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GIVING IT AWAY: OBSERVATIONS ON THE ROLE OF THE SEC IN CORPORATE GOVERNANCE AND CORPORATE CHARITY

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First, let me say thank you very much to New York Law School and particularly the *Law Review*, for putting on this very fine program.

It is nice to be able to be on what is, by any definition, a perfect panel. We have a professor named "Faith," the audience, no doubt, harbors the "hope" that I will be brief, and we are all discussing "charity." It is not often that you can combine faith, hope, and charity in one program.

As the last speaker of the day, I would like to wind up this symposium by offering some observations on the role of the SEC, because so many of the panelists have talked about the SEC as if it is the grand solution to this problem. This reminds me of when Drexel Burnham was about to go off a cliff due to a liquidity crisis, and its then CEO kept calling every day suggesting that we might bail them out. After the third or fourth such call suggesting that the federal government might want to pay Drexel's debts I remember telling the CEO that "if you think you hear horses, it is not the cavalry." Likewise, I am not sure that the SEC is the cavalry for this particular problem, although it does raise some fascinating issues.

When I served in two Republican administrations, culminating in serving as Chairman of the SEC, I was a great believer in deregulation. It is a particularly challenging thing to maintain your self-esteem in a Republican administration while being a regulator, since some of your colleagues would like to abolish all regulation. Of course at the SEC, we were always in favor of deregulating things, or at least reducing regulations where its burdens and costs exceed its benefits.[1] While we were committed to making securities regulation flexible, efficient and minimally intrusive on market mechanisms, I would occasionally remind my colleagues that, in my view, the proper definition of the completely unregulated taking of money belonging to someone else is "theft."

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1. These steps included creation of the Rule 144A market for securities purchased by qualified institutional buyers; creation of new, shorter forms under the Securities Act of 1933 and the Securities and Exchange Act of 1934 for small businesses; broad new exemptions for asset backed securities under the Investment Company Act; proposed legislation to exempt private investment funds for sophisticated investors; proposals to repeal state "Blue Sky" regulation of securities offerings, and many similar steps.

Therefore, if our other panelists are correct that the donation of money that unequivocally belongs to the shareholders is now unregulated in America, we could have a slight problem.

Philanthropy is something that has a long, long tradition in America, and we are all quite proud of it. Among other things, it makes America unique, particularly compared to the business communities of Europe and Asia. Americans, as individuals and as reflected in their institutions, have a deep commitment to philanthropy and a desire and belief that we should all do something to help our fellow citizens, particularly those less fortunate. Therefore, if I were still in government, I would not want to touch the issue of "regulating" corporate philanthropy with a 500 foot pole. The risk of being labeled Scrooge at the SEC by even discussing the question would be too great,[2] even if one's objective would be to minimize dividends to shareholders so they could make their own charitable donations.

As an outside observer, it is now easier to discuss areas where corporations may, in essence, be wasting shareholder assets without proper accountability. However, I disagree with the suggestion of one of our professor panelists that corporate use of sky boxes at sporting events is abusive. Perhaps it is a gender issue, but no one could possibly question, when sitting behind home plate, the value of that corporate expenditure. Perhaps this illustrates the subjectivity that quickly arises in this area.

There are several interesting questions raised by the broader issue of proper accountability for gifts of corporate property. One is, of course, what should be done? If you have a sense that something is at least out of balance, what should you do about it? And an equally important question if something should be done is, who should do it? And when you have done it, then how do you report it?

I am currently serving as a bankruptcy trustee and doing turn-around work. The company that I am presently overseeing is called the Bennett Funding Group, which has the dubious distinction of being the scene of the largest ponzi scheme in American history.[3] Bennett is a group of affiliated companies which in the last six years sold $2,137,000,000 worth of unregistered, and now largely worthless, securities. Bennett routinely

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2. We did impose disclosure requirements on legacy contributions on behalf of directors under the proxy rules, however.

3. *See* SEC v. Bennett Funding Group, No. 96-61376, 1996 WL 179996, at *1 (Bankr. N.D.N.Y. Apr. 15, 1996) (alleging that Bennett Funding Group engaged in a massive ongoing "Ponzi" scheme by selling tens of millions of dollars of lease assignments for office equipment leases that simply did not exist, including the assignment of over $55 million of fictitious and supposedly tax-exempt New York City Transit Authority leases).

pledged equipment leases to multiple buyers, as well as selling phony leases.

