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Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter Of: Self-Regulatory Organizations; Proposed Rule Change by New York Stock Exchange, Inc. Relating to Amendments to the Exchange's Voting Rights Listing Standards for Domestic Companies	File No. SR-NYSE-86-17

COMMENTS OF THE UNITED STATES DEPARTMENT OF JUSTICE

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I. Introduction and Statement of Position

In the present proceeding, the Securities and Exchange Commission ("Commission" or "SEC") has requested comments on a proposed rule change by the New York Stock Exchange, Inc. ("Exchange" or "NYSE"). 1/ The existing rule denies listing to any corporation that has disparate voting rights among its common stock. The proposed change would, under certain circumstances, permit the listing of companies having multiple classes of common stock with unequal voting rights (hereinafter "dual class common stock"). 2/

1/ Self-Regulatory Organizations; Proposed Rule Change by New York Stock Exchange, Inc. Relating to Amendments to the Exchange's Voting Rights Listing Standards for Domestic Companies, 51 Fed. Reg. 37529 (October 22, 1986).

2/ These circumstances are set forth in Section II A. of these Comments, infra.

Recent years have witnessed a renewed interest on the part of some public companies in issuing dual class common stock. Because the NYSE's ban on listing companies having such stock is far more stringent than the rules of its largest rivals, 3/ the Exchange is understandably concerned that continuation of that ban in unmodified form could cause companies that want to have dual class common stock to list their shares elsewhere. At the same time, the Exchange's proposed modification of its rule seeks to protect the shareholders of public companies with a single class of voting common from an involuntary conversion of their stock into limited voting common. To comply with its proposal, a public company with a single class of voting common that creates a class of limited voting common would have to obtain the prior approval of a majority of the votes of its public shareholders and a majority of the company's independent directors.

The United States Department of Justice ("the Department"), the Executive Branch agency responsible for promoting competition, believes that, based on currently available evidence, companies should be free to choose the form of corporate governance and capital structure that best suits

3/ The shareholder voting rights standards of the American Stock Exchange are less demanding than those of the Exchange, while NASDAQ has no shareholder voting rights standard. 51 Fed. Reg. at 37530.

them, so long as their choice does not cause substantial harm to minority shareholders or to third parties. We think it highly unlikely that the proposed rule change would harm minority shareholders. Shareholder wealth apparently was not harmed by past recapitalizations and modifications of voting rights that resulted in dual class common stock, and the NYSE's proposed rule appears to offer existing minority shareholders ample protection against reductions in their wealth. Investors that acquire the securities of dual class firms after the creation of dual class common stock will buy with full knowledge of the rights they are acquiring, and the price they pay for their shares will fully reflect all available information concerning the value of the firm whose shares they are acquiring.

The allowance of disparate voting power would not endanger other social interests. Dual class common stock does not represent a significant threat to the market for corporate control. Empirical evidence does not suggest that dual class common has been created systematically for the purpose of deterring takeover attempts, and it is not uncommon for dual class firms to be acquired by other firms. Nor would approval of the proposed rule change ignite a "race to the bottom" among stock exchanges, in which exchanges compete for listings by vying with each other to afford shareholders less and less protection against exploitation by management. The "race to the bottom" hypothesis lacks any substantial empirical support. Finally, a prohibition on listing dual class common stock cannot be justified by imputing to a concept of "corporate democracy" the same values attributed to political democracy. Attempts to draw an analogy between corporate voting and political voting overlook differences in the commonality and number of interests affected and the options available to shareholders and citizens.

In sum, there appear to be no likely adverse consequences from permitting the Exchange to adopt the proposed rule change, and the Commission ought, therefore, to approve that change.

II. Background

A. The Exchange's Proposed Rule Change

Since the mid-1920s, the Exchange has had a policy of refusing to list, and of removing from the list, any company having dual class common stock. This policy is often referred to as one requiring "one share, one vote". In 1984, in response to a growing number of listed companies' proposed recapitalizations involving the creation of a second class of common stock having multiple votes per share, the Exchange instituted a study of whether retention or modification of its traditional policy would best serve the interests of those directly affected--shareholders, their corporations and the Exchange.

