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Conflicts between Institutional Investors and Retail Investors in using Federal Securities Laws to regulate Campaign Finance

TESTIMONY

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Capital Markets, Insurance and Government Sponsored Enterprises

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Chairman Kanjorski, Ranking Member Garrett, and distinguished members of the Committee, it is a privilege to testify in this forum today. My name is J.W. Verret. I am an Assistant Professor of Law at George Mason Law School, a Senior Scholar at the Mercatus Center at George Mason University and a member of the Mercatus Center Financial Markets Working Group. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of state and federal authority in corporate governance.

There are two types of shareholders in American publicly traded companies. The first are retail investors, or ordinary Americans holding shares through retirement funds and 401(k)s. Half of all American households own stocks in this way. The other type of investor is the institutional investor, including union pension funds as well as state pension funds run by elected officials. H.R. 4537, the “Shareholder Protection Act of 2010,” seeks to give those institutional investors leverage over companies for political purposes at the expense of retail investors.

H.R. 4537 attempts to hijack the securities laws to regulate campaign finance. It would limit the ability of companies to communicate with legislators by giving Union shareholders power to stop those communications. This bill would not, however, limit Union political spending in any way. Further, it has nothing to do with the investor protection goals of the Securities Exchange Act.

Shareholders have two available remedies if they become dissatisfied with the performance of their companies. Shareholders can sell their shares, or they can vote for an alternative nominee in the next annual election of the Board. And they do both with some frequency. In the rare event that political advocacy actually results in corruption, there is a third line of defense in place. If the Audit Committee of the Board of Directors, which is independent of company management, determines that any political donations are inappropriate they are required under the Foreign Corrupt Practices Act to stop them immediately.

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The structure of American corporate law rests the authority to manage the day-to-day affairs of the company, including decisions of how to invest the company's funds, with the Board of Directors. Putting corporate expenditures to a shareholder vote, as H.R. 4537 requires, is the first step toward turning shareholder votes into town hall meetings. Some shareholders may want the company to locate a new factory in their town or give away free health benefits for employees without regard to whether the expenses risk bankrupting the company.

Shareholders choose the board of directors and delegate authority to make these decisions to the board in order to avoid that very problem. California's voter referendums have made its Constitution one of the longest in the world and helped precipitate its budget crisis. H.R. 4537 is a first step down a similar path for American companies.

Political risk poses a danger to the 401(k)s of ordinary Americans more now than ever before. Political leaders responsible for policies that subsidized dangerous mortgage practices through Fannie Mae and Freddie Mac now seek to expand financial regulations to generate the appearance of responsive action.

Against this backdrop, the Supreme Court recently affirmed that corporations have a constitutional right to advocate on behalf of their shareholders. Corporations do so particularly to protect the property rights of those shareholders from expenses associated with regulations whose benefits may exceed their cost. Many reputable companies spend money for this purpose. Berkshire Hathaway, one of the most highly regarded companies in America, spent \$3 million dollars last year advocating for the interests of the company and its shareholders.

This bill purports to re-define state corporate law to make un-voted expenditures a violation of the corporation's fiduciary duty to its shareholders. This represents a serious misunderstanding of how corporate law is structured. As Justice Powell wrote, "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."

The bills under consideration would also add disclosure requirements for political spending, but political expenditures rarely approach the materiality requirements of the securities laws sufficient to require disclosure. In 2008, for example, Exxon Mobil reported political expenditures of roughly \$450,000. In that same time period it earned \$45 billion dollars. Its political expenditures amounted to .001% of annual earnings. If shareholders had the time and expertise to review corporate expenditures at that minute level, they would be running companies rather than investing in them.

The Shareholder Protection Act of 2010 has absolutely nothing to do with reforming financial regulation in response to the financial crisis, and is indeed a distraction from that vital work. It is a power grab by union pensions funds and state elected treasurers in an attempt to enhance their leverage over the retirement savings of ordinary Americans. To call H.R. 4537 a "Shareholder Protection Act" is fundamentally misleading.

I thank you for the opportunity to testify, and I look forward to answering your questions.