REMARKS OF
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

BEFORE THE
NATIONAL INVESTOR RELATIONS INSTITUTE
ATLANTA CHAPTER

ATLANTA, GEORGIA

APRIL 28, 1993

*The views expressed herein are those of Commissioner Schapiro and do not necessarily represent those of the Commission, other Commissioners or the staff.

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I. Introduction

Without a doubt, 1992 was the Year of Corporate Governance at the SEC. Not in my tenure, and perhaps never, have so many significant initiatives been undertaken in one area in such a short period of time. The most important themes to emerge during this period were the encouragement of greater shareholder involvement, and providing more and better information to fuel that shareholder participation.

While I think the Commission can legitimately take credit for instituting fundamental reform of the regulatory underpinnings of the governance process, there were many events that drew widespread attention that neither occurred inside the SEC nor were controlled by this agency. I am speaking of course of the increase in shareholder activism, as seen in the changing relationship between major institutional shareholders, and the Boards of Directors and executives of companies whose stock is held within their portfolios. I am also referring to the rise of activist Boards, which in the past year, in major American companies such as IBM, American Express, and General Motors, have asserted their influence in the management of these companies in a manner rarely seen in corporate America.

II. New Commission Initiatives

Allow me to take a few moments to discuss the recent Commission initiatives, which I believe are useful tools in furthering the involvement of both shareholders and outside directors in the affairs of American corporations.

A. Shareholder Communications

The first 1992 initiative was the revision of the proxy rules as they pertain to shareholder communications. This topic had been a subject of staff study for some time prior to the initiation of rulemaking in 1991, motivated in large part by dozens of proposals from individual and institutional shareholder groups. The rulemaking process itself was unique for the number and level of sophistication of the comments, with well-reasoned arguments from both the corporate and shareholder sides of each issue.

At their heart, the changes provide an exemption from the proxy rules for shareholder communication not involving the solicitation of proxy authority. The basic premise that undergirds the changes is that, aside from attempts to gain proxy voting authority, to the degree that the rules inhibited the ability of shareholders to analyze and discuss issues pertaining to the operation of a company and its performance, those rules ran contrary to the best interests of shareholders. To attempt to remedy those concerns, the amendments significantly reduce the filing and dissemination burden for shareholder communications that do not involve contests for control.

To lower the cost of engaging in a regulated proxy solicitation, under the new rules, only proxy and information statements and forms of proxy are required to be filed in preliminary form. All other shareholder communications, such as fight pieces, "dear shareholder" letters, and newspaper ads, are to be filed when used, thereby making them not subject to prior staff review.

We also created an exemption from the rules to allow published or broadcast announcements of voting decisions. Likewise, solicitations using the broadcast or press media or other publication no longer trigger an obligation to mail proxy statements to all shareholders. This eliminates the so-called "Larry King scenario," in which someone making a solicitation in a public forum would be required to mail a proxy statement to every shareholder.

Another initiative that I was particularly proud of was the **bona fide nominee** rule. The effect of the rule change is that a shareholder seeking to nominate and elect a minority of board members will no longer have to ask shareholders to forego voting for any management nominee. I originally proposed the inclusion of this amendment and worked to keep it alive in the face of an onslaught of negative, and in my view non-constructive comments, that boards would become less collegial if an outsider were elected.

For everything that the proxy rule amendments will do to improve the franchise by making the market for corporate information freer and more efficient, nothing makes the franchise more meaningful than the increased ability to play a role in the nominating process. Facilitating the possibility of minority representation on the Board allows for constructive engagement, which is almost always preferable to a contest for control. The **bona fide** nominee rule changes should make it possible for dissident shareholders to nominate and elect a minority of directors to the Board.

Given how new the proxy rules are, it is difficult to draw many concrete conclusions about the level of effect they are having on shareholder discourse. Early anecdotal evidence, however, suggests that the rules have made it easier for institutional shareholders, who individually are already feeling their muscle, to communicate with each other.

Recently, the State of Wisconsin Investment Board used the new proxy rules to communicate with 150 other holders of Paramount Communications stock. In its letter to the other holders, the Wisconsin Board announced its intention to withhold its vote for the four directors who constituted Paramount's Compensation Committee, because of what the Board felt was a delinking between executive pay and corporate performance. Although Wisconsin's letter failed to elicit majority support for its "no" vote, it nonetheless was an important first step toward freer shareholder communication.

