REMARKS OF

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THE NEW PROXY RULES: FOSTERING MUTUALLY BENEFICIAL COOPERATION

BEFORE THE NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

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

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Good morning. The 1993 proxy season is now into its third month, and since this is the first proxy season under the SEC's new proxy rules, I thought I would share with you a few thoughts on how it is shaping up.

More than any other in recent memory, this year's proxy season has received a great deal of media attention. This is somewhat ironic, as there have been relatively few major proxy battles to grab headlines. Certainly, this paradoxical result is attributable in apart to the new proxy rules, because there looks to be no shortage of shareholders seeking to challenge corporate policy. It seems as if you can not turn on the news, or pick up a newspaper or business periodical, and not see one or more stories dealing with corporate governance issues.

Increasingly, shareholders and shareholder groups nationwide have become very active and outspoken. Across the country, at annual meetings and in press releases, they are very publicly questioning Board decisions on topics ranging from executive pay to corporate restructuring to the need for poison pills.

Perhaps the flavor of this year's proxy season is illustrated best by the drama that unfolded recently at Eastman Kodak Co. As you will recall, in response to shareholder's concerns, three months ago Kodak hired a new chief financial officer to help restructure the company and improve earnings. Three weeks ago, this new CFO resigned, citing philosophical differences with Kodak's chief executive officer. The price of Kodak's stock promptly declined by almost 10%, causing more shareholder concern, and placing even more pressure on the company. As one street analyst who followed Kodak remarked: "Either the Board gets the CEO to deliver results, or they deliver his head."

Of course, if the Board misses on either count, the implied threat is that their collective heads would be the next scheduled for delivery. And just in case the Board failed to appreciate this point, CALPERS, which controls in excess of $70 billion in assets, hastily arranged a meeting with Kodak's management to make its views known. The culmination to this drama came at last week's annual meeting, where shareholders made a powerful point of their own by nearly passing a proposal to end Kodak's staggered board system.

Despite its bluntness, the analyst's remark is a fairly accurate description of the current state of affairs in many parts of corporate America. Increasingly, Boards and the executives they hire are finding themselves under increased scrutiny concerning corporate performance. Some of this pressure originates from the Board itself, while in other cases, shareholders, and as the recent events at Marriott have demonstrated, even bondholders have led the call for change. But either way, the message is unmistakably clear: in today's business environment, shareholders are demanding performance and accountability, and directors are heeding the call.

The SEC's New Proxy Rules

Some have pointed to the SEC's new proxy rules and executive compensation disclosures as the root cause of this new wave of shareholder activism. No doubt, the new executive pay disclosures have focused more attention on the CEO's compensation package. And certainly, our new proxy rules have made communication among shareholders cheaper and easier.

In fact, The State of Wisconsin Investment Board recently used these new rules to send a short letter to almost 100 of the largest shareholders of Paramount Communications to voice its concern over executive pay. And just last month, they again used the new rules to successfully convince their fellow shareholders of Allergan, Inc. to approve a non-binding proposal to require a shareholder vote on the company's poison pill plan.

But rather than look to the SEC as the cause of these actions, I believe the fairer statement is that the SEC facilitated the evolution of market forces that were already well along in their development.

Institutional investors have become the central players in our capital markets. Or should I say that institutional investors are once again the central players in the our markets. It is interesting to note that despite the dissimilarities among the various types of institutions trading today, the last time that institutional investors were as concentrated and powerful as they are now was when the stock pools dominated the markets in the 1920's, before the creation of the SEC.

However, unlike their forerunners, some of whom profited by their size using trading practices long since outlawed, today's institutional investors are somewhat constrained by the magnitude of their holdings.

With billions to invest, their choices are limited, and quick sales of large unprofitable positions often serve only to depress market prices and further lower returns. Moreover, passive indexing strategies often reduce the effectiveness and desirability of even profitable short-term trading.

So with or without our new rules, over the past few years institutional investors have found themselves naturally adopting a longer term investment outlook. And in a few highly publicized instances, both institutional investors and shareholder groups throughout America, among others, were already questioning why executive pay continued to rise even when performance lagged.

These trends increasingly placed shareholders and management on a collision course. Lacking a viable option of selling their positions, waging costly proxy battles seemed to be the only avenue for large shareholders to express their views.

As I considered the proposed changes to the proxy rules last summer and into the fall, I was struck by the need to see what could be done to foster mutually beneficial cooperation instead of mutually destructive confrontation.

