REMARKS OF

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POST-COLD WAR CORPORATE GOVERNANCE

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Four days ago, President Bush and Boris Yeltsin celebrated the beginning of the new year by finally putting an end to the Cold War. In Moscow, the two heads of government signed the START II treaty, slashing each country's nuclear arsenal by two-thirds. START II was the result of a decade of tenacious negotiations, backed by American military and economic might.

But today, it's become fashionable to look back upon the last decade -- the 1980s -- as the "decade of greed." Let's not forget that it was America's unparalleled performance in the 1980s that brought the Soviet Union and other Communist countries to recognize that their system of oppression and central planning had failed. Indeed, it was our system of democratic capitalism -- our factories and markets rather than the battlefield -- that helped America win the cold war. And it was our long-term strategy -- not short-sightedness and quick fixes -- that ultimately allowed us to prevail.

As we enter this "new world order", the ability to project American leadership will be, once again, defined or perhaps limited, by America's economic strength. Our ability to compete in the global marketplace will be largely enhanced or constrained by the actions of government and corporations.

I'm happy to note that in the last decade, government has been undergoing a revolution which began with President Reagan and continued with President Bush -- the effort to reduce government regulations that had been holding America's companies back and a commitment to finding ways to sharpen American competitiveness. I'm glad to hear that this will be part of the agenda of the new Administration. Indeed, like our strategy during the Cold War, victory in the global marketplace requires long-term dedication.

PROXY REFORM

America's corporations are also going through their own revolution. One need only look as far as the business section -- or the front page -- of any major newspaper to note that the relationship between shareholders, directors and management has radically changed over the past five years. In the past year alone, some of the best known companies in America -- GM, Sears, American Express, and Westinghouse -- have all dramatically changed course after a management shake-up. At Sears and Westinghouse, the debate over the corporation's future was initiated from the outside, by institutional shareholders. At GM and American Express, the board's revolt against current management began in-house. In all cases, shareholder groups played an active and important role in suggesting alternatives and pressuring management to act.

Unfortunately, to the detriment of shareholders and managers alike, most of these changes did not come easy. By removing obstacles to open and effective communications between a company and its shareholders, it is my hope that the new proxy rules will usher in a new era of corporate governance that encourages cooperation rather than confrontation.

Our new proxy rules could not have come at a better time. As the 1993 proxy season approaches, shareholder activism has reached a new high-water mark. The motivation to act stems not from our rule changes, but flows naturally from the investment strategies of the large institutional investors that now dominate our trading markets. In 1950, the Cold War cast its shadow over American life, and the term "institutional investor" did not exist on Wall Street. Their influence was negligible, as these professional investors only controlled roughly 8% of the equities market. Today, some forty years later, institutional investors control over 60% of the U.S. equities market.

This trend should continue. The large pension funds have huge and stable cash flows, and will continue to grow, as the older baby boomers are still some 17 years from retirement, and the young boomers are just entering their high income years. For example, CALPERS currently has in excess of \$ 70 billion under management.

Moreover, individuals are exhibiting a growing proclivity for participating in the markets through professional intermediaries. Indeed, everyday newspaper headlines bear witness to the record amounts of cash that investors are pouring into mutual funds and other managed accounts. Through November of this year, net new sales of mutual fund shares have increased by \$ 176.3 billion. The escalating technological complexity and the volatility of the markets, in combination with other factors, such as the instantaneous dissemination of information, the proliferation of derivatives and the desire to diversify internationally, is resulting in individuals flocking to professional advisors.

Over the past few years the larger institutions have become increasingly dependent on indexing and other long-term passive portfolio strategies to achieve maximum performance. Consequently, the option of "voting with their feet" may no longer be a realistic alternative. Large institutions are now more committed than ever to the big blocks of shares they hold, leading to increased concern as to how these companies are managed for the long-term. It's ironic, but passive trading strategies have resulted in a marketplace full of some very active shareholders.

My hope is that if our proxy rules encourage this trend of longer-term relationships currently developing between large investors and U.S. corporations, we will strengthen America's ability to compete in a global economy. Proxy rules closely aligned with the realities of the marketplace create greater efficiencies, to the benefit of all parties.

Too often in the past, management and shareholders have viewed each other as adversaries, creating an atmosphere of mistrust and uncertainty that reached new heights during the LBO era. At the height of the Cold war, these same conditions presented the world with an all or nothing choice between a devastating war of superpowers or an anxious peace enforced by an expensive and improvident arms race.

