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**Philip R. Lochner, Jr.
Commissioner*
U.S. Securities and Exchange Commission
Washington, D.C.**

"The Current Debate Concerning 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.**

Thank you, and good afternoon.

I'd like to ask you to indulge me for a moment: lets assume it is 1999. Much has happened in the decade of the 1990's, but I'm just going to reflect on one area --- proxy reform. Come with me for a few moments --- "Back to the Future" --- as I review for you what happened in the 1990's.

What really started the proxy revolution of the '90's was the SEC's decision in 1990 completely to rewrite the proxy rules, making it far easier to challenge incumbent Boards.

First, the Commission adopted a rule allowing anyone with 1% of the voting stock of a public company to nominate him or herself to be a director. Then it granted these nominees free space in registrant proxy statements, including space for "campaign platforms". Then the SEC suspended the solicitation rules, so groups could get together to meet the 1% threshold.

Groups quickly formed and began to run their own Board slates.

In the early 90's, CACs --- or Corporate Action Committees --- began to appear to finance nominees for elections to Boards.

By 1994 Congress decided to lengthen the terms of all directors of public companies to four years, so that incumbents would have an opportunity to carry out their campaign platforms.

By 1996, it was clear that being nominated and funded by a CAC was not enough: A candidate needed name recognition to win, particularly when running for election to a Board like GM's, for example, with its vast numbers of shareholders. As a result, retired Governors and Senators became typical nominees of the late '90's. They brought with them their pollsters and p.r. experts. Others with widely recognized names soon followed the politicians.

By 1998 we had the landmark AT&T Board election when the AT&T shareholders elected a Board which consisted of three ex-Presidents of the United States, Meryl Streep and New Kids on the Block.

You've been very kind to indulge my little fantasy. Lest you think it too fanciful to suggest that directors' elections may come to resemble political contests, I hasten to point out that there are one or two possible straws in the wind. For example, Carl Icahn bought 30 seconds of commercial time on FNN urging

shareholders to vote for him in his recent USX proxy fight. And it is reported that 25% of Harold Simmon's expenses in the Lockheed fight were incurred for print ads which looked more like political print advertisements than, say, securities analysts' reports.

Of course, whatever happens in the next decade, it will no doubt differ from what I've just outlined. I'm just not very good at predicting the future --- I was the person at Time Inc. who thought PEOPLE magazine would never sell.

Nor do I necessarily favor the scenario I've just sketched out. The only reason, in fact, for starting with this fairy tale, is to emphasize one point --- we need to think carefully about where we're headed when making wholesale changes in the proxy system. And clear thinking requires us to discard rhetoric and to focus on facts.

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

system. Indeed, in some instances, changes are needed.

But I do want to take this kind opportunity to discuss some of the arguments that have been made concerning changes in the current proxy rules, and ask what these arguments add to discussion of proxy reform. Many of the arguments seem to me entirely theoretical and not subject to empirical validation.

An example is the argument that we'd have fewer expensive and disruptive takeovers if the proxy system was more accessible to shareholders: Tender offers --- it is said --- are used principally because they are the only effective method of disciplining management.

This argument was advanced primarily before last October, and defenders of the current proxy rules point out that tender offer fever seems to have broken without any proxy rule changes.

My own guess is that even if the proxy rules had been changed radically, we would still have plenty of tender offers, but for the fact that credit for tender offers and LBOs is less available, Mr. Milken is now a self-confessed felon instead of the junk bond king,

and we've awakened from what some have referred to as the day dreams of the '80's.

Having said all that, of course, does not mean that proxy reform may not indeed be a more effective tool to create responsive Boards than tender offers are, or may again be some time in the future. But this is all unverifiable speculation. It would be helpful if participants in the debate about proxy reform could generate facts as well.

Another frequently heard claim is that Boards have great power, and that in a democracy power must be held accountable to the public. 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. Well, "yes" and "no".

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 better question to ask is, I believe: "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 ABA, Harvard University, the Ford Foundation, Price Waterhouse, the Metropolitan Museum of Art, the Rand Corporation, Goldman Sachs, Skadden Arps, Cargill, and CalPERS, 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 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 Skadden Arps 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.

Substantial 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 lets suppose everyone agreed that a proper test of good management was total cash return to shareholders (dividends plus share price appreciation) generated by management. We all know share price appreciation is in some significant part an artifact of the stock market. Are all companies less well managed in bear markets than in bull markets? Of course not. So lets 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 are 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 have become 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 discussion about proxy reform 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? 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.

Another argument for proxy reform that is in need of careful analysis is the assumption that shareholders will become long term investors if they know their proxy votes will have a greater impact on issuers.

