See 'Corporate Governance'

U.S. Securities and Exchange Commission
Office of Public Affairs

Briefing Paper: Staff Report on Corporate Accountability

This summary of the Report and recommendations being made by the staff of the Division of Corporation Finance has been prepared to help persons attending an open meeting scheduled for September 4, 1980, follow the discussion at the Commission table. It is neither exhaustive nor definitive, and users should be aware that changes in the matters under consideration may be made in response to comments by Members of the Commission.

During the 1970's, numerous events raised questions about the adequacy of existing corporate accountability mechanisms. Disclosures concerning the collapse of several major companies, the hundreds of corporations involved in questionable payments, and corporate non-compliance with environmental and other laws astonished the public, shareholders, and, in many cases, even the affected company's directors. In assessing what went wrong, individual inquiries inevitably focused primarily on the specific circumstances surrounding each event, yet every successive investigation or report added support to the view that the corporate accountability system as a whole needed strengthening.

Responding to these developments and others the Commission, in April, 1977, initiated a broad re-examination of its rules related to shareholder communications, shareholder participation in the corporate electoral process and corporate governance generally (the "corporate governance proceeding") 1/ and announced that it would hold hearings in the fall of 1977, in order to receive the views of interested members of the public with respect to these matters. As a result of the hearings 2/ and the preceding written comment period,

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1/ Securities Exchange Act Release No. 13482 (April 28, 1977).

2/ The hearings were held in Washington, D.C., New York City, Los Angeles and Chicago.

the staff of the Division of Corporation Finance ("the staff") received information from over three hundred individuals, shareholder organizations, corporations, academicians, self-regulatory organizations, law firms, bar organizations, public interest groups, financial institutions, religious organizations, accountants and government officials. The corporate governance hearings served as the starting point for the staff's analysis of the issues addressed in the Report. Where appropriate, the staff has supplemented the testimony and written comments with information in the files of the Commission, staff interviews with additional individuals and organizations, and further research.

The Commission decided to address the complex issues raised in the hearings in stages. The first stage resulted in several amendments to the proxy rules. Commentators in the hearings had expressed general support for the proposition that a strong board of directors, able to exercise independent judgment, is a critical element in corporate accountability. Based on its review of comments and testimony during the proceeding and its experience in administering and enforcing the federal securities laws, the Commission determined that shareholders needed additional information about the structure, composition and functioning of boards of directors. Accordingly, in 1978, the Commission proposed and adopted rules intended to provide such information to shareholders. 3/ The final rules require disclosure of (1) certain economic and personal relationships between

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3/ Securities Exchange Act Release No. 14970 (July 18, 1978) and Securities Exchange Act Release No. 15384 (December 6, 1978).

directors or director nominees and an issuer or its management; (2) the existence and functioning of audit, nominating and compensation committees; (3) attendance of directors at board and committee meetings; and (4) resignations of directors. 4/

In order to develop information about the structure, composition and functioning of issuers' boards of directors, the staff analyzed the new disclosures described above by examining a sample of proxy statements of approximately twelve hundred issuers. The resulting information provides an important basis for the Report's conclusions and recommendations concerning boards of directors.

The second rulemaking initiative responding to the issues raised in the hearings occurred in 1979, when the Commission proposed and adopted rules intended to provide greater opportunities for shareholders to exercise their rights of ownership and to obtain information and advice with respect to matters on which they vote. 5/ The final rules require, in part, that each shareholder be provided with a form of proxy which (1) indicates whether the proxy is solicited on behalf of the board of directors; (2) permits shareholders to vote on director nominees individually, and (3) gives shareholders a means to abstain on each matter to be voted

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4/ Securities Exchange Act Release No. 15384.

5/ Securities Exchange Act Release No. 16104 (August 13, 1979). Final Rules were announced in Securities Exchange Act Release No. 16356 (November 21, 1979).

on other than elections to office. The rules also require disclosure of election results in certain circumstances.

The next stage of the Commission's corporate governance proceeding is its consideration of the staff Report. In the Report, the staff has examined the extent to which corporate governance and accountability mechanisms protect the interests of shareholders. The staff uses the term "governance mechanisms" to mean the process by which the corporation reaches decisions and takes action. Typically, this process is internal to the corporation, involving, for example, election by shareholders of a board of directors which oversees the management of the corporation. The phrase "corporate accountability" refers to the means by which those who manage and oversee the affairs of a company are held to account for their stewardship of corporate assets. Some governance mechanisms also may serve to hold those with decisionmaking responsibility accountable to the shareholders of the company. For example, the election of directors can be viewed as both a governance and accountability mechanism because, as mentioned above, it serves as the means by which individuals are chosen to direct the company and as the way in which the performance of such persons is evaluated by shareholders. Corporate accountability also includes the other devices, such as derivative suits and state corporation laws, available to protect shareholders.