Subsequently, in the summer of 1986, the Exchange Board of Directors adopted modifications to the "one share, one vote" standards and submitted them for SEC approval. The proposed rule would, if certain conditions are met, permit companies having dual class common stock to list their shares, or retain their listing, on the Exchange. Dual class common stock, if created as part of a recapitalization or modification of voting rights within an existing single class of voting equity security by a public company, would be permitted if approved by a majority of the company's independent directors and a majority of the votes eligible to be cast by its public — outside? yes. shareholders. Public shareholders do not include "insiders" and their affiliates or the company's affiliates. Listed companies that have created dual class common stock and have not received the required approval(s) will have two years from the effective date of the modification to comply. A firm applying to list under the new provisions must obtain the required approvals prior to listing on the Exchange.

These public shareholder and independent director approval requirements apply only to public companies. A company that at the time of its incorporation has dual class common stock, or that issues such stock prior to becoming a public company, would not be subject to the approval requirements of the Exchange's modified listing policy. For the purpose of the Exchange's policy, a company becomes a public company when it first has a class of equity security held of record by at least

500 persons. 4/ The approval requirements similarly do not apply to the typical "spin-off" transaction, when, for example, a firm distributes to its common stockholders, in accordance with their respective holdings, dual class common stock of another company that will hold certain assets of the distributing company.

B. Background With Respect to the Utilization of Dual Class Common Stock

The principle of "one share, one vote" was not an original tenet of business incorporation. On the contrary, early statutory and charter provisions in many cases limited the number of votes that large shareholders could cast. 5/ By the end of the nineteenth century, however, companies could, and generally did, provide for shareholder voting on the basis of equality of voting power for each share of common. 6/

In the beginning of the twentieth century state corporation laws were neutral on the issue of dual class stock.

4/ The Exchange borrowed this concept from Section 12(g) of the Securities Exchange Act, 15 U.S.C. §781(g) (1982), which requires an issuer with total assets exceeding $1,000,000 and a class of equity security held of record by five hundred or more persons to register with the Commission.

5/ Ratner, The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote," 56 Corn. L. Rev. 1, 3-8 (1970) ("Ratner"). See also 1 W. Scott, The Constitution and Finance of English, Scottish and Irish Joint-Stock Companies to 1720 162-163, 228, 270, 340-341 (1912).

6/ Ratner at 8-9.

Corporations could create dual class common stock, although few publicly-held companies chose to do so prior to 1917. During the years 1918 to 1929, however, dual class common stock became increasingly popular. 7/ From the investor's perspective, nonvoting (generally referred to as Class A) common offered the prospect of higher dividends than the voting stock of the same company; from the issuer's viewpoint, the use of nonvoting common was a means of raising equity capital that "allowed the management to retain full administrative control". 8/ Dual class common stock soon fell out of fashion, however, and persisted only in a small minority of firms with publicly-traded stock. 9/ In the past few years, there has been a slight increase in the utilization of dual class common stock; 37 firms created a second class of common stock from

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7/ Some idea of the popularity of dual class common stock in the 1920s can be gleaned from the fact that from 1925 to 1929 an average of 71.6 companies whose stock was publicly traded issued limited voting stock (by recapitalization or new issue) each year. 1 A. Dewing, The Financial Policy of Corporations 163 n. ooo (5th ed. 1953) ("Dewing"). It was during the mid-1920s that the Exchange imposed its policy of refusing to list companies with dual class common stock.

8/ Dewing at 163.

9/ See De Angelo and De Angelo, Managerial Ownership of Voting Rights 14 J. Fin. Econ. 33, 53-54 (1985) ("De Angelo and De Angelo"); Fischel, Organized Exchanges and the Regulation of Dual Class Common Stock 46 (February 1986) (unpublished report) ("Fischel").

1980-1984. 10/ This development occurred simultaneously with the more widespread adoption of antitakeover devices. 11/

Historically, firms that have utilized dual class common stock have often been controlled by members of a single family, and not infrequently members of the family and in-laws are among the most highly paid corporate officers. 12/ Firms that achieve dual class status through recapitalization are characterized by a high percentage of equity ownership by insiders both prior to and subsequent to recapitalization. 13/

10/ Partch, The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth 4 (September 1986) (unpublished manuscript) (forthcoming in J. Fin. Econ.) ("Partch").

