TESTIMONY OF ROBERT A.G. MONKS

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BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

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"This policy of supplying by opposite and rival interests, the defect of better motives, might be traced through the whole system of human affairs, private as well as public. We see it particularly displayed in all the subordinate distributions of power; where the constant aim is to divide and arrange the several offices in such a manner as that each may be a check on the other; that the private interest of every individual, may be a centinel over the public rights. These inventions of prudence cannot be less requisite in the distribution of the supreme power of the state." Federalist Papers # 51

Mr. Chairman and Members of the Committee, I am grateful for the opportunity to appear before you today to discuss this important issue. I would like to begin by correcting one important misunderstanding about the one share, one vote rule. It has been referred to by some commentators on this bill as a new requirement, imposed for the first time, and pre-empting state laws. On the contrary, Federal law for the past sixty years has provided that one share, one vote is a requirement for corporations listed on the New York Stock Exchange ("NYSE"). This is the law today. The only question is whether the Federal government will retain those standards,

standards that have effectively been enforced pursuant to Federal authority since before the stock market crash of 1929.[1]

The pressure to rescind the rule comes from companies who want to prevent takeovers by essentially taking their companies private without having to pay the full price. Chairman Phelan of the NYSE described the problem in testimony before Congress in July of last year: "In response to hostile takeovers, a small but growing number of listed companies have asked their shareholders to approve changes in voting rights that would, directly or indirectly, give management greater control. In some instances, this has involved creating a second class of common stock having multiple votes per share...We have consistently stated--and we repeat now--that the NYSE continues to favor the standard which we alone applied over the past sixty years: the standard of 'one share, one vote'."[2] The NYSE's problem is that dual class capitalization, traditionally limited

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[1] The NYSE is a Self Regulatory Organization under the authority of the Securities & Exchange Commission ("SEC"). This means that the NYSE is free to develop its own rules of procedure, unless such are disapproved by the SEC. The NYSE notified the SEC of its desire to change one share/one vote late in 1985. The SEC held unprecedented public Hearings in December 1986 and has, as yet, declined to approve the requested change. All companies that have elected dual class recapitalizations in the meantime are in a "limbo" category, continuing to be listed on the Exchange, pending final determination of the matter.

[2] Testimony of John J. Phelan, Jr., Hearings before Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce of the House of Representatives, One Hundredth Congress, First Session on H.R. 2172 (Serial No. 100-65), July 29, 1987 at p.538, 543,544.

to a very few, mostly family-run, companies, has all of a sudden become an easy way to protect management from hostile takeovers, and permitting the trading of dual class shares has made some of the NYSE-listed companies consider moving to the other exchanges. It has proven impossible for the Exchanges to agree on a common policy, notwithstanding the efforts of the SEC to promote such a result.

Even if the proposed SEC rule does become final, its impact will not be clear. The decision of the U.S. Supreme Court in April, 1987 in CTS[3] raises the question as to whether Indiana companies taking advantage of their anti-takeover statute would risk having their shares delisted by the NYSE.

The pressures of hostile takeovers have forced the question through the NYSE, the SEC and the Supreme Court to require, as a practical matter, that the Congress decide whether it wants to change what has been for sixty years one of the cornerstones of Federal Corporate Law.

Our testimony[4] presents three arguments for enactment of a Federal requirement assuring one share, one vote. First, it

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[3] 107 S.Ct. 1637 (1987).

[4] Attached to and made a part of this testimony is the written material submitted by Institutional Shareholders Services, Inc. to the Securities & Exchange Commission on December 16 & 17, 1986, including statements by Nell Minow, Richard S. Ruback, John Pound, and Robert A.G. Monks.

is essential that power in a democracy be meaningfully accountable to somebody and that those who bear the ultimate risk of profit or loss in the corporate structure should have the authority and the responsibility of voting control; second, the existing corporate voting process is dysfunctional, recapitalization into two voting classes is coercive and dual classification is irreversible; and third, competitive pressures have vitiated the capacity of both state law and the New York Stock Exchange to do what has to be done. In extremis, Federal involvement is necessary.

Background

"One Share/ One Vote" has played a colorful and dramatic role in American financial history. On October 28, 1925, William Z. Ripley, a Harvard University professor of political economy warned: "[T]he new stock, thus sold, is entirely bereft of any voting powers, except in case of actual or impending bankruptcy. General stockholders, to be sure, have always been inert, delegating most of their powers of election. But at worst they might always be stimulated to assist themselves, and, in any event, they all fared alike as respects profits or losses." Ripley's drawing attention to then current abuses touched off a literal fire storm in the public consciousness and one share, one vote became standard capitalization for the most prominent American industrial companies.

