OFFICE OF THE
INVESTOR ADVOCATE

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

MEMORANDUM

TO: U.S. Securities and Exchange Commission

FROM: Rick A. Fleming, Investor Advocate[1]

DATE: October 16, 2015

RE: Recommendation of the Investor Advocate
File No. SR-NYSE-2015-02

RECOMMENDATION:

Disapprove the proposal from the New York Stock Exchange LLC to amend Sections 312.03(b) and 312.04 of the NYSE Listed Company Manual to exempt Early Stage Companies from having to obtain shareholder approval before issuing shares for cash to Related Parties, affiliates of Related Parties or entities in which a Related Party has a substantial interest.

I. Introduction

Pursuant to Section 4(g)(4) of the Securities Exchange Act of 1934 ("Exchange Act"),[2] the Office of the Investor Advocate at the U.S. Securities and Exchange Commission ("Commission" or "SEC") is responsible for, among other things, analyzing the potential impact on investors of proposed rules of self-regulatory organizations ("SROs"). In furtherance of this objective, we routinely review and examine the impact on investors of significant rulemakings of SROs, including the New York Stock Exchange LLC ("NYSE" or the "Exchange"). As

[1] This Recommendation expresses solely the views of the Investor Advocate. It does not necessarily reflect the views of the Commission, the Commissioners, or staff of the Commission, and the Commission disclaims responsibility for all analyses, findings, and conclusions contained herein.

[2] 15 U.S.C. § 78d(g)(4).

appropriate, we make recommendations to help ensure that the interests of investors are fully considered as rules are adopted.

In File No. SR-NYSE-2015-02 (the "Notice"),[3] NYSE has proposed to amend Sections 312.03(b) and 312.04 of the NYSE Listed Company Manual (the "Manual") to exempt early stage companies from the existing NYSE requirement to obtain shareholder approval before selling shares for cash to related parties, affiliates of related parties, or entities in which a related party has a substantial interest. As proposed, an "Early Stage Company" would be defined as a company that has not reported revenues greater than $20 million in any two consecutive fiscal years since its incorporation.[4] Section 312.03(b)(1) of the Manual would continue to define "Related Party" as a director, officer, or substantial security holder (*i.e.*, a holder of five percent or more of the common stock) of the company. As specifically proposed, Early Stage Companies would be exempt from seeking shareholder approval for cash sales to a Related Party for new issuances of less than twenty percent of the issuer's then-outstanding common stock, provided that the Early Stage Company's audit committee or a comparable committee comprised solely of independent directors reviews and approves all such transactions prior to completion. For cash sales to a Related Party equal to or greater than twenty percent of the issuer's common stock, such issuance would remain subject to the shareholder approval provisions of Section 312.03(c) of the Manual.

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[3] Securities Exchange Act Release No. 74849 [April 30, 2015], 80 FR 26118 [May 6, 2015], File No. SR-NYSE-2015-02, *available at* http://www.gpo.gov/fdsys/pkg/FR-2015-05-06/pdf/2015-10503.pdf (the "Notice"). *See also* Securities Exchange Act Release No. 75599 [August 4, 2015], 80 FR 47978 [August 10, 2015], File No. SR-NYSE-2015-02, *available at* http://www.gpo.gov/fdsys/pkg/FR-2015-08-10/pdf/2015-19536.pdf (the "Order Instituting Proceedings").

[4] *See* Proposed Section 312.04(k) of the Manual. Any Early Stage Company will lose that designation at any time after listing on the Exchange that it files an annual report with the SEC in which it reports two consecutive fiscal years in which it has revenues greater than $20 million in each year. *Id.*

The Office of the Investor Advocate has reviewed the Exchange's proposed rules. In short, we do not support the Exchange's efforts to lower the listing requirements for certain small companies on a national securities exchange otherwise known for having high standards that preserve the quality of, and the public's confidence in, its market. As more fully described below, we believe that the NYSE's proposed rule change is inconsistent with investor protection. Accordingly, we recommend that the Commission disapprove, either directly or through authority delegated to staff,[5] the Exchange's proposed rule change in its current form.

II. Background

The Exchange Act requires, in relevant part, that the rules of a national securities exchange be designed, in general, to protect investors and the public interest.[6] The listing standards of an exchange should therefore be designed to protect financial markets and the investing public. For an issuer, listing on an exchange provides an environment that, in comparison to being quoted in over-the-counter markets, offers the potential for enhanced liquidity, transparency, and oversight. These benefits flow to investors. Thus, we generally support efforts to help companies, including small and mid-size companies, become or remain listed on exchanges under appropriate circumstances. We also acknowledge that the Exchange Act permits markets to develop their own eligibility standards for securities traded on their markets and that these standards may differ among markets.

