

**NEWS**

**SECURITIES AND  
EXCHANGE COMMISSION**

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SPEECH TO  
AMERICAN SOCIETY OF CORPORATE SECRETARIES  
AT THE  
MID-DAY CLUB  
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"POLITICS OF CHANGE IN THE  
COMPOSITION AND STRUCTURE OF  
CORPORATE BOARDS"

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## I. INTRODUCTION

CORPORATE GOVERNANCE IS A POPULAR AND TIMELY TOPIC. COINCIDENT WITH MY TAKING OFFICE AS A COMMISSIONER OF THE SEC, THE COMMISSION COMMENCED HEARINGS DESIGNED TO REEXAMINE OUR RULES RELATING TO SHAREHOLDER COMMUNICATIONS, SHAREHOLDER PARTICIPATION IN THE CORPORATE ELECTORAL PROCESS AND CORPORATE GOVERNANCE GENERALLY. THE AMERICAN SOCIETY OF CORPORATE SECRETARIES TESTIFIED IN THOSE HEARINGS AND HAS AN OBVIOUS INTEREST IN THEIR OUTCOME.

TONIGHT I WOULD LIKE TO SHARE WITH YOU SOME OF MY PERSONAL OBSERVATIONS AND INSIGHTS WITH RESPECT TO CHANGES WHICH ARE TAKING PLACE IN THE COMPOSITION AND STRUCTURE OF CORPORATE BOARDS. I ALSO WOULD LIKE TO RAISE THE QUESTION OF WHAT THE ROLE OF THE SEC IS OR SHOULD BE IN SUGGESTING OR IMPLEMENTING SUCH CHANGES.

## II. IMPETUS FOR REFORM

THE BOARD OF DIRECTORS OF U.S. CORPORATIONS HAS BEEN UNDERGOING SIGNIFICANT CHANGE IN RESPONSE TO A STRONG IMPETUS FOR CORPORATE REFORM WHICH UNDOUBTEDLY WILL CAUSE FURTHER CHANGES.

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THE SECURITIES AND EXCHANGE COMMISSION, AS A MATTER OF POLICY, DISCLAIMS RESPONSIBILITY FOR SPEECHES BY ANY OF ITS COMMISSIONERS. THE VIEWS EXPRESSED HEREIN ARE THOSE OF THE SPEAKER AND DO NOT NECESSARILY REFLECT THE VIEWS OF THE COMMISSION.

IT SEEMS TO ME THAT THIS IMPETUS FOR REFORM IS A COALESCENCE OF LEGAL, ECONOMIC, SOCIAL AND POLITICAL FORCES. NOT ONLY ARE THE STANDARDS BY WHICH WE MEASURE THE PERFORMANCE OF DIRECTORS AND BOARDS BEING QUESTIONED, BUT ALSO THE LEGITIMACY OF CORPORATE POWER.

PROFESSOR MELVIN A. EISENBERG BEGINS HIS INFLUENTIAL BOOK ON THE STRUCTURE OF THE CORPORATION (LITTLE, BROWN AND COMPANY 1976) WITH THE STATEMENT:

"CORPORATE LAW IS CONSTITUTIONAL LAW; THAT IS, ITS DOMINANT FUNCTION IS TO REGULATE THE MANNER IN WHICH THE CORPORATE INSTITUTION IS CONSTITUTED, TO DEFINE THE RELATIVE RIGHTS AND DUTIES OF THOSE PARTICIPATING IN THE INSTITUTION, AND TO DELIMIT THE POWERS OF THE INSTITUTION VIS-A-VIS THE EXTERNAL WORLD."

IN EXERCISING ECONOMIC, SOCIAL AND POLITICAL POWER, OUR LARGE PUBLIC CORPORATIONS IMPACT UPON A NUMBER OF CONSTITUENCIES IN ADDITION TO SHAREHOLDERS, NAMELY, EMPLOYEES, CUSTOMERS, AND OTHER CITIZENS.

MUCH OF EISENBERG'S TREATISE IS AN ANALYSIS OF THE DISCREPANCY BETWEEN THE RECEIVED OR THEORETICAL LEGAL MODEL FOR CORPORATIONS AND THE WAY IN WHICH CORPORATIONS ACTUALLY FUNCTION.

ALTHOUGH VIRTUALLY ALL STATE CORPORATION LAWS PROVIDE THAT THE DUTY OF THE BOARD OF DIRECTORS IS "TO MANAGE THE BUSINESS AND AFFAIRS OF THE CORPORATION, "MANAGEMENT AND POLICYMAKING ARE BEYOND THE BOARD'S REACH AND ARE CONDUCTED BY A CORPORATION'S EXECUTIVE OFFICERS. FURTHER, OTHER FUNCTIONS OF THE BOARD - PROVIDING ADVICE AND COUNSEL TO THE CHIEF EXECUTIVE'S OFFICE, PLAYING A FORMAL ROLE IN THE AUTHORIZATION OF MAJOR CORPORATE PROJECTS, AND PROVIDING A MODALITY FOR THE EXERCISE OF INFLUENCE AND CONTROL BY NONEXECUTIVES -- ARE RELATIVELY UNIMPORTANT OR CAN BE PERFORMED BY OTHERS. EISENBERG CONCLUDES THAT THE BOARD SHOULD BE STRUCTURED AND CONSTITUTED SO THAT IT CAN EFFECTIVELY SELECT, MONITOR AND REMOVE MEMBERS OF THE CHIEF EXECUTIVE OFFICE. HE RECOMMENDS THAT THE DISCREPANCY BETWEEN RECEIVED AND ACTUAL BOARD MODELS BE RESOLVED BY MAKING THE BOARD INDEPENDENT OF THE EXECUTIVES WHOSE PERFORMANCE IS BEING MONITORED AND ASSURING A FLOW TO THE BOARD OF ADEQUATE AND OBJECTIVE INFORMATION ON THE EXECUTIVES' PERFORMANCE.

A DIFFERENT CRITIQUE OF THE DISCREPANCY BETWEEN THEORY AND PRACTICE IN CORPORATE GOVERNANCE HAS BEEN MADE BY MESSRS. NADER, GREEN AND SELIGMAN IN THEIR POLEMIC TAMING THE GIANT CORPORATION (W.W. NORTON & COMPANY 1976). QUOTING FROM AN ADDRESS BY HENRY ADAMS IN 1896, NADER POINTS OUT THAT:

"CORPORATIONS ORIGINALLY WERE REGARDED AS AGENCIES OF THE STATE. THEY WERE CREATED FOR THE PURPOSE OF ENABLING THE PUBLIC TO REALIZE SOME SOCIAL OR NATIONAL END WITHOUT INVOLVING THE NECESSITY OF DIRECT GOVERNMENTAL ADMINISTRATION. THEY WERE IN REALITY ARMS OF THE STATE, AND IN ORDER TO SECURE EFFICIENT MANAGEMENT, A LOCAL OR PRIVATE INTEREST WAS CREATED AS A PRIVILEGE OR PROPERTY OF THE CORPORATION. A CORPORATION, THEREFORE, MAY BE DEFINED IN THE LIGHT OF HISTORY AS A BODY CREATED BY LAW FOR THE PURPOSE OF ATTAINING PUBLIC ENDS THROUGH AN APPEAL TO PRIVATE INTERESTS."

IT IS ARGUED, HOWEVER, THAT THE CONSENSUAL ECONOMIC CORNERSTONE FOR CORPORATE PRIVILEGE HAS CRUMBLED BECAUSE OF THE BREAKDOWN OF THOSE CONTROLS WHICH HAVE HISTORICALLY LEGITIMIZED CORPORATE POWER. THE CONTROLS WHICH ARE SUPPOSED TO INSURE THAT CORPORATIONS EFFICIENTLY AND RESPONSIBLY SERVE THE PUBLIC PURPOSE ARE RECITED AS: STATE CHARTERING, COMPETITION, REMEDIAL LAW, FEDERAL REGULATION, LABOR UNIONS, SHAREHOLDERS AND THE BOARD OF DIRECTORS. BUT EACH OF THESE, IN NADER'S VIEW, HAVE FAILED TO CONTROL OR PREVENT IRRESPONSIBLE AND UNLAWFUL CONDUCT BY CORPORATE EXECUTIVES, INDIVIDUALLY AND COLLECTIVELY.