11/ There are three basic voting patterns in firms with dual class common stock: voting-nonvoting, class voting, and pooled voting. Under voting-nonvoting, holders of Class B shares have all the votes and exercise them on a "one share, one vote" basis, while holders of Class A shares have no vote, or vote only in unusual circumstances (such as a continued default in the Class A dividends). In the case of class voting, all shares within a class carry equal voting rights with all other shares in that class, but Class A shareholders separately elect a minority of the directors, while Class B shareholders separately elect the majority. In pooled voting, all shareholders vote together for directors but each share of Class A stock carries only one vote, while each share of Class B carries multiple votes. More exotic variations on these patterns also exist, such as dual class common stock plus an issue of preferred stock that has some voting rights, a single class of common stock in which voting power per share varies with the length of time the security has been continously held, and a single class of common where voting power per share varies with the size of the shareholder's holding.

12/ See De Angelo and De Angelo at 50, 63-68.

13/ Partch at 8-11. In Partch's sample insiders controlled about half (average 48.6% and median 53.0%) of the equity and

Footnote Continued

III. Corporations Should Be Free to Choose the Capital Structure and Form of Corporate Governance That Best Suits Them, Provided That Their Choice Does Not Result in Substantial Harm Either to Minority Shareholders of the Corporation or to Third Parties

The ability of individuals and firms to write mutually agreeable contracts is essential to the working of a free enterprise economy. Contracts may create new property rights or relinquish old ones. Through the trade of assets, goods, and services facilitated by contracts, individuals maximize their welfare and firms maximize their profits. In our free enterprise system, government generally does not interfere with private contracts. Occasionally, however, a contract between two parties may create what economists call "negative externalities", *i.e.*, adverse effects on one or more third parties. If these negative externalities are significant enough, contracts that create them could be contrary to the public interest. 14/

13/ Continued

votes prior to the recapitalization and slightly less than half (average 43.7% and median 44.3%) of the equity after the recapitalization.

14/ A negative externality exists whenever the activities of one or more firms adversely affect third parties in ways that are not taken into account by the operation of the market. Negative externalities thus are one example of a market failure. A market failure exists when an unregulated market's equilibrium does not maximize social welfare. When there is a market failure, government regulation may be necessary to improve social welfare; the same may be true of regulation by a self-regulatory organization. *See generally* P. Samuelson and W. Nordhaus, *Economics* 712-721 (12th ed. 1985).

The central issue of this proceeding, therefore, is whether there is a reason not to allow the NYSE to revise its listing rules so that they allow private parties to contract with respect to a particular aspect of corporate governance. Stated conversely, the issue is whether maintenance of a mandatory "one share, one vote" rule is necessary to avoid a market failure of significant dimensions. The Commission thus must ascertain whether allowing a corporation to create dual classes of common stock would have such a significantly adverse effect either on minority stockholders of the corporation or on shareholders in general, or have the generalized effect of reducing the attraction of the securities market to the public. If these questions can be answered in the negative, there is no justification for denying approval of the proposed rule, which merely allows parties to contract about one aspect of corporate governance.

IV. The Department Is Unaware of Any Significant Negative Effects on Shareholder Wealth That Would Result from Permitting Firms to Create Dual Class Common Stock Under Conditions That Protect the Interests of Existing Minority Shareholders

A. The Exchange's Proposed Rule Change Appears to Offer Existing Shareholders Ample Protection Against Exploitation by Management

Companies choose dual class common stock to ensure greater management control. While managers themselves might seek greater control for entirely self-serving purposes, shareholders would be acting irrationally if they voted to accept limited voting common stock to enrich managers at the shareholders' expense. There is no reason to impute irrationality to any corporation's shareholders. Therefore, in those cases where shareholders do grant management control disproportionate to its equity interest we assume that they will do so because they believe that it will enhance their wealth.

