

# THE IMPACT OF THE SEC ON CORPORATE GOVERNANCE\*

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## INTRODUCTION

While the role of corporations in American society has been an occasion of recurring debate in this country for many years, the debate has quickened again, with perhaps unprecedented intensity, in the last half-decade. Many circumstances have renewed this controversy. There is the continuing concern with the accountability of institutions that control so much of the nation's wealth.<sup>1</sup> The consumer and civil rights movements have compelled examination of the extent to which American corporations are inattentive to environmental, safety, equal-employment, and other challenges and have created demands for measures to heighten corporate sensitivity to these concerns.<sup>2</sup>

No single incident or group of incidents, however, has done as much to intensify these discussions as the revelations following the 1972 Presidential election that numerous major American corporations, in what seemed to be clear defiance of the law, contributed to the campaign of a Presidential candidate and in some cases had made repeated illegal political contributions in the past;<sup>3</sup> that these payments had often been falsified on the books and records of the corporations;<sup>4</sup> that many corporations had also engaged in other questionable conduct at home and abroad;<sup>5</sup> and that in many instances top management was aware of the misconduct and often masterminded it.<sup>6</sup>

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1. R. NADER, M. GREEN, & J. SELIGMAN, *TAMING THE GIANT CORPORATION* (1976).

Justice Douglas noted in his dissent from the Supreme Court's dismissal of *SEC v. Medical Committee for Human Rights*, 404 U.S. 403, 409 (1972): "The modern super-corporations, of which Dow is one, wield immense, virtually unchecked power. Some say that they are 'private governments,' whose decisions affect the lives of us all" (footnotes omitted).

2. See *Medical Committee for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir.), cert. granted, 401 U.S. 973 (1970), appeal dismissed, 404 U.S. 403 (1972); *Natural Resource Defense Council, Inc. v. SEC*, 389 F. Supp. 689 (D.D.C. 1974); Note, *Disclosure of Payments to Foreign Government Officials Under the Securities Acts*, 89 HARV. L. REV. 1848, 1863-64 (1976).

3. See SECURITIES AND EXCHANGE COMMISSION, *REPORT OF QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES* (submitted to the Senate Banking, Housing, and Urban Affairs Comm.) (May 12, 1976) exhibits A & B [hereinafter cited as REPORT].

4. See *Hearings on the Activities of American Multinat'l Corps. Abroad Before the Subcomm. on Int'l Econ. Policy of the House Comm. on Int'l Relations*, 94th Cong., 1st Sess. 36-37 (1975) [hereinafter cited as *Hearings*]; REPORT, *supra* note 3, at 41-42.

5. See *Hearings*, *supra* note 4, at 36-37; REPORT, *supra* note 3.

6. See REPORT, *supra* note 3, at 41.

Most of the ventilation of these matters stemmed from the energetic and imaginative work of the enforcement staff of the Securities and Exchange Commission.<sup>7</sup>

Many questions have been asked as a consequence of these disclosures. Among the most probing and basic have been those related to the governance of the American corporation: Is there an inherent structural defect in the corporation that permits such misconduct? Is there need for a reconstruction of the governing structure of the corporation to avoid recurrences of these events? Is there a willingness and ability to reform within the corporate community? Is there a need finally for federal incorporation law?

These events have occasioned congressional hearings and numerous legislative proposals,<sup>8</sup> as well as regulatory initiatives;<sup>9</sup> and the end is not in sight.

Perhaps of prime importance, however, has been the acceleration of tendencies which had been emerging slowly and hesitantly for the Securities and Exchange Commission to move increasingly into matters of corporate governance and corporate structure, notwithstanding an apparently narrow mandate only to fashion and enforce a disclosure system for publicly held American business corporations. The description of this Commission activity—its development and its tendencies—is the purpose of this article.

## I

### HISTORICAL BACKGROUND

Historically, the internal governance of private corporations has been the province of state government under our federal system. During the colonial period corporations—then always organized for special, limited, quasi-public purposes—were created by royal grants.<sup>10</sup> When the colonies achieved inde-

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7. See generally REPORT, *supra* note 3; cases cited notes 67-71 *infra*.

8. In December 1977 Congress adopted and the President signed P.L. 95-213, which directly prohibits United States businesses from, among other things, making any payments, promises of payment, or authorizations of payment of anything of value to any foreign official, political party, candidate for office, or intermediary for the purpose of inducing such individual or party (1) to use his or its influence with a foreign government or instrumentality or (2) to fail to perform his or its official functions, to assist in the obtaining or retaining of business or to influence legislation or regulations. This extremely broad language might in some instances prohibit even so-called facilitating payments (although it would appear that such an interpretation of the bill would be outside the intent of those who drafted the statute). Willful violations of these prohibitions subject the violator to criminal prosecution and substantial penalties.

In addition to these prohibitions the legislation requires issuers subject to SEC filing requirements to maintain adequate books and records and systems of internal control sufficient to provide specified assurances.

9. See SEC Exchange Act Release No. 13185 (Jan. 19, 1977), [Current] FED. SEC. L. REP. (CCH) ¶ 80,896; SEC Securities Act Release No. 5466 (Mar. 8, 1974), [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,679; Letter from SEC Commissioner R. Hills to Hon. J. E. Moss (May 21, 1976), [1976] SEC. REG. & L. REP. (BNA) No. 354 (May 26, 1976); SEC Securities Act Release No. 10673 (Mar. 8, 1974).

10. J. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION 3-7 (1970).

pendence, though no specific constitutional provision reserved to the states the right to create corporations, the states assumed that power.<sup>11</sup> In the early days of the Republic, as before, corporations were organized to perform socially needful and significant tasks: to build and operate roads, waterways, railroads, flour mills, and so on.<sup>12</sup> Only in the first third of the nineteenth century did the notion become common that corporations organized for less publicly necessary purposes should be granted privileges accorded earlier corporations.<sup>13</sup> Gradually the powers and attendant privileges of corporations were expanded. While at first the requirement continued that a corporation be organized for specific purposes defined by the legislature which granted the charter, later the grant of the charter became less a matter of legislative discretion and more one of ministerial power.<sup>14</sup>

Gradually general laws of incorporation became prevalent in the states.<sup>15</sup> These laws determined, in effect, the basic structure of any corporation which was organized under their provisions. If a group banded together under the umbrella of these laws and followed the ritual prescribed, then certain consequences followed: the shareholders had specified rights and limitations on their liabilities; the directors had specified rights and responsibilities; certain matters that were peculiar to the corporation might be dealt with in the charter or bylaws; and some of the basic relationships within the corporation might be changed by following prescribed procedures. Toward the end of the nineteenth century, the potentials of this approach to corporation law became apparent, and first New Jersey, then Delaware and other states, began the process, often derided,<sup>16</sup> of minimizing the opportunities for shareholders to participate in corporate affairs and maximizing the latitude of management to order them.

During the 1920's, the nation experienced an explosive expansion of corporate activity. While this yielded demonstrable economic benefits and a seemingly high measure of prosperity, the subsequent description of attendant abuses after the 1929 stock market debacle displayed numerous instances of abuse by corporate officials of the power accorded them under state

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11. See generally A. BERLE, JR., *HISTORICAL INHERITANCE OF AMERICAN CORPORATIONS* 189 (1950); Williston, *History of the Law of Business Corporations Before 1800*, 2 HARV. L. REV. 105, 149, 165-66 (1888).

12. J. HURST, *supra* note 10, at 17; R. NADER, M. GREEN, & J. SELIGMAN, *supra* note 1, at 34; Conard, *An Overview of the Laws of Corporation*, 71 MICH. L. REV. 623, 632-33 (1973).

13. J. HURST, *supra* note 10, at 18, 21; R. NADER, M. GREEN, & J. SELIGMAN, *supra* note 1, at 34.

14. J. HURST, *supra* note 10, at 46, 56-57.

15. *Id.*

16. R. NADER, M. GREEN, & J. SELIGMAN, *supra* note 1, at 51-63; Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); see *Liggett Co. v. Lee*, 288 U.S. 517, 557-67 (1933) (Brandeis, J., dissenting); Note, *Federal Chartering of Corporations—a Proposal*, 61 GEO. L.J. 89 (1975).

statutes.<sup>17</sup> Federal laws of incorporation or licensing that would succeed or supplement state legislation, which had been proposed time and again since the earliest days of the Republic by conservatives and liberals alike, were urged as means of eliminating the abuses unveiled during congressional hearings.<sup>18</sup>

Notwithstanding the sorry record played in the hearings and notwithstanding strong urgings, Congress rejected the idea that the federal government should directly legislate rules for the governance and organization of corporations and instead adopted a limited approach designed to introduce larger measures of integrity, not into corporate governance, but rather into the corporate securities distribution and trading processes.

Thus, Congress adopted the Securities Act of 1933,<sup>19</sup> which related principally to the distribution of securities by those who issued them and those who controlled the issuers; and the Securities Exchange Act of 1934,<sup>20</sup> which was a potpourri of restraints on the conduct of insiders and trading markets, mandates for continuous disclosure, and regulation of the proxy-soliciting process used by listed corporations.

The principal thrust of these statutes was disclosure—disclosure which would permit investors to make informed investment decisions and permit shareholders to exercise their rights effectively and intelligently. Congress appeared to eschew the use of disclosure as a regulatory mechanism, that is, the use of disclosure to modify corporate conduct. This is repeatedly affirmed in the legislative history of the Acts.<sup>21</sup>

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17. SENATE COMMITTEE ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 1455, 73d Cong., 2d Sess. 55-68 (1933).

