"CORPORATE GOVERNANCE AND COMPENSATION"

REMARKS OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

TOWN HALL OF CALIFORNIA
LOS ANGELES, CALIFORNIA

JUNE 17, 1992

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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Ladies and Gentlemen:

For someone who grew up down the road in Manhattan Beach, it is a great pleasure to be with you at the Town Hall of California. Of course, with the global summit in Rio, most of the public's focus has been on the environment, not securities law. I felt pretty bad about that until I read that one of the most serious environmental problems now facing California is a sharp decline in the shark population off the coast, leading to a serious disruption of the marine ecosystem. Well, I must confess that I didn't realize that this had become a problem, but perhaps dealing with sharks every day made me overlook their special role. Now that we understand the problem, in the future the SEC will try to help out by always requesting incarceration in California.

One of the most publicly contentious issues in the corporate world today is the question of executive compensation. That topic is itself only part of a much bigger debate regarding our system of governing the 13,500 public corporations in America.

At the outset, it is worth noting that we have a special record of success in America with our securities markets in promoting broad public ownership of the economy. More than 50 million Americans directly or indirectly own stock in our public companies, which is by far the highest number of individual investors in the world. There are more individual investors than ever before, and they have roughly $2 trillion invested in corporate stocks, or approximately one-half of the equity of publicly traded companies.

The other half of ownership of U.S. corporations comes through institutional investors of all types. Here, corporate pension funds, mutual funds, public employee funds, multi-employer union pension funds, life insurance companies and other "institutions" own increasingly large blocks of equities in America's largest corporations. As recently as 1955, institutional investors held less than 25% of U.S. equities, and their percentage continues to increase every year. With that increase in ownership has come a steady increase in their desire to promote strong corporate performance through the governance process.

By fostering a sense of participation in the growth of companies, and creating entrepreneurial interests on a widespread scale, this democratization of the economy has many benefits. The widespread public ownership of corporate America also explains much of our long tradition of openness and public disclosure of important information about our public companies.

It is interesting to speculate what the level of investment would be if the U.S. did not have a tax code that is the most punitive against the equity investor of any industrial country. Lack of a capital gains exclusion and the double tax on dividends unfairly tax the equity investments of 50 million Americans, which is bad enough. However, they also make it much more difficult and more expensive for any person seeking to form a business to raise the capital necessary to get a start. The result of that is a loss of economic vitality for the country, and reduced opportunities for our people to pursue their economic dreams. In this area, so-called "tax fairness" seems to mean applying a dumb result to everyone.

In some ways our very success in fostering public ownership of corporations has contributed to the problems of finding effective means of governing large and widely diversified companies. It would at least have been possible to put all 498 of Coca-Cola's shareholders in 1928 into a room to discuss the company's business. Accommodating the 95,000 shareholders of Coke in 1990 would have been a strain even for the L.A. Coliseum. Handling the 500,000 shareholders of G.E., or the 2.5 million shareholders of A.T.&T. would certainly be impossible physically, and it would even be tough for an interactive video hookup. Aside from the practicalities, today's global business competition simply moves too fast to try to have a firm's market decisions reviewed by all the shareholders.

Thus, instead of a New England town meeting, we rely on representative democracy in governing our corporations. Here the theory says that the shareholders elect the board of directors to represent them in overseeing the day-to-day activities of the company's management. At least according to the theory, boards of directors will protect the shareholders against overreaching or inept performance by management.

It is important for this theory to be more than a Hollywood fantasy. By every measure, the board of directors is the linchpin of our system of corporate governance, and the foundation for the legitimacy of actions taken by management in the name of the shareholders. The board has the access to information and the power to provide meaningful oversight of management's performance in running the business, and it needs to use them cooperatively but firmly. This is particularly vital when a company is in a downward spiral, since the cost of waiting for a takeover or bankruptcy to make management changes will be far higher than through board action.

Increasingly, many people doubt whether the theory of board representation conforms to practical reality. In a petition for rulemaking submitted to the SEC last year, the United Shareholders Association stated:

> ...the election of directors and resolution of issues requiring a shareholder vote are perfunctory exercises dominated and controlled by corporate managers.... The theory of the publicly held corporation is not obsolete, but, in practice, the corporate governance mechanism is.... (Letter dated March 20, 1990, p. 2)

To remedy the perceived limitations of the current proxy process, shareholder groups have proposed numerous reforms designed to make it easier for groups of shareholders to communicate their views regarding companies to one another, and to make it easier to challenge management proposals or nominees where necessary. For example, some have suggested a right for large and longtime shareholders to be able to publish critiques of corporate performance in the company proxy, to nominate directors for inclusion on the company's proxy ballot, or to receive company reimbursement for proxy solicitation expenses. Confidential voting, independent tabulation of votes, mandatory shareholder votes on particular proposals and many other ideas have been suggested.

