Observations on the state of shareholder participation in corporate governance;

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I was very pleased to receive Professor Stettler's invitation to speak to you tonight about corporate governance. The subject is a timely and fascinating one, with more serious implications for the accounting profession than are generally recognized. In an obvious sense, there is a direct relationship between the structure and composition of corporate boards and the ability of auditors to maintain their independence. This relationship has been acknowledged by Congress, the Commission, and the profession. It is well established, as was noted by the Commission on Auditors' Responsibilities last January, that "[t]he board of directors, with outside members and an audit committee when appropriate, is the best vehicle for achieving and maintaining balance in the relationship between the independent auditor and management." More recently, the AICPA has demonstrated its agreement with this proposition by considering whether there is a need for independent audit committees as a condition for an independent audit.

Other Calls for Reform

Less obvious perhaps but equally significant is the direct parallel between the issues facing the accounting profession and those facing the corporate community. In both cases perceived problems and a decline in public confidence have given rise to Congressional concern and calls for reform. Radical but similar solutions, such as federal licensing of accountants and federal chartering of companies have been suggested. The question which must be answered in both cases is not whether change must come but how it will come—and whether the solutions will be supplied by the private sector or whether they will be imposed by government.

In recent months, there has been an incredible amount of activity in the field of corporate governance. In addition to the Commission's re-examination of its rules relating to shareholder communications, shareholder participa-
tion in the corporate electoral process, and corporate governance generally, corporate accountability projects have been announced by the FTC and the Department of Commerce. Following hearings held last summer by the Senate Judiciary Subcommittee on Citizens and Shareholders Rights and Remedies, Senator Metzenbaum has appointed an advisory committee to make recommendations relating to the need for federal minimum standards legislation. A working group of that committee is scheduled to report back to Senator Metzenbaum within the next six weeks. In the private sector, the American Bar Association, the American Law Institute, the Business Roundtable, the American Assembly and other organizations have undertaken a variety of corporate governance projects. Rarely does a week go by without an article appearing in some major publication on this subject. Graduate students are gathering on my doorstep in droves for assistance in researching their corporate governance theses, and if that were not evidence enough of a national movement, several weeks ago the New York Times published an editorial calling for the word “governance” to be stricken from the English language because of its pretentiousness and overuse.

Dissatisfaction with Corporate Governance

While the scope and focus of the various corporate governance projects differ, the projects all reflect a certain uneasiness or dissatisfaction with the way in which large modern corporations function. This dissatisfaction is not economic, for it is widely acknowledged even by critics that the corporate sector has performed well in providing goods, services, jobs and investment returns. Rather, there is a public perception that corporations have become vast aggregations of unchecked political and economic power with the capacity to do grave harm to society. Recent events, including widespread illegal conduct, mistreatment of consumers and shareholders, self-dealing, and misuse of corporate funds for personal gain have led many divergent groups to conclude that a problem exists and that the time has come to re-examine the checks and balances, internal and external, that regulate corporate conduct and to reconsider the basic questions about the role and responsibilities of the corporations in society.

As the staff member in charge of the Commission's corporate governance hearings, I have spent a substantial portion of the last year immersed in governance questions.

It is from this background that I draw the following comments on the status of that proceeding and offer you some personal observations.

The Hearings on Corporate Governance

In a release issued last April, the Commission announced its intention to re-examine its rules relating to shareholder communications, shareholder participation in the corporate electoral process, and corporate governance generally. The decision to undertake this study was based on the fact that recent events, such as the numerous corporate disclosures concerning questionable and illegal payments, had served to focus public attention on the subject of corporate accountability and raised questions about the adequacy of existing checks and balances related to corporate management. These events underscored the con-
cerns expressed many years ago by Berle and Means that the theoretical corporate governance model is a myth in the context of a large publicly held corporation. They asserted that directors who are chosen by management do not effectively monitor management conduct, and furthermore, since elections of directors are most often mere ratifications of management's slates, directors are not answerable to shareholders through the electoral process.

The Securities and Exchange Commission was granted a broad Congressional mandate under Section 14(a) of the Securities Exchange Act to make rules in connection with the solicitation of proxies which are necessary or appropriate in the public interest or for the protection of investors for the purpose of assuring fair corporate suffrage. Relative to this mandate, the Commission was concerned that existing regulations might not provide shareholders adequate opportunities to participate meaningfully in corporate governance or the corporate electoral process. The Commission noted that shareholders generally receive limited information about certain significant corporate policies and practices on matters not submitted to shareholders for their approval, and that shareholders have limited access to corporate proxy machinery. Election contests are rarely feasible because of the huge expenses involved, and the right to make nominations at annual meetings is of little practical significance, since at that point proxies have already been received by management and the number of shareholders attending an annual meeting typically is small. Despite the breadth of the Commission's existing authority, it recognized that a number of questions, such as the fundamental question of how corporations can best be made more responsive to their shareholders and the public at large, transcended the proxy rules in significance and that some methods of obtaining greater accountability could not be achieved within the present statutory framework. Comments therefore were requested on the desirability of Commission support for federal legislation, such as a bill establishing minimum federal standards of corporate conduct and shareholders' rights.