The regulatory framework governing the issuance and trading of public securities and the functioning of exchanges was almost entirely set up by two landmark statutes of the New Deal era. Congress passed the 1933 Securities Act and 1934 Securities and Exchange Act after exhaustive debate and in response to overwhelming evidence of mismanagement, deception and outright fraud during the stock market boom of the late twenties. In the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940, multiple classes of common stock with differing voting characteristics were flatly prohibited for the affected companies. Rather than attempt with industrial companies to remedy specific mistakes or abuses, lawmakers attempted a far more difficult task; they tried to set up a process of corporate accountability--an impartial set of rules preserving the widest possible latitude for shareholders to protect their financial interests. In searching for a reliable and familiar model, they turned to America's own traditions of political accountability. Shareholders were seen as voters, boards of directors as elected representatives, proxy solicitations as election campaigns, corporate charters and by-laws as constitutions and amendments. Just as political democracy acted to guarantee the legitimacy of governmental or public power, the theory went, so corporate democracy would control--and therefore legitimate--the otherwise uncontrollable growth of power in the hands of private individuals. Underpinning that corporate democracy, as universal franchise underpinned its political counterpart, was the principle of one share, one vote.

The one share, one vote standard was carefully adopted by the Federal government in the face of unignorable evidence of the evils of pyramiding and otherwise separating management from the need to account to ownership. Its application to industrial companies through the NYSE listing requirements has until recent changes in competitive conditions been an efficient procedure.

Need for Shareholder Accountability

Throughout American industrial history, public disaster has predictably followed any trend to remove managements from accountability to shareholders. For example, disastrous experience in the 1920's with public utility companies and investment companies who consolidated control in a few voting shares, held by managers, led to the enactment of legislation to impose the one share, one vote rule on those companies.[5] The

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[5] Public Utility Holding Company Act of 1935 (15 U.S.C. Secs. 799-79z-6) and Investment Company Act of 1940 (15 U.S.C. Secs. 80a-1-54).

Public Utility Holding Company Act was a response to a 78 volume report prepared by the Federal Trade Commission ("FTC") (S. Doc. No. 92, 70th Cong., 1st Sess., pt. 72-A et. seq. (1935)). In the report, the FTC noted:

> Instead of the corporation on one side and the public, on whom it will depend for trade and revenue, on the other, as was the case originally, we have a third party of minority ownership but with management and control which may be likened to absentee landlordism. Obviously, whenever this managerial group becomes swayed with lust for power and greed for excessive profits, the many other stockholders are treated as having few, if any, rights. In many instances, such managerial groups have failed to act as trustees for their corporations and other stockholders, as in equity they are supposed to do. (Id. 73-A at 64)

The Investment Company Act is also especially relevant here. The legislative history shows that it was enacted in response to three factors: the large proportion of investors involved (one out of 10 investors was a participant in an investment company, according to the SEC staff report to Congress), the serious discrepancy between equity interest and voting rights, and the consequent conflicts of interests between the senior and junior shareholders. The SEC found that multiple classes of stock with divergent voting rights were a major factor in the corruption and abuse prevalent in the investment industry in the 1940s. Section 18 of the Act, applying one share, one vote to investment companies, was adopted in response. Management must be made accountable to shareholders who can vote them out.[6] Last year, Arthur Levitt, Chairman of the American Stock Exchange, noted:

> One of the historical sources of the New York Stock Exchange rule against non-voting stock lay in the use of such shares in the public utility industry in the 1920's: non-voting stock was a key device that underlay the pyramiding of personal control in that industry and that ultimately led to collapse, to a tragic loss of public confidence in our capital markets, and to direct Federal regulation in the form of the Public Utility Holding Company Act. Hearings before the Subcommittee on Securities, supra, at 1171.

Corporate efficiency and legitimacy depends on the managers who are, in effect, the agents of shareholder-principals. To the extent that the "agency costs" of managers increase, productivity and innovation will decline. In an important analysis published in the Journal of Law and Economics, for example, Frank Easterbrook and Daniel Fischel argued that the separation of residual claims from voting power will always create agency costs which contribute to substantial inefficiencies in corporate oversight. They found that the one share, one vote rule ensures that no unnecessary agency costs will be created.[7]

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[6] The NYSE's adoption of the one share, one vote rule was influenced by Main Street and Wall Street, by W. Ripley. In his book he described particularly outrageous examples of abusive practices. In one, Industrial Rayon issued 600,000 shares of common stock. Only 2,000 carried voting rights.

[7] Easterbrook, Frank H. and Daniel R. Fischel, Voting in Corporate Law, XXVI Journal of Law and Economics 395, 410-11.

As the shareholder loses even the theoretical ability to control corporations by holding their managers to account, those corporations will cease to pay attention to the need to maximize profits. They will become bloated and inefficient, causing dislocation in supply and demand, and performance will drop. Furthermore, if managers cannot be held responsible for meeting clear, public standards of performance such as profits, sales or growth, then their focus of attention will shift from outside to inside the corporation. Managers will place a higher value on maintaining good relations with employees, suppliers or local communities than on increasing market share through improved products or services. The inevitable goal of the corporation will become self-perpetuation, the inevitable result will be a stifling level of bureaucracy.

This is not all, however. Once it becomes readily apparent that the mechanisms of corporate control are illusory--then the rationale for state and Federal governments not intervening in the private sphere will disappear. Governmental interference and regulation will be seen as the natural alternative, with exponentially greater agency costs and predictably disastrous results. American corporate capitalism will come to resemble European corporate socialism.

