Remarks Of

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Washington, D.C.

"Securities Regulatory Reform Initiatives"

National Association of Manufacturers
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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

The Commission has been actively engaged in regulatory reform initiatives this year. It goes without saying that any regulatory reform initiative undertaken in a year divisible by four is susceptible to criticism as being politically motivated. While such criticism is probably both valid and supportable, I submit that it is better to pursue regulatory reform initiatives in a presidential election year than not at all. Among the Commission regulatory reform projects are rule changes to assist small company capital formation, proposals for sweeping changes to the executive compensation disclosure requirements and proxy rules, and proposals to expand the eligibility of large issuers to use the simplified Form S-3 and "shelf' registration procedures in raising capital. Today, in addition to a brief discussion on the issue of securities litigation reform, I intend to address some of these regulatory reform initiatives.

II. Executive Compensation

Everyone in this room is well aware that last June, the Commission proposed a new regulatory framework for disclosure of executive compensation in the proxy statement. The comment period for this proposal ended August 31, and the Commission has received approximately 900 comment letters. This reflects an unusually high level of interest, which is not surprising given the media and congressional attention to the topic.

Much of the controversy began last year, when Senator Carl Levin of Michigan introduced the Corporate Pay Responsibility Act[1] that would have amended the Exchange Act to mandate increased disclosure of executive compensation. Many of Senator Levin's suggestions are reflected in the Commission's proposals. In addition, there have been several other bills introduced in both the House and the Senate purporting to cap executive compensation in some way. Thus, it is not only the Commission that has an interest in the subject of executive compensation.

The focus of the Commission, in contrast to some of those in Congress, has been on the adequacy and clarity of

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[1] S.1198 and H.R. 2522, 102d Cong., 1st Sess. (1991).

disclosure with respect to executive compensation, rather than on the level of compensation. Shareholders have argued that the current disclosure required by Item 402 of Regulation S-K is in practice incomprehensible. Compensation consultants have argued that the information disclosed should be more useful in determining total pay packages for purposes of comparisons between companies. In an effort to seek more useful, and less boilerplate, disclosure, the Commission has proposed a series of tables and charts to both summarize total pay, as well as to break out each component of the package.

The cornerstone of the executive compensation proposals is the summary table. It would, on one page, give the proxy reader a snapshot of executive pay for a three year period, with a separate column for each type of pay. Most of these columns ultimately have their own table as well.

In addition to disclosing quantity of compensation, the proposals would elicit disclosure concerning the quality of compensation. Shareholders have long advocated that pay should be linked to performance. To this end, a proposed chart would depict graphically company performance as measured by cumulative total shareholder return versus an industry index or an issuer self-constructed peer group and the S&P 500 stock index. In addition, the proxy statement would contain an analysis by the compensation committee of the company, explaining its compensation strategy and how it links pay to performance.

The wide range of commenters agree generally that enhanced disclosure is necessary, but they differ greatly as to which specific proposals are the most effective. Most commenters appear to support the summary table, with individual and institutional shareholders supporting the other proposals as well. Comments from the corporate community generally urge that the disclosures required should be balanced against the associated attendant costs. This appears to be sound advice.

The National Association of Manufacturers ("NAM") has submitted a comment letter that shares many concerns with other corporate commenters. I am sympathetic to the comment that the proposal may be overzealous in proposing approximately a dozen tables of disclosure, especially where there exist redundancies with other disclosure requirements. However, those tables providing unique and useful tools to shareholders, in my opinion, should be retained.

One of the suggestions contained in the NAM comment letter was that the number of executive officers subject to proxy disclosure should be reduced from five to three. This strikes me as a reasonable cut. It would streamline disclosure for all issuers, while retaining those officers that are of most interest to shareholders, as well as to Congress and the media. One could presume that the compensation for the number four and five officers would be incrementally less than the compensation for the number three officer. As for eliminating the disclosure requirement for executive officers as a group, the obvious question to answer is whether the aggregate dollar value has utility to shareholders.

Some persuasively argue that it is useful to gauge how effectively upper management is incentivized.

Let me respond briefly to a few criticisms of the executive compensation proposals before moving on to the subject of proxy reform. There has been criticism of the five year stock price performance table because it is argued that it would be misleading or not useful; yet, judging from the comment letters, shareholders appear to be very much in favor of such a table. Business academics can debate as to whether a company's stock price is a true measure of its performance. "Efficient market" economists argue that it is, and my non-scientific sampling of shareholder opinions indicates strong support for that view. As everyone here is well aware, stock price plus dividends is the bottom-line for many shareholders.

