BRUCE ATWATER

SENATE TESTIMONY

SUBCOMMITTEE ON SECURITIES

OCTOBER 17, 1991

Mr. Chairman and Members of the Committee, I am Bruce Atwater, Chairman of the Business Roundtable's Corporate Governance Task Force and Chief Executive Officer of General Mills, Inc.

Your letter of invitation asked me to testify on certain of the important principles in corporate governance and then to comment on a wide range of subsidiary issues such as proxy reform, executive compensation, and "One Share-One Vote". Since covering all these topics in the time allotted is clearly an impossible task, I would propose, with your permission, addressing first the subject of corporate governance and shareholder recourse, and then the current proxy reform proposals being considered by the SEC. I will also try to touch briefly on executive compensation.

First, Corporate Governance - The basic purpose of corporate governance is to ensure that a given corporation is structured and operated in such a way as to build shareholders' wealth over the long term. While there may still be some fringe disagreement with this principle, I believe most thoughtful institutional shareholders, as well as most corporate boards of directors and corporate managements agree with this performance oriented objective. In fact, the true measurement of the effectiveness of governance of a given corporation is the long-term financial performance of that corporation.

Corporations are formed by their shareholders to serve the purposes of the shareholders under the laws of the state in which the corporation is formed. Under these state laws the shareholders select a board of directors who have the responsibility of overseeing the affairs of the corporation. The primary responsibility of the directors to the shareholders is to select, evaluate, and replace if necessary the chief executive officer and other senior executives.

While Berle & Means' observations about fragmented powerless shareholders and dominant managements may have been true in 1932, that model is unrecognizable in the 1990's. Today's shareholders are no longer an unidentifiable group of individuals with relatively small shareholdings. They are, in fact, large institutional investors who control more than half the shares of America's 1,000 largest companies. Just 30 pension funds and other institutional investors alone control more than 15% of the shares of the country's ten largest companies. These are smart and powerful investors who wield increasing power over the economic system in the United States.

Despite these changes, the basic responsibilities of shareholders, boards of directors, and corporate managements are straight-forward and have stayed much the same over time. Ned

Regan, the widely admired controller of New York State and sole trustee of its vast pension fund, has outlined the proper responsibilities of each component of corporate governance as follows:

> "Officers should manage the corporation, and they should be subject to the oversight of the board of directors. Shareholders should hold the directors accountable for performing that oversight. Shareholders should not attempt to substitute their judgment for the judgment of the officers who have been selected by the directors."

This very clear statement addresses the accountability of the board of directors. The issue for shareholders is: what is their recourse in the event that they have serious disagreements with the way in which the board of directors is performing its duties?

Under the current proxy rules, an escalating series of recourse steps is available to dissatisfied shareholders. In order of escalation, they are as follows: (1) dialogue with corporate management, (2) communication with the board of directors, (3) withholding votes from the board of directors at the annual meeting, and (4) mounting or voting for an alternative slate to replace some or all of the board of directors.

It is obviously more productive to resolve dissatisfactions at the earliest recourse stage.

Last week, my friend Dale Hanson, who sits with us today, announced that CalPERS will not be filing any proxy resolutions in 1992. Dale plans instead to pursue CalPERS' interests in quiet dialogue with managements or communications with boards of directors. He has found that most corporations are pleased to discuss their financial performance with major shareholders.

Most corporations have been doing that with private institutional investors for years. And, most institutions find that it's far more effective to discuss specific performance issues with individual corporations than it is to push for blanket governance approaches, such as cumulative voting or the elimination of shareholders' rights plans.

I should add that Dale recognizes that the indexed nature of his equity portfolio does present a challenge to having available knowledgeable analysts who thoroughly understand the performance of individual companies, since index investors have very small investment staffs. I know that Dale is wrestling with how to resolve this problem.

Preferable though it may be, we cannot expect that private dialogue with corporate managements or boards of directors will satisfy shareholders in all cases. In this circumstance, shareholders must move to the next recourse step of withholding shareholder votes from the board of directors at the annual meeting and perhaps to the ultimate recourse step of mounting or voting for an alternative slate of directors.

I know of no board of directors that would not be moved dramatically by as little as 20% of the shareholder votes being withheld for the election of directors. The board would perceive itself as being extremely vulnerable and would do everything in its power to attempt to correct the situation which led to this shareholder vote of "no confidence." Yet this recourse step is seldom taken even though it is available under the current proxy rules.

Turning to the ultimate recourse step of mounting an alternative slate, last year the Georgeson Company studied proxy contests for control over the past six years. This study shows that this ultimate recourse step is far more effective than is commonly understood.

The specific results of the study are as follows:

- It found that in 28% of the cases, the challengers won control of the board.

- In 50% of the cases, the challengers either won control at once, won it soon after, or obtained minority representation on the board.

The incumbent retained full control in only 40% of the contests.

The corporate community would agree that boards which are not performing <u>should</u> be replaced and they frequently are. <u>This</u> is the appropriate way to achieve needed reform - not by circumventing the board's proper function with a proliferation of proxy resolutions on specific "micro-management" subjects.

Let me pause here to make a basic point. The stockholders of public corporations are not members of a limited partnership. Limited partners confronting a partnership roll-up need special protections that shareholders do not. Shareholders can exit quickly into a large, liquid equity market. Corporation boards of directors have a fiduciary responsibility to safeguard their shareholders' interests. Shareholders have easy access to a wide variety of published information about the financial condition and business prospects of their corporations. Among corporate shareholders, there are many sophisticated and well-equipped asset managers who have the ability and resources to analyze issues and to demand correction when something occurs that adversely affects shareholder interests.

