a greater role in corporate decision-making.