As the Commission has stated previously, the development and enforcement of adequate standards governing the initial listing and maintenance of listing of securities is an activity of

[5] 17 C.F.R. 200.30-3(a)(12); *see also* 15 U.S.C. § 78s(b)(2).

[6] *See* 15 U.S.C. § 78f(b)(5).

critical importance to financial markets and the investing public.[7] Listing standards serve as a means for a marketplace to screen issuers and to provide listed status only to *bona fide* companies with sufficient float, investor base, and trading interest to maintain fair and orderly markets.[8] In addition to those quantitative standards, qualitative requirements, such as audit committees, independent director oversight of executive compensation, a mandatory code of conduct, shareholder meetings (including proxy solicitation and quorum), review of related party transactions, shareholder approval (including voting rights), and disclosure policies should be designed to ensure that companies trading on a national securities exchange will adequately protect the interests of public shareholders.[9]

Among the qualitative standards contained in its Manual, NYSE currently requires shareholder approval prior to a listed company's issuance of additional shares where, among other things, the number of shares to be issued to Related Parties (officers, directors and substantial security holders)[10] exceeds one percent of either the number of shares of common stock or the voting power outstanding before the issuance (or five percent if a substantial security holder and the issuance relates to a sale for cash at a price at least as great as each of the book and market value).[11] As described above, the Exchange has proposed to exempt Early Stage

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[7] *See*, *e.g.*, Securities Exchange Act Release No. 65225 [August 30, 2011], 76 FR 55148 [September 6, 2011], File No. SR-BATS-2011-018, *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-09-06/pdf/2011-22627.pdf (Order Approving Proposed Rule Change to Adopt Rules for the Qualification, Listing and Delisting of Companies on the Exchange) ("BATS Approval Order").

[8] *See id.* at 55152 and footnote 30.

[9] *See id.* at 55152.

[10] *See* NYSE Listed Company Manual, Section 312.03(b)(1).

[11] *See* NYSE Listed Company Manual, Section 312.03(b).

Companies[12] from seeking shareholder approval before issuing up to twenty percent of outstanding shares to Related Parties, affiliates of Related Parties or entities in which a Related Party has a substantial interest, provided that the company's audit committee or a comparable committee comprised solely of independent directors reviews and approves of such transactions prior to completion.[13]

The Exchange represents that this proposal comes from a desire to compete with the NASDAQ Stock Market LLC ("NASDAQ"), although it also notes that NYSE MKT LLC ("NYSE MKT"), its affiliated exchange, already permits such companies to raise capital in this manner.[14] The Exchange also represents that, in its experience, listed Early Stage Companies do not generate revenue from sales and may be dependent on fundraising from the initial public offering and subsequent sales of equity securities to continue or expand operations.[15] Currently, if a subsequent share issuance to Related Parties is greater than one percent of common stock or voting power outstanding, the listed company is required to obtain shareholder approval. The Exchange represents that shareholder approval in such private placements is expensive and time consuming.[16]

The Commission has instituted proceedings to determine whether to approve or disapprove NYSE's proposed rule change.[17] The Commission expressed concern that: (1) audit

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[12] As noted above, an "Early Stage Company" would generally be defined as a company that has not yet reported revenues greater than $20 million in any two consecutive fiscal years since its incorporation. *See* Notice, *supra* note 3, at 26119.

[13] *See* Notice, *supra* note 3.

[14] *See Notice*, *supra* note 3, at 26120 and at footnote 8. The Notice does not mention NASDAQ OMX BX's venture exchange.

[15] *See Notice*, *supra* note 3, at 26119.

[16] *See Notice*, *supra* note 3, at 26119.

[17] *See* Order Instituting Proceedings, *supra* note 3.

committee approval may not be an effective substitute for the approval of shareholders, whose interests would be directly impacted by the potentially dilutive effect of such a transaction; and (2) the benefit to shareholders of allowing companies to raise additional capital quickly and inexpensively must be weighed against the potentially detrimental impact of a dilutive transaction on shareholders who would no longer have the right to approve it.[18]

In response to the Order Instituting Proceedings, NYSE submitted a comment letter and amendment to: (1) clarify that the NYSE had a long-standing policy requiring that any time a listed company sells equity securities to a director, officer or employee for a price that is at a discount to the then-current market price, such securities are deemed to be equity compensation requiring shareholder approval under Section 303A.08 of the Manual; (2) supplement arguments that the audit committee could be an effective substitute for shareholder approval in this context (*i.e.*, noting that directors owe a fiduciary duty to shareholders); and (3) amend the proposed rule text to make clear that it encompasses not only a Related Party, but also an affiliate of a Related Party or a company in which a Related Party has a substantial interest.[19]

III. Analysis

We appreciate NYSE's clarification that the sale of discounted shares to an officer, director, or employee would be considered equity compensation that is subject to a shareholder vote under NYSE's separate equity compensation rules.[20] However, the proposal will result in at

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[18] *See* Order Instituting Proceedings, *supra* note 3, at 47979.