18. James Madison twice proposed to the Constitutional Convention that Congress be given power to charter corporations. The Convention defeated his motions in the belief that federal incorporation was unnecessary and would be conducive to the development of monopolies. J. MADISON, NOTES OF DEBATES OF THE FEDERAL CONVENTION 638 (W. Norton & Co. ed. 1966). Reformers urged federal licensing of corporations as a solution to abuses of power by business trusts in the late 1800's, but Congress passed the federal antitrust laws instead. Watkins, *Federalization of Corporations*, 13 TENN. L. REV. 89, 92 (1935). Presidents Theodore Roosevelt and Taft each favored federal incorporation, the latter President proposing optional federal incorporation in a special message to Congress on January 7, 1910. Watkins, *supra* at 93. One commentator writes that between 1905 and 1909 thirteen bills which authorized federal incorporation or licensing were introduced in Congress. Note, *Federal Chartering of Corporations: Constitutional Challenges*, 61 GEO. L.J. 123, 126 (1972). Such proposals surfaced again in the 1930's, most notably in the FEDERAL TRADE COMMISSION REPORT ON UTILITY CORPORATIONS, S. DOC. NO. 92, 73d Cong., 1st Sess. pt. 69-A (1934). That report contains an exhaustive review of the history of federal licensing or chartering proposals. Additional proposals (sponsored primarily by the New York Stock Exchange) surfaced in the Senate hearings, *Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 & 57 (73d Cong.) Before the Senate Banking and Currency Committee*, 73d Cong., 2d Sess. 6637, 6583-84, 6678, 6939 (1934). Senators O'Mahoney and Borah continued to introduce federal licensing legislation through the remainder of the 1930's. Reuschlein, *Federalization—Design for Corporate Reform in a National Economy*, 91 U. PA. L. REV. 91, 106-07 (1942). See generally L. LOSS, SECURITIES REGULATION 107-11 (1961); FEDERAL TRADE COMMISSION REPORT ON UTILITY CORPORATIONS, *supra*.

19. 15 U.S.C. §§ 77a-77aa (1970).

20. 15 U.S.C. §§ 78a-78hh-1 (1970).

21. S. Res. 792, 73d Cong., 2d Sess. 10 (1934):

However, the aphorism underlying the legislation was the familiar one uttered by Brandeis in 1914: "Sunlight is said to be the best of disinfectants; the electric light the most efficient policeman."<sup>22</sup> This statement implies strongly that disclosure was a means of inducing right conduct, of cleansing society of misconduct, of causing would-be miscreants to forego undesirable conduct for fear of exposure.

While the dominant theme in the legislative history of the 1933 and 1934 Acts was indeed disclosure to assist intelligent investment and meaningful participation in the corporate suffrage process, still there may be discerned glimpses of the purposes implied in Brandeis' comment. For instance, the House committee that considered the 1934 Act said in its report:<sup>23</sup>

The Committee is aware that these requirements are not air-tight and that the unscrupulous insider may still, within the law, use inside information for his own advantage. It is hoped, however, that the publicity features of the bill will tend to bring these practices into disrepute and encourage the voluntary maintenance of proper fiduciary standards by those in control of large corporate enterprises whose securities are registered on the public exchanges.

Great expectations were entertained for "corporate democracy."<sup>24</sup> The belief was strong that if shareholders were given the opportunity to participate meaningfully and with possession of full information in the determination of issues that were required by state law to be presented to them, *e.g.*, election of directors, adoption of plans of merger, and the like, corporate conduct might be molded to a more responsible pattern. Thus, the 1934 Act gave the newborn SEC very broad power to regulate the solicitation of proxies.<sup>25</sup>

In contrast to the approach adopted in the 1933 and 1934 Acts, in 1940 Congress chose to direct in a substantive manner the governance of investment companies, though even here the touch was light and occasional, and there continued to be heavy emphasis on disclosure. The Investment Company Act of 1940<sup>26</sup> established that no more than sixty per cent of the board of an investment company could be "affiliated" persons, and it defined with some particularity those who fitted into that category.<sup>27</sup> Similarly, the 1940

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The principal objection against the provisions for corporate reporting is that they constitute a veiled attempt to invest a governmental commission with the power to interfere in the management of corporations. The Committee has no such intention, and feels that the bill furnishes no justification for such an interpretation. To make this point abundantly clear, section 13(d) specifically provides that nothing in the act shall be construed to authorize interference with the management of corporate affairs.

22. L. BRANDEIS, *OTHER PEOPLE'S MONEY* 62 (Harper Torchbook ed. 1967).

23. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13 (1934).

24. See H.R. REP. NO. 1383, 73d Cong., 2d Sess. 5, 13 (1934) ("Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange."); *cf.* SEC v. Transamerica Corp., 163 F.2d 511, 518 (3d Cir. 1947) (in enacting the Securities Exchange Act of 1934 "[i]t was the intent of Congress to require fair opportunity for the operation of corporate suffrage."), *cert. denied*, 332 U.S. 847 (1948); J. HURST, *supra* note 10, at 97.

25. 15 U.S.C. § 78n (1970).

26. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1—80a-52 (1970).

27. 15 U.S.C. §§ 80a-10, 80a-2(a)(19) (1970).

Act provided that certain specified matters had to be approved by shareholders,<sup>28</sup> that indemnification of directors could be made only in specified circumstances,<sup>29</sup> that directors had to conform to certain standards of conduct,<sup>30</sup> and so on. This contrasted sharply with the statutory standards of the 1933 and 1934 Acts, which avoided entirely the temptation to shape the relationships among management, directors, and shareholders and the internal structures of corporations.

In the Public Utility Holding Company Act of 1935,<sup>31</sup> too, Congress touched lightly on the problem of corporate governance by limiting the affiliations of directors (subject to SEC rule making) and regulating certain other narrow corporate governance matters.<sup>32</sup>

Through most of its history the Commission has heeded the general thrust of the legislative history which led to its creation, and regarded its mandate as one of disclosure for investor and shareholder use, not disclosure for the purpose of altering the conduct of corporate management. True, schedule A of the 1933 Act<sup>33</sup> required (subject to modification by the Commission) the disclosure of compensation paid certain officers and directors and the details of certain transactions between the corporation and management. It may well be argued that these disclosure requirements would condition and have conditioned management conduct; every lawyer who has represented a publicly held corporation has seen an affiliate transaction aborted because of the necessities of disclosure. Still, these requirements appear to have been designed principally to assist investors and shareholders in making suffrage and investment decisions. Thus, the relative indifference of the Commission to the problems of corporate governance seemingly dictated by the 1933 and 1934 Acts continued relatively unabated until the early 1970's.

## II

### THE EMERGENCE OF SEC CONCERN WITH CORPORATE GOVERNANCE

During the first part of the decade the issues of corporate governance and corporate responsibility became a subject of far wider concern, largely under the flogging of public interest representatives.<sup>34</sup> Specialized publications such

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28. 15 U.S.C. §§ 80a-13(a), 80a-15(a) (1970).

29. 15 U.S.C. § 80a-17(h) (1970).

30. 15 U.S.C. § 80a-35 (1970).

31. Public Utility Holding Company Act of 1935, 15 U.S.C. § 79—79z-6 (1970).

32. 15 U.S.C. § 79g(c) (1970).

33. 15 U.S.C. § 77aa (1970).

34. See M. MACE, *DIRECTORS: MYTH AND REALITY* (1971); C. STONE, *WHERE THE LAW ENDS* (1975); Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors and Accountants*, 63 CALIF. L. REV. 375 (1975); Eisenberg, *The Legal Role of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CALIF. L. REV. 1 (1969); Proceedings, The Airlie House Symposium, *An In-Depth Analysis of the Federal and State Roles in Regulating Corporate Management*, 31 BUS. LAW. 863 (1976); Roth, *Supervision of Corporate Management*, 51 N.C.L. REV. 1369 (1973).

as *Business and Society* gave considerable prominence to such issues. The celebrated contretemps of former Justice Arthur Goldberg, in which he, as a TWA board member, insisted upon having a separate staff, fired further discussion of the role of directors and the limitations on their utility.<sup>35</sup> Such events moved the discussion out of academic journals, onto the business pages of the *New York Times* and into the *Wall Street Journal*.

The Commission responded to these forces, and during the early seventies deeper Commission concern with corporate governance became apparent. It has become increasingly clear that the Commission is no longer content with its traditional role of abstention from interference with corporate governance and is restlessly seeking to affect the manner in which corporations are governed, the relationships between their managements and shareholders, the constitution of their boards of directors, and the manner in which the various parts of the corporate community conduct themselves and relate to each other.

The 1933 and 1934 Acts contain few references to directors. This is surprising in view of the fact that prior to 1933 there had been recurring expressions of concern over the manner in which boards were functioning. For instance, in 1926 the Michigan Supreme Court said:<sup>36</sup>

It is the habit in these days for certain well-to-do men with influence in their respective communities to accept positions on boards of directors of corporations as honorary directors, and then never render any service except to sign on the dotted line, vote as requested by the one in charge and afterwards to cash their directors' checks for attending the meeting. They give no judgment upon questions of business policy, and make no investigation of the real financial condition of the company. It is this kind of service by directors that helps to extract such a tremendous annual toll out of the public who happen to own industrial securities. The law requires a different kind of service of them.

During the course of the hearings in the House and the Senate which led to the 1933 and 1934 Acts, there were repeated references to boards which had failed to perform their duties.<sup>37</sup> In 1933, after the enactment of the 1933 Act but before the enactment of the 1934 Act, then Professor William O. Douglas remarked in an article, *Directors Who Do Not Direct*, that<sup>38</sup>

A popular theme in recent years has been that "Directors should assume the responsibility of directing and if their manifold activities make real directing impossible, they should be held responsible to the unsuspecting public for their neglect." . . .

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35. *The Goldberg Variation*, NEWSWEEK, Oct. 30, 1972, at 88; New York Times, Oct. 29, 1972, § 3, at 1.

36. *Chapple v. Jacobson*, 234 Mich. 558, 208 N.W. 754 (1926).

37. Stock Exchange Practices, Letter from Counsel for the Committee on Banking and Currency, pursuant to S. Res. 84, 73d Cong., 1st Sess. 7-35 (1933); SENATE COMMITTEE ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 1455, 73d Cong., 2d Sess. 55-68 (1933).

38. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1305-06 (1934).

In other words, the criticism has been symptomatic of indignation and disapproval of many different abuses and malpractices disclosed in recent years . . . .

