Corporate Federalism in the Administrative State: The SEC's Discretion to Move the Line between the State and Federal Realms of Corporate Governance

Robert B. Thompson

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CORPORATE FEDERALISM IN THE ADMINISTRATIVE STATE: THE SEC'S DISCRETION TO MOVE THE LINE BETWEEN THE STATE AND FEDERAL REALMS OF CORPORATE GOVERNANCE

Robert B. Thompson*

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* New York Alumni Chancellor's Chair in Law and Professor of Management, Vanderbilt University. I received very useful comments and direction from Steve Bainbridge, Lisa Bressman, Christopher Yoo, participants at the UCLA Sloan Colloquium, and at Seton Hall University School of Law.
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Introduction

Reform that followed in the wake of corporate scandals at Enron and WorldCom, the most dramatic changes in corporate governance in seventy years, arrived from a surprising direction. State law, the primary source of governance rules, stood pat, content to continue as before with a set of rules that trust directors and private ordering. Federal law, long distrustful of that approach but still unwilling to directly displace state incorporation rules, nibbled around the edges of governance by expanding the obligations of officers and prescribing increased roles for various gatekeepers of corporate practice. The most dramatic governance changes, instead, showed up in the listing standards of our national stock exchanges. Their detailed requirements for independent directors and their role in the corporation go to the heart of corporate governance.

Corporate governance from listing standards is not new; its roots are deep in the nineteenth century, when the exchanges were completely private bodies. But the recent use of these standards reflects a different use and a different motivation. The stock exchange denomi-
nated rules have become the means by which a federal agency, here the Securities and Exchange Commission (SEC), can avoid the federalism-based limits on its authority imposed by the federal courts in cases such as *Business Roundtable v. SEC*.¹ The effectiveness of these stock exchange governance rules against legal challenge stands in contrast to the agency’s more recent rulemaking as to mutual funds and hedge funds, which has been struck down by federal courts.² At the same time, technology and institutional changes in equity markets have dramatically modified the economic incentives of the exchanges to make and enforce governance listing standards. The result is an unstable equilibrium for corporate governance rules arising from this source.

This Article begins in Part I with a brief introduction of the triumvirate of lawgivers that shapes American corporate governance, focusing particularly on the current location of the line between federal and state law in this sharing of power. Part II traces the evolution of the stock exchange listing standard, a history that focuses on the dominant American exchange, the New York Stock Exchange. Part III models the lawgiving function of the exchange, probing the lessening economic incentives for an exchange to provide such rules, and changes brought about by the New York Stock Exchange going public in 2006. In the wake of these changes this Article suggests that listing standards have taken on a larger role as a means for the SEC to avoid judicially imposed limits on rulemaking. Part IV explores the SEC’s ability to use such exchange rulemaking to move the line of substantive corporate regulation between the federal and state realms and concludes with a peek into what we might expect in the future as to corporate governance rules from stock exchanges.

I. The Triumvirate of Lawgivers for Corporate Governance

This examination begins with the three major sources of formal rules provided for corporate governance: state law, federal law, and

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¹ 905 F.2d 406, 408 (D.C. Cir. 1990).

² Chamber of Commerce v. SEC, 412 F.3d 133, 143 (D.C. Cir. 2005) (holding that the agency failed to determine costs of requirements of independent chair of mutual fund and seventy-five percent independent directors and failed to address a proposed alternative). In a petition brought by the Chamber of Commerce in a follow-up case, the court found it inappropriate for the agency, in response to the first case, to rely on material not in the rulemaking record without affording any opportunity for public comment. Chamber of Commerce v. SEC, 443 F.3d 890, 901 (D.C. Cir. 2006); see also Goldstein v. SEC, 451 F.3d 873, 883–84 (D.C. Cir. 2006) (invalidating an SEC rule requiring hedge fund registration based on the court’s conclusion that the rule conflicted with the purposes of the Investment Advisor Act of 1940).
the listing standards of the stock exchange where a company's shares are traded. There are other sources that are important to governance, but they trail the impact of the first three and are put aside for the current discussion. These include, for example, the individual firm's articles of incorporation, its bylaws, and various contractual obligations that provide incentives or monitors for corporate governance.\(^3\) In addition, the various markets in which the corporation operates can be important constraints on governance.\(^4\) Norms, both of the individual directors and those that shape the business world, often act as substitutes for law.\(^5\)

A. State Law: The Traditional Locus of Corporate Governance Law

State law has traditionally occupied center stage among laws structuring corporate governance. It is state law that creates corporations and decrees the rights of the three key players in governance: shareholders, directors, and officers.\(^6\) In turn, the dominant state law approach has been defined by Delaware, that small mid-Atlantic state that has acquired a preeminent position in American corporate law as the home to more corporations than the other forty-nine states combined and holding an eighty-five percent market share among corporations that choose to incorporate outside of their headquarters' state.\(^7\) Delaware's approach to corporate governance has been clear for decades: trust directors and leave them ample space within which to make decisions about how to govern the corporation.\(^8\) Thus,

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\(^4\) These include the company product market, the market for capital, the market for executives and other employees, and the market for corporate control.


\(^6\) Burks v. Lasker, 441 U.S. 471, 478 (1979) ("[T]he first place one must look to determine the powers of corporate directors is in the relevant State's corporation law."); Cort v. Ash, 422 U.S. 66, 84 (1975) ("Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that... state law will govern the internal affairs of the corporation.").

\(^7\) Lucian Arye Bebchuk & Alma Cohen, Firms' Decisions Where to Incorporate, 46 J.L. & Econ. 383, 391 tbl.2 (2003).

\(^8\) See generally Robert B. Thompson, Delaware, the Feds, and the Stock Exchange: Challenges to the First State as First in Corporate Law, 29 Del. J. Corp. L. 779, 780–83
Delaware begins with placing all corporate power in the directors and provides expansive deference (via the business judgment rule and other doctrines) to their decisionmaking regarding the corporation.\(^9\) The implicit message of the Delaware system is not to reject the various constraints on corporate governance described in the introduction to this Part, but to funnel all of them through the board of directors and to leave the board relatively unfettered in making choices as it sees fit.

**B. Federal Law: No Longer Happy with a Supporting Role?**

Throughout the twentieth century, Congress chose not to enact a federal incorporation law that would displace state law rules of corporate governance. But, from time to time, usually when moved by corporate scandals, Congress has chosen to focus on particular aspects of corporate governance that seemed to be broken. Thus, the federal lawmakers have chosen to federalize part of the shareholder-director relationship, the officer-shareholder relationship, and particularly in the Sarbanes-Oxley Act of 2002 ("Sarbox"), the officer-director relationship.\(^10\) Specific examples of federal intrusion include:

- Insider trading;\(^11\)
- Solicitation of proxies;\(^12\)
- Tender offers and going private transactions.\(^13\)

The chosen method of federal regulation usually has been disclosure. As such, federal law has long acknowledged its supplemental role to the states in allocating substantive rights allocated among directors and shareholders. Other constituencies have been diverted

\(^{9}\) *Del. Code Ann. tit. 8, § 141(a) (2001)* (providing that all corporate power is by or under the direction of directors).


\(^{11}\) *Louis Loss & Joel Seligman, Fundamentals of Securities Regulation* 936-39 (5th ed. 2004) (noting that thanks to Rule 10b-5, the minority rule under state common law as to insider trading has become the law of the land).

\(^{12}\) *See 15 U.S.C. §§ 77k(a)–(g) (2000).*

\(^{13}\) *See 113 Cong. Rec. 854 (1967) (remarks of Sen. Williams)* ("The need for such legislation has been caused by the increased use of cash tender offers rather than the regular proxy fight to gain control of publicly owned corporations... This legislation will close a significant gap in investor protection under the Federal securities laws... "); *see also* S. Rep. No. 90-550, at 4 (1967) (explaining that the proposed bill would "provide for full disclosure in connection with cash tender offers and other techniques for accumulating large blocks of equity securities of publicly held companies").
to other statutes, leaving corporate law focused on directors, shareholders, and officers.\footnote{Mark J. Roe, Delaware’s Politics, 118 Harv. L. Rev. 2491, 2499–2504 (2005).}

Traditional notions of federalism framed judicial responses when federal courts or the SEC sought to widen the reach of federal law. In the 1960s and 1970s, a series of lower federal court decisions expanded the reach of the antifraud provision of the federal securities law to take in much of corporate mismanagement.\footnote{See, e.g., Green v. Santa Fe Indus. Inc., 533 F.2d 1283, 1299 (2d Cir. 1976) (holding that fraudulent undervaluing of shares in a merger can constitute 10b-5 fraud), rev’d 430 U.S. 462 (1977); Schoenbaum v. Firstbrook, 405 F.2d 215, 221 (2d Cir. 1968) (en banc) (holding that majority self-dealing, without more, can constitute 10b-5 violation).} In \textit{Santa Fe Industries, Inc. v. Green},\footnote{430 U.S. 462 (1977).} the Supreme Court brought a halt to such judicial redefining of the allocation between federal and state law.\footnote{Id. at 479 (quoting Cort v. Ash, 422 U.S. 66, 84 (1975)).} It held that shareholder complaints about majority shareholders pushing through a merger on allegedly unfair terms should be left to state law:

\begin{quote}
Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. As the Court stated in \textit{Cort v. Ash}, . . . “Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.”\footnote{Id. at 478–80.}
\end{quote}

