Sir Adrian

I have started delving into shareholder resolutions & voting on directors' pay. I will let you have a note once I have pursued things as far as I can. In the meantime you might like to see the attached speech made by Richard Breeden two weeks ago. It is a thoroughly excellent speech - my only problem with it is that I do not understand the last para on page 11 and the following para on page 12. I am trying to get to the bottom of them.

Regards,

Nigel.

18/6

CAD-03227

TESTIMONY OF

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

CONCERNING EXECUTIVE COMPENSATION

BEFORE THE SUBCOMMITTEE ON TAXATION
OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE

JUNE 4, 1992

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

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

CONCERNING EXECUTIVE COMPENSATION

BEFORE THE SUBCOMMITTEE ON TAXATION
OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE

JUNE 4, 1992

Chairman Boren and members of the Subcommittee:

I appreciate the opportunity to testify before the Subcommittee on Taxation on behalf of the Securities and Exchange Commission regarding the issue of executive compensation. While the SEC does not have any responsibility for tax policy, we do have responsibilities for administering the proxy voting system pursuant to the Securities Exchange Act of 1934, and for overseeing generally accepted accounting principles ("GAAP"). Pursuant to this responsibility, the SEC will shortly be proposing for public comment new rules designed to improve the public disclosure of information concerning executive compensation packages. We also plan to require boards of directors to explain the specific rationale for compensation decisions.

Public Controversy Over Compensation

The subject of executive compensation has aroused considerable public concern. Rightly or wrongly, there is a perception of abuse when a company whose financial results have been deteriorating awards its senior executives substantial compensation increases. The same perception may arise when a particular company has seriously underperformed the market as a whole (or its principal competitors) for a sustained period, yet the CEO continues to receive multimillion dollar compensation. "Mega-grants" of stock options or restricted stock with a value of tens of millions of dollars have also raised questions of proportion and perspective even where the issuer itself has had positive earnings and increases in its stock price.

In at least some specific instances, it is difficult to understand what factors a board of directors could have relied on in reaching compensation decisions. Some particular practices, such as "resetting" the price of management's options where a company's shares have plummeted in value, are difficult to justify as consistent with shareholder interests. Similarly, interlocking compensation committees, where one CEO serves on the compensation committee of another company, whose CEO in turn serves on the compensation committee of the first company, create outright conflicts of interest.

Use of Stock Options

Stock options are the source of some of the largest amounts of compensation for managers of large, publicly traded corporations. However, stock options are absolutely vital to small and high-tech businesses. Smaller companies -- especially the high-tech startup companies that provide a significant portion of new U.S. technology -- use options in recruiting and retaining executive and scientific talent. Indeed, many small companies utilize options widely, often providing for participation by all employees, as a means of motivating employees to work for long-term corporate growth.

Stock-based incentives are particularly vital for companies in a high-growth phase, where every possible dollar needs to be reinvested in the business. These companies often use options to avoid cash demands for benefit or pension programs, purchases of technology rights or for many other purposes. Options are widely used in venture capital situations to attract and compensate employees, and also as extra incentives for investment in highly risky companies. Since the U.S. tax code now fails to create any incentives for investing in small startup companies, it is vital for these companies to be able to utilize other economic incentives, such as stock options, to attract investment.

Increasingly, large companies like G.E., Pepsico, Merck, General Mills and others are using stock options as a means of providing entrepreneurial incentives to a large number of employees throughout the company. Once thought of largely as compensation for executives, stock options have become a common and widely used means of instilling the pride and economic incentives of ownership in literally thousands of employees. This use of stock options parallels incentives for widespread employee stock ownership that Congress has traditionally provided, such as favorable tax treatment for Employee Stock Ownership Plans. However, unlike indirect ownership of company stock through a pension plan, options are provided to selected individuals and result in economic incentives that are identical to direct ownership of stock. From a policy perspective, converting employees into owners is highly desirable, and we should be facilitating, not impeding, this trend.

Many companies -- large and small -- go to great efforts to seek to align the incentives for executives with the long-term interests of shareholders. Here, the stock option is one of the very best tools for creating management incentives to improve shareholder value. Unlike straight cash salary or bonus, with stock options the executive does not usually profit unless the shareholders also profit.[1] Some of the largest amounts of "executive compensation" have also corresponded with enormous increases in shareholder wealth. Furthermore, the growth in value of options, though it may be realized in a single year, may represent the fruits of many years of work for an executive.