Unhappy large investors formerly faced a similar no-win decision of either doing nothing or making a run at the company. Today, boardroom activism is emerging as a viable win-win alternative. If we have done our job right at the SEC, we will foster an atmosphere that will encourage a more stable capital base for corporate America, and incrementally lower the costs of capital for all U.S. public companies. Our trading partners in Germany and Japan have long enjoyed the benefits of patient capital, albeit within a different regulatory and corporate governance framework.

THE NEW PROXY RULES

I believe the new proxy rules finalized by the SEC in October will greatly improve the system through which management and shareholders air their differences. This was one of the most intensive rulemaking efforts ever undertaken in the history of the SEC, as evidenced by the nearly 2,000 comment letters we received. Under the old rules, shareholders had to think twice before publicly commenting on management's performance. After a 1956 Commission release on the proxy process, almost any shareholder statement could be construed to be a "solicitation" under the federal securities laws, thereby triggering expensive and burdensome filings with the SEC.

We decided to eliminate the oppressive aspects of the old rules by broadly exempting most communications from the purview of the new rules. For the first time, shareholders will be able to freely discuss with one another matters they are voting on, including the link between executive pay and performance, certain shareholder resolutions, and the election of directors. Under the new rules, shareholders who are not seeking voting authority can announce how they intend to vote, or engage in informal communications, without first consulting a lawyer or going to the government for approval of their conduct. Shareholders still must file proxy statements if they are soliciting proxies, and those shareholders who own more than $5 million of the company's securities must file a notice if they engage in written solicitations.

As I considered the proposed proxy rules this fall, I became particularly concerned that the blanket exemption provided to oral communications might grow into a back door solicitation process. If large shareholders initiated orchestrated campaigns utilizing phone banks and scripts, the shareholders they contacted might be deprived of the necessary minimum level of protection the proxy rules have always been designed to provide. In the end, I believe my concern was adequately addressed by subjecting these types of organized oral solicitations to the same notice and filing requirements that apply to written materials. Of course, despite any exemption provided under the new rules, all solicitations, whether oral or written, still remain subject to our anti-fraud provisions, which prohibit false or misleading statements in shareholder communications.

Perhaps of equal importance to you, the new rules also end confidential treatment for most proxy materials and eliminate the need to file preliminary soliciting materials. Forms 10-K and 10-Q have been amended to require disclosure of each matter voted on by shareholders during the reporting period, including, for the first time, a statement of the voting results that tallies the votes cast for, against or withheld. After some intense debate, companies retain control of access to their shareholder lists, and still must either mail the dissident's proxy materials or provide them the shareholder list.

As a result of a change to the bona fide nominee rule, dissidents seeking to elect a minority of directors will now also be able to solicit authority to vote for one or more of the company's nominees. However, to avoid any potentially misleading appearance that the company's nominees support the minority representation, the dissidents' materials will only be allowed to refer to the company's nominees that they do not support. Finally, multiple proposals can no longer be bundled together, but may still be conditioned upon the passage of other proposals, as allowed by state law.

I believe that on the whole, these rule changes will eliminate most of the frustrating barriers shareholders previously encountered when trying to communicate among themselves. They now have greater freedom to discuss the board's, or for that matter, anyone else's proposals for corporate action. Indeed, today's press is filled with reports of annual meetings that are an active forum for dialogue.

As Centel's directors experienced last month when they solicited proxies in support of a proposed merger with Sprint, shareholders now have much greater freedom of communication to challenge board decisions. Five large shareholders took advantage of the new proxy rules to circulate written materials making their views known. Last year they would have been forced to spend thousands of dollars in legal fees just to be heard. Now, they simply filed their materials and the requisite one page notice with the Commission. Countless other shareholders also were able to actively discuss the desirability of the merger without fear of incurring any costs or unwittingly violating the federal securities laws.

I believe all interests were better served by the full and uninhibited public debate which surrounded the Centel shareholder vote. Free speech and sunlight is a remarkable tool for assessing the vitality and wisdom of any democratic proposal, be it corporate or geo-political.

COMPETITIVENESS THROUGH COMMUNICATION

It is important to remember that none of our actions alter the basic structure under which corporations are governed. The board still sets the agenda for the corporation, and management is left free to do the job it has been hired to do: run the business as efficiently and effectively as possible to achieve the board's desired goals, which include obtaining the best long term rates of return for all shareholders.