This dissatisfaction with directors found explicit expression in the basic statutes only twice: in the 1933 Act directors as such became liable for material omissions and material misstatements in registration statements filed with respect to the distribution of securities unless they could establish that after reasonable investigation they had reason to believe and did believe that the registration statement suffered from no material misstatement or omission;<sup>39</sup> under the 1934 Act directors had a liability to repay profits realized in short-term trading.<sup>40</sup>

All other responsibilities and liabilities of directors found under those Acts have stemmed either from strictures that applied equally to everyone or as a consequence of a director's being deemed a "controlling person."<sup>41</sup> For instance, directors might have liability if they directly participate in a violation of section 12(1) of the 1933 Act<sup>42</sup> or engage in manipulative activity contrary to section 9 of the 1934 Act.<sup>43</sup> Though not explicitly stated in the statutes, it has been generally accepted that in some circumstances directors might have liability as aiders and abettors of the offenses of others,<sup>44</sup> as conspirators,<sup>45</sup> or in some other secondary role.<sup>46</sup> As mentioned, they might be liable as controlling persons; both the 1933 Act and the 1934 Act contain sections creating

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39. Sections 11(a)(2) and 11(b)(3)(A) of the Securities Act of 1933, 15 U.S.C. §§ 77k(a)(2) and 77k(b)(3)(A) (1970).

40. Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1970).

41. 15 U.S.C. § 77o (1970); 15 U.S.C. § 78t (1970).

42. 15 U.S.C. § 771(l) (1970).

43. 15 U.S.C. § 78i (1970).

44. 18 U.S.C. § 2 (1970):

§ 2. Principals.

(a) Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal.

(b) Whoever willfully caused an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.

See generally Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delecto, Indemnification, and Attribution*, 120 U. PA. L. REV. 597 (1972).

45. 18 U.S.C. § 371 (1970):

§ 371. Conspiracy to commit offense or to defraud United States.

If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than \$10,000 or imprisoned not more than five years, or both.

If, however, the offense, the commission of which is the object of the conspiracy, is a misdemeanor only, the punishment for such conspiracy shall not exceed the maximum punishment provided for such misdemeanor.

See generally Ruder, *supra* note 44.

46. See L. LOSS, *SECURITIES REGULATION* 1476, 1992 (1961), and cases cited therein.



liability for controlling persons who could not establish one of the statutorily afforded defenses.<sup>47</sup>

Before the 1970's the only occasion on which the Commission commented as a body upon the application of the securities laws to the responsibility of directors was *In the Matter of Franchard Corporation*,<sup>48</sup> and even then it commented only obliquely. In that administrative proceeding the staff urged the Commission to determine that the respondent's registration statements were deficient because, among other reasons, they failed to disclose that the directors had virtually abdicated their responsibility to the principal officer and shareholder of the company. The Commission said that the issue was ". . . whether the prospectuses were deficient in not disclosing that the directors, in overseeing the operations of the company, failed to exercise the degree of diligence which the Division believes was required of them under the circumstances in the context of the day-to-day operations of the company."<sup>49</sup> Significantly, the charge was not that there had been a violation of the securities laws by the failures of the directors to exercise their responsibilities properly; the assertions of the staff clearly related to deficiencies of disclosure. The Commission concluded, "We find no deficiencies in this area."<sup>50</sup>

In its decision the Commission adopted a conservative (at least by today's standards) stance and emphasized that the directors' responsibilities were set by state law. It said, "The [Securities] Act [of 1933] does not purport, however, to define federal standards of directors' responsibility in the ordinary operations of business enterprises and nowhere empowers us to formulate administratively such regulatory standards."<sup>51</sup>

It could be argued, of course, that the staff was not asking for a formulation of regulatory standards but simply a determination that there had been a deficiency of disclosure. The Commission apparently felt that a decision with respect to the sufficiency of disclosure would necessarily have involved them in a substantive determination of matters that lay within the province of state law. The Commission has not, of course, allowed the problems of making such determinations to deter it in its administration of rule 14a-8 pertaining to shareholder proposals.<sup>52</sup>

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47. Section 15 of the Securities Act of 1933, 15 U.S.C. § 77o (1970). Section 20 of the Securities Exchange Act of 1934, 15 U.S.C. § 78t (1970).

48. 42 S.E.C. 163 (1964).

49. *Id.* at 175.

50. *Id.* at 176.

51. *Id.*

52. 17 C.F.R. § 240.14a-8 (1977). One of the bases upon which management may omit a proposal from its proxy statement (relying often upon an expression of opinion from the staff of the Commission as to the propriety of its so doing) is

. . . [I]f the proposal as submitted is, under the laws of the issuer's domicile, not a proper subject for action by security holders. . . .

It is an interesting speculation whether the Commission would today adopt such a sweeping statement of the limitations on its power; at a minimum one might expect that the Commission would suggest that a failure of directors to exercise their responsibilities under the securities laws is an appropriate matter for disclosure. As suggested in the Commission's release with respect to the outside directors of National Student Marketing Corporation,<sup>53</sup> drawing the line between the general responsibilities of directors and their responsibilities under the securities laws is not easy, and the distinction is not one the Commission is now overly fastidious in drawing.

However, consistent with its approach in the *Franchard* case, the Commission has never established an explicit rule with respect to the conduct of directors in any formal fashion. The closest it came to this was an effort, following a speech by Chairman G. Bradford Cook in 1973, to establish guidelines for the conduct of directors in securities matters. In his speech, Chairman Cook said:<sup>54</sup>

The Commission feels a sense of obligation to the courts, to public investors, to the securities bar and to those persons whose activities may place them within the strictures of the federal securities laws, to enunciate the broad standards these Acts impose. I believe the players have a right to know what the rules of the game are.

Subsequently Chairman Ray Garrett, Jr., reaffirmed Chairman Cook's commitment to develop guidelines. However, he later acknowledged the difficulty of developing such guidelines and stated the project had been abandoned.<sup>55</sup> During the interim, members of the Chairman's staff had made a diligent effort to develop such guidelines and had even gone so far as to draft proposals. Among the difficulties encountered was the fact that the Commission's authority at its broadest extended only to matters concerning securities transactions. It would have been difficult to articulate guidelines that avoided the charge of Commission intrusion into matters of state law, that meshed appropriately with state requirements, and that provided any guidance superior to that already furnished by general articulations of directors' duties.

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53. SEC Exchange Act Release No. 11516, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,219.

54. The Director's Dilemma, Address before the Southern Methodist University School of Business Administration, SEC News Release, April 6, 1973, at 4. See [1973] SEC. REG. & L. REP. (BNA) No. 197: A-7 (April 11, 1973).

55. Corporate Directors and the Federal Securities Laws, Address before the Thirteenth Annual Corporate Counsel Institute, Northwestern University School of Law, SEC News Release, Oct. 3, 1974, at 4-5. See [1974] SEC. REG. & L. REP. (BNA) No. 272: A-11 (Oct. 9, 1974). See also A Commission Dilemma, Address before the Conference Board, SEC News Release (May 7, 1974).

## A. Policy by Commissioner Statement ("Jawboning")

Notwithstanding this aborted effort to state an official Commission position on directors' responsibilities in securities matters, individual Commissioners have repeatedly expressed their personal opinions with regard to directors' responsibilities. These, for the most part, have had the mark of consistency. In short, while the Commission itself has not spoken as a body, individual Commissioners have articulated what appear to be the generally accepted conceptions of the Commission with respect to directoral conduct. In the 1973 speech mentioned above, Chairman Cook described the responsibility of directors in securities matters in this way:<sup>56</sup>

[D]irectors are fiduciaries and have an affirmative responsibility to act fairly and honestly to seek to assure that their corporations do the same. They owe this responsibility not only to their own shareholders but to all public investors who buy, sell or hold their company's securities. . . .

. . . I believe the federal securities laws require that all directors avoid negligence in the performance of their responsibilities. Now I recognize that negligence is a vague enough term which has filled the casebooks with thousands of decisions. But perhaps I can focus a bit more precisely on this. Essentially, a director is negligent if he knows, or should have known, of actions or potential actions that could violate the securities law. The concern here is with the conduct and not whether it actually is known to be a violation of the law. The courts do not require proof that an accused director knew the precise scope of the law. What is required to be shown is that the director knew, or should have known, of conduct which later is held to be in violation of the federal securities laws. . . .

. . . All directors have a duty to act on wrongdoing of which they are, or should be, aware—even when they do not carry responsibility for that particular area. As holders of a public trust, directors who learn of any fraudulent conduct must insure that appropriate steps are taken to prevent or rectify violations. This is particularly crucial in the securities field, where most violations and their impacts are long enduring. The knowledge or indication of fraudulent corporate actions puts a clear obligation on all directors to insure that corrective action is taken. . . .

. . . When outside directors are asked to vote on critical issues, they should be able to determine whether they have enough information upon which to base an intelligent and informed vote. I do not think the federal securities laws will tolerate outside directors meeting anything less than this burden, completely and fully. Outside directors who choose to gamble by approving action without sufficient basis for doing so may find the cost to be very high. As in all areas of professional responsibility, a great deal of trust must be placed in the integrity and conscientiousness of all those people who assume the position of corporate directors. And the existence of civil liability is a deterrent to a cavalier disregard of these obligations. . . .

. . . Outside directors should resist all attempts to pressure them into approving complex decisions in the absence of adequate time for preparation and full understanding. This includes insisting on ample time to digest and understand vital documents. I recognize that it would be far easier if outside directors could rely upon other members of the board of directors or corpo-

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56. The Director's Dilemma, *supra* note 54, at 7-8.

rate employees to read and summarize these materials for them, but I believe that a director's basic responsibility requires that he read these materials. Although directors cannot delegate their responsibility to direct, I do believe they should have access to reliable experts who can help them decipher some of the highly technical jargon contained in corporate releases and filings. . . .

In Chairman Cook's remarks the distinction between misconduct under the federal securities laws and misconduct under the general standards relating to director conduct is obscured; much of what he appears to consider violative of the securities laws is merely in violation of the director's duty of care.

During the following four years, Chairman Garrett and other Commissioners addressed these questions on numerous occasions. All of their statements emphasized the high measure of responsibility borne by directors when their corporations engage in securities transactions, and might well be read as stating a general standard of conduct. For instance, Commissioner Loomis said in 1975:<sup>57</sup>

The Congress quite clearly was dissatisfied with the way boards of directors operated in the 20's and imposed responsibilities and liabilities upon directors as one means of protecting investors and advancing the public interest. Any developments which improve the effectiveness and status of directors should serve that end. While the idea that directors should serve as watchdogs for the stockholders can be, and often is, overdone, nevertheless vigilant and independent directors, functioning effectively, can be an important safeguard.