Though use of options as compensation (as well as to encourage investment) seems very desirable, the current pricing of huge option grants may be less than optimal from a shareholder's perspective. During a time of steadily rising stock market levels, stock prices should be expected to rise as a consequence of inflation and other market factors rather than company-specific factors. From the end of 1981 through the end of 1991, the Standard & Poor's 500 stock index rose 240%. Thus, an option granted in 1981 at a company's then-current market price for a term of 10 years, for example, did not require good corporate performance in order for the executive to profit handsomely. That option would have had considerable value even if the company's stock had underperformed the market by 200%. Recently, some major companies such as AT&T have begun to issue options whose exercise price includes a "hurdle rate" that requires the company's stock to improve more than a specified amount before the option becomes exercisable. From a shareholder perspective this represents a major improvement, because the company's stock must rise by varying amounts over time before the option becomes valuable.

---

[1] This is why "resetting" or "swapping" options is a questionable practice. In such a case, the stock price may have fallen significantly, yet by lowering the strike price the board has permitted the executive to profit even where the company's value to stockholders has fallen. Investors, of course, cannot simply "reset" their acquisition cost for stock. In such a case the executive profits if the company does well, but the executive also profits when the company does badly, measured by changes in stock value.

Determining Performance and Compensation

Though abuses have undeniably occurred in some companies, it is important to keep these cases in perspective. America's economy includes several million corporations, with approximately 13,500 publicly owned companies. These firms include tiny startup companies with only a few employees and stockholders. They also include some of the world's largest corporations with billions of dollars of shareholder investment and tens of thousands of employees.

The appropriate level of compensation of corporate officers depends on the specific circumstances of each particular company in a particular time period. Compensation that might seem excessive in one company could be inadequate in another, and what is deemed "appropriate" must be constantly adjusted to reflect the circumstances of the company at the most recent times. For example, a company that lost money, but moved from tenth to second in market share or earnings in a particular industry, could justifiably be deemed to have had an extremely successful year. A company might wish to increase compensation for an executive who was successful in substantially reducing defects in the company's products, or who developed unique and valuable technology for future products, even if the company lost money that year. By contrast, another company that actually had some profits, but seriously underperformed the market or the company's competitors, could possibly be deemed to have had inadequate (though profitable) performance.

Who can say what the exactly "appropriate" level of compensation would have been for Sam Walton, Walt Disney, or Henry Ford? Each of these entrepreneurs created businesses from nothing that went on to employ hundreds of thousands of Americans over many generations. Typically, such entrepreneurs benefitted through the creation of value of their shareholdings, thereby aligning their own personal interests with those of other shareholders.

For example, few shareholders who purchased shares in Wal-Mart's initial public offering in 1970 at $16.50 per share would complain about their board's compensation decisions. Each of those shares is now worth $27,840. An investment of only $602.50 in Wal-Mart stock then would be worth $1 million today.[2] Similarly, investors in Microsoft's IPO in March of 1986 at $21 are unlikely to complain about the value of CEO Bill Gates' compensation. Each of their shares is now worth over $700.

The same problem arises in deciding what pay is appropriate for an executive of a mature corporation, who frequently must oversee the deployment of billions of dollars in shareholder investment. Again, who can say for sure what is the "correct" amount of pay for running G.E. or AT&T? These executives have an enormous impact on the 284,000 and 317,000 employees, respectively, of the two companies, and on their 490,000 and 2,426,354 shareholders. Obviously the same could be said for trying to specify exactly what network newscasters, fashion models, sports stars or others who typically earn enormous salaries are really "worth."

---

2 Many employees of Wal-Mart became millionaires in exactly that fashion. Starting from one store in Bentonville, Arkansas, Wal-Mart has grown into a company that employs 366,000 people.