The preliminary stages of the re-examination consisted of a request for public comments and the holding of public hearings on a variety of issues relating to corporate governance and corporate responsibility. While too numerous to mention in detail here, these issues fell into three categories—

- The adequacy of existing avenues of communication between shareholder and corporations, and particularly, whether shareholders should be provided with more information than is now available with respect to socially significant matters affecting their corporations. Also involved was whether Rule 14a-8 regarding shareholder proposals, should be amended to further facilitate the presentation of shareholder views and concerns in the corporate proxy materials.
- The role of the shareholders in the corporate electoral process and whether the Commission should amend its proxy rules to provide shareholders access to corporate proxy materials for the purpose of nominating persons of their choice to serve on the board of directors.
- Whether additional disclosure relevant to an assessment of the quality and integrity of management should be required, such as information relating to the existence and composition of corporate nominating committees, the existence of business and personal relationships be-
tween nominees or their affiliates and the board, time spent on cor-
porate affairs by incumbents, directors resignation and reasons there- 
for, and more detailed or comprehensive disclosure of management 
remuneration and transactions.

Related questions, such as the appropriate role of the self-regulatory or-
ganizations in improving corporate governance through revisions of their listing 
requirements, the perceived costs and benefits of various changes, and the need 
for revisions in the format of proxy cards were also considered.

Public Hearings Response

The response of the public to the Commission’s request for input was en-
couraging. In total, more than three hundred persons and organizations in-
cluding corporations, business associations, government officials, public interest 
and religious groups, law firms, bar associations, financial analysts, academics, 
accountants, and individuals submitted written comments or testified during 
the five weeks of public hearings. So voluminous were the materials offered to 
the Commission, in fact, that the staff spent the winter fighting through masses 
of paper, attempting to draw some conclusions from the array of comments and 
proposals presented.

While the paper war is not quite over, we are beginning to see the light at 
the end of the tunnel. Shortly, the staff intends to present a concept paper to 
the Commission and seek authorization to develop a number of rule proposals 
for publication. The staff is also preparing an extensive report for publication 
which will present, in excruciating detail, a summary of the information con-
tained in the record of this proceeding along with staff analysis and recom-
mendations concerning the various issues under study.

Emerging Trends

Although our final tally has not been completed, a few general trends have 
emerged from the record. First, while a number of commentators believe that 
the present system is working well and that corporations are fulfilling their eco-
nomic functions in a satisfactory manner, there is a growing recognition that 
the old notion that corporate responsibility is limited to returning a profit is 
obsolete, and that new accountability mechanisms are necessary. There is also 
an increasing awareness that regardless of the adequacy of existing checks and 
balances or the degree to which corporate accountability has broken down, there 
is a public perception that problems exist amid a decreasing level of confidence 
in corporations by shareholders and consumers. This lack of confidence has 
obvious implications for the ability of companies to raise capital in the future.

Second, although there is a widely held perception that both individual and 
institutional investors are passive “creditors” of a company more interested in 
that company’s income stream than in playing an active ownership role in cor-
porate affairs, it is clear that these investors are becoming increasingly concerned 
with certain corporate policies and expressing growing frustration about their 
inability to influence management decisions. While major financial institutions 
are still somewhat squeamish about using their voting power to influence man-
agement decisions, individual shareholders, universities, church groups and pension funds are showing less hesitation to politicize the corporate electoral process.

Third, there is clearly growing, although by no means unanimous, support for a number of proposals designed to give shareholders more information in proxy statements and to provide them with added opportunities to participate in the corporate electoral process.

Boards of Directors as a Focal Point

Although a large number of proposals were made regarding ways in which corporate accountability could be improved, and it would be simplistic to suggest that any one of them was supported by the majority of commentators, we did encounter substantial support for the notion that the key to improved corporate governance is the evolution of stronger, more independent boards of directors. Various means to strengthen boards were suggested, including the creation of increased opportunities for shareholder input into the electoral process, the adoption of SEC disclosure requirements which would stimulate structural changes, encouraging the voluntary establishment of nominating committees and the inclusions of more independent, nonaffiliated outsiders on the board, and the enactment of legislation specifying the fiduciary obligations of directors and officers and providing certain shareholder rights, redressable in federal court. A more drastic legislative solution, involving federal chartering of corporations, also was advocated by a small number of witnesses. However, the concept of establishing constituency boards, an integral part of federal chartering, proved to be extremely unpopular.