Improved communication between shareholders is likely to fuel the so-called "relationship investing" phenomenon. Hardly a new idea, relationship investing is the current buzzword for shareholders using their clout to influence the decisions of the companies they have invested in. Increasingly, the size of the stock holdings of the largest public institutional investors has forced them into the role of working to improve corporate performance. While it might be an exaggeration to say that they are running out of places to invest, it is certainly true that there are limited new places to put existing and newly raised funds, and the costs of liquidating a large position can be extremely high, severely restricting the ability of these funds to vote with their feet when corporate performance begins to lag. The feeling that they, to a certain extent, have little choice but to be in it for the long run, has led the larger institutional shareholders to use their influence to remedy what they perceive to be weaknesses in corporate philosophy or leadership.

This new wave of shareholder activism has taken a variety of forms, to a myriad of effects. The traditional form, with institutions pressing for meetings with corporate CEOs to air their demands, is certainly alive and well. Examples include Eastman Kodak, where meetings between Robert Monks of Lens Inc. and CEO Kay Whitmore and pressure on management from a number of public pension funds have led to significant changes by the company, and American Express, where the Board's decision to allow James Robinson to remain as Chairman was quickly reversed in the face of shareholder complaints.

An interesting new tactic has been for the institutions to supplement management interaction with meetings with independent directors alone, away from management. While still a new strategy, we are beginning to see its effects with some major companies. Clearly, the most significant events were the ouster of senior management at General Motors and Westinghouse. In each of these cases, institutional shareholders expressed their concerns directly to the Board of Directors, after concluding that the best course for the company involved changing the chief executive. The ability of large investors informally to meet periodically with the Board of Directors to discuss corporate performance or other relevant issues would seem like an efficient and constructive way to avoid the high profile crisis situations that result when problems have been ignored for too long.

It is my opinion that, in general, shareholder activism is a very positive development for American corporations. It has the potential to make management more responsible to the shareholders, and may add a new force into the corporate dynamic to ensure the independence of directors and keep those directors focused on their duty to the owners of the company. Therefore, to the extent that activism reinforces traditional responsibilities, it is a most positive development. At the point, however, when it takes the form of shareholder boards overseeing management or the Board, adding an unnecessary layer to the corporate bureaucracy, and implicitly or explicitly differentiating between small and large shareholders, the benefits of shareholder activism may be less clear.

The most positive aspect may be the attention it draws to the role of the outside director. Criticism has been levelled, not for the first time, at outside directors for not being independent of the executives who, in many cases, are responsible for their nominations, and for their failure to identify more directly with shareholders than management. While it is unfair to refer to them as "pet rocks" or "potted plants" some of the criticism they have received is valid. It is important for directors to continue the trend of getting more involved in the companies they oversee, and not just at crisis points. Companies must expect more from their Boards, both substantively and in terms of commitment of time and attention. Commitment must be manifested in a continuous and real involvement in the corporation - because only then will the Board be able successfully to monitor corporate performance and make the necessary judgments concerning the need for change.

The Board needs to be well informed and independent for other reasons, too. For example, too often, I see enforcement cases involving financial statement or other issuer fraud of an egregious nature and been left to wonder where were the Board of Directors and how could they have possibly missed this? To be driven to act only as the company begins to topple over the edge of the cliff, when shareholder value has already been significantly eroded or a massive fraud has been perpetrated, is really not to adequately fulfill one's fiduciary responsibilities.

But independence of outside directors remains the key, remembering that their allegiance should be to shareholders before management. Perhaps one way to reinforce that idea is to encourage the separation of the positions of Chairman and CEO, in that way lessening the power of the chief executive over the outside directors. The SEC does not have a position on this issue, nor do I believe we should, but it is worth thinking about. Companies could also choose to increase the number of outside directors, making it easier for non-management directors to reach decisions that they feel are in the best interests of the company. I do believe that it is a good idea for issuers to place, to the extent possible, only outside directors on their compensation committee, to minimize potential conflicts of interest and in hopes of increasing the likelihood of a connection between pay and performance.

B. Executive Compensation

The other major initiative of the past twelve months involved the hot political issue of executive compensation. The solid philosophical support for our undertaking in this area was the belief that the amount of compensation that senior management receives is of particular interest to the holders of a company's stock, and the existing disclosure was incomplete and often confusing. Shareholders need a clear, concise, and understandable picture of executive compensation.