Some doubt that arbs will become born-again long-term value investors under any set of circumstances. They ask whether it is really true that, upon wholesale rewriting of the proxy rules, institutions will throw away their computers, trash their indexation programs and bone up on Warren Buffett and Graham and Dodd? Rather, might not they use their new found muscle, perhaps, to break up and sell off companies in order to yield higher short-term returns?

The current proxy system reflects an attempt to balance the interests of management in efficiently operating a business, and of shareholders in exercising voting rights. Some claim the balance is tilted to management's side. But this argument assumes there is an ideal level playing field and that it can be discovered.

But how would we know, at any one point in time, if the playing field were level, assuming it is not level now?

Let me take an analogy from political life. We know most members of Congress are, if they care to run for re-election,

mostly re-elected. The percentage of Congressional incumbents who win re-election, if memory serves, is in the 90's. Lets suppose you thought that state of affairs was insufficiently "democratic".

How would you know when it was democratic enough? When the percentage of incumbents winning re-election dropped to 50%? Because if we agreed on what the goal was, it would be possible to tinker with the rules to get us to the goal.

So, by analogy, how much corporate democracy is "enough"? And why is that the right amount? Do we want half the incumbent Boards in any one year to fail to win re-election? One third? Two thirds?

Most shareholders, I suspect, don't care about insuring the defeat of X% of incumbent Boards. They don't care if Boards don't change for a generation, they may not even care if managers get rich, as long as the shareholders get high returns.

This response, in turn, raises a further question: If companies don't provide good returns what can the investor do if he can't throw management out? Sell the stock has been the

traditional reply. Sorry, says the large institutional investor, I've got so much of International Widget that I can't sell it without tanking the market.

Of course, a large holder has substantial leverage with management even without any change in the current proxy rules. Look at some of the events of the last year or so.

Lockheed has committed to adding directors from institutional ranks, to installing confidential voting, and to opting out of the Delaware takeover statute.

Honeywell's institutional investors, without a shareholder list, in 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.

Would providing large institutional shareholders with greater power to influence Boards improve corporate management? Does

skill at managing an investment portfolio presuppose skill in managing Boeing or SmithKline Beecham?

Is there systematic evidence that institutions are better managers, or pickers of management, or long term planners, than corporate managers?

We don't yet know.

Another question worth raising is whether we are working with the right "model". Use of the phrase "corporate democracy" in the rhetoric of corporate governance suggests corporations ought to be run --- or their managements should be chosen --- in roughly the way they are in a political democracy. The Board, some say, is like the President; the corporation is like the United States; the shareholders are the voters. As my little fable at the start of these remarks may have suggested, I'm not sure this is a model we should adopt.

But this analogy is not persuasive, anyway, others say. You don't, when you are born, automatically become a citizen of IBM or McDonald's, unless perhaps your last name is Watson or Kroc. Coca

Cola and Ford can't tax your income, or draft your children into military service, or jail you for violating their corporate by-laws. If you want to quit the United States, you have to leave family, friends, employment, and community. If you want to quit 3M, you call your broker.

But if more democracy is such a good thing for a corporation, why stop with common shareholders? Shouldn't debt holders have a vote? Holders of commercial paper? Creditors? Employees? If democracy is a terrific idea, shouldn't institutional shareholders be required to pass proxy voting rights through to the real beneficial owners of the shares?

If political theory is not the proper source for a model for proxy voting and corporate governance, what is? Some have suggested the market is the model we ought to be following. Academics have even floated the idea of selling proxy votes. Whether the market model will be further developed, or whether other models will emerge, I cannot say.

Let me conclude at about the point I started. All I have is

unanswered questions. Discussion of the role of the proxy rules in corporate governance to this point has been more rhetoric than facts, and the facts that have been generated have demonstrated very little. Rules, including the proxy rules, have economic costs. Changing rules already in place creates additional economic costs. Before incurring those costs we need to be sure that there is a real problem --- by which I mean one that affects a significant portion of our roughly 13,000 public companies. We also need to be sure that the proposed solutions will, to mix my metaphors, cure the patients and not have unpleasant side effects.

What we need now is a quieter discussion of issues and more systematic development of facts. We may even need to ask whether the debate over better managed, more responsible companies needs to include elements in addition to the proxy rules. The proxy rules seem, at best, blunt tools to improve management and ensure international competitiveness. If the goal is better management with a longer view, maybe the debate should be widened to include such things as tax policy, monetary policy, and savings rates.

My point is not that the proxy rules don't need to be changed; as I said earlier, in fact, I think in some respects they do. My point is, instead, that we need fewer grand and vague pronouncements from both sides in the debate and more hard facts.

Thank you.