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News Release

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"Improving Corporate Governance for the Nineties: The Role of Institutional Investors and Proxy Reform"

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

IMPROVING CORPORATE GOVERNANCE FOR THE NINETIES: THE ROLE OF INSTITUTIONAL INVESTORS AND PROXY REFORM

Thank you, and good afternoon.

My topic today is corporate governance. Corporate governance issues are currently being debated with a vigor that has not been seen since the late 70's. The renewed interest in corporate governance is the result, I believe, of a number of factors.

One factor which has caused a renewed interest in corporate governance is the aftermath of the takeover mania of the 80's. During its heyday, the hostile takeover was viewed as the most effective tool available to maximize shareholder value. But it was a crude tool, at best. Recent studies have shown that the average takeover premium during the past decade was over 40%. Thus, only in the most extreme cases did takeovers serve to maximize shareholder value.

In the post-takeover era the focus is on how to improve share value without a hostile bid or LBO. Improving corporate governance increasingly is seen as one of the answers. Particular attention is being given to who runs companies as well as how well they are run.

Another factor contributing to the renewed interest in corporate governance has been the rapid growth and influence of institutional investors. Institutions now hold roughly 50% of all public equity, and account for a similar percentage of all share trading. As their portfolios continue to grow, some institutions are demanding more direct access to corporate decision making.

The new prominence of institutions, combined with the decline of hostile takeovers, has led to a renewed focus on proxy contests and related efforts to change the current proxy process.

Although many proxy contests continue to be battles for corporate control, a growing number are being waged to influence or reverse policies traditionally seen as being within the sole domain of management or the board of directors.

As more interest groups attempt to use the proxy process to promote their own agendas, calls for changes in the proxy process have followed. Institutional investors such as the California Public Employees' Retirement System (CalPERS) have been particularly active in promoting proxy rule changes.

In my view, the growing influence of institutional investors and the various proposals for changes in the proxy rules are the two most prominent factors in the current debate on corporate governance. I would like to explore these two areas briefly and raise some questions that I think need to be answered before reaching judgments about greater institutional activism or proxy rule changes, or both.

<u>The Role of the Institutional Investor</u>

The growing activism of institutional investors is perhaps best demonstrated by their increased participation in the proxy process.

During the 1986 proxy season institutional investors submitted 33 shareholder proposals to management. Three years later, during the 1989 proxy season, the number of proposals submitted by institutional investors almost quadrupled to 124.

As institutions have become more active in the proxy process they have discovered elements of the process which they do not like. As a result, increased institutional activism in the proxy arena recently has translated into calls for changes in the proxy rules.

One of the most frequent changes urged by institutional investors is an easing of the restrictions imposed by SEC rules on communications among shareholders. These rules, in essence, prohibit certain communications among shareholders without filing a proxy statement with the SEC. Some believe that large, sophisticated investors should be allowed, without compliance with the proxy rules, to communicate freely among themselves about corporate governance matters. These institutions argue that changes in proxy rules are needed because the current rules are too cumbersome and expensive to permit effective participation by institutional shareholders in corporate governance.

I believe that we need to proceed cautiously in this area, because there are many more questions than answers at this juncture. I'm not sure that we have had enough experience with institutional involvement in the proxy process to reach any firm conclusions on this issue. Indeed, if recent events are any indication, it would appear that institutional investors have substantial leverage with management even without any change in the current proxy rules.

For instance, as a result of institutional pressure, Lockheed has committed to adding directors from institutional ranks, to installing confidential voting, and to considering opting out of the Delaware takeover statute. Wrong

Honeywell's institutional investors, without a shareholder list, in about one week, blocked two management antitakeover proposals.

Texaco, after institutional pressure, added a director at least indirectly selected by institutions.

Examples could be extended to include Avon, Armstrong, Champion, Exxon, and Xtra Corp., where substantial shareholders had material successes.

SO WHAT

Another question is whether providing large institutional shareholders with greater power to influence Boards would improve corporate financial performance? Rather, might not institutions use their new found muscle, perhaps, to break up and sell off companies in order to yield higher short term returns. Would such a result be good for the economy or the society?