Another table criticized by some commenters is the stock option valuation table. Everyone should recall that the Commission initially considered proposing a present value analysis along the lines of a Black-Scholes model. Senator

Levin's bill would have required such a valuation, and many commenters continue to advocate a present valuation requirement. A valuation requirement utilizing a Black-Scholes model, in my opinion, could lead to misleading values and burdensome disclosure requirements. While there can be disagreement as to the appropriate percentages to be utilized, the valuation table was a practical and simple alternative designed to permit shareholders to ascertain the potential value of stock options and remains so in my judgment.

The Financial Accounting Standards Board ("FASB") continues its eight year march to present value accounting for employee stock options. While I do not have a firm view at this time on the proper accounting treatment for executive stock options, I continue to be of the opinion that the Commission and the Congress should defer to the FASB in this area. There is a strong historical relationship between the FASB and the Commission regarding the establishment of accounting standards, and I believe that accounting decisions of this type properly belong in the first instance with the FASB and the private sector.

Last, let me comment on the proposal requiring a report of the compensation committee. No one desires to add another ten pages to the proxy statement, especially if much of it is boilerplate. However, shareholders apparently perceive a need to know the compensation strategy of the board members serving on the compensation committee in order for them to make an informed vote. The task before the Commission, in my opinion, is to find a way to satisfy that need for disclosure while designing the requirement to encourage, if not mandate, short pithy statements that are neither boilerplate nor burdensome nor invasive to the company. Possibly the Commission should reconsider the proposal requiring the signature of all the members of the compensation committee to the compensation committee report.

The other tables will require a closer scrutiny as to whether the benefits to shareholders outweigh the costs of disclosure. It has been suggested to me that some of the tables could be combined, such as the executive officer's and director's beneficial ownership tables, and that additional flexibility should be provided in the tabular format requirements. These suggestions appear to be sound ones. The balancing of costs and benefits with respect to these tables will be one of my tasks in the days remaining before the Commission meeting addressing the executive compensation disclosure proposals.

III. Proxy Reform

Most of the commenters on the executive compensation proposals also have commented on the companion release which reproposed rules to facilitate shareholder communication while reducing the cost of compliance with the proxy rules. If the application of the proxy rules were not so broad and the cost of compliance not so high, I doubt that most of these proposals would have been initiated in the first place.

Any time someone speaks to more than ten shareholders "under circumstances reasonably calculated to result in procurement, withholding or revocation of a proxy,"[2] the proxy rules apply, which triggers considerable compliance costs. Presumably, a disgruntled shareholder employee who turns to eleven of his or her colleagues and mutters that the board of directors were not worthy of re-election could be engaged in a proxy solicitation. The same probably could be true if the employee instead commented that the board was doing a great job and deserved to be re-elected.

There is a certain tension that exists when one attempts to regulate oral communication, even commercial speech, in light of First Amendment concerns. This has become a major issue of contention with the proxy reproposals. On the one hand, the Commission wishes to encourage free and open communication among shareholders, while on the other hand the Commission wishes to be sensitive to the concern that total deregulation of oral communications will encourage oral

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[2] 17 C.F.R. §240.14a-1.

"back-room" deals involving large shareholders, or professional "phone-bank" concerted proxy solicitations. The problem is how to regulate oral communications. It seems awkward to me to require someone to file memoranda of their telephone or personal conversations with the Commission, unless the solicitor was using a prepared written script or outline.

There are two other controversial issues with respect to the proxy reproposals that I wish to address as well. First is the bona fide nominee rule, which would permit solicitors to provide shareholders an opportunity to vote for some directors from management's slate on their proxy card. Many directors of public companies have submitted comment letters on this subject opposing the proposed rule because they claim in essence that they should be free to associate with whichever directors they choose and do not desire to be included on a dissident's slate of directors. This response is curious to me since I was not aware previously that a director's continued service was contingent upon maintaining the composition of the present board. In any event, a board member can resign at any time. To threaten to resign if a dissident slate is successful causes me to question the sincerity of the director's initial commitment to the company and its shareholders.

Second is the suggestion offered by Ned Regan, whereby large shareholders would be given space in the proxy statement to discuss their views of the company. While there is merit in encouraging large long-term shareholders to present their views to the smaller shareholder, I note that many commenters already are concerned that the Commission is enlarging the size of the proxy statement through the reproposals, and comment in favor of this particular proposal does not appear to be as strong as that of the other proposals. As with any other proposal, the costs and benefits must be weighed carefully.

There are many other issues involving the proxy rules such as proposed Form 14, when it should be filed and what it should disclose, but I will spare you from the details. Let me close out this subject by stating that I expect imminent Commission action on both the executive compensation and proxy rules. If new rules are adopted, they are best adopted sufficiently in advance of the proxy season so as to give companies and shareholders sufficient time to implement the changes.