The origins of the Bennett Funding case, like many of the worst and most flagrant cases of corporate abuse, may ultimately arise out of a simple, common tendency on the part of misguided management in these companies to think that they can treat the corporation as their own personal kitty. In fact, we called the main repository of accounts of this particular company, in which incoming funds from investors as well as payments from lessees were deposited, the honey pot, and that is exactly the way corporate officers treated it. They paid legitimate corporate expenses out of the honey pot. They also bought racetracks and casinos, went on trips and did anything that they felt like doing with the funds in this account. There seemed to be absolutely no capability or desire to distinguish between money that belonged to other people and money that belonged to the family members who ran the company.

So any time in the stewardship of shareholder funds that corporate management is not sensitive to the fact that it is dealing with other people's money, and that it has a fiduciary duty to use the money wisely, then there is a problem. There is also a broader issue of making sure that management understands the limits and accountability by which it must live.

If profligate corporate charity is a problem as the other panelists have argued, then who is going to do something about it? At the federal level, the SEC and the Internal Revenue Service (IRS) are probably the two most logical agencies, and perhaps the ERISA division of the Department of Labor. However, as the Business Round Table never tired of telling us at the SEC, the SEC does not have the power to create corporate law, which is a job reserved to the states. So, the SEC is not a general purpose doctor for corporate legal issues. Similarly, efforts to use the tax code for corporate governance social engineering, though not uncommon, have had only limited success.[4]

It is a widely held tenet that we do not and should not have a federal corporate law in this country. The states have a long history in this area. Having multiple sources of corporate law gives the states the ability to act as a laboratory for experiment, and that is a good thing. Monopolists in government behave no more effectively than monopolists in private life, so anything that Uncle Sam does because of its monopolistic characteristics can have some very deleterious effects. Thus, for good reasons, even the SEC itself does not wish to become the law giver of basic corporate law.

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4. The Clinton Administration's limitation on deductibility of executive compensation if not done in a specified manner is unlikely to prove effective in addressing such a complex issue. However, tax legislation promoting employee stock ownership may have had a more successful record.

Indeed, when the SEC has been perceived to have gone in that direction, the courts have not hesitated to call it short.[5]

The SEC's role in the proxy area provides an interesting contrast. Here the SEC has long had an express statutory role in regulating the use of proxies.[6] The SEC does not require corporations to hold an annual meeting (and quite possibly does not have legal authority to do so), but it does regulate the process by which votes are solicited for any meetings that are held, as well as specifying the content of required disclosure. In the 1980s when the SEC was concerned that companies had gone too far in the differential voting rights area and tried to promulgate a rule requiring "one share, one vote," the courts held that that was ultra vires to the SEC.[7] Yet, if the SEC wants to specify that all corporate proxies, the ballots themselves, must all be printed on purple paper, that is within the agency's statutory power.

So the SEC tiptoes along in the corporate governance area, with an omnipresent shadow of doubt surrounding the question of the breadth of the SEC's own mandate. The SEC certainly has a role to play in corporate governance, but there are limits to that role, and the Commission has to be terribly careful that it does not intrude on the proper role of the states. Equally important, the SEC must not intrude into the proper role of the market itself in disciplining aberrational behavior. And when I say the market itself, I include not only stock prices, but also the actions of directors.

In my era, we took up several critical issues in the area of corporate governance and proxy reform. We felt the rules concerning basic shareholder communications with one another had not kept up with market demographics or with technology. Therefore, we set out to revise the proxy rules seeking to remove requirements that could chill the robust exercise of freedom of speech concerning corporate governance issues. We also sought to improve our disclosure rules, particularly concerning corporate compensation, so that market mechanisms could do a better job of disciplining abusive conduct.

Actually, most of what the SEC does as regulation is really done in the form of disclosure. However, how something is taxed and how people are required to tell their neighbors about it are two very effective ways in

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5. *See, e.g.*, Business Roundtable v. SEC, 905 F.2d 406, 407 (D.C. Cir. 1990) (holding that the SEC exceeded its statutory authority in promulgating rule barring national security exchanges and associations from listing stock of corporations which nullify, restrict or disparately reduce per share voting rights of common stock shareholders).

6. *See* Securities Exchange Act of 1934 § 14(a), *reprinted in* 15 U.S.C. § 78n(a) (1994).