Limited partners have no such variety of safeguards, and in their position, there may well be a case for action. But, their problems should not be used as an excuse for unnecessary and unwise changes in the corporate setting.

With this background on governance, I would like to turn to the SEC proposal to change the system of proxy solicitation -- a system I would point out that has served us well since the enactment of the SEC Act of 1934. The most significant of the proposed changes would abolish the requirement that proxy solicitation be public -- that it be out in the open, known to anyone with an interest. It is, if I may so characterize it, a radical proposal. I strongly believe it would undercut the SEC's historic premise that investors are best protected by the full disclosure of all actions that would change the nature or degree of an investor's interests or his ability to protect them. It would allow powerful institutional investors to solicit proxy voters in secret, without the other stockholders or the company management being aware of the action.

Allowing the managers of these funds to communicate with each other in secret would change the basic machinery by which corporate decisions are made. There would no longer be disclosure and, therefore, there would no longer be open debate. It would give rumors, half-truths, and misinformation a new force that neither management nor the other shareholders would be able to respond to or correct. Most individual shareholders would not even be aware that an active proxy campaign was under way or of the issues involved. By the time they knew, the deck would be stacked and the fight would be over.

This is a serious threat to the rights of individual investors, more serious than it appears at first glance. The true share<u>owners</u> are the men and women whose money or retirement funds are being invested by the institutional fund managers. It is their money -- as well as the money of other individual investors -- which is at stake. If the amendments are passed, they will have absolutely no right to know what positions their asset managers are taking on proxy issues affecting the value of their investments. Moreover, let me point out, public pension funds are generally controlled by elected officials or political appointees. Most of them are quite aware of their responsibility to protect the interests of the beneficiaries, but they also face other pressures from political and social interests which may conflict with the fundamental interests of the men and women who actually own the shares.

As Thomas O'Hara Chairman of the Board of Trustees of the National Association of Investors, an organization serving individual investors, points out, many corporations already have the power to vote most any change they desire. And, he adds, that, as he sees it, "...from the individual investor's point of view, any enhancement of the institution's ability to control our wealth is unnecessary and dangerous. It doesn't seem prudent to enhance their already dominant power."

These funds have, of course, a right to have a strong voice as shareholders of the corporations in which they have invested.

But as several recent analyses of proxy contests confirm, they have it already. O'Hara asks the right question: Is there any logical reason to increase their power? If there are technical problems with the current disclosure requirements, the answer is to simplify them, not eliminate them. Why is the filing of a simple disclosure statement such a burden for a large, sophisticated institutional investor?

There is another related proposal under consideration. It would eliminate the requirement that the SEC staff review solicitation materials for truthfulness prior to their use. Chuck Corry, the CEO of USX who has been through two proxy fights in two years, has been required to submit materials for review and challenge by the SEC. As he tells it, "If you say your oil business has improved, they make you prove it or change the statement." At first, he told me he found this as "a pain in the neck," but he quickly came to appreciate its value. As he put it, "Icahn's statements were also subjected to the same scrutiny and challenge and this kept the discourse honest."

The nation's experience with junk bonds and the savings and loan debacle has demonstrated the high cost of financial manipulations, manipulations that resulted from lax regulatory oversight. It should be a fair warning not to abandon the proven value of prior review by the SEC that keeps the game honest. No one I've talked to believes that false or misleading statements can be effectively policed by costly, after-the-fact litigation.

Now let me quickly turn to the issue of executive compensation. Clearly, there are compensation practices which have not properly linked compensation to performance and which have resulted in highly overpaid CEOs. The recourse in this situation is identical to the recourse in situations of poor overall corporate performance that we discussed before. Shareholders and boards of directors have both the responsibility and the necessary power to correct these situations. Since it is the shareholders who are being directly disadvantaged, it is the shareholders and not the Congress who should deal with this matter using the recourse steps I outlined earlier.

I would like to make two other comments on executive compensation. First, the headlines which proclaim individual CEO annual payments in the tens of millions of dollars are nearly always the result of substantial gains on the exercise of stock options. These gains are the result of stock price appreciation, benefiting all shareholders. Annual cash compensation, consisting of salary and bonus, is almost never the cause of the over ten million dollar figures that you read about.

Second, option plans can only be utilized when specifically approved by the shareholders. In the typical company, the shareholders authorize a specific number of shares available for options every five years. The board of directors can then divide that specific number of shares in a way that they feel best motivates the employees of the company. In other words, shareholders already have complete control over the aggregate number of option shares granted by their corporation.

Finally, the capital structure of their corporation should also be determined by the shareholders. While the preponderance of common stock today has equal voting rights, there are situations in which a capital structure involving multiple classes of common stock with different voting rights may be desirable. If so, shareholders should be in a position to decide what is best for themselves and for the companies in which they invest.

The key to making this work is a set of procedures which guarantees that shareholders will be fully informed and that widespread consensus among shareholders is reached, not merely a majority. These special protections may include approval by a two-thirds vote or some lesser majority of shares not affiliated with management or other controlling shareholders.

Mr. Chairman, if shareholders have problems, they also have readily available solutions. They can focus their attention and efforts on poorly performing companies, as my friend Dale Hanson does. The current proxy process can be used very effectively without undue cost or burden.

Under the current rules, management must provide full and fair disclosure to all shareholders. Shareholders and shareholder groups should be required to do the same. The rules should not be changed to allow -- indeed to encourage -- secret back room maneuvering by a few to promote an agenda that affects the interests of all shareholders.

Thank you Mr. Chairman and members of the Subcommittee.

TESTIMONY OF

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

SHAREHOLDER RIGHTS: THE ROLE OF THE FEDERAL PROXY REGULATORY SYSTEM

BEFORE THE SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS
UNITED STATES SENATE

OCTOBER 17, 1991

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