III. Small Business Initiatives

Changing gears to some extent to the subject of small business, most of you are aware of the new Regulation S-B that was recently adopted for small business issuers. This regulation streamlines the disclosure requirements for eligible small issuers.

While I support streamlined capital raising procedures for small issuers and voted in favor of the new small business rules, I wonder why some of the disclosure requirements eliminated for small business issuers should not likewise be eliminated for other issuers as well. Logic should dictate that disclosure requirements are not as necessary for established companies as they are for new companies, such as small businesses, since more information is probably already publicly available for the larger, more established issuer.[3] It appears to me that it would have been more appropriate for the Commission to act first on reducing the disclosure requirements for large issuers, then for middle-sized issuers, and finally for small issuers.

An upside-down approach moving at warp speed exposes the Commission to charges of acting in a politically motivated manner.[4] Such an approach also places undue

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[3] Such a view has been advocated for some time. See Coffee, Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va. L. Rev. 717 (1984). "This article will suggest that a mandatory disclosure system should focus on disclosures that assist the investor . . .; greater disclosure seems also justified in the case of small firms given their apparent immunity to the predictions of the [efficient capital markets hypothesis]." Id. at 719-20, n. 10.

[4] See Laing, Errors of Commission: On Several Counts, the SEC is Putting the Investor at Risk, Barron's (September 7, 1992) at 8.

emphasis on the ability of an issuer to pay for disclosure requirements rather than on acting for the protection of investors. This criticism of a reverse logic approach is something that I mentioned at the Commission meeting adopting the small business rules, and I hope the staff examines this issue further in the near future. Having started backwards, there is no reason why the Commission should stop with small business issuers. In addition to Form S-3 and "shelf" registration, there undoubtedly exist other capital formation procedures which could be streamlined for large and middle-sized issuers.

IV. Securities Litigation Reform

Let me conclude my remarks today by briefly addressing the subject of securities litigation reform. The Commission has always viewed private actions for violation of the securities laws as a necessary and important supplement to its own enforcement activities. Although Congress has in recent years increased substantially both the scope of its enforcement powers and the size of its budget, the

Commission still lacks the resources to investigate every fraud claim.

Meritless securities litigation, however, has become a problem. Although securities litigation represents less than one percent of all litigation filed in federal court, its impact is far greater due to the substantial litigation expenses and complexity associated with such actions. For example, it is my understanding that securities actions have constituted almost ten percent of the recent federal civil trials lasting more than 20 days.

One potential reform mentioned to deter meritless securities litigation is to amend the Racketeer Influenced and Corrupt Organizations Act ("RICO"). While RICO, like the securities laws, provides for recovery by victims of fraud, the civil liability provisions of RICO operate in many cases to convert otherwise untenable routine private securities fraud claims to successful verdicts, by exposing defendants to extraordinary liability not available under the securities laws themselves. RICO entitles successful plaintiffs in those cases to treble damages, despite the express limitations under the federal securities laws to actual damage. By allowing private plaintiffs to bypass the carefully crafted liability provisions of the securities laws, RICO has thus tended to undermine the balanced structure that has developed under our federal securities laws. This distortion imposes substantial costs on our capital formation system.

At a minimum, RICO should be amended to limit civil actions to major and serious frauds and thereby to eliminate it as a mainstay of commercial litigation without depriving victims of egregious conduct adequate judicial recourse. By addressing the abuse of RICO in private actions that are essentially securities fraud cases, a measure of appropriate reform could be accomplished in the area of securities litigation; and the efficiency of our capital formation process should be correspondingly enhanced.

However, what puzzles me is the continued pursuit by securities litigation reformists of worn tort reform concepts such as proportionate liability, the loser pays all litigation costs, a cap on counsel fees, a cap on directors' liability, and limits on discovery, which sound appealing but are all more or less flawed. The promotion of these concepts should be dropped if for no other reason than the remote possibility of their ever attracting sufficient legislative support to achieve passage.

By zeroing in on RICO reform and shedding the other concepts, a meaningful step in the direction of securities litigation reform becomes viable. Further, such a strategy would increase exponentially the credibility of the cause of securities litigation reform and may even garner the support necessary to be approved.

For those that seek securities litigation reform as the desired objective, a slimmer, winnable legislative agenda should be advocated. RICO should be targeted for specific reforms. Amendments to eliminate the overlap between private remedies under RICO and those available under the federal securities laws should be aggressively pursued.

Congressional passage of such a legislative program is attainable.

The continued application of a securities litigation reform legislative strategy that includes the pursuit of superficially attractive but substantively lacking tort reform concepts is not attainable and, in my view, will fail.