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(c)(5) AND (c)(7): NOW YOU (c) IT, NOW YOU DON'T

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

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I. Introduction

It is a pleasure to be here this evening, although I hope that those of you who made it to Washington last week are willing to sit through another discussion with me about proxy rules and shareholder proposals. I don't know about the rest of you who were in Washington last Thursday, but to me the afternoon required the ability to divide one's attention: our meeting, a press conference, and numerous newspaper articles either previewing or summarizing the content of those proceedings. Given the inability of any of us to be in two (or three) places at one time, I thought I'd use this opportunity to discuss in a bit more depth last week's proposals and where I think those concepts are taking us, and then spend a few minutes on the sometimes complex world of Rule 14a-8 interpretations.

II. Proposed Amendments to Item 402

Having read, as I am quite sure you did, the Chairman's statement concerning amendments to Item 402 of Regulation S-K, I feel compelled to make two important points. First, the changes announced on Thursday are only proposals, in fact plans for proposals, which will, just like any other rule amendment, enjoy a full and fair notice and comment period. Second, I believe the proposed

rules will, appropriately, present a modest and measured response to the issue of executive compensation, a response that remains faithful to the goal of Reg. S-K of providing complete and understandable corporate disclosure. The proposals also will not stray from our strongly held belief that the Commission, and the federal securities laws, have no place in setting or determining the appropriate level of corporate salaries. Boards of Directors motivated by market forces, not government regulation, should be the primary determiner of executive pay.

At the heart of the proposal will be a move away from a singular focus on the pages and pages of narrative disclosure toward more easily read graphs and tables. The proposal likely will provide for a summary table, providing compensation paid and incentive awards available to executives. Although not yet finalized, the table would probably require separate columns for salary and fees, bonuses and short term cash incentives, bonus stock and restricted stock awarded during the year, and the market value of options or stock appreciation rights granted during the year. The proposal also would require the Board to explain, textually, the criteria it uses to award executive compensation. These changes are designed to make it easier for

shareholders to understand and evaluate the compensation determinations made by the Board of Directors.

In an attempt to gain perspective, it has been suggested that the summary table contain comparative information from the prior two years. It would be my preference, however, to not make such a provision retroactive, but to allow tables produced in the first year after adoption to contain information about that year only, followed the next season by a two year table, before complete implementation of the 3 year table. I think to suggest otherwise would require costly reviews and recalculations during the first two years, the burdens of which would outweigh the benefits.

Corporate concern about the valuation of stock options or SARs in the tables is misplaced. To make the information useful to shareholders making comparisons between companies, it is essential that there be uniformity in the calculation of the present value to these derivative rights. Such uniformity also would ease the burden on issuers in calculating such rights, and likewise simplify the enforcement of the disclosure requirements. The Commission's economists currently are working on a model, probably a Black-Scholes with limited modifications, that will permit companies and

individuals to assess the value of options with a reasonable degree of certainty.

Let me emphasize that our concern here is disclosure, not financial statement accounting. However, as you know, FASB is working on a project on accounting for stock compensation plans which arises from the continuing concern that accounting treatment for options is unduly affected by the form of the particular compensation plan involved. In addition, as the Chairman announced last week, the Commission's Office of the Chief Accountant is actively studying - on a short fuse (120 days) - the accounting treatment of options.

The rules may also include a chart portraying the relationship between CEO compensation and shareholder wealth, defined as change in stock price plus dividends. This proposal evoked rather less attention and consternation than I would have expected from such a graphic disclosure, comparing pay and stock price.

Speaking personally, I believe the information that such a chart would provide could be quite important to a shareholder making a decision about purchasing stock in a company or, having already

purchased, in deciding whether to vote with management. However, care must be taken to ensure that the format does not oversimplify the issue of the relationship between CEO pay and corporate health, and that the chart is not rendered inflammatory or misleading.

One protection is that the chart is based on grant of benefits rather than receipt. Therefore, if options, for example, are granted to a CEO in a year of very positive corporate results but are exercised a year later when the stock price is down, shareholders will not be misled to believe that the Board was rewarding poor corporate performance.

My overall feelings on the proposals concerning Item 402 are positive ones. The proposals won't change dramatically the information that 402 is intended to provide. Instead, the goal of the amendments is to make the information more useful and readable, thereby allowing shareholders to understand more fully the pay structure of their executives.