I believe our new proxy rules have achieved this goal. So far, this year's proxy season has shown that our new rules have provided a less hostile and less costly environment for all interested parties to exchange their views and work out their differences. America's ability to compete in the global economy can only be improved when investors and management can both find themselves on the same page without each side wasting valuable time, effort and money. As security analysts Benjamin Gramm and David Dodd noted in their classic work <u>Security Analysis</u>, removing the distrust that exists between shareholders and management may be one of the best ways to promote the flow of capital into free enterprise.

Intuitively, we all know that our markets work best when they are free from unnecessary regulation. We also know that with full and fair disclosure, markets will naturally allocate capital to its most efficient uses. U.S. corporations perform best when managers manage, directors direct and shareholders are confident that their best interests are being protected. The quality of dialogue between all participants in the capital formation process has definitely improved, which should help our markets and our companies operate more efficiently.

Still, there is a price to be paid for this increased efficiency. Across the country, independent directors are finding themselves in the spotlight - or cross-hairs, depending on who is doing the aiming. As of late, their duties are becoming more and more time consuming, in addition to the other pressures placed on the Board as a whole. I am quite concerned that we may reach a point where we are placing too many demands on these part-time employees.

Increasingly, independent directors are finding themselves under close scrutiny from the press as well as shareholders, and there is the constant exposure to legal liability for their every move. How long will it be before rising numbers of independent directors decide that the job just isn't worth the trouble ? Already we are seeing some evidence of this phenomenon in the banking section.

Now, more than ever before, American corporations are dependent on their independent directors for leadership. At home and abroad, the challenges of a competitive global economy are becoming more complex and involved. As shareholders press forward with their demands for change, they would be wise to remember that their interests will be protected best if they can foster an environment where the most able directors will continue to be willing to serve. We must field our "A-Team" if U.S. corporations are going to continue competing on the international economic battlefields of the 1990's and beyond.

Relationship Investing

No doubt, a new dawn is now casting its rays over corporate America. Institutional shareholders are now realizing that their own financial performance is inexorably linked to the performance of those companies whose shares they hold, and they are seeking to protect their long-term interests. This realization is leading some large institutional players to act less like passive investors and more like owners.

In this vein, two weeks ago CALPERS announced that it was considering a move towards relationship investing. Under this strategy, CALPERS would hold larger stakes in fewer companies, presumably to pay closer attention to, and become more with, corporate performance, in hopes of increasing shareholder values.

If CALPERS' proposed shift becomes reality, it could prove quite beneficial. Corporate America has long complained that investors concentrate too heavily on short-term results, and this type of relationship investing would seem to be one cure for this problem. Executives confident of a stable capital base would have greater leeway to pursue long-term growth strategies. And if shareholders are confident that their concerns are being heard and understood, management will have more time to focus on running the business.

Relationship investing is not a new concept, and its potential benefits are well known. Warren Buffet has become a billionaire practicing this type of investment strategy. And in Japan and Germany, relationship investing is the norm, not the exception.

But what works for Warren Buffet at Salomon Brothers, and for Deutsche Bank at Daimler-Benz, may not work so well for CALPERS at

Kodak. An initial problem is that bigger positions will mean more illiquidity and concentration risk, and it remains to be seen how much money the large pension funds will be willing to venture.

Moreover, the mechanics of how the big institutional players will be involved in corporate affairs is the subject of great debate. It is one thing to demand the CEO's resignation, and quite another to provide informed and insightful guidance concerning on-going corporate policy matters. Certainly, one has to question how well-equipped America's large institutional shareholders are to handle all that relationship investing entails. Warren Buffet can successfully employ this strategy because, well, he's Warren Buffet. And German bankers are equally well-qualified to act as partners to German corporations.

By their very nature, holding large stock positions encourages what I call the George Steinbrenner factor, which is the temptation to micro-manage. For those skilled enough to do it, the rewards can be great. But the damage can be equally great with the reins in lesser hands. The big institutional players must appreciate these nuances or the potential benefits relationship investing could evaporate quickly.

One of the more intriguing permutations of the relationship investing strategy is a fund recently started at Dillon, Reed & Company. Under the guidance of Lilli Gordon, former consultant to activist shareholders, the firm plans to raise $600 million to purchase 10 to 15 percent of moderately large companies. The fund will seek one Board seat and require that companies pursue strategies that the fund believes will improve performance. The fund has recruited several current and former CEO's of Fortune 500 companies to serve as the board members.

Executive Compensation

Moving on, it is almost impossible to discuss the 1993 proxy season without talking about executive compensation. The Investor Responsibility Research Center counted over 100 proxy proposals this year concerning various aspects of executive pay, including items such as pay caps, increased disclosure and special shareholder votes. Still, despite new proxy rules that allow almost unlimited communication among shareholders, none of these proposals gained more than 25% of the vote. Still, this is an improvement from last year, when no executive pay proposal garnered more than 16% of the vote.

