Dockets
112-2

MEMORANDUM

September 27, 1976

TO : The Commission

FROM : The Division of Corporation Finance

SUBJECT : Proposals to integrate and make more meaningful disclosure concerning management

RECOMMENDATIONS : That the Commission authorize the publication for comment of the attached release which:

A. Proposes amendments to Forms S-1 and S-11 under the Securities Act of 1933 ("Securities Act") and Forms 10, 10-K and 8-K and Schedule 14A under the Securities Exchange Act of 1934 ("Exchange Act") to:

1. require additional disclosure with respect to the background, qualifications and affiliations of and remuneration received by directors and executive officers;

2. conform the disclosure requirements in the applicable forms and Schedule 14A concerning background of management and pending legal proceedings; and

3. require certain disclosure in proxy statements concerning illegal or questionable payments.

B. Requests comment from interested parties regarding the need for and possible format of additional disclosure concerning management remuneration, including executive compensation plans, and certain transactions of management involving the issuer or its subsidiaries.

ACTION REQUESTED BY: Regular Calendar

NOVEL, UNIQUE OR COMPLEX ISSUES : The attached release proposes an amendment to Item 6 (Information Regarding Management) of Schedule 14A to require disclosure of: (1) whether or not the issuer has any policy regarding questionable or illegal payments or transactions and (2) facts surrounding the involvement of any director, nominee for election or executive officer of the issuer in any questionable or illegal payments or transactions.

OTHER DIVISIONS OR OFFICES CONSULTED: Divisions of Enforcement, Investment Management and Corporate Regulation and the Offices of the General Counsel and Economic and Policy Research.

Preliminary Statement

The attached release contains proposals to various registration and reporting forms under the Securities Act and the Exchange Act and Schedule 14A which are designed to improve the quality of information disclosed to investors regarding the background of directors and executive officers of public companies and also to further conform and integrate the disclosure requirements under the Securities Acts.

The proposed amendments to items requiring disclosure of certain management information would result in additional substantive disclosure with respect to all directorships held by each director of an issuer in any company subject to the requirements of Sections 12 or 15(d) of the Exchange Act or registered pursuant to the Investment Company Act of 1940 and disclosure of memberships held by each director on any committee of the issuers board of directors. The proposed amendments would also expand the information called for with

respect to certain material events in the background of directors and executive officers to include injunctions prohibiting such person from engaging in any type of business practice, injunctions and consent decrees prohibiting violations of federal and state securities laws and any civil actions involving violations of such laws. In addition, those items concerning management remuneration would be amended to require disclosure of all direct remuneration received from the issuer and its affiliates.

The proposed amendments relating to the conformation and integration of disclosure requirements are primarily designed to eliminate certain discrepancies between the requirements contained in Part II of Form 10-K and Schedule 14A. Pursuant to General Instruction H(a) to Form 10-K, issuers may omit the information called for by Part II if the issuer has, since the close of the fiscal year or within 120 days thereafter, filed a proxy or information statement relating to the election of directors. Issuers electing to follow this procedure, however, are not presently required pursuant to Schedule 14A to disclose information consistent with the requirements of Part II.

The proposed amendments are designed to eliminate these disclosure gaps, principally with respect to Item 6 of Schedule 14A which calls for information regarding nominees and directors. It is also proposed that differences in language and substance among various registration and reporting forms and Schedule 14A in the items concerning disclosure of pending legal proceedings and management background information be eliminated.

In view of the extensive nature of the discussion of the proposals in the Proposed Release, the Division will not burden the Commission with a redundant explanatory memorandum. Rather, the Division respectively calls the Commission's attention to the attached release which we believe is self-explanatory. Discussed below are the proposed amendments and other matters the Division believes are most significant.

Questionable or Illegal Payments

The attached release proposes an amendment to Item 6 (Information Regarding Management) of the proxy rules to require disclosure of whether or not the issuer has any policy regarding "questionable or illegal payments or transactions, including but not limited to illegal political contributions; the disbursement or receipt of funds outside the normal system of accountability; questionable or illegal payments to or from foreign governments, officials, employees or agents; and payments or receipts improperly entered in the books and records."

The proposed disclosure would also state that where facts pertaining to the involvement of any director of the issuer, any person nominated for election as director, or any executive officer of the issuer in any material questionable or illegal payments or transactions involving the issuer and its affiliates have not been previously reported in a filing with the Commission and described in an issuer document distributed to shareholders, management should disclose such facts in its proxy or information statement, depending upon the extent of involvement and knowledge of such persons. 1 / The proposed new proxy disclosure item would also call for information of whether or not any such disclosed transactions conform with the issuer's policy.