While giving management greater control would not be expected to be in the shareholders' best interests in all circumstances, there are situations in which shareholders could reasonably take such action. Managerial control can benefit stockholders by increasing managerial incentives to invest in organization-specific human capital. Often managers have to invest their own time and resources in order to understand the workings of a company. If managers make those investments, they make the company more valuable and thus benefit stockholders. In most cases, the management skills are of general value. In some cases, however, these investments may be organization-specific: the skills managers acquire from making these investments would make them more valuable only to the particular company and are not transferrable to other companies. If managers have no job security, they are less likely to make investments in organization-specific human capital. Hence shareholders may feel that in order to provide sufficient incentives for management to make such investments and to enhance the worth of the company, they should confer more security on managers through voting for greater managerial control. 15/

In addition, managerial control may permit stockholders of a target corporation to exact a higher price as a condition of transfer of control. A tender offeror that can obtain control for a small premium is unlikely to offer a larger premium, even if it believes a larger premium is justified. If shareholders are unable to act collectively, those who hold a majority of the company's shares may tender to the offeror's relatively low bid to avoid the risk of losing the entire premium if the tender offer is unsuccessful and the stock price reverts to its pre-offer level. 16/ Greater managerial control can overcome

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15/ De Angelo and De Angelo at 35; Fischel at 39-40.

16/ *See* Comments of the United States Department of Justice before the Securities and Exchange Commission in the Matter of Concept Release on Takeovers and Contests for Corporate Control 10 & n. 13 (October 17, 1986).

the collective action problem by permitting management to negotiate a higher price for the shares. 17/

Under the Exchange's proposed rule, voting changes and recapitalizations that create a second class of limited voting common will only be permitted if a majority of the outside stockholders vote their approval (and a majority of outside directors approve as well). Since the stock held by insiders is excluded, such changes will be dependent on the assent of a majority of those whose voting power will be reduced. It seems most unlikely that a majority of outside shareholders and independent directors would vote for a transaction that clearly had an adverse impact on shareholder wealth.

B. There is No Empirical Evidence That Indicates That The Creation of Dual Class Common Stock Would Reduce Shareholder Wealth

While there is only a limited amount of empirical data on the wealth effects of recapitalizations and voting rights modifications that create dual class common stock, that evidence indicates that "shareholder wealth does not appear to be affected by the creation of a class of limited voting common stock". 18/ The Department is not aware of any empirical

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17/ Fischel at 41-42.

18/ Partch at 25. Partch's results appear to be supported by an unpublished Canadian study of the reaction of shareholders to the issuance of limited voting common by 33 firms listed on the Toronto Stock Exchange. See Partch at 1 n. 3. Lease, McConnell and Mikkelson, The Market Value of Differential

Footnote Continued

studies that reach the conclusion that shareholder wealth suffers a significant adverse effect from such transactions. 19/

C. The Efficient Capital Market Hypothesis Rules Out Any Adverse Effect on the Wealth of Shareholders Who Purchase Common Stock in a Firm With Dual Class Common

As Professor Fama h-s explained:

> An efficient capital market is a market that is efficient in processing information. The prices observed at any time are based on correct evaluation of all information available at that time. In an efficient market, prices "fully reflect" available information. 20/

It is generally agreed among economists that the Exchange is an efficient capital market. 21/ Hence the prices of any security

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18/ Continued

Voting Rights in Closely Held Corporations, 57 J. Bus. 443 (1984) observed generally negative average returns from the month of issuance through six months after issuance of a class of limited voting common stock for the small sample of firms they studied, but concluded that "these results do not resolve whether the issuance of limited voting shares helps or harms the firm's stockholders." Id. at 449.

19/ As indicated supra, in the past the creation of dual class common stock occurred primarily in corporations in which insiders owned a substantial percentage of the stock. In such circumstances, the absence of negative stock price effect data is not surprising, since a substantial portion of any such negative wealth effect would have been borne by insiders. See n. 13 supra and accompanying text.

20/ E. Fama, Foundations of Finance 133 (1976).

