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<u>Introduction</u>

Chairman Brady, Ranking Member Lungren, and members of the Committee, I thank you for the opportunity to testify.

The DISCLOSE Act (H.R. 5175) is an important, corrective response to the shock of *Citizens United*. I am a corporate law scholar, and former corporate lawyer (having been a partner at Wachtell Lipton), and I do not view myself as expert in constitutional law. I will not engage the question of whether *Citizens United* was or was not consistent with Supreme Court precedent generally, or whether the DISCLOSE Act is constitutional. I can say with confidence, however, that *Citizens United* radically unsettled long-standing expectations of corporate owners about corporate governance and federal election activity, and that the DISCLOSE Act will assist corporate owners, at a reasonable cost, in trying to address the new governance risks that *Citizens United* creates. I will comment on three aspects of the DISCLOSE Act that will improve corporate governance – the disclosure requirements, the endorsement requirements, and the inclusion of conduits in the new disclosure regime – as well as the foreign control provisions, each of which I favor.

Federal elections have long been understood as off-limits for US corporations. This understanding predated the formation of most currently active US corporations. This understanding thus predated the basic bargains over governance struck between shareholders and creditors, on the one hand, and directors and managers, on the other. As a result, the owners of most currently active companies had in the past no reason to address federal election activity in making investment or governance decisions. To be sure, investors have not thought that corporations would be banned from all political activity – corporations have long participated as advocates for legitimate corporate ends, including through policy advocacy, lobbying, research funding, and opinion leadership, and through separately funded political action committees. The legitimate business interests represented by corporations have been amply represented in robust exercises of First Amendment rights – and all of that will continue unaffected if the DISCLOSE Act is passed.

For closely held companies, which are the most common form of company, individual shareholders have been and continue to be able to extract profits and use them to participate directly in election activity in their individual capacity. They really did not need *Citizens United* to help them, contrary to what the Supreme Court seem to think. Consider Michael Bloomberg, for example: his “corporate wealth” was available to him both before and after Citizens United for any political purpose otherwise permitted to the rest of us, and would remain available whether the DISCLOSE Act is passed or not. Ted Olson’s arguments to the contrary notwithstanding, the DISCLOSE Act would have no meaningful impact on the ability of the individual US citizen-owners of US companies to speak freely in elections. But public companies, not private companies, hold most of the dollars of invested capital in the US, account for the great bulk of economic activity, have the weakest governance (in terms of protecting owners’ interests), and represent the most

important channel through which *Citizens United* affects owner governance of corporate political activity.

What owners of public companies had long understood – before *Citizens United* – is that they did not need to worry about managers using corporate funds to pursue managers' personal political ends, such as through the election of individual officials, without regard to whether those pursuits would in fact benefit owners.[1] Owners did not need to negotiate disclosure requirements, or monitor expenditures, or install control systems, because the underlying activity was thought to be illegal. Put simply, *Citizens United* created a massive new risk for investors in US companies, one that is not currently addressed in any meaningful way by existing corporate governance mechanisms, or by state law, or by SEC regulations, or stock exchange rules. That risk is that corporate managers will misuse corporate funds – "other people's money" in Louis Brandeis's classic phrase[2] – to pursue their own, personal, political objectives, which would not be supported by all, or even a majority, of shareholders, and that they will be able to do this secretly, without any disclosure or possibility of a private corporate governance response to correct this misuse. In stark terms, the risk is that corporate managers will steal shareholder money, and pervert the very First Amendment rights – the rights of corporate *owners* – that the slim majority in *Citizens United* purported to protect.

The DISCLOSE Act is an important corrective to the new governance risk created by *Citizens United*. By requiring real-time, ongoing disclosure of election expenditures, the bill would allow shareholders to monitor the use of their capital in the election context, and take whatever actions they want to discipline managers for misusing their funds. Investors will be able to learn the level of new political activity permitted by *Citizens United* in the companies in which they invest. They can look for patterns consistent with managerial pursuit of private interests. If patterns are found, they can engage in self-help, by selling their shares, by suing managers for "waste" of corporate assets,[3] or by proposing bylaw amendments to directly control political activity, or if managers act particularly egregiously, to pressure boards to discipline managers.[4]

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[1] This risk is consistent with most research on corporate PACs, which finds little evidence that it produces benefits for corporate sponsors of the PACs, and instead appears to be a form of managerial "consumption" – i.e., undertaken primarily to benefit the private interests of corporate managers. Stephen Ansolabehere, John M. de Figueriredo & James M. Snyder, Jr., Why is There so Little Money in U.S. Politics?, 17 J. Econ. Persp. 105-130 (2003) (surveying numerous prior studies); cf. Michael J. Cooper, Huseyin Gulen & Alexei V. Ovtchinnikov, Corporate Political Contributions and Stock Returns, 65 J. Fin. 687 (2010) (finding positive correlation between corporate PAC contributions and subsequent abnormal stock returns and earnings, with the strongest effects for contributions to House Democrats, but not being able to conclude the effect is causal).

