The Disenfranchisement of America
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One of the more troublesome aspects of the response of corporate America to the threat of takeovers has been the gradual circumscribing of the voting rights of shareholders through a variety of corporate charter and by-law amendments. Coupled with new state anti-takeover statutes and other corporate actions, this development may have the short run result of impeding changes of control and devaluing certain equity interests. Longer term consequences of a disenfranchisement of shareholders may pose more significant issues. As shareholders' "bargaining positions" are diminished, will corporate managements become less responsive to shareholders' needs and interests? Will investors begin to shift out of corporate equities into other investment opportunities in which capital has a stronger bargaining position, such as debt securities; residential, commercial and industrial real estate; oil, gas and other limited partnerships which offer the prospect of tax sheltered income and appreciation; tangible assets such as gold, silver and commodities; and collectibles such as art, stamps and coins? Under our corporate form of enterprise, more, not less, equity capital is essential to growth and development. The disenfranchisement of shareholders poses a present and real issue that must be debated and addressed.

The single largest piece in the disenfranchisement puzzle has been the recent spate of anti-takeover charter and by-law amendments which reduce the common shareholders' voting rights under certain circumstances. The best estimates are that in 1983 upwards of 200 companies adopted such defensive charter amendments. In 1984 that number has doubled. The movement is not limited to smaller issuers. By the end of this year's proxy season, over 50 of the Fortune 200 companies had adopted some form of anti-takeover amendment.

Most popular among the current crop of proposals are so-called "fair price" provisions. A fair price provision generally becomes operative when a stockholder of a company exceeds a certain level of ownership, usually between 5 and 20 percent of all outstanding shares. In that event, the "interested party" is then required to meet the stipulations in the amendment to avoid incurring supermajority vote requirements to effect a consolidation of corporate assets. One typical stipulation is that the acquirer must pay the same or equivalent consideration for all acquired shares.

Another anti-takeover provision that has been adopted with great frequency is the supermajority vote requirement. Standing alone, or as part of a fair price mechanism, the supermajority voting provision requires that certain types of takeovers must be approved by more than a simple majority of shareholders -- generally ranging from two-thirds to as much as 90%.

A third anti-takeover amendment is the staggered, or classified, board. Under such a provision, the board of directors is grouped into classes -- typically three -- with each class standing for election in a given year. With a staggered board, two elections may be necessary to change a board, even if a majority of shares favors the change.

Finally, companies have proposed the so-called "blank check" stock authorization as another form of anti-takeover posturing. Under such a proposal, shareholders are asked to approve the creation of a new class of stock -- normally convertible preferred -- the issuance and terms of which are entirely within the discretion of the board.

Companies adopting one or more of these anti-takeover provisions, and almost all such proposals have been approved, are effectively devaluing the worth of the common shareholder's vote. For the sake of flexibility and independence in the face of a takeover bid, directors are limiting the ability of a simple majority of shareholders to take action on change of control issues. This movement works an undeniable erosion of a fundamental principle of corporate democracy.

Other developments are conspiring to accentuate this problem. Companies are resorting to more than by-law provisions to discourage takeovers. Certain of these tactics also work a disenfranchisement of shareholders. One such tactic is the creation of multiple classes of common stock with different voting characteristics. There have been a number of recent instances where companies have created two classes of common stock where one class has disproportionate voting rights. A.O. Smith Company, for instance, restructured its voting stock into Class A and Class B common stock. Class A shareholders were entitled to one vote per share and to the election of 75% of the directors. Each Class B share, on the other hand, had only one-tenth of a vote on all matters and the right to vote for the remaining 25% of the Board. Figgie International, Inc. reincorporated in Delaware in an effort to limit the voting rights of major shareholders. Under Figgie's voting provisions, no holder, regardless of shareholdings, is entitled to cast more than 15% of the total number of votes on any corporate matter. In addition, each voting share held by a single stockholder which represented an amount exceeding 10% of the company's shares was entitled to only l/100th of a vote. More recently, Dow Jones & Co., Coastal Corp. and General Motors have instituted similar distinctions in common stock voting rights.