It is the Division's view that this new requirement is necessary to confirm the obligation of an issuer to disclose material information as to such matters concerning the ability and integrity of management. Moreover, the proposed item contemplates a procedure for disclosing questionable or illegal transactions in a manner which is intended to clarify that, in the view of the Commission, such matters should be disclosed in periodic reports filed with the Commission, and that they should also be disclosed to security holders in order that they might have necessary information with which to assess the ability and integrity of management.

---

1 / Once an issuer does disclose such transactions in a proxy or information statement, it will be "previously reported" and thus would not require repeated disclosure in any subsequent proxy or information statement. See the definition of "previously reported" in Rule 12b-2(m); pursuant to Rule 14a-1, this definition applies to Regulation 14.

Other than through the inclusion of certain non-exclusive examples of what might be considered "material questionable or illegal payments or transactions", the proposed item does not attempt to establish guidelines or standards for defining this term. It is recognized that any such definition would be difficult if not impossible to resolve in a rule of general application, and it is further recognized that it likely is more desirable at this time to retain a degree of latitude so that the Commission, issuers, the courts and Congress might provide further refinements in particular cases. It may be noted that the terms used in the proposals -- questionable or illegal corporate payments and practices; illegal political contributions; the disbursement or receipt of funds outside the normal system of accountability -- all are derived generally from the Commission's May 12, 1976 report to the Senate Banking, Housing and Urban Affairs Committee.

The Division has received two memoranda from other offices on the proposals, and both commented on the proposed disclosure of questionable or illegal payments. 2 / The following will discuss our views on those comments. 3 /

Director of Economic and Policy Research

The comments received from the Director of Economic and Policy Research opposed the contemplated disclosure, generally on the ground that the existence of such a disclosure requirement would impose an undue impediment on economic decision-making; that the proposals are not clear as to when disclosure is required; that this uncertainty may have a chilling effect on management; and that the requirement to disclose whether or not the company has a policy on such matters may force registrants to develop a policy, rather than allow flexible management evaluations of such transactions.

2 / The Division also received oral comments on the questionable payments proposals from the Office of the General Counsel and the Division of Enforcement; we agree with their comments and they have been incorporated into the proposals.

3 / See Attachment B for a full copy of the comments of other offices.

In our view, the proposals simply highlight an area which is and should be a proper area of management concern, and which should be the subject of review and scrutiny by management. As discussed above, we have not attempted to define a "material questionable or illegal payment" due to the difficulty in doing so by rule. We do not believe the present situation is any less confusing to issuers and, in fact, the proposed disclosure requirements would at least clarify that a particular questionable transaction, once disclosed in a proxy statement, generally would not be required to be disclosed again. To this extent, the proposals do add certainty.

It should also be noted that nothing in the proposals undertakes to prescribe any particular element of the issuer's policy concerning such payments. We believe it may be safe to assume that the obligation to disclose such a policy may be an incentive for issuers to develop policies, however, we do not believe this step is any different from the recently adopted requirement for disclosure of the audit committee (Item 8(e) to Schedule 14A) nor do we believe it represents an unwarranted intrusion into the preogatives of managment.

Division of Investment Management

The Division of Investment Management opposed the proposal, stating that disclosure of a corporate policy on questionable payments was no more important than a policy on a number of other subjects; that the sanctity of the books and records is not particularly related to a proxy or information statement about management; and that the other proposed disclosure revisions dealing with litigation rely on court or administrative proceedings as the standard for disclosure and do not require disclosure of any illegal activities apart from legal proceedings.

The Division believes the uncertainty, the controversy and the degree of public and governmental interest in this area justifies this type of treatment in the disclosure rules. Moreover, to the extent such practices do lead to improper books and records, we believe it is acutely important that the disclosure of such activities be made in the proxy or information statement. Rules 14a-3 and 14c-3 recognize that financial statements of the issuer are an integral part of the information security holders must have in voting to elect directors, and even though such financial information might not be part of the proxy statement, it appears clear that this type of disclosure is highly relevant to an evaluation of the ability and integrity of management.

Requests for Comments on Additional Disclosure

As indicated in the attached release, the proposed amendments are only intended as a first step toward improving the adequacy of information concerning corporate management. The Division has received various criticisms and recommendations from interested parties regarding certain areas of information concerning management which are not affected by the current proposals. Rather than proposing specific provisions at this time, the Division proposes that the Commission invite comment on the need for and possible format of additional disclosure requirements.

Initially, the Proposed Release requests public comment concerning the adequacy of information about management compensation, especially executive compensation plans. The current requirements have been criticized as providing insufficient information for purposes of determining management's actual compensation and for purposes of shareholder approval of such plans. It has been suggested that the Commission consider the adoption of a universal formula or standard to be used in evaluation of these plans.