[2] Other People's Money – And How the Bankers Use It (1914).

[3] Victor Brudney, Corporations and Stockholders' Rights under the First Amendment, 91 Yale L.J. 235 (1981).

[4] The practicality of shareholder self-help should not be overstated. Collective action problems, including free-riding, as well as legal impediments, will make it hard for shareholders to implement restrictions of the kind suggested in the text. Nevertheless, without the disclosures required by the DISCLOSE Act, such self-help will be even more difficult, if not impossible.

The DISCLOSE Act's disclosure requirements also fit perfectly the role that the federal government has played for over 100 years in the governance of public companies. Through the SEC, the federal government has imposed detailed disclosure requirements on companies that wish to sell their stock to the public, and ongoing disclosure and reporting obligations as long as that stock is widely held or traded on a stock exchange. In addition, federal law has long forbidden fraud, including misleading statements as well as deceptive omissions when companies speak. Since corporations are required to speak to their investors regularly, federal law has long essentially imposed a broad ban on speech that is materially misleading, even by omission. These requirements have never been seriously challenged as unconstitutional, even though they clearly impose "burdens" on a corporation's ability to speak freely – corporations in essence have long been required to speak more carefully than individuals. It is primarily through these requirements that the federal government has supplemented private contract, state corporate law and stock exchange rules in the governance of public companies. The DISCLOSE Act's disclosure requirements, in short, are entirely consistent with a long tradition of federal regulation of corporate governance, and will be beneficial for precisely the same reasons that disclosure has generally been thought beneficial for investors.

It may be asked why the corporate governance risks associated with involvement of corporations in election activity is different in kind from the risks associated with other kinds of political activity in which corporations could and did engage prior to *Citizens United*, such as lobbying, or of other activities in which corporations engage that are not necessarily directly related to their business strategies.[5] Election expenditures are particularly risky for shareholders for three reasons. First, other political activities of corporations have long been permitted, as noted above. As a result, *Citizens United* represents no "shock" to corporate governance arrangements as applied to those kinds of activities, and existing disclosure laws and other governance arrangements are more likely to provide sufficient information about those activities to owners. Second, election activity by definition involves attempting to influence the election of an official, who will vote on numerous laws, most of which will have little or no effect on the legitimate business interests of any given corporation, so that a dollar spent by a corporation in an election fight will typically have a greatly diluted impact relative to the same dollar spent in direct lobbying on issues of interest to the corporation's owners. Third, because an elected official will have to vote on a range of issues, the probability that any public company's shareholders will have uniform set of preferences over how the official will vote are nearly zero. Any corporation the managers of which make election expenditures

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[5] Charitable donations are another similar activity, long controversial among governance scholars. See Victor Brudney & Allen Ferrell, Corporate Charitable Giving, 69 U. Chi. L. Rev. 1191 (2002). The difference between charitable work and election work is that charities are already subject to separate reporting regimes, and have generally involved "trivial" corporate expenditures, id. at 1198. If corporate election expenditures remain similarly low in the future, then further governance reform to address them would not then be warranted. But the only way for owners to know if the expenditures in fact remain low is for the kind of disclosure regime required by the DISCLOSE Act to be adopted.

will inevitably be neglecting or harming the preferences of a large fraction (even a majority) of the company's shareholders on most of the issues on which the official will vote. A corporation that confines its expenditures to lobbying, by contrast, will be able to target issues that affect the corporation directly, and thus that affect shareholders (as such) uniformly.[6] Even if some shareholders may disagree even about core business strategies (and thus specific political issues of direct concern to the corporation), the odds that a majority of shareholders will disagree with managers' views will be much lower.[7]

For those reasons, it is my firm belief that most owners of public companies do not want their corporations to compete in elections. Owners certainly do not want companies to end up in an arms' race of zero-sum competition, with each company drawing on general treasury funds in an effort to outspend rivals in election campaigns, with little net effect on political outcomes, all the expense of shareholders. A more straightforward example of socially harmful rent-seeking could not be found. The DISCLOSE Act will reduce the risk of such harms, and thereby benefit the majority of voters who are also shareholders.[8]

A second component of the DISCLOSE Act that is useful from a corporate governance perspective is the requirement that CEOs personally endorse the use of corporate funds in elections. A long line of research in management shows that personal attention from senior management has an important disciplining effect on the potential misuse of corporate funds. In the political arena, this may be a particular benefit, as studies document that senior management of large companies have been caught unawares by the political involvements of their companies, instituted by lower level employees without adequate supervision – and this was in the context of traditional corporate political activity, such as the funding of trade associations.[9] Occasionally, this activity has been brought to the attention of senior management – often through the unfortunate means of public criticism and unwanted media attention on controversial political positions taken by trade groups nominally on behalf of shareholders on issues that had nothing to do with