Similarly, Chairman Garrett on several occasions addressed this problem and stated:<sup>58</sup>

In determining whether a director has been diligent and conscientious in performing his responsibilities, I think it important to look at such factors as whether he regularly attended board meetings, whether he sought and obtained information from management with respect to important corporate transactions, and carefully considered the information he receives, whether he was an active participant in board meetings and raised questions with the management, as well, of course, as the time he spent in discharging his duties.

Earlier Chairman Garrett had suggested that the Commission's activities with respect to the directors might be seen as an extension of the Commission's historic franchise, but Garrett wept no tears at the prospect:<sup>59</sup>

It is true that, in order to find authority in ourselves to proceed, and jurisdiction under Rule 10b-5 or cognate provisions of the laws that we administer, there must be a fraudulent or deceptive element or failure of disclosure of material information. It is also true that in some cases the gravamen of the complaint lies in the substantive evil of the conduct involved and not in the failure to disclose this to investors. In this sense, we may be going beyond

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57. Director Responsibility—A Government View, Remarks at Loyola College, Baltimore, Md., SEC News Release, April 8, 1975, at 14. See [1975] SEC. REG. & L. REP. (BNA) No. 298: A-29 (April 16, 1975).

58. A Commission Dilemma, *supra* note 55, at 22.

59. Corporate Directors and the Federal Securities Laws, *supra* note 55, at 4-5.

enforcement of disclosure and engaged in efforts to encourage right conduct among corporate directors. If this is the case, I make no apology for it. Except for specific, limited types of misbehavior, there is no other agency, state or federal, with responsibility or authority over the activities of our publicly-owned corporations, and while plaintiffs and their attorneys in class actions on the whole do more than we do in this area, we think there is need for official federal action.

Similarly, the writer, while a Commissioner of the SEC, stated:<sup>60</sup>

A skepticism, an alertness to the possibility of wrongdoing on the part of corporate officers, should be the stock in trade of every director. This is not to suggest that there is a need of hostility, that directors cannot wine and dine with the officers of the corporation, that the good fellowship that characterizes many boards cannot be maintained. But it does mean that if a man assumes a responsibility to the public which a board member does then he must realize that his client, if you will, is not management but the public shareholders and the public market place.

### B. Policy by Litigation and Settlement

The Commission has not limited itself to words. The greatest impact the Commission has had on corporate conduct and corporate governance has been the byproduct of its use of its powers over the disclosure obligations of corporations.

The potential of disclosure to shape corporate conduct is most clearly seen in the disclosures that have resulted from the Commission's activities with respect to political contributions and sensitive overseas and domestic payments. Throughout the development of these disclosures the Commission and its staff have contended that the purpose of the program was simply to inform investors and shareholders,<sup>61</sup> while critics have contended the Commission's activity was an unwarranted and unauthorized extension into areas of substantive law.<sup>62</sup> Regardless of the motives for the Commission's activities, the fact is that these endeavors have unquestionably affected the manner in which American corporations are conducting and governing their affairs.

This has been occurring in several ways. First, the Commission has, in settling litigation involving political contributions and sensitive payments, developed imaginative approaches to remedies.

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60. Directors and the Federal Securities Laws, Address by A. A. Sommer, Jr., before the Colorado Association of Corporate Counsel, Denver, Colo., [1974] SEC. REG. & L. REP. (BNA) No. 241: F-1, F-5 (Feb. 1974).

61. *Hearings*, *supra* note 4, at 36 (prepared statement of Commissioner Loomis); see SEC Securities Act Release No. 5466 (Mar. 8, 1974), [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,699.

62. See Freeman, *The Legality of the SEC's Management Fraud Program*, 31 BUS. LAW. 1295 (1976); Note, *Disclosure of Payments to Foreign Government Officials Under the Securities Acts*, 89 HARV. L. REV. 1848, 1861, 1863, 1869-70 (1976); Note, *Foreign Bribes and the Securities Acts' Disclosure Requirements*, 74 MICH. L. REV. 1222, 1241-42 (1976). But see Stevenson, *The SEC and Foreign Bribery*, 32 BUS. LAW. 53 (1976).

At one time the Commission typically sought only conventional injunctive relief. However, in recent years it has increasingly tried to expand the remedies sought in an effort to make more meaningful the relief resulting from civil court proceedings, a response perhaps to the criticism that the typical result of its civil proceedings has been only a slap on the wrist. Thus, in some cases the Commission has sought and secured the appointment of a receiver,<sup>63</sup>

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63. Investment Company Act of 1940, § 42(e), 15 U.S.C. § 80a-41(e):

In any proceeding under this subsection to enforce compliance with section 80a-7 of this title [relating to proscribed transactions], the court as a court of equity may, to the extent it deems necessary or appropriate, take exclusive jurisdiction and possession of the investment company or companies involved and the books, records and assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, who with the approval of the court shall have power to dispose of any or all of such assets, subject to such terms and conditions as the court may prescribe.

Pursuant to this authority, the Commission has successfully sought the appointment of receivers for investment companies in:

(1) SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3 (S.D.N.Y. 1968), *aff'd* 435 F.2d 510 (2d Cir. 1970).

(2) SEC v. Fiscal Fund, 48 F. Supp. 712 (D. Del. 1943).

(3) SEC v. Keller Corp., 323 F.2d 397 (7th Cir. 1963). The Court in *Keller* also expressed its belief that the district court possessed inherent power to appoint a receiver, independent of the specific statutory authorization in § 42, upon a showing of violations of the fraud provisions of § 17(a) of the Securities Act, 15 U.S.C. § 77q(a) (1970), and the registration provisions of the Investment Company Act:

The district court was vested with inherent equitable power to appoint a trustee-receiver under the facts of this case. The prima facie showing of fraud and mismanagement, absent insolvency, is enough to call into play the equitable powers of the court. It is hardly conceivable that the trial court should have permitted those who were enjoined from fraudulent misconduct to continue in control of Keller's affairs for the benefit of those shown to have been defrauded. In such cases the appointment of a trustee-receiver becomes a necessary implementation of injunctive relief."

323 F.2d at 403.

(4) SEC v. S & P Nat'l Corp., 360 F.2d 741 (2d Cir. 1966).

The SEC has also successfully sought appointment of receivers in the absence of explicit statutory authorization in cases of egregious violations of the anti-fraud provisions of the 1933 and the 1934 Acts.

(1) SEC v. Bowler, 427 F.2d 190 (4th Cir. 1970);

Defendants resist strongly the appointment of a receiver on the ground that the defendant corporations were not insolvent. The short answer is that the authorities cited do not limit the appointment of a receiver to cases where insolvency is shown. Rather, a receiver is permissible and appropriate where necessary to protect the public interest and where it is obvious, as here, that those who have inflicted serious detriment in the past must be ousted.

427 F.2d at 198.

(2) SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972):

Once the equity jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy. Thus, while neither the 1933 nor the 1934 Acts specifically authorize the ancillary relief granted in this case, '[i]t is for the federal courts to adjust their remedies so as to grant the necessary relief where federally secured rights are invaded.'

J.I. Case Co. v. Borak, 377 U.S. 426, 433 (1964), 458 F.2d at 1103.

(3) SEC v. Charles Plohn & Co., 433 F.2d 376 (2d Cir. 1970).

the rescission of transactions,<sup>64</sup> the disgorgement of ill-gotten gains,<sup>65</sup> and other remedies.

In recent years, the most noteworthy use of novel remedies has been in the area of corporate governance and accountability. This practice commenced prior to 1973<sup>66</sup> (the first emergence of the problem of political and sensitive payments) and has flourished most fully in the context of those problems.

Historically most of the Commission's cases have been concluded with settlements, for which it has been criticized. As a consequence, it is unclear whether a court, in the context of a contested case, would conclude that it could or should grant the sort of relief which the Commission has repeatedly secured through settlements. In at least one injunctive case, in which the Commission sought an ouster of the chief executive officer of a real estate investment trust, the District Court for the Eastern District of Virginia rebuffed the Commission and said:<sup>67</sup>

The relief asked for by the SEC would require the Court to replace the Chief Executive of ART and appoint new trustees without providing the protection of continuous supervision of this Court. Even if the power existed, it would seem unwise under these facts to replace an incumbent President, appoint additional trustees to serve on the Board, and oversee the operation of the Trust. Such expansive authority should not be exercised except in the most extreme cases.

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64. SEC v. American Agronomics Corp., SEC Litigation Release No. 5667 (N.D. Ohio 1972); SEC v. Rasso Rural & Suburban Settlement Co., SEC Litigation Release No. 4157 (S.D.N.Y. 1969); SEC v. Codition Corp., SEC Litigation Release No., 3799 (S.D.N.Y. 1967).

65. SEC v. Manor Nursing Centers, Inc., 458 F.2d 182 (2d Cir. 1972):  
Clearly the provision requiring the disgorging of proceeds received in connection with the Manor offering was a proper exercise of the district court's equity powers. The effective enforcement of the federal securities laws requires that the SEC be able to make violations unprofitable. The deterrent effect of an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illicit profits. (The court of appeals remanded the case for a proper determination of the amount defendants were required to refund, holding defendants were not required to refund profits made while utilizing the proceeds of fraudulent action.) SEC v. Golconda Mining Co., [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,504 (S.D.N.Y. Oct. 30, 1969); SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974); SEC v. VTR, Inc., SEC Litigation Release No. 3311 (S.D.N.Y. 1965), [1964-1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,618; SEC v. Skogit Valley Telephone Co., SEC Litigation Release Nos. 3390, 3393, & 3482 (W.D. Wash. 1965-66); SEC v. Parvin Dohrmann Co., SEC Litigation Release No. 4848 (S.D.N.Y. 1970); SEC v. Frigitemp Corp., No. 73-596 (D.D.C. March 28, 1973).

66. SEC v. VTR, Inc., SEC Litigation Release No. 3311 (S.D.N.Y. 1965):  
In lieu of appointing a receiver, the court directed the controlling group to cause the election of four independent directors [of a five-man board] designated by the court to supervise the filing of proper annual reports and proxy statements with the Commission and to supervise a determination of the exact amount misappropriated.  
32 SEC ANN. REP. 116-17 [1966]; SEC v. Tilco, Inc., [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,240 (D.D.C. 1971).