Since \textit{Santa Fe}, the context generating the principal discussion of corporate law federalism has moved from the litigation setting, which generated the earlier cases, to rulemaking by the SEC.\footnote{An exception involving neither judicial common law nor rulemaking is the case law around the question of whether the United States Constitution preempts state legislation raising defensive tactics against takeovers. \textit{Compare} Edgar v. MITE Corp., 457 U.S. 624, 640 (1982) (holding unconstitutional an Illinois anti-takeover act as indirect violation of the Commerce Clause), \textit{with} CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 86–87, 94 (1987) (sustaining Indiana anti-takeover law against pre-emption and Commerce Clause challenges).} Also since that time, the Supreme Court has developed the \textit{Chevron} doctrine as to administrative deference to an agency’s actions.\footnote{Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–45 (1984).} The framework for judicial discussion of the federalism aspects of SEC action at the
boundary between federal and state authority is most clearly set out in
the D.C. Circuit’s opinion in Business Roundtable,21 relating to an SEC
rule that, in effect, banned midstream adoption of dual class voting in
corporations, albeit through a requirement that stock exchanges
impose such a limit.22 Dual class voting is a corporate governance
structure that gives one set of shareholders (usually managers or the
founders) a class of votes with multiple votes per share, thereby
permitting them to maintain control of the enterprise even though
having only a minority of the equity interest.23 Such voting rules are
at the core of the state law of corporations. The federal appellate
court threw out the federal prohibition of this voting arrangement
based on federalism concerns and citing Santa Fe.24 The opinion con-
cluded with a strong rebuke of the SEC’s efforts: “To argue that Con-
gress’s ‘equal regulation’ mandate supports SEC control over
corporate governance through national listing standards is to gamble
that the court will accept a Commission spin on a statutory fragment
without even a glance at its context. Wrong court, bad gamble.”25

Congressional action in passing Sarbox can provide the kind of
clear indication of congressional intention sought by the Court in the
Santa Fe and Business Roundtable cases. There the federal government
imposed new regulations on: (1) accountants/auditors;26 (2) attor-
neys;27 and (3) analysts.28 These rules do not directly impinge on Dela-
ware corporate law. These gatekeepers certainly impact governance,
but their regulated activities are not central to the model that Dela-
ware follows. Some parts of the federal law do define the roles of
directors and officers beyond what federal law had done previously.
As to directors, it specified the function of the audit committee of the
board,29 required that all members of that committee be indepen-

23 See generally Stephen M. Bainbridge, The Short Life and Resurrection of SEC Rule
19c-4, 69 Wash. U. L.Q. 565, 568–74 (1991) (tracing the history of the rule’s develop-
ment and litigation).
24 Bus. Roundtable, 905 F.2d at 410.
25 Id. at 416.
27 15 U.S.C. § 7245 (Supp. IV 2004). This led to an SEC regulation titled “Stan-
dards of Professional Conduct for Attorneys Appearing and Practicing Before the
28 Sarbanes-Oxley Act of 2002 § 501. This led to regulation promulgated by the
and effectively required that at least one member be financially literate. Those rules are not inconsistent with Delaware law, but Delaware law does not even require an audit committee, nor does it have any qualifications for directors (other than that they be natural persons). What the federal law has done, for the first time, is take away the right of Delaware to leave this space vacant and to let private ordering determine the appropriate means by which directors do their jobs.

In addition Congress has imposed several very specific obligations on officers: (1) requiring the CEO and CFO to certify financial statements; (2) requiring the corporation's attorneys to report to the chief legal officer or the chief executive officer about breaches of fiduciary duty; (3) requiring the CEO to certify whether controls in place are effective; and (4) requiring a code of conduct or an explanation why the company lacks one. Again, these requirements are not in conflict with any affirmative requirement of Delaware law. Indeed Delaware law is almost completely silent about officers and says nothing about what they must do. Section 142 of the Delaware General Corporation Law refers to officers, but the section defers almost completely to the corporation's bylaws or board resolutions as to what officers should do, how they are chosen, and how vacancies


31 15 U.S.C. § 7265 (requiring the SEC to issue rules mandating that issuers “disclose whether or not, and if not, the reasons therefor, the audit committee . . . is comprised of at least 1 member who is a financial expert, as such term is defined by the Commission”); see Standards Relating to Listed Company Audit Committees, Exchange Act Release No. 33-8220, 68 Fed. Reg. 18,788 (Apr. 16, 2003). The release adds Item 401(h) to Regulation S-K. Id. at 18,817–18. It also adds Item 7(d)(3) to Schedule 14A. Id. at 18,807–08.

32 Del. Code Ann. tit. 8, § 141(b) (Supp. 2002 & 2006) (requiring that each member of the board of directors be a natural person, but not specifying other directors' qualifications or requiring that board members be shareholders); id. § 141(c) (2001) (permitting the board to designate one or more committees, but not requiring any).


35 See id. § 7262.

36 See id. § 7264.
are filled. This new federal law now constricts the space that Delaware has given directors to define or not define what the directors want the officers to do.

C. The Third Side of the Triangle: Stock Exchange Listing Standards

In addition to state and federal law, American corporate governance rules derive from the listing standards of the stock exchanges. Exchanges specify particular internal governance rules that apply to a company that chooses to have its stock listed on that exchange. Although a recent New York Stock Exchange (NYSE) release touted the Exchange as the nation’s “principal source of corporate governance standards,” the impact of the exchange prior to Enron had shrunk to a fairly minor level. In the aftermath of Enron and WorldCom, however, changes to the listing standards have brought the exchanges back into the board room in terms of specifications for director behavior and corporate governance.

The evidence discussed below suggests that the stock exchange rules as to corporate governance usually occupy a space between what is currently required by state corporate law and what is currently required by federal securities and can be a means to change the boundary between them. The new requirements for independent directors found in stock exchange listing requirements were provoked, nurtured, massaged, modified, and approved by the agency. As this is currently unfolding, this process is more one of disguised federalization with the SEC using stock exchange regulations to address areas that have not clearly been within the federal space, but which the federal agency does not want to leave to the results currently provided by state law. Thus stock exchange governance regulations have a federalism aspect more than some other examples of rulemaking at the intersection of government and private organization and are more of a branch of federal regulation than their form might suggest.

39 For greater detail on this point, see infra Part II.
40 See infra Part II.C.3.d.
41 See Stephen M. Bainbridge, Revisiting the One Share/One Vote Controversy: The Exchanges’ Uniform Voting Rights Policy, 22 SEC. REG. L.J. 175, 176 (1994) (arguing that the SEC “has misused its informal power to regulate exchange listing standards . . . . As such, the present proposal may be viewed as a lawless power grab by the SEC.”).
II. SOURCES OF THE STOCK EXCHANGE’S ROLE IN CORPORATE GOVERNANCE

A. Overview

The 2002-2003 revisions to the stock exchange listing standards, which require a majority of independent directors for listed companies and key committees made up entirely of independent directors, are the latest illustration of corporate governance from exchanges in a line that stretches back to 1869.42 Early exchange rules as to governance came from the NYSE. The American Stock Exchange eagerly sought to provide a market for those shares not traded in New York, but saw little need to provide governance listing requirements as a means to do that until the 1960s.43 In the last two decades, Nasdaq has competed directly with the NYSE for company listings, but governance listing requirements have not been the usual basis for that competition.44 The growing ease by which investment funds can move across national borders has broadened the scope of the relevant market for stock exchanges in recent years. At least until the collapse of the bubble economy, foreign listings had been the major source of growth for the NYSE in the 1990s. Any discussion of listing requirements must necessarily include the possibility of competition from exchanges in other countries.45


44 Until 2006, Nasdaq was not an exchange under the Securities Exchange Act, a regulatory difference not directly relevant to the promulgation of listing standards. For purposes of this Article, Nasdaq is treated as an exchange for the entire period of the independent governance listing standards. See generally Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40,760, 63 Fed. Reg. 70,844, 70,852 (Dec. 22, 1998) (excluding from the interpretation of “exchange” certain “activities that could be considered traditional brokerage activities”).

