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The Securities and Exchange Commission and Corporate Democracy

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THE SECURITIES AND EXCHANGE COMMISSION AND CORPORATE DEMOCRACY

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On April 28th of last year, the Securities and Exchange Commission announced it would begin a comprehensive re-examination of the shareholders' role in corporate governance.[1] After receiving

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1. Securities and Exchange Commission Release No. 13482, (April 28, 1977) [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶81,130 p. 87889 entitled "Re-examination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally." Therein the Commission explains the background of its concern:

> Recent disclosures concerning a wide variety of questionable and illegal corporate practices, accomplished in certain instances with the knowledge and participation of top corporate management, have served to focus public attention on the subject of corporate accountability. A number of proposals designed to achieve a new "corporate governance" have been suggested, including placing greater emphasis on the role of outside directors and audit committees, increasing federal control over corporate conduct through legislation which requires federal chartering or setting of minimum standards of corporate conduct, and providing mechanisms to assure a higher level of management accountability to shareholders through revisions of the Commission's proxy rules.
>
> The SEC, through its jurisdiction over proxy solicitations, has broad power under Section 14(a) of the Securities Exchange Act to promulgate proxy rules and regulations which are "necessary or appropriate in the public interest or for the protection of investors." The Commission recognized that under the existing regulations shareholders often may not be provided adequate opportunities to participate meaningfully in corporate governance or the corporate electoral process. Shareholders generally have limited information relating to certain significant corporate policies and practices on matters which are not submitted to shareholders for their approval; and, as a practical matter, limited access to corporate proxy machinery. For the vast majority of shareholders, an election contest is not feasible because of the huge expenses involved. Although shareholders may be permitted to make nominations from the floor at annual meetings, it is clear that this right is of little practical value, since at that point proxies have already been received by management, for nominees which it has chosen, and the number of shareholders attending an annual meeting typically is insignificant. The Commission believes that it is now appropriate to study these issues on a broader basis. (footnotes deleted).

Id. at 87890-891.

close to one hundred and fifty letters of comment,[2] the Commission commenced hearings on September 29th in Washington D.C.[3]

Few issues are so worthy of the Commission's concern. Under state corporation law, shareholders have the power to nominate and elect members of the board of directors. Today this power is virtually meaningless in publicly held corporations. The vast majority of shareholders vote by proxy. But neither state nor federal law guarantees shareholders access to the corporate proxy machinery. Instead, incumbent management is allowed to use corporate funds to solicit proxies on their own behalf while all other shareholders must pay for proxy solicitations for their nominees out of their own pockets. The result is that only incumbent mangagement can afford to make nominations.

This is a very serious development for our competitive capitalistic economy. Both the market and shareholders lack an electoral mechanism to replace incompetent, dishonest, or self-dealing directors with more diligent, honest, and loyal representatives. Since electoral mechanisms generally can be expected to be swifter and more certain than market pressures or tender offers, the most direct

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2. Securities and Exchange Commission Release No. 13901, (August 29, 1977) [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶81296 p. 88461, 89463.

3. The hearings began on an unexpected note. Federal Trade Commission Chairman Michael Pertschuk announced that the FTC has established a Task Force on Corporate Accountability under the direction of the Office of Planning to explore such topics as: (1) whether new remedies may be called for to combat certain patterns of behavior, e.g., the appointment of special directors, or the creation of special duties of inspection and reporting; (2) the extent to which the revolving door exchange of employees among government, industry, and professional firms has implications for competition and consumer protection; (3) whether due process requirements of fairness should be extended to corporate relations with customers and suppliers; (4) the effects which current standards for the selection, performance, and indemnification of directors may have on competition and consumer protection; (5) whether to recommend federal chartering of certain types of corporations; (6) the extent to which greater disclosure of audit data may be necessary if competition is to be fostered; and (7) whether "social audits" of a company's behavior would promote greater fairness in the market. Pertschuk explained:

> I think a case can be made that leaving it to states to define the entire responsibility of corporations doesn't work. The interests of shareholders, customers, suppliers, and the general public may be left unnecessarily at risk. Today, Federal Government intervention is piecemeal and comes only in response to crises which should have been avoided. We should be trying to prevent serious injuries to innocent parties instead of pouring on tons of "cure". And the cry for regulatory reform fits right in there. The Federal Government might be able to lighten its regulatory hand in areas where responsible corporate decision-making is endured. I think minimum Federal standards could achieve this kind of restructuring.

Re-Examination of Rules Relating to Shareholder Communications and Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, begun August 27, 1977, Washington, D.C., PUBLIC COMMENT FILE No. S7-693.

and effective stimulus to good corporate governance has been removed.

Under section 14(a) of the Securities Exchange Act of 1934, the Commission has the power to prescribe proxy rules and regulations "as necessary or appropriate in the public interest or for the protection of investors."[4] For the first time in its forty-three year history, the Commission is seriously considering employing this authority to promulgate proxy rules to protect shareholder rights in nominating and electing directors; or alternatively, recommending to Congress new federal legislation "such as a bill establishing minimum federal standards of corporate conduct and shareholders' rights."[5] This article describes current state and federal law affecting the election of corporate boards of directors and suggests; first, a rule that the Commission might issue under its section 14(a) authority; and, second, a broader legislative approach that the Commission might propose to Congress. The article concludes by arguing that the problems of corporate governance are sufficiently serious so that the Commission's best approach would be to seek new legislation from Congress.