67. SEC v. American Realty Trust, 429 F. Supp. 1148, 1177-78 (E.D. Va. 1977).

The relief sought here by the SEC, the appointment of trustees and removal of the President, infringe on activities traditionally controlled by the states. The federal securities laws are at best a limited federal corporate law and the SEC and federal courts are "bound to respect the limits which are inherent in a statutory scheme aimed at ensuring disclosure in the sale of securities and not the substantive regulation of business itself." *Equitable Remedies in SEC Actions*, 123 U. Pa. L. Rev., 1188, 1216 (1976). Except in the most egregious cases, courts should not interfere with corporate democracy. Those circumstances are not present in the instant action.

It is through the medium of settlements of these proceedings that the Commission has made its most notable inroads into corporate governance and accountability. And it is the implications of these settlements that will endure and influence corporations long after the issues of political and sensitive payments have ceased to claim newspaper space.

Basically the Commission's settlements involving governance and accountability may be grouped in this way: (1) settlements which require the appointment of additional outside directors;<sup>68</sup> (2) settlements in which specific responsibilities, sometimes of an ad hoc nature, sometimes of a continuing nature, are imposed on an existing board;<sup>69</sup> (3) settlements which require the appointment of an audit and/or other committee given special responsibilities;<sup>70</sup> (4) settlements which require the appointment of a special counsel to

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68. SEC v. Canadian Javelin, SEC Litigation Release No. 6441 (S.D.N.Y. 1974), 4 SEC DOCKET No. 17, at 620 (June 30, 1974); SEC v. Mattel, Inc., SEC Litigation Release Nos. 6531 & 6532 (D.D.C. 1974), 5 SEC DOCKET No. 8, at 241 (Oct. 16, 1974).

69. SEC v. Emersons Ltd., SEC Litigation Release No. 7392 (D.D.C. 1976), 9 SEC DOCKET No. 12, at 667 (May 25, 1976); SEC v. Foremost-McKesson, Inc., SEC Litigation Release No. 7479 (D.D.C. 1976), 9 SEC DOCKET No. 20, at 1074 (July 21, 1976); SEC v. Brad Ragan, Inc., SEC Litigation Release No. 7681 (W.D.N.C. 1976), 11 SEC DOCKET No. 1, at 1113 (Dec. 14, 1976); SEC v. General Telephone and Electronics Corp., SEC Litigation Release No. 7760 (D.D.C. 1977), 11 SEC DOCKET No. 16, at 1662 (Feb. 15, 1977).

70. SEC v. Canadian Javelin, SEC Litigation Release No. 6441 (S.D.N.Y. 1974), 4 SEC DOCKET No. 17, at 620 (June 30, 1974); SEC v. Mattel, Inc., SEC Litigation Release Nos. 6531 & 6532 (D.D.C. 1974), 5 SEC DOCKET No. 8, at 241 (Oct. 16, 1974); SEC v. American Ship Building Co., SEC Litigation Release No. 6534 (D.D.C. 1974), 5 SEC DOCKET No. 8, at 242 (Oct. 16, 1974); SEC v. Minnesota Mining & Mfg. Co., SEC Litigation Release No. 6711 (D. Minn. 1975), 6 SEC DOCKET No. 6, at 272 (Feb. 18, 1975); SEC v. Gulf Oil Corp., SEC Litigation Release No. 6780 (D.D.C. 1975), 6 SEC DOCKET No. 11, at 465 (March 25, 1975); SEC v. Missouri Public Service Co., SEC Litigation Release No. 7299 (W.D. Mo. 1976), 9 SEC DOCKET No. 2, at 9117 (March 16, 1976); SEC v. General Tire & Rubber Co., SEC Litigation Release No. 7386 (D.D.C. 1976), 9 SEC DOCKET No. 12, at 667 (May 25, 1976); SEC v. Firestone Tire & Rubber Co., SEC Litigation Release No. 7443 (D.D.C. 1976), 9 SEC DOCKET No. 17, at 920 (May 30, 1976); SEC v. Chicago Milwaukee Corp., SEC Litigation Release No. 7472 (D.D.C. 1976), 9 SEC DOCKET No. 19, at 1008 (July 19, 1976); SEC v. J. Ray McDermott & Co., SEC Litigation Release No. 7603 (D.D.C. 1976), 10 SEC DOCKET No. 13, at 687 (Oct. 19, 1976); SEC v. Diversified Industries, Inc., SEC Litigation Release No. 7650 (D.D.C. 1976), 10 SEC DOCKET No. 19, at 980 (Oct. 30, 1976); SEC v. Brad Ragan, Inc., SEC Litigation Release No. 7681 (W.D.N.C. 1976), 11 SEC DOCKET No. 1, at 1113 (Dec. 14, 1976); SEC v. Uniroyal Inc., SEC Litigation Release No. 7759 (D.D.C. 1977), 11 SEC DOCKET No. 9, at 1581 (Feb. 8, 1977); SEC v. General Telephone & Electronics Corp., SEC Litigation Release No. 7760 (D.D.C. 1977), 11 SEC DOCKET No. 10, at 1662 (Feb. 15, 1977); SEC v. Anheuser-Busch, Inc., SEC Litigation Release No. 7930 (D.D.C. 1977), 12 SEC DOCKET No. 6, at 502 (June 7, 1977).



conduct an investigation into certain practices;<sup>71</sup> and (5) the appointment of a special auditor to assist in the work of special counsel.<sup>72</sup>

A review of these cases indicates that some settlements have combined different components. For example, the *Canadian Javelin* settlement provided that forty per cent of its directors be outside, independent directors approved by the Commission; that an outside counsel approved by the SEC be named to take responsibility for reviewing the dissemination of all information to the public and for securing compliance with securities laws by Javelin; that Javelin designate a public-information officer; and that Javelin establish a standing committee a majority of which would be independent outside directors. The settlement further stipulated that the special outside counsel could not be removed without prior notification of the Commission.<sup>73</sup> In another case, after the Commission was informed that Mattel, Inc., filed financial statements which overstated its profits and understated its costs, a settlement was reached which stipulated that the majority of Mattel's board of directors would be SEC- and court-approved unaffiliated directors, that the new unaffiliated directors could appoint a special counsel, and that the special counsel could appoint a special auditor to be approved by Mattel, the Commission, and the court in order to audit the financial statements of Mattel.<sup>74</sup> Emersons Ltd.'s difficulties with false financial statements and illegal payments from liquor, wine, and beer producers resulted in the requirement that Emersons appoint three approved independent directors and additional independent directors as replacements for any present board members who cease to serve as directors until independent directors constitute a majority of Emersons' board of directors.<sup>75</sup> This particular part of the settlement may be distinguished from the *Mattel* settlement in that the number of independent directors would increase gradually.<sup>76</sup> The *Emersons* settlement also provided for the appointment

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71. SEC v. Canadian Javelin, SEC Litigation Release No. 6441 (S.D.N.Y. 1974), 4 SEC DOCKET No. 17, at 620 (June 30, 1974); SEC v. Mattel, Inc., SEC Litigation Release Nos. 6531 & 6532 (D.D.C. 1974), 5 SEC DOCKET No. 8, at 241 (Oct. 16, 1974); SEC v. General Tire & Rubber Co., SEC Litigation Release No. 7386 (D.D.C. 1974), 9 SEC DOCKET No. 12, at 664 (May 25, 1976); SEC v. Emersons Ltd., SEC Litigation Release No. 7392 (D.D.C. 1976), 9 SEC DOCKET No. 12, at 667 (May 25, 1976); SEC v. Brad Ragan, Inc., SEC Litigation Release No. 7681 (W.D.N.C. 1976), 11 SEC DOCKET No. 1, at 1113 (Dec. 14, 1976); SEC v. Ormand Inds., Inc., SEC Litigation Release No. 7910 (D.D.C. 1977), 12 SEC DOCKET No. 4, at 415 (May 29, 1977).

72. SEC v. Mattel, Inc., SEC Litigation Release Nos. 6531 & 6532 (D.D.C. 1974), 5 SEC DOCKET No. 8, at 241, 242 (Oct. 16, 1974); SEC v. Brad Ragan, Inc., SEC Litigation Release No. 7681 (W.D.N.C. 1976), 11 SEC DOCKET No. 1, at 1113 (Dec. 14, 1976).

73. SEC v. Canadian Javelin, SEC Litigation Release No. 6441 (S.D.N.Y. 1974), 4 SEC DOCKET No. 17, at 620 (June 30, 1974).

74. SEC v. Mattel, Inc., SEC Litigation Release Nos. 6531 & 6532 (D.D.C. 1974), 5 SEC DOCKET No. 8, at 241 (Oct. 16, 1974).

75. SEC v. Emersons Ltd., SEC Litigation Release No. 7392 (D.D.C. 1976), 9 SEC DOCKET No. 12, at 667 (May 25, 1976).

76. Compare SEC v. Emersons Ltd., SEC Litigation Release No. 7392 (D.D.C. 1976), 9 SEC DOCKET No. 12, at 668 (May 25, 1976) with SEC v. Mattel, Inc., SEC Litigation Release Nos. 6531 & 6532 (D.D.C. 1974), 5 SEC DOCKET No. 8, at 241 (Oct. 16, 1974).

of a special counsel and a special committee comprised of the independent directors, who would review financial reporting, releases, and communications to the public, accounting policies, and the selection of auditors.<sup>77</sup>

Other SEC settlements have affected corporate governance and conduct in a variety of ways. In the *Foremost-McKesson* settlement the SEC required only that the existing board assume some additional responsibilities. These responsibilities included the completion of an investigation into various matters, the submission of a written report, and the maintenance by the board of a policy prohibiting any cash payment or rendering of merchandise in violation of laws or regulations, or the payment of anything of value which is material in nature directly or indirectly to any foreign governmental official or entity.<sup>78</sup> The General Tire and Rubber Company was required to establish a special review committee to conduct an extensive investigation with the help of a special counsel.<sup>79</sup> Again in the *Missouri Public Service Company* settlement, a special review committee was required to investigate unlawful contributions.<sup>80</sup> The major requirement in the *Anheuser-Busch, Inc.*, settlement was the appointment of a review person by the company's auditing committee, with the approval of the Commission, to review the adequacy of the auditing committee's investigation and the disclosure based thereon.<sup>81</sup> The *GTE* settlement stipulated that GTE's board of directors would adhere to guidelines adopted by GTE with respect to payments by GTE to any official or employee of any private customer or government or to any official or employee of any entity owned or controlled by any government when those payments are unlawful under the laws of the United States or such foreign country. Any change in the guidelines must be filed with the Commission.<sup>82</sup>

In a settlement<sup>83</sup> little noticed until Chairman Harold Williams referred to it in his testimony before the Senate Subcommittee on Reports, Accounting and Management in June 1977, the Commission caused the court to set forth with particularity its notions of what the duties of an audit committee should be. While the settlement, of course, is binding only upon the defendants, it

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77. SEC v. Emersons Ltd., SEC Litigation Release No. 7392 (D.D.C. 1976), 9 SEC DOCKET No. 12, at 668 (May 25, 1976).

