Remarks Of

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"Suggestions to Improve Corporate Governance"

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

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I. Introduction

I appreciate the opportunity to address the National Association of Corporate Directors on the rather broad topic of corporate governance. This subject has received increasing interest and attention as the pressures of our globally expanding and increasingly competitive market makes more urgent than ever the need for well managed American companies. It is my intention today primarily to make several suggestions on methods to improve corporate governance other than through legislation or regulation. I believe that is important to the continued vitality of our capital formation system to have in place a sound effective corporate governance system.

The recognition of the importance of corporate governance is not a phenomenon of the 1990's. Issues surrounding the direction of companies first came into prominence in the 1960's and 70's, as corporate wrong-doings forced the creation of outside directors and of significant new board committees. During this time, the Commission floated a number of corporate governance proposals, but disciplined approaches to corporate management quickly were swept aside in the wave of takeovers that characterized the 1980's. In that decade, if management did not meet expectations, its company simply became a target, with a new management, a new board -- and a new vision -- charting a more effective course for the company. At least, that was how it was supposed to work.

In the more sober '90's, the desire for improved corporate governance appears to be taking a more thoughtful approach. Institutional shareholders are flexing their muscles and are communicating to management the importance of maximizing shareholder value. And judging from changes at GM, IBM, Kodak and other companies, directors are beginning to listen. I view this increased communication as positive for the sustained growth of our capital formation system, and I hope that it continues.

II. Importance of Independent Directors

I believe that corporate governance activity in the 90s will consist generally of these themes of communication and negotiation, as opposed to the confrontation that occurred in the 80's. Thus, it is important that public companies have strong boards of directors.

In particular, I believe that independent directors will continue to be an integral component necessary to maintain the vitality corporate America. Increasingly, one hears calls for true independence on boards, for men and for women capable of directing change in the focus of their companies, and for men and for women who are not afraid to stand up to management when necessary. I was encouraged to read in Director's Monthly recently that during the past five years, outside directors have assumed an increasing number of board seats, and that this trend is expected to continue. I hope that is the case. If so, corporate governance matters will continue to be handled much more smoothly and effectively than they were in the volatile 80s.

Now, what do I mean when I speak of an "independent director?" Perhaps it is easier to address the question by describing what an independent director is not. An independent director is not a person who is (or was) an executive employee, or related to an executive employee, of the company, or who is affiliated with a significant customer or supplier, or with one of the professional advisors to the firm. And while such a criterion would be difficult to specify by regulation or by statute, a truly independent director should not be a close personal friend of the CEO. In sum, an independent director is an individual free to exercise independent judgment based upon significant business experience, not upon ties or relationships with management. Outside directors, if indeed independent, should have the freedom, and the incentive, to meet as frequently as they not management, deem necessary.

This call for increased board representation by independent directors is not intended to question the ability or integrity of "inside" directors. For years, many of these men and women have devoted their time and energies to ensuring that their twin duties of loyalty and care have been fulfilled. It is, however, the primary function of the board of directors to monitor and to question management, and even to replace management when necessary. The conflicts of interest that these duties create for inside directors are greater than even the most scrupulously honest person should have to resolve.

Thus, I believe that the ideal hypothetical board should be comprised, except for the CEO, of members completely independent of management. At a minimum, boards should have a majority of outside directors. While not as an important factor as an independent board, I also generally prefer a board where the functions of Chairman and CEO are not vested in the same person. Further, I would argue that the audit, compensation, and nominating committees should be comprised entirely of outside directors. Finally, in order to align the board's interests with shareholders, strong consideration should be given to partially compensating directors with company stock or options. I am of the view that the policy of pay for performance is positive for our capital formation system and should be encouraged even for directors.

I wish to stress, however, that the job of a board should not be to micro-manage the company. The purpose should be to delineate clear goals for top management, to establish a system of incentives to help meet those goals, and to monitor diligently management's progress.

In April of this year, Chairman Markey held hearings on the role of independent directors on corporate boards. As I indicated earlier, I do share his concerns regarding the need for more outside directors and regarding the lack of true independence exhibited by many "outside" directors. I do not, however, believe that legislation or additional rulemaking is the most appropriate method to address these problems. It is my opinion that change must be dictated by the marketplace itself, and there are indications that this process of change has already been initiated. According to a recent survey of corporate boards, well over 90% of the companies surveyed now have a majority of outside directors on their board.

Truly independent boards have the freedom to keep management challenged to strive for the best quality products or services, prices, and technological innovations. While it is understandable that management may become wedded to the strategies that have provided years of success, an objective eye is required to see when these managers become paralyzed in the face of today's changing markets. This is the time when a strong board must step in and dictate the future of the company. Hence, the reason that I stress the need for more outside, "independent" directors as one suggestion to improve corporate governance.