I. State Corporation Law

Under state corporation law shareholders have exclusive power to nominate and elect directors at a shareholders' meeting.[6] Usually shareholder control is described in state statutes in a fairly elaborate way. For example, section 211(b) of the Delaware General Corporation Law provides that, "An annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the by-laws."[7] Section 222 indicates that each shareholder shall receive written notice of the place, date, and hour of the meeting not less than ten days nor more than sixty days before the date of the meeting.[8] Section 212 indicates that each shareholder shall be entitled to one vote for each share of stock held by such shareholder;[9] section 216 identifies the quorum required at the meeting.[10] These statutory rules codify the

4. 15 U.S.C. § 14(a) (1970).

5. Release, *supra* note 2, at 88463.

6. *See, e.g.*, DEL. REV. CODE ANN. tit. 8 § 211(b) (1974); N.Y. BUS. CORP. LAW § 703(a) (McKinney's 1963); ABA MODEL BUS. CORP. ACT § 34 (1960); Eisenberg, *Access to Proxy Machinery*, 83 HARV. L. REV. 1489 (1970).

7. DEL. REV. CODE ANN. tit. 8 § 211(b) (1974).

8. DEL. REV. CODE ANN. tit. 8 § 222(b) (1974).

9. DEL. REV. CODE ANN. tit. 8 § 212(a) (1974).

10. DEL. REV. CODE ANN. tit. 8 § 216 (1974).

historic theory of corporate governance: the owners of a corporation have the right to control its decision-making in the manner they believe most likely to protect or enhance the value of their investment.

But few shareholders personally attend annual meetings. Sylvan Silver, a Reuters correspondent who covers over 100 Willmington annual meetings each year, described to me representative 1974 meetings: at Cities Service Company, the 77th largest corporation, with some 135,000 shareholders, 25 shareholders personally attended the meeting; El Paso Natural Gas, with 125,000 shareholders, had 50 attendees; at Coca-Cola, the 69th largest corporation, with 70,000 shareholders, 25 shareholders attended the annual meeting; at Bristol Meyers, with 60,000 shareholders, a like 25 shareholders appeared. Even "Campaign GM," the most publicized shareholder challenge of the past 20 years, was unable to attract more than 3,000 of General Motors' 1,400,000 shareholders, or roughly two-tenths of one percent.[11] The vast majority of shareholders vote by signing and returning proxy cards.

State corporation law is largely silent on the mechanics of proxy elections. As Professor Melvin Eisenberg has written, "By and large, state corporate statutes do not even recognize the existence of proxy solicitation, let alone regulate it."[12] But it is the near universal practice in publicly held corporations for the board of directors or a nominating committee or the corporate chief executive officer to nominate a management slate and to use corporate funds and personnel to solicit proxies on its behalf.[13]

Shareholder democracy has broken down because state courts have allowed incumbent management to use corporate funds on behalf of their candidates while requiring all other shareholders to bear the costs of proxy solicitation for their nominees, with the slim possibility of reimbursement if they win control of the board.[14]

11. Schwartz, *The Public Interest Proxy Contest: Reflections On Campaign GM*, 69 MICH. L. REV. 419, 429 (1971).

12. Eisenberg, *supra* note 6, at 1492.

13. *Id.*; Caplin, *Shareholder Nominations Of Directors: A Program For Fair Corporate Suffrage*, 39 VA. L. REV. 141 (1953).

14. Leading modern decisions reflecting this rule include: Steinberg v. Adams, 90 F. Supp. 604 (S.D.N.Y. 1950); Locke Manufacturing Co. v. United States, 237 F. Supp. 80 (D. Conn. 1964); Braude v. Havenner, 38 Cal. App. 3d 526, 113 Cal. Rptr. 386 (1974); Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Super. Ct. Del. 1964); Hall v. Trans-Lux Daylight Picture Screen Corp., 20 Del. Ch. 78, 171 A. 226 (1934); Campbell v. Loews, 36 Del. Ch. 563, 134 A.2d 852 (1957); Lawyers Advertising Co. v. Consolidated Lighting and Refrigerating Co., 187 N.Y. 395, 80 N.E. 199 (1907); Rosenfeld v. Fairchild Engine and Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955); Cullom v. Simmonds, 139 N.Y.S.2d 401 (1955).

The states of New York and Delaware have extended the rule even further. The leading decision in New York, *Rosenfeld v. Fairchild Engine and Airplane Corp.*,[15] all but ruled that there were no practical limits on how much management might spend to retain control. As Judge Van Voorhis noted in dissent: "[Management's] outlay included payment for all of the activities of a strenuous campaign to persuade and cajole in a hard-fought contest for control of this corporation. It included, for example, expenses for entertainment, chartered airplanes and limosines, public relations counsel and proxy solicitors."[16]

A thorough description of permissible expenditures under current state law is provided in Aranow and Einhorn's treatise, *Proxy Contests for Corporate Control.*[17] Items include: proxy solicitors ("The use of professional solicitors in large proxy contests has become almost normal.");[18] public relations experts; accountants; and security analysts. Aranow and Einhorn additionally note:

> In bitterly contested or close contests, managements of large corporations often use the services of their own employees. These services have ranged all the way from performance of clerical and ministerial duties to public relations work and the solicitation of proxies. Efforts have been made by insurgent groups to obtain a court order restraining the corporation from using employees for campaign purposes.[19]

But these efforts have been unsuccessful. Instead, as Louis Nizer vividly described in his memoir[20] of the proxy contest which resulted in the lawsuit known as *Campbell v. Loews*,[21] large corporations may mobilize thousands of employees on behalf of incumbent management's slate in a contested proxy election.[22]

This practice has been wisely criticized as unfair. Professor Melvin Eisenberg has questioned whether the current practice is even lawful under state law:

> Is this practice lawful? While this question must be answered under state law, neither statutes nor cases speak directly to the point. How-

15. 309 N.Y. 168, 128 N.E.2d 291 (1955).