[19] Letter from Clare F. Saperstein, Associate General Counsel, NYSE, to Brent J. Fields, Secretary, Commission, dated August 31, 2015, *available at* http://www.sec.gov/comments/sr-nyse-2015-02/nyse201502-1.pdf ("NYSE Comment Letter and Amendment").

[20] *See* NYSE Comment Letter and Amendment, *supra* note 19, in which the Exchange, in relevant part, clarifies that any issuance to a director, officer or employee for a price that is at a discount to the market price would be deemed equity compensation requiring shareholder approval under Section 303A.08 of the Manual.

least two significant changes. First, shares could be sold to substantial security holders at a discount, and those sales would no longer require shareholder approval unless they exceeded twenty percent of outstanding shares or resulted in a change of control. Second, all Related Parties, including officers and directors, could obtain a significantly larger share of ownership control by paying the then-current market price for additional shares in a private transaction, without a vote of the existing shareholders.

When new shares are sold at a discount from the greater of book or fair market value, it results in economic dilution. Economic dilution reduces the value of an existing shareholder's investment in the issuer because it spreads the underlying value of the company among more owners, and the new owner injects a less-than-proportionate share of capital into the business.[21] In effect, the issuance results in an immediate transfer of value from existing shareholders to the new shareholder(s).

In addition, current investors in these companies would face potential dilution of their ownership control. Specifically, shareholders could find that their percentage of equity ownership has been reduced by up to 16.6 percent[22] and that insiders or other Related Parties of the issuer now control that additional voting power. This dilution of ownership control could ultimately result in decisions that are adverse to the interests of the original shareholders.

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[21] *See* Order Instituting Proceedings, *supra* note 3, at 47979.

[22] For example, upon issuing an additional 19.9 percent of shares, a shareholder that previously held 10 percent would now own only 8.33 percent (10% / 119.99%) , a reduction of 16.6 percent in their portion of ownership [(10 - 8.33) / 10]. The short term effect of the newly acquired cash on the issuer's book and market value depends upon the specifics of the private placement (*i.e.*, how deeply the shares are discounted, the impact of mandatory holding periods on share value, etc.). The long term effect on share price is much less certain and depends on how effectively the company employs the additional capital raised.

Of course, it is easy to envision situations in which an infusion of capital into a company could be in the existing shareholders' long-term best interest, even if it results in significant dilution of their economic and ownership interests in the near term. However, when the recipient of new shares is a Related Party, it creates a risk that the company may be engaging in a "sweetheart deal" that is motivated by a conflict of interest. Under these circumstances, where a transaction with a Related Party creates a heightened risk of significant harm to existing shareholders, those shareholders should be given the opportunity to evaluate the merits of the transaction and to vote on whether to approve it. The NYSE proposal would strip this right from them.

Moreover, it is important to note that time-sensitive situations can already be addressed without the new rules. Existing rules provide NYSE-listed issuers assistance when the delay in securing shareholder approval would seriously jeopardize the financial viability of the enterprise.[23] The proposed rules would remove shareholder protection even when time is not the most pressing factor, thereby increasing the likelihood that listed companies could engage in issuances in ways and at times that may not be in their investors' best interest.

The Exchange argues that adequate protection is afforded to shareholders because any transaction will require the review and approval of the audit committee (or a comparable committee of independent directors).[24] However, we do not agree that audit committee approval is an adequate substitute for a shareholder vote in this instance. Although the audit committee performs many critical functions that serve to protect the interests of investors, an audit committee will not always reach the same conclusion as shareholders regarding the best interest

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[23] *See* NYSE Listed Company Manual Section 312.05.

[24] *See* Notice, *supra* note 3, at 26120.

of the company. Thus, certain corporate actions that directly and significantly impact shareholders' interests should appropriately be subject to shareholder approval. Just as shareholder approval is the standard for equity compensation plans, we believe shareholder approval should be required for sales of shares to Related Parties.

We are also concerned that this proposal reflects something of a "race to the bottom" amongst the exchanges.[25] While it may be true that other exchanges are less strict in their requirements for shareholder approval of related party transactions, we believe the Commission should be encouraging the exchanges to *enhance* their standards, not devolve to the lowest common denominator because of competitive concerns.