NADER'S PRESCRIPTION IS FEDERAL CHARTERING, WHICH WOULD RESTRUCTURE THE BOARD OF DIRECTORS, REDEFINE ITS RELATIONSHIPS WITH MANAGEMENT, EMPLOYEES AND SHAREHOLDERS AND REGULATE CORPORATE DISCLOSURE AND CONDUCT IN CERTAIN SIGNIFICANT AREAS OF SOCIAL CONCERN.

WHAT IS COMMON TO THE OBSERVATIONS OF BOTH PROFESSOR EISENBERG AND MR. NADER IS THE DISPARITY BETWEEN THEORY AND REALITY IN CORPORATE GOVERNANCE. AND IT DOES SEEM TO ME THAT THE CURRENT CLAMOR FOR CHANGE IN CORPORATE GOVERNANCE ARISES FROM FUNDAMENTAL AND FAR REACHING ALTERATIONS WHICH ARE TAKING PLACE IN OUR ECONOMIC AND SOCIAL STRUCTURES. OUR NATIONAL ECONOMY HAS BEEN ADVERSELY AFFECTED BY WORLD WIDE SHIFTS IN ECONOMIC POWER AT A TIME WHEN GROUPS WHICH ARE AT THE BOTTOM AND ON THE SIDES OF OUR SOCIO-ECONOMIC HIERARCHY ARE DEMANDING ENTRY INTO OUR ESTABLISHMENT INSTITUTIONS. THE STRAIN WHICH HAS BEEN PLACED ON OUR GENERAL POLITICAL FABRIC IS FELT BY, AND TO SOME EXTENT DIVERTED TO, OUR LARGE PUBLIC CORPORATIONS BECAUSE THEY ARE EXPECTED TO FUNCTION FOR THE PUBLIC GOOD AS WELL AS FOR THE PRIVATE BENEFIT OF MANAGEMENT AND SHAREHOLDERS.

CURRENT ECONOMIC PRESSURES ON CORPORATIONS ARE RAISING A SERIOUS QUESTION AS TO WHETHER CORPORATE STRUCTURE IS FUNCTIONALLY DEFICIENT.

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OVERSTATED PROFITS IN VIEW OF INFLATION, THE GENERAL LAG IN THE CAPITAL FORMATION PROCESS, PERSISTENT UNEMPLOYMENT AND THE INCREASING THREAT OF FOREIGN COMPETITION ARE CAUSING CONCERN THAT CORPORATE HEIRARCHY IS IN NEED OF STRUCTURAL CHANGE TO CREATE AND MAINTAIN EMPLOYMENT OPPORTUNITIES AND THE TRADITIONAL ECONOMIC GOAL OF EARNINGS AND PROFITS.

IN ADDITION, SOCIAL UPHEAVALS HAVE RELEASED PRESSURES ON CORPORATIONS TO BE MORE RESPONSIVE TO POLITICAL AND ENVIRONMENTAL ISSUES WHICH AFFECT SOCIETY AS A WHOLE. DISPARATE CRITICS ARE DEMANDING THAT LARGE PUBLIC CORPORATIONS RECOGNIZE OBLIGATIONS TO THE PUBLIC IN GENERAL WITH RESPECT TO DIFFICULT PROBLEMS AFFECTING CONSUMERS, THE ENVIRONMENT, EMPLOYMENT AND LOCAL COMMUNITIES. BECAUSE THESE CORPORATIONS AFFECT SOCIETY IN MANY SUBSTANTIAL WAYS, IT IS ARGUED THAT THEY CAN NO LONGER MERELY BE CONCERNED WITH MAXIMIZING PROFITS.

THE IMPETUS FOR REFORM HAS GAINED MOMENTUM FROM CORPORATE MANAGEMENT'S APPARENT INDIFFERENCE TO ECONOMIC AND SOCIAL PROBLEMS AND ITS LACK OF ACCOUNTABILITY FOR ITS OWN MISCONDUCT. HIGHLY PUBLICIZED CASES OF ILLEGAL BEHAVIOR INVOLVING SENSITIVE PAYMENTS, PERQUISITES, DISCRIMINATION AND POLLUTION HAVE UNDERMINED THE LEGITIMACY OF EXECUTIVE AUTHORITY AND HAVE RAISED CONCERN ABOUT WHETHER OR HOW CORPORATE BOARDS CAN EXERCISE INDEPENDENT LEADERSHIP AND CONTROL CORPORATE POWER.

YET, I DO THINK IT IS SUFFICIENT TO CONDEMN CORRUPT PRACTICES ON MORAL, OR EVEN ON LEGAL GROUNDS.

UNLESS WE HAVE A BETTER UNDERSTANDING OF THE ECONOMIC AND SOCIAL PROBLEMS WHICH MOTIVATE A CHIEF EXECUTIVE OFFICER TO ENGAGE IN BRIBERY TO INCREASE SALES OR DISCRIMINATE AGAINST WOMEN AND MINORITIES IN HIRING, I AM SKEPTICAL ABOUT OUR ABILITY TO REFORM CORPORATE STRUCTURE TO EFFECTIVELY IMPROVE CORPORATE BEHAVIOR.



### III. NEW MODELS FOR CORPORATE BOARDS

CURRENT CONCERN ABOUT CORPORATE GOVERNANCE AND DEFINING THE PROPER ROLE OF THE BOARD OF DIRECTORS HAS LED TO VARIOUS PROPOSALS FOR NEW MODELS IN CORPORATE BOARDS. THE SECTION OF CORPORATION, BANKING AND BUSINESS LAW OF THE AMERICAN BAR ASSOCIATION IN 1976 PUBLISHED A "CORPORATE DIRECTOR'S GUIDEBOOK", 32 BUS. LAW. 5 (NOV. 1976) WHICH INCLUDED A PROPOSED MODEL OF BOARD AND COMMITTEE STRUCTURE FOR A PUBLICLY-OWNED BUSINESS CORPORATION. ALTHOUGH THE MODEL IS NOT DERIVED FROM EXPRESS STATUTORY PRESCRIPTION OR REGULATORY REQUIREMENTS, IT IS BASED ON PERCEIVED EMERGING TRENDS IN CORPORATE GOVERNANCE. A CORNERSTONE OF THE MODEL IS THE INCLUSION OF INDEPENDENT UNAFFILIATED DIRECTORS ON THE BOARD, WHO ARE RESPONSIBLE FOR CERTAIN IMPORTANT FUNCTIONS THROUGH THE COMMITTEE SYSTEM.

THE GUIDEBOOK MAKES A DISTINCTION BETWEEN "MANAGEMENT DIRECTORS" AND "NON-MANAGEMENT DIRECTORS". A MANAGEMENT DIRECTOR IS ONE WHO DEVOTES SUBSTANTIALLY FULL-TIME AND ATTENTION TO THE AFFAIRS OF THE CORPORATION. A FORMER OFFICER OR DIRECTOR WHO NO LONGER HAS STAFF OR OPERATING RESPONSIBILITY IS STILL REGARDED AS A MANAGEMENT DIRECTOR. ALL OTHER DIRECTORS ARE NON-MANAGEMENT DIRECTORS.

UNDER THE GUIDEBOOK MODEL, NON-MANAGEMENT DIRECTORS MUST CONSTITUTE NOT LESS THAN A MAJORITY OF THE FULL BOARD. THE GUIDEBOOK EXPLAINS THAT THIS IS TO INSURE A BOARD AND COMMITTEE ENVIRONMENT CONDUSIVE TO EFFECTIVE DISINTERESTED OVERSIGHT OF MANAGEMENT. NON-MANAGEMENT DIRECTORS ARE FURTHER DIVIDED INTO "AFFILIATED NON-MANAGEMENT DIRECTORS" AND "UNAFFILIATED NON-MANAGEMENT DIRECTORS". AFFILIATED DIRECTORS ARE THOSE WHO ENGAGE IN TRANSACTIONS WITH THE CORPORATION WHICH ARE MATERIAL, SUCH AS THE CORPORATION'S COMMERCIAL BANKER, INVESTMENT BANKER, ATTORNEYS OR SUPPLIERS. THIS DICHOTOMY IS MADE FOR PURPOSES OF BOARD COMMITTEE COMPOSITION.