21/ See, e.g., J. Lorie and M. Hamilton, The Stock Market: Theories and Evidence 70-97 (1973).

traded on the Exchange, whether one with full voting rights or limited voting rights, are based on correct evaluation of all information available at that time. If firms with dual class common stock as a general matter have worse prospects than firms with a single class of voting common, or if shareholders with limited voting rights enjoy a lower probability of gain than shareholders with full voting rights, this information will be fully reflected in the prices of the shares. An investor that purchases shares in a firm with dual class common stock will thus always pay a price that fully reflects the prospects of that firm, as perceived by the market. Those who purchase public shares of a firm after it has created a dual class common stock structure know what they are buying and pay a price that already reflects the market's evaluation of the recapitalization.

D. Dual Class Common Stock Does Not Pose a Significant Threat to the Market for Corporate Control

The Commission has recognized that takeovers and the threat of takeovers represent important mechanisms by which managements are constrained to operate efficiently and to maximize the wealth of shareholders. 22/ Thus impediments to

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22/ Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965). Other mechanisms, such as the presence of independent directors, the use of performance-based compensation contracts for managers, and manager turnover based on firm performance are also important means of spurring management effort on behalf of shareholders.

takeovers, or factors that significantly reduce the probability that a firm will be taken over, can reduce the incentive for managers to maximize shareholder wealth.

Recapitalizations and voting modifications that result in dual class common can undoubtedly serve to make takeovers more difficult. In the past, managements have often stated in proxy material that the creation of dual class common stock may lessen the likelihood of hostile takeover attempts. 23/ However, there is little reason to suppose that such recapitalizations have been used systematically, or will be used systematically, to deter takeover attempts that shareholders believe would benefit them. Requiring a majority (ordinarily a supermajority) of all shares, and also a majority of shares held by public shareholders rather than insiders, to approve the recapitalization should help to ensure that managements do not engage in recapitalization merely for the purpose of entrenching themselves. There simply is no reason to presume that an increasingly sophisticated body of shareholders will prove incapable of discerning their own best interests. Moreover, because a substantial proportion of the stock held by public shareholders is likely to be in the hands a relatively small number of large institutional investors, organizing the public shareholders to defeat proposals that

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23/ Partch at 17.

would be harmful to their wealth should ordinarily be feasible. While creation of dual class common stock may be contrary to the best interests of stockholders in some cases, that will not always be the case. As indicated supra, there are a number of reasons why insider-managers might want to retain control--and why outside shareholders should want to vote for insider-manager retention of control--that are consistent with the maximization of shareholder wealth. 24/ Finally, the notion that recaptalizations are used simply to entrench managements lacks empirical support as well. Of the firms in Partch's sample, for example, only one had been the target of a takeover attempt reported in The Wall Street Journal within two years prior to the recapitalization. 25/

E. Approval of the Proposed Rule Change Does Not Threaten to Precipitate a "Race To the Bottom" Among Stock Exchanges That Would Adversely Impact the Interests of Shareholders

The concern has sometimes been expressed that permitting

24/ See text at nn. 15-17 supra. The popularity of dual class common stock in the 1920s (see n. 7 supra) cannot be attributed to a desire to frustrate takeover bids, since the cash tender offer did not achieve popularity until forty years later. See Cohen, A Note on Takeover Bids and Corporate Purchases of Stock, 22 Bus. Law. 149 (1966).

Another reason for believing that the adoption of a dual class common stock capital structure does not unduly inhibit the market for corporate control is that firms with this type of capital structure have not infrequently been acquired. Of the 45 firms in the De Angelo and De Angelo study that had dual classes of common stock in 1980, for example, four were acquired by other firms by the end of 1982, and another had its Chairman replaced as a consequence of a proxy contest. De Angelo and De Angelo at 63-68.

25/ Partch at 12.

the Exchange to change its rules will result in a negative effect in the form of a "race to the bottom" as stock exchanges compete for listings and trading volume by adopting less and less stringent corporate governance rules for listed companies. 26/ The result of this race, it is feared, will be uniformly lax rules that will permit corporate managements more easily to exploit investors. The Department believes that this fear is unfounded.