The stock exchanges began as private entities, establishing and enforcing rules for the behavior of their members, but legislative changes in the twentieth century gave them a public dimension as well. The Securities Exchange Act of 1934 required all exchanges to register with the federal government and regulated various aspects of behavior occurring on the exchange (although originally not extending to listing standards). Specific sections of the 1934 Act covered behavior such as the margin requirement for trading and insider trading. Another section of the Act authorized the SEC to make a study of rules of the exchanges, including their governance and discipline. In 1937 SEC Chairman William O. Douglas threatened to enact new trading rules as a way to spur reorganization of the NYSE's governance. Exchange discipline of the trading conduct of its members is overseen by the SEC in a shared public-private function that grew out of similar efforts elsewhere in government during the New Deal and continued to evolve after the Supreme Court's limiting of such partnerships in it's A.L.A. Schechter Poultry Corp. v. United States decision in 1935.

Statutory changes in 1975 expanded the reach of the federal government over trading markets in a way that reached listing standards. The legislation vested the SEC with new and broad authority to regulate the trading markets as part of a mandate to develop a national market system. This included new powers over the stock exchanges and the National Association of Securities Dealers (NASD) (the creator and then owner of the Nasdaq market) which provided

47 Id. § 7.
48 Id. § 19(c).
50 295 U.S. 495, 528-29 (1935) (holding unconstitutional the National Industrial Recovery Act of 1933 as exceeding the federal government's power under the interstate Commerce Clause and as an invalid delegation of legislative power).
52 Id. § 11A (amending the Securities Exchange Act of 1934 and charging the SEC to develop a national securities system, including powers to designate securities eligible for trading in national markets).
the means by which parallel regulation could be achieved over the Nasdaq stock market. The SEC received the power to approve, disapprove, abrogate, add to, or delete from, rules adopted by the exchanges.53 It was pursuant to Section 19(c) that the SEC in the late 1980s promulgated the one share/one vote rules discussed below, and it was Rule 19c-4 that led to the opinion of the D.C. Circuit in the Business Roundtable decision that struck down the rule as beyond the SEC's authority.54

B. Governance Listing Standards: A Relatively Small Part of the Economic Function of a Stock Exchange

Setting governance requirements for listed companies is a small part of what U.S. stock exchanges do, and this activity plays second fiddle to their other core functions. The regulation of the trading process, particularly as it relates to the brokers and other intermediaries who trade, remains the most important economic function of an exchange. Rules relating to obligations to settle contracts and to the obligation of specialists to make a market illustrate stock exchange rules of this type.55 Second, stock exchanges traditionally developed a disciplinary system relating to broker-dealers and other participants in the exchange process who deal with end-point buyers and sellers.56 Internal governance requirements for companies whose shares are listed on the exchange are more removed from the core economic functions of an exchange.

The traditional organizational structure of the NYSE reflected its diverse panoply of functions relating to the interactions of the members who trade on the exchange and the larger investment community. Until 2006, the NYSE had been a mutual, member-owned, not-

53 Id. §§ 19(b)–(c). The SEC's power under Section 19(b) is different from its power under Section 19(c). Section 19(b) requires an SRO to file proposed rule changes with the SEC, which must approve or reject them based on whether they are consistent with the requirements of the Act. See 15 U.S.C. §§ 78s(b)(1), 78s(b)(3)(C) (2000). The Court in Business Roundtable listed a host of such SRO rules that relate to matters traditionally regulated by state law. See, e.g., Bus. Roundtable v. SEC, 905 F.2d 406, 409 & n.4 (D.C. Cir. 1990) (observing that no party expressed doubt as to the SEC’s jurisdiction as to those actions). In contrast, Section 19(c) permits the SEC to affirmatively impose SRO rules if they are “necessary or appropriate” to further the purposes of the Act. See 15 U.S.C. § 78s(c) (2000).
54 Bus. Roundtable, 905 F.2d at 417.
55 See, e.g., NYSE Rule 492 (member’s obligation to provide best execution for a customer’s order).
56 See supra text accompanying notes 48–50.
for-profit corporation. This juxtaposition of a nonprofit label with what is frequently portrayed as the heart of the American capitalistic system may seem a little jarring. It does not mean that members were not about seeking to make a profit. They were. And they expected the exchange to be very profitable to them in that process. Members' seats, which provided the right to buy and sell on the exchange, could themselves be sold for prices that routinely were in the seven figures, a price that reflects the economic value that members see in being able to trade on the exchange. The exchange's nonprofit status meant that the exchange could not pay dividends, a constraint that both affected its needs for income and dampened concerns of groups of members that they could be taken advantage of by other groups of members seeking to take money out of the exchange.

Members traditionally had the right to elect the board of directors of the NYSE, although pursuant to a series of changes in the NYSE articles of incorporation, their influence became more and more indirect. Prior to 2003, half of the board members could come from the securities industry participants who typically owned the seats on the exchange. The others, although voted on by the members, were designated as public members who often reflected the interest of listed companies and the investing public. As in public corporations, the nominating committee is crucial to selection of membership to the board. Membership influence here did not appear to be very great; that of the CEO, such as Richard Grasso, appeared to be stronger. Changes made to the governance of the NYSE after the departure of CEO Richard Grasso in 2003 following a controversy

57 See Aaron Lucchetti, Big Board Will Ring Its Own Bell, WALL ST. J., Mar. 7, 2006, at C1.
59 See N.Y. NOT-FOR-PROFIT CORP. LAW § 515 (McKinney 2005) (stating that a not-for-profit corporation "shall not pay dividends or distribute any part of its income or profit to its members, directors, or officers").
60 See NYSE, supra note 38, at 3 & n.9 (describing the pre-2003 governance).
61 See New York Stock Exchange, Certificate of Incorporation, art. IV (1978) (on file with the author). The board also included the Chairman, Executive Vice-Chairs and President of the Exchange.
over his compensation further weakened the direct power of the members to shape the board. A majority of board members then had to be independent of industry, and the disciplinary functions of the exchange were moved into a separate corporate division, following a pattern set by the Nasdaq/NASD boards in the 1990s. The NYSE’s merger with Archipelago, approved by shareholders in December 2005, provides a new publicly owned parent entity that will change the exchange’s economic incentives to provide both regulation and listing standards, as discussed in more detail below.

NYSE governance has traditionally been somewhat opaque, with power shared among a richly layered committee structure. As revealed on the NYSE website, it has a multitude of standing committees and advisory committees to undertake its various tasks. This structure may have originally reflected the heterogeneous interests of various participating groups on the exchange—specialists, floor brokers, and upstairs brokers, for example—so that one group could not opportunistically take advantage of another. In recent decades, this broad structure permitted the exchange to give a greater governance role to stakeholders other than its members, particularly the interests of listed companies and public investors.

The exchange’s board of directors adopts listing standards without any direct involvement of the members or shareholders. The committee structure means that these rules are subject to comments from various quarters, but it is not yet clear how this function fits within the other functions of the exchange, the regulatory separation

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64 NAT’L ASS’N OF SEC. DEALERS, INC., EXECUTIVE SUMMARY OF THE REPORT OF THE NASD SELECT COMMITTEE ON STRUCTURE AND GOVERNANCE TO THE NASD BOARD OF GOVERNORS, at app. A (1995) (usually referred to, as it will be here, as the Rudman report, after its chairman, former Senator Warren Rudman). The Committee was appointed by the NASD Board of Governors in November 1994 in the wake of the odd-eighths scandal.


envisioned by the 2003 reorganization, and the 2006 changes in ownership structure.

C. The Evolution of Listing Standards

The New York Stock Exchange grew from origins said to be under a buttonwood tree in the late eighteenth century. The NYSE was formed in 1793 to provide a place of trading.\(^68\) In its early days, it focused on the means for trading to occur and be efficiently completed.\(^69\) Over time, the exchange began to enter into contracts with companies that sought to have their shares listed on the exchange. To the extent that there were requirements for listing, they reflected economic aspects that related to trading, such as the size of the company and the number of shares traded, items that did not relate directly to corporate governance. During the nineteenth century, stock exchange listing requirements began to include some provisions that related to corporate governance. For example, in 1869, the NYSE formed a Committee on Stock Lists to evaluate applications to list\(^70\) and began to require share registration in an effort to eliminate watered stock.\(^71\) Prior to 1900, the NYSE developed listing agreements with each company whose shares were listed. What we refer to today as listing standards were the guidelines for provisions to go into those individual listing agreements.\(^72\) In that setting, any change in listing standards did not affect those with agreements that predated a change, a characteristic that kept the standards from having uniform application.

Listing standards generally served a business purpose. Professor John Coffee has traced how the NYSE’s policies over the nineteenth century worked to attract foreign money to invest in American corpo-

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71 James L. Cochrane, Senior Vice President, Strategy & Planning, New York Stock Exchange, Inc., Presentation at the Vanderbilt University Law School & the Owen Graduate School of Management: The NYSE and Corporate Governance (June 9, 2003) (on file with author).
His story is one of the evolution of the NYSE as a brand name for a place that protected minority shareholders more so than the exchanges of the Old World, although governance provisions per se made up a modest part of that perception.