THE GUIDEBOOK RECOMMENDS A MINIMUM OF THREE WORKING COMMITTEES, NAMELY, THE AUDIT, NOMINATING, AND COMPENSATION COMMITTEES ON THE BELIEF THAT THEY ARE NEEDED TO EXERCISE THE MOST COMMONLY RECURRING NEEDS FOR DISINTERESTED OVERSIGHT. THE MODEL DIRECTS THAT THE AUDIT AND COMPENSATION COMMITTEES BE COMPRISED OF NON-MANAGEMENT DIRECTORS, A MAJORITY OF WHOM SHOULD BE UNAFFILIATED, BUT THE NOMINATING COMMITTEE MUST BE COMPRISED ENTIRELY OF UNAFFILIATED NON-MANAGEMENT DIRECTORS.

IN ADDITION TO THIS MODEL OF A STRUCTURED INDEPENDENT BOARD OF DIRECTORS WITH THREE WORKING COMMITTEES, IT IS RECOMMENDED THAT NON-MANAGEMENT DIRECTORS, TO ADEQUATELY CARRY OUT THEIR DUTIES, BE GIVEN DIRECT ACCESS TO THE CORPORATION'S CORPORATE COUNSEL AND INDEPENDENT AUDITOR. STAFF ASSISTANCE FROM WITHIN THE CORPORATION SHOULD BE AVAILABLE TO INSURE A FREE FLOW OF INFORMATION, BUT NO OUTSIDE STAFF SHOULD BE MAINTAINED ABSENT EXCEPTIONAL CIRCUMSTANCES.

THE GUIDEBOOK'S PROPOSALS REFLECT PRACTICES AND STRUCTURES PRESENTLY FOUND WITHIN MANY OF THE BETTER ORGANIZED AND BETTER RUN MODERN CORPORATIONS, AND ARE DESIGNED TO ACHIEVE DESIRABLE DISINTERESTED OVERSIGHT. ACCORDING TO A RECENT CONFERENCE BOARD STUDY, BACON & BROWN, "THE BOARD OF DIRECTORS: PERSPECTIVES AND PRACTICES IN NINE COUNTRIES" (1977), 66% OF 163 COMPANIES SURVEYED HAVE BOARDS ON WHICH A MAJORITY ARE OUTSIDE DIRECTORS, DEFINED TO EXCLUDE PRESENT, FORMER OR RETIRED EMPLOYEES, WHILE OVER 80% OF 208 SURVEYED COMPANIES HAVE BOARDS ON WHICH OUTSIDE DIRECTORS, DEFINED IN A BROADER SENSE TO INCLUDE PRESENT, FORMER OR RETIRED EMPLOYEES, ARE IN A MAJORITY.

THIS SOCIETY RECENTLY COMMENTED ON THE GUIDEBOOK'S PROPOSED MODEL FOR THE BOARD OF DIRECTORS. CORPORATE DIRECTOR'S GUIDEBOOK: COMMENTS SUBMITTED BY THE AMERICAN SOCIETY OF CORPORATE SECRETARIES, 33 BUS. LAW 321 (NOV. 1977). ALTHOUGH THE SOCIETY AGREED WITH THE GENERAL PLAN OF RESTRUCTURING, IT DISAGREED WITH THREE PREFERENCES OF THE GUIDEBOOK. SPECIFICALLY, IT TOOK ISSUE WITH THE RECOMMENDATIONS THAT NON-MANAGEMENT DIRECTORS SHOULD NECESSARILY CONSTITUTE A MAJORITY OF THE FULL BOARD; THAT THE NOMINATING COMMITTEE SHOULD BE COMPRISED ENTIRELY OF NON-MANAGEMENT DIRECTORS; AND THAT THE ROLE OF THE OUTSIDE DIRECTOR SHOULD BE CHARACTERIZED AS A "MONITOR" OR "OVERSEER".

THE SOCIETY ALSO NOTED THE OMISSION IN THE GUIDEBOOK OF ANY MENTION OF THE CORPORATE SECRETARY, AS AN IMPORTANT SOURCE OF ASSISTANCE TO THE BOARD AND INDIVIDUAL DIRECTORS. YOU HAVE CHARACTERIZED THE CORPORATE SECRETARY AS "THE CLEARING HOUSE FOR COMMUNICATIONS", SINCE THE SECRETARY IS THE OFFICER MOST LIKELY TO BE INVOLVED WITH MATTERS CONCERNING THE FLOW OF INFORMATION TO THE BOARD, ARRANGING ORIENTATION FOR DIRECTORS, COORDINATING REQUESTS FOR ADDITIONAL INFORMATION, AND SERVING AS A FOCAL POINT FOR COMMUNICATIONS ON BOARD MATTERS.

ANOTHER PROPOSED MODEL FOR A CORPORATE BOARD WAS THAT SUBMITTED BY MESSRS. NADER AND GREEN AT THE SEC'S CORPORATE GOVERNANCE HEARINGS. THEY CALLED FOR A BOARD OF ALL OUTSIDE DIRECTORS WITH A FULL-TIME STAFF AVAILABLE TO MONITOR EXECUTIVE PERFORMANCE. THE BOARD WOULD REVIEW ALL FUNDAMENTAL BUSINESS DECISIONS, HIRE AND DISMISS THE CHIEF EXECUTIVE, SET THE SALARY OF ALL EXECUTIVES, NOMINATE THE CORPORATION'S FINANCIAL AUDITORS AND SELECT THE CORPORATION'S GENERAL COUNSEL. THE NADER/GREEN BOARD WOULD BE COMPRISED OF "CONSTITUENCY DIRECTORS", EACH WITH A GENERAL DUTY TO SEE THAT THE CORPORATION IS PROFITABLY RUN AND WITH A SPECIFIC DUTY TO OVERSEE A PARTICULAR ASPECT OF CORPORATE MANAGEMENT. THE DIFFERENT CONSTITUENCIES OF THESE DIRECTORS WOULD BE THE SHAREHOLDERS, EMPLOYEES, CONSUMERS, TAXPAYERS AND LOCAL COMMUNITIES. FURTHERMORE, SUBSTANTIAL DISCLOSURE ABOUT THE FINANCIAL STATUS AND BACKGROUND OF THESE DIRECTORS WOULD BE REQUIRED.

ANOTHER MODEL TO WHICH SOME ATTENTION IS BEING GIVEN IS THE SO-CALLED TWO-TIER OR GERMAN MODEL. THIS MODEL HAS A DUAL-BOARD IN WHICH THE FUNCTIONS SUPPOSEDLY PERFORMED BY THE SINGLE BOARD UNDER THE RECEIVED U.S. LEGAL MODEL (MANAGEMENT AND SUPERVISION) ARE DISTRIBUTED BETWEEN TWO SEPARATE ORGANS, ONE ENTRUSTED WITH MANAGEMENT, AND THE OTHER WITH SUPERVISION.

THIS TWO-TIER SYSTEM HAS BEEN SPREADING THROUGHOUT EUROPE IN RECENT YEARS. THE MANAGING BOARD IS COMPRISED OF THE CORPORATION'S TOP EXECUTIVES WHILE THE SUPERVISORY BOARD MUST BE COMPRISED OF INDEPENDENT PERSONNEL AND CANNOT INCLUDE ANY MEMBER OF THE MANAGING BOARD.

ALTHOUGH THE TWO-TIER SYSTEM IS SOMEWHAT DIFFERENT IN FORM FROM THE OTHER MODELS I HAVE DESCRIBED, IN REALITY IT MAY BE SUBSTANTIVELY VERY SIMILAR TO OUR SINGLE BOARD WITH OUTSIDE DIRECTORS AND WORKING COMMITTEES EXERCISING INDEPENDENCE.