Corporate accountability, in its broadest sense, includes the various ways in which corporations seek to justify their actions to all those affected by corporate activities, including employees, consumers, communities, federal, state and local governments and the public generally. The report does not address the adequacy of existing accountability mechanisms in serving those noninvestor constituencies or what the obligations are of the corporation to those constituencies. These larger corporate accountability issues transcend the jurisdiction and expertise of this Commission and appropriately should be considered by others. Inevitably, the effectiveness of a corporation's board of directors and the degree of concern and participation by its shareholders will affect the corporation's relationships with other constituencies, but the Report is, first and foremost, about accountability of the board to shareholders and investors.

The Report's focus on the mechanisms of accountability emphasizes that there are a number of different routes that can be pursued to protect shareholders' and investors' interests. An active and effective board, involved shareholders, meaningful state laws, and attentive regulatory authorities can all safeguard those who invest in corporations. The Report identifies strengths and weaknesses of each approach and urges greater effort with respect to mechanisms, such as nominating committees, whose full potential has not yet been realized. The staff believes that, if properly functioning, the components of the corporate accountability system should have the effect of creating a "set of built-in institutional arrangements that on a daily basis prevent, or at least contain within tolerable limits, undesirable conduct or ineffective performance by corporate managers, directors and their companies." 6/

As summarized below, the Report is divided into four parts. The first three parts address the role of shareholders, boards of directors and others in the corporate accountability process. The fourth part of the report evaluates the efficacy of these accountability mechanisms. Included in the summary of each chapter, which follows, are the staff's recommendations concerning the issues considered in the chapter.

Part I of the Report contains five chapters discussing the role of shareholders in corporate accountability. The Commission's concern with the role of shareholders in the corporate accountability process arises from Section 14 of the Securities Exchange Act of 1934 ("Exchange Act") which empowers the Commission to regulate the solicitation of the proxies of the owners of securities registered under the Exchange Act. The legislative history of Section 14 indicates that the Congress expected the Commission's rules to assure "fair corporate suffrage", in part, by assuring adequate disclosure about the matters to be acted upon at the security holders' meeting. The purchase of corporate securities creates an ownership relationship between investor and issuer which gives the shareholder an opportunity to participate in the corporation's electoral

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6/ Manning, "Thinking Straight about Corporate Reform," 41 Law and Contemporary Problems 3, 27 (1977); See also C. Stone, Where The Law Ends 120 (1975); Coffee, "Beyond The Shut-eyed Sentry: Toward A Theoretical View of Corporate Misconduct and Effective Legal Response," 63 Va. L. Rev. 1099, 1275 (1977); C. Brown, Putting the Corporate Board to Work 21 (1976); Leech and Mundheim, "The Outside Director of the Pubicly Held Corporation," 31 Bus. Law. 1799, 1827 (1976).

and decisionmaking processes as well as the right to share in the company's profit. Most shareowners participate in corporate affairs by means of written communications — only a small percentage of shareowners ever attend an annual meeting, visit the issuer's principal offices or otherwise have direct contact with its officers, directors or employees. Therefore, the proxy solicitation process is at the center of effective shareholder communications.

Chapter One: The Shareholder Proposal Rule and Annual Meetings

Chapter One describes the operation of the Commission's shareholder proposal rule (Rule 14a-8), which permits shareholders to include resolutions in issuers' proxy materials. The general consensus of the participants in the corporate governance proceeding was that the shareholder proposal rule offers a viable means for shareholders to convey their concerns to management and their fellow shareholders. Although proposals opposed by management are rarely passed, even a favorable vote of 5 percent on a proposal may cause challenged company policies to be reexamined or revised. The staff explores various alternatives to the present procedure by which it acts as an intermediary between shareholder proponents and issuers seeking to exclude proposals from proxy materials, but concludes that the present process is less costly and more efficient than the alternatives.

The chapter also reviews the procedural requirements of Rule 14a-8 and recommends several minor amendments:

1. Rule 14a-8(a)(2) should be amended to clarify that any person qualified under state law to present a proposal, whether or not he or she is also a company

shareholder, may represent the proponent at the annual meeting.

2. Rule 14a-8(b) should be amended to require disclosure in proxy materials of the names, addresses, and shareholdings of shareholder proponents.
3. Rule 14a-8(a)(4), which restricts the text of a proposal to 300 words and a proponent's supporting statement to 200 words, should be amended to permit a proponent 500 words, to be divided between the proposal and supporting statement at the proponent's discretion.

The substantive grounds set forth in the rule for excluding proposals are identified and some are discussed in detail in the chapter, particularly the "not significantly related to the issuer's business" standard (Rule 14a-8(c)(5)) and the "ordinary business" standard (Rule 14a-8(c)(7)). These standards have been difficult to apply at times and may require futher clarification. In connection with the "ordinary business" exclusion, the staff recommends the issuance of an interpretive release to consolidate previous staff positions. In connection with the "not significantly related" standard, the chapter considers the Supreme Court's decision in First National Bank of Boston v. Bellotti 7/ and concludes that the existing proxy rule provisions may not be adequate to deal with the concerns of

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7/ 435 U.S. 765 (1978).