78. SEC v. Foremost-McKesson, Inc., SEC Litigation Release No. 7479 (D.D.C. 1976), 9 SEC DOCKET No. 20, at 1074 (July 21, 1976).

79. SEC v. General Tire & Rubber Co., SEC Litigation Release No. 7386 (D.D.C. 1974), 9 SEC DOCKET No. 12, at 664 (May 25, 1976).

80. SEC v. Missouri Public Service Co., SEC Litigation Release No. 7299 (W.D. Mo. 1976), 9 SEC DOCKET No. 2, at 114 (March 16, 1976).

81. SEC v. Anheuser-Busch, Inc., SEC Litigation Release No. 7930 (D.D.C. 1977), 12 SEC DOCKET No. 6, at 502 (June 7, 1977).

82. SEC v. General Telephone and Electronics Corp., SEC Litigation Release No. 7760 (D.D.C. 1977), 11 SEC DOCKET No. 10, at 1662 (Feb. 15, 1977).

83. SEC v. Killearn Properties, Inc., [1977] SEC. REG. & L. REP. (BNA) No. 421: D-2, 3 (Sept. 28, 1977).

does provide significant insights into the Commission's conception of audit committees' duties in general. The court order referred to three "special duties" of the audit committee:<sup>84</sup>

1. Review the engagement of the independent auditors, including their compensation, the scope and extent of their review of the company's financial statement, and the audit procedures they will utilize;
2. Review with the company's independent accountants and chief financial officer (as well as other appropriate personnel) the general policies and procedures used by the company with respect to internal auditing, accounting, and financial controls;
3. Review releases by the company to the media, shareholders, and the public which concern financial matters.

Under each of these three areas the order specifies with considerable particularity the actions which the audit committee must take in carrying out its responsibilities.

The above is by no means a complete delineation of the cases in which the Commission in negotiating settlements has secured relief which has affected the structure of corporate governance and the manner in which authority is exercised within the corporation; a member of the Commission staff has informally stated to the writer that he counts some sixty cases in which the settlements have affected corporate governance. These cases and others not discussed display a remarkable variety of judicially mandated techniques and practices to deal with corporate wrongdoing through modifications of corporate practices and structures. These judicial orders and others similar to them, of course, constitute direct intervention in corporate structure and corporate governance. The orders are binding upon the corporations under penalty of contempt of court and appear to be binding in perpetuity. Thus, in effect, the charters of these affected corporations are amended and the requirements of state corporation laws, which generally require only that a corporation have a board of directors and do not specify any particulars (*e.g.*, the number of inside versus outside directors) other than the minimum number of directors, are significantly and permanently supplemented by federal court decree.

The decrees in these cases obviously are only binding on the parties to the case; nonetheless the emergence of these patterns in numerous cases has drawn considerable attention to the various role players in the corporate process. While it is difficult to trace such corporate reforms as the introduction of larger numbers of outside directors, the institution of audit committees, and the like directly to these settlements, the publicity accorded such settlements

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84. *Id.*

has certainly in some measure conditioned the minds of corporate leaders to accept these trends and to enhance them. This is evident in many of the discussions of these problems which frequently allude to the settlements.<sup>85</sup>

### C. Policy by Coaxing

A second, perhaps even more far-reaching example of the manner in which corporate conduct has been conditioned by the disclosures arising out of Watergate is found in the Commission's so-called voluntary disclosure program.

On July 17, 1975, the Commission, speaking through Commissioner Philip A. Loomis, Jr., who testified before the Subcommittee on International Economic Policy of the House of Representatives International Relations Committee, proposed that corporations which suspected that they might have engaged in questionable conduct undertake an internal investigation and then publicly report the results of it.<sup>86</sup> Commissioner Loomis stated:<sup>87</sup>

With respect to past activities, we propose to publish a summary of the cases which we have already brought, together with a description of other situations of a similar nature which have come to our attention, and accompany this by a suggestion that other companies who, upon reviewing their own affairs, conclude that they may have a similar problem might proceed somewhat as follows:

First, make a careful investigation of the facts, similar, I might add, to those that have been made by the companies we have had the problem with, under the auspices of persons not involved in the activities in question, such as their independent directors.

If this investigation discloses that a problem does in fact exist, the board of directors of the company should consider in consultation with their professional advisers what types of disclosures seem to be called for.

Such companies would probably find it advisable to discuss the matter with our staff prior to filing any documents with us. Companies often do that where they have a somewhat novel problem.

In order to consider the adequacy of the proposed disclosure, our staff would need to be fully informed as to the facts.

While our enforcement activity in this area will continue, we are going forward, the foregoing procedures could lessen the need for enforcement action in particular cases, especially where the Commission is informed in advance that a company which is not now under investigation proposed to proceed in this manner.

How many corporations have satisfied all the conditions of the voluntary program is uncertain, but at the date of this writing about four hundred corporations have made public disclosure of questionable or illegal activity at home or abroad.

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85. See Comment, *Court Appointed Directors*, 64 GEO. L.J. 737 (1976); see generally *Northrop's Punishment for Campaign Giving*, BUS. WEEK, Feb. 24, 1975, at 60.

86. *Hearings*, *supra* note 4, at 63-64.

87. *Id.*

The Commission has never adopted any rules incorporating the voluntary disclosure program. The only official elaboration has been in the Commission's May 12, 1976, report of the Senate Banking, Housing and Urban Affairs Committee and in statements by Commissioners and staff.<sup>88</sup>

To qualify for the uncertain benefits of the voluntary disclosure program (these were asserted to be a reduction in the likelihood of a Commission proceeding against the errant corporation and its officers)<sup>89</sup> a corporation, as noted, would have to undertake to cease the practices described.

No one has suggested that the Commission has the power to proscribe these activities, although it has often negotiated settlements that included undertakings and injunctions that prohibited substantive misconduct as well as the failure to disclose it.<sup>90</sup> But by holding out the conditional promise of immunity from Commission proceedings, the Commission has succeeded in causing innumerable companies to undertake to desist from courses of conduct some of which at least were not clearly illegal.

By its failure to articulate standards for disclosure concerning sensitive payments and related matters (except to the extent that standards may be said to be stated in its May 12, 1976, report), the Commission has created in the corporate community and among corporate advisors profound uncertainty concerning the kinds of conduct that are subject to the SEC reporting requirements.<sup>91</sup> Partly as a consequence of this uncertainty, a very large proportion of the publicly held companies in the United States (and there are some ten thousand subject to the 1934 Act reporting requirements) have engaged in some internal soul searching, and many of those which have not made disclosures have nonetheless determined to forego the types of conduct that have been the subject of suits brought by the Commission, if for no other reason than to create equities which might forestall an injunction in the event the SEC discovered the nondisclosure and brought an action. (While much is made of the number of companies that have made disclosures, it should not be overlooked that there are over nine thousand companies reporting to the Commission that have not made any disclosures.) And it is not unlikely, though it may not be acknowledged, that the increased presence of outsiders on boards of directors and the organization of audit committees have often flowed from these behavioral decisions.

The impact of these disclosures upon the behavior of corporate America would appear to exceed by far the impact on investors. Most studies that have

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88. REPORT, *supra* note 3, at 6-13.

89. *Id.* at 8 n.7.

90. SEC v. Northrop Corp., No. 75-0536 (D.D.C., filed April 18, 1975); SEC v. Phillips Petroleum Co., No. 75-0308 (D.D.C. Mar. 6, 1975).

91. Lowenfels, *Questionable Corporate Payments and the Federal Securities Laws*, 51 N.Y.U. L. REV. 23 (1976); Note, *Disclosure of Corporate Payments and Practices: Conduct Regulation Through the Federal Securities Laws*, 43 BROOKLYN L. REV. 681 (1977).

been done (though none claim to be conclusive or of definitive depth) would indicate that disclosures of improper activity abroad or at home have not had a lasting effect on either the prices or volume of trading of a company's securities.<sup>92</sup> Anecdotal evidence of the relative indifference of shareholders to confessions of corporate misconduct is common: at the first United Brands stockholder meeting following the tragic suicide of Eli Black and the disclosure of United Brands' bribes in a Central American country to forestall a substantial levy on bananas, shareholders present were far more interested in conventional matters—earnings prospects, for instance—than in the relatively recent scandal involving their company.<sup>93</sup> Similarly, shareholders at other meetings have shown little concern with the morality of their officers. At Northrop Corporation, the governing structure of which was substantially reorganized as a consequence of shareholder litigation, the restructured board, including a majority of outsiders agreeable to the plaintiff in the action, restored the principal author of the corporation's misconduct to all of his offices because they concluded his talents were essentially irreplaceable.<sup>94</sup>

Ephemeral as the consequences of the disclosures may be to investors and shareholders, the consequences in the structure and governance of these corporations, both those making disclosures and those not, remain and bid fair to become a permanent part of the corporate landscape.

#### D. Policy by Statutory Transference

Another subtle source of influence on corporate governance derives from the Investment Company Act of 1940.<sup>95</sup> As remarked above, this Act more than any other statute administered by the Commission addresses questions of corporate governance explicitly. It may be suggested that in some measure the attitude of the Commission and the staff with regard to such matters is determined by concepts of directoral responsibility which have developed under the 1940 Act. Less as a consequence of Commission activity than of private litigation, the responsibilities of investment company directors under the 1940 Act have been increasingly delineated. While most of the cases involve situations that are unique to investment companies—transfer of investment-advisor contracts, the desirability of using different arrangements for executing securities transactions, the fairness of management fees—the courts have nonetheless been steadily stating principles that may have a much broader relevance.<sup>96</sup>

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92. See Note, *Disclosure of Payments to Foreign Government Officials Under the Securities Acts*, 89 HARV. L. REV. 1848, 1855 n.45 (1976); Griffin, *Disclosure Policy and the Securities Markets: The Impact of the 1975-76 Sensitive Payment Disclosure* (submitted to the SEC Advisory Committee on Corporate Disclosure) (Dec. 1976).