16. 309 N.Y. at 177; 128 N.E.2d at 295 (Van Voorhis dissenting). *See also,* Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Super. Ct. Del. 1964).

17. E. Aranow & H. Einhorn, Proxy Contests For Corporate Control 556-64 (1968).

18. *Id.* at 557-58.

19. *Id.* at 563-64.

20. L. Nizer, My Life In Court (1961).

21. 36 Del. Ch. 563, 134 A.2d 852 (1957).

22. See a similar example in Aranow and Einhorn, *supra* note 17 at 270, involving an unnamed "large national corporation" in which a substantial part of the sales force was employed on a national scale to contact designated shareholders.

ever, several important principles of corporate law each lead to the conclusion that the shareholders are entitled to designate candidates for directorships in any proxy card or proxy statement issued by the corporation which lists candidates names. These principles are: That the exclusive power to elect the board and the right to nominate candidates for the board rests with the stockholders; that corporate funds and facilities cannot be applied to the personal benefit of corporate officers; and that corporate assets cannot be applied to the benefit of individual shareholders except in an evenhanded manner.[23]

Mortimer Caplin concluded an often cited 1953 law review article:

> [A]s presently employed—with the proxy machinery completely dominated by the managers of industry, with the nominations for directors being made by the managers themselves, and with the shareholders being denied the opportunity of making independent nominations in management's proxy statement—the proxy system of voting has become an anti-democratic device, destructive of any real system of checks and balances against possible managerial abuse, and operating in contravention of our fundamental notions of fair play.[24]

More recently, Donald Petrie, an attorney, former partner in Lazard Freres and Co., and former chairman of the executive committee of Avis, Inc., testified to the Senate Commerce Committee on June 16, 1976:

> The Congress in adopting the Federal Election Campaign Act of 1971, as amended in 1974 and 1976, has gone far to set standards of fairness, balance, and decency in the financing of elections to Federal office.
>
> By comparison, the present practice with respect to financing corporate elections is neither fair, balanced nor decent: election expenses of incumbents are paid out of the corporate treasury; election expenses of challengers must be advanced by the challengers themselves and may be recouped only if the challenge is successful.[25]

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23. Eisenberg, *supra* note 6 at 1504. *See generally, Id.* at 1504-08.

24. Caplin, *supra* note 13, at 151.

25. *Hearings before the Committee on Commerce, United States Senate,* 94th Cong., 2d Sess., on "Corporate Rights and Responsibilities" Serial No. 94-95 at 113. *See also* F. EMERSON AND F. LATCHAM, SHAREHOLDER DEMOCRACY (1954); Note, *Financing Proxy Contests with Corporate Funds,* 44 GEO. L.J. 303 (1956); L. Machtinger, *Proxy Fight Expenditures of Insurgent Shareholders,* 19 CASE W.L. REV. 212 (1968); and Note, *A Proposal for the Designation of Shareholder Nominees for Director in the Corporate Proxy Statement,* 74 COLUM. L. REV. 1139 (1974).

The cost of nominating a candidate for the board remains a nearly insurmountable barrier to shareholder suffrage. A telephone survey of several large public corporations found that the cost of management's routine uncontested proxy solicitations for elections to boards of directors presently ranges from $.41 per shareholder to $3 per shareholder, not including substantial in-house costs such as personnel and computer time. The following chart itemizes these findings. All data were voluntarily supplied by officers of the named corporations; in each instance the costs refer to the 1975 or 1976 annual proxy solicitation.

COST OF UNCONTESTED PROXY SOLICITATIONS[26]

Corporation	Proxy Solicitation Cost	Number of Shareholders	Cost Per Shareholder
1. Allegheny	$ 12,000	29,000	$ .41
2. Chrysler	$170,000	230,000	$ .74
3. Coca-Cola	$ 46,300	67,000	$ .69
4. Exxon	$500,000	700,000	$ .71
5. ITT	$250,000	238,000	$1.05
6. Marriott	$ 20,000	42,000	$ .48
7. Mobil	$158,000	227,000	$ .69
8. US Steel	$117,000	250,000	$ .47
9. Washington Post	$ 6,000	2,000	$3.00
10. Xerox	$140,000	140,000	$1.00

When there is a proxy contest, expenses are substantially greater. For example, MGM which experienced a proxy fight for control in 1967 reported management expenditures of $9.88 per shareholder and opposition shareholder expenditures of $13.88 per shareholder. The following chart shows expenses incurred by management and challengers in recent proxy contests. Again, the figures are fragmentary; they do not include the imputed value of management's use of employee time.

High as the cost barrier to outside shareholder nomination of candidates is, it is likely to increase as: (1) the number of shareholders in publicly held corporations increases; and (2) postage, printing, and other solicitation costs increase.

26. The data were collected by Robert Bildner and myself in May, 1976, when both of us were working for Ralph Nader's Corporate Accountability Research Group in Washington D.C. Certain corporations broke their costs down more specifically. For example, Exxon indicated that its $500,000 expense included $80,000 for printing; $150,000 for mailing; $120,000 for tabulation of votes and related costs; and $150,000 for broker's fees. ITT indicated that its costs might be somewhat larger than other corporations of a comparable size since 18 percent of its shareholders were not United States citizens, necessitating higher mailing costs.