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. Accordingly, the staff recommends that Rule 14a-8(c)(5) and (c)(7) be reexamined in light of the Bellotti decision. In view of the difficulty and lack of precedent with respect to these issues, the staff recommends that a concept release be issued, covering the following issues:

1. Whether the Commission should adopt requirements concerning disclosure of information on corporate political activities and expenditures consistent with the assumptions regarding "procedures of corporate democracy" articulated by the Court in Bellotti; 8/

2. The role of the shareholder proposal process in meeting the goals and assumptions regarding "corporate democracy" enunciated by the Court in Bellotti;

3. The need, if any, for treating shareholder proposals requesting disclosure of corporate political expenditures and activities different from

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8/ On July 21, 1980, the Institute for Public Interest Representation filed a petition requesting the Commission to amend Rule 14a-3 "to provide for disclosure relating to corporate political contribution funds, otherwise known as political action committees." File No. 4-235.

those requesting positive or negative corporate action;

4. Whether the standards and concepts should be limited to political activities, and if not, what other areas should be included;
5. How "political" activities should be defined;
6. What forms of contributions and activities should be covered;
7. Whether a threshold amount or level of activity would be appropriate, and if so, how the threshold should be determined.

In addition, the staff recommends the issuance of an interpretive release on Rule 14a-8(c)(8), clarifying that shareholder proposals which recommend establishment of procedures to accommodate shareholder nominations shall not be excluded as "relating to the election of directors."

The final section of the chapter discusses several procedures and practices that could improve the operation of the annual meeting of shareholders, including:

1. Rotation of the location of the annual meeting;
2. Scheduling of the annual meeting at a convenient time;
3. Regional shareholder meetings to supplement the annual meeting;
4. Post-meeting reports; and
5. Surveys of shareholders to discover questions they may have, responses to those questions at annual meeting, and

6. Reports of questions and responses in post-meeting reports.

Chapter Two: Disclosure of Socially Significant Information

Chapter Two considers the adequacy of the Commission's approach to the disclosure of socially significant corporate information. During the 1970's, the Commission increasingly was called upon to consider questions relating to the disclosure of information which, while not necessarily material from an economic standpoint, was so socially significant that disclosure to shareholders and investors perhaps was warranted. Moreover, extensive legislation was adopted during the 1960's and 1970's to regulate directly corporate conduct affecting society. These legislative developments affected the work of the Commission. When registrants became subject to extensive new legal liabilities for noncompliance with increasingly stringent regulatory requirements, a variety of novel disclosure issues emerged, such as to what extent must information about the impact of environmental laws on the company and the impact of the company's operations on the environment be disclosed and to what extent must companies accrue or disclose material loss contingencies. Moreover, the same forces that hastened enactment of conduct-related laws focused increasing attention on the adequacy of existing corporate disclosures.

The chapter evaluates the extent to which socially significant information should be disclosed in proxy statements for the purpose of permitting shareholders to make informed voting decisions. While many shareholders may consider the nature of management's social performance in connection with the election of the board of directors which oversees management, the staff believes that it would be inappropriate for the Commission to require disclosure of additional specific categories of social information since, in the staff's experience, the extent and nature of shareholder social concerns varies from company to company and changes over time. The staff believes that the shareholder proposal process generally serves to generate disclosure of whatever socially significant information interests a substantial number of shareholders and can be used by ethical shareholders to make issuers aware of their social concerns. The staff rejects several specific suggestions to enhance further the operation of the shareholder proposal rule for these purposes because of technical difficulties with the proposed changes and the extent to which corporations already respond to shareholder proposals concerning corporate social responsibility.

The staff's conclusion is based, in part, upon the effective functioning of the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 5: Accounting for Contingencies, ("FAS 5") which is intended to generate timely disclosure of material financial contingencies, including loss contingencies arising from practices related to environmental compliance, equal employment opportunity and other matters of social concern. While the staff concludes that FAS 5 is basically sound, it notes that the absence of additional practical guidance about the meaning and application of the key terms in FAS 5 may affect the extent to which there currently is adequate disclosure of contingencies. Accordingly, the staff recommends that the Commission should authorize it to:

1. Monitor the adequacy of current disclosure of loss contingencies in corporate reports filed with the Commission.
2. Urge issuers to carefully examine the adequacy of the manner in which they comply with FAS 5.
3. Convey its views and concerns with respect to lawyers responses to auditor inquiries about loss contingencies to the American Bar Association through its Commission on Evaluation of Professional Standards, or otherwise.
4. Continue to confer with the Financial Accounting Standards Board in order to explore developing further guidance to registrants concerning the types of factual occurrences that may give rise to an obligation to disclose loss contingencies or accrue liabilities in financial statements prepared in accordance with generally accepted accounting principles.