It's clear that our system of corporate governance is the cornerstone of the wealthiest, most productive, and most successful market economy the world has ever seen. Through enhanced communication, we hope to foster mutually beneficial long-term partnerships between shareholders and the companies they own. Then all ideas - whether good or bad, big or small - can be addressed in a far more efficient manner. Shareholders will also be able to determine what will and won't fly before engaging management in expensive and time-consuming battles. The competitiveness of corporate America can only be improved when all legitimate ideas to increase performance receive a hard and fair look. There is evidence that shareholder initiatives can make a difference. A report recently issued by Wilshire Associates determined that shareholder initiatives sponsored by CALPERS resulted in a net return of $137 million on an investment of $500,000 on their part.

Because of their size and trading strategies, today's large shareholders are committed to a longer-term investment goal of maximizing the value of their holdings. To this end, they will, as they have in the past, continue to target a limited number of underperforming companies whose stock they hold, publicly announce the names of those companies selected, and then seek meetings with the management or the Boards of these corporations to discuss their concerns.

Already, for the 1993 proxy season, New York City's two largest pension funds, which together control in excess of $ 40 billion, announced that they are jointly introducing proposals for a variety of corporate governance reforms at 24 companies. For the following corporations, these proposals primarily take the form of shareholder resolutions:

-- splitting the posts of chairman and chief executive officer at Champion International, Sears, Kerr Group and Polaroid, similar to the action the board initiated at GM;

-- insuring the confidentiality of proxy balloting at Dow Chemical, Goodyear Tire and Rubber, and Federal Express;

-- reorganizing the board with a majority of independent directors at General Dynamics, Wang Labs and Cray Research; and

-- forming independent compensation committees at Bally Manufacturing, W.R. Grace, Polaroid and USF&G.

To make life even more interesting for investor relations professionals, I recently saw a newspaper article reporting that CALPERS now will consider two additional categories when assessing corporate performance: criticism of the company in the press and poor shareholder communications.

Investor relations has moved into the spotlight of the corporate governance debate. As one commentator noted, responding to our proxy rule changes means focusing on the basics: an effective shareholder relations program; an agenda for the annual meeting that considers corporate needs and shareholder concerns; and active independent directors.

Consequently, the new proxy rules will increase the demand for independent directors. The real crisis I worry about is whether we will have a willing supply of qualified applicants to fill these leadership roles. In addition to the growing demands of the job, potential candidates will find themselves under increased scrutiny from the press as well as shareholders. Corporations are seeking directors with specialized qualifications, but many find that because of increased exposure to litigation, these directorships are not worth the trouble. If U.S. corporations are going to continue competing in the international economic battlefields of the 1990's and beyond, we must insure that our best and brightest are willing and able to serve as independent directors.

Communication, not confrontation, between management and shareholders should be the watchword for the immediate future. And that is where everyone in this room will be challenged. By helping to foster a healthy and open dialogue between shareholders and their companies, you promote better understanding of long-term goals and help strengthen the competitiveness of corporate America.

EXECUTIVE COMPENSATION

Improving communications between management and shareholders by insisting on clear, understandable disclosure was also the goal of our new rules for executive compensation. As security analysts Benjamin Gramm and David Dodd noted in their classic work Security Analysis, executive compensation is one of the few issues on which management and shareholders have a direct conflict of interest. The authors concluded that this conflict was best resolved when management's compensation was closely related to the performance of the company, which of course places management and shareholders on the same side of the table.

Unfortunately, in several recent situations headlined in the media and replayed in Congressional hearing rooms, the reverse happened at some companies. Executive pay increased as performance lagged. Management shareholder relations became increasingly contentious when shareholders discovered that it was next to impossible to determine the full extent of the paychecks being handed out in the executive suites. Shareholders were not alone in their frustration. Even professional pay consultants reviewing the same lengthy and detailed disclosures provide different answers when asked to determine how much individual executives were being paid.

Let me give you just one example. In January, 1991, the Wall Street Journal reported that Rand Araskog's 1990 compensation at ITT increased 63% to $ 7.3 million. A month later, after spending more time and effort trying to decipher the 19 single-spaced pages regarding his salary in the company's proxy statement, the Journal had to run a second story revising their best guesstimate to $11.4 million. When sophisticated professionals can only provide ball-park estimates of corporate salaries plus or minus $ 4 million, the system is clearly in need of refinements.

To clear the air ànd provide shareholders with an unobstructed view of executive compensation, we attempted to make the disclosure more user-friendly. We have replaced the pages and pages of single-spaced narrative boilerplate previously mandated by our rules with five tables designed to show more precisely what was paid to the CEO and the four most highly compensated officers.

