United States - Mexico Law Journal

Volume 10 *Presentations at the Tenth Annual Conference* Article 23

3-1-2002

Development of Corporate Governance in the Context of Full Disclosure in the United States

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DEVELOPMENT OF CORPORATE GOVERNANCE IN THE CONTEXT OF "FULL DISCLOSURE" IN THE UNITED STATES

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A. Historic Background

Until the 1930s, laws governing the formation and operation of corporations in the United States were the province of state governments within the U.S. federal-state regulatory regime. Prior to 1933 no federal laws existed regarding corporate organization and operation. Corporations, partnerships and other business entities (other than national banks) were formed under laws of individual states, and state law exclusively governed corporate governance, including stockholders' voting rights, powers and duties of directors and sales of securities.

Federal regulation of securities in the U.S. began with the reform legislation adopted in the first days of Franklin Roosevelt's 1933 New Deal administration. The stock market crash of 1929 had produced a general public disaffection with Wall Street. President Roosevelt endorsed calls for a federal law requiring "truth in securities" and modestly stated that his only goal was to require the sellers of securities in new public offerings to be truthful with their customers. The Truth in Securities Law, roughly based on the English Companies Act of the nineteenth century, became the Securities Act of 1933.

Two central provisions of the Securities Act were (1) that issuers in new public offerings must file with the federal government "registration statements" containing the offering prospectus and (2) the revolutionary concept that virtually everyone involved in bringing new offerings to the public (not only the issuer but also the issuer's executive officers, experts including lawyers and accountants, and the underwriters), were responsible for the accuracy of statements made in the written prospectus now required to be filed and given to investors. If those statements were inaccurate, all of the parties signing the prospectus, the experts who worked on it, and the underwriters who sold it, could potentially be liable under vastly expanded concepts of fraud contained in Sections 11 and 12 of the Securities Act.

B. Regulatory Framework

Full disclosure is the universally recognized standard of federal securities laws. Over the past sixty-eight years, that standard has expanded to include a host of almost uniquely American disclosure requirements, including reporting and

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disclosure requirements for "foreign corrupt practices,"[1] insider trading,[2] and intensive regulation of hostile tender offers[3]. The basic framework is contained in the Securities Act, which requires registration and disclosure for new securities offerings, and the Securities Exchange Act, which requires ongoing reports by publicly held companies and regulates financial markets (such as the New York Stock Exchange and Nasdaq) and broker dealers who sell securities.

1. Securities Act Registration - The Beginning of Federal Corporate Governance

Section 5 of the Securities Act requires all new offerings of securities to be registered with the SEC unless some specific exemption from registration exists. The Securities Act only literally requires that a registration statement be filed with the government at least twenty days prior to beginning the sales effort, but the regulatory regime instituted by the SEC under its first three Chairmen, Joe Kennedy, James Landis, and William O. Douglas, is much more rigorous. Chairman Landis conceived that the SEC not only should receive the registration statement but also should review and comment upon it. As a result, the SEC's regulatory practice requires that all new issuers file a "delaying amendment" waiving their right to automatically "become effective" and sell the issue on the twentieth day after filing. Once effectiveness is waived, the SEC staff can review the registration statement in detail and issue comments based on their view of whether the disclosures in the registration statement are complete and accurate. After the SEC staff is satisfied with the disclosures, preliminary clearance is given and the issuer is signaled that the registration may be made effective upon filing a notice of effectiveness.

The SEC's comments on registration statements quickly took on the air of more than just information sharing. For instance, early on, the SEC decided that because of the new civil liability requirements in the Securities Act, it must be against public policy for corporations to indemnify their officers and directors for violations of securities laws. While the SEC could not flatly prohibit corporations from providing such indemnity, the SEC did make them disclose in all securities registration statements the "SEC Position on Indemnification", that stated the SEC thought such indemnity provisions were void. The federal courts have seen fit to take notice of this position in deciding whether indemnification is permitted.

2. The Securities Exchange Act

The Securities Exchange Act has less to do with underwriting and selling new issues and more to do with the regulation of the securities markets. The Exchange Act gives the SEC authority to regulate the national securities exchanges, the over-the counter market, and the brokers and dealers who execute transactions in those markets. The Securities Exchange Act also requires that publicly held companies whose companies are traded on those markets, and other companies over a minimum

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1. Foreign Corrupt Practices Act of 1977; Pub. L. 95-213, Securities Exchange Act § 30A.
2. *See*, Securities Exchange Act § 16 and 21A. In contrast to the detailed provisions in federal securities laws and extensive historic case law on insider trading, the European Community only introduced minimum rules on prohibition of insider trading in 1989, with the Insider Trading Directive of November 13, 1989 (89/592/EEC).
3. Securities Exchange Act § 14(d).

size and with a minimum number of shareholders, register under the Exchange Act (as opposed to Securities Act registration) and file periodic reports, including annual and quarterly reports, under that Act. The Exchange Act also contains the Commission's authority over proxy solicitations, tender offers, and transactions by corporate insiders in their corporation's stock. The Securities Exchange Act also contains the most widely known securities anti-fraud law, Section 10(b), and SEC Rule 10b-5[4] thereunder.