Some have claimed that these proposals will fare better in the future once institutional investors decide to become involved. Maybe - but I wouldn't bet on it.

The trend seems to be that large shareholders will not support efforts to curb executive salaries, as long as the executives only win big when shareholders win big too. Indeed, more than a few people have claimed that the shareholders of Walt Disney would be more than happy to give Michael Eisner another $200 million if he could match his past performance.

Certainly, one effect of our new disclosure rules is that corporate pay is becoming more closely linked to performance. To be certain, chief executive salaries climbed over 8% in 1992, but corporate profits were also up some 22%. If you look at the executives earning the multi-million dollar pay packages, a large portion of their pay comes from the exercise of long term stock options.

Now, stock option awards are starting to include much higher strike prices, and some are even being pegged to the amount by which the stock outperforms the S&P 500 or some other index. Moreover, stock options are now displacing other forms of compensation and becoming a larger proportion of the overall pay package.

This trend makes sense for shareholders and management alike, because their interests will be more closely aligned, to their mutual benefit. I think that's the same reason you see more company's such as Campbell Soup and Hershey Foods requiring that their executives purchase company stock, because they know employees with a vested interest in the corporation have just a little more spring in their step.

But only time will tell with executive compensation. Our new disclosure rules appear to have achieved their primary goal of fostering clearer and more understandable disclosure in the proxy statement. But that was not our only goal. When we considered these rule changes last fall, one of my primary concerns was that we provide companies as much leeway and protection as possible to encourage the most useful disclosures. Our regulatory and legal system already imposes on U.S. corporations significant cost disadvantages not faced by their foreign trading partners, and I was greatly concerned that any action we take does not add to that disadvantage.

Nothing would be more detrimental to our efforts to encourage more meaningful disclosure than to expose companies and their directors to more onerous regulatory burdens and to more 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.

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.
I was also pleased to see that on the whole, the rules allow the marketplace the maximum flexibility to fashion appropriate disclosures without burdensome and costly interference.

So far, it appears that a good faith effort has been made to comply with our rules. Still, there have been the inevitable problems associated with any new disclosure requirements. For registrants, the learning curve has been steep, particularly in this first year as companies struggle to fashion appropriate responses. It seems the greatest difficulties are determining which form of compensation goes into which column on the Summary Table and finding the right disclosures for the compensation committee report.

Based on its experiences over the past few months, the Division of Corporation Finance plans to issue an interpretive release in the summer, which should help clarify some of the problem areas.

Stock Option Accounting

No discussion of executive compensation would be complete without mentioning the FASB's recent proposal concerning how to account for stock options. As most of you are no doubt aware, last month the FASB voted to require that the value of employee stock options be recorded as a corporate expense at the time the options are awarded.

Supporters of FASB's action argue that employee stock options are a form of compensation and, as such, should be reflected as an expense on corporate income statements. To do otherwise, they reason, misleads shareholders and other readers of financial statements, because two identical companies could report vastly different income if one paid salaries in cash and the other used stock options as a significant part of the pay package. By addressing this inconsistency and treating all compensation similarly, corporate financial statements become more credible and consistent, or so the argument goes.

I have two concerns with the FASB's proposal. First, I do not believe that a serious problem exists under the current accounting standards for options. Second, assuming that there is a problem, I fear that the FASB's attempts to solve it may cause far more serious problems than the one they are trying to eliminate. To put it another way, I don't believe the patient is ill, but even if he is, I believe that the side-effects of the proposed cure are far worse than the disease itself.

How sick is the patient? I have trouble believing that shareholders are truly disadvantaged under the current practice used to account for stock options. After all, the effect of stock options on corporate profits is already reflected in every public company's income statement, under the line item "Earnings per Share." That's because under APB 25, the earnings per share calculation must include the potential dilution from unexercised stock options if the market price of the stock exceeds the strike price of the option. So if the FASB's concern is protecting shareholders by maintaining their ability to compare apples to apples and oranges to oranges, EPS figures are already available to make the necessary comparisons.

Of course, this comparison only measures the dilutive effect of options on corporate earnings, and does not tell readers of the financial statements what these options cost the company to provide. Some believe that this lack of information has led to abusive compensation practices by a handful of corporations, and serve as a means to keep escalating executive salaries hidden from view.

But if exposing and communicating the cost of providing options is the problem that the FASB wants to address, then, by all means, they should address that problem -- by adding more footnote disclosures so that readers of the financial statements are told precisely what costs are involved, at least to the extent that these notional costs can be "precisely" guesstimated.