OTHER PROPOSED MODELS OF INTEREST WOULD NOT CHANGE THE STRUCTURE OF CORPORATE BOARDS, BUT WOULD ENCOURAGE GREATER INDEPENDENCE BY INDIVIDUAL DIRECTORS. SOME ADVOCATE THE ADVENT OF PROFESSIONAL DIRECTORS. A SMALL CADRE OF PROFESSIONAL DIRECTORS HAS DEVELOPED IN THE U.S., PRIMARILY COMPRISED OF SEASONED BUSINESS EXECUTIVES OR OTHER PROFESSIONALS WITH BUSINESS EXPERIENCE. ONE COMMON TYPE OF PROPOSAL CALLS FOR FILLING BOARD POSITIONS WITH PERSONS WHO WOULD MAKE A CAREER OUT OF SERVING AS OUTSIDE DIRECTORS IN A NUMBER OF CORPORATIONS AND WOULD, THEREFORE, PRESUMABLY BE MORE EXPERT IN AND MORE ATTENTIVE TO THEIR OBLIGATIONS AS DIRECTORS. ALTHOUGH SOME HAVE QUESTIONED WHETHER A SUFFICIENT NUMBER OF POTENTIAL PROFESSIONAL DIRECTORS NOW EXISTS TO AVOID THE PROBLEMS OF INTERLOCKING DIRECTORSHIPS, I BELIEVE THERE IS AMPLE TALENT AVAILABLE FOR DIRECTORSHIPS, PARTICULARLY IF BUSINESSES SEARCH FOR TALENT OUTSIDE OF THE CLOSED AND COZY SOCIAL NETWORKS OF EXISTING TOP MANAGEMENT.

PARTICULARLY, IF THE DIRECTOR'S COMPENSATION IS INCREASED, THE PROFESSIONAL DIRECTOR COULD BECOME A NEW AND INTERESTING PROFESSION.

ANOTHER PROPOSAL SHORT OF RESTRUCTURING THE BOARD WAS PUT FORTH BY ARTHUR GOLDBERG, WHO, IN RESPONSE TO HIS OWN EXPERIENCE SITTING AS AN OUTSIDE DIRECTOR, ADVOCATED THAT OUTSIDE DIRECTORS BE PROVIDED A FULL-TIME STAFF SO THAT THEY CAN BE MORE FULLY INFORMED AND CAN TAKE A STRONGER HAND IN CORPORATE AFFAIRS. THIS PROPOSAL WOULD APPEAR TO BE AN EFFORT TO BRING THE WORKING MODEL OF THE BOARD IN LINE WITH THE THEORETICAL RECEIVED MODEL AND ENABLE DIRECTORS TO BETTER "MANAGE" THE BUSINESS AND AFFAIRS OF THE CORPORATION. A CRITICISM OF THIS PROPOSAL IS THAT MANAGEMENT BY BOARDS ON A DAY TO DAY BASIS IS NOT REALISTICALLY ACHIEVABLE, AND A FULL-TIME STAFF FOR OUTSIDE DIRECTORS WOULD BE DUPLICATIVE, EXPENSIVE AND OVERLY BUREAUCRATIC.

#### IV. THE POLITICS OF CHANGE

THE SEC HAS NO DIRECT OR SPECIFIC MANDATE TO STRUCTURE OR ALTER THE STRUCTURE OF CORPORATE BOARDS. PERSONALLY, I HAVE NEVER SERVED AS A DIRECTOR OR OFFICER OF ANY CORPORATION -- I HAVE NEVER SEEN THE CORPORATION FROM THE VANTAGE POINT OF CORPORATE SECRETARY -- AND I AM NOT SANGUINE ABOUT MY ABILITY OR EXPERTISE AS A GOVERNMENT BUREAUCRAT TO GENERALLY REGULATE CORPORATE BEHAVIOR.

YET, DURING THE SEC HEARINGS MANY WITNESSES URGED THE COMMISSION TO TAKE A MORE ACTIVE ROLE IN SOLVING PROBLEMS OF CORPORATE GOVERNANCE. SOME OF THE WITNESSES URGED US TO COMPEL CORPORATIONS TO BE MORE RESPONSIVE TO THE NEEDS AND WISHES OF THEIR SHAREHOLDERS.

OTHER WITNESSES URGED US TO BE MORE SENSITIVE TO SOCIALLY SIGNIFICANT ISSUES WHICH TRANSCEND SHAREHOLDER INTERESTS.

AS POINTED OUT IN A RECENT ARTICLE BY PROFESSOR WALTER WERNER, "MANAGEMENT, STOCK MARKET AND CORPORATE REFORM: BERLE AND MEANS RECONSIDERED", 77 COL. L. REV. 388 (1977), SOCIETY'S GOALS AND SHAREHOLDERS' GOALS MAY, AND IN THE PAST HAVE TENDED TO, COINCIDE, BUT THEY ALSO MAY CONFLICT. ALTHOUGH THE CORPORATION IS BOTH A BUSINESS ENTERPRISE OPERATED FOR PRIVATE GAIN AND A SOCIAL INSTITUTION, WHERE MEETING COMMUNITY DEMANDS IS LIKELY TO AFFECT SHAREHOLDERS ADVERSELY, MANAGERMENTS TEND TO SUBORDINATE COMMUNITY TO SHAREHOLDER INTEREST.

BY REASON OF OUR STATUTORY MANDATES AND BECAUSE OF OUR TRADITIONAL PREOCCUPATION WITH INVESTOR PROTECTION, THE SEC ALSO HAS FOCUSED PRIMARILY UPON SHAREHOLDERS' CONCERNS, RATHER THAN GENERAL ISSUES OF SOCIAL SIGNIFICANCE. NEVERTHELESS, THERE IS A SYMBIOTIC RELATIONSHIP BETWEEN GENERAL PUBLIC AND INVESTOR CONFIDENCE IN THE BUSINESS COMMUNITY, WHICH IS RECOGNIZED IN THE FEDERAL SECURITIES LAWS AND WHICH GIVES THE SEC A LEGITIMATE INTEREST IN REFORMING THE STRUCTURE OF CORPORATE BOARDS.



THE BOARD OF DIRECTORS NOT ONLY DETERMINES THE RELATIONSHIP BETWEEN SHAREHOLDERS AND MANAGEMENT, BUT ALSO ACTS AS AN INTERMEDIARY BETWEEN MANAGEMENT AND THE MARKETPLACE.

ALTHOUGH THERE APPEARS TO BE A GROWING CONSENSUS THAT A MORE INDEPENDENT BOARD WILL BE MORE EFFECTIVE IN PROMOTING BOTH SHAREHOLDER AND COMMUNITY OBJECTIVES, PROPONENTS OF RESTRUCTURING HAVE SUGGESTED DIFFERENT MEANS TO THE END OF SUCH A BOARD. THESE PROPOSALS RANGE FROM VOLUNTARY CORPORATE ACTION TO FEDERAL CHARTERING. THE PROPER ROLE OF THE SEC IN THIS PROCESS OF CHANGE HAS NOT BEEN FOCUSED UPON VERY CLEARLY. FURTHER, TO THE EXTENT THAT THE IMPETUS FOR CHANGE ARISES FROM AN EFFORT TO SUBVERT SHAREHOLDER FOR COMMUNITY GOALS, THE COMMISSION MAY BE FORCED TO BROADEN ITS TRADITIONAL SIGHTS.

IN A SOCIETY AS PLURALISTIC AS OURS, WHERE THE RELATIONSHIP BETWEEN GOVERNMENT AND BUSINESS IS BOTH ADVERSARIAL AND COOPERATIVE, SIGNIFICANT CHANGE IN OUR PUBLIC CORPORATIONS EVOLVES THROUGH AN INTERACTION OF GOVERNMENT AND PRIVATE SECTOR INITIATIVES. THE WAY IN WHICH THIS PROCESS HAS WORKED IN THE PAST MAY BE INSTRUCTIVE IN DEMONSTRATING HOW BOARDS CAN OR SHOULD BE REMODELED IN THE FUTURE.

## V. SEC INFLUENCES ON CHANGE

THE FORM OF ANY RESTRUCTURED BOARD MODEL CAN OBVIOUSLY BE INFLUENCED BY COMMISSION ACTION. IN RECENT YEARS THE COMMISSION HAS OBTAINED VARIOUS TYPES OF ANCILLARY RELIEF IN NUMEROUS ADMINISTRATIVE AND COURT CASES WHICH REQUIRED SUBSTANTIAL ALTERATIONS IN THE STRUCTURE OF BOARDS OF DIRECTORS AND BOARD COMMITTEES. SUCH ANCILLARY RELIEF HAS REQUIRED THAT CERTAIN NUMBERS OF INDEPENDENT DIRECTORS BE APPOINTED TO THE BOARDS OF DIRECTORS, OR THAT A NEW INDEPENDENT AUDIT COMMITTEE BE ESTABLISHED. USUALLY APPOINTMENTS TO THE BOARD AND AUDIT COMMITTEE (AS WELL AS OTHER COMMITTEES) MUST BE APPROVED BY THE COMMISSION AND THE COURTS. MOREOVER, OFTEN THE ANCILLARY RELIEF HAS REQUIRED THAT A FULLY INDEPENDENT COMPLIANCE COMMITTEE AND AN EXECUTIVE COMMITTEE BE FORMED. NORMALLY, BOARD COMMITTEES REQUIRED TO BE ESTABLISHED MUST MAINTAIN AN INDEPENDENT MAJORITY ACCEPTABLE TO THE COMMISSION.

