REPORT OF THE ADVISORY COMMITTEE ON CORPORATE GOVERNANCE

APPOINTED BY SENATOR HOWARD M. METZENBAUM

On the first day (June 27, 1977) of the hearings of the Subcommittee on Citizens' and Shareholders' Rights and Remedies of the Committee on the Judiciary of the United States Senate, Senator Howard M. Metzenbaum, Chairman of the Subcommittee, stated,

> The time is ripe for a full-scale exploration into what, if anything, the American people should be doing to make corporations more accountable to their shareholders and to the public. I am not here to say that all corporations are bad, because that is not true. Some far-sighted corporations and corporate lawyers have initiated some modest changes on their own. But the fact is that there is need for change. The only question left is how it is to come about. (emphasis supplied)

To assist him in answering that question, as well as the correlative one, what should be done, Senator Metzenbaum appointed this Committee consisting of citizens with varied and extensive experience with corporate governance and accountability matters. It was felt that by bringing it together under the aegis of a United States Senate Subcommittee, such a group, if it shared the concerns articulated by Senator Metzenbaum, might be a source of proposals to be incorporated by Senator Metzenbaum in legislation he indicated he intended to introduce dealing with corporate governance and accountability.

Through a Subcommittee of the full Committee, which again included persons with wide but differing experiences in the corporate community, as in-depth examination of various proposals for corporate reform was undertaken. Among the more far-reaching ones considered were federal incorporation and the elaboration of a set of minimum federal fiduciary standards (an idea espoused by Professor William L. Cary, a member of the principal Committee and a former chairman of the Securities and Exchange Commission). In addition other reforms were discussed, including federal action requiring cumulative voting, limiting the scope of indemnification of officers and directors, permitting removal of directors without cause, requiring reasonable location of annual meetings, permitting shareholder nomination of candidates for director, extending dissenters' rights to types of transactions to which they do not presently apply, expanding the instances in which shareholder approval must be secured, restricting short-form mergers, establishing federal jurisdiction for derivative shareholder actions beyond that afforded by the federal securities laws, establishing standards of fair dealing of majority with minority shareholders, establishing means of holding corporations accountable to the communities in which they have facilities, especially if removal of them were proposed, and regulating redemptions of blocks of stock at premiums and "going private" transactions.

The Subcommittee dealt most extensively with questions related to the structure of the board of directors, including composition and committees of the board. Also considered were the possibility of a national standard of care for directors based upon that in the Model Business Corporation Act and the desirability of shareholder ratification of the appointment of auditors.

The Subcommittee has reported to this Committee that it was unable to reach a concensus concerning proposed legislation. Notwithstanding this inability of the Subcommittee, the Committee believes that there may be certain propositions upon which its members can agree, although they continue to differ among themselves concerning the means of effectuating movement in certain directions.

The Committee agrees upon the following propositions:

1. Corporate governance and corporate accountability are of extraordinary importance, not only to the economy of the nation, but to its social well-being as well. Corporations are the creators of the bulk of the consumer and capital goods which have contributed to the prosperity and well-being of this nation. As such, they employ the overwhelming bulk of the employable population; they own vast amounts of the resources of the nation; their conduct can impact communities and masses of people in a profound manner. If they are inefficiently managed, then the nation may be denied goods at fair prices it might otherwise have; if they are managed in a manner indifferent to the demands and needs of their employees, they may create harsh hardships; if they are indifferent to the welfare of society, they may make life in our nation less rich and human.

Events of recent years suggest that the general efficiency of the corporate community has, unfortunately, been accompanied by seeming indifference by some companies to the larger concerns of society and the expectations of that society with respect to proper and moral corporate conduct.

If corporations are to function most efficiently and economically, and most satisfactorily in terms of society's broader needs, it is important that the respective rights, duties and needs of management, shareholders and others who have an interest in the consequences of corporate conduct be reasonably balanced through adequate mechanisms, procedures and practices and through people who are sensitive to the needs for such a balance.

2. The most immediately available means of accomplishing changes conducive to more efficient and accountable conduct of corporate affairs is through a proper structure and quality of the board of directors. Among means which have been generally accepted as desirable, though not necessarily ultimate, mechanisms have been the inclusion on boards of a majority of directors who are "independent", the constitution of audit committees consisting solely of such "independent" directors, and nominating committees with at least a majority of such "independent" directors. Such audit committees would have significant responsibilities, including recommending the selection of, and a close working relationship with, the independent auditor and the monitoring of the corporation's internal control function and financial reporting practices. Nominating committees independent of management control would provide a

mechanism for securing greater opportunity for shareholders to participate in the director election process.