As noted above, investors have an expectation that listed companies are subject to heightened qualitative standards, and this would seem particularly true of NYSE-listed companies. Indeed, we believe this is recognized by issuers who seek to list and trade on NYSE to improve their visibility and aid in their capital formation efforts. Given these particular public expectations, a commensurate level of quality and investor protection should be assured in their listing standards.

We believe it is inadvisable to create what could be considered a *de facto* second tier on the NYSE, with lower corporate governance standards for smaller companies. It could lead to significant investor confusion about the listing standards on the exchange, as investors may be

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[25] *See, e.g.,* Concept Release Concerning Self-Regulation, Securities Exchange Act Release No. 50700 [November 18, 2004], 69 FR 71256 [December 8, 2004], *available at* https://www.sec.gov/rules/concept/34-50700.htm ("As with SRO competition for members and order flow, competition for issuers may cause an SRO to fail to discharge its self-regulatory responsibilities properly. This can take the form of admitting to trading issuers that fail to satisfy initial listing standards; delaying the delisting of issuers that no longer satisfy maintenance standards; failing to enforce listing standards (including the new issuer corporate governance standards); and reducing (or even eliminating) listing fees. This competition also can reveal itself in an unwillingness to restrict issuer activities or impose requirements that may be more stringent than similar rules of competitor SROs.").

surprised to learn that some companies do not follow the same standards of accountability. Unfortunately, the proposal before the Commission does not appear to take any meaningful steps to preclude likely investor confusion; for example, NYSE's Manual will not otherwise describe or highlight the proposed exception.[26]

Although some companies may not be suited to flourish under the current listing standards on NYSE, a single exchange need not be all things to all issuers. In considering this proposed rule change, we believe that the benefit to be afforded to a small subset of issuers on NYSE would be unreasonable when weighed against the anticipated investor confusion concerning the protections afforded with respect to corporate governance and shareholder rights on NYSE.

Finally, the Notice does not provide sufficient information for the Commission to properly evaluate the proposal's impact on efficiency, competition, and capital formation, as required by Section 3(f) of the Exchange Act.[27] There is no count or description of the current NYSE-listed companies that would qualify for the proposed exemption, nor is there a count or

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[26] *See* NYSE Listed Company Manual, Section 303A.00 Introduction ("Section 303A applies in full to all companies listing common equity securities, with the following exceptions: …"). When BX Venture Market sought to adopt its listing standards, it recognized its standards would "attract smaller, less liquid companies, which may create higher risks for investors." *See* Securities Exchange Act Release No. 64437 [May 6, 2011], 76 FR 27710 [May 12, 2011] (File No. SR-BX-2010-059) ("BX Approval Order"). The Commission noted that, "[m]indful of these risks and the … objective to preserve the quality of and public confidence in its market, the [exchange] has adopted rules to preclude investor confusion[.]" Among other things, that exchange committed to prominently include information on its website describing the differences of its market and, in connection with issuances not requiring shareholder approval, the exchange committed that listed companies would provide notice of any five percent change in its shares outstanding and any capital-raising transactions, and exchange staff would review such issuances for public interest concerns, including issuances significantly below the market price or for the benefit of related parties. Although not a perfect analogy, as BX Venture Market sought to list companies that were not "blue sky" exempt nor subject to Regulation NMS, here, there appears to be no commitment in the Notice for how NYSE will seek to appropriately preclude investor confusion with respect to its own proposal. As suggested by the Notice, NYSE currently has only a small number of such small issuers. Without more prominent investor education and oversight, the proposal could create an almost hidden tier.

[27] 15 U.S.C. § 78c(f).

description of the larger universe of such companies listed on other exchanges or quoted over-the-counter. The Notice does not describe how many list (or delist) in a given year or how often, if ever, such companies accessed capital through private placements to Related Parties. There is no description of the cost of seeking shareholder approval in those instances, nor the suggestion that any of those companies have experienced issues with the level of access to capital afforded by NYSE's listing standards, other than the assertion that this standard factored into the decision of other companies to list on NASDAQ (or, perhaps, NYSE MKT). While it may require work by NYSE to obtain detailed information regarding NASDAQ-listed "early stage companies" or those quoted over-the-counter, such information would allow for a data-driven and meaningful consideration of the proposed rule's impact on efficiency, competition, and capital formation.

IV. Conclusion

In conclusion, we urge the Commission to disapprove the proposal. Although we support efforts to facilitate capital formation for smaller listed companies, we have significant reservations about the potential consequences of lowering corporate governance standards on the NYSE. The proposal will weaken the rights of existing shareholders, result in economic dilution, and cause ongoing investor confusion. Such a change could also have significant impact on investors' confidence in the market.