Not surprisingly, the business community expressed a strong preference for voluntary action in lieu of the more heavy-handed approaches, citing in support of this position, the many encouraging developments and innovations which have been adopted by companies in recent years, such as the establishment of audit and other standing committees, the inclusion of more outsiders on the board, voluntary disclosure, and improved shareholder communication programs. Other more skeptical witnesses suggested that these so-called voluntary changes have occurred only in response to governmental prodding, and that reliance on voluntarism would not result in meaningful reform.

While it is clear that there is no one answer to the numerous issues which have been raised, my own view is that the commentators who stressed the importance of the role of the board of directors in monitoring corporate conduct and improving corporate accountability are correct. The evolution of stronger, more independent boards with a broader understanding of the long term social and economic responsibilities of the modern corporation and an ability to truly represent the shareholders, monitor management performance, and approve major policies would appear to be the most effective means of making corporations more accountable. Moreover, whether or not one agrees with the recent suggestion of Chairman Williams that boards be composed entirely of independent outsiders with the exception of the chief executive officer and that the CEO not serve as chairman of the board, it seems to me to be indisputable that independent directors, who are neither employees of the corporation nor providers of profes-
sional or business services, are more able to ask the probing questions that must be asked of management. Given adequate compensation, adequate information, and an adequate understanding of their responsibilities, such boards should be well equipped to perform their function.

Audit committees composed entirely of independent directors with direct access to the outside and internal auditors and prescribed duties covering all facets of the audit process obviously are desirable, although as was demonstrated in the National Telephone Case, the existence of an audit committee is meaningless absent an understanding of committee responsibilities and procedures to perform them. I look forward with interest to the AICPA’s recommendations in this regard. Similarly, nominating committees which do not include any management directors should strengthen the effectiveness of boards by reducing the indebtedness felt by nominees to the CEO and expanding the universe of candidates from which board members are chosen. Compensation committees are yet another promising accountability tool, if properly constituted. Taken together, the effect of these structural reforms should be to restore, at least in part, the validity of the theoretical model of corporate governance under which management is answerable to the board.

These propositions are of course in no way novel. They are widely espoused by large segments of the business community and government. Recently a no less radical publication than *Business Week* called for the election of genuine shareholder representatives as board members in place of the crony system which now prevails. The only real question is how reforms will be achieved.

**Effecting Needed Reforms**

On this point, it is clear that the easiest and quickest method of effecting change either would be for each corporation to adopt structural reforms voluntarily and immediately or for Congress to mandate such change. I do not believe the former is likely to happen, and the latter, while conceivable at some point in the future, has a number of serious disadvantages, including the stifling effect it is likely to have on innovation and experimentation. Somewhere between these two extremes I believe that a number of interesting possibilities exist.

It seems to me that there are several alternatives available to the SEC within its existing statutory authority which would foster an environment of greater accountability. The adoption of disclosure requirements which provide more information about the quality of management and the structure, composition, and functions of the board and its committees would serve to encourage improvements in corporate governance and would provide investors with information vital to an assessment of management. Of particular importance, in my view, is expanded information about the business and personal relationships between board members or nominees and the corporation; information about committees and about director resignations and the reasons therefore; and disclosure about directors fees, indemnification arrangements, and an indication of the number of meetings attended. Changes in the listing requirements of self regulatory organizations also seem to warrant further attention. Additionally, the continued articulation of directors’ responsibilities, both through reports of investigation and the issuance of “white papers” or guidelines could be fruitful.
Similarly, some expansion of the role of shareholders in the corporate electoral process, such as the adoption of a rule permitting shareholder nominations in corporate proxy materials, in my view, would provide a safety valve for expressions of deep-seated dissatisfaction with management performance. Despite the fact that such a procedure would not affect board composition or the outcome of corporate elections in the majority of cases, it could increase the chances of including true shareholder representatives on boards which have not been responsive to investor concerns, particularly where institutional holders are stimulated to use their voting power.

These proposals would not cause any drastic changes nor are they meant to. Instead, it is to be hoped that the alternative I have described would provide a stimulus for evolution of better governance procedures and a heightened level of awareness among corporate leaders of the responsibilities which the public expects them to meet.