3. The SEC and Corporate Governance Regulation

The SEC has expansively used its power to regulate disclosure in securities transactions to impose substantive corporate governance requirements on the operation of publicly held companies. It has done this in two ways:

1. Imposing minimum requirements for *what* must be disclosed and *when* it must be disclosed; and
2. Overseeing the securities markets (the stock exchanges and Nasdaq), which in turn impose direct substantive requirements on issuers whose securities trade in those markets.

Most U.S. public companies that are traded on Nasdaq and the national stock exchanges have relatively few voting shares in the hands of their founders and senior management, even if the public associates the corporate name with an individual founder or leader.[5] U.S. companies tend to be widely held by smaller investors, or by institutions such as mutual funds which are prohibited by their corporate charters from exercising an active role in management of the companies in which they invest. These investors exercise their pleasure or displeasure with management by "voting with their feet"—selling off stock of corporations of which they disapprove, and by buying corporations where management and profits look attractive. Federal disclosure regulations exert a powerful influence on management to refrain from actions that would not be approved by financial analysts who carefully read federal disclosure reports and corporate announcements and punish poor performance with widely disseminated sell recommendations if they are dissatisfied with results.

a. Some Disclosure Rules Impose Corporate Governance Standards

The most obvious substantive corporate regulations imposed by the SEC regulate the conduct of shareholder meetings and take-over attempts. Prior to adoption of the Securities Exchange Act in 1934, shareholders' meetings and voting were exclusively governed by state law. The Exchange Act authorizes the SEC to adopt rules and regulations governing proxy solicitation for annual meetings.[6] SEC rules govern the minimum number of days that proxies must be mailed before annual meetings. More importantly, the SEC broadly defines what constitutes a proxy solicitation to include any communication to security holders "under circumstances

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4. 17 C.F.R. § 240.10b-5

5. For example, only about 12% of the common stock of Dell Computer Corporation is owned by Michael Dell and his family. Warren Buffett and his family own a relatively large 34% of Berkshire Hathaway, Inc. (Source: Annual Proxy Statements of Dell Computer and Berkshire Hathaway.)

6. Securities Exchange Act § 14(a).

reasonably calculated to result in the procurement, withholding or revocation of a proxy."[7] If a communication, such as letter or possibly a phone call, is directed to a shareholder to obtain a vote at a shareholders' meeting, the SEC views that communication as a proxy solicitation that must be sent to all shareholders. This can be a very limiting requirement in consulting with shareholders on matters, such as corporate mergers, that require shareholder votes.

The SEC has also adopted disclosure regulations that have the effect of imposing substantive requirements in tandem with stock exchange and Nasdaq regulations (which rules are subject to SEC approval). The SEC, for example, requires annual disclosure to shareholders of a report by a compensation committee and an audit committee of the board of directors. The compensation committee report, for large companies, must:

1. discuss the compensation committee's bases and criteria for setting the chief executive officer's compensation;
2. include a discussion of the chief executive, compared to the executive's compensation for the most recent prior year;
3. include a line graph that shows the yearly percentage change in the executive's compensation, compared to the yearly percentage change in the common stock price of the issuer; and
4. be made over the name of each member of the compensation committee.[8]

Considering how common shareholder suits have become in the U.S., making the compensation committee members add their name to the report encourages them to be very careful, writing that report.

b. Marketplace Rules Impose Substantive Standards

Many of the substantive standards of corporate governance imposed on U.S. companies come from the self-regulatory organizations — the New York Stock Exchange, American Stock Exchange, and Nasdaq, whose rules are subject to approval by the SEC. The New York and American Exchanges are much older organizations than the SEC itself, and they have always imposed some minimum standards, such as minimum voting rights for common shareholders. With the encouragement of the SEC, these exchanges and Nasdaq have increased their substantive, regulatory oversight of corporate governance.

Minimum standards for establishing independence of corporate directors are found in the marketplace rules, rather than in the SEC's "full disclosure" rules or any state law.[9] The Nasdaq Stock Market's rules are typical of the other marketplaces. The prescribe minimum standards for determining who is an independent director, the minimum number of independent directors, and the establishment of an audit committee composed entirely of independent directors.[10] The marketplace having established the audit committee, the SEC's rules then provide minimum standards for an annual report to the shareholders by the audit committee, again published over the name of each of the committee members.

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7. SEC Regulation 14a-1(k), 17 C.F.R. § 240.14a-1.
8. SEC Regulation S-K, Item 402(k), 17 C.F.R. § 229.402.
9. NASD Rule 4200(k).
10. NASD Rule 4350, especially subsections (c) and (d).