During the twentieth century, "governance" listing standards advanced in fits and starts, in part related to what state and federal law were (or were not) doing. Three principal periods of activity are visible.

1. Pre-Great Depression Standards

In the period prior to the enactment of the first federal securities laws in 1933 and 1934, the NYSE required disclosure provisions beyond those then (or now) required by state corporations law. By the turn of the twentieth century, the exchange included in listing agreements a provision that called for listed companies to issue regular financial statements. This requirement was extended to semiannual disclosure in 1917 and to quarterly filings in 1923. In 1926, the exchange added its one share/one vote requirement, which reappears later in this Article in the discussion of regulation during the most recent period. The dual class stock that permitted investors with a relatively small financial investment to control the voting shares of the company aroused populist ire during the 1920s and led to a stock exchange ban (rather than prohibitions in state corporations

74 Id. at 1801–03.
75 Gilbert W. Cooke, The Stock Markets 340 (rev. ed. 1969). The effectiveness of this requirement was qualified because until 1910 listing was not a requirement for trading on the Exchange; the Exchange continued to maintain an “Unlisted Department” that included many of the industrial stocks and these companies were not subject to the listing standards. See Robert Lang et al., Special Study on Market Structure, Listing Standards and Corporate Governance, 57 BUS. LAW. 1487, 1497–98 (2002).
76 Cooke, supra note 75, at 340 (explaining that listing agreements contained requirements for semiannual income statements and balance sheets by 1917 and quarterly earnings by 1923).
77 See Seligman, supra note 49, at 693–99 (tracing the evolution of the NYSE policy).
Listing requirements were extended in 1932 to require newly listed companies to have independent audits.

In this era, listing standards could be seen as a substitute for government regulation. General corporation statutes had become common by 1890. For another forty years there were no federal corporate or securities laws, although proposals had been made since the time of Theodore Roosevelt. The NYSE could argue that if listing standards for securities adequately protected the investment public then government regulation would be unnecessary.

The entry of the federal government into this field, particularly with the Securities Exchange Act of 1934, overran this evolving trend. The Act required that all companies with securities registered on a national securities exchange (which did not include over-the-counter stocks) must submit independently certified reports of financial conditions. Section 13 of the 1934 Act required periodic reports, both annual and quarterly, of listed companies. Other provisions of the federal law regulated proxy solicitation and trading by insiders.

The Act also created the Securities and Exchange Commission, which was given supervisory authority over exchanges. Indeed, the exchange was now defined as a "self-regulatory organization" by the Act, a cousin of other public-private agencies created by New Deal

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79 See Banker’s Control of Trade Deplored, N.Y. Times, Oct. 29, 1925, at 27. The following year the reaction to the NYSE’s announcement of a listing by Dodge Brothers, Inc. with a dual class structure propelled the adoption of the NYSE standard. See Seligman, supra note 49, at 694–98.

80 LEFFLER, supra note 43, at 140 (“In April, 1932, the Exchange made its 1928 policy of independent audits mandatory for all new companies applying for listing.”).


82 Message to Congress on Dec. 3, 1901, in 15 THE WORKS OF THEODORE ROOSEVELT 81, 92 (Hermann Hagedorn ed., 1926) (“The nation should, without interfering with the power of the States in this matter itself, also assume power of supervision and regulation over all corporations doing interstate business.”).

83 See Max Lowenthal, The Stock Exchange and Protective Committee Securities, 33 Colum. L. Rev. 1293, 1294–95 (1933); see also Stock Exchange Practices: Hearing on S. Res. 84 Before the Subcomm. on Banking & Currency, 72d Cong. 286 (1932) (statement of Richard Whitney, President, NYSE) (“The attitude of the exchange is constant watchfulness.”).


85 Id. § 78m.

86 Id. § 78n.

87 Id. § 78p.

88 Id. § 78d.

89 See id. § 78c(a)(26) (defining “self-regulatory organization” to mean any national securities exchange or registered securities association). The NYSE has been a national securities exchange since 1934. The SEC in 2006 approved Nasdaq’s appli-
legislation, some of which were stricken by Supreme Court decisions.90 The Self Regulatory Organizations (SROs) aspect of the exchange is most visible in its work to discipline broker-dealers, but this statutory structure, including amendments made in 1975, also becomes relevant to later action on listing standards.

2. Changes to Listing Standards in the 1950s

With the adoption of the federal securities legislation, listing requirements remained stable into the 1950s.91 Then, over a period of eight years, the exchange added a series of governance requirements that, for the most part, covered topics that would have been included in state corporations codes. After the passage of the federal securities laws, it became common to divide the realms relating to corporate governance into the state realm, which covered internal corporate relations among directors, shareholders, and officers, and the federal realm, which was mostly concerned with markets and some discrete transactions that took place on markets, often framed as requiring disclosure to investors. Against this backdrop, the changes made in the 1950s clearly addressed matters that fit in the state law realm. These included:

- In 1953, the listing standards specified a minimum level necessary to achieve a quorum for shareholder action.92 State corporations statutes at the time typically provided for a quorum but there was great variation and also broad flexibility for corporations to dilute the requirement in their charter or bylaws.

- In 1955, the listing requirements required shareholders to approve conflict of interest transactions or acquisitions in which the number of shares increased by more than twenty percent.93 The first is typically dealt with under state corporations law by judicial decisions after the fact deciding whether board action in
a conflict situation was a breach of fiduciary duty.\textsuperscript{94} State statutes passed during this period to clarify the common law were written in the negative—conflict transactions were not void or voidable solely because of that conflict if they received shareholder approval.\textsuperscript{95} In contrast, the new stock exchange requirements were written to require positive action. As to the requirement of shareholder approval, this was a powerful addition to the relatively short list of corporate actions that require shareholder approval, thereby extending the shareholder franchise to transactions that would not be covered by state law.\textsuperscript{96} This provision, for example, required shareholder voting by Time, Inc. shareholders of the initial Time/Warner combination proposed in the classic Time/Warner/Paramount takeover battle in the 1980s even though Delaware law did not require such a vote.\textsuperscript{97}

\begin{itemize}
\item In 1956, the listing standards were amended to require two outside directors, an independence requirement still not addressed by state corporations law today.\textsuperscript{98}
\item In 1959, a change to the listing standard required listed companies to solicit proxies.\textsuperscript{99} The result was to effectively widen the reach of the federal disclosure system. Under federal law, disclosure is triggered only by solicitation of proxies, so that if proxies were not solicited, no disclosure would occur.\textsuperscript{100}
\item In 1960, the listing standards required disclosure of change of control,\textsuperscript{101} a provision that could (and later did) come under federal disclosure law.\textsuperscript{102}
\end{itemize}

These changes coincided with a broad campaign identified with NYSE President Keith Funston to court small investors and to combat

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\item See, e.g., Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378, 380–81 (N.Y. 1918) (invalidating conflict transaction when director and chair of executive committee of one company was the chief shareholder of the counterparty). \textit{But see Model Bus. Corp. Act} § 8.60 (2005) (defining a “director’s conflicting interest transaction”).
\item State law typically provides for shareholder election of directors and shareholder approval of director-initiated action to merge, sell substantially all of the corporation’s assets, or dissolve. \textit{See, e.g., Model Bus. Corp. Act} §§ 11.02, 12.01, 13.02 (2005).
\item Paramount Commc’n, Inc. v. Time, Inc., Nos. 10866, 10670, 10935, 1989 WL 79880, at *26 (Del. Ch. July 14, 1989) (“Delaware law created no right . . . to vote on the original Warner merger . . . . [I]t was only NYSE rules that prompted the proposed submission of that transaction to the Time annual meeting.”).
\item Michael, \textit{supra} note 72, at 1469.
\item H.R. Doc. No. 88-95, pt. 4, at 568 (1963).
\item H.R. Doc. No. 88-95, pt. 4, at 568.
\item See 15 U.S.C. § 78m.
falling trade volume resulting from a rising concentration of shares in the hands of large institutions. Corporate democracy was seen as essential to reaching more of these individual investors. Professor Michael has noted, "[t]he listing standards of the day were pitched with the individual investor in mind, heralded by the NYSE as furthering 'broader share ownership' with 'greater shareowner participation in corporate affairs.'”

After 1960, there was another stable period in terms of the form of the listing standards that extended until the post-Watergate revelations as to bribery and other corporate wrongdoing provided a sufficient push for enactment of new listing standards. A change in the listing standards to require an audit committee made up of independent directors ushered in the latest round of listing standards changes, one that has a different look to it than the earlier two.