Moreover, to highlight the correlation between pay and performance, we added two new disclosure requirements: the Compensation Committee Report and the Performance Chart. But in seeking these new disclosures, the Commission went to extraordinary lengths to work with the marketplace and provide companies with as much leeway and protection as possible to encourage the most useful and informative disclosures.

I recognize the important role that the SEC plays in helping shareholders and management form better working relationships to increase the competitiveness and profitability of all U.S. corporations. To that end, it's important that regulators can have the foresight to set parameters and allow the marketplace the maximum flexibility to fashion appropriate disclosures without burdensome and costly interference.

For example, for the first time, the compensation committee of the board will have to provide a report articulating its basis for its recommendations to the board for executive compensation. Providing these disclosures is essential if shareholders are to accurately assess the performance of the directors that they have elected. Directors are, and should remain, solely responsible for deciding the dimensions of the executive pay scale, but to judge this decision, shareholders are entitled to know its basis.

The Report must discuss certain specific items, such as

- the compensation committee's policies for executive compensation;

- the bases upon which the committee's determined the CEO's pay, including any factors or criteria underlying the decision; and

- the committee's discussion of the relationship, if any, between corporate performance and executive pay.

The exact wording of the Compensation Committee Report is left to the discretion of the committee. When we adopted the final requirements for the report, we took into consideration the company's needs to protect its proprietary business information and the confidential nature of discussions among committee members, particularly those subjective personal factors relating to an executive's performance. As a result, this type of information is not required. All that is required is the committee's policy and rationale for the compensation provided, and its relationship to the company's performance.

In a similar manner, we also provided companies maximum flexibility in constructing the new Performance Charts. The minimum requirement is for the graphs to compare the company's total shareholder return with the performance of the overall stock market, and also with either a published industry index or a company constructed peer group index. The comparison is required to cover only the preceding five years, with shareholder return measured on a dividend-reinvested basis.

Within these parameters, however, a company will have a great deal of latitude to formulate what it believes will be the most effective means to compare its performance with the market in general and with its industry in particular. To enhance comparability, a company included in the S&P 500 must use that index; but all others are free to choose different broad market indexes that include companies traded on the same exchange, on NASDAQ, or are of comparable market capitalization.

As for the peer group comparison, a company has broad discretion. Like any securities analyst might do, it can compare itself to one or more domestic or foreign issuers, and can use other comparisons besides industry or lines of business. All that is required is an explanation of the basis for the comparison. If a company determines that, due to its unique nature, no peer comparison is useful, it can even disclose that, and compare itself to one or more companies of similar market capitalization or other attributes which the company deems appropriate.

For both the Compensation Committee Report and the Performance Chart, the important point is that it is management, not the Commission, that will be deciding the details of the disclosure provided. In my view, almost any good faith effort will satisfy the requirements of these rules. The Commission clearly signaled that we are not looking to private litigants as the primary policemen to monitor the contents of the disclosure provided. Instead, we will look to a much more effective group to supervise compliance: the company's shareholders. If the Compensation Committee Report and Performance Charts do not meet their expectations, I trust shareholders will turn to the ballot box, not the jury box.

Nothing would be more detrimental to our efforts to encourage more meaningful disclosure than to expose companies to frivolous litigation risks. Certainly, the quantity of disclosure would increase, but its quality would decline as a company's counsel mandated that each statement made by management include all possible defenses to every obscure legal theory a plaintiff's lawyer could possibly imagine. Our regulatory and legal system already imposes on U.S. corporations significant cost disadvantages not faced by their foreign trading partners, and I am greatly concerned that any action we take does not add to that disadvantage.

For that reason, I was quite pleased that under our final rules, the Compensation Committee Report and the Performance Chart were accorded the same legal status as the annual report to shareholders, thus insulating them from potential liability in private suits under the proxy rules.

Another area of executive compensation where the Commission has worked extensively with the marketplace through our comment process is the new Option/SAR Grants and Value table. This table requires disclosure of all stock options and SARs, or stock appreciation rights, granted to the five named officers during the past fiscal year. Of particular importance is the controversial requirement that the stock options and SAR's be valued as of their grant date.

Again we left the ultimate decision of what appears in the proxy statement in the hands of the marketplace. As part of the table, the value of the stock options and SAR's can be estimated on the basis of two assumed annual appreciation rates of 5% and 10%. If the exercise price is below the market price, a 0% column must also be included. Alternatively, at a company's choosing, these awards can be valued at their present value at grant date. A company selecting this alternative must footnote the methodology used, either by stating that a variation of the Black-Scholes model was used, or by explaining the methodology and assumptions underlying any other valuation method.