Our project got underway in February 1992 with completeness and readability as its goals. The end result is a new requirement for information about the CEO and the four other highest paid executive officers. The linchpin of the disclosure scheme is a three year overview provided in the Summary Compensation Table. The Table has separate columns for: salary; bonus; other annual compensation, including perks, earnings on restricted stock, the spread on discounted stock and other deferred compensation; stock options;

long-term incentive payouts; restricted stock; and a residual, "all other" category.

A number of other tables underlie the Summary Compensation Table. The Option Grant Table provides data on options granted to the executives, with a valuation requirement incorporated. The Aggregate Exercise Table complements the Option Grant Table by providing information about option exercises on an individual executive basis. A Long Term Incentive Chart adds additional detail to that column in the Summary Table.

Two items in the new disclosure scheme, the Compensation Committee Report and the Performance Graph, drew heightened attention during the rulemaking process. The purpose of the compensation committee report is to provide shareholders with more information about their company's compensation decisionmaking process. Shareholders should then be better able to assess how well directors are representing their interests. The report requires specific information about the compensation decision for the CEO only. For all other executives, the compensation policies for each element of compensation must be discussed. The report is made over the names of the compensation committee members. In response to concerns about increased outside director liability, the adopting release made clear that the report is not soliciting material and not filed for purposes of Section 18 of the Exchange Act, which provides for private rights of action based on misleading statements or filings.

It is important that the compensation committee report discuss with specificity the factors that are considered in determining pay. We made it clear in adopting the rules that the report should not devolve into boilerplate language, but instead should cite the specific justification for compensation decisions. It does not, however, require the disclosure of target levels with regard to specific quantitative or qualitative performance-based factors, or any confidential commercial or business information, disclosure of which would adversely affect the registrant.

My review of a number of compensation committee reports has led me to conclude that while some are not as specific as we might like, most companies are making a good faith effort to provide full disclosure. I think shareholders will find them very useful. Since the rules are new and the staff is reviewing a large number of proxies (nearly 1200 during this proxy season), we decided to make our comments prospective, and not require the incorporation of our comments into this year's proxies. Thus, we hope that while we got off to a bit of a slow start in the review process, we should not be holding anyone back from mailing.

As I noted, the vast majority of comments concerned the level of detail, as we attempted to nudge issuers away from vague, general platitudes toward concrete reasons for their compensation decisions. Take stock options, for example. We saw a number of compensation reports that attempted to explain the grant of options to the CEO by reciting the positive attributes of stock options, such as aligning management interests with those of shareholders and providing powerful incentives to the CEO. In future proxies, this will be an inadequate level of detail. Shareholders want to know why the committee decided on 50,000, not 10,000 options; or what the CEO's existing holdings are, because if the CEO already holds one million shares, that 50,000 share grant looks a lot less like an incentive and a lot more like straight compensation.

The performance graph is a fairly simple line graph with a reference period of five years and three lines of data. The base line is the registrant's cumulative total shareholder return, defined as stock price change plus dividends reinvested. Registrants that are included within the Standard and Poor's 500 Index must include the Index's return over that period, while companies not included in S & P may provide data on another broad based equity market index, such as the NASDAQ or Wilshire indexes. Finally, registrants must include a line on a smaller peer group or industry-related index. This index can either be an existing index, for example the Dow transportation subgroup, or the registrant can create the index, but if so, it must identify the constituent companies. While I remain slightly concerned about presenting an oversimplified view, I believe that shareholders will find this snapshot of corporate performance useful and informative.

Apparently, our efforts in the area of executive compensation are not the last word on the topic. The idea of eliminating the deduction for tax purposes of executive compensation of over one million dollars under certain circumstances is being considered by both Congress and the administration.

III. Other Issues

Although I am proud of the steps the Commission has taken to improve shareholder participation, we have not been completely consistent. In our proxy rule amendments, we sent a clear message that shareholder involvement is important to the efficient operation of the corporation. Yet, in another context, namely the question of inclusion of shareholder proposals under Rule 14a-8, we have sent a different signal. Recently, there has been a trend, and in my opinion a disturbing one, making it more and more difficult for shareholder to get their proposals included in their company's proxy materials.

By way of brief background, the Rule allows issuers to exclude certain shareholder proposals from their proxy statements. Proposals may be excluded, for example, if they would violate state law, are substantially similar to previously defeated proposals, or deal with the ordinary business of the company. The latter exception historically had been interpreted by the Commission and staff not to apply if the proposal pertained to a question of significant social policy. Logically, the Commission believed that proposals concerning the company's business ties to South Africa or their involvement in the tobacco industry were of sufficient significance to allow them to come to a vote.

