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News Release

DUAL CLASS CAPITALIZATION:

SOLUTIONS IN SEARCH OF PROBLEMS

Remarks to

The New York Stock Exchange
Legal Advisory Committee

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The views expressed herein are those of Commissioner Cox and do not necessarily represent those of the Commission, other Commissioners or the staff.

Good Afternoon. It is a pleasure and honor to be asked to address the New York Stock Exchange Legal Advisory Committee. I suspect that we in Washington have kept you here in New York very busy lately. The top items on the SEC's agenda seem to be insider trading, the "one share-one vote" rule and program trading. With these three problems, the SEC seems to have brought its own version of "triple witching" to bear upon the Exchange. I trust that these areas present interesting issues to you in your collective capacity as legal adviser to the Exchange. But you may rest assured that we have been kept busy with these same problems in Washington. The Commission was called to testify before Congressman Dingell's Subcommittee last week, as were Exchange officials. The Commission held two days of hearings this week on the "one share-one vote" issue, and the Exchange was invited to testify. And today, we once again brace ourselves for the quarterly experiment in dampening the effects of program trading on the Exchange. Indeed, it appears that triple-witching is all around us; our problems seem to come in threes.

Today I would like to isolate one of this trio of problems to discuss with you. Each is equally timely, but I believe that the issue of dual class capitalization -- more popularly but inaccurately and inelegantly known as "one share-one vote" is the issue that merits more current thought and discussion. In the other two areas -- insider trading and program trading -- the outlines of the problems are clear. However, in the area of disparate voting, we do not know what the problems are which we are attempting to solve.

I have titled my remarks today "Dual Class Capitalization: Solutions in Search of Problems." I would like to tackle the so-called "one share-one vote" area in the same manner as a contestant on the popular TV game show "Jeopardy." The Securities and Exchange Commission has been presented with an answer; now all we have to do is come up with the question. What makes the "one share-one vote" controversy a current issue is that the Exchange has presented the Commission with a rule proposal for our approval. In short, the Commission has been presented with an answer. In order to determine whether this is an appropriate answer, however, we must determine what the question is. Or alternatively, we need to look at what the problems are to which the Exchange's rule proposal is supposed to be a solution. In keeping with my "three-part" orientation today, I would propose that there are three potential "problems" for which the Exchange's rule proposal could be a solution. Those problems are:

(1) competition among the various securities markets for listings;

(2) the issue of "shareholder democracy" or "fair corporate suffrage," and

(3) whether the SEC should delve into questions of corporate governance.

I'd like to consider these problems with you in that order, because I believe that consideration of one flows naturally into the next.

<u>Should Dual Class Capitalization be an Item of Competition?</u>

The first problem to which the Exchange's rule proposal may be a solution is that of competition among stock markets. Indeed, the main reason the Exchange gave for rescinding its "one share-one vote" rule is competitive pressure. It is apparently the Exchange's judgment that the advantage of a listing on the New York Stock Exchange no longer outweighs the disadvantages of a "one share-one vote" requirement enough to keep as many listed companies as the Exchange would like.

The question that has been posed at the hearings in Washington was essentially this: Should dual class capitalization be an item or area of competition among the New York Stock Exchange, the American Stock Exchange, the regionals and the NASD? It's clear to everyone that the answer is no. The stock markets should not compete on this basis -- everyone should be the same. The market solution was that all stock markets should <u>permit</u> dual class capitalization. The policy decision to be made is whether all stock markets should <u>prohibit</u> dual class capitalization.

It is important to look at this first as a competitive issue, because that's what brought "one share-one vote" to the SEC's doorstep in the first place. The Exchange has taken the position that it reluctantly proposes rescission of its long-standing rule. Commissioner Grundfest at the hearings this week in Washington characterized the Exchange as coming to the Commission pleading "stop me before I kill again." I don't believe he meant to equate dual class capitalization and homicide, but he did accurately characterize the aura of helplessness with which the Exchange has approached the Commission. I believe that this is somewhat disingenuous. If the Exchange really detests the abolition of its "one share-one vote" rule, then it should retain it. Perhaps retention of this rule would increase the status associated with a New York Stock Exchange listing, and the Exchange could trumpet its "high class" standards. Professor Fischel made this same point in his study conducted for the NASD, concluding that promulgation of pro-management and anti-shareholder rules, as the one share-one vote rule is perceived, is not necessarily an exchange's profit-maximizing strategy. 1/

But this was not the route chosen. The Exchange chose to rescind the rule, citing competitive pressures as the reason. I assume this means that the Exchange fears a massive exodus by listed companies. And if that is the case, then what is the vaunted "one share-one vote" rule protecting? Surely it's not the managements of the listed companies, for they have indicated through competitive pressures that they want the option of dual class capitalization. We presume in this instance that it's the interests of the shareholders of these listed companies that we are protecting, and we further presume that these interests are not taken into account by management in this case.

