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WASHINGTON, D.C. 20503

JAN 14 1987

MEMORANDUM FOR THE DEPUTY DIRECTOR

FROM: WENDY L. GRAMM
SUBJECT: One Share, One Vote

The Securities and Exchange Commission held hearings on the "one share, one vote" issue on December 16 and 17. They are now considering the comments they have received, and will probably not reach a decision before February. The Department of Justice (Antitrust Division) submitted comments to the SEC in early December that urged the SEC to approve the NYSE proposed rule change to permit dual class common stock.

The Council of Economic Advisers is currently planning to file their views with the SEC also, and they have asked if we (OMB) would join them in such a filing. CEA also believes that the SEC should approve the NYSE proposed rule. The purpose of this memo is to outline the issue for you to assist in deciding whether to join such a filing.

PROS and CONS

The issue is a complicated one, involving arguably conflicting and counterintuitive economic evidence, federalism issues, and a dynamic context. I will try to summarize the arguments on both sides of the issue:

Arguments for Approving
the Proposed Rule

- o Dual class capital structures are necessary to provide corporations with flexible capital structures that best suit their individual needs.
- o Studies of the effect of dual class recapitalizations that have occurred in the past generally confirm that stock prices increased as a result, contradicting the thesis that shareholders are harmed.

Arguments Against Approving
the Proposed Rule

- o Dual class capital structures can and have been implemented in ways that are clearly antithetical to shareholder interests and that shareholders are effectively powerless to stop.
- o Economic studies that show stock price gains from past recapitalizations are not useful in predicting future effects since most uses of dual class shares in the past have occurred with companies that already have very high levels of insider stock ownership (30-50%).

- o Because the proposed rule requires dual class capitalization to be approved by a majority of the companies outside directors and shareholders, it provides adequate protection against abuse of outside shareholders by insiders.
- o The increasing holdings of NYSE companies' shares by institutions that are sophisticated investors provides added assurance that shareholders will not be abused.
- o Historical evidence indicates that firms generally undertake dual class recapitalizations for reasons other than management entrenchment, although such an objective is certainly possible.
- o The analogy between "one share, one vote" and "one person, one vote" is inappropriate on many grounds -- government power over its citizens is far greater, exit costs of a corporate shareholder are far less, objectives of shareholders are usually the same (while citizen's objectives often differ), corporate policies are disciplined by the marketplace, corporate "democracy" is based on the amount of investment (not a unitary "citizen"). Moreover, competing models already exist on the American Exchange and NASD system.
- o The issue of allowable capital structure for corporations is fundamentally a matter of contract among shareholders of the firm and the firm itself. Such matters are traditionally the province of State law, and should not be the subject of Federal intervention except in cases of a serious market failure of national dimensions.
- o The rarity of success in challenging corporate managers in proxy contests provides strong evidence of serious inefficiencies in the corporate voting system that should be corrected before allowing corporations to make such irrevocable changes as concentrating voting control in insider hands.
- o Some empirical evidence suggests that a greater presence by institutional shareholders reduces the probability of success in proxy challenges to management.
- o If permitted, dual class stock will be used to immunize firms against hostile takeovers, eliminating a crucial "check" in the system of corporate governance.
- o The concept of "one share, one vote" is as essential to the legitimacy of corporate democracy as "one person, one vote" is to political democracy.

- o A decision to prohibit dual class capitalization will likely incur costs by discouraging firms from going public, decreasing public ownership of stocks, and causing profitable investment projects to be foregone or delayed.

Other Alternatives

The SEC is apparently considering at least two major alternatives to simply approving or disapproving the NYSE proposal.

- o Promulgate a rule that requires all exchanges to adopt a "one share, one vote" rule -- This is the result that both the NYSE and AMEX would prefer to see, presumably with some exceptions.
- o Promulgate a rule, as above, but try to allow as much flexibility as possible, with the end result of prohibiting only those dual class structures that seem to be most problematic. Exceptions would likely include:
 - grandfathering all existing cases;
 - allow any new issues (i.e. prohibit exchange offers);
 - permit new classes of stock in acquisition transactions (e.g., GM in acquiring Hughes or EDS).

The key to this alternative is the elimination of exchange offers, which appear to present a major opportunity for "coercion" of shareholders. The remaining opportunity for abusing shareholders would be the retroactive restriction of alienability of existing shares (e.g. prohibiting the transfer of voting rights with the sale of stock).

Summary

While dual class capitalization structures are appropriate in many cases and appear to have been used appropriately in the past (with a few exceptions), they clearly present an opportunity for abuse by corporate insiders. While the voting protections provided by the NYSE proposal should be sufficient to protect outside shareholders by requiring their majority assent, there is some evidence that shareholders, especially institutional shareholders, may not always vote in their shareholders interest -- a most disturbing prospect! There is not, however, sufficient evidence to justify reversing our reliance on shareholder democracy in favor of government regulation.

Moreover, the questions of voting rights and capital structure are fundamentally issues of corporate governance, which has traditionally been regulated by State law. Not only does the historical evidence not demonstrate a national market failure associated with dual capitalizations, it suggests they have generally created shareholder value. The problem is reconciling what could happen (which is bad) with what has happened (which has been generally good).

I don't think joining CEA in comments is necessary. Not only has DOJ already commented, but the formal comment period is now closed (although the SEC would still receive and consider CEA's comments). Also, although I believe CEA's and DOJ's positions are correct, the evidence is somewhat mixed.