THE COMMISSION HAS HAD A MORE DIRECT BUT POSSIBLY LESS SIGNIFICANT INFLUENCE OVER CORPORATE STRUCTURE UNDER CERTAIN SECTIONS OF THE INVESTMENT COMPANY ACT OF 1940. THOSE PROVISIONS GIVE THE COMMISSION SPECIFIC STATUTORY POWERS TO REGULATE THE COMPOSITION OF CORPORATE BOARDS OF REGISTERED INVESTMENT COMPANIES.

FOR EXAMPLE, SECTION 10(A) REQUIRES THAT AT LEAST 40% OF THE BOARD OF DIRECTORS OF A REGISTERED INVESTMENT COMPANY BE COMPOSED OF UNAFFILIATED PERSONS OR INDEPENDENT DIRECTORS. ALTHOUGH IN PRACTICE THE INDEPENDENCE OF UNAFFILIATED DIRECTORS HAS NOT ALWAYS BEEN ACHIEVED, THE COMMISSION HAS SUBSTANTIAL AUTHORITY UNDER THE 1940 ACT TO REQUIRE A BOARD MODEL WHICH WOULD INSURE THE STATUTORY STANDARDS OF INDEPENDENCE.

THE SEC'S EFFORTS OVER THE YEARS TO DEFINE WHAT CONSTITUTES "INDEPENDENCE" WITH RESPECT TO ACCOUNTANTS WHO AUDIT FINANCIAL STATEMENTS FILED WITH THE COMMISSION ARE ALSO WORTHY OF SOME NOTE. TO THE EXTENT THE COMMISSION'S PRONOUNCEMENTS ON INDEPENDENCE OF ACCOUNTANTS MAY BE APPLIED IN OTHER CONTEXTS, THEY MAY INFLUENCE THE CONCEPT OF INDEPENDENCE WITH RESPECT TO THE COMPOSITION OF CORPORATE BOARDS OF DIRECTORS.

THE COMMISSION HAS BROAD AUTHORITY UNDER SECTION 19 OF THE SECURITIES EXCHANGE ACT OF 1934 OVER RULES AND REGULATIONS OF THE VARIOUS REGISTERED EXCHANGES AND THE NASD. IN 1975 THE COMMISSION WAS ALSO GIVEN THE AUTHORITY IN SECTION 11A(A)(2) OF THE EXCHANGE ACT TO DETERMINE WHICH SECURITIES SHOULD BE QUALIFIED FOR TRADING IN THE NATIONAL MARKET SYSTEM.

THESE POWERS CAN BE UTILIZED TO IMPACT CORPORATE GOVERNANCE, AS EXEMPLIFIED BY THE RECENT RULE CHANGE OF THE NEW YORK STOCK EXCHANGE TO REQUIRE, AS A CONDITION FOR LISTING, THAT EACH LISTED COMPANY HAVE AN INDEPENDENT AUDIT COMMITTEE.

SINCE 1934 THE COMMISSION HAS HAD CERTAIN OVERSIGHT POWERS CONCERNING LISTING REQUIREMENTS OF THE VARIOUS EXCHANGES. THE 1975 AMENDMENTS EXPANDED THE COMMISSION'S AUTHORITY SIGNIFICANTLY OVER SELF-REGULATORY ORGANIZATIONS AND REQUIRED THAT THE COMMISSION APPROVE ALL PROPOSED RULE CHANGES. IN ADDITION, THE COMMISSION WAS GIVEN BROAD AUTHORITY TO AMEND ANY SELF-REGULATORY RULE IN ANY RESPECT CONSISTENT WITH THE ACT. IT WAS IN THIS REGULATORY FRAMEWORK THAT THE COMMISSION SUGGESTED AND THE NEW YORK STOCK EXCHANGE SUBMITTED ITS RULE PROPOSAL REQUIRING THAT BY JUNE OF 1978 ALL LISTED DOMESTIC COMPANIES MUST HAVE AN INDEPENDENT AUDIT COMMITTEE AS PART OF THEIR BOARD STRUCTURE.

THE COMMISSION HAS BROAD REGULATORY POWERS UNDER SECTION 14(A) OF THE EXCHANGE ACT TO MAINTAIN, PROMOTE AND IMPROVE FAIR CORPORATE SUFFRAGE FOR SHAREHOLDERS. OUR PROXY POWERS ARE AN INTRUSION OF FEDERAL LAW INTO THE INTERNAL AFFAIRS OF CORPORATIONS WHICH COULD BE USED TO AFFECT CHANGES IN BOARD STRUCTURE. FOR EXAMPLE, IN MY OPINION THE COMMISSION COULD MANDATE THE USE OF NOMINATING COMMITTEES UNDER THIS AUTHORITY.

A FURTHER COMMISSION INFLUENCE FOR CHANGE HAS BEEN THE HEARINGS ON CORPORATE GOVERNANCE IN WHICH THE COMMISSION SPECIFICALLY ASKED QUESTIONS CONCERNING CORPORATE ACCOUNTABILITY AND HOW TO ACHIEVE IT. THE COMMISSION'S FOCUS ON ISSUES OF CORPORATE ACCOUNTABILITY REFLECTS ITS CONCERN ABOUT CORPORATE STRUCTURE. OUR REQUEST FOR COMMENT ON WHETHER OR NOT STRUCTURAL CHANGE IS WARRANTED, AND THE NATIONAL DISCUSSION WHICH THUS ENSUED WILL HOPEFULLY HAVE SOME INFLUENCE ON THE PROCESS OF REFORM.

FINALLY, THE COMMISSION'S VARIOUS DISCLOSURE REQUIREMENTS WILL IN ALL LIKELIHOOD BRING ABOUT SOME CHANGE IN CORPORATE STRUCTURE. FOR EXAMPLE, IN 1972 THE COMMISSION ENDORSED THE CONCEPT OF INDEPENDENT AUDIT COMMITTEES FOR PUBLIC CORPORATIONS. THEN IN 1974 THE COMMISSION REITERATED ITS SUPPORT FOR AUDIT COMMITTEES AND AT THE TIME AMENDED ITS RULES TO REQUIRE DISCLOSURE IN PROXY STATEMENTS OF WHETHER OR NOT A CORPORATION HAD AN INDEPENDENT AUDIT COMMITTEE. THE REQUIREMENT TO DISCLOSE WHETHER OR NOT AN AUDIT COMMITTEE EXISTS HAS PRESUMABLY TENDED TO ENCOURAGE THE FORMATION OF SUCH COMMITTEES. ANOTHER EXAMPLE OF REFORM THROUGH DISCLOSURE IS THE COMMISSION'S INTERPRETATIVE RELEASE CONCERNING DISCLOSURE OF EXECUTIVE REMUNERATION CLASSIFIED AS PERQUISITES. ALTHOUGH REMUNERATION OF CORPORATE MANAGEMENT IS ALREADY REQUIRED TO BE DISCLOSED, THE CRITICAL SCRUTINY OF PERQUISITES MAY WELL INFLUENCE THE ESTABLISHMENT OF BOARD COMPENSATION COMMITTEES.

## VI. PRIVATE SECTOR INITIATIVES

ALTHOUGH I WOULD LIKE TO CLAIM THAT THE SEC HAS HAD A BENEFICIAL INFLUENCE ON STRUCTURAL REFORM OF CORPORATE BOARDS, I RECOGNIZE THAT MOST INITIATIVES FOR STRUCTURAL REFORM IN CORPORATE GOVERNANCE HAVE AND MUST CONTINUE TO COME FROM THE BUSINESS COMMUNITY. THE CONFERENCE BOARD STUDY WHICH I REFERRED TO EARLIER NOTED THAT A GROWING NUMBER OF BOARDS HAVE BEGUN MAKING STRUCTURAL CHANGES TO ASSERT AUTHORITY WHICH IN THE PAST HAS BEEN LARGELY USURPED BY CORPORATE MANAGEMENT. EXPERIMENTATION WITH EXISTING MODELS WAS TESTIFIED ABOUT BY A NUMBER OF WITNESSES AT THE COMMISSION HEARINGS ON CORPORATE GOVERNANCE.