EXPENDITURES IN CONTESTED PROXY FIGHTS[27]

Company	Date of Contest	No. of Share-holders	Manage-ment Expenses	Cost Per Share-holder	Insur-gents Expenses	Cost Per Shareholder
1. Thompson-Starret Co.	1947	6,800	$ 20,110	$ 2.98	$ 25,755	$ 3.79
2. Fairchild Engine & Airplane Corp.	1949	10,400	133,966	12.68	127,556	12.27
3. Sparks-Withington Corp.	1950	8,500	51,105	6.01	6,000	.71
4. United Cigar-Whelan Stores Corp.	1951	16,000	60,159	3.76	30,534	1.91
5. New York Central Railroad	1954	41,000	875,000	21.34	1,308,733	31.92
6. New York, New Haven, and Hartford Railroad	1954	5,100	94,321	18.49	94,834	18.59
7. U.S. Smelting, Refining, & Mining Co.	1963	2,782	231,388	83.17	—	—
8. Republic Corp.	1964	7,078	257,000	36.30	365,215	51.60
9. MGM	1967	12,654	125,000	9.88	175,000	13.83

27. Data derived from Aranow & Einhorn, *supra* note 17, at 487 and Eisenberg, supra note 6, at 1501; shareholder data for items 8 & 9 from MOODY'S INDUSTRIAL MANUAL 1364 (July, 1968), 762 (June, 1965). The two most significant illustrations above are U.S. Smelting, Refining & Mining Co., in which management spent $83.17 for each shareholder-voter, and the New York Central Railroad, in which management and insurgents spent over $50 for each shareholder-voter. By contrast, candidates for the United State Senate are only allowed to spend 10 cents per voter.

Already the cost barrier is virtually insurmountable. In 1974, the Securities and Exchange Commission supervised the proxy solicitations of 6,615 corporations.[28] Management ran unopposed in 6,600 companies or 99.8 percent.[29] In 6,606 companies, or 99.9 percent, management's entire slate was elected.[30] These results were consistent with those of the previous 18 years.[31]

As the law stands today it is virtually impossible for a shareholder of a major U.S. corporation to make a board nomination through a proxy solicitation. During 1973, for example, in the 500 largest industrial corporations, no incumbent management was even challenged. Since these 500 corporations account for some 66 percent of the sales of all U.S. industrial corporations, the failure of the corporate electoral machinery there alone would be a serious matter. But, as the above data indicate, corporate board elections rarely accord outside shareholders a chance to vote out incompetent, dishonest, or self-dealing directors in any of the more than 6,000 firms subject to the SEC's proxy regulations.

II. Federal Securities Law

It was exactly this type of abuse that section 14 of the Securities Exchange Act of 1934 was intended to alleviate. As has often been remarked, the purpose of section 14 is to restore "shareholder democracy."[32] Yet the present regulations do not directly affect elec-

28. 40th Annual Report Securities and Exchange Commission 33 (1974).
29. *Id.*
30. *Id.*
31. See chart at 10 *infra*.
32. Both the House and Senate Committee Reports on the Securities Exchange Act of 1934 explicitly state that the purpose of section 14 was to insure "fair corporate suffrage." In the words of the House Commerce Committee Report:

> Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange. Management . . . should not be permitted to perpetuate themselves by the misuse of corporate proxies. . . . Inasmuch as only the exchanges make it possible for securities to be widely distributed among the investing public, it follows as a corrollary that the use of the exchanges should involve a corresponding duty of according to shareholders fair suffrage. For this reason the proposed bill gives the . . . Commission power to control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which have frustrated the free exercise of the voting rights of shareholders.

House Comm. on Interstate and Foreign Commerce, H.R. Rep. No. 1383, 73rd Cong., 2d Sess. 13; *Accord*, Senate Comm. on Banking and Currency, 5 Rep. No. 792, 73rd Cong., 2d. Sess, 12, 77.

This purpose has consistently been recognized by the courts. As the United States Supreme Court stated in J.I. Case v. Borak, 377 U.S. 426, 431-32 (1964): "[Section 14(a)] was intended to control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which . . . [had] frustrated the free exercise of the voting rights of stockholders." *Accord*, Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970);

MANAGEMENT DOMINATION OF PROXY MACHINERY

1956 - 1973

Fiscal Year (July 1-June 30)	Total No. of Corps.	Total No. of Proxy Contests	Percent Management Unopposed	No. Contests for Representation	No. Contests for Control	No. Management Lost Control	Percent Management Retained Control
1973	6,744	23	99.7	5	18	10	99.9
1972	6,328	23	99.6	7	16	4	99.9
1971	5,864	31	99.5	9	22	7	99.9
1970	5,095	24	99.5	4	20	5	99.9
1969	4,548	25	99.4	5	20	5	99.9
1968	4,473	27	99.4	6	21	5	99.9
1967	4,370	37	99.2	19	18	5	99.9
1966	3,632	37	99.0	13	24	8	99.8
1965	2,391	26	98.9	10	16	7	99.7
1964	2,274	18	99.2	6	12	1	99.9
1963	2,205	27	98.8	9	18	5	99.8
1962	1,807	17	99.0	7	10	4	99.8
1961	1,680	32	98.1	12	20	5	99.7
1960	1,864	25	98.7	9	16	1	99.7
1959	1,790	19	99.0	8	11	3	99.9
1958	1,780	34	98.1	12	22	6	99.7
1957	1,726	20	98.8	9	11	3	99.8
1956	1,705	17	99.0	9	8	2	99.9

Data compiled from 22nd—39th ANNUAL REPORT SECURITIES AND EXCHANGE COMMISSION. (1956-73).

tion of the board, which is the single most important aspect of shareholder suffrage. Indeed, to my knowledge, and apparently that of Professors Loss[33] and Eisenberg,[34] the last time the Commission publicly discussed granting outside shareholders access to corporate proxies to make board nominations was in 1943. Wartime SEC