In the area of environmental disclosure, the Commission has special obligations that were created by the National Environmental Policy Act. The staff believes that, for the most part, the Commission's existing rules in the area of environmental disclosure are adequate, although minor revisions are suggested. The staff also believes additional environmental information could be made more accessible to shareholders at little cost to issuers. The staff therefore recommends that the Commission authorize it to develop rule proposals to:

1. Require issuers to include a notice in the annual report to shareholders, or the proxy statement, which informs share-

holders where to obtain copies of significant environmental compliance reports compiled pursuant to federal law.

2. Revise existing rules requiring disclosure of all pending or contemplated legal proceedings relating to environmental matters to devise a threshold standard for disclosure based, at least in part, upon the significance of the pending or contemplated proceeding.

Consideration also is given to the extent and adequacy of the voluntary disclosure of socially significant information in annual reports to shareholders because such practices may affect the need for additional disclosure requirements. The staff concludes that the practice by issuers of voluntarily disclosing socially significant information is valuable and generally beneficial to shareholders. However, issuers should be careful to avoid one-sided disclosure and should ensure that voluntary disclosures accurately depict corporate performance in the areas addressed. The staff notes that formation of a public policy committee of the board can make positive contributions to corporations endeavoring to give greater consideration to corporate social performance or to the nature or extent of their disclosure of socially significant information.

The Corporate Democracy Act of 1980, recently introduced in the U.S. House of Representatives, contains provisions requiring disclosure of certain information concerning corporate social performance regardless of the materiality of such information to investors. This chapter sets forth the staff's view that investors might be disserved if a program for public dissemination of socially signficant information were appended to the existing securities disclosure system.

Chapter Three: The Beneficial Owners of Street Name Stock and the Corporate Accountability Process

Chapter Three describes the phenomenon of recording stock ownership in street or other nominee name, a practice which affects roughly 25 percent of outstanding equity securities and is expected to increase in the future.

While acknowledging and affirming the necessity of nominee stock registration, which eliminates the need for physically transferring stock and substantially decreases the costs of stock transfer, the staff notes that the practice complicates the relationship between companies and the beneficial owners of their stock. While under state law the record stockholder enjoys the rights associated with stock ownership, the rules of the stock exchanges require that nominees follow the directions of the beneficial owners and the Commission's rules require companies and broker-dealers to disseminate proxy materials to the beneficial owners.

The chapter discusses certain adverse effects of street and other nominee stock registration upon issuers, broker-dealers and the rights of those who beneficially own such stock. For example, issuers sometimes are forced to postpone shareholders' meetings or to resolicit proxies because of inadequate responses by nominee held stock. Moreover, beneficial stock owners are adversely affected because their proxy materials may arrive late and they may not receive the interim corporate reports and other shareholder communications that the issuer sends to its stockholders of record. The staff observes that communications practices that do not provide beneficial stock owners with the same extent of information provided to record owners may be inconsistent with the philosophy of the disclosure system administered by the Commission. Mooreover, as the Commission moves forward with its proposals for further integration of the Securities Act of 1933 and the Securities Exchange Act of 1934, the dissemination of information to beneficial owners, as well as record owners, becomes increasingly important. The staff notes that this situation could be eliminated to a large extent, if the exchanges revised listing requirements to include a new requirement that all corporate communications distributed to shareholders of record also must be directed to the beneficial owners of the company's securities. The staff expresses concern about permitting broker-dealers to vote street name stock pursuant to the "Ten-Day Rule", because broker-dealers automatically vote in favor of issuers' slate of director nominees and issuers' positions on other matters without regard to the interests of their customers whose stock they hold.

The staff explores alternatives to the present system but, in light of the numerous technical issues involved, concludes that formation of an advisory committee composed of representatives from banks, broker-dealers, proxy processing companies, transfer agents, the self-regulatory organizations, issuers, the Commission and the federal bank regulatory agencies is necessary. Such an advisory committee would assist in the the development of a system for issuers to identify the beneficial owners of stock held in street or other nominee name for the purpose of establishing a uniform system for distributing proxy material and other corporate communications to all shareholders. The staff therefore recommends that the Commission authorize the staff to take the necessary preparatory steps to create such an advisory committee. The development of such a system should eliminate the need for broker-dealers to vote proxies other than pursuant to an agreement which specifically grants voting discretion to the broker-dealer.

Pending completion of the work of the Advisory Committee, the staff has the following recommendations.

1. In view of the fact that some issuers do not send out search cards to record holders as required by Rule 14a-3(d), all issuers should review their procedures and practices to assure they are in compliance with this aspect of Rule 14a-3(d).

2. Rule 14a-3(d) also requires issuers to respond to broker requests by providing additional copies of proxy material "in a timely manner." The staff, therefore, urges issuers not to delay filling broker-dealer requests for proxy materials until such materials are distributed to all record holders. The staff will monitor issuer practices with respect to Rule 14a-3(d). If improvements in this area are not forthcoming, it may be necessary to amend Rule 14a-3(d) to require each issuer to deliver the requested number of copies of proxy materials to broker-dealers, banks or their nominees by at least a specified number of days in advance of the meeting of security holders.