3. Changes to the Listing Standards in the Modern Period

There have been four sets of listing standards during the modern period: (1) prescribing audit committee functions first addressed in 1977, revisited in 1998 and made a part of Sarbanes-Oxley in 2002; (2) one share/one vote requirements, a reprise of the listing standards first inserted in 1926 that evolved through a series of events from 1986 to 1994 leading to a modern version of that older standard; (3) requiring shareholder participation in approval of compensation plans, a reprise of the standard from the 1950s that was the subject of extensive revision process from 1998 to 2003; and (4) the 2002 post-Enron/WorldCom proposals empowering independent directors.

These changes differ from those described in the two earlier eras in significant ways. First, the "standards" moniker no longer seems to apply. Unlike previous iterations, which were standards to be included in individual listing contracts and did not bind, other than by persuasive efforts, companies who had signed listing agreements earlier, these standards look more like mandatory law and are written to apply to all listed companies. There is nothing like the dramatic change that occurred after the Supreme Court's decision in Trustees of Dartmouth College v. Woodward that had found state corporations charters to be contracts that could not be unilaterally changed by gov-

104 Michael, supra note 72, at 1470 (quoting releases from 1959 and 1960, announcing listing standards regarding mandatory solicitation of proxies and additional shareholder voting requirements, respectively).
This ruling led to changes in state corporations statutes that explicitly bound corporations to any subsequent changes in the statute. The NYSE standards do not have such a provision. Nevertheless, the listing standards of the modern period are written as if there were such a provision.

Second, the agenda appears to be that of the SEC more than the stock exchange. The trigger for the process typically was the SEC chair calling for action by the exchanges. There was not a standing committee of the exchange looking for changes that needed to be made. SEC attention continued through the process, including prodding if the process did not evolve satisfactorily. This SEC involvement was often accompanied by a statement to the effect that the agency could do it, but it would be really good if it came from the private sector. Yet the subject matter, the duties of directors, and the relative rights of shareholders in corporate governance issues, lies at the core of state corporations law and stands as the most likely to run afoul of federalism concerns.

a. One Share/One Vote

Changes in the one share/one vote rule beginning in the late 1980s reflect the modern evolution of listing standards. As discussed above, the NYSE had had a one share/one vote rule prohibiting dual class shares since 1926 (with a notable exception in 1956 when Ford Motor Company went public using a dual class structure that permitted the Ford family to maintain a leadership role in the company). Developments in the 1980s provoked a major challenge to the status quo. The takeover wave of the early 1980s threatened corporate managers in many American companies, leading to a wave of anti-takeover defenses including use of dual class shares. The interest in America’s largest companies, including General Motors, which had acquired EDS and wanted to have multiple classes of stock to reflect that acquisition, led to pressure on the NYSE to liberalize its sixty-year-old rule. At the same time, the Amex permitted dual class stock pursuant to its

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106 See id. at 594 (holding that a corporate charter is a contract between the corporation and the state so that unless the state granted the charter subject to a reserved power to repeal or amend it, any subsequent change would be an unconstitutional impairment of contract).

107 After the Dartmouth College case, the power to amend corporate charters via subsequent amendment in corporations statutes has been reserved by the states. See Del. Code Ann. tit. 8, § 364 (2001).

108 See infra text accompanying notes 120–21.

“Wang formula” that permitted one-tenth of one vote per share.\textsuperscript{110} The growth in the Nasdaq market created new exposure to possible loss of business if the NYSE was to maintain the more restrictive rule.\textsuperscript{111} In 1984, the NYSE announced a moratorium on delisting for dual classes, appointed a committee to reevaluate its policy, and in 1986 modified its rule.\textsuperscript{112} This led to congressional hearings, SEC efforts to persuade the exchanges to adopt a uniform rule, and finally in 1988, SEC adoption of its own rule, Rule 19c-4, that limited future midstream adoption of a dual class structure.\textsuperscript{113} Two years later a federal appellate court threw out that rule as beyond the SEC’s power to effectuate—it was a substantive intrusion into corporate governance regulated by state law and beyond the disclosure-based provisions authorized by the 1934 Act.\textsuperscript{114} In the aftermath of that decision, both the SEC and the NYSE voiced support for an exchange rule that would return to the status quo, since an exchange rule was not the federal government for purposes that would come under the court’s holding. But it took the SEC four additional years to get all of the exchanges on the same page and to prevent differences in rules among the exchanges from being a basis for competition for listings.\textsuperscript{115} The SEC was able to accomplish indirectly via listing standards what it had not been able to do directly by rule in terms of what it saw as a need to protect shareholders from possible actions of management to entrench themselves.

b. Audit Committees

Audit committees are a committee of a corporation’s board of directors and as such are subject to whatever requirements may be imposed in state corporations law as to who directors are and how they act. There are none. Since 1977 there have been three different

\textsuperscript{110} Karmel, \textit{supra} note 70, at 331 (describing Amex decision to list Wang Laboratories, Inc. even though it had been rejected by the NYSE because of unequal voting rights and subsequent following of the Wang formula).

\textsuperscript{111} See Seligman, \textit{supra} note 49, at 704-06.


\textsuperscript{113} 17 C.F.R. § 240.19c-4 (2006).


\textsuperscript{115} See Lang et al., \textit{supra} note 75, at 1505-06 (describing SEC efforts to first get the NYSE to adopt a rule, then the Nasdaq, but resistance by the Amex leading to a suggestion by the SEC chair that Congress consider identifying minimum federal protections for voting rights); \textit{see also} Amy L. Goodman, \textit{One Share/One Vote . . . Again, Insights, June 1991, at 2 (describing additional pressure from the Council of Institutional Investors and others on the exchanges).
changes to listing standards to ratchet up the duties of this committee, each one reflecting the pattern of SEC dominance seen in the modern period. SEC interest in the composition of audit committees actually goes back longer than that—to the 1940s when the agency first began to recommend (but not require) that public corporation audit committees be comprised of independent directors. In the 1970s in the aftermath of post-Watergate revelations of improper payments by large numbers of corporations, the agency pushed listing standard changes to strengthen audit committee independence. An SEC release making the case for such a rule suggested that it come from the NYSE. Thus, in 1977 the NYSE modified its standards to require listed companies to have an audit committee of independent directors. Concern over earnings management in the 1990s produced a similar pattern of activity. Arthur Levitt, then the SEC chairman, made a widely publicized speech about the danger of then current practices. He stated the agency stood ready to take action, but that a private sector response seemed wiser. One difference from two decades earlier was that this time, the NYSE was joined by the Nasdaq in appointing a blue ribbon commission. The result was a commission report within months and listing standards enacted within another year requiring that audit committee members be both independent and have financial literacy. Sarbanes-Oxley in 2002 codified both the independence and the financial literacy require-

119 See ROBERTA KARMEL, REGULATION BY PROSECUTION 152 (1982) (“The voluntariness of the New York Stock Exchange’s adoption of the rule is debatable.”); Kripke, supra note 117, at 190 (“[T]o characterize the New York Stock Exchange’s action as . . . voluntary . . . is unreal.”).
121 Id.
123 See Lang et al., supra note 75, at 1508-09 (“The forum approach to corporate governance rulemaking, exemplified by ‘broad-based dialogue . . . between [the SEC], academia, the legal community, and issuers’ had, with the support of the SEC, prevailed over the process of unilateral action by the SEC.”).
ments from the earlier rounds of listing standards revisions, and also mandated new audit committee practices such as the committee hiring and firing the auditor. As to the audit committee, these changes overran listing standard changes proposed by the NYSE and Nasdaq in 2002 requiring the audit committee, as well as the nominating and compensation committee, to be made up entirely of independent directors.

c. Shareholder Approval of Compensation Plans

During the period between 1998 and 2003, the NYSE and the SEC engaged in another dance over empowering shareholders to vote on certain compensation plans similar to what had gone on with one share/one vote and audit committees. Recall the earlier listing standards that required shareholder approval of conflict transactions and certain other corporate actions. Under these standards, the NYSE required shareholder approval of broad-based options plans. As part of a 1998 codification of its practices in this regard, the NYSE provided for exemptions from shareholder voting for certain compensation plans. After the exemption had been subjected to and received SEC approval pursuant to a process that included a public notice filing and an opportunity for interested parties to comment, some institutional investors complained that the changed language was too generous to managers. The NYSE responded to the new concerns by issuing a white paper, requesting additional comments, and asking a task force to make recommendations. This led to a temporary rule with a narrower definition of “what was broad based.” SEC Chairmen Arthur Levitt and Harvey Pitt both pushed

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124 See supra notes 29–31 and accompanying text.
125 The report of the NYSE committee to its board in June 2002 required that the audit committee be composed entirely of independent directors. By the time this was approved by the NYSE board and sent to the SEC for approval, Sarbanes-Oxley had intervened with a more stringent standard. See NYSE, supra note 42 (requiring greater independence for directors); see also NAT'L ASS'N OF SECURITIES DEALERS, INC., supra note 42, at 3–4, 12 (proposing revisions to Nasdaq listing requirements, including a requirement that boards have a majority of independent directors and that directors meet without company management).
126 See supra text accompanying note 93.
127 See Lang et al., supra note 75, at 1509.
129 See Lang et al., supra note 75, at 1509.
130 Id.
for shareholder protection in this area of listing standards, but it took four years before the new listing standards were approved as part of the broader set of listing changes enacted after Enron.

d. Independent Directors

The parallel proposals made by the NYSE and Nasdaq in the aftermath of Enron are the single event that best illustrates the newly empowered status of stock exchange listing requirements. As with the second audit committee requirements described above, these proposed changes followed a pattern of the NYSE and Nasdaq moving along parallel lines. As with the audit committee, shareholder approval, and one share/one vote, these changes had the SEC as their initiator and the government exercising the biggest say on what eventually made their way into the listings standards. This time it was a suggestion from SEC chairman Harvey Pitt, in February 2002, three months after Enron had gone belly-up, that the NYSE and Nasdaq should move on corporate governance standards.