This brings me to the popular but worn characterization of this problem as "a race to the bottom." That is, everyone apparently follows his own self-interests to the detriment of the whole. As you know, this is precisely contrary to generally accepted economic theories. Professor Fischel noted in his study that the theory of a "race to the bottom" originated in the analysis of state chartering of corporations. He further notes that the theory "has been vigorously analyzed and completely discredited on both a theoretical and empirical level," and goes on to conclude that "the analogous argument that competition among exchanges in their choice of voting rules is harmful to investors is equally without merit." 2/ As an economist, I am skeptical of arguments about a "race to the bottom," "ruinous competition" and so forth. I suspect that what this really means is that, if you don't like the outcome of the race, you call it one to the bottom; if the competition is ruining your business, you call it ruinous.

Is the competitive answer the wrong one in this case? Is there a "market failure" such that the prices of shares

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1/ Fischel, "Organized Exchanges and the Regulation of Dual Class Common Stock" 22 (study prepared for the National Association of Securities Dealers, Inc.)(Feb. 1986).

2/ Id. at 18.

do not accurately reflect all their attributes -- financial claims on the enterprise as well as the ability through voting to influence control of the enterprise?

The competitive answer in the area of dual class capitalization is that voting is not very valuable. Virtually all studies conducted of dual class capitalization have found the price of nonvoting or low-vote shares to be near that of the voting shares. The differences have averaged in the neighborhood of three to five percent, 3/ although there are notable exceptions. 4/

Those who would dispute these findings do so on the basis of a "control premium." It is clear, they argue,

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3/ The following table summarizes some of the findings of leading studies in this area.

Discount	Trading Markets	Sample Size	Author
2%	All U.S. mkts; higher div. to low-vote stock	16	OCE; 1986 unpub. mem.
8%	All U.S. mkts; same div. to both groups	10	"
5%	All U.S. mkts	27	Lease, McConnell, Mikkelson
7%	Toronto Stock Exchange	130	Jog and Riding

Sources: Office of the Chief Economist, Securities and Exchange Commission, "The Effects of Dual-Class Recapitalizations on the Wealth of Shareholders" (unpublished manuscript)(Dec. 12, 1986); Lease, McConnell and Mikkelson, The Market Value of Control in Publicly-Traded Corporations, 11 J. Fin. Econ. 439 (1983); Jog and Riding, Price Effects of Dual Class Shares, Fin. Analysts J., Jan.-Feb. 1986, at 58.

4/ Professor Levy surveyed stocks traded on the Tel Aviv Stock Exchange, none of which had any difference in dividends between high-vote and low-vote or nonvoting stock. The average discount of the low-vote or nonvoting stock was 45 percent (22 firms). Levy, Economic Evaluation of Voting Power of Common Stock, 38 J. Fin. 79 (1982).

that controlling interest in a corporation can demand a premium over the price of other shares or those same shares purchased individually. This premium, or the potential for collecting it, is taken away when shares are made low- or no-vote shares, and therefore they should trade at a substantial discount. Not only does this fly in the face of all our empirical research, it ignores the fundamental character of decisions on the margin.

The share price is for the next additional purchase; it's not necessarily representative of the price for a control block. Professors Harry and Linda DeAngelo have done research calculating the actual control premium paid to superior-vote shares in four control exchanges to be between 83 and 200 percent. 5/ But the decisions of shareholders in large companies, certainly those listed on the Exchange, are made on the margin -- for the next several thousand shares. This does not represent a control block. The applicable premium or discount represents the market's evaluation of that particular group of shares participating in a control premium. The market evaluates both the size of that premium and the probability that it will ever be realized. And the empirical results tell us that traders believe the premium is very small or the probability of realization is very low, or both. The DeAngelo study hypothesizes that the difference between the premium paid on takeover and the premium in the trading market is due to the fact that the open market prices "have been discounted to reflect the low probability that a control transfer will occur at terms which provide differential compensation for publicly-held superior voting stock." 6/ We cannot say that, as applied to individual purchases and sales of stock, that this is the "wrong" answer.