Recently, however, the Commission has begun to abandon this line of reasoning. The social policy exception to the ordinary business exemption has been narrowed considerably by Commission decisions and staff interpretations. This year, the staff, in a decision affirmed by the Commission, allowed the exclusion of a proposal concerning corporate employment policies based on sexual preference at Cracker Barrel Old Country Store. In issuing this interpretation, the Commission was saying that the social policy exception in effect ceased to exist in the employment context. Because the case is in litigation (the shareholder sued us), I'll let you draw your own conclusions about the continued vitality of the social policy exception generally.

As you perhaps have surmised, I did not concur with my colleagues on this issue. Consistent with my feelings on proxy reform, I believe shareholder involvement is a positive thing, and shareholder have demonstrated an increased interest in significant issues concerning their companies. while I appreciate the fear of issuers that they will be overrun with shareholder proposals without the protection of the exclusionary provisions of Rule 14a-8, I remain convinced that social policy issues, when linked to a business nexus, are the appropriate subject of shareholder votes.

The attempt to narrow the social policy exception recently was dealt a blow when Judge Wood in the Southern District of New York required the inclusion of an EEO proposal in Wal-Mart's 1993 proxy. In short, the judge found that the company's position, asserted in reliance on Commission no-action positions, was in conflict with our own 1976 Release interpreting the scope of the ordinary business exception.

Interestingly, the whole debate about executive compensation within the Commission itself first arose with our response to many shareholder proposals concerning executive compensation practices. By requiring companies for the first time to include those proposals in their proxies, finding that they no longer constituted ordinary business, we opened the door for revamping the entire compensation disclosure system. In this proxy season, we have found that some clever shareholders, knowing we <u>will</u> require the inclusion of proposals regarding executive compensation, have begun linking social and environmental issues to executive compensation packages. Westinghouse Electric, Eastman Kodak, DuPont, Texaco and Chrysler have received proposals, which the SEC staff have required be included in the proxy, which would direct the Board of Directors to study and report on, among other things: ways to link executive compensation to environmental and social performance of the corporation; and ways to link financial viability of the company to long term environmental and social sustainability.

Finally, I want to take a moment to discuss a corporate development that isn't, in the strictest terms, governance or shareholder related, although it certainly came up in the context of executive compensation disclosure. The issue is the accounting treatment of stock options, a popular element of many executive, and an increasing number of non-executive, compensation packages.

In addressing the subject of executive compensation disclosure we realized, a little late, what a difficult question it really is. Accountants argue, not without philosophical basis, that when granted, options have value and should therefore be booked as a compensation expense. However, a number of companies, especially smaller, high-tech companies, express great concern over the expensing of options. These companies, often short of cash at the start-up phase, have found that stock options often are the best, and perhaps the only way to attract talented people. They argue that requiring the expensing of options pursuant to a valuation model would have a significant effect on the income statement of these companies, threatening their ability to raise capital or in fact their viability as an enterprise. Others dispute the reliability of valuation methods thus injecting an element of unnecessary speculation into financial statements. Some argue that the cost of stock options is measured through the dilution of existing stockholders and that the impact is already reflected in the earnings per share.

The Commission long has valued and attempted to promote the efficiencies that result from meaningful employee ownership of U.S. corporations. The broad-based use of stock options is consistent with, if not the best example of, this ownership structure. In considering this issue in connection with our executive compensation proposals, we were very sensitive to the comments of those companies that believe that expensing stock options would have a chilling effect on their use. For a variety of reasons, including those comments, the Commission chose not to require valuation of executive stock options except for disclosure purposes.

Although I, and others on the Commission, believe that enhanced disclosure should be given an opportunity to work, the FASB, after years of study, has decided to move forward on this issue. It has voted to issue an exposure draft of a rule that would require expensing the option at grant date and amortizing its cost over the life of the option. I intend to watch the comment and data gathering process very carefully and hope that FASB will ultimately be persuaded that the enhanced disclosure proposal, recently advocated by a number of groups, is the better approach.

IV. Conclusion

In conclusion, I should say that I believe the changes and developments we've seen thus far in the 1993 proxy season are very positive. Likely, the 1994 season will be the better test of the effect of the new rules. We will then be able to assess whether the disclosure in this year's proxies allows shareholders to target compensation proposals at those companies believed to have a problem establishing appropriate pay policies and levels.