7. *See Business Roundtable*, 905 F.2d at 407.

which the activity can be "regulated," generally with less cost and more flexibility than prescriptive rules of conduct. In the compensation area, our SEC never considered that it knew how much companies should pay their CEOs. However, we did believe that shareholders were entitled to know what was paid, who decided to pay it, and what factors they considered in making this decision.[8]

In recent years, the rules on disclosure of compensation had become outdated. The country is now populated with consultants whose thriving business is dreaming up new ways to pay people. Over the years, the new forms of compensation had gone well beyond the things called for in the SEC's disclosure requirements.

As a result, we set out to try and capture, preferably in one simple table, all the elements of compensation that were received by management. Having a comprehensive disclosure of all compensation is important so that the shareholders are aware of what is being done with their money. This disclosure is also critical to allowing oversight and accountability to take place through the board of directors and, to a lesser degree perhaps, informed shareholders. In the compensation area, there were signs that these oversight mechanisms might not be working effectively. The problem, as we defined it, was not that compensation was too high, but that there were too many cases in which compensation seemed to show no correlation to performance. No one should quarrel if someone who makes all the shareholders rich is richly rewarded. However, if the company is stagnating or heading for bankruptcy, and the CEO still receives very substantial pay increases, that is a very troubling sign.

To help the market mechanisms that should control an issue like executive compensation work better, we mandated much more extensive proxy tables,[9] and we mandated taking advantage of computer graphics.[10] Instead of proxy statements that were nothing but words, we required companies to throw in a couple of pictures. One of those pictures had to include a chart showing the annual return to shareholders of that company compared with the annual return of the market as a whole, as well as the return to shareholders of competing companies.[11] These performance

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8. *See* 17 C.F.R. § 240.14a-101 (1996); *see also* 17 C.F.R. § 229.402 (1996) (requiring disclosure of all information connected with executive compensation including compensation committees members' names and the bases for their decisions).

9. *See* 17 C.F.R. § 240.14, Sched. 14A, Item 10 (1996); *see also* 17 C.F.R. § 229.402 (Item 402) (1996).

10. *See* 17 C.F.R. § 240.14, Sched. 14A, Item 10 (a)(2)(i) (1996) (requiring use of specified tabular format for disclosure of executive benefits plans); *see also* 17 C.F.R. § 229.402 (Item 402) (b)(1), (c)(1), (d)(1), (e)(1), (f)(1), (i)(3)(i) (1996) (specifying distinct tabular layouts for disclosing various types of executive compensation plans).

11. *See* 17 C.F.R. § 229.402(k)(1)(i)(ii) (1996).

comparisons allow every shareholder to see quickly and easily whether the company was performing, in relative terms, even with the market, much better, or much worse. We felt that was important information for shareholders to have when they were getting ready to decide whether to re-elect the incumbent board.

The last thing that we did, which might be something portable to the area of charitable giving, was to add a small essay. This can be very dangerous in the disclosure area because if you give in to every idea for expanding disclosure you can easily produce a disclosure document that is unreadable. Everybody can think of something they need to add to disclosure, and as the disclosure document gets larger and larger, at some point one has succeeded in burying everything significant under layers of trivia. Once people are overloaded, they do not continue reading. If there is a disclosure on page 437 that says, "yesterday, I stole all the money," but nobody reads past page 436, the disclosure rule will have lost all effect. To preserve the ability of disclosure to work you have to single out the key things.

One of the things we did, at the risk of too much disclosure, was to require that the compensation committee of the board had to include a short description of the numeric or other factors that they used in reaching a particular award.[12] If the company was going downhill but the CEO's pay had increased by one hundred percent, we thought the shareholders should know what factors contributed to the committee's decision before they voted to re-elect such a person as a director. Did sales go up even though profits did not, or did the company obtain a new patent on revolutionary technology which has not turned into profits yet, but may down the road? There are many good reasons why a company that is not generating current profits may nonetheless increase executive compensation. This is particularly true in venture stage private companies, but it also occurs in public companies. Therefore, we required the compensation committee to give the shareholders greater insight into the rationale for their decisions.

Along with mandating the descriptive material, we also required that the members of the compensation committee should be identified with their statements. This was our attempt to underline to the members of the board their critical role in exercising their oversight role in a meaningful way. For the most part, people do a good job running America's companies and serving on their boards. However, this requirement improved the degree to which people thought about how performance should be measured and rewarded, and how boards should apply some consistency to those decisions. The objective was to keep compensation decisions under market mechanisms, and out of politics.