A third aspect of disenfranchisement has been reflected in certain recently adopted or proposed state takeover statutes. Ohio, for instance, has enacted a provision requiring prior approval by a majority vote of the "disinterested shareholders" before consummation of a "control share acquisition." This, of course, disenfranchises those shareholders that are deemed by law to be "interested." Maryland has taken a different approach. Under that system, certain business combinations must be approved by a vote of 80% or more of the company's outstanding shares and 66-2/3% or more of the shareholders other than an "interested stockholder." Pennsylvania, Kentucky, and Wisconsin have new legislation modeled after either the Ohio or the Maryland approach, and it is expected that Michigan and Minnesota will soon follow suit. Laws such as these, though on the surface adopted to protect local economies, all undermine the integrity of "one-share, one-vote."

It is easy to understand why companies may feel compelled to join this movement. Changing economies, as well as the evolution that new technologies have brought to many industries, have created an environment in which there are large and rapid realignments of capital. Such realignments have led to an almost epidemic preoccupation with the possibility of change in control. Managements have sought greater flexibility in order to respond to potential change of control situations. The net perception seems to be that this flexibility can be obtained by tinkering with shareholder voting provisions.

In the short run, the significance of this disenfranchisement is predictable. First, companies that adopt anti-takeover provisions may impede capital realignment and even takeovers themselves. More significantly, there is evidence to suggest a drop in the market price of stock classes affected by these protective charter and by-law amendments. In a study of 87 exchange listed companies that proposed fair price and supermajority provisions between 1980 and 1983, our staff has measured an average net-of-market stock price decline of 3 percent. There was a 5 percent decline for the 40 OTC firms in this study. This represents an aggregate capital loss to shareholders of those 127 firms of $1.35 billion.

These short term consequences may not in themselves be long lasting. They raise, however, broader issues that must be addressed. Under our corporate form of enterprise, equity capital is essential to the growth and development of America. The value of equity capital is, of course, integrally related to the stake in corporate affairs that such equity brings its holders. Anything that devalues that stake, ultimately devalues the equity itself. Thus, disenfranchisement of shareholders through corporate charter and by-law amendments or other anti-takeover protective measures may have the cumulative effect of discouraging equity investment. Shareholders may begin to shift out of corporate equities with circumscribed voting rights and into other investment opportunities in which their capital yields a stronger bargaining position.

There are two areas in which solutions may be considered: shareholder activism and listing standards of self regulatory organizations.

It goes without saying that to the extent shareholders must approve various corporate charter and by-law amendments, those shareholders are in a position to prevent the kind of disenfranchisement about which I have been speaking. The difficulty here has been that the issues raised are complex and do not generate or catalyze wholesale scrutiny by small shareholders. On the other hand, there is a growing indication that larger shareholders, particularly institutions, have become increasingly sophisticated in their review of these proposals. Whereas five years ago it could be predicted that an institutional shareholder would accede to a management proposal -- the so-called "Wall Street Rule" -- today, no such prediction is realistic.

In a 1983 survey of 2,500 institutions, 75% opposed requirements that mergers be approved by supermajorities, and half opposed staggered boards. More recently, a D. F. King study found that 75 of the 100 major institutions were generally opposed to increasing management protective provisions. Certain institutions, including the $11 billion Batterymarch Financial Management and Citicorp's $36 million investment management division, have been particularly outspoken. Moreover there are signs that institutional investors may combine forces. California State Treasurer Jesse Unruh is leading a campaign to form a nationwide Council of Institutional Shareholders. Mr. Unruh is the director of two state pension systems with combined assets of $37 billion. He is interested in a coalition that will stimulate greater institutional activism. Robert Monks, the U. S. Labor Department official who administers federal pension-fund regulation, has spoken out urging pension funds to act like owners. It is estimated that institutions own over 50% of all corporate assets in America. Given that figure, unrest among institutions could stem further erosion of shareholder suffrage.

On the other hand, notwithstanding mounting opposition from institutional corners, all but a few of the anti-takeover proposals considered this year have passed. This suggests that more than institutional opposition is necessary.

Moreover, it may be unrealistic to place great weight on sustained or unified institutional opposition to management. The balance of power still remains on the side of the corporation. Management has not only the greater resources with which to argue the case, but also the implied threat that should an institutional shareholder become too militant, it might imperil other lucrative relationships, such as commercial banking or pension management links.