3. The Commission should encourage the efforts of the banking and securities industries to eliminate impediments to the distribution of proxy materials created by the piggybacking of depository-held securities. The staff should monitor developments in this area to determine whether action by the Commission is necessary.

4. It is recommended that the securities industry be urged to prepare a brochure explaining to customers the effects of street or nominee name registration on their voting rights. The availability of such a brochure could be of immediate benefit to those who hold stock in street or nominee name and also may help educate beneficial owners during the period of transition to a more effective system of beneficial owner participation in the corporate electoral process.

5. The compliance departments of the exchanges should monitor the nature and extent of the process by which late arriving voting instructions from beneficial owners are given legal effect.

Based upon the nature of the recommendations the Commission receives from the Advisory Committee, the Commission may wish to consider whether to amend Rule 14b-1 so as not to permit broker-dealers to vote proxies unless instructions are received from the beneficial owners thereof, or in the alternative, urge the exchanges to amend their own rules to accomplish the same objective. Also based upon the nature of the recommendations from the Advisory Committee, the Commission may wish to recommend amending Section 12(i) of the Securities Exchange Act by making Section 14(b) one of the enumerated sections pursuant to which the bank regulatory agencies are required to issue regulations substantially similar to those promulgated by the Commission.

Chapter Four: The Role of Institutional Investors in the Corporate Accountability Process

Financial institutions, which invest and manage funds for the benefit of millions of individuals, are rapidly becoming the major shareholders of many American corporations. When the first federal securities law was adopted in 1933, institutions owned less than 8.5

percent of the outstanding New York Stock Exchange listed securities. 9/ By the end of 1979, however, the holdings of institutional investors amounted to approximately 35 percent of the value of all stock outstanding. 10/ Moreover, institutional stockholdings will increase further with the continued growth of private and public pension plans.

Institutional shareholders face somewhat of a dilemma in their relationships with portfolio companies. They are accused by some of exerting undue influence if they actively participate in corporate affairs. On the other hand, institutions that abstain from shareholder participation are accused by others of not fulfilling their responsibility to their beneficiaries and to other shareholders. Moreover, when institutions adhere to the Wall Street Rule by automatically voting with management they are nevertheless exercising their control.

The chapter analyzes institutional voting practices and procedures. Information submitted during the corporate governance proceeding and from other sources indicate that there is a clear trend away from the Wall Street Rule, pursuant to which institutions sold the securities of a company if they did not approve of management rather than exercise their voting authority. Instead, an increasing number of institutions, especially banks, are establishing formalized systems for processing

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9/ Staff of Subcomm. on Securities of Senate Comm. on Banking, Housing and Urban Affairs, Securities Industry Study Report, S. DOC. No. 13, 93rd Cong., 1st Sess. 113 (1973).

10/ Securities and Exchange Commission, 39 Statistical Bulletin 28 (July, 1980).

and examining proxy statements and for reaching objective decisions about how to vote. The primary voting criterion considered by institutions is whether adoption of the proposal will enhance or be detrimental to the investment. Many matters to be voted upon, however, have no investment implications, and it is unclear on what basis institutions reach voting decisions with respect to such matters. Accordingly, the staff recommends that the Commission urge institutions, which have not already done so, to:

a) Establish formalized procedures for processing proxy statements and reaching voting decisions.

b) Establish voting criteria designed to produce objective voting decisions consistent with fiduciary responsibilities. Such criteria should include consideration of the way in which decisions having no investment implications are reached.

c) Discontinue the practice of categorizing an uncontested election of directors as a routine matter warranting an automatic vote for the entire slate of nominees, bearing in mind that more exacting judgments with respect to the election of directors may improve corporate accountability and long-term profitability.

Based on its review of the comments and testimony submitted in the corporate governance proceeding, the Commission, in July 1978, concluded that there was inadequate information available about institutional voting policies and practices. While a few institutions, voluntarily make such information public, many other institutions do not. Accordingly, the Commission proposed Rule 14a-3(b)(11), which would have required certain institutions and parent holding companies subject to the proxy rules to disclose their voting policies and procedures in their annual report to shareholders. The public commentators identified a number of problems with the proposed rule, including the fact that many large institutions, such as banks, other than bank holding companies, are not subject to the proxy rules and therefore would not be covered by the proposal. The Commission decided to withdraw the proposal because it concluded the proposal was "not an appropriate vehicle for eliciting such disclosure." However, the Commission, at the same time, reaffirmed its belief that "there is shareholder interest in institutional voting policies and procedures."

The staff continues to believe that this information is important and therefore recommends that all financial institutions make information concerning their voting procedures and practices readily available to customers and the public. Moreover, the staff recommends that the Commission authorize it to study the extent to which institutional investors make public their proxy voting procedures and practices and the extent of shareholder interest in such information. If it is determined as a result of this study that such information is not readily available at present and there is interest in obtaining it, the staff should be authorized to develop a legislative proposal to amend Section 13(f) of the Securities Exchange Act to require disclosure by institutions of their proxy voting procedures and practices. 11/ Any such legislation should authorize the Commission to determine, by rule, the exact nature of the information to be disclosed.