[6] Research suggests that companies that engage in large amounts of lobbying "appear to be more bipartisan and less ideological than other groups" active in politics, "giving more equally to both parties and more broadly across the ideological spectrum." Stephen Ansolabehere, James M. Snyder Jr. & Micky Tripathi, Are PAC Contributions and Lobbying Linked? New Evidence from the 1995 Lobby Disclosure Act, 5 Bus. & Pol. 131 (2002). Research also suggests that lobbying is more effective than corporate PAC donations. See note 1 supra; Brian K. Richter & Krislert Samphantharak, Lobbying and Taxes, 53 Am. J. Pol. Sci. 893 (2009) (finding that lobbying expenditures result in lower taxes for the average firm that lobbies).

[7] There may also be broader social effects of corporate lobbying (particularly of the purely redistributive kind consistent with Richter et al. noted in note 5), and I do not here mean to defend all types of corporate lobbying, only to make the point that corporate lobbying is less likely to harm shareholders' interests than election expenditures, and thus is much more defensible from a corporate governance perspective than electioneering. Lobbying, in any event, is subject to a disclosure regime of its own. E.g., 2 U.S.C. § 1601 et seq.

[8] Research provides evidence that greater transparency reduces rent-seeking. E.g., Helena Svaleryd & Jonas Vlachos, Political Rents in a Non-Corrupt Democracy, 93 J. Pub. Econ. 355 (2009).

[9] Center for Political Accountability, Hidden Rivers (2006), available at: www.politicalaccountability.net/index.php?ht=a/GetDocumentAction/i/932

genuine corporate interests. Once discovered, these activities have often been reversed, consistent with my view that owners – and boards of directors acting on full information – will typically not want their companies to engage in general political activities ranging far a-field of legitimate business interests. In the new post-*Citizens United* era, the risks of misuse by lower level employees will be intensified if the DISCLOSE Act is not enacted and CEOs are not required to take control of their companies' election-related expenditures.

A third component of the DISCLOSE Act that promises to counteract the corporate governance risks created by *Citizens United* is the requirement that corporations report the election activities of conduits and other expenditure-laundering organizations to which the corporations make donations. The use of shell entities or general purpose trade associations to eliminate the paper trail associated with corporate political activity was already a problem prior to *Citizens United*, and *Citizens United* dramatically raises the stakes for this kind of subterfuge. By requiring disclosure of transfers of funds to other organizations with the purpose of influencing elections, the DISCLOSE Act will shine a light for the first time on the shadowy relationships between companies overtly run for the benefit of shareholders and the networks of election activist organizations the primary purpose of which is to engage in political activity.

Without these requirements, the other disclosure requirements in the bill would be worse than useless – they would help camouflage the ability of corporate managers to waste shareholder money by allowing corporations to officially report low (direct) election expenditures while secretly ramping up their (indirect) election activities. Here, the role of nominally general purpose donations to advocacy groups is even more troubling, since for-profit corporations have sought to avoid being linked to direct election activity by turning over large sums with no formal strings attached to these groups. As a result, these groups have been free to diverge even farther from shareholder goals than corporate managers have been able to do directly. In effect, the role of general purpose donations to such advocacy groups has been to double down on the agency problems troubling America's corporate governance system: first, managers diverge from shareholders' interests, and then the chieftains of the advocacy groups diverge even further, all without any information being provided to shareholders, on whose behalf all of this activity is supposedly undertaken.

Finally, the part of the DISCLOSE Act that bans foreign-controlled US corporations from participating in US elections is also a good change. To facilitate US economic development, US law has long attempted to permit US companies to be created quickly and cheaply, without any requirement that they have capital, employees, or even an economic purpose. Thus, many companies – both US and foreign – have thousands of "shell" subsidiaries in the US whose sole purpose is to hold assets or own other companies.[10] Prior to *Citizens United*, none of these shell companies could engage in election activity. After *Citizens United*, all of them can – even if controlled by foreign persons otherwise banned from such activity.

[10] In 2009, Morgan Stanley alone reported 1,306 subsidiaries (50% organized in the US, 50% foreign), 1,122 wholly owned (www.sec.gov/Archives/edgar/data/895421/000119312509013429/dex21.htm).

A prominent example is CITGO, which was created as a wholly owned US subsidiary of Occidental Petroleum in 1983, and later had its stock sold to the national oil company of Venezuela. Prior to *Citizens United*, CITGO could not engage in US election activity . After *Citizens United* it can, even though it is controlled by Hugo Chavez. I, for one, would make clear that US election candidates do not have to compete for US voters' attention during election season with the US subsidiaries of The CITIC Group (the state-owned investment company of the People's Republic of China), OAO Gazprom (the world's largest natural gas company, controlled by the Russian government), or, for that matter, Societe Generale (the French bank that was able to extract more than $10 billion from US taxpayers via the AIG bailout).