There is no concensus concerning the proper definition of “independent”. At a minimum the term should not embrace anyone employed by the corporation. In the estimation of many members of the Committee it should not include attorneys who do significant amounts of work for the corporation, former employees, suppliers or customers whose transactions with the corporation are significant, or investment or commercial bankers which serve the corporation.

It is recognized that regardless of affiliations, past or present, the true test of the independence of a director is essentially his or her state of mind - willingness and ability to exercise independent judgment. More, it is also recognized that the ability to comprehend a corporation’s affairs and its relationships to society, the ability to make incisive judgments on facts available, the ability to operate in a collegial manner with fellow directors are essential ingredients of a competent director.

It is the conviction of the members of the Committee that all involved in the corporate process should take all reasonable measures to establish institutional arrangements and procedures to maximize the likelihood that directors are elected to boards who are competent to monitor management’s conduct of the corporation’s affairs, who are sensitive to the interests of employees, of the communities in which facilities are located, and of the shareholders, and who have a diversity of interests and backgrounds. While no process can assure that only persons with such characteristics will be elected as directors, a maturing combination of appropriate disclosure concerning nominees and the development of independent nominating committees will constitute a significant step toward the election of such persons.

Statistical evidence indicates that the incidence of “independent” directors on the boards of publicly held corporations (especially larger ones) and audit and nominating committees constituted largely, if not wholly, of “independent” directors is mounting steadily, although in all areas the practices are far from uniform and there exists considerable diversity, largely related to the size of corporations. Independent auditors are, of course, mandated by the federal securities laws for all corporations with significant public ownership. The accounting profession and the Securities and Exchange Commission are engaged in a number of programs to strengthen the independence of such auditors.

The members of the Committee also believe that shareholders should have the right to ratify the selection of the corporation’s independent auditor and note the apparent increase in the incidence of this practice.

3. The members of the Committee agree that the foregoing trends are desirable, though there is disagreement about whether the simple continuation of them in response to present stimuli will accomplish sufficient corporate reform to satisfy critics of corporate governance and accountability. There is agreement upon the need for a continuation of these trends and agreement that, at least with respect to larger corporations, boards with majorities of

outside directors and key committees consisting mostly or wholly of outside directors are desirable.

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However, there is profound, but not unexpected, disagreement among members of the Committee concerning the means by which further change should be accomplished. Some members of the Committee previously filed separate statements of their views which are available on request. Some members of the Committee, largely identified with the management of large corporations, believe that federal legislation related to the governance of corporations is not necessary because the fundamental disclosure premise of the securities laws has provided and will continue to provide an effective and proper method of federal regulation of corporations. Moreover, corporations are subject to many other federal and state laws and constraints imposing substantial controls on their conduct. They also point out that the corporate community is now sufficiently animated and alerted that it may be relied upon to continue reforms that will, consistently with continuing economic efficiency, also serve well the larger community with which corporations are increasingly concerned, and which is increasingly concerned with the conduct of corporations.

Others, largely consumer, shareholder and labor representatives, believe that structural reforms of the board (which some members of the Committee regard as desirable, but less than is necessary to cure perceived ills in the conduct of corporations) can only be adequately achieved through legislation. These members of the Committee would have the Congress adopt legislation requiring such reforms as a minimum, and would go further to require other reforms ranging from a comprehensive federal incorporation or licensing law to a series of federal minima, such as standards for indemnification.

It has been suggested by some members of the Committee that on the basis of the Subcommittee's deliberations the Securities and Exchange Commission should be asked to study carefully the extent to which it has the power to adopt rules which would give shareholders the opportunity to nominate candidates for the board through the proxy machinery and to regulate the "going private" phenomenon (it is understood the Commission has recently adopted rules with respect to this.) If this suggestion is acted upon the Commission could be requested to report to the Senate the results of its inquiry.

The Committee, while in a sense feeling unfulfilled because of its inability to answer with one voice Senator Metzenbaum's question concerning what actions should be taken, nonetheless feels that the interchange of viewpoints has sensitized them to the need for constructive change and strengthened their capacities in their respective areas of endeavor to facilitate that change.

Messrs. I. S. Shapiro and John D. deButts have submitted a separate statement of their views which will be made available upon request by writing to the following address:

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Respectfully submitted,

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