The following categories of information provide a suggested starting point for determining the adequacy of existing institutional disclosure of voting practices and procedures and appropriate parameters of any new legislation or rulemaking addressing this subject:

(1) A public statement of whether or not the institution has established voting procedures and criteria;

(2) Description of the procedures for processing proxy statements, obtaining additional information related to voting issues and reaching voting decisions;

(3) The criteria or guidelines employed in deciding whether to to vote for or against a matter or to abstain from voting;

(4) The voting practices during the period covered by the report, indicating, for example, how the institution voted on each proposal or, in the alternative, instances when the institution voted against the issuer's recommendation; and

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11/ In recommending a similar requirement in its Institutional Investor Study Report, the Commission stated that such disclosure:

> would focus the obligation of institutions to act in the interests of their beneficiaries and lead to their setting up procedures for systematic attention to questions of stockholder voting. As a number of institutions responding to the Study's questionnaires indicated, the beneficiary should be able to choose the institutional manager whose policies on investment management appear to him most appropriate. The only way in which this can be done is to give beneficiaries full information about the policies followed, including policies regarding relationships with portfolio companies. The public nature of such information would also serve to inform corporate management and other shareholders of any general policies of the institution.

Securities and Exchange Commission, Institutional Investor Study Report XXXI (1971).

(5) A brief explanation of the reasons for any deviation from the institution's own voting procedures and criteria.

With respect to the subject of passthrough voting, the staff notes that some groups have expressed concern about whether the interests of persons having an economic interest in the accounts managed by institutions are reflected adequately in the investment and voting decisions made by investment managers. The record of the corporate governance proceeding, however, conveys little sentiment favoring passthrough voting or the polling of beneficiaries. The staff recommends that the Commission monitor the studies currently under way elsewhere on passthrough voting. Based upon the conclusions reached in such studies and the actions resulting therefrom, the staff may recommend further action to the Commission in the future. The staff is cognizant, however, that this issue may transcend the existing authority of the Commission.

Chapter 5: Shareholder Participation in the Corporate Electoral Process

An important factor prompting the Commission's re-examination of its rules was the fact that under the then existing proxy rules "shareholders often may not be provided adequate opportunities to participate meaningfully in . . . the corporate electoral process." Many specific questions concerning shareholder participation were raised in the governance proceeding including, among other things, increased disclosure concerning the board of directors and shareholder nominations.

One of the most controversial issues discussed in the proceeding was the extent of shareholder interest in participating in corporate governance. The vast majority of corporate commentators expressed the view that shareholders have little interest in participating in corporate governance — they are interested primarily in the company's economic performance. Others, however, testified that shareholders are interested in making their participation more meaningful, and several commentators opined that shareholder apathy reflects frustration with the powerlessness of the role of shareholder/investor.

The chapter discusses the adoption and implementation of proxy rule amendments following the hearings which were designed to provide shareholders with increased information concerning the structure, composition and functioning of the board of directors (Item 6(b) and (d) of Schedule 14A). After a year's experience with the new rules, the staff solicited further public comment on ways to improve their efficient operation and these comments are analyzed in the chapter. Based on this analysis, the staff recommends that it be authorized to amend Item 6(b) to:

1. eliminate the need for issuers to review transactions involving certain de minimis subsidiaries in determining whether disclosure of a relationship is required;
2. increase the threshold required for the disclosure of relationships between two companies, whose only connection is the presence of a common outside director, to 5 percent;
3. increase the level of equity ownership which triggers disclosure of business conducted with the issuer to 5 percent;
4. specify that indebtedness, for purposes of Item 6(b)(3)(iii), is to be determined at the issuer's fiscal year end rather than at any time during the year;

5. require disclosure of debtor-customers with indebtedness in excess of the amounts specified in Item 6(b)(3)(iii) who sit on a lender's board.

With respect to shareholder nominations, the Commission explained, in announcing commencement of this proceeding, that the right of shareholders to make nominations from the floor at annual meetings "is of little practical value, since at that point proxies have already been received by management for the nominees it has chosen, and the number of shareholders attending an annual meeting typically as insignificant." While most commentators who addressed this issue in the proceeding agreed that the Commission has authority to promulgate a shareholder nomination rule as an amendment to the proxy rules, they questioned whether there would be sufficient practical benefits from such a rule to warrant the expense of developing and implementing it. Many suggested, as an alternative to giving shareholders direct access to the proxy statement for the purpose of making nominations, that nominations from shareholders be considered by a nominating committee of the board of directors.

