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News Release

# U.S. EQUITY MARKETS IN THE 1990s: INSTITUTIONS AND CORPORATE GOVERNANCE

Remarks of

Richard C. Breeden, Chairman
U.S. Securities and Exchange Commission

Council of Institutional Investors
Annual Meeting
April 2, 1990

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The beginning of the final decade of the century is an appropriate time to pause and evaluate the state of the U.S. financial markets. My focus today will be on the condition of our equity markets, including the institutionalization of those markets. I also want to discuss a few of the important corporate governance issues raised in part by the increasing role of institutions.

## I. CURRENT TRENDS IN THE U.S. EQUITY MARKETS

Our equity markets are the "crown jewel" of the U.S. economy. They performed well during the 1980s, with an aggregate rate of return for equities during the decade of about 400%. This was capped off by a 31.5% rate for the S&P 500 stocks last year. Our equity market capitalization more than doubled from about $1.3 trillion to $3.0 trillion.

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* The views expressed herein are Chairman Breeden's and do not necessarily represent the views of the other Commissioners or the Commission staff.

Unfortunately, our major competitors did better. The U.K. equity market rose by nearly four times during the 1980s; the Japanese market by more than 11 times. The result was that our percentage of global equity market capitalization plummeted from about 55% to about 29%.

In another disturbing trend, the value of equity securities pulled out of the U.S. economy as a result of leveraged buy-outs and other forms of recapitalizations during the last five years exceeded the value of equities issued by nearly $500 billion. At the same time, there was an $867 billion net issuance of corporate debt, and an almost $1.65 trillion net issuance of government securities.

This trend toward smaller equity markets and much larger debt burdens has serious implications for the long-run health of the U.S. economy. Among other things, equity capital is vital to providing the base for companies to invest in long-term research or development, or to have the staying power to succeed in industrial competition on a global scale. Happily, there are a number of steps we can take to reverse this trend and improve the efficiency and competitiveness of our equity markets in the coming decade.

One thing we must do is improve the U.S. savings rate. Our current rate of 5.7% is better than the 3.3% low we hit in 1987, but it is well below the Japanese rate of about 15% and the rates that prevail elsewhere in the industrialized world. This difference in savings rates plays a major role in the evolution of equity and other capital markets, because savings provide the capital base on which those markets are built. I fully support the President's suggestion of a new program of savings incentives in the form of family savings accounts.

We also must eliminate barriers to investment caused by conflicting and duplicative regulatory structures. One critical issue in this area is the dual regulation of equity-based products at the federal level by the SEC and the Commodity Futures Trading Commission ("CFTC"). We are the only country in the world with developed market systems that divides regulation of equity securities from regulation of derivatives on those securities. The inefficiency and potential dangers inherent in this system should be of particular concern to institutions, which dominate the markets for S&P 500 stocks and stock index futures.

The recent IPs decision demonstrates all too clearly how our current regulatory system stifles innovation and competition. As a result of the Seventh Circuit's interpretation of the Commodity Exchange Act's exclusivity clause, it is most unlikely that any

U.S. securities exchange will trade, or any corporate issuer will issue, any new security that may even be argued to include any element of a futures contract. This result may or may not be a correct literal interpretation of the existing statute. However, if it is a correct decision, then this provision of the commodities laws could do incalculable damage to the U.S. equity markets. It means that you, as investors, will be denied access to some of the most innovative products our markets have to offer.

A second regulatory concern is the outdated division of authority between the Commission and federal banking authorities effected by the Glass-Steagall Act. I think the stability and international competitiveness of our financial markets would be enhanced if Glass-Steagall were modified to allow banks to be affiliated with securities firms. Those securities firms would be regulated in the same manner as securities firms that are not affiliated with banks. In addition, investor protection would be enhanced if banks' securities activities were fully subject to the registration and reporting requirements of the federal securities laws.

A third and final regulatory concern is the impact on our equity markets of state securities and corporate takeover laws. Our ability to compete effectively against a single Japanese market and a unified European market in the 1990s will depend in part on our ability to minimize unnecessary burdens caused by our dual state-federal regulatory structure. This does not mean we should abolish all forms of state regulation. States have a central role to play in protecting investors from fraud and regulating the affairs of the corporations they charter. At the same time, the Commission has a mandate under federal law to create a national market for securities, and a national clearance and settlement system. We also have a strong federal interest in maintaining fair and open national securities markets and effective shareholder suffrage.

Our equity markets also should benefit from recent Commission initiatives designed to increase cross-border securities offerings and ease restrictions on secondary market transactions in privately placed securities. For example, the Commission has initiated a process of negotiating systems for mutual acceptance of foreign disclosure documents with securities regulators of other countries, beginning with Canada.

Proposed Rule 144A and Regulation S, which are scheduled for Commission consideration on April 19, also should have a major impact on the institutional equity market. Rule 144A would provide a framework in which qualifying resales of securities not subject to Commission registration could be undertaken freely by institutional investors. Regulation S should enhance the benefits of Rule 144A by enabling institutions to resell U.S. and foreign issuer securities in the offshore markets without incurring the costs of Securities Act registration.

## II. CORPORATE GOVERNANCE ISSUES

Let me turn now to the corporate governance issues that are critical to the long-term strength of our equity markets. As you know, many of these issues have a direct impact on institutional investors and have arisen in part due to the increasing role of institutions in our equity markets.