NOTEWORTHY EXAMPLES OF INTERNAL REFORMS HAVE TAKEN PLACE WITHIN THE BOARDS AT AT&T, GENERAL ELECTRIC, TEXAS INSTRUMENTS, GENERAL MOTORS, CONNECTICUT GENERAL INSURANCE, AND FIRST PENNSYLVANIA CORP. AT CONNECTICUT GENERAL, FOR INSTANCE, SHAREHOLDERS APPROVED IN 1976 A REDEFINITION OF THE ROLE OF ITS BOARD OF DIRECTORS, WHICH EXPRESSLY SEVERS THE BOARD FROM MANAGEMENT. AMONG OTHER THINGS, THE AMENDMENT PROVIDES THAT THE BOARD SERVE,

"ON BEHALF OF THE STOCKHOLDERS, [AS]  
THE GUARDIANS OF INTERESTS OF THOSE  
WHO HAVE A STAKE IN THE HEALTH OF THE  
ENTERPRISE ... [WHICH INCLUDES]  
STOCKHOLDERS ... CUSTOMERS, EMPLOYEES  
SUPPLIERS, THE COMMUNITIES IN WHICH  
IT OPERATES AND SOCIETY AS A WHOLE."

THE AMENDMENT, WHICH WAS ENDORSED BY THE CHAIRMAN OF  
THE BOARD OF DIRECTORS, CLEARLY DISTINGUISHES THE ROLE  
OF MANAGEMENT FROM THAT OF THE BOARD AND GUARANTEES  
THAT THE AUDIT COMMITTEE WILL BE COMPOSED SOLELY OF  
OUTSIDE DIRECTORS.

AT&T HAS A SPECIAL CORPORATE STAFF WHICH IS AVAILABLE  
TO GIVE OUTSIDE DIRECTORS INFORMATION ABOUT ANY ASPECT  
OF COMPANY OPERATIONS. THE GROUP IS CALLED THE  
"CORPORATE ANALYSIS SECTION" AND WORKS UNDER THE IMMEDIATE  
DIRECTION OF THAT COMPANY'S CORPORATE SECRETARY. ALTHOUGH  
THE MEMBERS OF THE STAFF HAVE REGULAR CORPORATE DUTIES,  
THEY ARE INDEPENDENT OF ANY SPECIFIC COMPANY DEPARTMENT.

FREQUENTLY MENTIONED AS A MODEL FOR CHANGE IS  
TEXAS INSTRUMENTS WHICH ADOPTED A POLICY CLASSIFYING  
ITS DIRECTORS AS "GENERAL DIRECTORS", DIRECTORS AND  
OFFICERS OF THE BOARD.

THE TEXAS INSTRUMENT BOARD IS COMPOSED OF A MAJORITY OF GENERAL DIRECTORS, WHO ARE NON-MANAGEMENT AND WHO MUST SERVE A MINIMUM OF 30 CALENDAR DAYS AND PREFERABLY 80 OR MORE DAYS EACH YEAR. IN ADDITION, THE GENERAL DIRECTORS ARE REQUIRED TO PARTICIPATE IN ALL ASPECTS OF THE BOARD'S ACTIVITIES INCLUDING MEMBERSHIP ON (AUDIT, NOMINATING OR COMPENSATION) COMMITTEES, CHAIRMANSHIP OF SUCH COMMITTEES AND OPTIONAL ACTIVITIES IN THE INTEREST OF TEXAS INSTRUMENTS. IN ORDER TO PROVIDE ADEQUATE COMPENSATION AND TO STIMULATE GENERAL DIRECTORS' PARTICIPATION, GENERAL DIRECTORS WHO SERVE 30 CALENDAR DAYS ARE PAID \$30,000 AND IF MORE SERVICE IS RENDERED THEN COMPARABLE ADDITIONAL FEES ARE PAID. "DIRECTORS" AS OPPOSED TO "GENERAL DIRECTORS" USUALLY ARE INDIVIDUALS WITH INTIMATE KNOWLEDGE OF TEXAS INSTRUMENTS FROM A FORMER ASSOCIATION WITH THE COMPANY. DIRECTORS IN THIS CATEGORY ARE EXPECTED TO SPEND AT LEAST 15 DAYS A YEAR ON TEXAS INSTRUMENT BUSINESS AND ARE APPROPRIATELY COMPENSATED. THE FINAL CATEGORY, OFFICERS OF THE BOARD, ARE TEXAS INSTRUMENTS EMPLOYEES, OTHER THAN THE CHAIRMAN OR PRESIDENT, WHO DEVOTE A PRINCIPAL AMOUNT OF THEIR TIME TO BOARD DUTIES.



AN IMPORTANT QUASI-PUBLIC INFLUENCE FOR REFORM OF THE BOARD IS THE NEW YORK STOCK EXCHANGE, WHICH REPRESENTS AND IN TURN REGULATES, DIRECTLY OR INDIRECTLY, AN INFLUENTIAL SEGMENT OF THE PRIVATE SECTOR. THE EXCHANGE HAS RECOGNIZED THAT OUTSIDE DIRECTORS OF PUBLICLY-OWNED COMPANIES ARE WIDELY ACCEPTED AND BENEFICIAL. ON THE BASIS OF A JOINT STUDY BY THE CONFERENCE BOARD AND THE AMERICAN SOCIETY OF CORPORATE SECRETARIES IN 1973 WHICH SHOWED THAT OUTSIDE DIRECTORS REPRESENTED A MAJORITY OF THE BOARD OF DIRECTORS IN 86% OF SURVEYED NON-MANUFACTURING COMPANIES AND 71% OF MANUFACTURING COMPANIES, THE NYSE RECOMMENDED THAT AT LEAST THREE OUTSIDE DIRECTORS BE INCLUDED ON THE BOARD OF EACH LISTED COMPANY. AS I STATED EARLIER, THE EXCHANGE LAST YEAR MADE IT A REQUIREMENT OF LISTING THAT CORPORATIONS HAVE AN INDEPENDENT AUDIT COMMITTEE. THIS REQUIREMENT AFFECTS OVER 1500 CORPORATIONS WHICH OVERWHELMINGLY SUPPORTED THE PROPOSAL.

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA) ALSO HAS THE ABILITY TO INFLUENCE CHANGES IN THE STRUCTURE AND COMPOSITION OF CORPORATE BOARDS. IN 1967, THE AICPA STATED THAT AUDIT COMMITTEES WERE "GOOD FOR THE COMPANY AND GOOD FOR THE PUBLIC."

MORE RECENTLY, THE AICPA HAS ORGANIZED A COMMITTEE TO STUDY WHETHER AND HOW THE AICPA MAY IMPOSE ON AUDITORS OF PUBLICLY OWNED CORPORATIONS A REQUIREMENT THAT SUCH CLIENTS HAVE AN AUDIT COMMITTEE, COMPOSED ENTIRELY OF INDEPENDENT DIRECTORS, THEREBY FORCING STRUCTURAL CHANGE ON THE BOARDS OF CORPORATIONS.

ASSOCIATIONS SUCH AS THE BUSINESS ROUNDTABLE AND THE AMERICAN SOCIETY OF CORPORATE SECRETARIES HAVE ALSO BEEN ACTIVE IN SEARCHING FOR APPROPRIATE REFORMS IN OUR GIVEN MODELS FOR CORPORATE GOVERNANCE. IN 1976 THE ROUNDTABLE CREATED A COMMITTEE ON CORPORATE ORGANIZATION POLICY WHICH SPONSORED A SYMPOSIUM AT HARVARD LAST MAY TO CONSIDER THE "ROLE AND COMPOSITION OF THE BOARD OF DIRECTORS OF A LARGE PUBLICLY-HELD CORPORATION." THAT COMMITTEE THEN MET AGAIN IN JUNE OF LAST YEAR AS A CONFERENCE FOR CHIEF EXECUCIVE OFFICERS IN NEW YORK TO CONSIDER THE SAME SUBJECT. THE ROUNDTABLE AT THE COMMISSION'S HEARINGS STATED ITS SUPPORT FOR CORPORATE RESTRUCTURING OF THE BOARD AND FOR REFORM WITHIN THE PRESENT SYSTEM OF CORPORATE GOVERNANCE.