III. Shareholder Proposals

A. The Role of Rule 14a-8

Prior to last week's announcement, the issue of executive compensation had been viewed predominantly through Commission interpretations of Rule 14a-8. As you are aware, under this rule shareholders that comply with the procedural requirements of paragraphs (a) and (b) may submit proposals for inclusion in proxy materials unless the issuer demonstrates that the proposal may be excluded under one of the thirteen grounds for exclusion set forth in paragraph (c). A proposal may be excluded, for example, if it includes subject matter that is improper for shareholder action under applicable state law, if inclusion would render the proxy statement misleading under Rule 14a-9, or if it is substantially duplicative of a previously submitted included proposal.

Of the various grounds for exclusion, subparagraph (c)(7) has provided the most fertile interpretive ground. This provision allows omission if a proposal "deals with a matter relating to the conduct of the ordinary business operations of the registrant." This provision reflects directly state law, which provides as a general matter that the day-to-day operations of the corporation's business is the province of management, not the shareholders. It also is a refinement of (c)(1), which is the general exclusionary section for provisions that are outside the scope of shareholder action.

The feature that makes the rule, and (c)(7) in particular, such an interpretative minefield is that issues can transform from ordinary business to significant policy questions as public perception of the issues changes. Such was the case in the anti-smoking and golden parachute initiatives of a couple of years ago, as it is today with executive compensation.

The requirement that Commission staff be the arbiters of when an issue has undergone a metamorphosis from "ordinary" to "significant policy" is burdensome. Therefore, I believe this area is ripe for reform.

I have asked on more than one occasion why we don't just remove ourselves from the process - either by letting issuers go it alone without the "cover" of an SEC no-action letter or simply by requiring everything to be included subject only to an exclusion for duplicative or illegal proposals, or proposal improper under state law. While perhaps overly dramatic, these two positions can help frame the issue for reform as we seek to find the appropriate middle ground between a meaningful shareholder role and the needs of management to run the business.

I know that Rick Roberts went on record in front of this group in October expressing his desire to extricate the Commission from the social policy aspect of the process altogether, and exclude all proposals that dealt not primarily with economic matters but instead with social or public policy issues. I understand that he believes that, not only should the Commission get out of the business of determining what rises to the level of significant social policy, but that social policy questions are not proper subjects for shareholder vote. Although the philosophy and directness of Rick's suggestions have a certain appeal, I am not in complete agreement with the results.

I tend to take a more inclusive view than Rick concerning the bounds of (c)(7). At this point perhaps I can be accused of not being appreciative of who my audience is. As owners, the shareholders have a right to participate in decisions that are important to the company. Like the other Commissioners, I am far more comfortable when those important decisions relate specifically or solely to the economic fabric of the company. But I have proven to be flexible on those issues that are not strictly economic, so long as there is a significant nexus to the business of the company.

For example, I was in the minority last spring that would have upheld the staff's position in requiring the inclusion of a shareholder proposal presented to Capital Cities/ABC calling for a report on EEO and affirmative action policies. The report would have had to include the company's programs and policies concerning minority and female hiring, management, production, and programming. To me, that proposal was consistent with existing precedent that suggest that issues other than the mundane still fall within the ambit of the shareholder franchise.

Affirmative action is certainly - by any measure - an issue that has become important social policy. But it also is directly tied to the business operations of the issuer. This is in notable contrast to a recent proposal by the National Alliance on human rights violations in Palestine. A social policy issue? Yes. But no nexus to the business of the issuer. I believe that there was a time when virtually all social policy issues were required to be included, that this would have as well.

The existing precedents date from the 1970 Court of Appeals decision in Medical Committee.^{1/} That decision opened the door for the inclusion of social and political policy questions by noting that shareholders have the right to influence all "important" decisions that affect their status as owners of the company. The term "important" was then viewed to include policy, as well as economic, decisions. I believe that we have gotten a little too far away from "important" - in economic terms - and need to recouple social questions with economic impact.

The desire to keep shareholders involved in the process should not be so inviolate as to permit it to destroy the proxy process. I am not insensitive to the oft-repeated "floodgates" argument. I also agree with Rick that the Commission staff, and the Commissioners, would quite likely appreciate being relieved of the responsibility of being the arbiters of what is or is not a significant policy issue.