The NYSE quickly appointed a blue ribbon committee co-chaired by high profile figures—Leon Panetta, former Chief of Staff for President Clinton, Gerald Levin, former Time Warner CEO, and Carl McCall, an influential New York political figure. Within four months of the first call, the committee had held a series of hearings and made recommendations to the NYSE board of directors. Approval of the board followed in sixty days and then submission to the SEC. But in those sixty days, Sarbanes-Oxley had gone from unlikely legislation to a freight train of reform that gathered new provisions quickly and was

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131 Arthur Levitt, Jr., Chairman, SEC, Remarks at the 2000 Annual Meeting of the Securities Industry Association (Nov. 9, 2000), available at http://www.sec.gov/news/speech/spch420.htm (urging the markets “to restore promptly the rightful balance between shareholder and management interests by requiring shareholder approval for all plans that grant options or award stock to officers and directors”); Harvey Pitt, Chairman, SEC, Remarks at the Inaugural Lecture of the JD/MBA Lecture Series at Northwestern Law School (Apr. 4, 2002), available at http://www.sec.gov/news/speech/spch547.htm (“We will have to make it clear . . . that although it was a request, it was expected to be implemented. They should move with alacrity.”).


133 See supra note 42 and accompanying text.


signed by the President by the end of July.\textsuperscript{136} The statute superseded much of what the listing standard process had recommended about audit committees.\textsuperscript{137} Over the succeeding months, the part of the listing standards proposal about shareholder approval was broken off from the main proposal and approved by the SEC. The remainder of the listing proposals received SEC approval in November 2003.\textsuperscript{138}

III. MODELING THE CREATION OF STOCK EXCHANGE LISTING STANDARDS

How ought we model a stock exchange as a lawgiver on corporate governance matters? Economic incentives of exchanges and their owners provide motivations for rulemaking that can explain the pattern of changes to listing standards. This Part develops how changes in technology and organizational structure have modified the traditional incentives. These changed incentives and the historical pattern described above suggests an alternative theory to the pure market explanation for promulgation of listing standards. The SEC is trying to get the stock exchanges to do what the agency fears the federal courts will not let it do directly, and which, until the next Enron, will not provide Congress sufficient reason to authorize additional federal intrusion into the area traditionally regulated by state law.

A. Traditional Economic Incentives for Exchanges to Provide Efficient Listing Standards

Exchanges owned by participants who profit when trading occurs there have an economic incentive to provide listing standards that will encourage investors to trade there and companies to list that stock for trading there. These participants will push their directors and managers to adopt listing standards that maximize income from trading on the exchange. For exchanges, this means rules that assure investors that they will not be taken advantage of, and that trading costs are efficient, but it also means rules that differentiate the quality of companies listed on one exchange from others. Recall Professor Coffee's

\textsuperscript{137} The NYSE proposal, approved by the NYSE board in June 2002, contained a requirement for an audit committee (as well as the compensation and governance committee) made up entirely of independent directors. See Lang et al., supra note 75, at 1506–09. The bill enacted into law the following month included the requirement for the audit committee only. See 15 U.S.C. § 78j-1 (2000).
story of the New York Stock Exchange in the nineteenth century, when it lacked the preeminence among American equity exchanges that it has today; he observed the success that it had in establishing a brand name redounded to the benefit of those who bought and sold securities there.139

These economic incentives suggest the possibility of competition among providers of these services. As demonstrated in the previous Part, many of the stock exchanges listing standards as to corporate governance fill gaps, usually where neither state nor federal law have previously provided a rule. In our current economy there is more than one potential provider of such rules among stock exchanges. Just as the New York Stock Exchange and Nasdaq compete for stocks to be traded, they could use governance listing requirements as a means to compete for listings and for the trades that follow those listings. And these exchanges, in turn, can compete with the governance packages offered by either the state or federal government. As securities trading increasingly crosses national boundaries, stock exchanges will be able to compete with exchanges elsewhere, with listing requirements as one means for such competition.

If there were to be such competition, would it be a race to the bottom as William Cary labeled corporate law in the 1970s140 and what Louis Brandeis labeled in the early twentieth century as a race of laxity?141 Each author was concerned about the willingness of state legislators to provide laws tilted toward management and against shareholders. Cary noted that it is management who chooses where to incorporate, and that in making that choice, we should not be surprised if they choose a state whose laws are comforting to management.142 The counterargument made by Judge Ralph Winter in his days as an academic143 and by his academic colleagues such as Roberta Romano, is that the market for shares not only counters this tendency but insures a race to the top.144 If managers choose to

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139 Coffee, supra note 73, at 1828–29.
141 Louis K. Liggett Co. v. Lee, 288 U.S. 517, 557–60 (1933) (Brandeis, J., dissenting in part) ("Lesser states, eager for revenue derived from that traffic in charters, had removed safeguards for their own incorporation laws. . . . The race was not one of diligence but of laxity.").
142 Cary, supra note 140, at 666.
144 Roberta Romano, The Genius of American Corporate Law 14–24 (1993); see also Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 NW. U. L. REV. 913, 920 (1983) ("Delaware's preemi-
incorporate in a state with lax laws that permit managers to take advantage of their position, the company's performance will suffer as compared to comparable companies in states without such lax laws.

Governance rules set by stock exchanges exhibit similar core characteristics to the making of state corporations law. Directors, not shareholders, choose where the corporation's stock is to be traded.\textsuperscript{145} The exchanges have the same incentives as do state legislatures to shape their listing requirements so as to appeal to management and thereby obtain the fees that come from listing and profits that accrue from additional trading. If shareholders have a contrary view, it is very difficult for shareholders to overturn the directors' decision. To change the place of incorporation would require filing a new charter, or amending the charter or approving a merger. In each, directors have a gatekeeper position by state law that prevents shareholder initiation.\textsuperscript{146} Efforts to change a place of listing have been similarly insulated. Until its removal in 2003, NYSE Rule 500 required supermajority votes of the board and shareholders before a change of listing was possible.\textsuperscript{147} Even with the relaxation of that rule, efforts to change the place of listing necessarily go through the directors. Shareholders might be able to accomplish such a change against the wishes of the directors by directly amending the bylaws at an annual meeting, but Delaware courts have yet to decide whether such action would interfere with the plenary power given to the directors by statute to run the corporation.\textsuperscript{148}

Thus the most likely constraint on stock exchanges will be the principal learning from the race to the top literature. At some point, if an exchange has inefficient governance rules that contribute to a loss of value for those stocks relative to stocks traded on another exchange, investors will bid down the stocks traded on an exchange...

\textsuperscript{145} This comes within the provisions of Del. Code Ann., tit. 8, § 141(a) (2001) that all corporate power shall be exercised by the board.

\textsuperscript{146} Id. § 261.