Finally, too much pressure from institutions has its own downside. There is growing uneasiness with the power wielded by institutional investors. Management, it is argued, must increasingly focus its attention on short term, quarter-by-quarter results. The recent dividend cut by ITT Corp. demonstrates management's predicament. On July 11th, ITT announced that it was cutting its dividend by nearly 2/3 so that it could afford heavy investments in the U.S. telecommunications business. Money managers stampeded to dump their shares. By days end, the price of the stock had dropped by nearly 1/3. Moreover, some suggest that the wave of anti-takeover amendments is a reaction to the pressure by institutional investors for improved short-term performance. Thus, emphasis on institutional activism may be counterproductive.

The second area that may present a solution involves the standards set by self regulatory organizations for listing of securities. The New York Stock Exchange has some rules to assure stockholders of the right to vote their proportionate equity interest and to approve certain corporate actions. The American Exchange offers only limited protections in this area. The NASD imposes no structural accountability requirements on NASDAQ-traded companies with respect to stockholder voting rights. This difference in listing standards creates a competitive imbalance that may act as an incentive for a company to move to the market with the least restrictive conditions. In July of this year, in response to the proposed issuance by three listed companies of a second class of common stock that departed from the one-share one-vote standard, the New York Stock Exchange announced that it would begin a major review of restrictions that it places on listed companies. This review is slated to focus on stock voting provisions and shareholder approval rights.

At present, New York Stock Exchange rules prohibit listed companies from having more than one class of common stock listed on the exchange. Those rules also permit the Exchange to delist or refuse to list any stock of a company that creates a class of stock, whether or not such stock is to be listed, with "unusual voting provisions that tends to nullify or restrict voting" or that has voting power "disproportionate" to the degree of investment it represents. Further, the Exchange's rules require delisting of an issuer's common stock, if the company issues non-voting stock "however designated which by its terms is in effect a common stock." Finally, the Exchange requires shareholder approval of issuance of large blocks of stock.

The AMEX also prohibits the listing of non-voting common stock, but lacks NYSE-type prohibitions against the listing and issuance of classes of stock with different voting power relative to their equity interest. The AMEX will list, for example, common stock which has the right to elect only a minority of the board of directors. There are currently 51 companies listed on the AMEX with two classes of common stock, some of which came to the AMEX after being delisted by the NYSE. Moreover, AMEX regulations, unlike the NYSEs', do not prohibit the issuance of classes of stock that restrict or nullify the voting power of another class of the issuer's stock. Finally, AMEX-listed companies may also create classes of stock with virtually no restrictions as to the properties attached, so long as the stock is not AMEX-listed.

The NASD lacks any rules governing the issuance of multiple classes of common stock with different suffrage characteristics.

Thus, AMEX and NASD rules differ markedly from NYSE rules in that they permit the management of issuers to consolidate control through the issuance of a second class of listed common with minimal or no voting power.

Assuming that the erosion of the one-share, one-vote concept is occurring, and further assuming that such an erosion has negative long term implications, imposition of uniform listing standards may present an orderly check on such an erosion.

The Commission has always encouraged shareholder participation in the corporate electoral process. Further, its responsibilities for regulating proxy solicitation have been premised on the need to assure "fair corporate suffrage" for every securityholder. Thus, the Commission may wish to consider its jurisdiction over the self-regulatory organizations with a view to upgrading and standardizing listing standards as regards shareholder voting.

The developments about which I have been speaking are only now cresting. It is unclear how the situation will ultimately stabilize. Some may argue that the market can assimilate these new developments. Stock with lesser voting rights will be valued accordingly. Issuers seeking to raise equity capital will appreciate the degree of this discount. On the other hand, it is not clear what the impact of disenfranchisement may be on the overall attitude of investors toward equity participation.

In conclusion, the response of corporate America to the threat of takeovers has precipitated what may be a gradual encroachment on the voting characteristics of common stock. To the extent that this encroachment devalues the basic worth of equity investments, significant issues are raised for our capital markets. In the months ahead, the Commission intends to monitor this area carefully and to evaluate possible regulatory responses.