SEC v. Transamerica, 163 F.2d 511 (3d Cir. 1947), *cert. denied,* 332 U.S. 847 (1948). "[I]t was the intent of Congress to require fair opportunity for the operation of corporate suffrage. The control of great corporations by a very few persons was the abuse at which Congress struck in enacting Section 14(a)." *Id.* at 518; Medical Comm'n for Human Rights v. SEC, 432 F.2d 659, 676 (D.C. Cir. 1970), *vacated as moot,* 404 U.S. 403 (1971). "It is obvious to the point of banality to restate the proposition that Congress intended by its enactment of the Securities and Exchange Act of 1934 to give true vitality to the concept of corporate democracy." *Id.;* Werfel v. Kramarsky, 61 F.R.D. 674 (S.D.N.Y. 1974).

Initially the greatest obstacle to corporate suffrage was management secrecy. "Insiders have at times solicited proxies without fairly informing the shareholders of the purposes for which the proxies are to be used and have used such proxies to take from the shareholders for their own selfish advantage valuable property rights." H.R. REP. No. 1383 *supra* at 13. "Too often proxies are solicited without explanation of the real nature of the questions for which authority to cast his vote is sought." S. REP. No. 792 *supra* at 74. *See also,* J.I. Case v. Borak, 377 U.S. 426, 431-32 (1964); Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); Bernstein and Fisher, *The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy,* 7 U. CHI. L. REV. 226, 228-29 (1940); Friedman, *SEC Regulation of Corporate Proxies,* 63 HARV. L. REV. 796 (1950); Orrick, *The Revised Proxy Rules of the Securities and Exchange Commission,* 11 BUS. LAW. 32 (1956).

But there is near universal agreement that the Securities and Exchange Commission has the power under section 14 to reach any abuse that threatens corporate suffrage and to provide remedies "as necessary or appropriate in the public interest or for the protection of investors." Professor Loss has explained: "The Commission's power under § 14(a) is not necessarily limited to ensuring full disclosure. The statutory language is considerably more general than it is under the specific disclosure philosophy of the 1933 Act." II L. LOSS, SECURITIES REGULATION 868 (2d. ed. 1961). From the breadth of section 14 other authorities have concluded that the Commission both has the power and the duty to prescribe proxy rules "as necessary or appropriate in the public interest or for the protection of investors." *See, e.g.,* Armstrong, *The Role of the Securities and Exchange Commission in Proxy Contests of Listed Companies,* 11 BUS. LAW. 110, 111 (1955). "The breadth of the grant of authority can hardly be questioned, considering the wording of the Exchange Act." *Id.*; Caplin, *Shareholder Nominations of Directors: A Program for Fair Corporate Suffrage,* 39 VA. L. REV. 141, 155 (1953):

> The . . . statutory standard, if not precise in its scope, certainly lends itself to the interpretation that Congress intended to grant to the SEC the broadest of authority in the control of proxy solicitation, a grant which would support the adoption by the SEC of any reasonable regulatory provision and not simply provisions devoted to securing the bare disclosure of information."

Id., Medical Comm'n for Human Rights v. SEC, 432 F.2d 659, 671 (D.C. Cir. 1970) and SEC v. Transamerica, 163 F.2d 511, 518 (3d Cir. 1947).

Indeed, the Commission has already recognized its power to prescribe a rule requiring inclusion of shareholder nominees in the corporate proxy by circulating such a rule for comment in 1942. See text of rule and discussion in Caplin, *Proxies, Annual Meetings and Corporate Democracy,* 37 VA. L. REV. 653, 682-85 (1951). Note his doubts about the Commission's power were quickly dispelled. Caplin, *Shareholder Nominations of Directors: A Program for Fair Corporate Suffrage,* 39 VA. L. REV. 141, 154-161 (1953).

33. Loss, *supra* note 32, at 901 n. 178.

34. Eisenberg, *supra* note 6 at 1502-03.

Chairman Ganson Purcell testified to a House Subcommittee of the Committee on Interstate and Foreign Commerce on June 9th. Purcell indicated that in August, 1942, the Commission's staff had proposed a rule to permit "stockholders to use the management's proxy statement to canvass stockholders generally for the election of their own nominees for directorships."[35] The Commission opposed this rule.[36] An accompanying memorandum described the proposal and the Commission's objections. Any security holder could nominate directorial candidates, but management—on an equitable basis—would only be required to include twice as many candidates on the proxy as positions to be filled. According to the memorandum, there were no reasons to support this proposal. But, among other objections, the Commission: (1) doubted it had authority to change the proxy into a ballot; (2) feared unqualified persons might be nominated; and, (3) doubted the equitable basis test would be workable.[37]

It is difficult to believe that the Commission took the issue seriously. Congressman Winter asked Chairman Purcell if rules then in effect, "just simply help management to stay in." Purcell responded, "I doubt very much if they do."[38] In point of fact, it was exactly because they did that section 14 was enacted. As prior SEC Chairman William O. Douglas had written, it was the conventional wisdom that "the group that names the proxyholders controls the board."[39]

The first two of the Commission's three major objections seem little more serious. The Commission already had transformed the corporate proxy into a ballot by allowing shareholders to include proposals for action in 1940.[40] Of course, incompetent individuals might be nominated. But the reality is that incumbent management's nominees often do not do a competent job.[41] And the theory of corporate law is plain that the shareholders' ownership gives them the right to select directors whom they believe are competent.[42]

35. *Hearings on Security and Exchange Commission Proxy Rules Before the House Comm. on Interstate and Foreign Commerce*, 78th Cong., 1st Sess., Part I, at 19 (1943).