\textsuperscript{148} Delaware state law permits shareholders to initiate changes to the bylaws without depending upon director action. Del. Code Ann., tit. 8, § 109 (2001). Delaware courts have declined to take up the issue as to whether such shareholder exercise of bylaws can be used to impinge on the plenary power given to directors under the Delaware Code, Id. § 141 (2001 & Supp. 2002 & Interim Supp. 2005 & 2006-1 Del. Code Ann. Adv. Leg. Serv. 228 (LexisNexis)), that all corporate power is to be exercised by or under the authority of the board of directors unless a contrary rule is set out in the company's articles of incorporation, not the bylaws.
with the management preferring rules. Professor Fischel put it this way:

If an exchange allows managers of some firms to exploit investors, investors will lose confidence in the exchange, as a whole, causing all firms on the exchange to face higher costs of capital. This in turn will decrease the amount of listings in the future and thus also will reduce the amount of trade. Loss of confidence in the exchange also will lead to a decline in the value of listed securities. A decline in the value of listed securities, like a decline in the amount of trade, will decrease income from commissions. And any action that decreases commission income will decrease the value of membership on the exchange. Thus, any decrease in the amount of trade or value of securities listed on the exchange reduces the wealth of member firms. Once again, it is clear that the profit-maximizing strategy for an exchange is to promulgate rules that maximize, not minimize, investors' welfare.149

Empirical evidence as to such competition is, as yet, incomplete. A good bit of work has been done on testing the hypothesis that Delaware state law, as opposed to another state's, creates or reduces value. Earlier studies focused on whether firms that reincorporate in Delaware experience lower stock prices.150 More recent studies have addressed whether Delaware firms differ from other firms based on economic measures such as Tobin's Q.151 Similar studies that sought to measure gains when the primary listing of a firm moved between exchanges showed mixed results.152 The difficulty with drawing firm conclusions in this area is that these studies will usually measure a combination of any change in governance and any change in trading technology that occurs when trading of a company's stock moves

152 Gary C. Sanger & John J. McConnell, Stock Exchange Listings, Firm Value and Security Market Efficiency: The Impact of NASDAQ, 21 J. Fin. & Quantitative Analysis 1, 22 (1986) (finding price response to announcement to list on NYSE was positive before and after the introduction of Nasdaq, but statistically significant only in the pre-Nasdaq period).
between exchanges. Studies during the last decade point to real differences between the NYSE and Nasdaq as to the trading costs during a time that Nasdaq avoided trading at odd-eighths pricing intervals.\textsuperscript{153} Although those differences seemed to have disappeared with the move to decimal trading, there remain some differences as to trading technology between the NYSE open outcry auction, even with the great automation that has been introduced into that system, and the Nasdaq’s use of dispersed market-makers.\textsuperscript{154} These changes are likely to dominate any differences in governance listing standards in the move between exchanges, particularly since the modern trend, discussed below, reflects no competition between the exchanges based on differences in listing standards.\textsuperscript{155}

A model of stock exchanges as lawmakers ought to incorporate the quasi-public role they have played since 1934 and their explicit designation as SROs. The exchanges as SROs date back to an era in which President Franklin Roosevelt’s New Deal made extensive use of private or quasi-public bodies to make public policy, some of which did not survive constitutional attack and others such as SROs in the securities industry that did. They reflect a model based on the role of government (here the federal government) facilitating rulemaking by a private institutions, here the stock exchanges. Such an approach, illustrated by scholars sometimes grouped under the banner of the New Institutional Economics include examples based on the Maghribi

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\item \textsuperscript{153} William G. Christie & Paul H. Schultz, \textit{Why do NASDAQ Market Makers Avoid Odd-Eighth Quotes?}, 49 J. FIN. 1813, 1814 (1994) (finding that market makers avoided quoting prices in four of the eight price points available for their bid and ask quotes, thus effectively doubling the cost of transactions by investors).
\item \textsuperscript{154} Hendrik Bessembinder, \textit{Trade Execution Costs on NASDAQ and the NYSE: A Post-Reform Comparison}, 34 J. FIN. & QUANTITATIVE ANALYSIS 387, 405–06 (1999).
\item \textsuperscript{155} Mark Roe presents Delaware as not in a race with other states to create corporate law, but rather in a vertical relationship with the federal government in which Delaware makes law in the space only where the federal government does not choose to preempt. Mark J. Roe, \textit{Delaware’s Competition}, 117 HARV. L. REV. 590, 601 (2003). He provides examples from the last two decades in which the federal lawmakers exercised gravitational pull on the substance of state law and then released it and suggests, for example, that Delaware’s anti-takeover law became stronger after the feds more or less left the field. \textit{Id.} at 618–19, 630–32. Similarly, the stock exchanges could be seen to occupy a similar relationship. Their listing standards occupy space that the federal government has not chosen to occupy. As with state government, rule-making by stock exchanges must occur in the shadow of federal power. But, less so than the states, the exchanges cannot be easily described as chomping at the bit, desirous of imposing additional listing standards, and held back by the threat of countervailing federal legislation. \textit{Id.} at 619–20.
\end{itemize}
tribes or the law merchant to take advantage of when private governance will have a relative advantage over rules made by government.

Governance rules by stock exchanges can fit within such a model. Stock exchanges have strong economic incentives to develop efficient rules and bring to the task efficiencies that sometime give them advantages over government. The incentives are well-known and have already been mentioned. Maintaining the value of the listing gives a strong self-interest to exchanges to adopt efficient rules. This value can depend both on institutional structure, such as how trading takes place, and factors relating to individual companies, of which governance would be a relevant factor. Professor Mahoney has suggested that exchanges can create value that investors would find attractive by reducing the divergence among their listed companies by addressing factors such as the reliability of contracts, the absence of fraud, the creditworthiness of companies, and the quality and validity of the securities themselves.

The exchanges traditionally have had several efficiencies, as compared to government, that argued for their undertaking these functions. Exchanges are made up of repeat players in these kinds of transactions with the incentives and efficiency that come with that. They are made of participants who are recognized to be more knowledgeable in these subjects than any corresponding group in government. Some of the information needed for enforcement can be gathered in the normal course of trading securities. Even more, there is a likelihood that over history there has been some cross-subsidization that the bundling of trading, enforcement and other services under the exchange banner has permitted some of the surplus generated by the trading business to be used for enforcement. There have been some economies of scale in enforcement that derive from a

156 Avner Greif et al., Coordination, Commitment, and Enforcement: The Case of the Merchant Guild, 102 J. Pol. Econ. 745, 746 (1994).
centralized market. More importantly, the exchange has traditionally been a closely-knit community that has reduced transaction costs. The monopoly rents that members could obtain from being on the exchange gave them an incentive to support the internal governance structure.

B. Changes in the Function and Ownership of Exchanges

Technology and regulatory change have dramatically modified the economic context in which exchanges operate. Liquidity has been a prime economic benefit provided by exchanges, along with monitoring of nefarious trading practices and providing a brand name label for companies traded on the exchange. The challenge for the exchange has been that close substitutes have developed for each of its functions.\textsuperscript{159} The NYSE's open-outcry auction was thought over time to have provided relatively greater liquidity because the floor brokers and specialists located at one central place provided depth of quotations and trading. With the growth of computing power and electronic interconnectivity, liquidity can now be provided in different ways that are more decentralized and fragmented. Technology has permitted individual traders to provide more liquidity and larger institutional traders can move between markets to provide liquidity, lessening the advantage of the centralized open-outcry exchange. The end of fixed commissions and the reduction in spreads has made the trading market more competitive, reducing the value that members obtain by their membership on an exchange.\textsuperscript{160}

Technology likewise has decreased some of the firm-specific values of those who owned the exchange and simultaneously has increased the need for capital to innovate and compete with markets around the world. In this context, the relative value of mutual, nonprofit ownership has dissipated. Public forms of ownership have swept exchanges around the world, as evidenced most recently by the NYSE's new public status.\textsuperscript{161} This has put new pressure on ancillary services traditionally provided by exchanges such as regulation of the conduct of intermediaries who function in such exchanges and listing standards for companies whose shares are traded on such exchanges.


\textsuperscript{161} Macey & O'Hara, \textit{supra} note 159, at 564 (noting that with New York going public, nine of the top ten world equity exchanges are publicly owned).
The pressure on profit margins in a for-profit structure raises questions about resources diverted for developing and maintaining enforcement. Regulation is the current focal point of this debate, but the same issues generally apply for listing standards.\footnote{164} The NYSE has adopted a new system placing traditional regulatory functions within a separate not-for-profit subsidiary of the new for-profit exchange and holding company.\footnote{165} The new subsidiary has its own CEO and its own board and remains in the private sector. Public comment on the proposal has raised questions about the ability of a group located within a for-profit entity to provide sufficient enforcement.\footnote{166} Similar concerns arose three years ago as to whether senior management of the exchange had sufficient reasons to ride herd on the industry it regulated at a time when senior executives of companies were exchange board members providing large salaries and bonuses to those running the exchange.\footnote{167}

Regulation is a cost of exchanges doing business, and the new public owners of the exchanges are likely going to want to hold down costs. At the same time, the learning of the traditional economic model that exchanges and their owners benefit from high standards for listed companies can still apply. But the pressures are different today than even a decade ago. Trading costs, as measured by bid-ask spreads (the profit intermediaries get for standing ready to make market in stocks) have dropped dramatically, from more than 6.25

\footnote{164} Id. at 596 (describing regulatory systems in other countries which include some with a single government regulator, some with government oversight that includes government oversight of listing and trading, and some with self-regulation but with separation of operation and supervision).