Not to be outdone, management groups complain about increasingly direct pressure from large institutional shareholders, whose motives or objectives are sometimes questioned. In addition to opposing suggestions for liberalization, some business groups have suggested reducing the scope of shareholder communications. One proposal is that the SEC ought to narrow the current exemption from proxy regulation for communications with no more than 10 shareholders by imposing a 5% aggregate ownership test.

In the midst of this debate, various "reform" proposals have been introduced in Congress. These bills would make numerous legislative changes in our traditional systems of governance. Among other things, one bill would require that the SEC change generally accepted accounting principles ("GAAP") to require that corporations treat the amount of the estimated present value of options granted to management as an expense in the year of grant.

While there may be many ideas well-worth considering to improve corporate governance, the idea of Congress' setting any specific accounting principle by statute would be a disastrous precedent. Irrespective of the accounting merits of any specific proposal, we should never allow the setting of accounting principles to be a matter of Congressional politics.

Several other proposals would impose a new "excise tax" on shareholders by disallowing corporate deductions for salaries in excess of specified limits. Different bills have proposed a cap on deductibility of compensation of $1 million, $500,000, or 25 times the lowest salary in the company. In addition to being totally ineffective to limit compensation, each of these proposals would actually hurt the most innocent parties -- the shareholders. Creating higher corporate taxes hardly seems like the best way to improve corporate governance mechanisms.

Admittedly, sometimes it is difficult for outsiders to guess what factors the board relied on in making decisions. When a company whose financial results have been sharply deteriorating, or even merely stagnating, awards its executives huge pay increases, many people rightly ask, "Where were the directors?"

When a company underperforms its competitors significantly year after year, many ask, "Why doesn't the board make a change?" Not many baseball managers would stay on the job if their team finished in the second division every year.

When a company whose stock has plunged in value "resets" the management's stock options to lower the strike price, many shareholders ask, "Who is the board representing?" That looks like the old game of "heads I win, tails you lose," because the management profits if it is successful, but it also profits if it fails. Since the stockholders cannot "reset" the price of their investment, why should management be able to rewrite history, as it were.

Of course these questions are intensified where a company does not have a compensation committee composed exclusively of outside directors, or where there are "interlocking" memberships on compensation committees. In those cases the decisions may not have involved impropriety, yet the perception of a lack of independence in the decisionmaking is simply too strong to justify. Although this is not an area for the SEC to set absolute rules, we should expect more extensive disclosure of what is really going on when these potential conflict situations exist.

One frequent suggestion to improve corporate governance is to reduce the concentration of power in the hands of the CEO by adopting the European model of separating the function of chairman of the board from that of the chief executive officer. Without deciding that question, I believe that shareholders would be well-served if every large publicly traded company had an independent compensation committee, and an independent nominating committee, just like they generally have an independent audit committee.

Most large companies already have compensation and nominating committees, but the perception and the reality of board independence and capacity to play a meaningful role would be enhanced if every large company followed this practice. To serve their intended functions, these committees should never include as members the CEO or other senior officer of a company on whose corresponding committee senior officers of the first company sit.

Directors who sit on compensation or nominating committees should be actively informed as to the strengths and weaknesses of the company. The definition of an "independent" director need not suggest combativeness or antagonism. For the future, service as an independent director should suggest an active and constructive engagement in the affairs of the company.

These suggestions are not intended as ideas that the SEC should require as a matter of law, but rather as steps that the corporate community could and should take on its own. However, the SEC can help make our current governance process work better.

Though reasonable minds can differ on the subject, I believe that the current proxy rules go somewhat too far in restraining freedom of speech among shareholders. This is, after all, a free country where we take the expression of even contentious views as a sign of vitality in a wide-open marketplace for ideas. I thus find current rules unacceptable insofar that a shareholder considering appearing on a television program or writing a newspaper op-ed piece arguing that a corporation is not being well-managed should have to submit his or her views to prior review by the SEC. Making an investment needs to be attractive, and bring rewards, not penalties. Just for buying stock a shareholder should not forfeit the right of free speech.

Where the shareholder is not seeking to obtain any proxy authority, and does not have any special interest in a matter other than as a shareholder, it should not take the permission of the federal government in order to tell 11 or more other shareholders how you feel about a proposal. Similarly, merely announcing that you plan to vote for or against management's nominees, and why, should not be deemed to require regulation by the government.

In addition to the obvious question of constitutionality, using federal employees and tax dollars to review all such communications seems unjustifiable in the face of a $400 billion deficit. Here is an area where the marketplace of ideas put forward by both management and the shareholders should not require federal bureaucrats as thought monitors. Of course in every case one can label a critical analysis "misleading," but should the government pay public tax dollars to referee those disputes or should we let shareholders make up their own minds as long as there is not any clearly erroneous or fraudulent material in use?