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12. *See* 17 C.F.R. § 229.402(k) (Item 402 (k)) (1996).

Where corporate governance abuses have gone beyond a tolerable level, disclosure can be an effective corrective tool if used judiciously. There are clear similarities in the issue of how wisely shareholder funds are used in compensation and the issue of shareholder funds used for charitable donations. On the other hand, the level of potential abuse in the latter case is probably significantly less than the former, because there is less direct self-interest at work (though spousal self-interest may be an issue). To the degree issues of corporate donations rise as a concern, greater disclosure can help enhance the effectiveness of board oversight.

Shareholder resolutions, a uniquely frustrating area of proxy law, could conceivably also come into play in considering corporate charity. The SEC has been bedeviled for decades with provisions of proxy rules that require the Commission to act as referee on whether shareholders can put a resolution about animal rights, smoking, employment practices, environmental impacts, executive compensation, labor unions, or any other subject, in a proxy.[13] How the SEC got itself in this wonderful position is not as clear as the fact that it is an unsatisfactory position for the agency, creating cost and controversy without resolving issues. Under current law, if an issue directly affects the value of a shareholder's shares, he cannot propose a resolution on the grounds it is a matter of ordinary business. That shareholders *cannot* express their views on the issues that most affect the value of their property is, at best, counter-intuitive.[14] However, if a subject is completely irrelevant to the profitability of the company, the shareholders are free to demand a vote in the name of social policy engineering.[15] This rule is probably not the only area in which Washington has things 180 degrees out of phase.

This is an area where the SEC has never been able to draw lines very well, and the courts have also spent considerable time and tax dollars deciding these intensely subjective "categorization" issues. Shareholder rights in this area depend on a label, not sound principles or economic interest. Sadly, very talented people, both on the courts and at the SEC, spend large amounts of time refereeing disputes over whether or not a resolution about animal rights should be included in a proxy statement,

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13. *See* 17 C.F.R. § 240.14a-8 (1996).

14. *See, e.g.*, Roosevelt v. E.I. Dupont de Nemours & Co., 958 F.2d 416, 429 (D.C. Cir. 1992) (excluding shareholder proposal concerning the cessation of production of chloroflourocarbons and halon and the development of environmentally sound alternatives, as relating to the ordinary business operations of the company).

15. *See, e.g.*, Philip Morris Co., SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶79,474, at 77,413 (Feb. 22, 1990) (allowing shareholder proposal concerning cessation of the manufacture of tobacco products to be included in proxy statement because it relates to the social and public policy issues surrounding tobacco products, not the ordinary business operations of the company).

without any consistent tool for measuring when or how such discussions should be made. If charitable donations is deemed to be a social issue it can go on the ballot, but if it is deemed ordinary business it may stay off the ballot, even if all the shareholders want to express their view.

There may now be an answer for that problem, as well as perhaps to the problem of charitable contributions, in technology. In state governance, if five percent of the electorate, or whatever the state law mandates, says that this is a resolution that should be on the ballot, the resolution is added to the ballot and the people vote on it. However, if you cannot get five percent of the people, or whatever the threshold is, to say that this is a subject we all want to vote on, then the public is spared the expense of getting it on the ballot.

The same kind of thing would work very well with shareholder resolutions. If one can communicate with people and get the indication that some minimum threshold of shareholders are genuinely concerned about a subject, then put it on the ballot. However, the key element is finding out what people are thinking about that issue. The Internet gives us a way that we never had before to reach out and communicate with all the shareholders, rather than relying on the intermediaries of the board, the legal community or activist groups.

Any group wishing to publish a resolution for consideration could offer it on a special corporate website. The proposed resolution and supporting arguments could be easily and cheaply made available on the web. If the issue demonstrates sufficient support through shareholder approval, it could be placed on the proxy at the next opportunity. This approach would allow shareholders a more flexible tool for communicating views on issues such as corporate charity that are by their nature somewhat in a gray area between business and social concerns.

The use of corporate funds for charitable donations, like other issues of corporate governance generally, raises problems of information and of accountability. Because of the risk of controversy, and the highly subjective questions of charitable giving, this is not an area the SEC would be likely to want to address.

Corporate donations are consistent with the first traditions of our society, yet they do raise questions of who should oversee the wise use of corporate resources. Here management must play the lead role, overseen by the board. Ultimately, dividending excess cash to the shareholders may be best, for they can then make their own selection of charities.