Voting Deficiencies

"It is the shareholders after full disclosure, who determine voting rights within their corporation."[8] This sentiment, presented as part of a concurring Senate Committee report, unfortunately confuses tradition and theory with the practical reality. It must be recognized that the existing state of corporate democracy makes those two words the classic oxymoron.

The statement from the Committee report is inapplicable here for two reasons. First, shareholders are structurally prevented from "determining" anything through the proxy system. "Since they offer the voter no real choice, these elections are "democratic" only in a very limited sense. They are procedurally much more akin to the elections held by the Communist Party of North Korea than those held in Western Democracies."[9] Management controls the ballot and counts the votes. Inefficiency, corruption, and, again, agency costs, prevent the beneficial owners from having any say in how their shares are voted.[10] Those who reiterate the absolutely essential element in corporate

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[8] Additional Views of Senators Sasser, Sanford, and Chafee, Report of the Committee on Banking, Housing and Urban Affairs, Unites States Senate to accompany S. 1323 (December 17, 1987), at p. 87.

[9] Epstein, Edward J., Who Owns the Corporation, Twentieth Century Fund, 1986, at p. 13.

[10] See Conflicts of Interest in the Proxy Voting System, James E. Heard and Howard D. Sherman, Investor Responsibility Research Center.

governance that some majority of shareholders approve a particular action, do not recognize that "shareholdings in thousands of companies, dispersed among tens of millions of individuals, tend to be too fragmented to organize around any kind of election campaign."[11] Shareholder approval under present circumstances is meaningless.

The process by which shareholders are presented with a proposal for recapitalization into dual classes of voting stock is inherently coercive. Apparent efforts to provide equal value for each choice backfire, in fact, increasing the coercive character of the recapitalizations. Easterbrook and Fischel said, in discussing the possibility of a market in votes, "The collective choice problem would exert a strong influence over the market price of votes. Because no voter expects to influence the outcome of the election, he would sell the vote (which to him is unimportant) for less than the expected dilution of his equity interest. He would reason that if he did not sell, others would; he would then lose on the equity side but get nothing for the vote...Thus, the legal rules tying votes to shares increase the efficiency of corporate organization." By enacting provisions which skew the voting power of different classes of stock and thereby protecting directors and officers from removal, management tends to make itself self-perpetuating at the expense of shareholders.

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[11] Ibid., at p. 43.

Giving any shareholders the opportunity to dilute or relinquish their votes puts them on the horns of a dilemma. Massachusetts Institute of Technology professor Richard Ruback has demonstrated that "The terms of the dual class recapitalization can be structured to compel individual outside shareholders to exchange even though the outside shareholders, acting collectively, would choose not to exchange...(so that) the rational choices by individual outside shareholders leads to an outcome that harms the outside shareholders" as a group. (Emphasis in original.) In other words, when the issue of limited voting rights is presented to shareholders, a rational, fiscally optimal choice made by an individual may, when made by enough individuals to carry the resolution, result in significant reduction in value of the holdings of all of them.

Need for Federal Action

We share the concerns of the Committee about Federal preemption of matters traditionally left to the states. But one share, one vote has traditionally been an NYSE listing standard, imposed at the Federal level through the SEC's approval of standards issued by a self regulatory organization. As was apparent throughout its testimony to the SEC in December 1986, the NYSE submitted its proposed change despite its own finding that the one share, one vote rule is "good for its listed companies, good for their shareholders, and good for this country...has served the market well, [and]...[i]n an ideal world, most people would want it to be retained."[12] The NYSE has found, however, that it can no longer be the sole standard bearer, as major companies threatened defection to the other Exchanges, unless the rule was rescinded.

The recent opinion of the U.S. Supreme Court in CTS v. Dynamics Corporation of America[13] calls into question the status of the one share, one vote doctrine and whether the standard can continue without explicit statutory authorization.

The current situation is chaotic. Private, state, and regulatory action have been proven incapable of resolving it. This is just that rare situation that justifies Federal

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12 Testimony of the New York Stock Exchange to the Subcommittee on Telecommunications, Consumer Protection and Finance of the Committee on Energy and Commerce, United States House of Representatives, May 22, 1985; see also testimony before the Securities Subcommittee of the Committee on Banking, Housing and Urban Affairs, United States Senate, June 12, 1985).

Apparently, even in the real world, most people want it to be retained. Careful reading of the NYSE's submission to the SEC shows that the 86 percent favorable rating it cites for listed companies is only the percentage of those responding who were in favor of changing the rule. In fact, only 13 percent of the 3224 Exchange constituents and other interested parties surveyed on this issue responded at all, suggesting little interest in changing the rule. Only 249 (less than 8 percent) of all of those surveyed responded in favor of the change. (Submission of the NYSE, File No. SR-NYSE 86-17, Exhibit B.)

13 See note #3, supra.

involvement. One share, one vote is a seminal concept--a notion that is central to the legitimacy of private power in the United States. It is appropriate for the Federal government to establish one share, one vote as an indispensible characteristic of corporate existence in the United States. It is analogous to the fundamental liberties guaranteed to citizens under the Bill of Rights to the Federal Constitution.