THE AMERICAN SOCIETY OF CORPORATE SECRETARIES IS A DISTINGUISHED, ACTIVE ORGANIZATION THAT HAS BEEN AND SHOULD BE VERY MUCH INTERESTED IN EFFORTS TO IMPROVE CORPORATE GOVERNANCE.

WITH OVER 2400 MEMBERS REPRESENTING MORE THAN 1700 CORPORATIONS YOU ARE AN ORGANIZATION OF INDIVIDUALS WHO SERVE AN IMPORTANT FUNCTION IN MAKING THE BOARD OF DIRECTORS EFFECTIVELY CONDUCT ITS AFFAIRS. I LISTENED WITH GREAT INTEREST TO THE SOCIETY'S STATEMENT AT OUR CORPORATE GOVERNANCE HEARINGS, AND I HAVE REVIEWED YOUR COMMENTS CONCERNING THE CORPORATE DIRECTOR'S GUIDEBOOK. ANY NEW MODELS FOR A BOARD SHOULD TAKE INTO ACCOUNT THE ROLE OF THE CORPORATE SECRETARY. I HOPE THAT THE OFFER OF ASSISTANCE MADE BY YOUR CHAIRMAN AT THE HEARINGS ON SEPTEMBER 30, 1977, IN CONDUCTING SURVEYS OR STUDIES WITH RESPECT TO THE ISSUE OF CORPORATE ACCOUNTABILITY CAN BE UTILIZED TO GOOD PURPOSE. I NOTE THAT THE SOCIETY HAS ENDORSED THE CONCEPT OF A NOMINATING COMMITTEE, AND I WOULD BE ESPECIALLY INTERESTED IN LISTENING TO YOUR SUGGESTIONS AS TO HOW NOMINATING COMMITTEES OR OTHER STRUCTURAL REFORMS IN THE BOARD OF DIRECTORS CAN BE ACCOMPLISHED.

#### VII. LEGISLATION

DESPITE THE INITIATIVES TAKEN BY THE PRIVATE SECTOR, AND THE INFLUENCE FOR REFORM IN CORPORATE GOVERNANCE WHICH HAS BEEN EXERCISED BY THE SEC, THERE ARE MANY BELIEVERS IN DIRECT FEDERAL REGULATION OF CORPORATE STRUCTURE.

THE IDEA OF FEDERAL CHARTERING OF MAJOR CORPORATIONS SEEMS TO BE GAINING WIDESPREAD ATTENTION, AND HAS SOME SUPPORTERS ON CAPITOL HILL.

IN 1975, REP. JAMES V. STANTON INTRODUCED THE CORPORATE CITIZENSHIP AND COMPETITION BILL WHICH PROVIDED FOR FEDERAL CHARTERING TO ACHIEVE ANTI-TRUST OBJECTIVES. DURING THE SUMMER OF 1976 THE SENATE COMMERCE COMMITTEE HELD HEARINGS ON THE BEHAVIOR OF BUSINESS CORPORATIONS AND SEVERAL WITNESSES URGED FEDERAL CHARTERING. CORPORATE GOVERNANCE HAS ALSO BEEN THE SUBJECT OF THE HEARINGS LAST JUNE BEFORE THE SUBCOMMITTEE ON CITIZENS AND SHAREHOLDER RIGHTS AND REMEDIES OF THE SENATE COMMITTEE ON JUDICIARY. IN THE PAST FEW WEEKS PRESIDENT CARTER SIGNED INTO LAW THE FOREIGN CORRUPT PRACTICES ACT OF 1977 WHICH PROHIBITS FALSIFICATION OF CORPORATE ACCOUNTING RECORDS AND REQUIRES THAT MANAGEMENT DEVISE AND MAINTAIN ADEQUATE ACCOUNTING CONTROLS.

AN ALTERNATIVE TO FEDERAL CHARTERING IS THE PROPOSAL OF PROFESSOR CARY FOR A FEDERAL MINIMUM STANDARDS ACT. SUCH LEGISLATION WOULD SPECIFY MINIMUM FIDUCIARY STANDARDS WITH RESPECT TO DIRECTORS, OFFICERS AND CONTROLLING SHAREHOLDERS AND IMPOSE RESTRAINTS TO PREVENT MANAGEMENT CONFLICT OF INTEREST AND REPREHENSIBLE CONDUCT. THE CARY PROPOSAL FOCUSES, HOWEVER, ON STANDARDS OF CONDUCT FOR CORPORATE MANAGEMENT AND DOES NOT ADVOCATE STRUCTURAL REFORM.

### VIII. THE AUDIT COMMITTEE - A CASE STUDY

THE DEVELOPMENT OF A CONSENSUS FOR A CHANGE IN CORPORATE GOVERNANCE IS VERY WELL ILLUSTRATED BY THE DEVELOPMENT OF THE AUDIT COMMITTEE COMPOSED OF INDEPENDENT DIRECTORS. I HAVE MENTIONED THE AUDIT COMMITTEE MODEL SEVERAL TIMES THIS EVENING SINCE I BELIEVE ITS INCREASING ACCEPTANCE IS AN INFORMATIVE CASE HISTORY IN THE COOPERATION BETWEEN THE PUBLIC AND PRIVATE SECTORS IN RESPONSE TO QUESTIONS OF CORPORATE ACCOUNTABILITY. AT THE RISK OF SOME REPETITION, I WOULD LIKE TO REVIEW THE HISTORY OF THE AUDIT COMMITTEE MODEL AS A REQUIREMENT FOR NEW YORK STOCK EXCHANGE LISTING.

THE LISTING AGREEMENT, WHICH HAS TRADITIONALLY BEEN A PRINCIPAL MEANS BY WHICH THE EXCHANGE ENFORCES ITS LISTING STANDARDS, WAS FIRST ADOPTED BY THE NEW YORK STOCK EXCHANGE IN 1899. THAT AGREEMENT, AND THE POLICIES SET FORTH IN THE NYSE COMPANY MANUAL HAVE DEVELOPED GRADUALLY OVER THE YEARS AND IMPOSE A WIDE VARIETY OF REQUIREMENTS FOR INITIAL AND CONTINUED LISTING. THOSE POLICIES FREQUENTLY REQUIRE A LISTED COMPANY TO TAKE ACTION WHICH IT WOULD NOT OTHERWISE BE REQUIRED TO TAKE UNDER STATE LAW, AND PREVENTS A LISTED COMPANY FROM TAKING ACTION WHICH IT WOULD OTHERWISE BE PERMITTED TO TAKE UNDER STATE LAW.

AS FAR BACK AS 1940, FOLLOWING THE INVESTIGATION OF MCKESSON AND ROBBIN DRUGS, INC., THE COMMISSION RECOMMENDED AUDIT COMMITTEES AS A MEANS FOR IMPROVING FINANCIAL STATEMENT DISCLOSURE. IN THE SAME YEAR THE NYSE SUGGESTED TO ITS LISTED COMPANIES THE CONCEPT OF THE AUDIT COMMITTEE.

IN 1967 THE AICPA RECOMMENDED THAT ALL LARGE PUBLICLY-HELD CORPORATIONS HAVE AUDIT COMMITTEES. THEN IN 1972 THE COMMISSION SPECIFICALLY ENDORSED THE ESTABLISHMENT BY ALL PUBLICLY-HELD COMPANIES OF AUDIT COMMITTEES COMPRISED OF OUTSIDE DIRECTORS. A YEAR LATER THE NEW YORK STOCK EXCHANGE STRONGLY RECOMMENDED THAT EACH LISTED COMPANY FORM AN AUDIT COMMITTEE PREFERABLY COMPOSED EXCLUSIVELY OF OUTSIDE DIRECTORS. BY 1973, ABOUT 80% OF COMPANIES LISTED ON THE NYSE HAD APPOINTED AN AUDIT COMMITTEE, AND ANOTHER 13% HAD DEVELOPED PLANS TO DO SO. IN 1974 THE COMMISSION REITERATED ITS SUPPORT FOR AUDIT COMMITTEES IN AMENDING ITS RULES TO REQUIRE DISCLOSURE IN PROXY STATEMENTS OF THE EXISTENCE OR ABSENCE OF AN AUDIT COMMITTEE.