Some claim that current US law, which forbids foreign persons from directly or indirectly engaging in US election activity, would apply to CITGO, since its activities would represent indirect activity of Venezuela. That argument does make a kind of common sense – why, indeed, should foreign persons be able to do indirectly what they cannot do directly? But I am unaware of any authority for this proposition, and existing law restricting the political activity of foreign persons risks being evaded by the very kinds of legal "creativity" and judicial "activism" – terms that I do not intend as compliments – that infuses *Citizens United*, which treats US corporations, such as CITGO, as distinct "persons" for First Amendment purposes, despite the fact that the First Amendment nowhere contains the word person, despite the fact that the US Constitution nowhere mentions corporations, and despite the fact that the only corporation that was a party to the case was a closely held corporation formed expressly to participate in political advocacy, unlike the vast majority of corporations affected by the decision. Perhaps those who assert that current law governing foreign persons is sufficient are correct, but I for one do not trust the common sense of the current Supreme Court, at least in cases involving corporate political activity. In any event, it cannot hurt for Congress to clarify the law in this respect, to make it clear that foreign persons are not permitted to use US corporations to engage in activities that are and should be limited to US citizens. In doing so, Congress will simply be doing what it has already done in numerous other areas of law, including purchases of stock of US companies involved in telecommunications,[11] airlines,[12] defense contracting,[13] maritime shipping,[14] fishing,[15] banking,[16] mutual

[11] 47 U.S.C § 310(b) (foreign persons may not own >25% of a US air cargo company).

[12] 49 U.S.C. § 40102(a)(15) (foreign persons may not own >20% of the stock of a US telecom company).

[13] See Christopher F. Corr, A Survey of United States Controls on Foreign Investment and Operations, 9 Am. U.J. Int'l L. & Pol'y 417 (1994) (describing restrictions on foreign ownership of companies that do business with the Department of Defense); Melvin Rishe, Foreign Ownership, Control, or Influence: The Implications for United States Companies Performing Defense Contracts, 20 Pub. Cont. L.J. 143 (1991) (same).

[14] 46 U.S.C. § 55102 (vessels in inland maritime transport must be owned by US citizens).

[15] 46 U.S.C. § 12102(c) (foreign persons may not own >25% of companies owning US fishing vessels).

funds,[17] nuclear energy,[18] or any activity foreign control of which is deemed a threat to national security.[19]

In effect, Citizens United created a giant loophole in the pre-existing law governing foreign election activity. Justice Alito's reaction to the President's State of the Union speech suggests that at least some members of the Supreme Court did not even realize what they had done. The DISCLOSE Act will close that loophole, and restore the sensible status quo position – that just as foreign individuals cannot vote in US elections, foreign-controlled US companies should not be able to influence US elections through election activity.

In sum, *Citizens United* was a radical shift in US corporate governance. The DISCLOSE Act is an important, tailored response, following in the tradition of federal disclosure laws that date back to the Securities Act of 1933. It will enable shareholders to monitor and respond to corporate election expenditures; it will reinforced existing control systems by requiring senior managers to be personally involved in such expenditures; and it will prevent managers from evading these requirements by relying on conduits and general purpose donations to do indirectly what they know shareholders would not want them to do directly. In addition, by closing the loophole in current laws limiting US election activity to US citizens, the bill straightforwardly corrects a mistaken legal consequence of the *Citizens United* decision.

Thank you for your time. I would be happy to answer questions on my testimony, or other aspects of corporate governance or other issues raised by the DISCLOSE Act. I hope you will proceed to pass the DISCLOSE Act as rapidly as possible.

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[16] http://www.federalreserve.gov/pf/pdf/pf_5.pdf (foreign persons cannot acquire >5% of US bank or bank holding company if the Federal Reserve does not find that they are subject to "comprehensive supervision" by their home country bank regulators, a finding not made for a number of foreign countries); 12 U.S.C. § 72 (all directors of US national banks must be US citizens).

[17] See John C. Coates IV, Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis, 1 J. Legal Analysis 2 (2009), available at ojs.hup.harvard.edu/index.php/jla/article/view/59/72 (describing differences in US regulation and taxation of US and foreign mutual funds).

[18] See Atomic Energy Act of Aug. 30, 1954, 68 Stat. 921 (codified as amended in scattered sections of 42 U.S.C.) (foreign-controlled companies may not own US nuclear power plants or operations prospecting for uranium and other source material).

[19] 50 U.S.C. App. 2170 (President may take such action as the President considers appropriate in response to any merger, acquisition or takeover by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the US).