Determining how much compensation is appropriate is, fundamentally, a market decision. Companies that make shareholders wealthy and provide opportunities for their employees have a greater rationale for offering significant rewards to their senior managers than do companies that are performing miserably. Since there is not any universal measure of what is appropriate, under our traditional system of corporate governance, the board of directors is charged with deciding issues of executive tenure and compensation in the best interests of the corporation. To play this role successfully, a director should have both the knowledge and the independence necessary to serve as an informed and active representative of the shareholders.[3]

If directors do not take that responsibility seriously, the system will fail to produce an appropriate result, at least in the short term. However, at that point directors should expect that their actions will be publicly reported, and that they will have to justify those decisions to well-informed shareholders. Enabling shareholders to provide effective oversight of the board's performance is more likely to produce the best decisions over time

---

3 In a recent speech, William T. Allen, Chancellor of the Delaware Court of Chancery noted:

> "Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of the long-term strategic, financial, and organizational goals of the corporation and should approve plans to achieve those goals; they should as well engage in the periodic review of short and long-term performance according to plan and be prepared to press for correction when in their judgment there is need."

Speech to the Ray Garrett Jr. Corporate and Securities Law Institute, April 30, 1992, p. 10-11.

than any system that tries to substitute the federal bureaucracy or the federal tax code for private market decisionmaking by those with a direct stake in the matters at issue.

Limiting compensation to some bureaucratically devised formula (such as 25 times the salary of entry level workers) or arbitrary amount (such as $1 million) would certainly damage incentives for risk-taking, and result in a general loss of valuable flexibility. A company consisting of Albert Einstein and three clerks might justifiably want to pay its CEO more than 25 times the lowest salary. Similarly, a company ranked first in the world in its industry should perhaps want to be able to keep its management or scientific team intact, even though it might have to pay $1 million in order to match domestic or foreign competitors trying to recruit them. Indeed, no sooner did legislation proposing a $1 million cap on salary deductibility come before Congress than legislation proposing a $500,000 cap on deductibility was introduced. One need only look to the quality of the Russian economy to see the ultimate results of government rather than private control of pricing in an economy.

These examples are not meant to ignore the reality of excess and abuse that have occurred in specific companies. Certain types of practices do need to be corrected by the corporate community. However, we need to recognize that use of the tax code or any absolute set of rules to govern every company, irrespective of its particular situation, will involve enormous costs and unintended negative results. Thus, if ever there were a decision that would appear best left to the flexibility of the market, this is it.

The ability of numerous companies to compete for executive talent, or to use stock options to lower cash outlays or reduce capital costs, could be prejudiced by attempts to use the tax code to constrain decisionmaking that appropriately belongs with the board of directors. Many small, high-growth companies could have their very survival imperiled if the use of stock options became financially prohibitive. Though Congress might think it was shooting at CEO pay, the first casualty would most likely be broad-based employee stock option plans that really benefit both workers and companies. Even for large companies, tax legislation could only raise the cost to shareholders of compensating management. Creating the equivalent of an excise tax on CEO pay would only penalize shareholders, not executives, since companies will still have to pay what their board determines to be a market value to their executives.

Pay or Performance -- What is the Real Issue?

In many respects, the most serious problem is not the amount of pay, but rather whether our current system demands adequate accountability for producing good corporate performance. Indeed, where an executive has not been able to produce superior earnings for the company and increased value for the shareholders for a period of years, the issue should not be pay, but tenure. Too many shareholders, employees and others depend on the performance of a large corporation for the board of directors to allow it to deteriorate indefinitely without forcing a change in management. When executives don't perform, board action to replace them is a far better way to promote economic growth than creating new taxes.

The recent action of the board of directors of General Motors in forcing senior executive personnel changes after a period of adverse results is an example of forceful action by a board that may help to restore a greater sense of accountability for performance. Board action with respect to inadequate management may ultimately avoid replacement of management through a hostile acquisition or a bankruptcy proceeding at vastly higher cost to the company, its employees and shareholders. If boards are not adequately vigilant in either replacing management or making reasonable compensation decisions, public pressure will certainly mount for stronger action -- preferably through increased shareholder participation in decisionmaking.[4]

In my personal view, it would be best to focus our efforts on removing impediments to the workings of market forces in dealing with these issues. Here, improved public disclosure concerning both corporate performance and compensation awards, and better opportunities for shareholder input to the board of directors, should help control abuses without creating significant new problems.