The Commission originally proposed estimating valuation solely by the use of the assumed annual appreciation rates. This approach was motivated by the debate raging last summer on Capitol Hill and in the media, as well as the debate simmering for the last nine years at FASB. The debate concerns the proper accounting and tax treatment for stock options. At the time we acted, the Commission remained unconvinced that any known options-pricing models could accurately value with a single dollar figure any unvested, non-fungible stock options of long-term duration. But we determined that by disclosing estimated potential values, we could still achieve the overall goal of informing shareholders of the possible future value of this form of compensation.

Be it Black-Scholes, Cox-Ross-Rubinstein, or others, all current options-pricing models of which I am aware have difficulty pricing long-term options. In today's marketplace, sophisticated traders are struggling to price options with two and three year terms. For options with longer time frames, say five to ten years, the problems multiply. Accurately assessing the various components of any pricing model -- anticipated dividends, predicted interest rates, and the future performance and volatility of the company's stock, among others -- becomes increasingly difficult as the term of the option lengthens. Moreover, it is very important to stay focused on the fact that these employee stock options are non-transferable and thus have to be valued differently than fungible options.

Because of these and other practical considerations, absent a major breakthrough in the current valuation theories and models, I expect that the disclosure provided in the table will be at best a good faith educated guess. Still, I am pleased that in response to requests we received from commenters, we were willing to provide the companies with the flexibility to experiment with what they determine will provide the best disclosure to the investors.

I do have one fear. As companies begin to value these options for disclosure purposes, the numbers they provide may be misunderstood.

Technocrat accountants, or perhaps those hungry for revenue in Congress, may seize upon these estimated valuations as sufficiently reliable and accurate such that they can and must be included as expenses in the company's financial statements, and perhaps even taxed in the hands of the company's employees. Such actions would immediately decrease the earnings of almost every public company, increase the volatility of quarterly earnings, and require executives to pay taxes on income they may never realize.

These problems could be especially acute for young hi-tech and other emerging growth companies that provide the vast majority of all new job creation in this country. Under current options pricing models and formulas, their options may be assigned artificially high values. These types of companies typically have no earnings to pay dividends, and characteristically have erratic stock prices because of their uncertain future prospects. This combination of no dividend and a volatile stock price would cause the premium for the company's long term options to skyrocket under standard options pricing formulas. These companies would then be forced to choose between taking a drastic reduction in earnings, or simply not using employee stock options.

Such misuse of what I see as an attempt to improve good faith disclosure would be unfortunate. The sole intent of requiring disclosure of the estimated value of employee stock options was to provide additional information on which shareholders could judge how well directors were representing their interests. The tremendous advantages of stock options as a compensation tool -- linking pay to performance, allowing cash poor start up companies to hire and retain key employees, and providing incentives for all employees to be more productive, just to name a few -- will be irreparably harmed if stock options are accounted for or taxed on the basis of educated guesses rather than hard data.

CONCLUSION

The undisputed utility of employee stock options is that they put employees and shareholders on the same side of the table. Each has a defined stake in the future of the company, each has a commitment to efficiency and excellence. Our goal in reforming our proxy rules and executive compensation disclosures is to achieve the same excellence by streamlining regulations and eliminating unnecessary burdens. Indeed, we hope that this 1993 proxy season will signal the beginning of a new era of corporate governance -- a governing system built on partnership and constructive dialogue among shareholders, management and the board.

Corporate America is not alone in facing this challenge. Just last month in Essen, Germany, CALPERS sought and received permission to speak at the annual meeting of RWE, the eighth largest industrial company in Germany. Supported by enthusiastic applause from the German audience, a CALPERS representative specifically questioned the company's two tier voting system, arguing that it was naive for RWE or any other German company to maintain voting restrictions and still expect to enjoy continued access to the international capital markets.

And two days before Christmas, the Wall Street Journal reported that in response to another CALPERS request, Nomura Capital Management, an affiliate of Nomura Securities, had appointed an outside director to its board in order to facilitate "clearer communication."

The waves of shareholder activism sweeping across the landscape of corporate America are only just beginning to ripple throughout the world. The reality of today's inter-dependent global economy is that capital knows no borders. On the post-Cold War economic battlefields of the 21st century, those that hide behind regulatory barriers can not succeed, and those that harness the immense power of free markets can not fail.

It was American resolve that brought the Soviets to the negotiating table. We need to continue with that same resolve if we are to compete in the global marketplace. This time, it will also mean a commitment to long-term excellence -- to highly skilled managers and directors, to motivated and productive employees, to innovative products and services, and of course, to capital markets that are second to none.

Thank you.