While prior restraint and costly regulatory proceedings do not seem appropriate for mere communications among shareholders, requiring the submission of written materials that have been circulated to some other shareholders to the SEC so that they are open to all does not involve either prior restraint or the same degree of wasted federal expenditure. Materials that are circulated should also remain subject to the antifraud requirements, and the SEC should be available to review allegedly false or misleading materials submitted by any party on a rapid basis.

In the area of compensation, our contribution is to seek to improve public disclosure of the facts, and the rationale that went into specific decisions. All too often today proxy descriptions of compensation are lengthy, legalistic narratives that obscure rather than illuminate the most relevant facts. To change this situation, the SEC will be proposing for public comment very shortly new summary disclosure charts and graphs designed to set forth in detail the components of compensation to senior executives. In some cases this may be painful, but the owners of the company have every right to know just exactly what they are paying to those who run the company.

In addition to improving disclosure of financial data, we also would like to see disclosure of the analysis that went into the board's decisions on compensation. Before voting to reelect a board, the shareholders should be entitled to know what the incumbent board's reasoning was concerning pay decisions, and the performance factors that the board looked to in making an award.

In most cases the board does carefully review performance before acting. Hopefully, this new section in the proxy statement will help shareholders understand better the factors that went into a board's decisions. This should be particularly helpful where the company's overall performance has not seemed to match that of its major competitors, though individual performance by specific officers may have been excellent.

While we hope to improve disclosure and accountability in this area, much of the public criticism of some types of compensation practices is overdone. People who make their shareholders wealthy should earn a great deal. Few shareholders objected to Wal-Mart's compensation policies, because the shareholders saw the value created in the company return to them. Indeed, a share bought for $16.50 in Wal-Mart's IPO in 1970 is now worth $27,840, and investment of $602.50 then would be worth $1 million today.

Like many entrepreneurial companies, pay and performance were closely linked in Wal-Mart, so that everyone benefitted -- management, investors and employees. That is how the system ought to work. Certainly neither government nor the media have the capacity to decide how much Sam Walton should have been paid, or for that matter Walt Disney or Henry Ford. The directors have to make that decision based on the circumstances of the company, but it has to be made in the interests of the company as a whole, and that means the shareholders.

One way to achieve better results for shareholders is through greater use of stock ownership for employees and managers. While some decry the use of stock options in compensation packages, the option is actually a very good device for aligning the interests of managers and shareholders. Ideally, the more stock a manager receives and holds, the more his or her incentives will be precisely the most desirable: building stockholder value. Policies that promote significant levels of stock ownership as a primary tool in compensation may be one of the best ways of encouraging corporate competitiveness over the long run.

Stock options have always been a critical tool for startup companies where conserving cash is a matter of survival. Options can be used instead of cash to create benefit and pension programs in small companies. Even startup companies are often able to attract top scientific and managerial talent they could never afford to pay for in cash through liberal use of options.

Many small companies extend options to their entire workforce, thereby creating vital loyalty and willingness to think long-term throughout the ranks of the company's workers. Increasingly, larger companies are also using stock options to give a wide range of employees the incentives of ownership. G.E., PepsiCo, Merck, General Mills and others are increasingly using options to instill both pride and the economic incentives of ownership to a large number of managers and employees.

Indeed, one of our important competitive advantages over countries like Germany and Japan is the capacity to create stock-based entrepreneurial incentives down to the lowest level of the company. Thus, in approaching issues of valuing, accounting for and taxing stock options, we need to keep a cool perspective on our economic interests, and not be driven solely to react against the obvious abuses that have occurred.

It is worth remembering that gains from options typically reflect individual effort over as long as a decade. Except where there have been resets, where options have produced the largest gains to executives, the shareholders have also generally enjoyed substantial increases in their stock value. Boards can help restore the credibility of options by pricing options -- and especially the very large grants -- in a way that requires a decent return to shareholders before the executive benefits significantly. For example, some companies have introduced a "hurdle rate" that makes the stock outperform inflation or another index before the option becomes valuable.

Our overall goal in this area is to make sure that all the key facts regarding compensation the shareholders are expected to pay are out in the open. Through both improved disclosure and greater freedom for shareholders to express their views directly to the board, we hope to see improved accountability of the board to the shareholders in a manner that will enhance rather than impair the board's vital role.

Ultimately, market forces and the views of all the concerned parties -- management, directors and shareholders -- need to resolve these difficult issues in each company. Deciding how to govern America's public corporations should rely on market forces, not government dictates or social engineering through the tax code. As a nation we have far too much at stake in global economic competition to allow public trust in the legitimacy and fairness of public corporations to erode too far. Ultimately, we must insist on a governance system that provides meaningful accountability for poor results and strong rewards for success. Hopefully, then we can get on with the critical job of providing investment capital for small and large businesses to be innovative, productive and successful at building the businesses for our economic future.