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But suppose all institutions were long term investors. Should they, as opposed to other shareholders, have special access to corporate management? Does skill at managing an investment portfolio presuppose skill in managing Boeing or SmithKline Beecham?

(3) CHEAP SHOT

Is there systematic evidence that institutional investors are better managers, or pickers of management, or long term planners, than corporate managers or other shareholders?

Another troubling issue arises from the fact that institutional investors are not traditional shareholders. Phrases like "accountability to shareholders" and "corporate democracy" presuppose that the individuals who vote the stock also own it. But institutions typically vote (4) shares as fiduciaries for thousands of individual investors who are never polled before the institutions cast their votes. Of course, state and federal laws provide some guidelines for institutional investors in casting their proxies. Nevertheless, the demand by some institutional investors for greater accountability by corporate boards to their shareholders, raises the question of whether institutions themselves are sufficiently accountable, in turn, to their beneficiaries.

Proxy Reform

As you may know, the SEC staff is currently conducting an extensive review of the proxy rules, and what rule changes --- if any --- the SEC might want to consider. I do not intend to preempt that review by what I say here. Changes may be needed in the proxy system. Indeed, in some instances, I believe changes are needed.

But I do want to discuss some of the arguments that have been advanced for making changes in the current proxy rules -- in particular, changes that advocates claim will improve corporate governance. Many of the arguments seem to me entirely theoretical and not easily susceptible to empirical validation.

(5)

NOT AN SEC QUESTION

An example is the broad argument that corporate boards have great power, and that in a democracy power must be held accountable. Boards are seen in this view as self-contained, self-perpetuating oligarchies accountable to no one. Such a state of affairs, it is maintained, cannot be allowed, and the proxy rules must be changed to prevent it.

Opponents of change in the proxy rules reply that corporations are, of course, accountable to the public through a wide variety of laws --- ones protecting consumers, employees and the environment, for example. These laws affect many aspects of corporate operations. The question is not, "are corporations accountable", but, "do corporations need to be held more accountable"?

Opponents of change in the proxy rules have also asked if it is appropriate to raise concerns about corporations being centers of "unaccountable" power and not also address, for example, the American Bar Association, Rice University, the Jesse H. Jones Foundation, Arthur Anderson, Goldman Sachs and Baker & Botts, just to name a few. Has it been so terrible for the country, the opponents say, that these institutions are controlled by "entrenched, unaccountable, self perpetuating" groups of managers?

Of course, if lack of accountability is an evil, then I believe it is surely no answer to say that it exists outside corporate America, too, or that changes must be made elsewhere before or at the same time that changes are made in the proxy rules to make corporations more accountable.

Besides, many critics of the proxy rules will point out that the issue is not some vague one of democratic accountability but rather accountability to owners. What these critics say is that Baker & Botts is accountable to its owners --- that is, its partners. IBM isn't.

Defenders of the current governance rules argue that there are differences between large law firms and large corporations; that it seems intuitively right for a law firm's partners to run the law firm: They spend their working lives there, they are true owners of the firm, and they may have substantial personal liability for the firm's failures. Surely that is different from the relationship of most IBM shareholders to IBM.

Many state corporate laws distinguish between closely held and widely held corporations, and different rules can apply --- ones which give the shareholders more leverage in the first instance than in the second.

Perhaps more distinctions of this type are needed. Perhaps shareholders who have been such for 10 years should be treated differently from those who have held their shares for 10 minutes.

Some shareholders certainly look like real owners. Others cheerfully admit to merely having bought wagers which will pay off if stock prices rise.

Another facet of the discussion about proxy reform that needs to be examined closely is the assumption that if directors stood in more substantial risk of being voted out of office, corporations would end up being better managed.

Major definitional problems would have to be resolved before this proposition could be adequately tested. First, there is little agreement on what good management is and how to measure it. But let's suppose everyone agreed that a proper test of good management was total cash return to shareholders (dividends plus share price appreciation). We all know share price appreciation is in some significant part an artifact of the performance of the entire stock market. Are all companies less well-managed in bear markets than in bull markets? Of course not. So let's assume further that statistical techniques can eliminate market effects, and inflation effects, and everything else other than "true return". Is there good evidence suggesting companies with high returns got that way by being more responsive to their shareholders? If so, it needs to be placed on the record.