Based on its survey of 1979 proxy statement disclosures made by 1200 issuers, described elsewhere in the Report, the staff notes that only approximately 29 percent of companies disclose that they have nominating committees and only 78 percent of such companies indicated that their nominating committee considers shareholder nominations. Therefore, the staff concludes that it should monitor the disclosures contained in 1980 proxy statements concerning nominating committees and their consideration of shareholder nominations. If there is not a substantial increase in the percentage of companies with independent nominating committees who consider shareholder nominations, the staff recommends that the Commission authorize it to develop a rule requiring companies to adopt a procedure for considering shareholder nominations.

Chapter Six: The Composition, Structure and Operation of Boards of Directors and Chapter Seven: The Proxy Disclosure Monitoring Program

While commentators at the corporate governance hearings disagreed about the extent of shareholder interest in participating in corporate affairs, there was almost universal agreement that a strong, independent board of directors is a key to effective corporate accountability. Therefore, drawing on information about 1200 boards of directors generated by the Commission's first large scale survey of corporate proxy disclosure practices which is summarized in Chapter Seven, as well as other information, Chapter Six examines the evolving composition and organizational features of boards of directors, as well as their potential for enhancing corporate accountability. The staff reports that a general consensus has emerged with respect to the composition and structure of boards of directors — at least a majority of the board independent of management with effectively functioning audit, compensation and nominating committees. The composition of the boards of surveyed issuers is somewhat consistent with this consensus. For example, the data indicates that only approximately 19 percent of the responding issuers have boards on which a majority of the directors are employed by the issuer or one of its affiliates.

Despite the trend toward more independent boards, the monitoring program data reveal that 29.4 percent of all directors of the issuers surveyed have significant economic or personal relationships with the issuer or its management which potentially could interfere with the exercise of independent judgment. 12/ In particular, 7.5 percent of all directors of surveyed companies were associated with law firms performing legal services for the company on whose board they served. A majority of the boards of 19 percent of the issuers surveyed were composed of directors having a relationship with the company which potentially could interfere with the exercise of independent judgment. The chapter analyzes the problems that may arise when such persons serve on the board, and discusses the reasons why commentators deem it desirable that at least a majority of the board be completely independent of management.

In view of the proxy monitoring data, and the general consensus discussed above, the staff recommends that issuers give careful consideration to board composition. Such an evaluation should consider the appropriate number of management employees on the board, if any, the independence of its "outside directors," including questions relating to customers, suppliers, lawyers and bankers on the board, and the overall performance of the board.

12/ The relationships studied were (1) former officer or employee, (2) relative of an executive officer, (3) affiliation with a significant supplier, customer or creditor of the issuer, (4) associated with a retained law firm, (5) associated with an investment banking firm retained by the issuer, and (6) a control person.

The chapter reviews the functions performed by audit, compensation, nominating, executive and public policy committees. The audit committee today has become so well established that any company which has chosen not to establish such a committee, composed solely of directors independent of management, should weigh carefully the costs of such a decision in terms of liability and loss of control against the reasons, if any, for not establishing an audit committee. In addition, companies who have established audit committees should ensure that they are functioning effectively. 13/ For its part, the staff recommends that the Commission should continue to monitor the trend of establishment of audit committees and strive to obtain such committees in appropriate enforcement cases. While the staff does not believe that an audit committee rule is necessary at the present time, due to the significant percentage of companies that have established such committees, it will return to the Commission with further recommendations if the trend in establishment of such committees does not continue or if it appears that further guidance with respect to the functions of audit committees is necessary.

A second committee that is critical to an effectively functioning board of directors is the nominating committee. Such a committee holds the promise of not only fostering director independence, but also acting as an initiator and evaluator of other corporate accountability efforts.

13/ See SEC v. Falstaff (No. 79-1467, D.D.C. May 29, 1980) in which the Court held that disclosure that an audit committee existed is false and misleading where the audit committee never met or functioned.

While many companies, especially the larger ones, appear to be forming nominating committtees, the extent to which these committees are fulfilling their promise remains unclear. It appears that many such committees currently are limited to searching for qualified candidates and may not be searching very far. While this is an important function, it is essential that these committees assume responsibility for assessing the way in which the board is functioning, including evaluation of board members. In this connection, selection criteria and procedures need to be developed and disclosed to shareholders. Such criteria should ensure that the board is sufficiently independent and has a broad range of backgrounds to achieve a breadth of view points regarding future board problems. If corporations do not voluntarily disclose more information about the criteria and processes for director selection, the Commission may want to authorize the staff to consider amending the proxy rules to require such information.

Moreover, if nominating committees develop effective means to encourage and consider shareholder nominations, including disclosure of the criteria and selection process, a separate rule by the Commission in this area may not be necessary. It is essential to recognize, however, that under corporate statutes the power to elect the board is vested in the shareholders, and to the extent that boards of directors are not more forthcoming in their efforts to facilitate shareholder participation in the electoral process, a shareholder nomination rule, as discussed above, may be necessary.

The chapter also addresses the functions performed by the full board of directors, including monitoring management performance, providing of advice and counsel to the chief executive officer, assuring legal compliance and attention to social responsibility, and participating in corporate policymaking and strategic planning.