Therefore, if allowing all stock markets to list dual class shares is a "race to the bottom," it's not because control is being priced inaccurately by the market. Rather, the more forceful argument is that shareholders shouldn't be allowed to trade away their right to vote. The race is characterized as one "to the bottom" because it's perceived as a race away from fundamental standards of shareholder democracy. This brings me to the second problem to which the "one share-one vote" rule is purported

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5/ H. DeAngelo and L. DeAngelo, Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock, 14 J. Fin. Econ. 33, 60 (1985).

6/ Id.

to be a solution: the erosion of the inherent value placed on shareholder voting.

Shareholder Democracy and Fair Corporate Suffrage

The so-called "shareholder democracy" argument goes somewhat like this: shareholder voting is fundamental and must be required, not just permitted. Shareholders should not be permitted to vote themselves out of a vote.

I would like to first note a few preliminary matters. I am assuming that any dual class capitalization would be submitted to a vote of the shareholders. The proposed Exchange rule requires approval of a majority of the "public" shares and disinterested directors. I think that these requirements on the shareholders' "disenfranchisement" vote are appropriate. In addition, I believe that "going private" type disclosure should be required. Several witnesses in our hearings mentioned the need for disclosure analogous to that required in Schedule 13E-3 for "going private" transactions. 7/ The amount of disclosure to be required for a shareholder vote in this area is a classic SEC type of inquiry, and I don't believe anyone has questioned the proper role of the Commission in this area.

These preliminary matters aside, the question remains -- even with a fully-informed vote, should shareholders be permitted to disenfranchise themselves? It is at this point that I must confess I find some circularity in the argument. We are told that the shareholder's right to vote is fundamental. Although the analogy to the right to vote in political elections is imprecise at best, 8/ let's

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7/ Securities Exchange Act Rule 13e-3 requires filing of a Schedule 13E-3 in any purchase of securities, tender offer or solicitation of proxies which would result in an issuer registered under the Securities Exchange Act to have fewer than 300 shareholders of record, or would result in delisting from an exchange or removal from quotation on NASDAQ. *See* Rule 13e-3(a)(3). Schedule 13E-3 requires detailed descriptions of the issuer, the affiliated persons and the transaction, including "the effects of the Rule 13e-3 transaction on the issuer, its affiliates and unaffiliated security holders." *See* Schedule 13E-3, Item 7(d).

8/ The origin of the "one person-one vote" rule is the 14th Amendment of the United States Constitution. The Supreme Court has stated that equal protection

Footnote Continued

assume for the moment that this is a fundamental right. That being the case, how can we justify abridging that right on the issue of dual class capitalization? If the shareholders' right to vote is fundamental, why shouldn't they be permitted by that same vote to decline their fundamental right?

This line of inquiry about fundamental rights raises the question of whether the SEC should be involved in the area of setting normative standards of corporate governance. This is the third problem to which I believe the Exchange's rule proposal might be intended as a solution.

Regulation of Corporate Governance and Listing Standards

If shareholder voting is a fundamental right, should it be protected by the rules of securities exchanges and national securities associations? In answering this question, I do not intend to discuss whether the Commission has the authority so to regulate. Rather, I would like to approach the question as one of policy. Would this regulation be like the Commission's other activities in this area? Would a decision on dual class capitalization be sufficiently like other decisions made regularly by the Commission and its staff, so that we can say we are not straying too far from familiar ground?

There are several areas of Commission activity and authority which come to mind. Section 11A of the

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requires that voting power be proportional to population. See Baker v. Carr, 369 U.S. 186, 207-08 (1962) and cases cited. No similar requirement exists independent of state corporate law or exchange listings. No similar "fundamental" right has been found by the courts to apply to corporate electors.

Professor Fischel concluded in his study for the NASD that

> no reason exists to believe that the optimal voting rules for publicly held corporations engaged in the production of goods and services will be identical to the voting rules for representative governments. [T]here is little similarity between the two.

Fischel, supra, at 67.