In our free-market system, investors in corporate equity assume substantial investment risks in exchange for unlimited potential reward. Protection of the fundamental voting rights associated with equity ownership, which provide shareholders with their sole means of monitoring the performance of corporate managers, is essential to the continued stability and soundness of this system. Unless assured that management can be held accountable directly to shareholders through the exercise of the voting franchise, institutions and other investors could well shift their much-needed capital from equity to debt securities, or to other types of domestic or foreign investments.

Just as institutional investors have begun effectively to assert their rights as owners through the voting and proxy process, however, significant efforts are underway in some states to shield management from shareholder oversight. A controversial

Pennsylvania proposal dramatically illustrates the negative consequences that could result for our equity markets from proposals that would tilt the balance of corporate power in favor of corporate management and against shareholders by protecting decisions of the boards of directors from effective challenge by shareholders. In December 1989, the Pennsylvania Senate passed S. 1310, which is scheduled for a Pennsylvania House vote this week. That legislation contains several provisions that would amend Pennsylvania corporate law to create direct economic and legal deterrents to takeovers and shareholder proxy solicitations. This result would most likely occur even in some circumstances where the insurgent may not have intended to effect a change of control.

A provision of the Pennsylvania bill that I do not believe is found in any other state's corporate laws could do substantial damage to shareholders' well-established federal right to use the proxy machinery to replace the board of directors. Although it purports to restrict greenmail, this provision could be construed to reach far beyond standard greenmail transactions to require disgorgement of all profits realized by any shareholder who has acquired, or merely disclosed an intent to acquire, voting power over 20% of the corporation's shares, whether directly or through the solicitation of revocable proxies. Despite some attempts to mitigate the language of the bill, the statute could do enormous damage to the traditional right of shareholders to use the proxy voting system to replace a board of directors that does not act in the shareholders' best interests.

Absent an ability by shareholders to take issue effectively with management policies and performance through resort to the proxy mechanism, the risks of entrenched, self-perpetuating boards of directors would become much greater. In its ultimate form, removal of existing disciplines might leave inefficient or incompetent management free to run a company into the ground. Clearly, such diminished accountability raises serious concerns for the continued vitality of our equity markets, as well as for the competitiveness of U.S. corporations in the global economy. What investor would want to make a long-term investment in the equity of a company whose management or directors thought themselves unaccountable to the owners of the corporation, the shareholders?

Because the proxy system provides the principal mechanism for exercising corporate voting power in this country, the proper functioning of the Commission's proxy rules is an important part of preserving the attractiveness of equity as an investment in this country. The Commission has exercised its rulemaking authority to ensure an active shareholder role in corporate governance through the proxy process, particularly where necessary to keep pace with the evolving dynamics of intracorporate relationships. We will remain vigilant to protect the rights of shareholders under the Securities Exchange Act of 1934 to exercise the corporate franchise through the proxy process.

With similar goals in mind, the Commission adopted Rule 19c-4 in 1988 against a background of increasing attempts by corporate managers to strip shareholders of vested voting rights as a defense against hostile takeovers. The Commission's decision to adopt Rule 19c-4 in order to preserve the shareholder franchise followed attempts by the New York Stock Exchange, under pressure from listed companies, to abandon its 60-year prohibition on listing common stocks having less than full voting rights, thereby permitting listed companies to dilute or rescind voting rights of existing shareholders. As the Commission emphasized in adopting the rule, "[s]hareholders who purchase voting shares in a company do so with the understanding that the shares will be accompanied by the voting rights attendant to the stock at the time of purchase. The diminution or limitation of these rights is inconsistent with the investor protection and fair corporate suffrage policies embodied in ... [the Exchange] Act." 1/ Rule 19c-4 put the Commission on record with respect to the importance of the shareholder franchise in this country.

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1/ Release No. 34-25891 (July 8, 1988) [53 FR 26576, 26581].

The Commission is now reviewing the shareholder voting and proxy process in light of the realities attendant to the dramatic growth of institutional equity holdings and activism. Last November, CalPERS submitted a thoughtful letter outlining suggestions for regulatory changes designed to facilitate participation in the proxy process by all investors, not merely the institutions that are better-equipped to bear the substantial costs typically engendered by a solicitation.

CalPERS recommended restructuring the proxy rules to (1) establish secret balloting in order to protect shareholders from management efforts to coerce their vote, (2) afford shareholders an opportunity to influence the agenda for voting in the election of directors and other fundamental aspects of corporate governance, and (3) establish clear guidelines that would permit shareholders to communicate among themselves without fear of violating these rules.

Most recently, United Shareholders Association ("USA") submitted a rulemaking petition addressing many of the same issues. Moreover, the Senate Securities Subcommittee has requested the Commission's views on a number of these issues in light of specific legislative proposals that would, among other ideas, require confidential voting, shareholder access to corporate proxy statements to nominate board candidates or to oppose management proposals, and a mandated shareholder vote on poison pills, greenmail and golden parachutes.

At the heart of all of these proposals lie strong shareholder concerns that management is free under current rules to dominate the proxy agenda, influence shareholder votes through its exclusive ability to examine balloting results, and unilaterally use corporate funds to subsidize solicitations. The Commission fully appreciates the gravity of these concerns, and is giving serious and close consideration to the CalPERS and USA proposals, as well as those now pending before Congress. You can be assured that proxy regulation will be an active part of the Commission's agenda over the next few years.

## III. CONCLUSION

I can assure you that the Commission will do everything it can to resolve the issues outlined above in a manner that promotes healthy and vibrant U.S. equity markets. Because institutional investors are primary participants in the U.S. equity markets, you have a great stake in the successful resolution of these issues. I look forward to working together with you as we seek to provide conditions in the capital markets that will stimulate capital formation, job creation, and economic growth in the United States.