Comment is also invited with respect to the need for possible amendments to the items in various forms requiring disclosure of certain transactions of management involving the issuer or its subsidiaries. These items differ significantly from each other in both language and substance. In connection with the future conformation of these items, the Division is also considering certain recommendations received from the staff and interested parties. Specifically, it is recommended that the current exceptions from disclosure where: (1) the interest of the specified persons is solely that of a director of another party to the transaction; (2) the transaction involves services as a bank depository of funds, transfer agent or similar services; or (3) the transaction involves a loan and the issuer or any of its subsidiaries is primarily engaged in the business of lending be deleted.

The Division believes that the general request for public comment concerning the need for additional disclosure in these areas, in connection with the specific recommendations currently under consideration, will result in significant comment from interested parties.

Other Divisions and Offices Consulted

On September 10, 1976, the Division circulated for comment a draft of the Proposed Release to those Divisions and Offices listed on page 2 of this memorandum. Oral comments were received from the Office of the General Counsel and the Division of Enforcement and written comments from the Divisions of Investment Management and the Directorate of Economic and Policy Research. Except for the comments of the Division of Enforcement all comments related solely to the proposals concerning questionable or illegal payments or transactions and are discussed above.

Recommendation

Based on the above and for the reasons articulated in the attached release, it is recommended that the Commission authorize the publication for comment of the attached release which:

A. Proposes amendments to Forms S-1 and S-11 under the Securities Act and Forms 10, 10-K and 8-K and Schedule 14A under the Securities Exchange Act of 1934 to:

1. require additional disclosure with respect to the background, qualifications, and affiliations of and remuneration received by directors and executive officers;

2. conform the disclosure requirements in the applicable forms and Schedule 14A concerning background of management and pending legal proceedings; and

3. require certain disclosure in proxy statements concerning illegal or questionable payments.

B. Requests comment from interested parties concerning the need for and possible format of additional disclosure concerning management remuneration, including executive compensation plans, and certain transactions of management involving the issuer or its subsidiaries.

Prepared By

J. Rowland Cook (51750)
Susan Greenberg (51750)
Paul A. Belvin (51750)

Attachments

Attachment A: Proposed Release
Attachment B: Comments received from other offices and divisions

ATTACHMENT B

September 20, 1976

MEMORANDUM

To: Paul Belvin
Susan Greenburg
Division of Corporation Finance

From: Richard Zecher, Director
Economic and Policy Research

Re: Proposals to Revise Disclosure Concerning Management

Your memorandum of September 10 has been reviewed. The attached memo by Cliff Tuck of my staff basically reflects my views on this subject. If you have any comments on this memo, please feel free to contact me.

Office Memorandum • SECURITIES AND EXCHANGE COMMISSION

DATE: September 15, 1976

TO : Richard Zecher Director
of Economic and Policy Research

FROM : Cliff Tuck OK Chief
Branch of Securities Offerings and Studies

SUBJECT: Div. of Corp. Finan Proposed Revision of
Disclosure Rules Concerning Management

A review of the economic implications of the proposed disclosure rule changes concerning corporate management (as contained in the attached memorandum from the Division of Corp. Finance dated Sept 10, 1976) suggests that a proposed change regarding the disclosure of management's policies or lack of policies vis-a-vis questionable or illegal payments could adversely effect management's economic decision making ability.

The proposed rule is Item 6 (d)(i) of Sch. 14A, the corporate proxy statement. The rule reads as follows: "Indicate whether or not the issuer has any policy regarding questionable and illegal corporate payments or transactions, including but not limited to illegal domestic political contributions; the disbursement of funds outside the normal system of accountability, payments to foreign governments, officials, employees or agents, and payments improperly entered in the books and records. If the issuer has such a policy, briefly describe it.

The proposed rule covers two kinds of activity -- illegal and questionable payments. The difficulty lies with the requirement to disclose "whether or not" the issuer has a policy concerning "questionable" payments. Presumably corporate managements can distinguish between a payment that is "illegal" and one that is "questionable". One assumes the Division of Corporate Finance means by "questionable" a payment that is not illegal on its face but has aspects that public conduct standards might consider unethical.

The difficulty, then, with a phrase like "questionable" is that it is not defined in proposed rule 6(d)(i) or its accompanying instructions. There may be, in the absence of a more rigorous definition many instances where management is unsure that a particular business practice is "questionable." The resulting uncertainty may then taint a practice and cause proper business transactions to be called into question. Or, some prospective transactions may be assigned a higher risk factor because of management's uncertainty regarding "ex post" judgments concerning such transactions. Thus, possibly at the margin, some legitimate transactions may be forgone and profit opportunities "passed-up."