Taking Nasdaq as an example, other corporate governance standards imposed by the marketplaces include:

1. Minimum standards for communications with the company's outside auditors by the audit committee, including assurance of the auditor's independence;
2. Review of related party transactions by the board and audit committee for potential conflicts of interest;
3. Minimum quorum requirements for shareholder meetings (33-1/3%);
4. Advance shareholder approval of issuances of employee stock options and of any issuance of securities amounting to more than 20% of the company's outstanding voting securities.[11]

C. Duties of Corporate Directors

The federal securities laws, together with market regulation by the exchanges and Nasdaq, have set minimum governance standards in the name of full disclosure, as described above. Nevertheless, the standard for federal corporate *liability* for wrongdoing remains full disclosure. The SEC has substantively regulated corporate conduct by prescribing what must be disclosed, and federal securities laws impose civil and even criminal liability for failing to disclose information that the SEC deems "material." Nevertheless, federal regulation is largely limited to providing what must be disclosed and when it must be disclosed. The laws of individual states within the federal system continue to control the substantive standards for basic fairness of the corporation to its shareholders, and more importantly for the duties of corporate directors to the corporation and its shareholders. These standards are not imposed by rules or regulatory interpretation, but by the state statutes concerning incorporation and by state courts interpreting those statutes in litigation.

In most states, including Delaware, where a substantial number of publicly traded corporations are organized, the basic standard for review of a director's decision is the *business judgment rule*. In Delaware, the business judgment rule provides that an independent corporate director who makes a business decision on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation, will not be held personally liable for mistakes of business judgment that damage corporate interests.[12] However, in Delaware and elsewhere, the business judgment rule is balanced by the recognition that directors owe a *fiduciary* duty to the corporation and its shareholders.[13]

When a corporate change of control occurs, either by merger, sales of substantially all assets, or increasingly, an exchange offer of most of the outstanding shares of stock of one corporation for another, the change may require advance approval from the company's shareholders. When this is the case, the directors will also be required by state law in most cases, to recommend to the shareholders whether to approve the proposed change. Because management may well have a vested interest in approval of one proposal over another, the corporation's directors, particularly the independent directors, are charged by state law with the duty to exercise their *business judgment* in the context of *fiduciary* loyalty to the shareholders, to decide what is best for them. The question of whether they

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11. *Id.*
12. *In re J. P. Stephens & Co., Shareholders Litig.*, Del. Ch., 542 A. 2d 770, 780 (1988).
13. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

discharged this duty is judged in the hindsight of litigation instead of in application to any regulatory authority for advance approval of the transaction.

The fiduciary duty, at least in Delaware, includes the duty of *loyalty, care* and *candor*.[14] In brief, the duty of *loyalty* imposes an obligation from doing anything that would injure the corporation or deprive it of profits or advantages that the director might bring to the corporation. "Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests ... and undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest."[15] This duty is most often associated with so-called misappropriation of corporate opportunities.

The duty of *care* requires that directors must exercise their *business judgment* in managing the corporation with due care and in good faith.[16] This duty has grown more complex over the past decade, especially in the context of changes of corporate control. The duty of care may impose special duties on directors when it is possible more than one suitor will bid to buy control of a public company. Where it is possible that a bidding war could develop by competing companies when a company appears to be up for sale, directors today have duties of enhanced scrutiny that may require them to hire their own outside counsel and investment advisors to advise them on the merits of a proposed transaction, separate and apart from the advisors retained by a corporation and its management.

The duty of *candor* in Delaware requires that directors refrain from using information that they have, but which may not be available to other directors, to mislead others in the management of the corporation and performance of their duties.[17] This duty may be seen as a state adjunct to federal securities laws requiring full disclosure, but it is slightly different. The fiduciary duty here is to share relevant information in the process leading up to a decision to recommend to shareholders that they approve a transaction.

D. Conclusion

U.S. corporate governance standards for public companies have evolved in recognition of the fact that, in the U.S., it is unusual for voting control of a public company to be in the hands of a few. The managers of the company often don't have an identity of interest with the company's widely dispersed owners. Considering further that mutual funds and other financial institutions may be prohibited by their charter, or by the preferences of their managers, from exerting any influence on corporate management other than to sell off companies when they are disappointed, the welfare of shareholders is left to the integrity of the marketplace. The SEC, the exchanges and Nasdaq have adopted measures in the name of full disclosure — audit and compensation committee requirements, reporting on compensation and conflicts of interest — designed to let the marketplace reward good management with investor interest and rising stock prices, and to punish poor management practices with falling interest, falling prices, and the

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14. *Id.*
15. *Guth v. Loft*, 5 A.2d 503, 514-515 (Del. 1939).
16. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A. 2d 125, 130 (Del. 1962).
17. *Stroud v. Milliken Enterprises, Inc.*, 552 A.2d 476, 480 (Del. 1989).

occasional investor lawsuit. Technical standards outside of directors' fiduciary duties are couched in favor of disclosure. The shareholders depend for their protection on widespread review of that disclosure by sophisticated investors and analysts, rather than by regulatory approval or disapproval.