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Statement of

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before the

Committee on Banking and Currency

House of Representatives

on

H.R. 13884

To Prohibit Federally Insured Banks from Voting Their Own Stock and to Provide for Cumulative Voting in Federally Insured Banks

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H.R. 13884 is designed to do two things: (1) prohibit Federally insured banks from voting their own stock, and (2) require that such banks conduct their elections for directors on the basis of cumulative voting by shareholders.

Bank Voting of Own Stock

The Board recognizes that inherent in a bank voting its own stock is a potential conflict between the self-interest of the bank's management and the best interests of its shareholders. As the Board has earlier indicated to this Committee, it considers the practice of a bank's voting its own stock held by it in trust "undesirable and has tried by persuasion to encourage State member banks to eliminate, as far as possible, voting of such stock except by direction or instruction from others." (1967 Hearings entitled "Meetings with Department and Agency Officials", page 172.)

In attempting to develop an appropriate legislative line between what is to be prohibited and what is to remain permissible, it always seems desirable to use existing laws in the area as a framework for consideration. Under section 5144 of the Revised Statutes, in an election of directors a national bank is permitted to vote stock held by it as sole trustee only if "under the terms of the trust the manner in which such shares shall be voted may be determined by a donor or beneficiary of the trust and . . . such donor or beneficiary actually directs how

such shares shall be voted". That section also provides that, if the bank owns such stock as co-trustee, the other trustee may vote the stock as if he were the sole trustee.

A question arises whether the best solution to the problems involved in this area might be to prohibit a bank from holding its own stock in any capacity. That would entirely avoid any potential conflict and would also avoid denying certain owners voting rights--which results from permitting banks to hold their own stock in a fiduciary capacity but not to vote it.

Prohibiting a bank from owning its own stock would be a simple solution to the problems in this area but one that may be more drastic than is necessary. It might deprive the trustee of the opportunity of making a sound investment on behalf of the beneficiary of the trust. Conceivably, it might encourage bank trust departments to increase their holdings of stock in competing commercial banks, which would aggravate another situation that may already have undesirable aspects.

Certainly, prohibiting a bank from owning its own stock in any capacity would prevent a person with full knowledge of the facts from establishing with a bank a trust that expressly authorizes the purchase of stock of the bank. On balance, the Board believes that it would be desirable to allow such a person to establish a trust authorizing the purchase of stock of the bank, despite the possibility

that a bank could take advantage of its role as financial adviser and suggest the merits of including such a provision in the trust agreement.

It might be noted that, as a practical matter, prohibiting a bank from voting its own stock--which is the approach adopted by H.R. 13884--may strongly discourage ownership of such stock and thus have some of the effect of a prohibition against ownership. Voting of stock is an attribute of ownership, and a trustee, depending upon the terms of the trust instrument, might be considered negligent in the performance of his duties if he invested in stock in which he could not exercise the normal incidents of ownership.

Returning to section 5144 of the Revised Statutes, from the standpoint of the beneficial owners of the stock, the existing provisions of that section assure that such owners will not be deprived of having basic ownership rights exercised in their behalf. The Board is unaware of any harmful consequences resulting from these provisions, although, to the extent that owners are denied voting rights, the value of such rights of the remaining owners is proportionately increased.

In sum, it seems to the Board that the need for legislation in this area at this time would be fulfilled if State banks were subject to limitations comparable to those of section 5144. Accordingly, the Board suggests that consideration should be given to modifying the apparently unqualified prohibition in H.R. 13884 against an insured

bank exercising voting rights of its capital stock to make clear that the stock of any such bank held by it in a fiduciary capacity may be voted in the ways presently authorized by section 5144 of the Revised Statutes.

Before turning to the cumulative voting provisions of H.R. 13884 let me comment briefly regarding one of the situations to which the prohibition against a bank voting its own stock is addressed. As this Committee's recent report on trust activities of banks points out, the Cleveland Trust Company, an Ohio-chartered member bank of the Federal Reserve System, owns in a fiduciary capacity approximately 33 per cent of the outstanding stock of the bank and, despite much adverse criticism, continues to vote much of such stock. Through such voting, the management of the bank effectively controls the election of its board of directors.

At the present time, the legality of the Cleveland Trust Company voting its own stock is solely a question of Ohio law. In an effort to clarify its authority in this respect, the bank itself initiated a suit for declaratory judgment. In June 1967, the Common Pleas Court of Cuyahoga County held against the bank, concluding that "no corporate fiduciary is permitted to vote any shares issued by it under the existing statutory law of Ohio." The bank is appealing this decision.