Perhaps the best way to incorporate the concept of economic nexus is through a revival of the reach of paragraph (c) (5). As it stands now, the 5% asset or earnings test exists in name only;

^{1/} Medical Committee for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir., 1970).

expansive interpretations of the "otherwise significantly related" clause of that provision have limited significantly the utility of that section. Some revision of that interpretation to narrow the reach of that clause might eliminate certain less than worthy proposals. I would probably not revert to a strict 5% test. The latter clause in a modified form still has some merit. Perhaps a demonstration by a proponent that the subject matter of the proposal could expose the issuer to significant litigation or concrete financial risk could satisfy the requirement, even if the proposal failed to meet the 5% threshold. Importantly, however, I believe that the nascent threat of a boycott should not be enough to satisfy automatically the "otherwise significantly related" test.

I might also be willing to attack these concerns not by strengthening the substantive reach of (c)(7), but by altering the procedural landscape. For example, I would be in favor of a remedy that this group has suggested, namely an increase in the favorable vote requirement, although I am not sure that I am willing at this point to sign on to 10%, 15% and 30% thresholds. Further, if a static or more expansive interpretation of the "ordinary business" clause of (c)(7) did result in ever-increasing numbers of social or political proposals, I would consider a system for the random selection of such proposals. But I doubt that it would come to that.

B. Recent Interpretations

1. Executive Compensation

Despite an agreement on the need for reform, it is quite likely that the staff, and the Commissioners themselves, are not in complete agreement as to what is the best course of action. Therefore, having been less than completely successful in informing you of the Commission's future path as to Rule 14a-8 reform, perhaps I should take a few moments to discuss recent interpretations, again in the context of (c)(5) and (c)(7). Maybe in discussing what I perceive to be the deciding factors in recent proposals, you can better understand the staff's decision-making activities.

As I mentioned a few moments ago, executive compensation proposals are a prime example of an issue that has undergone a transformation from ordinary to significant. I have been on record for some time that this transformation, or the recognition of it, is appropriate. I believe that issues which are important to the company should be exposed to shareholder democracy, and that includes the executive pay issue.

There has been widespread public interest and debate concerning the policies and practices of senior executive compensation and an increasing recognition that these matters raise significant policy issues. One only needs to examine the dramatic increase in shareholder proposals on the issue. In 1986, there were approximately 35 proposals concerning all manner of compensation-related issues. In 1990, that number grew to 110. Under any scenario or interpretation of (c)(7), executive compensation is a fundamental (but not ordinary) business matter, albeit social policy as well, that should not be excluded.

In recognition of the growth of importance of this issue, the Commission announced that ten pending shareholder proposals would have to be included in the proxy materials of the affected companies. Interestingly, the proposals that are to be included are only advisory in nature. In fact, some of the ten proposals (e.g. Chrysler) were not advisory, and the Commission's response to the issuers noted that the language of the proposal had to be changed by the proponent in order to be included. Failure to make the change would result in the proposal violating paragraph (c)(1) as subject matter not appropriate for security holder action.

At the same time, the Commission permitted the exclusion of 14 other compensation-related proposals which dealt with general employee compensation questions, which were deemed to relate to the conduct of the issuer's ordinary business. The juxtaposition between these proposals and their executive counterparts demonstrates that societal or political forces can still result in changes in interpretation. It may also demonstrate that the Commission continues to believe, as it stated in an interpretative release 15 years ago, that significant policy and ordinary business remain mutually exclusive terms.

Having disappointed you with (c)(7) and teased you with (c)(5), let me end with a discussion of the recently released AT&T letter concerning a National Alliance proposal regarding business in Israel. The National Alliance letter, correctly, I believe, ignores (c)(7) and permits exclusion based on (c)(5). Clearly, AT&T was able to stay under the 5% threshold, but unlike recent interpretations, the staff did not hang the proposal up on the "otherwise significantly related" test. The staff's letter noted that the policy issue raised by the proposal, namely Israel's treatment of Palestinians, was unrelated to the company's business in Israel. This might be distinguished from certain South Africa proposals, in which the political practices of

apartheid was directly related to the companies doing business in that country. What this signifies for future social policy proposals, or reconsideration of prior proposals such as the Mobil/McBride Principles letter, is unclear. However, it seems clear that a door that before had been closed, has now been opened slightly.