EXECUTIVE OFFICE OF THE PRESIDENT

June 6, 1988

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: File No. S7-22-87 (Proposed Rule Concerning Voting Rights Listing Standards; Disenfranchisement)

Dear Mr. Katz:

The Office of Management and Budget opposes adoption of Rule 19e-4 proposed by the Securities and Exchange Commission ("Commission") which would impose a uniform rule concerning shareholder voting rights on firms listed on a national securities exchange or whose equity securities are reported on a quotation system of a national securities association. We believe that the proposed rule is too broad and would prohibit activities beneficial to shareholders. Moreover, adoption of the rule raises serious competitive concerns that have not been adequately addressed. Finally, there are less harsh alternative means for preventing possible abuses of shareholders during recapitalizations.

The proposed rule would establish a uniform approach to shareholder voting standards. Specifically, it would prohibit securities exchange listing, quotation and/or transaction reporting of the common stock and equity securities of companies which adopt voting rights plans that "would have the effect of nullifying, restricting or disparately reducing the voting rights" of the companies' public shareholders.[1] As we understand the proposed rule, it is aimed at "recapitalizations" whereby existing shareholders consent to have their voting rights eliminated or significantly reduced. In such cases, the proposed rule would require the firms' equity securities to be delisted or deauthorized (for quotation and reporting purposes). The proposed rule, however, would permit firms to issue stock with inferior voting rights in initial or subsequent offerings of stock so long as they do not have the effect of reducing or eliminating voting power of existing shareholders. In addition, the proposed rule would "grandfather" companies who already have disparate voting right plans as of May 15, 1987.

Even though the proposed rule does not prohibit all disparate voting rights plans, it would prevent existing companies who have "one share, one vote" plans from changing to another standard upon shareholder consent. The rationale for prohibiting such recapitalizations is based on the allegation that recapitalizations are inherently "coercive" and "act to disenfranchise existing shareholders." In addition, the Commission noted their use in recent times to ward off

[1] 52 Fed. Reg. 23665 (June 24, 1987).

hostile takeovers and concluded that "safe havens from hostile acquisitions" should be discouraged.[2]

The proposed rule seeks to prevent shareholder abuse that is believed to occur during the recapitalization process. Although the prevalence of this problem is not clear, it is theoretically possible that due to the inability of dispersed shareholders to act in a collective manner, some shareholders can be pressured into relinquishing their right to a control premium. While the proposed rule would prevent shareholder abuse in such situations, the solution needlessly introduces a new problem -- reducing competition in the securities markets. This reduction of competition harms both companies and shareholders and is contrary to Congress' intent in passing legislation to establish a national market system. Moreover, there are ways to prevent shareholder abuse in recapitalization situations without reducing competition between the exchanges. The solution is also too broad in that it does not distinguish between transactions that abuse shareholders and those that benefit them.

1. The Role of Competition

The one share, one vote issue arose as a controversy during the past decade as the National Association of Securities Dealers (NASD) increasingly was able to obtain and retain listings of firms that traditionally would have listed or switched to the New York Stock Exchange (NYSE). In addition, some important NYSE listed firms such as General Motors defied the Exchange's listing requirements by issuing dual class voting shares for acquired divisions (e.g. GM "E" stock for Electronic Data systems). The NYSE responded to this competitive behavior by proposing a rule that would liberalize its listing requirements. In 1986, the SEC sought public comment on this proposal. However, in 1987, the SEC encouraged the exchanges to meet and come up with a uniform standard. When negotiations between the exchanges failed to produce an agreement, the SEC came up with its current proposal.

What is especially troubling about this proposal is the Commission's apparent abandonment of the earlier NYSE proposal that would have permitted companies and shareholders greater choice, and would have fostered greater competition among exchanges. That proposal would have modified the Exchange's existing requirement that listed firms provide one vote for every share of common stock. The NYSE proposal came in response to growing internal and external competitive pressures. Internally, a number of NYSE-listed companies began issuing classes of stock with inferior voting rights, while others recapitalized in a manner that created disparate voting rights. Externally, the American Stock Exchange (Amex) and NASD began to attract and retain listings because of their more lenient voting rights standards. As the NYSE candidly concedes, it would not have proposed liberalizing its own standard had it not been for these competitive pressures.[3]

Instead of ruling on the merits of the NYSE proposal, however, the Commission has changed course and has proposed a rule of its own radically different from that initially proposed by the NYSE. Moreover, this rule is being proposed on the heels of the Commission's

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[2] 52 Fed. Reg. at 23672

[3] 52 Fed. Reg. at 23668, n.36.

unsuccessful effort to encourage the exchanges to develop a uniform standard among themselves. Whatever the merits of the debate concerning the issue of recapitalization, we believe that the Commission has lost sight of an important value -- that of competition. For in encouraging the three major exchanges to meet together to come up with a uniform rule, the Commission, in effect, is shielding the NYSE from competition. Voting rules, after all, are an important factor in competition for listings among the exchanges. We believe that the stifling of such competition is neither desirable nor furthers the objectives of legislation passed in 1975 to create a national market system. Far from compelling the Commission to establish uniform and homogeneous standards to create one securities market, the 1975 amendments to the Securities and Exchange Act of 1934 were enacted to permit market forces to dictate the correct configuration of a national market system. As part of this plan, Congress authorized the SEC to remove anticompetitive rules that hinder the development of a national market system.[4] The Commission's actions to date -- repudiating the NYSE's proposal and instead encouraging the exchanges to agree on a uniform standard -- are a far cry from the evolution of a market system by competitive market forces Congress had in mind. In any other setting, such cartel-like behavior would be condemned as a violation of the antitrust laws.