Securities Exchange Act requires the Commission to designate standards for National Market System eligibility. The proxy regulation and disclosure requirements of Section 14(a) and the Williams Act regulation of tender offers are premised on general notions of fairness in corporate elections. But while these are relevant to the capitalization and voting standards of corporations, none require the Commission to address dual class capitalization in its own right. One could argue that NMS standards are furthered when all markets have the same rule, regardless of what the rule is. One could argue that proxy regulation is based on disclosure, not regulation of corporate structure. And one could argue that the Williams Act is concerned mostly with fairness in the shareholder's opportunity to participate in a corporate takeover, and not with creating a right to participate in takeovers when that right would not otherwise exist.

Apart from these specific areas, the Commission has broad authority under Sections 6(b) and 15A(b) of the Securities Exchange Act over the rules of national securities exchanges and national securities associations. Notwithstanding that broad power, the Commission has in the past exercised it primarily to assure that rules of these self-regulatory organizations conform to statutory standards: to prevent fraud, promote just and equitable principles of trade, foster trading, clearing and settling cooperation, and so on. 9/ As a matter of policy, at least, I believe that the Commission's use of its "plenary oversight" of self-regulatory organizations 10/ requires it to identify some specific justification for Commission

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9/ See Securities Exchange Act §§6(b)(5) (requirements for rules of a national securities exchange) and 15A(b)(6) (requirements for rules of a national securities association).

10/ Section 19(b)(2) of the Securities Exchange Act requires that the Commission approve a proposed rule change if it finds the proposal "consistent with the requirements of [the Act] and the rules and regulations thereunder, and to disapprove the proposed rule change if it cannot so find.

Section 19(c) of the Act authorizes the Commission to alter the rules of any self-regulatory organization "as the Commission deems necessary or appropriate" to insure fair administration of the self-regulatory organization, to conform those rules to the requirements of the Act, or "otherwise in furtherance of the purposes of [the Act]."

action. Absent such limitations, we would be hard pressed to deny petitions to regulate election of directors, cumulative voting, merger procedures and a host of other topics which are now the domain of state corporation law. Such a theory of SEC regulation would federalize corporate law to an unprecedented and I believe unintended degree.

It is interesting to note in passing that the Commission now has before it another proposed abrogation of the "one share-one vote" rule in a different context. The New York and American Stock Exchanges adopted rules waiving certain listing requirements for foreign companies, including, in appropriate circumstances, their "one share-one vote" rules, and presented these proposed rules to the Commission for approval. 11/ The history of this rule proposal suggests to me that the real concern in the hearings which were held Tuesday and Wednesday is corporate governance, and not necessarily listing standards of the exchanges. The Commission received only four letters of comment on these proposals. This is not the great wringing of hands which accompanied our consideration of "one share-one vote" for domestic companies. No one decried a "race to the bottom," where you might suspect it is the most important -- in the international market. These rules were proposed by the exchanges in light of serious competition from the NASD. According to the Securities Industry Association, in 1985 the New York and American Stock Exchanges combined had 105 foreign companies listed, while 265 were quoted on NASDAQ, which currently has no similar listing standards applicable to foreign companies. 12/

It's clear from this differential response that one of two things must be true: either the securities markets and the general public don't view protection of holders of foreign shares as seriously as protection of holders of domestic shares, or the purported concern about protection of holders of domestic shares is really directed at controlling the behavior of domestic corporations. It simply is not realistic to attempt this same degree of control over foreign corporations. I believe that this

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11// See Securities Exchange Act Release No. 23469, 51 Fed. Reg. 27618, 27619 n. 4 (1986)(New York Stock Exchange proposal); Securities Act Release No. 23064, 51 Fed. Reg. 11125, 11126 (1986)(American Stock Exchange proposal).

12/ Letter from Hugo J. Gelardin, Chairman, International Committee, Securities Industry Association to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Exhibit 3 (Sept. 22, 1986).

explains the great interest in the domestic "one share-one vote" rule and the relative apathy over the foreign "one share-one vote" rule, and demonstrates that the rules of the exchanges and the NASD appear to be incidental to the real issues.

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Now that I've discussed three possible problems which the Exchange rule proposal might be solving, I hope I've made the question that we're answering a little clearer. I believe the issue can be framed quite succinctly. Dual class capitalization is what the New York Stock Exchange wants to be able to permit. There are other rules which require shareholders to vote on a dual class recapitalization. Surely it is the SEC's job to see that this vote is an informed one. Beyond that, we must assess what, if anything, our approval of national securities exchange listing rules or national market system designation standards should have to do with a substantive examination of corporate governance standards. We need to determine with as much detail as possible what the problem is to which we all so earnestly seek solutions.