36. *Id.*

37. *Id.* at 157.

38. *Id.* at 70-71.

39. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1316 (1934).

40. 17 C.F.R. § 240.14a-8 (1977).

41. *See, e.g.*, M. MACE, DIRECTORS: MYTH AND REALITY (1971); R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION 75-102 (1976).

42. W. CARY, CORPORATIONS 150, 190-93 (4th ed. 1969); D. VAGTS, BASIC CORPORATION

The third Commission objection, however, endures as a substantial one: there are practical and "equitable" difficulties in designing a system of access to the corporate proxy that will insure both (1) that outside shareholders have the opportunity to make nominations; and (2) the proxy is not overloaded with so many nominees that rational selection of directors becomes difficult. But under section 14, it is the duty of the Commission to design and supervise such a system where "necessary and appropriate in the public interest or for the protection of investors."[43] In the administration of the rules for shareholder proposals for action, the Commission has shown the ability to create practical and fair rules that resolve an analogous problem. That analogy suggests solutions to each of the practical problems involved with allowing outside shareholders the opportunity to nominate directors in the corporation's proxy.

III. A Proposal to Allow Outside Shareholders to Nominate Candidates to the Board in the Corporation's Proxy

As with the Securities and Exchange Commission's Rule 14a-8 respecting Proposals of Security Holders, a rule allowing outside shareholders to nominate candidates to the board in the corporation's proxy must: (1) establish the rights of management; (2) establish the rights of other security holders; (3) delineate the form of management and other security holders communications to all security holders; (4) establish funding rules; (5) establish the relation of the new rule to the general rules respecting proxy solicitations; and (6) establish the right of other security holders to timely access to the corporation's shareholder list. A new rule might run along the following lines.

(1) *MANAGEMENT*—Incumbent management, which should be defined broadly to include all operating executives of the corporation, outside attorneys, bankers, accountants, insurers, suppliers, distributors, *et al.* doing business with the firm, and all related "beneficial interests" as defined under section 16 of the 1934 Act, shall be allowed to nominate one candidate for each position to be filled on the board of directors. Any incumbent director who is not renominated by management may be renominated by another security holder.

Law 307-09 (1973); Mace *supra* note 41, at 6-7; R. Gordon, Business Leadership in the Large Corporation 116 (1961).

43. 15 U.S.C. § 14(a) (1970).

(2) *OTHER SECURITY HOLDER*—Any security holder or security holder group owning .1 percent or $50,000 of the corporation's voting stock may nominate candidates to the board of directors in the corporation's proxy, but if the number of nominees made by other security holders exceeds two for each position to be filled the corporation shall only be required to include in its proxy two nominees for each position to be filled and shall include the candidates nominated by a security holder or security holder group owning the greatest amount of the corporation's voting stock.[44]

(3) *CAMPAIGN COMMUNICATIONS*—The corporation shall publish at its expense a campaign statement to accompany the corporation's proxy. The statement shall list the qualifications of each candidate for the board in no more than 100 words; his or her nominator; and a statement by the candidate of up to 200 words describing his or her reasons for seeking election.[45]

(4) *CAMPAIGN FINANCE RULES*—The corporation may make no expenditures on behalf of any candidate or slate of candidates, nor may corporate employees be employed on behalf of any candidate provided, however, that the corporation may employ corporate or other personnel to solicit votes for the single purpose of insuring enough votes are cast to equal the corporation's quorum.

(5) *PROXY SOLICITATION RULES*—If outside shareholders are allowed to seek the support of other shareholders to form a security holder group with a sufficient number of shares to insure the presence of their nominees on the corporation's proxy, this process may be considered a "solicitation" within the meaning of the SEC Proxy Rules. Such a construction would mean that the nominator would have to include a proxy statement with each request for support pursuant to Rule 14a-3, comply with the filing requirements of 14a-6, and adhere to the strictures against false and misleading statements under 14a-9. These barriers to access to the corporation's proxy would likely dissuade many potential nominations but would also insure that few frivolous nominations occur. Whether or not oral or written communications for the purpose of forming a security holder group to make a nomination should be within the proxy solicitation rules is a question the Commission will have to resolve prior to issuing a proposed rule in terms of its assessment of (1) the dangers of allowing outside shareholders to solicit support for nominees outside of these rules; (2) the added burdens to outside shareholders of complying with the rule; (3) the likelihood that merito-

44. *See* 74 Colum. L. Rev. *supra* note 25, at 1157-61.
45. *Id.* at 1165.

rious nominees will continue to be priced out of the proxy process; and (4) the added cost to the Commission of enforcing the proxy solicitation rules if they are extended to this process.

(6) *SHAREHOLDER LISTS*—Any proposed rule must guarantee outside shareholders timely access to the corporate shareholder list so that they will have the ability to select other shareholders with whom to correspond for the purpose of forming a security holder group.

A substantial case may be made for a rule of this sort. Previous statements of the Commission indicate that it believes that it has the power under section 14(a) to promulgate such a rule.[46] Shareholders' investment in publicly held firms arguably will be worth more if shareholders possess the power to replace—or at least challenge—incompetent, dishonest or disloyal directors. Similarly, the overall economy will function more efficiently if such directors can easily be replaced.