The fact that exchanges have different philosophies regarding voting standards should not be cause for alarm. Rather than being viewed as something harmful, this diversity in exchange-provided standards is a sign itself of a healthy and competitive market for exchange services. And rather than seeking to protect the NYSE from competitive pressures exerted by rival exchanges, we believe that the NYSE should be free to adapt to these developments with market-oriented responses of its own. Whether the Exchange should be permitted to alter its listing requirements as they pertain to voting rights of listed members' shareholders, in other words, is a matter that should be determined by the Exchange and its members. The adoption of a rule that institutionalizes the long-standing NYSE standard just as competitive forces are emerging prevents interested parties from working out an efficient accommodation.

2. The Voting Rights Process

The proposed rule as described in the notice of proposed rulemaking would prevent firms from changing from one share, one vote to disparate voting rights plans even if the matter is subject to shareholder approval. The rationale for such a restriction is the belief that the shareholders voting process may not be fully effective to prevent disenfranchisement of shareholders. Although we agree with the Commission regarding the importance of preserving the rights of minority shareholders in corporate voting matters, we do not believe that a prohibition of all such recapitalizations is warranted. If rulemaking is necessary, it should be limited to safeguarding the voting process rather than precluding it.

Such a broad prohibition unduly interferes with what is essentially a contractual relationship between corporate management and shareholders and between corporations and securities exchanges. Indeed, that relationship often anticipates that corporate rules will be

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[4] Macey and Haddock, "Shirking at the SEC: The Failure of the National Market System", 1985 U. Ill. L. Rev. 315, 323 (1985).

changed sometime in the future.[5] How firms alter their rules varies with different combinations of shareholders and often requires independent director consent. Different state laws also play an important role. But the fact that rules are fundamentally being changed, by itself, does not compel the imposition of a prohibition of such change.

Before interfering with this voting process, there should be substantial and convincing empirical evidence that shareholders cannot adequately exercise their rights when faced with issues concerning corporate governance. It is one thing to allege defects in the corporate shareholder voting mechanism and to propose remedies tailored to correcting those defects. It is quite another to take the paternalistic route proposed by the Commission and prevent certain issues from being considered at all by shareholders.

Even if collective action limitations prevent shareholders sometimes from acting in their best interests, imposing uniform exchange listing requirements is a poor tool to correct such problems. There are currently a number of safeguards to prevent abusive recapitalizations including state law, resort to court action, and amendments to corporate charters. If additional safeguards are needed, they should be limited to addressing flaws in the voting process itself. For example, requiring that a majority (or even a super majority) of both outside directors and shareholders approve a recapitalization proposal would be preferable to prohibiting such proposals from being considered at all.

Conclusion

We believe that listing standards neither need be identical for all exchanges, nor need they be established by governmental authorities. Given the competitive forces at work, we believe that voting rules, like other matters of corporate governance, should be established by private contract and certainly not as a result of collusive arrangements between the exchanges. To the extent that the recapitalization voting process is flawed, we believe that any proposed remedial solution should address that process itself and not strive to govern the content of the

[5] As with other issues of corporate governance, how firms go about changing voting rights can be fashioned by contract without the need for a uniform method.

> Whatever the voting rules selected, the possibility exists that the rules will be altered in the future in light of changed circumstances . . . if certain previously agreed-upon procedures are followed (typically approval of the proposed change by shareholders).

Fischel, “Organized Exchanges, and the Regulation of Dual Class Common Stock” (Lexecon, Mar. 1986), at 4.

voting process or reduce choices that shareholders can make.[6] Given the important economic benefits that disparate voting rules can provide to some corporations -- which the Commission acknowledges -- we believe that the proposed rule is too sweeping and that a more limited solution should be fashioned.

Sincerely yours,

James C. Miller III
Director

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[6] On this point, we agree with a statement by the NYSE's Subcommittee on Shareholder Participation and Qualitative Listing Standards:

> . . . shareholders should have considerable latitude in determining the capital structures of the corporations in which they have invested, they should not be arbitrarily barred from so determining, even if in judgement of others the course adopted may in the long run be harmful to their interests . . .

NYSE, Initial Report of the Subcommittee on Shareholder Participation and Qualitative Listing Standards, "Dual Class Capitalization," (Jan. 3, 1985), at 4.