If the "race to the bottom" hypothesis were sound, shareholders would prefer stocks that were listed on the Exchange because its rules on corporate governance are more stringent than those of, for example, the over the counter ("OTC") market. Thus the announcement that a firm was being listed on the Exchange should have an immediately discernible positive effect on the price of that firm's shares. The studies do not, however, confirm the hypothesis. There has not been a statistically significant positive stock price reaction to the announcement that a firm would be listed on the Exchange, at least for years after 1970. 27/

26/ See, e.g., 131 Cong Rec. S8318 (daily ed. June 18, 1985)(statement of Sen. D'Amato); 131 Cong. Rec. E.2845 (daily ed. June 18, 1985)(exension of remarks of Rep. Dingell).

27/ Sanger and McConnell, Stock Exchange Listings, Firm Value, and Security Market Efficiency: The Impact of NASDAQ, 21 J. Fin. Quan. Anal. 1, 22 (1986).

V. Prohibition of Dual Class Common Stock Cannot Be Justified By Imputing to a Concept of "Corporate Democracy" the Same Values Attributable to "Political Democracy"

A final negative effect that has been attributed to dual class common stock is that it is subversive of the principle that each share of common stock has exactly the same voting rights as every other share. According to some opponents of the Exchange's rule change, just as "one person, one vote" is a basic tenet of political democracy, so "one share, one vote" is a fundamental tenet of "corporate democracy." 28/ The Department does not believe that a ban on dual class common can be justified by an analogy to political equality: there are substantial differences between the interests involved in corporate and political voting.

There are very significant differences between one's interests as a corporate shareholder and as a member of a body politic. Corporations have only a very limited amount of power over the lives and wealth of their shareholders. Governments, by contrast, regularly exercise vast powers over those they govern. Hence a citizen has far more at stake in a political election than a stockholder has in a corporate election. 29/

28/ *See* 131 Cong. Rec. S8318 (daily ed. June 18, 1986) (statement of Sen. Metzenbaum).

29/ *See, e.g.*, Easterbrook and Fischel, *Voting in Corporate Law*, 26 J. L. & Econ. 395, 396-397 (1983) ("Easterbrook and Fischel").

This important distinction is reflected in the fact that it is a fundamental principle of democratic government that those directly affected by the exercise of government power can vote, 30/ while many of those most directly affected by corporate decisionmaking, e.g., employees, customers, suppliers, and creditors, cannot ordinarily vote. 31/

The objectives of different political voters are often mutually exclusive. Governments cannot simultaneously satisfy the wishes of those who want less butter and more guns and those who want fewer guns and more butter. The right to vote in political elections is critical precisely because those who lack the vote will be those whose wishes are most likely to be disregarded. In corporations, however, all shareholders tend to have similar interests. Higher profits, leading to higher share prices, benefit all shareholders alike, and lower profits hurt everybody. Moreover, unlike governments, corporations are severely limited--by the discipline of the marketplace--in the policies they can adopt. Because of the similarity of interest among shareholders and because of market restraints on corporate action, the right to vote is of much less significance in the corporate than in the political arena.

30/ See, e.g., U.S. CONST., amend. XXIII (allowing residents of the District of Columbia to vote in Presidential elections); amend. XXVI (extending the right to vote to all persons eighteen years old or older).

31/ Easterbrook and Fischel at 396.

A final major difference between political and shareholder voting is that the dissatisfied citizen can ordinarily exercise the exit option 32/--move to another country, state, or municipality--only at a very high cost, 33/ while dissatisfied shareholders can and do exit their companies at a very low cost. 34/

VI. Conclusion

The proposed rule change does not appear likely to result in significant negative consequences either for shareholders of NYSE listed companies or for third parties. Consequently there is no justification for governmental interference with freedom of contract, and the Commission should approve the NYSE's proposal.

32/ See generally, A. Hirschman, Exit, Voice, and Loyalty (1970)("Hirschman").

33/ Manne, Some Theoretical Aspects of Shareholder Voting, 64 Colum. L. Rev. 1427, 1445 (1964)("Manne, Voting").

34/ Hence the well-known Wall Street rule: "if you do not like the management you should sell your stock." See Hirschman at 46. Another difference between political voting and corporate voting is that a stockholder can acquire more votes by buying more shares, whereas a voter has no (lawful) means of increasing his political influence by purchasing votes. Manne, Voting at 1445.

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