Many turnarounds in U.S. corporations have occurred. Some poorly managed companies of the '70's became well managed in the 1980's. Some well managed companies have slipped and fallen over the last decade. But there have been no significant changes in the rules governing corporate proxy voting. Thus, some conclude, no argument has been made that proxy rules are an important variable.

But this argument is hardly persuasive. It may be the case that a strong dose of corporate democracy would have righted the ill-managed companies and further improved the well-managed ones.

A further issue involving the "shareholder accountability equals good management" proposition, is that it suggests a model of what motivates management: not pride or ego or individual competitiveness or the discipline of the markets, but fear of job loss. Is this model empirically correct? Does it comport with what we know about human behavior?

What much of the discussion about the proxy rules seems to lack is a firm factual basis. It is suggested, for example, that increased corporate democracy will enhance international competitiveness. But what is the relationship between corporate democracy and international competitiveness? Is there more corporate democracy in France, or Germany, or Japan, or South Korea, or Switzerland, or India than in the United States? Do their companies produce consistently better returns? Judgments on those issues will be made very difficult because of the problems of comparability: Are we measuring shareholder returns in these countries with the same yardstick we would use here, given the differences in currencies, accounting practices, taxes and the like? How do we compare levels of corporate democracy? These complexities need to be addressed.

Improving Corporate Boards

Much of the focus by proxy reformers and institutional investors is directed toward improving corporate performance by influencing who ends up sitting on corporate boards. The common theme of critics is that board members are inevitably captured by management. Even outside directors are captured, the argument goes, because they are usually current or former CEOs with a "management" point of view, or they come from the same business and social circles. Moreover, critics charge that no matter how independent minded a director may be, he eventually will develop loyalty to the process and the company that caused his selection as a director.

One proposed solution is to create a pool of professional directors, whose sole occupation would be to serve on a half dozen or so boards. Under this proposal, professional directors would be employed, paid for and nominated to boards by organized shareholder groups. This suggestion, of course, raises serious questions about loyalty: If a director is paid by one shareholder, can he or she adequately represent all the shareholders?

Whatever the merits of this approach, I do not think we should overlook other areas that might improve the performance of corporate boards.

For example, in order to improve corporate governance, we need to focus on the more mundane subject of how boards actually function. In other words, what makes boards work effectively?

I believe it is difficult, at best, to legislate good boards into existence. Nor can you easily compel good board behavior through the threat of legal liability --- all legal liability can do is avoid the worst sort of board behavior. But we ought to be able to reach a consensus on some minimum criteria necessary for the functioning of a board by drawing on the wealth of experience concerning how well run boards operate.

Before concluding today I want to make a few points on the mechanics of corporate governance that may be overlooked if we focus too much on how directors are selected, instead of what they do after they are selected.

For instance, no matter how independent directors may be, they will not be able to supervise adequately if they fail to devote enough time to their directorial responsibilities. A board member who sits on fifteen boards is unlikely to be able to do justice to any of them.

While it is true that boards cannot and should not attempt to micromanage companies, board members should be expected to take the time to understand the company's business. It may make sense, for example, for companies to have meetings in addition to regular board meetings, to review significant aspects of the business in detail. Also, serious consideration should be given to letting the board or its committees hire independent consultants where appropriate to aid in their review.

CONCLUSION

I have mentioned several topics today -- changes in the proxy rules, the growing influence of institutional investors and improving corporate boards. Let me suggest though that the first two topics -- the proxy rules and the institutional investor's quest for more influence -- have a common thread --- both seek to improve corporate governance. Accordingly, it seems to me that before we completely revamp the proxy system or conclude that institutions should have greater influence over boards, we need first to reach agreement on what a good board is and how to create a good board. These are difficult subjects, not amenable to quick and easy judgments. However, I am confident we can improve the way corporations are governed if we only give the subject the careful attention it deserves.

Thank you.