MEMORANDUM ON FEDERAL CORPORATE GOVERNANCE LEGISLATION

Since the only definitive legislation before Senator Metzenbaum's Special Advisory Committee was set forth in the draft bill entitled "Protection of Shareholder Rights Act of 1979", the following remarks are directed primarily to its provisions. We want to make it clear, however, that for the following reasons we are opposed to any type of federal corporate governance legislation that would prescribe the structure of corporations or intrude into their internal affairs.

We do not believe that corporate governance legislation should be recommended to the Congress. This viewpoint is based upon our belief that the need for such legislation has not been established. Further, it is premature, in our opinion, to recommend such legislation to the Congress, and its enactment would be harmful and undesirable.

There Is No Need For The Proposed Legislation

We support the disclosure philosophy of the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), under which publicly-held corporations are required to disclose information deemed material to an enlightened investment judgment and fair corporate suffrage. We agree with the statement of Professor William L. Cary, former Chairman of the Securities and Exchange Commission ("SEC") that:

> "Disclosure restrains because of the sensitivity of public reaction, caution about response to the 'dissident shareholder' and the possibility of legal action. I firmly believe that disclosure does operate in this deterrent manner."[1]

With respect to disclosure in solicitations of the stockholders, the United States Supreme Court in J. I. Case Co. v. Borak stated:

> ". . . the purpose of Section 14(a) of the Exchange Act is to prevent management or others from obtaining authorization for corporate actions by means of deceptive or inadequate disclosure in proxy solicitations. The section stemmed from the Congressional belief that 'fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange.'"[2]

The federal securities laws and regulations have been undergoing continuous and rapid development in recent years, particularly in the disclosure area. The SEC published in the fall of 1978 regulations[3] requiring more disclosure about board nominees and executive remuneration. As part of its ongoing effort to examine issues of corporate governance and accountability, the SEC has announced that new disclosure regulations will be issued and that a staff report on corporate governance issues will be published before the end of the year.[4] In sum, we believe that the fundamental disclosure premise of the securities laws has provided, and will continue to provide, an effective and proper method of federal regulation of corporations.

It is our opinion that the hearings of the Senate Subcommittee on Citizens and Shareholders Rights and Remedies held on June 27 and 28, 1977, and its subsequent Report[5] simply do not establish any need to justify replacing the disclosure philosophy of the securities laws with prescriptive legislation. Such legislation would mandate for the first time how business corporations should be structured, and establish a federal fiduciary standard.

There was no substantial evidence at the Senate Subcommittee hearings of any groundswell of concern about the "plight" of shareholders who wish to participate in more corporate activities. To the contrary, Dean Ruder of the Northwestern University School of Law testified that:

> ". . . there does not appear to be a great demand for better voting rights stemming from either the smaller shareholders or the financial institutions which have accumulated larger holdings . . .".[6]

Professor Winter of the Yale Law School testified that the list of witnesses at the hearing demonstrated to him that there is no "hue and cry" on the part of shareholders for a federal intervention on their behalf.[7]

A. A. Sommer, Jr., former member of the SEC and the Chairman of the Special Advisory Subcommittee on Corporate Governance, testified as follows:

> "Things are now happening in the board room that I think are extremely important. I would hope that they will continue, and I would hope that Congress will monitor closely whether these tendencies continue. But I would also hope that Congress would not, as long as these tendencies are strong, see fit to intrude into the board room with regulations that necessarily would be cumbersome and inflexible."[8]

It is true, as noted in the Senate Subcommittee's Report, that a number of corporations committed acts which the corporations themselves admitted were questionable or unlawful. But these practices were submitted to public scrutiny through the disclosure process under existing law. Not only have the SEC and the Justice Department instituted civil and criminal actions against several corporations under federal statutes to prevent repetition of and to punish past acts of this nature, but shareholders of a number of corporations have successfully prosecuted derivative actions against errant managements for breaches of their fiduciary duties to the corporation and its shareholders. The corporations in question, as well as many others, have established internal procedures to prevent future questionable and illegal actions. Congress dealt with the specific issues of these practices by enacting the Foreign Corrupt Practices Act of 1977[9] ("FCPA") which further amended the Exchange Act. The FCPA also contains provisions for accounting controls, which have been described as the most significant extension of federal law

into the internal affairs of corporations since the passage of the Securities and the Exchange Acts.[10]

In addition to these Acts, corporations are subject to substantial controls imposed by a variety of federal and state laws designed to deal with specific social problems and establish standards for corporate conduct. These include legislation concerned with antitrust, equal employment, occupational health and safety, product safety, the environment, pension plans, and labor relations, among others. We submit that these measures dealing with specific problems are a more effective way of making corporations accountable than governance legislation. In this connection, we quote from a speech of SEC Chairman Williams:

> "The eventual painful lesson may be that it is one thing for the federal government to legislate on discrete socially impacting issues, such as safety standards; it is another for it to begin to deal directly with the process by which private economic activity is directed and controlled."[11]

In addition to those types of laws, there are constraints on corporate managers established by existing state corporation laws. At the hearings of the Senate Subcommittee, Dean Ruder also testified:

> "There are enormous restraints on corporate managers which are within the State laws. Indeed the subject of most of my teaching over the years has been to show the means by which a shareholder can force his management, using State law, to be accountable to the corporation and to himself.
>
> The presence of that restraint, which I regard as existing, makes turning to Federal legislation in this area [corporate governance] unnecessary."[12]

As to the fiduciary or duty of care standard proposed in the "Shareholder Rights" bill which Senator Metzenbaum submitted to the Special Advisory Committee, there has not been cited to us one state where the same or a substantially similar fiduciary standard does not

exist either in case or statutory law. There may be differences in the words of some of the statutes and in the cases from those stated in Senator Metzenbaum's "Shareholder Rights" bill, but we do not believe these variations provide a sufficient reason to have a federal fiduciary standard. We fully support the principle that fiduciary standards should apply to boards of directors and senior management, but we believe that a federal fiduciary standard is needless.

We think it significant that some members of the SEC do not support any prescriptive federal legislation in the governance area. Chairman Williams recently stated:

> "I personally do not look forward with any pleasure to the possibility of federal measures designed to bring in their wake a body of federal corporation law directed at the structure and governance of the corporation. In my judgment, the emphasis should be on fostering private accountability -- the process by which corporate managers are held responsible for the results of their stewardship -- rather than on devising ways of intervening in the mechanism of corporate governance in an effort to legislate a sort of federal 'corporate morality.'"[13]

Commissioner Karmel also has indicated that she does not favor federal legislative intervention. She said:

> "Nevertheless, my personal preference is for changes in such matters as corporate governance to be the product of cooperative interaction between the public and private sectors. . . . I do not believe we can solve the basic economic and social problems of our society through greater regulation of business."[14]

The Proposed Legislation Is Premature

There is much evidence that corporations have taken enormous strides in the area of corporate governance in the past few years, and we urge that these developments be allowed to continue on a voluntary basis. These emerging practices include placing more independent directors on boards; the establishment of audit, compensation, nominating, and public policy committees;[15] and the adoption of codes of ethics and policies with respect to conflict of interest. A former Chairman of the SEC said concerning these developments that the progress that corporations have voluntarily made since 1965 has been "awesome" and that there will be more in the future.[16]

There have been other significant developments in the field of corporate governance. One is the publication of the Corporate Directors' Guidebook by the Section on Corporation, Banking and Business Law of the American Bar Association. This Guidebook, among other things, urges directors to engage in continuing review of their responsibilities and conduct. It provides meaningful guidance and a useful reference point to the corporate director seeking to perform his role properly.[17] The American Society of Corporate Secretaries in 1978 recommended the Guidebook to all of its more than 1,700 member companies.

The 1978 publication of the Business Roundtable on "The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation" noted that there are abundant indications that procedures and operations for preventing some of the unfortunate developments of the past years have been improved and that board composition has been broadened. The Roundtable endorsed the tendency of business corporations to move toward a board structure based on a majority of outside directors.[18] In addition, the Roundtable's

statement said that it was highly desirable that the board be served by audit, compensation, and nominating committees composed of a majority of outside directors.

A new Federal Securities Code has been approved by the American Law Institute for submission to the Congress, and the ALI also has undertaken an in-depth study in the whole area of corporate governance and fiduciary standards. These important developments should not be ignored.

The Law Proposed Will Be Harmful And Undesirable

We believe that legislation related to the structure and internal affairs of corporations will inevitably be followed by additional regulations. This, in turn, will add to the burdens of those companies subject to the law and is contrary to the current philosophy that we should have less regulation, not more.

The proposed legislation could be harmful to the smaller of the 6,600 companies now subject to Section 12 of the Exchange Act. To require these concerns to restructure their boards to have a majority of outside directors and to establish committees as provided in the proposed law could result in substantial detriment to their principal activity of producing goods or services for a profit. At least there should be some evidence adduced to show what effect the proposed structural requirements would have on these companies and whether there would be any benefits to justify the additional burden of compliance. Moreover, the proposed or a similar law, if enacted, could be the forerunner of the enactment of even more onerous legislation, with the inevitable proliferation of new regulations.

In addition, we do not believe the proposed law is desirable because it would intrude upon an area traditionally and properly left to the states. The concentration of federal control of our nation's economic activity in Washington is viewed with alarm by all of us and the

proposed legislation represents an unattractive further extension of federal authority into an area that should be reserved to the states.