III. Present Corporate Governance Dynamics

Press accounts during the past few years have related increasing instances of active boards demanding changes in the face of consistently poor corporate performance. These directors have been encouraged in their efforts by increasingly activist shareholders, particularly institutional shareholders capable of holding a substantial block of a company's stock. I do wish to mention a couple of these instances.

For one example, IBM, under its new chairman, has become the first large

U.S. company to create a "directors and corporate governance committee" of the board of directors, composed of non-executive directors. This committee will review the size, composition and functions of the board and its committees, as well as respond to significant proposals from shareholders. I understand that this committee will also nominate new directors and will evaluate any recommendations from shareholders. It strikes me that such a committee may now be a necessity for most companies, and I recommend this concept to the members of this audience for consideration for utilization by your respective employer.

Another recent example of strong leadership from independent directors occurred at Kodak. There, the non-executive directors formed a special board committee to take a more active role in corporate directions. Apparently frustrated at the slow pace of Kodak's restructuring, the board ousted their CEO, a 36-year company veteran, and made no secret of the fact that he exited at the board's insistence.

These changes and others like them occurred at the insistence of institutional investors concerned with the company's failing performance. More and more, academics, managers, shareholders and regulators are realizing that large institutional investors represent a ready constituency, able to influence management to accept the challenges needed to maintain competitiveness into the 21st century.

To give you a slightly outdated idea of the size of institutional holdings, data gathered by Dr. Carolyn Brancato for Columbia Law School's Institutional Investor Project revealed that in 1990, institutional investors held approximately 53% of outstanding equities and controlled assets of approximately $6.5 trillion. Together, institutional investors held almost 55% of the shares of Business

Week's top 100 companies, and it is estimated that a mere five institutions own between 10-11% of the largest 25 corporations.1/ This is a formidable force, and I suspect that these numbers have even increased since 1990.

I must emphasize, though, that the role I envision for institutional investors is one of general oversight regarding the "big picture" of a company's activities. Institutional investors should have neither the time, the resources, the expertise, nor the inclination to involve themselves in the day-to-day activities of corporations. Their function should be
to make the board an active monitor of corporate performance -- a body empowered to encourage managers to make the decisions necessary to respond to the global changes and realities confronting American businesses today.

In exercising this general oversight, involved shareholders should resist the temptation to satisfy only short-term goals. I believe that many large investors are now realizing that ultimately, their best interests lie in the continued success of the companies that they partially own. Unfortunately, however, too many performance goals still concentrate on quarterly results or other short-term measures of success. In meeting competitive challenges, a company needs owners focused on its future, on building its strengths, and on taking the measures necessary to provide for that future.

Institutional investors have varying incentives to assert themselves in corporate affairs. Public pension funds are uniquely poised to lead the way, in my judgment, in this new vision of shareholder involvement. Last year, public pension funds held almost 12% of all institutional investor assets and about 30% of all pension fund assets.

1/ Carolyn K. Brancato, Institutional Investor Project, Columbia University School of Law, Institutional Investors and Capital Markets: 1991 Update.

Aside from the leverage that these holdings provide, public pension funds are also free of many of the relationships and conflicts that limit other large shareholders' involvement in corporate direction. For instance, many banks and private pension funds have business relationships with corporations that could be jeopardized if a too aggressive stance were adopted. Further, mutual funds typically have short-term goals which may be inconsistent with the need for long range planning and for the short-term sacrifices required to maintain competitiveness.

I should add, however, that some mutual funds are taking steps to become more involved. For example, I understand that Fidelity, the largest mutual fund family, has amended the fundamental investment policies of many of its mutual funds to provide for more active participation in proxy contests. Apparently other funds are also acknowledging a long-term approach to stock investments, as the limited number of qualified securities for certain portfolios is changing the "Wall Street walk" mentality that characterized mutual funds for so many years. I hope this trend continues.

Moreover, many articles this fall have noted a change in the strategies adopted by some of the country's largest institutional investors. Rather than seek reform through expensive and contentious proxy battles, the California Public Employees' Retirement System, or "CalPERS," for one, has announced that it will first seek an audience with management in an effort to negotiate changes. CalPERS has made clear, however, that if it fails to receive sufficient cooperation through "behind-the-scenes-diplomacy," the public exposure and proxy route will remain an option.

For another example, the Council of Institutional Investors recently released a report to its members profiling the fifty worst performing large U.S. companies.