IN MAY OF 1976, THE COMMISSION REPORTED TO THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE ON ITS INVESTIGATION INTO QUESTIONABLE CORPORATE PAYMENTS AND PRACTICES.

WE REFERRED TO THE ACTIVITIES OF AUDIT COMMITTEES IN UNCOVERING FALSIFICATION OF CORPORATE RECORDS AND THE USE OF "SLUSH" FUNDS AND CITED THE COMMITTEES AS APPROPRIATE MODELS OF CORPORATE BEHAVIOR.

FOLLOWING THAT INVESTIGATION AND AS PART OF THE REPORT THE COMMISSION URGED STRENGTHENING THE INDEPENDENCE AND VITALITY OF CORPORATE BOARDS OF DIRECTORS AND SUGGESTED IN A LETTER FROM SEC CHAIRMAN HILLS TO WILLIAM M. BATTEN, THAT THE NEW YORK STOCK EXCHANGE

"COULD TAKE THE LEAD IN THIS AREA BY APPROPRIATELY REVISING ITS LISTING REQUIREMENTS, THUS PROVIDING A PRACTICAL MEANS EFFECTING ... IMPORTANT OBJECTIVES WITHOUT INCREASING DIRECT GOVERNMENTAL REGULATION."

THE EXCHANGE THEREAFTER CONDUCTED A COMPREHENSIVE RULEMAKING PROCESS WHICH ENJOYED WIDE PARTICIPATION IN THE CONSIDERATION OF DEVELOPING RULES WITH RESPECT TO AUDIT COMMITTEES. LISTED COMPANIES OVERWHELMINGLY APPROVED THE CONCEPT. THE NYSE THEN SUBMITTED THE PROPOSAL TO THE COMMISSION WHICH, ON MARCH 9, 1977, APPROVED THE NYSE RULE REQUIRING ALL LISTED DOMESTIC COMPANIES TO ESTABLISH BY JUNE 30, 1978, AND MAINTAIN THEREAFTER, AN AUDIT COMMITTEE COMPRISED SOLELY OF DIRECTORS INDEPENDENT OF MANAGEMENT AND FREE FROM ANY RELATIONSHIP THAT WOULD INTERFERE WITH THE EXERCISE OF INDEPENDENT JUDGMENT AS A COMMITTEE MEMBER.

SUBSEQUENTLY, THE AICPA HAS UNDERTAKEN A STUDY AS TO WHETHER AND HOW IT CAN EXTEND THE BENEFITS OF AN AUDIT COMMITTEE TO ALL PUBLIC COMPANIES.

#### IX. CONCLUSION

CORPORATIONS ARE CREATURES OF THE GOVERNMENT AND ACCORDINGLY, IN OUR DEMOCRATIC SOCIETY, THEY MUST ULTIMATELY BE RESPONSIBLE NOT ONLY TO THEIR SHAREHOLDERS BUT TO THE PEOPLE. I WOULD NOT FIND IT DIFFICULT TO ADVOCATE A CASE FOR FEDERAL CHARTERING, TO ARGUE THAT MY CASE HISTORY ON THE AUDIT COMMITTEE IS INSTRUCTIVE BECAUSE IT SHOWS THAT ABSENT DIRECT FEDERAL REGULATION IT TOOK OVER 35 YEARS FOR A MODEST NON-CONTROVERSIAL REFORM TO BE IMPOSED UPON OUR LARGE PUBLIC CORPORATIONS. 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 AM AFRAID THAT FEDERAL CHARTERING WOULD RAISE PUBLIC EXPECTATIONS THAT COULD NOT BE MET. I DO NOT BELIEVE WE CAN SOLVE THE BASIC ECONOMIC AND SOCIAL PROBLEMS OF OUR SOCIETY THROUGH GREATER REGULATION OF BUSINESS. AT THE SAME TIME, THE PUBLIC PROPERLY EXPECTS OUR POWERFUL PUBLIC CORPORATIONS TO MAKE A SIGNIFICANT CONTRIBUTION TO THE SOLUTION OF THESE PROBLEMS. OTHERWISE, THESE INSTITUTIONS WILL LOSE THEIR LEGITIMACY IN THE POLITICAL ARENA.



SELF REGULATION IS AN INTEGRAL PART OF THE FEDERAL SECURITIES LAWS AND THEIR ADMINISTRATION BY THE SEC. SELF REGULATION IS FREQUENTLY INEFFICIENT AND INEFFECTIVE; BUT SO IS DIRECT GOVERNMENT REGULATION. THE QUESTIONS WHICH I HOPE YOU WILL THINK ABOUT IN THE WEEKS AHEAD ARE WHY AND HOW CHANGES IN THE COMPOSITION AND STRUCTURE OF CORPORATE BOARDS SHOULD OCCUR.

MUCH OF THE IMPETUS FOR REFORM OF THE PUBLIC CORPORATION IS CONFLICTING BECAUSE THE CORPORATION HAS BECOME A PRINCIPAL FOCUS FOR THE FRUSTRATIONS AND EXPECTATIONS OF A SOCIETY UNDERGOING RAPID SOCIAL AND ECONOMIC CHANGE. IN A SLOW OR NO GROWTH ECONOMY, IT IS DIFFICULT TO RECONCILE THE DEMANDS FOR A "GREENING" OF THE CORPORATION WITH DEMANDS FOR BETTER "BOTTOM LINE" RESULTS. THIS PROBABLY IS PART OF A GENERAL POLITICAL CONFLICT BETWEEN PROPONENTS OF REGULATION AND PROPONENTS OF COMPETITION. INCREASING INSTITUTIONAL OWNERSHIP OF OUR LARGE PUBLIC CORPORATIONS PROBABLY ONLY ACCENTUATES THE CONFLICT BETWEEN SOCIAL AND FINANCIAL RESPONSIBILITIES.

THE MOVEMENT FOR GREATER INDEPENDENCE (FROM MANAGEMENT) BY BOARDS OF DIRECTORS IS AN EFFORT TO MAKE CORPORATIONS MORE RESPONSIVE NOT ONLY TO SHAREHOLDERS, BUT TO VARIOUS PUBLIC CONSTITUENCIES. THIS CAN BE VIEWED AS AN ALTERNATIVE TO DIRECT REGULATORY CONSTRAINTS WHICH MIGHT PUT U.S. CORPORATIONS AT A COMPETITIVE DISADVANTAGE IN THE GLOBAL ECONOMY.

NEVERTHELESS, IT IS ONLY ASSUMED, AND NOT PROVEN THAT MORE INDEPENDENCE BY DIRECTORS WILL MAKE CORPORATIONS EITHER MORE SOCIALLY AWARE OR MORE PROFITABLE. THERE MAY BE OTHER BETTER MECHANISMS FOR ACHIEVING GREATER CORPORATE ACCOUNTABILITY.

THE CHALLENGE TO TODAY'S PUBLIC CORPORATION IS NOT WHETHER THERE WILL BE REFORM IN CORPORATE GOVERNANCE, BUT WHAT SUCH REFORM WILL BE AND HOW IT WILL BE ACCOMPLISHED. BOTH GOVERNMENT AND THE PRIVATE SECTOR ARE INITIATING CHANGES IN THE STRUCTURE AND COMPOSITION OF BOARDS AND COMMITTEES OF BOARDS IN THE NAME OF GREATER ACCOUNTABILITY. IF THESE CHANGES ARE MANDATED UNCRITICALLY, THERE IS A DANGER THAT TODAY'S CONCEPTS OF PROPER GOVERNANCE WILL CURB INNOVATION AND COMPETITION TOMORROW. ACCORDINGLY, IT IS IN THE BEST INTERESTS OF THE CORPORATE COMMUNITY AND THE PUBLIC FOR THE PRIVATE SECTOR TO RETAIN THE INITIATIVE IN CHANGING CORPORATE STRUCTURE SO THAT BOARDS OF DIRECTORS CAN EFFECTIVELY RESPOND TO ECONOMIC AND SOCIAL PRESSURES. BUT IF THE BUSINESS COMMUNITY FAILS TO RESPOND INTELLIGENTLY TO ITS CRITICS, AND OPENLY EXPLORE THE AVENUES TOWARD BETTER CORPORATE GOVERNANCE, THE PRESSURES ON CONGRESS AND THE INDEPENDENT REGULATORY AGENCIES LIKE THE SEC TO PROMOTE FEDERAL CHARTERING WILL BE DIFFICULT TO RESIST.