It is also our opinion that the feature of the Senator's bill that categorizes directors as "independent" or "management" directors is undesirable because these labels misrepresent a director's or a nominee's qualifications in a serious way. Such a provision could also impair the efforts to retain and recruit the best qualified persons to the board, with the resulting disservice to the shareholders and the company. The evaluation of the characteristics, qualities, and relationships of the directors should first be made by the board of directors, and all the relevant material information about the directors related to their business associations and principal activities should be disclosed to shareholders so they can make their own judgments as to their qualifications to serve.

* * *

In summary, we agree with SEC Chairman Williams that government does not have the requisite wisdom to be prescriptive and that the area of corporate governance does not lend itself to solution in this manner. Instead, as Chairman Williams said, the proper role of government is to help

> "create an environment which encourages corporate accountability and to stimulate the private sector to take advantage of the opportunity which that environment affords to maintain public trust."[19]

Since the proposed legislation is contrary to that philosophy, and for the other reasons set forth in this statement, we respectfully submit that it should not be recommended to the Congress.

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Irving S. Shapiro

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John D. deButts

April 27, 1979

FOOTNOTES

[1] Cary, "Corporate Standards and Legal Rules", 50 Calif. L. Rev. 408 (1962).

[2] 377 U.S. 426, 431 (1964).

[3] Securities Exchange Act Release Nos. 15380 (Dec. 4, 1978) and 15384 (Dec. 6, 1978).

[4] Securities Exchange Act Release No. 6040 (March 22, 1979).

[5] Report of the Committee on the Judiciary, United States Senate, Made by its Subcommittee on Citizens and Shareholders Rights and Remedies Pursuant to S. Res. 78 and 170, Senate Report No. 95-737, 95th Cong., 1st Sess. (1978).

The Report of the Subcommittee set forth the following alleged findings that apparently form the basis for the proposed legislation. Some of these are:

(1) The "plight of the individual shareholder. . . if he or she is interested in corporate activities".

(2) Management has become increasingly powerful and the individual shareholder's ability to influence management has become a "de facto" nullity.

(3) There have been "shocking revelations of corporate misconduct -- bribery, political slush funds, perquisites, etc."

(4) Restrictive court decisions have left the shareholder with no remedy at all, or with an inadequate remedy like appraisal.

(5) Stockholder proposals almost invariably lose, which shows that shareholder democracy is feeble.

(6) Some corporations hold their annual meetings in inconvenient places.

(7) Although there are some "signs of improvement, the corporate director has usually been either an insider, a friend of the officers, or simply indifferent, and they have not been protecting the individual shareholder".

[6] The Role of the Shareholder in the Corporate World: Hearings Before the Subcommittee on Citizens and Shareholders Rights and Remedies of the Committee on the Judiciary, United States Senate, 95th Cong., 1st Sess., 59 (June 27, 28, 1977) (hereinafter referred to as "Hearings").

[7] Hearings, p. 80.

[8] Hearings, p. 136.

Footnotes (Continued)

[9] Act of Dec. 19, 1977, Pub. L. No. 95-213, 91 Stat.

[10] A view shared by many other persons, including Alan Levenson, former Director of the Division of Corporation Finance, SEC. 451 SRLR, p. D-1 (5/3/78). We note that the FCPA represents a regrettable departure from the disclosure premise of the Securities Exchange Act of 1934.

[11] Speech by Chairman Harold M. Williams, Fifth Annual Securities Regulation Institute, San Diego, California, "Corporate Accountability" (January 18, 1978).

[12] Hearings, p. 55.

[13] Speech by Chairman Harold M. Williams, Fifth Annual Securities Regulation Institute, San Diego, California, "Corporate Accountability" (January 18, 1978).

[14] Speech by Commissioner Roberta S. Karmel, American Society of Corporate Secretaries, Chicago, Illinois, "Politics of Change in the Composition and Structure of Corporate Boards" (January 11, 1978).

[15] Recently, the American Society of Corporate Secretaries, in cooperation with the New York Stock Exchange, surveyed 1,750 companies represented in the ASCS membership regarding board structure and committee activities. Of the 993 responses tabulated, 97% of the companies have audit committees. This survey also disclosed that 30% have nominating committees, and an additional 33% are giving active consideration to establishing nominating committees. This study also revealed that 84% of the 993 responding companies have compensation committees, an increase of 22% from 1977.

[16] Financier, June 1978, p. 15.

[17] 33 Bus. Law. 1597 (1978).

[18] Business Roundtable Statement, "The Role and Composition of the Board of Directors of the Large Publicly Held Corporation" (1978), reprinted in 33 Bus. Law. 2083 (July, 1978).

[19] Speech by Chairman Harold M. Williams, Fifth Annual Securities Regulation Institute, San Diego, California, "Corporate Accountability" (January 18, 1978).