As a member bank of the Federal Reserve System, Cleveland Trust Company is, of course, subject to supervision by the Board of Governors. On occasion, the Chairman of this Committee has suggested that the Board should investigate the bank's practice of voting its own stock. The Board has been and is aware of the undesirable aspects of the Cleveland Trust situation. While it encourages banks under its supervision to dispose of their own stock held by them in a fiduciary capacity, the Board is reluctant to engage in interpreting closely-disputed questions of State law. In other words, the Board considers that its supervisory responsibilities in this respect relate principally to assuring that the soundness of the bank and its trust accounts are not adversely affected by the investments in the bank's own stock.

Where a bank such as Cleveland Trust is subject to the Board's Regulation F, which relates to public disclosure of information concerning stock of certain member State banks, the Board has the duty to assure that the bank fairly discloses all information necessary to enable an investor to make an intelligent decision with respect to ownership of the bank's stock. The Board believes that it fulfills this duty with respect to the stock of the Cleveland Trust Company, as well as with respect to the stock of other banks within its jurisdiction.

Cumulative Voting

The general aim of cumulative voting is to allow a minority to secure representation on the board of directors. Under such method

of voting, where several directors are to be voted upon at the same time, a shareholder is entitled, if he desires, to cast votes equal to the whole number of shares held by him, multiplied by the number of directors to be elected, for one candidate.

The danger in this method of voting is that an unwary majority may find that a vigilant minority has deprived the majority of control. This could arise by the majority spreading their votes over too many offices. However, this danger can be overcome by the majority foregoing any attempt to elect a complete board and cumulating their votes on such a proportion of the members of the board as the number of their shares bears to the total number of shares which will be voted at the election.

The question of whether bank shareholders should have cumulative voting rights is controversial. In fact, in 1956, the Senate passed a bill that would have modified the present requirement for cumulative voting in elections of directors of national banks so that such method of voting would apply only if the bank's articles of association so provided. A similar modification was considered in connection with the proposed "Financial Institutions Act of 1957".

Much of the debate on the merits of cumulative voting centers around the question of what should be the proper role of a board of directors. Some argue that a board of directors should be similar to the cabinet in the government of the United Kingdom--all representing

the same interests involved in a common effort to ascertain and administer effectively the policies of the corporation. Others say that a board of directors should be similar to a legislature--policies should be questioned and debated by persons representing diverse interests.

Insofar as banking is concerned, it seems particularly desirable that the board of directors should serve more like a legislature. The Board believes--and we think this has been borne out in both Federal and State legislation--that a bank must consider and act to a greater degree with regard to the public interest than the typical industrial or commercial corporation. Banks should be responsive to the convenience and needs of their communities. Accordingly, efficiency in the decision-making process and the maximization of profits must, on occasion, play a secondary role to community service.

Certainly not all of the stock even of a local bank is owned by persons interested in the community. Many such shares are owned by outside investors. Nevertheless we do hope and believe that there is sufficient stock ownership of the local bank by persons interested in the community that we should reject such arguments against cumulative voting as "If you don't like the policies of the corporation, sell your stock."

We are well aware of the danger from "mandatory" cumulative voting of a minority of shareholders impairing corporate action. However, an unchallenged management is more likely to be unresponsive to the needs of the community. On balance, the Board considers that the dangers of dissidence are outweighed by the advantages of an airing of viewpoints.

To be effective, cumulative voting for directors requires on the part of shareholders accurate and detailed knowledge of the strength of the competing interests, their strategies, and candidates. This could be cited as a danger of cumulative voting, but belief in and reliance upon an intelligent and informed electorate is the basis of democracy, either corporate or political.

It might be noted that, in the past, regulation of State banks under Federal banking laws has generally been directed toward assuring the soundness of such banks, rather than toward protecting the interests of shareholders of banks, as H.R. 13884 would do. Nevertheless, State-chartered banks have been made subject to a number of the provisions of the Federal securities laws, including those directed against insiders taking unfair advantage of their position--one of the principal purposes of H.R. 13884.

In conclusion, the Board of Governors supports the objectives of H.R. 13884. The Board would, however, favor a provision limiting an insured bank voting its own stock held by it in a fiduciary capacity more along the lines of section 5144 of the Revised Statutes.