The staff notes that effective operation of the the board depends on the receipt of adequate relevant information. Unfortunately, little information is available today with respect to this issue. If shareholders are to be able to evaluate the functioning of their board of directors, they need information about the board's processes, including the way in which it is informed. The staff believes that disclosure concerning the way in which a corporation's board is informed would provide useful information to shareholders, and, at the same time, provide an incentive for companies to study their information systems. However, companies utilize many different practices to keep their board informed and it therefore is difficult to formulate a generic disclosure requirement in this area. Nevertheless, this is important information for shareholders. The staff recommends that the Commission urge companies to disclosure this information voluntarily, in the way most meaningful to their shareholders.

The chapter also notes that various private sector groups have performed a valuable function in addressing questions of board composition and structure publishing guidelines for director conduct. The staff, therefore, urges these groups to continue their efforts to provide guidance to directors. The staff also recommends that the Commission continue to set forth its views on director conduct in the context of enforcement proceedings. The chapter concludes that pressures by interested parties, including the corporate and legal communities, the accounting profession, professional organizations and the Commission, must continue so that a "rubber stamp board" that "doesn't make waves" becomes a thing of the past.

Chapter Eight: The Role of Self-Regulatory Organizations in Promoting Corporate Accountability

The self-regulatory organizations ("SROs"), in particular the New York Stock Exchange, historically have imposed requirements on listed companies, including disclosure and more substantive regulatory requirements. More recently, the Commission has sugested to the SROs that they require that their listed companies have audit committees composed of independent directors, and the chapter reviews the manner in which the exchanges have responded. The staff recommends that SROs continue to be concerned about corporate accountability as it relates to investor confidence. However, the staff also recommends that the Commission not require SROs to make changes in their listing standards relating to internal corporate structure.

Chapter Nine: The Role of State Regulation in Promoting Corporate Accountability

Although the standards to which directors are held primarily are ones established by state law over which the Commission has no jurisdiction, controversy over the adequacy of state law has led to increased calls for federal legislation setting minimum standards of care for directors. Since the standard of care required of directors is critical to corporate accountability, this chapter of the Report discusses recent developments under state law concerning this standard and suggests ways to respond to emerging problems.

The staff's discussion focuses on the issue of whether directors under present law have, or should have, a reasonable duty of inquiry into the business conducted by the companies on whose boards they sit. It is noted that cases such as Greene v. Emersons Ltd. 14/ may have the anomalous result of encouraging director inattentiveness. On the other hand, a duty of care stated in terms of what a prudent person would do in like circumstances is a potentially dynamic concept. Thus, the staff urges courts to be sensitive to emerging trends with respect to boards of directors, including the increasing use of directors independent of management and the presence of audit and other committees, and to incorporate these changes into the standard of care required of directors.

The chapter also addresses recent judicial developments concerning application of the business judgment rule to defend legal challenges to decisions made by the board of directors. In particular, the staffs notes that if board decisions to terminate shareholder derivative suits are subjected to judicial examination of the independence of the decisionmakers, the adequacy of the decisionmaking process, and the reasonableness of the explanation, courts will encourage the establishment of corporate processes which will serve the board well in all its decisionmaking.

14/ CCH SEC. Law Rptr. ¶97,266 (S.D.N.Y. 1980).

Chapter Ten: Congressional Initiatives Concerning Corporate Accountability

Chapter Ten traces the long history of interest in framing some form of Federal corporation law and notes that this interest is unlikely to diminish. It also presents a description of several recent legislative proposals that could affect the system of corporate accountability, including the Shareholders' Rights Act of 1980 and the Corporate Democracy Act of 1980.

Part IV: The Efficacy of Existing Accountability Mechanisms

The staff concludes that a combination of financial debacles, questionable and illegal payments, and Commission actions has resulted in voluntary actions by corporations which are changing expected standards of performance of directors. Whether or not these changes are occurring at a sufficient pace and degree to make federal legislation unnecessary remains to be seen. The staff notes that while there have been a number of changes in boards of directors, the private sector has ignored, for the most part, the possibility of enhanced shareholder participation. The Commission has taken some steps to facilitate shareholder participation and may need to consider further steps in the future, such as a rule assuring consideration of shareholder nominations. The staff concludes that in view of the substantial evidence concerning changes in the board of directors of many companies, and the Commission's existing authority to encourage shareholder participation, it is premature at this time for the Commission to determine whether to recommend or support federal legislation in this area. The staff indicates, however, that if legislation is to be enacted in this area, it believes it should be directed toward raising standards of care and providing a federal cause of action for breaches of standards.

The debate concerning the capacity of existing mechanisms of corporate accountability to respond to the needs of investors and others undoubtedly will continue. By the nature of its work, the Commission inevitably will be caught up in the vortex of controversy involving federal legislation governing corporations. In such situations, the staff believes the Commission should contribute its technical expertise and institutional judgment in order to maintain and enhance public confidence in the capital markets.