The Council states that its report was not meant to be a "hit list," but merely a means to lower monitoring costs among institutional investors by disseminating information to funds that could not afford to gather the data on their own.

Finally, one of the country's largest investors, the Teachers Insurance and Annuity Association and College Retirement Equities Fund, recently released guidelines for companies in which it invests. Essentially, the fund supports boards with a majority of outside directors and with major committees comprised entirely of outside directors. Apparently, it looks for boards with a diverse membership by experience, race, sex and age, and with procedures in place for directors to evaluate both management's performance, as well as their own. Further, the fund advocates one class of common stock, with one vote per share and with confidential voting. As I will indicate shortly, I continue to support the concepts of one share, one vote and confidential voting as an approach to improving corporate governance.

IV. Enhanced Shareholder Communications Through Proxy Reform

As everyone here is probably aware, the Commission significantly amended its proxy rules last year to facilitate shareholder communications.2/ In adopting the amendments, the Commission stated that the purposes of the proxy rules are best served by promoting free discussion, debate and learning among shareholders and interested persons. I wholeheartedly agree with this approach.

I hope that by removing unnecessary restrictions on discussions among shareholders regarding corporate performance and other matters of direct interest to all shareholders, the new rules will reduce the obstacles to effective and appropriate shareholder input. If so, the amendments should improve corporate

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2/ Securities Exchange Act Release No. 31326 (October 16, 1992).

governance. The amendments also should lower the expense of conducting a regulated solicitation by shareholders, management and others by minimizing costs related to the dissemination of soliciting materials.

Specifically, the new rules provide that when not more than ten people are contacted, proxies may be solicited by anyone other than management without complying with the proxy rules. Further, any solicitation by or on behalf of any person who does not seek the power to act as a proxy for a shareholder is also exempt from most of the proxy rules. Of course, this exception does not apply to nominees for director or to an officer or director of the registrant if the solicitation is financed by the registrant.

Moreover, in an effort to voice dissatisfaction with the company's performance, a number of institutional investors have recently encouraged other securities holders to "just say no" and to withhold their votes for management's slate of directors. The amended rules facilitate this strategy by excluding from the definition of a "solicitation," communications by a shareholder who simply states how he or she intends to vote, and the reasons supporting that vote. Initial reports from shareholders using the new proxy format indicate that the rules accomplish their objectives -- and allow shareholders to communicate with less expense and in a more timely fashion. I hope that continues to be the case.

The recent proxy season also saw the implementation of new rules designed to require heightened disclosure about executive pay.[3/] I believe that there previously has been some discussion at this conference regarding the mechanics of these new rules, and the Commission's recent request for comments on certain amendments to these rules. Let me add to that by stating

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3/ Securities Exchange Act Release No. 31327 (October 16, 1992).

that I am of the view that the new charts, graphs and supporting discussions, while possibly being a little too detailed and going a bit overboard, should help facilitate shareholder communications with directors, management and each other regarding the company's performance and executive remuneration.

The reforms of last year should pave the way for more informed communications between shareholders and boards of directors, and I believe that the appropriate role for the Commission at this point is to stand back and to allow this dialogue to continue. In my view, the new proxy rules and executive compensation disclosure rules have gone a long way toward improving the ability of shareholders to understand the companies in which they invest, and to assert themselves when a company appears to be drifting from a sound business policy. Flaws in the corporate governance system of many companies, however, continue to exist in my judgment. I will mention some of these flaws in the hope that the members of this audience will take it upon themselves to correct any corporate governance deficiencies that may exist with their respective employer.

For instance, I would like to see all corporations afford their shareholders the right to vote and the right to vote confidentially. While I acknowledge that these factors are probably not as useful in encouraging superior performance as a strong independent board, I believe that they can improve corporate governance which should lead to more efficient companies and improved performance.

As a general proposition, I also support proposals calling for shareholder votes prior to management's adoption of poison pills, golden parachutes or other anti-takeover devices. I do not believe that these control mechanisms are inappropriate in all cases; my point is merely that shareholders should ultimately determine their suitability.

V. Conclusion

Since my time has expired, I will conclude. I am pleased to say that with only a few exceptions, I believe that corporate governance is heading in the right direction in the 90s, particularly since the gateways to communication have been opened and are being used, resulting in the displacement of contested takeovers with negotiation. Dialogue between directors and shareholders has already highlighted the need to address weaknesses in certain companies' business plans and has become the needed catalyst for change when necessary. For this trend to continue, all directors must become vigilant in their supervision of management and must become alert to the tides of technological and competitive change that are sweeping the world. I challenge everyone here today to do so.