Implicitly, the SEC's enforcement actions against such firms as Mattel[47] and Northrop[48] have paid homage to this principle. For these cases have shown that the Commission itself believes that it must seek replacement of certain directors and officers when they commit illegal acts if present electoral mechanisms will not replace them. Clearly the Commission's actions in these cases and its proposals to the New York Stock Exchange to increase the number of outside directors on listed firms' boards show a recognition that new mechanisms must be created to improve the competence, honesty and loyalty of the board.[49]

It is important also to realize how rarely electoral mechanisms succeed today in uprooting incompetent, dishonest, or disloyal directors and officers. In an article in *The Nation,* I outlined a series of recent examples of poorly managed corporations—in none of these companies did shareholders challenge the incumbent directors through the proxy machinery.[50] On August 24, 1975, *The New York Times* showed that the overwhelming majority of executives convicted of campaign finance violations by the Watergate Special Prosecutor were still on the job.[51] To this date none of these corporations' boards have been challenged through the proxy process.

46. *Id.* at 1155-56.

47. [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶94,807 (1974).

48. Springer v. Jones Civ. No. 74-1455-F (D.C.C.D. Cal. 1975).

49. See letter dated May 11, 1976 from Securities and Exchange Commission Chairman Roderick Hills to the New York Stock Exchange cited in Release, *supra* note 1, at 87891.

50. June 12, 1976 at 709.

51. August 24, 1975 § III at 1.

A proxy rule of this sort would eliminate the pivotal weakness in the current regimen of the law of corporate governance: the opportunity for incumbents to use corporate funds to outspend challengers who must initially bear all their own campaign costs. Although the proposed rule does not prohibit either side from spending more than the other out of its own funds, it does insure that each candidate will be adequately described to the shareholder electorate and removes the opportunity for incumbents to use the corporate treasury on behalf of their nominees.

Clearly this is consistent with the original intent of state corporation statutes. The purpose of the state corporate law of governance—that shareholder owners have the power to elect the corporation's board of directors—has been frustrated by state judicial decisions which allow incumbent management to spend nearly unlimited amounts of money on behalf of their own candidates. If the Commission prescribed the proposed rule the original purpose of state corporate law could be realized; the most important aspect of corporate democracy could be restored.

It is preferable that the Commission rather than the states or stock exchanges issue such a rule. Not only is it the duty of the Commission to act under section 14, but there is ample reason to doubt that any state will legislate such a rule.[52] It is also unlikely that the stock exchanges will.[53] But even if a legislature or exchange could be persuaded to issue such a rule, it would be preferable that the Commission do so. Neither the states nor the exchanges could reach all the large publicly held corporations that the Commission can under its proxy rule-making authority. If only some states or some exchanges instituted such a rule, these states or exchanges could be evaded by corporations changing their state of domicile or stock listing to less rigorous jurisdictions or exchanges.

To the objection that too many frivolous nominations might be made, it can be argued that this is within the Commission's control. It can design a rule—as it has done uncer Rule 14a-8—that creates reasonable conditions for the employment of the proxy nomination process. Above a series of such conditions have been suggested: (1) a minimum of .1 percent or $50,000 of the voting stock must be owned before the shareholder or shareholder group would have the opportunity to nominate directors on the corporate proxy; (2) outsiders would be limited to two nominees for each position to be filled on the board; and (3) seeking support for a nomination could be

52. *See* Nader, Green and Seligman, *supra* note 41, at 33-61.

53. *See* 74 COLUM. L. REV. *supra* note 25, at 1153-54.

considered a proxy solicitation. These and similar procedures could be employed to meet this objection.

What is not reasonable is for the Commission to allow outside shareholders to be disenfranchised on the theoretical ground that it cannot design a perfect or ideal voting procedure. Obviously, it cannot. But it can design a procedure that is fairer than the current autocratic practice of nearly every large corporation where only incumbent management has the opportunity to make directorial nominations.

Nor is the fear that the rule would favor rich outsiders realistic. Under the proposed rule, management may use their own personal funds to campaign. They may make telephone calls or write letters on their own behalf after business hours. They may ask that sympathetic employees campaign on behalf of management's candidates *on their own time.*

Management, also, will run as the "incumbents." Given the historically cautious nature of shareholder voting, this advantage alone may countervail any financial advantage of outsiders. Management will still have the opportunity to prepare the annual report and the other practical advantages of being the incumbents.

But most importantly, no outsider, no matter how rich, can buy votes. All he can do is advertise or hire proxy solicitors. Votes will still be cast by rational thinking shareholders—many of whom, such as bank trust department officers, are unlikely to be impressed by the campaign budget of either side.

Both state corporation statutes and section 14 mandate that democratic practice—whatever its risks—prevail. This is a wise policy. Shareholders, with their inherent caution, are likely consistently to back the incumbents unless they violate laws, perform unprofitably, or in a self-interested fashion. It is exactly under those circumstances that they should be uprooted.

IV. New Legislation

Alternatively, the Securities and Exchange Commission could propose a broader legislative remedy.[54] Arguably this is preferable.

54. I describe this legislative proposal in a more detailed form in Nader. Green and Seligman, *supra* note 42, at 118-22. There seems little question that such a reform of corporate law would require a new federal statute. Under section 14(a) of the 1934 Securities Exchange Act, the Commission may require greater disclosure of financial or perhaps social data without a new enactment; it may require corporations subject to its jurisdiction to list opposing candidates in the corporation's proxy without a new enactment; but it is unlikely that it may bar operating executives from making nominations to or serving on the board without a new law. See chart at 10 *supra*.

