

Testimony as Prepared for Delivery before the Senate Banking Committee

Hearing on Corporate Governance Policies

By Phil Gramm

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Chairman Crapo and Ranking Member Brown, it is a privilege to testify before the committee I served on and chaired for eighteen years. I accepted your invitation because I believe the debate about how corporate governance is structured and who money works for will have a profound impact on our prosperity and freedom. I respect the opinions and good intentions of those who would collectivize America's corporate structure, but I believe such policies would hurt the very people they seek to help.

The Enlightenment liberated mind, soul and property, empowering people to think their own thoughts, worship their own gods and benefit from the fruits of their own labor and thrift. As labor and capital came to serve their owner, not the crown, the guild, the church or the village, medieval economies began to awaken from a thousand years of stagnation. The Parliament in England stripped away the leaching influence of royal charters and initiated reforms that ultimately allowed businesses to incorporate by simply meeting preset capital requirements. Parliament further established in law the principle that business would be governed by the laws it passed, in a process of open deliberation, not by the corrosive influences and rampant cronyism that were pervasive in the medieval marketplace.

The Enlightenment recognized that the crown, guild, church and village had become rent seekers, leaching away the rewards for work, thrift and innovation and in the process reducing productive effort and progress. The Enlightenment principle that labor and capital were privately owned property and not communal assets subject to involuntary sharing, unleashed an explosion of

knowledge and production, creating a never before equaled human flourishing that continues to this day.

Extraordinarily in America, the crown jewel and greatest beneficiary of the Enlightenment, political movements are afoot that seek to overturn the individual economic rights created in the Enlightenment and return to a medieval world of subjects and subjugation. Today we hear proposals to force businesses to again swear medieval fealty to “stakeholders” – the modern equivalent of crown, guild, church and village – “the general public...the workforce...the community...the environment...societal factors”. These stakeholders would not have to “stake” any of their toil or treasure, but, as they did in the Dark Ages, they would claim communal rights to share the fruits that flow from the sweat of the worker’s brow, the saver’s thrift and the investor’s venture.

Whereas the Enlightenment was based on the principle that people owned the fruits of their labor and thrift, America now faces a host of proposals to force the sharing of economic rewards that take us back to the medieval concept of communal property where the powerful few could extort part of the fruits of your labor and capital using the logic that if you own a business “you didn’t build it”.

Thankfully, many of these proposals to overturn the Enlightenment’s concepts and benefits of economic freedom would at least employ its democratic process by seeking to change the law. This latest struggle for the survival of economic freedom and prosperity will be played out in elections during the next decade. But an even greater threat to the Enlightenment’s economic foundations comes today from the surreptitious battle now being waged in stockholder meetings and corporate board rooms across the country. Today political activists are pressuring corporate America to adopt political, social and environmental policies that would subvert labor and capital in ways that have been rejected by State Legislatures, the Congress, and the Courts.

Past reforms by Congress, the SEC and the courts, designed to enhance shareholder rights, have unintentionally empowered special interest groups to subvert corporate governance, forcing corporations to deal with political and social problems they were never designed or empowered to deal with. The explosion of index funds, whose managers vote shares they do not own, has dramatically increased the danger posed by political activists not just to American corporate governance but to our prosperity and freedom as well.

Today index funds hold 17.2% of all U.S. shares and are the largest shareholder in 40% of all U.S. companies. Their future growth seems guaranteed by the tremendous price advantage gained by simply buying a slice of various equity indices rather than incurring the cost of analyzing each investment. But such efficiency is not free. An index fund's profitability is not significantly affected by the performance of any given company in the index since their primary competitors sell the same indices. Therefore index funds and their proxy advisers have neither the knowledge nor the aligned interest to make informed judgements on business-specific questions that arise in the stockholder meetings of the companies in which they control an ever-increasing share of stockholder votes.

When index funds vote their investor's shares on broad social and political issues, the problem is not just the lack of aligned interest and knowledge, the problem is that index funds have a glaring conflict of interest. On those high profile issues, the profitability of the scale-driven index fund business will be affected largely by how the public perceives the vote the fund cast and how that vote affects the marketing of the firm. The index funds financial interest, therefore, can and often will conflict with the investor's interest.

Before his death, the great Jack Bogle, founder of Vanguard, urged legislation to explicitly impose a fiduciary duty on funds "to vote solely in the interest of the fund's shareholder". Anybody voting somebody else's shares or advising on how to vote those shares should be bound by strict

fiduciary responsibility. But even enhanced fiduciary responsibility won't solve the inherent conflict of interest that index funds face in voting investor shares on high profile social and political issues that have a potential impact on the marketability of the fund. On those issues maybe it is time for the SEC to require that index funds poll their investors and vote their shares only as specifically directed. We cannot allow the economic interest of index funds to effectively convert "private purpose" C corporations into "public benefit" B corporations which the investors in general index funds didn't invest in.

History teaches us that if we want to be prosperous and free, within the Rule of Law, we must let private interest create wealth and reap the rewards of its creation. Only after wealth has been created should we debate the cost and benefits of taxing and redistributing it.