The uncertainty surrounding "questionable" payments is exacerbated by the requirement to disclose affirmatively policies or lack of policies concerning these transactions. Very likely managements will feel compelled to develop a policy concerning these payments in lieu of a statement in the proxy statement that states management does not have such a corporate policy. Thus the need to develop internal policy will cause management to make conservative judgments regarding the kinds of transactions it will be a party to because of liability concerns. Arbitrary and inflexible guidelines may well be substituted for sound management evaluations of those kinds of transactions. As a consequence an impediment is introduced into the corporate decision-making process.

CC: R. Spencer

ATTACHMENT B

Memorandum • SECURITIES AND EXCHANGE COMMISSION

DATE: September 23, 1976

TO : Paul Belvin and Susan Greenberg
Division of Corporation Finance

FROM : Jean Gleason, Associate Director
Division of Investment Management

SUBJECT: Proposed Proxy Rule Amendments

As you know under current rules, investment companies must provide in their proxy statements the information called for by Schedule 14A. We are concerned that because we have difficulty understanding the proposed amendment to the proxy rules relating to the issuer's policy on questionable and illegal corporate payments or transactions (proposed Item 6(d) of Schedule 14A), we would have difficulty administering it.

Item 6(d)(i)

The scope of paragraph (d)(i) is not clear. What are "questionable or illegal corporate payments or transactions?" The examples given suggest that such payments or transactions would be narrowly construed to include only those relating to the "traditional" foreign payment and domestic bribery situations. We fail to understand how the issuer's policy on these types of transactions is any more material to investors than the issuer's policy on other types of "questionable or illegal" corporate transactions and activities, such as those relating to pollution, equal employment, anti-trust, fair advertising, product safety, labor relations, and so forth. Is the use of corporate money to bribe someone any more material to investors than the use of corporate money to discriminate or to build a plant that will pollute the nearby waterways, or to develop products that will be dangerous to consumers (to use the standard cliches)?

If the primary problem is the sanctity of the books and records (as the examples suggest) the item should be limited to that. Even then, we are not sure why this is something that is particularly related to a proxy statement or information about management. Normally there are no financial statements in a proxy statement. Of course, it is vital to investors that there be a policy of accurate record keeping; it is vital to them that the management obey any number of laws, but we do not usually ask for a statement that management intends to obey those laws.

Paragraph (d)(i) can also be read broadly to require a statement of corporate policy about all questionable or illegal corporate activities. We can only assume that most corporations could develop a general corporate policy against engaging in illegal or questionable activities. What this knowledge will add to the investor's store of information about the issuer is questionable. Regardless of the interpretation of the proposed rule, we are not sure what type of disclosure is being sought. It is difficult to imagine anything other than general boiler plate.

Item 6(d)(ii)

We have more serious problems with paragraph (ii). It is an unusual rule making technique to require management to "consider" disclosure. If management could prove that they "considered" disclosure, but decided against it, they would have a defense against liability for omission of material information. In addition, since the public has been given little guidance as to what is considered material in this area, it is not clear what standards management should use in "considering disclosure".

Assuming that the "consider" language is changed to a specific requirement, we believe that the proposed item is inconsistent with new Item (d)(2) of the proxy rules requiring disclosure of, among other things, criminal convictions, injunctions against engaging in any type of business practice, or convictions of violations of the securities laws. This proposed item requires disclosure of such events if they occurred within the past five years and if they are material to an evaluation of the ability and integrity of any director. The item relies on court proceedings as the standard for disclosure; it does not require disclosure of the activities themselves. For example, it requires disclosure of a criminal convictions; it does not require disclosure of a criminal act; it requires disclosure of a conviction of the securities laws; it does not require disclosure of a violation of those laws. There are good reasons for this. It is possible to administer a standard for disclosure that relies on determinations made by our court system. It is not possible to administer a standard based on admission of guilt. Usually, people are presumed innocent until proven guilty in a court of law. In addition, it is unrealistic to expect that normally (there are always exceptions) people will disclose violations of other domestic laws in order to avoid violating the securities law. This is not to say that there may not be occasions where the harm to the individual may be outweighed by the necessity for the public to know. However, these would be only the most extraordinary circumstances.

In light of this, we find the proposed rule very troublesome. It seems to make the judgment that "questionable or illegal" payments or transactions (assuming a narrow definition) are so much more important than any other type of activity that disclosure of "known" facts must be made immediately regardless of when they occurred whereas other types of illegal activities relating directly to business must be described only if convictions have resulted in the past 5 years, and then only if material to an evaluation of the ability and integrity of the person.