REMARKS OF

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U.S. SECURITIES AND EXCHANGE COMMISSION

KEEPING AMERICA'S MARKETS COMPETITIVE

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About 20 years ago while watching the Today show, I saw Tom Wolfe being interviewed. It was during that interview that he coined the term "the we generation" to describe the sixties, and "the me generation" to describe the seventies. What struck me most, however, was his prediction that future generations would describe the eighties as the "purple generation" -- a "royal" reference to the growing gap between the "haves" and the "have nots."

Tom Wolfe isn't here today to help us generalize about the nineties, but I suspect that one day we can sit back and say that one of the most important themes of this decade was preparing America to meet the challenges that the integrated global economy now presents. It may sound alarmist or sensationalist to talk about a time in the not-to-distant future when the United States loses its pre-eminence in international finance. But, remember, it was somewhere between the "we generation" and the "me generation" that it sounded alarmist to talk about the United States, not as a creditor nation, but as a debtor nation. Nevertheless, it was during the "purple generation" that the United States became the world's largest debtor nation.

In fact, the challenges of the new integrated global market are at the forefront of the SEC's agenda. Last July, the SEC authorized Market 2000 to address some of these issues. The main goal of the study is to make sure the U.S. markets are in the best possible position to compete, domestically and internationally, in the 21st century. The study will consider a number of investor protection and competitive issues that have arisen in the last 20 years. In addition, a primary mission of the study is to consider whether regulatory costs and benefits are allocated fairly among the markets and their competitors. The fact is, we find ourselves straining against a regulatory system that made imminent sense in 1975 when our focus was largely domestic, but is becoming dated in today's integrated global marketplace. If we do our job right, we will marshall the competition that has made our markets great to ready them for the international competitive battles they will face in the next century.

The multiple market structure that has developed in the United States has had profound implications for the way capital is allocated. Issuers have a choice about where and how their securities are traded, depending on whether their preference is an auction or a dealer market. And investors have a choice about which market to trade in.

Ultimately, investors are best served by competition among different markets. That means competition not only among exchanges trading the same security, but also competition among the exchanges, NASDAQ and proprietary trading systems. It is competition that has driven the many advances in the securities markets over the last 15 to 20 years. Competition has encouraged the markets to automate their processes to provide customers with the quickest, most efficient, and cheapest executions possible. And competition has brought us many new products and services, such as stock index warrants and extended trading hours.

On the other hand, there are those who argue that competition among the markets has gone too far; that our markets are fragmented. They argue that investors suffer as a result, because fragmented markets are inefficient markets.

Payment for order flow

Some argue that these competitive pressures have led to some unfair competitive practices among the markets. One of the most controversial these days is payment for order flow, which the SEC is examining as one of the central competitive and inter-related elements of Market 2000.

Generally speaking, payment for order flow is the practice of market makers or exchange specialists paying brokers for directing customer orders to them. Some market makers and specialists pay a small fee, usually around one or two cents per share, for retail orders routed to them.

In that sense, payment for order flow is roughly analogous to a finder's fee. Think of the newspaper recycling industry. It doesn't make economic sense for the recycler to come to your house and your neighbors' houses, collect your newspapers and pay you a small amount for them. But it does make a lot of sense for the recycler to pay someone else to collect it, bundle it up and deliver it to the recycling company.

You can't carry that analogy too far, however. What makes payment for order flow substantively different from newspaper recycling is that the brokers who are receiving compensation for "collecting" their customers' orders and for sending them to market makers are fiduciaries. And fiduciaries must serve their customers' interests -- not their own.

There's no doubt that payment for order flow raises substantial investor protection issues. And those issues are something the SEC must tackle soon. Investors should, at a minimum, be given adequate disclosure of their broker's payment for order flow arrangements.

But that's only half the story. Payment for order flow raises substantial competitive issues among the exchanges and the over-the-counter market. That's why it's a significant part of Market 2000. After all, the study was billed as the study that was going to take a comprehensive look at the major competitive issues facing the U.S. secondary markets today.

The release announcing the study stated that rather than continue the "piecemeal" approach to addressing the predominant issues facing the markets, the SEC would address them comprehensively in Market 2000. Yet in Congressional testimony last week, my two colleagues on the Commission expressed their preference that the Commission might consider the issue of payment for order flow separately in the very near future.

I disagreed. Why are we going back to the piecemeal approach now? This is not a simple issue. The SEC has been trying to deal with payment for order flow as an isolated issue since at least 1986 but, because it is so inextricably linked with other competitive issues facing the markets today, has been unable to come to a resolution. That's the reason we solicited comment on the issue as one of the central focuses of Market 2000. What's made it so critical now that we have to jump the gun on that study? After all, Market 2000 was intended to address all these competitive issues as a whole. Our willingness to strip off one of the most, if not the most important competitive issues we face today seems to call into question the purpose of Market 2000. It most certainly will delay completion of the study. In my view, the best approach is to focus our limited resources on completing the study, and, then, depending on what its conclusions are, moving forward on payment for order flow.

Corporate governance

You may not have been familiar with the debate on payment for order flow before today, but I'm sure you are very familiar with the ongoing debate about corporate governance. 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.

Increasingly, it appears 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.

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 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 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.

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.

With billions to invest, institutional investors' 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 both institutional investors and shareholder groups were already questioning why in some well-publicized instances executive pay continued to rise even when performance lagged.

These trends increasingly placed shareholders and management on a collision course. Because voting with their feet was not as viable an option anymore, 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 are achieving 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.

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.

Executive pay

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 more 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 large 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.

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 SEC's Division of Corporation Finance plans to issue an interpretive release in the summer, which should help clarify some of the problem areas.

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 may 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, all 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." Others in Washington, hungry for revenues, see this proposal as a way to tax employees for income that they may or may not ever see.

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. The SEC is committed to cleaning out the underbrush in our regulatory system. Market 2000 and the proxy rule revisions are clear evidence of the Commission's commitment.

The United States markets now are the most vibrant, competitive, and fair markets in the world. And for good reason. We have shown that we can weather major crises like Black Monday in 1987 and the failure of Drexel and come back stronger than ever. Our markets' resiliency is largely due to the close partnership between market participants and regulators and a mutual healthy respect for the roles of each. As we approach the next millennium with the challenges it presents, it is critical that we continue to work together.

Our international competition is getting stronger and we have to be prepared to meet the challenge. Market 2000 and our recent proxy rule revisions represent a healthy re-examination of regulatory burdens that the SEC must continue to engage in if we are to make sure our capital markets are at their competitive best.

Thank you.