The modern corporation is akin to a political state in which all powers are held by a single clique. The senior executives of a large firm are essentially not accountable to other officials within the firm. These are exactly the circumstances that in a democratic political state require a separation of powers into different branches of authority. As James Madison explained in the *Federalist No. 47:*

> The accumulation of all powers, legislative, executive and judiciary, in the same hands, whether of one, a few or many, and whether hereditary, self-appointed, or elective, may justly be pronounced the very definition of tyranny. Were the federal constitution, therefore, really chargeable with this accumulation of power, or with a mixture of powers, having a dangerous tendency to such an accumulation, no further arguments would be necessary to inspire a universal reprobation of the system.[55]

A similar concern over the unaccountability of business executives historically led to the elevation of a board of directors to review and check the actions of operating management. As a practical matter, if corporate governance is to be reformed in a meaningful way, the reforms should begin by restoring the board to its historical role. The board should serve as an internal auditor of the corporation, responsible for constraining executive management from violations of law and breaches of trust. Like a rival branch of government, the board's function must be defined as separate from operating management. Rather than vaguely stating that directors should "manage" the corporation—as current state corporations statutes do—the board's role as disciplinarian should be clearly described. For example, new legislation might require that a board of directors establish and monitor procedures that assure that operating executives are informed of and obey applicable federal, state and local laws. Or, the board might be required to approve or veto all fundamental operating executive business initiatives such as merger or dividend decisions.

To accomplish such a redefinition of the board's role would require the institutionalization of a new profession: the full-time "professional" director. Corporate scholars frequently identify William O. Douglas' 1940 proposal for "salaried, professional experts [who] would bring a new responsibility and authority to directorates and a new safety to stockholders"[56] as the origin of the

55. *See* THE FEDERALIST 62 (Cooke ed. 1964).

56. W. DOUGLAS, DEMOCRACY AND FINANCE 46-55 (1940).

professional director idea. More recently, corporations including Westinghouse and Texas Instruments have established slots on their boards to be filled by full-time directors.

To succeed, professional directors would need to put in the substantial time necessary to perform an adequate job. One cannot monitor the performance of a billion dollar corporation at a once-a-month meeting. The obvious minimum here is an adequate salary to attract competent persons to work as full or near full time directors. The board would also need to be sufficiently staffed. A few board members alone cannot oversee the activities of thousands of executives. To be able to appraise operating executives, the board would need a staff to help analyze complex business proposals, spot-check accountability and frame pertinent inquiries. And the board would need timely access to corporate data. To insure this, the board should be empowered to nominate the corporate financial auditor, select the corporation's counsel, compel the forwarding and preservation of corporate records, require all corporate executives to answer fully all board questions respecting corporate operations, and, if necessary, dismiss any executive who fails to do so.

This proposed redesign of corporate management attempts to make operating executives more accountable to law and their shareholders without diminishing operating efficiency. Like a judiciary within the corporation, the board would have ultimate powers to judge and sanction. Like a legislature, it would review executive activity. Yet executives would retain their power to initiate and administer business operations. The chief executive officer would continue to have control over the organization of the executive hierarchy and the allocation of the corporate budget. The directors are given ultimate control over a narrow jurisdiction: Does the corporation obey the law and protect the shareholders' investment? The executive contingent retains general control over corporate operations.

No doubt there would be objections that this structure is too expensive or that it will disturb the "harmony" of corporate management. But it is unclear there would be any increased cost in adopting such a board. The true cost to the corporation could only be determined by comparing the expense of a fully paid and staffed board with the savings that might result from the elimination of possible conflicts of interest or corporate inefficiency. It is true that such a board would reduce the "harmony" of corporate management in the sense that the power of the chief executive or senior executives would be subject to knowledgeable review. But a board which monitors rather than rubber-stamps operating executives'

decisions is exactly what is necessary to diminish the near unfettered power of corporate chief executives. Under normal circumstances there should be a healthy friction between operating executives and the board to assure that the wisest possible use is made of corporate resources. When corporate executives are breaking the law, there should be no "harmony" whatsoever.

V. Conclusion

Testifying before the Securities Exchange Commission on the first day of its current hearings on corporate governance, Senator Howard Metzenbaum, Chairman of the Senate Citizens and Shareholders Rights and Remedies Subcommittee, predicted "remedial legislation in the not-too-distant future is very likely. . . . The controversy is thus not over whether *something* should be done. Everyone agrees that reform is necessary. . . . The real controversy is over how much should be done and—more importantly—how should the reforms be implemented?"[57]

The first footnote of the Securities and Exchange Commission's recent Release calling for a re-examination of corporate governance perhaps is the best testament to the fact that the Commission is aware that the need for a new pattern of shareholder suffrage may have been established. That footnote states:

> During the last two years, more than three hundred and fifty corporations have made disclosures, in public documents filed with the Commission, of a wide variety of questionable and illegal corporate practices including bribes, kickbacks, illegal political contributions, and improper accounting practices. As noted in the "Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices," submitted to the Senate Committee on Banking, Housing and Urban Affairs (May 12, 1976), "[t]he almost universal characteristic of the cases reviewed by the Commission has been the apparent frustration of our system of corporate accountability. . . ."[58]

It is my belief that only if operating executives are barred from nominating candidates to or serving on the board of directors can the board perform its logical role as an internal auditor of the corporation. The greatest virtue of a fully independent board would be its tendency to prevent inefficient or illegal transactions from ever occuring. By removing operating executives from control of the

57. Testimony of Howard M. Metzenbaum before the Securities and Exchange Commission, September 29, 1977.

58. Release, *supra* note 1, at 87890 n. 1.

board that is supposed to review their actions, directors would be able to ask tough questions without fear of offending fellow directors; they will be able to confirm operating executives' assertions of fact and subject senior executives' business initiatives to independent scrutiny. At the very least, the Commission should amend its proxy rules to permit outsiders to make competitive nominations to the board when operating executives have failed to meet reasonable standards of diligence and loyalty.