93. New York Times, August 19, 1974, at 45, 51.

94. Wall Street Journal, Jan. 17, 1975, at 1; *Id.* Jan. 18, 1975, at 14.

95. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-52 (1970).

96. See, e.g., *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971); *Tannenbaum v. Zeller*, 399 F.

The evolution of concepts originating in the 1940 Act into concepts broadly applicable to corporations in general is, of course, difficult to document; as a matter of fact, in its *Tannenbaum* brief the Commission explicitly disavowed any intent to state standards that had applicability beyond the 1940 Act.<sup>97</sup> However, discussions with staff members and examination of evolving attitudes indicate that the standards stated in that brief, as an example, indeed bear close similarity to the Commission's and the staff's convictions concerning the responsibility of all outside directors:<sup>98</sup>

Specifically, the decision of the board of directors of this investment company—to forego capture of excess brokerable commissions—should be dispositive *if* this Court satisfies itself that—

(1) in so deciding, the independent directors were truly independent of domination by or undue influence of the advisor;

(2) the independent directors were completely informed, and fully aware, of the available alternative; and

(3) the decision reached was a reasonable business judgment made after a thorough review of all relevant factors by the independent members of the board.

While the footnote following this portion of the brief disavows any intention to apply these standards to non-investment-company directors, it is nonetheless difficult to derive these standards solely from the 1940 Act. They resemble closely statements made by Commission and staff members concerning their conceptions of the responsibilities of all directors, especially outside directors, under the securities laws in general.<sup>99</sup>

#### E. Policy by Rule Making—Direct and Indirect

The Commission has moved cautiously toward the imposition-by-rule of substantive standards in the area of corporate governance. Two examples of this have been the release proposing rules in connection with “going private” transactions and the release announcing hearings on changes in the proxy rules.

In its initial release with respect to going private,<sup>100</sup> the Commission proposed alternative rules. Both of these proposed rules, in addition to requiring extensive disclosure (no one appears to dispute that the Commission has power to compel disclosure under section 13(e) of the 1934 Act), contained

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Supp. 945 (S.D.N.Y. 1975); *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir. 1975); *Papilsky v. Berndt*, 466 F.2d 251 (2d Cir.), *cert. denied*, 409 U.S. 1077 (1972); *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971).

97. Brief of the Securities and Exchange Commission (*amicus curiae*) at 20 n.24. *Tannenbaum v. Zeller*, 399 F. Supp. 945 (S.D.N.Y. 1975).

98. *Id.* at 20.

99. See generally, *The Director's Dilemma*, *supra* note 54; *A Commission Dilemma*, *supra* note 55.

100. SEC Securities Act Release No. 5567 (Feb. 6, 1975), 6 SEC DOCKET No. 7, at 250 (Feb. 25, 1975).

substantive provisions: *e.g.*, a requirement that a "fair price" be determined in a specified way; provisions similar to those contained in section 14(d) of the 1934 Act pertaining to third-party tender offers with respect to withdrawal of deposited shares; requirement of a "take out" period for shareholders who did not accept the offer; and a requirement that there be a valid business purpose for the transaction. In addition to these proposals, the Commission asked specifically for comment on other substantive questions such as a possible requirement that controlling interests vote their shares in proportion to the votes of other shareholders or perhaps with the majority.<sup>101</sup>

On November 17, 1977, the Commission published for comment revised proposed rules concerning going-private transactions. While the revised rules depart in many ways from the earlier proposals, they would most significantly require that the transaction be fair, and would specify procedures and indicia which would tend to reflect fairness.<sup>102</sup>

Recently, again purporting to use its powers over disclosure, the Commission issued two releases announcing the proceedings looking toward the amendment of the proxy rules. The releases suggested several areas for consideration; many of these bore in one measure or another upon questions of corporate governance. For instance, the Commission solicited comment on whether shareholders should have access to management's proxy-soliciting material for the purpose of making nominations for election to the board of directors; whether in conflict situations affiliates or other persons should be required to vote their shares in accordance with the majority or in proportion to the votes of the shareholders not having a conflict; whether the Commission should recommend legislation providing for federal incorporation or federally established minimum standards for officers' and directors' conduct; whether institutions should be required before voting shares they hold to solicit the views of persons having an economic interest in the shares.<sup>103</sup>

In a similar vein the Commission's Advisory Committee on Corporate Disclosure recommended that<sup>104</sup>

The Commission should develop a package of disclosure requirements that, taken as a whole, will strengthen the ability of boards of directors to operate as independent, effective monitors of management performance and that will provide investors with a reasonable understanding of the organization and role of the board of any given issuer.

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101. The argument of those who assert that the Commission was not given power to regulate substantive matters under section 13(e) is well stated in the comment of the Committee on Federal Regulation of Securities, ABA Section of Corporation, Banking, and Business Law (submitted in response to the proposed rule making) (July 18, 1975).

102. SEC Securities Act Release No. 5884, [Current] FED. SEC. L. REP. (CCH) ¶ 81,366 (Nov. 17, 1977).

103. SEC Securities Exchange Act Release No. 13482 (Apr. 28, 1977), 12 SEC DOCKET No. 2, at 239 (May 10, 1977); SEC Securities Exchange Act Release No. 13901 (Aug. 29, 1977), 20 SEC DOCKET No. 20, at 1630 (Sept. 12, 1977).

104. SEC ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, FINAL REPORT (November 3, 1977).



The adoption of these proposals would represent a novel exercise of power by the Commission. It might well be that this exercise would be tested and found wanting; however, the peculiar dynamics of securities regulation minimize the likelihood of such a challenge. Issuers seeking proxy statement clearance have not the time to contest the Commission's demand for additional information or text modification, and it is unlikely that an issuer would find it prudent or feasible to contest, for instance, a Commission requirement with respect to proposals to amend a corporation's bylaws to provide for shareholder nominations. Similarly, a company seeking to go private would probably find compliance with the Commission's mandates a less costly, more reliable, and more expeditious process than prolonged litigation. Securities transactions and proxy solicitations are time-limited: events do not generally permit a long delay. Furthermore, while the Supreme Court has curtailed significantly the applications of the federal securities laws,<sup>105</sup> the Commission's rule-making power has not been limited; hence an assault upon action taken under the Commission's broad rule-making power would have an uncertain outcome. Finally, while one may read the Supreme Court decisions as indicating a strong tendency to limit the implication of remedies, there is nothing in recent Supreme Court history to justify the conclusion that the Court felt similarly inclined to deal narrowly with agency rule-making powers.

Another example of proposed rule making that appears to represent a broad expansion of asserted power, and which has potentially significant consequences for corporate governance, is SEC Exchange Act Release No. 13185. In 1976, as a consequence of the disclosures with respect to sensitive payments, including disclosure that these had generally been accompanied by financial record falsification, a number of legislative proposals were introduced in Congress to deal with the problem. The proposals that gained the strongest support were contained in S. 3664. These provided in substance that United States businesses would be prohibited from, among other things, making payments to any foreign official, political party, candidate for office, or intermediary for the purpose of inducing some individual or party to influence a foreign government, its legislation, or regulations or fail to perform official functions or assist in obtaining or retaining business. More important perhaps, this legislation provided that it would constitute a violation of law if a company failed to maintain proper internal controls or failed to maintain proper books and records, or if anyone misrepresented information to an auditor or falsified the records of the corporation.

This legislation passed the Senate on September 15, 1976, by a vote of 88 to 0 and it was confidently expected to pass the House by a wide margin. However, a combination of circumstances prevented the House Rules Com-

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105. See cases cited notes 107-11 *infra*.

mittee from voting on the proposal, and thus it died with the 94th Congress.<sup>106</sup>

Shortly thereafter, however, the Commission proposed to adopt, virtually verbatim, the accounting portions of the aborted legislation under its traditional rule-making power. Thus in SEC Exchange Act Release No. 13185 it proposed rules that would require issuers registered under section 12 of the Exchange Act or required to file periodic reports under section 15(d) of that Act to<sup>107</sup>

- (a) maintain books and records which accurately reflect the transactions and dispositions of assets of the issuer;
- (b) maintain a system of internal accounting controls which would provide reasonable assurance that:
  - (1) transactions are executed in accordance with management's general or specific authorization;
  - (2) transactions are recorded as necessary (a) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (b) to maintain accountability for assets;
  - (3) access to assets is permitted only in accordance with management's authorization; and
  - (4) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

The proposal would also have prohibited:

- (a) falsification of an issuer's accounting records; and
- (b) false or misleading statements to accountants by directors, officers, or shareholders of an issuer.

In December 1977 Congress adopted and the President signed Public Law 95-213, which included the prohibitions against foreign payments and some of the accounting provisions—with some modifications—but omitted the prohibitions against falsification of records and misrepresentation to accountants. The Commission is however considering the adoption of a rule incorporating the provisions omitted from the statute.

The enactment by Congress of a requirement that corporations maintain systems of internal controls obviated the adoption of a rule to this effect by the Commission. However, the fact that the Commission seriously considered such a rule is clear evidence of its willingness to extend its reach over corporate governance by the rule-making route.

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106. The bill was, however, reintroduced by Senator Proxmire in the present session of Congress (S. 305, 95th Cong., 1st Sess. (1977)) and was adopted and signed in December.

107. SEC Securities Exchange Act Release No. 13185 (Jan. 19, 1977), [Current] FED. SEC. L. REP. (CCH) ¶ 80,896, 42 FED. REG. 4854 (1977).

Ironically, the increasing Commission presence in the area of corporate structure and governance occurs at a time when the Supreme Court has been delineating the limits of the federal securities laws more narrowly than at any time in their history. It has sharply rejected efforts to expand the definition of "security,"<sup>108</sup> the ability of rule 10b-5 plaintiffs to recover,<sup>109</sup> the availability of relief under the tender-offer provisions of the 1934 Act to defeated tender offerors,<sup>110</sup> the standing of someone who is neither a purchaser nor seller to maintain an action under rule 10b-5,<sup>111</sup> and the applicability of rule 10b-5 to breaches of fiduciary duty by those having control of corporations.<sup>112</sup> However, the clearest rejection of the effort to stretch the federal reach into areas traditionally regarded as those of state government was stated in *Cort v. Ash*:<sup>113</sup>

Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation . . . .

. . . [B]ecause implication of a federal right of damages on behalf of a corporation under § 610 would intrude into an area traditionally committed to state law without aiding the main purpose of § 610, we reverse.

The Commission has intervened in corporate governance in more direct ways. In 1976, SEC Chairman Roderick M. Hills wrote William M. Batten, chairman of the New York Stock Exchange, urging that the exchange amend its listing agreement to require each listed company to have an audit committee made up predominantly if not exclusively of outside directors.<sup>114</sup> The New York Stock Exchange responded affirmatively to this and on March 9, 1977,<sup>115</sup> adopted an amendment that required domestic companies already listed on the exchange to comply by June 30, 1978, and those listing for the first time to comply before listing. The proposal required that<sup>116</sup>

Each domestic company with common stock listed on the NYSE, as a condition of listing and continued listing of its securities on the NYSE, shall establish no later than June 30, 1978, and maintain thereafter an audit committee comprised solely of directors independent of management and free from any relationships that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member.

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108. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975).

109. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

110. *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1976 (1977).

111. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

112. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977).

113. *Cort v. Ash*, 422 U.S. 66, 84-85 (1975).

114. See REPORT, *supra* note 3, Exhibit D.

115. See SEC Exchange Act Release No. 13346 (Mar. 9, 1977), 11 SEC DOCKET No. 15, at 1945 (March 22, 1977), for a discussion of this matter.

116. SEC Exchange Act Release No. 13245, (Feb. 4, 1977), 11 SEC DOCKET No. 11, at 1072 (Feb. 21, 1977), 42 FED. REG. 8737 (1977).

### F. Policy by Pronouncement

In cases and reports on investigations involving outside directors the Commission has with considerable particularity set forth its conception of the responsibilities of directors; again it should be emphasized that these have occurred in the context of settlements and do not represent judicial conclusions concerning directors' responsibilities.

In *Report of Investigation in the Matter of Stirling Homex Corporation Relating to Activities of the Directors of Stirling Homex Corporation*<sup>117</sup> the Commission criticized sharply the failures of two outside directors. While recognizing that the outside directors were deceived by the management of Stirling Homex, the Commission faulted them on several scores:<sup>118</sup>

In the Commission's opinion, they did not obtain a sufficiently firm grasp of the company's accounting practices and other aspects of the company's business related thereto to enable them to make an informed judgment of its more important affairs or the abilities and integrity of its officers. Kheel and Castellucci relied upon the fact that Stirling Homex's independent accountants had accepted these accounting practices as being in conformity with generally accepted accounting principles. While this reliance was understandable, it resulted in their making no significant effort to analyze or familiarize themselves generally with these accounting practices . . . and their susceptibility to abuse. While they periodically asked general and conclusory questions, they frequently obtained only superficial answers which they accepted without further inquiry.

While the Commission recognizes the difficulties which may confront outside directors, particularly in a situation such as this, where management as part of a fraudulent course of conduct to deceive the public was not willing either to take the outside directors into their confidence or to keep them even reasonably well informed, this case illustrates a situation where these directors, in the opinion of the Commission, did not provide the shareholders with any significant protection in fact, nor did their presence on the Board have the impact upon the company's operations which shareholders and others might reasonably have expected.

Similarly in *SEC v. Shiell*,<sup>119</sup> the Commission alleged that the outside directors did not exercise sufficient care with respect to the affairs of the corporation and did not go beyond officers' statements in ascertaining the state of the business:<sup>120</sup>

The minutes and agendas of the Board of Directors meetings starting in 1972 reflect that the directors had in effect relinquished substantial control over the president. The directors, as outside directors, relied upon the president as their sole source for all information regarding the activities and operations of the company. The minutes do not reflect that any other officers of the company were present at the meetings nor did the directors require any other

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117. [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,219, at 85,462-63 (July 16, 1975).

118. *Id.*

119. [1976] SEC. REG. & L. REP. (BNA) No. 383: A-8 (Dec. 22, 1976).

120. *Id.* at A-10.

officer to report to them regarding the activities of the company to any significant extent. The testimony of the directors indicates that they did not deem it necessary to have other officers present at meetings for they believed (by accepting the president's report at face value) that they were getting accurate and complete information from the president. Additionally, they felt that questioning other officers about the company's activities or, in fact, requiring other officers to report to them independently of the president would 'constitute an intrusion into the functions of management.' Even when the directors visited the company offices from time to time, and encountered other key officers, there were few discussions regarding the company's activities.

In a similar vein, in its report to the Congress with respect to its study of the Penn Central collapse, the Commission staff dwelt at length on the failures of the directors of Penn Central to come to grips with the worsening situation of the corporation. The staff summarized this failure in these words:<sup>121</sup>

The Board failed in two principal ways. It failed to establish procedures, including a flow of adequate financial information, to permit the board to understand what was happening and to enable it to exercise some control over the conduct of the senior officers. Secondly, the board failed to respond to specific warnings about the true condition of the company and about the questionable conduct of the most important officers. As a result, the investors were deprived of adequate and accurate information about the condition of the company.

The Commission followed this report with the filing of a complaint naming, among others, three outside directors of Penn Central as defendants. In the fourth cause of action of the complaint these directors (all of whom had long service on the board of the company and one of its predecessors, and all of whom had backgrounds indicating familiarity with financial matters) were charged with knowing or having reason to know that securities were being sold without disclosure of adverse information concerning Penn Central.<sup>122</sup>

As a part of the Commission's settlement of a complaint against Gould Inc. and two of its officers for alleged violations of the securities laws (one of the violations involved nondisclosure of a transaction in which the company and some of its officers were involved, although they were not dealing with each other), the Commission issued a report of investigation under section 21(a) of the 1934 Act describing the allegedly wrongful transactions and stating its opinion with respect to the responsibility of directors when confronted with such transactions:<sup>123</sup>

With regard to the review of the board of directors of management involvement in a transaction affecting the company, the Commission is of the opin-

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121. STAFF OF THE SECURITIES AND EXCHANGE COMMISSION, *THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY* 153 (1972) (submitted to the Special Committee on Investigations).

122. *SEC v. Penn Central Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,527, *complaint filed* (E.D. Pa. May 2, 1974).

123. [Current] FED. SEC. L. REP. (CCH) ¶ 96,077, at 91,863 (D.D.C. June 9, 1977).

ion that in such instances, the board should carefully ascertain all of the relevant facts to determine whether the transaction is in all ways fair to the company and to assure that it has been fully disclosed to shareholders as required by the federal securities laws. In ascertaining facts, the board should not rely solely on information from interested management but should also seek information from independent non-interested sources when available.

#### CONCLUSION

Several significant aspects of these activities of the Commission with respect to corporate governance deserve comment. First, the Commission has significantly affected corporate governance. The increasing number of outside directors on boards, the explosive growth in the number of audit committees, the adoption of codes of conduct by many companies, the eschewing of previously accepted business practices by multinational corporations—these and many more developments have had their strongest impetus from the activities of the Commission.

Second, the Commission's impact on corporate governance has been accomplished with surprisingly few formal actions by the Commission either in the realm of rule making or in enforcement actions specifically aimed at directors. As noted, the most direct effort to provide standards for director conduct—the effort to articulate guidelines—aborted. The number of actual suits filed by the Commission against outside directors because of their conduct as such is only two, and in one, *SEC v. Shiell*,<sup>124</sup> the relationship of the directors to the company was significantly different from the conventional relationship of outside directors to a publicly held corporation: they had been among the founders, were clearly the controlling persons, and in general there was an atypical intimacy of involvement.

Third, the Commission has incontestably concluded that to administer the securities laws effectively it is necessary to address the problem of corporate governance. With the exception of its sponsorship of section 1 of S. 305, it has not sought additional power from Congress. Rather it has been through resourceful use of jawboning by Commission and staff members, skillful expansion of its enforcement powers (including imaginative settlement proposals and provisions), and artful use of its powers to accelerate the effectiveness of registration statements and release proxy-soliciting materials, that the Commission has enormously changed the structure and governance of American corporations.

This paper passes no judgment on either the power of the Commission to do as it has done (though full disclosure compels admission that the writer participated in many of the actions which have promoted these tendencies) or the propriety of its actions. Critics of both the tendencies in general and the

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124. [1976] SEC. REG. & L. REP. (BNA) No. 383: A-8 (Dec. 22, 1976).

particular deeds have not been wanting.<sup>125</sup> These critics are undoubtedly dismayed by signs that under the chairmanship of Harold M. Williams, a veteran of both the business and the academic worlds, the effort of the Commission to influence corporate governance will not only continue but accelerate. In an address shortly after his accession to the chairmanship of the Commission, he said:<sup>126</sup>

It is my ideal . . . that a board consist of the chief executive and outside directors. Standards need to be set for what is expected of an outside director in terms of behavior and performance. I would also urge that the chairman of the board not be the chief executive officer.

What it means is that the large corporation has ceased to be private property—even though theoretically owned by its shareholders. It is now a quasi-public institution. If it is such a quasi-public institution, then the self-perpetuating oligarchy that constitutes management does not have the same rights it once had.

This is not the language of a person who will lead the Commission in a retreat from its forward position in the field of corporate governance.

This article has not discussed the manner in which the Commission is affecting corporate governance by its increased oversight of the accounting profession and its increased concern with the role of corporate counsel in the corporate structure. The Commission appears to see an insistence upon the expansion of the responsibilities of these professionals as a means of furthering management responsibility and conformity to acceptable standards of conduct; it may be that this will prove to be the most potent weapon in the Commission's arsenal.

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125. See Freeman, *The Legality of the SEC's Management Fraud Program*, 31 *BUS. LAW.* 1295 (1976); Note, *Disclosure of Corporate Payments and Practices: Conduct Regulation Through the Federal Securities Laws*, 43 *BROOKLYN L. REV.* 681 (1977).

126. Corporate Ethics, Address by Harold M. Williams, American Assembly, Columbia University (April 16, 1977).