Indeed, that is the approach suggested by an extraordinary coalition of the Business Roundtable, the Council of Institutional Investors and the Big Six accounting firms. What did it take to get these typically opposing forces on the same side of the table? In the face of such rare unanimity among Fortune 500 companies, their shareholders and their independent accountants, one has to wonder just who needs the help the FASB is so eager to offer. Moreover, with all the executive compensation disclosures now required under our new rules, the problem of "hidden" executive compensation looks to be disappearing rather quickly.

I fear that the FASB's helping hand may have serious collateral consequences that are far worse than the current difficulties shareholders supposedly face. Certainly, from a purely technical accounting viewpoint, I can appreciate and understand the FASB's desire to treat all forms of compensation the same. But practically speaking, all forms of compensation are not the same.

Employee stock options provide unique benefits that salaries, commissions, overtime pay, or even long-term guaranteed contracts lack. These benefits -- which include 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 -- are quite valuable to all corporations as well as to our economy as a whole.

If the FASB's proposal is adopted, the economic cost of using this valuable compensation tool will increase dramatically. Last week, the Wyatt Company, an employee benefits consulting firm, released a study showing that if the FASB proposal becomes final, high-tech companies will suffer an almost 50% decline in earnings, and other companies will lose about 6% of their earnings. According to the study, high-tech firms will suffer more because their stock prices are more volatile, which increases the estimated value of the option. Moreover, they are more dependent on options as a compensation tool.

As a result of the FASB's action, U.S. corporations will be forced to choose between taking a drastic reduction in earnings, or simply not using employee stock options. Either way, it's a virtual no-win situation.

A majority of publicly held companies in the United States have adopted stock option plans. These plans are not limited to executive stock options, but on the contrary, also include stock options for all employees. Employee stock option plans are a significant component of the compensation packages of many managers and employees in companies across America, especially employees of young, high-tech and other emerging growth companies.

These companies have recently provided the vast majority of all new job creation in this country, and stock option plans have been critical to their ability to attract, retain and motivate the best and the brightest. Furthermore, competition for employees does not stop at the border and, in this increasingly competitive global environment, <u>all</u> American companies would lose what arguably is one of their most effective and attractive recruiting tools.

On the other hand, if companies decide they have no choice but to keep using stock options, the resulting hit to earnings will inevitably lead to lower stock prices, which in turn will raise their cost of capital. That could have serious repercussions on the ability of U.S. companies to compete with larger, better capitalized foreign competitors.

When all is said and done, the FASB's proposal could seriously impair the efforts of many American companies and, consequently, could seriously impair the country's economic performance for years to come. I hope all those involved in the process will seriously consider the collateral consequences of their actions as they strive for technical accounting purity.

Eight years ago, the FASB first began debating how to account for fixed-price stock options. Unfortunately, during this odyssey, the eight-year debate over technical accounting issues has been politicized and enveloped into the larger public debate over the size of corporate pay checks. Some are now looking to the FASB's proposals as the beginning of the end for what they call the "corporate gravy train."

But why are we looking to accounting pronouncements to resolve problems that the market is already dealing with? For the first time this spring, shareholders across America are getting the benefit of our new disclosure requirements and are receiving proxy statements that spell out in significantly greater detail the compensation awarded to top corporate executives, including non-cash compensation and specifically highlighting the estimated value of stock option grants.

Given time and full disclosure, the market will correct any abuses associated with using employee stock options as a compensation tool. In the meantime, we should not punish all American workers and hinder the country's potential for future economic growth by needlessly making employee stock options more expensive to provide.

Conclusion

Our market economy is today the most successful the world has ever seen. And it works best when each participant is allowed to pursue his or her best interests without the burden of excessive and outdated government regulation. By easing our proxy rules, shareholders now have a much easier and less expensive avenue to let directors and company officers know what's on their mind.

Frustrated shareholders make for less understanding investors, and in today's highly competitive global environment, it is more important than ever before for those that provide the capital to clearly understand how their investment is being managed. Our foreign competitors have long enjoyed the advantages of a stable, long-term capital base. Since U.S. corporations already incur significant regulatory and litigation costs that their direct competitors do not bear, we should closely examine all means to level the playing field.

Moreover, we have to give U.S. corporations the most cost effective tools to attract and retain the key employees who will turn today's new ideas into tomorrow's new industries. We gain little if the populist attempt to stem the flow of golden eggs ends up killing the goose too. We should let the market decide how much is too much, and let directors, not accountants, decide the best methods to motivate employees to increase the value of the firm.

I believe that his year's proxy season has shown that with less regulation and full and fair disclosure, the markets are capable of making the best corporate governance decisions. I hope that the market forces currently at work will be allowed to continue to develop, so that we can foster an environment in which U.S. corporations are even more competitive and more profitable.

Thank you.