Enhanced Disclosure for Investors

The SEC is currently working on amendments to the disclosure requirements concerning executive compensation. Our proposals will be designed to get the facts out into the open in a clear and unambiguous manner. Since the shareholders ultimately pay

---

4 Executive compensation is frequently analogized to compensation for baseball players. It is generally (though not universally) true that pitchers with an E.R.A. that is extremely high will find themselves looking for another team, and managers whose teams consistently finish in last place may receive the opportunity to explore another line of work.

these compensation packages, they have every right to know exactly what decisions the board has made, and what the company that they own is paying to the officers. Today proxy disclosure is all too often a very lengthy, obtuse narrative filled with legal boilerplate that obscures the relevant facts. In its place, we plan to require summary charts and graphs that will clearly set forth, in detail, the components of compensation awards to senior officers.

In addition to enhancing disclosure, the SEC will propose to require the members of the compensation committee of the board of directors to state publicly the performance factors in the company that were relied on in granting specific compensation packages. If companies do not have a compensation committee that is exclusively composed of outside and non-interlocking directors, we will propose even more detailed disclosures concerning the facts that went into these decisions, and the value of interrelationships among the decisionmakers.

Especially where a company is losing money, this requirement for directors to explain publicly their actions will enhance their accountability for the decisions that they reach. It will also permit shareholders to understand better the board's actions where there are perfectly legitimate factors in particular compensation decisions.

Another step that the SEC has already taken should complement better disclosure. Effective earlier this year, the SEC began to require all public companies to include resolutions setting forth shareholder views concerning compensation for senior executives in corporate proxy statements. While these resolutions are only advisory in nature, they allow shareholders to provide direct input to the board concerning the board's compensation decisions without the need to mount an expensive and disruptive proxy election contest to oust the members of the board.

Though seeking to replace members of the board who do not adequately represent shareholder interests is the ultimate recourse under the proxy system, the ability to vote on proxy resolutions concerning compensation should result in a better-informed board. Pursuant to the new voting policy interpretation, ten companies were required to include resolutions regarding senior executive and director compensation in their 1992 proxy statements,[5] and an additional 33 shareholder proposals were submitted to shareholders regarding executive compensation disclosure and golden parachutes.

The SEC's program is simple. Our goal is to assure that shareholders are well-informed, and that all the facts regarding the compensation that the shareholders are being

---

5 Of the twelve proposals that the Commission decided should be included under the new policy, only nine have come to a vote. Proposals for Battle Mountain Gold Co. and Grumman Corp. were not voted upon because the proponents did not make revisions necessary to bring the proposals within the requirements of Rule 14a-8. A proposal for Gerber Products will be voted upon in August. The voting on the other nine proposals was:

	For	Against	Abstain
Aetna Life & Casualty Co.	7.5%	80.3%	12.2%
Baltimore Gas & Electric Co.	12.2	83.6	4.2
Bell Atlantic Corp.	10.9	74.6	14.5
Black Hills Corp.	36.9	47.6	15.5
Chrysler Corp.	5.6	79.5	14.9
Eastman Kodak Co.	15.9	67.8	16.3
Equimark Corp.	16.5	81.4	2.1
Int'l Business Machines Corp.	16.7	83.3	Not Avail.
Reebok Inc.	19.2	51.9	28.9

asked to pay are out in the open. At the same time, we seek to foster better accountability of the board of directors to the shareholders for the decisions that they reach, because the board is legally responsible for protecting the interests of the shareholders. Through these steps, we hope to allow shareholders, directors and management to work out for themselves, in a totally open process, what is the best decision for each particular company. Market forces, not governmental dictates, should decide what is best for America's publicly owned corporations.

In keeping with this philosophy of market disciplines for compensation decisions, the SEC strongly and unequivocally opposes direct government regulation of compensation. We also oppose the indirect use of the tax code or legislatively mandated accounting rules to try to accomplish the same objective. Artificial tax rules might provide regulation that would be better camouflaged, but it would still represent government regulation.

In our view, shareholder interests in corporate performance should be at the forefront in decisionmaking on compensation. Boards of directors should be prepared to reward executives who perform well, but they must also be prepared to act with respect to those who simply never perform. Well-informed shareholders and independent and active board members can help achieve greater accountability for performance in corporate governance, thereby putting the appropriate focus of concern back on devising the best ways for America's businesses to be successful global competitors.