\footnote{165} The current corporate structure approved by the SEC in connection with the merger, includes a parent NYSE Group, Inc., which includes separate entities for the NYSE and Archipelago. See Self-Regulatory Organizations, Exchange Act Release No. 53,382, 71 Fed. Reg. 11,251 (Feb. 27, 2006). This entity is also the only member of a New York not-for-profit, NYSE Regulation, Inc., with directors somewhat separate from the remaining part of the group.


\footnote{167} See supra Part II.B.
cents in the early 1990s to a low as a penny a share today for the largest stocks.\textsuperscript{168} The traditional not-for-profit, mutual organization of exchange permitted them to fund things like regulation and governance with the surplus generated in the trading function.\textsuperscript{169} New electronic markets seek to poach the territory of the existing exchanges.\textsuperscript{170} Markets in other countries are better able to attract alternative listings, and in some of these countries regulation and its costs have been shifted to the government.\textsuperscript{171} To the extent that changing economic incentives have seen exchange profit margins competed away and given the changes in technology and trading practices, there may be fewer resources to devote to regulation and governance, such that this function may not be sustainable as a stock exchange function.

Government (particularly state government) already provides the kinds of governance rules found in the recent listing standards. Do exchanges have a relative advantage in providing such rules? The federal government, in fact, has gone to great lengths to quell the breakout of any competition between exchanges over governance standards. In each of the four primary examples of governance listing standards discussed above, there has been a conscious effort by the SEC to avoid competition. Former SEC Chairman Harvey Pitt acknowledged the fear of competition directly, and suggested that the reason for the reluctance of each exchange to create standards for shareholder approval of option plans was the fear of creating a competitive advantage in attracting companies for other exchanges.\textsuperscript{172} An earlier NYSE task force on that topic warned against additional rules that would get out in front of other exchanges because “with regard to corporate governance, the leading securities markets should seek to harmonize their rules in the best interests of investors, not to compete on the basis of disparities in their rules.”\textsuperscript{173} The delay in SEC approval of the stock exchange’s post-Enron governance proposals for more than a year after they were submitted was attributed to

\begin{itemize}
  \item Pirrong, \textit{supra} note 67, at 443.
  \item See Macey & O’Hara, \textit{supra} note 159, at 596.
\end{itemize}
efforts to harmonize the rules of the various exchanges, similar to the four-year process that was required before one share/one vote policies were implemented by the exchanges in the aftermath of the Business Roundtable decision in 1990.¹⁷⁴

C. A Model of Stock Exchange Listing Standards as Indirect Agency Rules

As developed above, the traditional economic incentives of exchanges to provide corporate governance standards for companies listed on their exchange have dramatically lessened in the last decade and can be expected to be lesser still going forward. Listing standards cover topics that can be, and are already, in the government’s space for providing corporate regulation. The pattern of governance regulation from stock exchanges appears not to demonstrate exchange behavior that we might expect were exchanges competing among themselves for business, or were the exchanges seeking to fill whatever space the federal government makes available to it, or if the federal government were encouraging efficient rulemaking by a private collective entity. Rather, the history seems to show more of a pattern of the exchanges picking up the direct suggestion of the federal agency which believes a change in policy is appropriate but prefers that the impetus come from a private group, not the agency. If the impetus was because the agency believed that the SRO’s expertise provided the basis for believing a new rule was needed, this would illustrate the model in the prior subpart, but more likely there is a simpler federalism explanation.

The Securities and Exchange Commission, despite the growth in the exercise of federal power, feels real limits in what it is able to do vis-à-vis corporate governance given the existing federal statutes and judicial decisions such as Business Roundtable. Acting through the SROs permits the agency to extend its reach further into the domain traditionally reserved for state law than would be available to it if it directly sought to promulgate the same substantive rule through federal regulation. The agency may give up something in this process and the result may not be as close to its desired result as if it promulgated rules through the normal administrative procedure process. But the alternative choice for an agency is not a different federal rule, but the rule as determined by state law.

This lends itself to a richer strategic model drawn from political science and public choice literature that the actor (here the agency) would not necessarily adopt its most preferred position, but rather

¹⁷⁴ See supra Part II.C.3.d.
would only go so far toward that position as would not provoke the federal courts to step in and block the rule. This can be depicted to the accompanying figure where S is the status quo of the current state law, A is the preferred position of the agency, and C is the position at which point a federal court would be expected to strike down the agency action as inconsistent with the existing congressional view on federalism. By acting through exchange listing requirements, the agency may be able to move the applicable rule to point E without triggering a judicial finding of invalidity.

**FIGURE 1**

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S -- C -- E -- A

Least Intrusive  Most Intrusive
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My view is that most of the current debate over stock exchange listing standards is taking place in the space between what the SEC would like to do in an unconstrained world and the point at which it thinks it would provoke a limiting judicial decision (i.e. in the space between C and A on the spectrum depicted above). In this setting the preferences of the SEC overshadow any distinct preference of the exchange.

Why would the NYSE do the agency’s bidding? To some extent the agency and the exchange have formed a natural alliance over the seventy years of self-regulation such that their goals are parallel. To the extent that there are differences, the SEC may have more intense feelings, particularly given the technological and regulatory changes described earlier that have made listing standards less central to the economic function of the exchange. And to the extent that there are differences, the NYSE has compelling reasons to stay on the good side of the federal agency that regulates stock exchanges. In the last two years the NYSE has gone through massive changes as it has moved from its traditional open-outcry auction model to one that relies much more on an electronic platform. In 2006 it announced a merger that will take it into Europe. It is fair to say that its business plan has gone through a substantial revision. Its ability to continue to compete effectively with its American counterpart and with other exchanges worldwide was under real question in its traditional structure. At any number of points in the process, the response of the

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federal agency overseeing the regulation of the stock exchanges could dramatically affect the ability of the NYSE to move into this new world and the costs it would incur in such a move.

There are other examples of agencies seeking to use a SRO-type body to put forward an agency agenda. For example, in the 1970s, the Family Viewing Hour was promulgated by industry code, not by agency action, yet the story told is that FCC chairman Richard Wiley applied extensive governmental pressure including calls from the White House and other government persuasive powers to achieve a new standard in the industry. More recent examples include ASCAP's determination of policy in the music industry or ICANN determining internet names. There are a variety of reasons why industry rules will come from a private or quasi-public body. A legal challenge to that model often occurs under question of state action—is the particular action that purports to be private really performing a public action such that various constitutional protections ought to apply?

Of course such a conflict turns upon the agency's willingness to pursue a rulemaking agenda that is more activist than the status quo provided by state law. It is not obvious that Republican-appointed members of an agency like the SEC (split three-to-two between the parties) would continue to push an agenda at the activist end of the spectrum described above. Yet, the Republican-controlled SEC has advanced not just the stock exchange regulations described here, but also new regulation of hedge funds and mutual funds. The collapse of the dot-com bubble and the fall of Enron likely have created a different environment that has resulted in a more activist agency than perhaps might be expected in an administration of the political views of the current one.

177 See Glen O. Robinson, The Electronic First Amendment: An Essay for the New Age, 47 Duke L.J. 899, 919 (1998). For a longer description, see Geoffrey Cowan, See No Evil 80–115 (1979). A federal district court found the chairman's action violated the First Amendment. That opinion was vacated by the appellate court and remanded to the FCC, at which point the NAB Code was dropped. See Writers Guild of Am. West, Inc. v. FCC, 423 F. Supp. 1064, 1143 (C.D. Cal. 1976), vacated, 609 F.2d 355 (9th Cir. 1980).

178 See Merges, supra note 158, at 1295–96.


180 See supra note 2.
IV. **IS INDIRECT AGENCY ACTION TO CHANGE THE FEDERALISM LINE WITHIN AN AGENCY’S POWER?**

The principal areas of stock exchange regulation in recent years have been within the traditional domain of state corporations law. Requiring most board members to be independent and mandating a committee structure of the board to include only independent members on key committees comes within no traditional federal policy. The substance of voting rights of shareholders as specified in a one share/one vote procedure is state law, as the D.C. Circuit directly told the SEC in the *Business Roundtable* decision.\(^{181}\) Whether shareholders get to vote on compensation (as opposed to how the voting occurs) is straight out of state corporations law. Even the composition of audit committees and their financial literacy, seemed to be clearly within the orbit of state law prior to congressional action in Sarbanes-Oxley.

So what is common to modern day governance listing requirements is that they intrude into the area traditionally decided by state law. There may, of course, by very good reasons to change that law, but doing it by stock exchange rule at the behest of the SEC seems more directed to making the federalism decision more opaque and to expand federal jurisdiction by the back door. This Part addresses how the federal-state line might be changed, first by congressional action and second by agency action.

**A. Constitutional Limits on Congress Shifting the Federalism Line**

Prior to the New Deal, corporate and securities laws were only regulated within state law. Under President Franklin Roosevelt’s administration and in the wake of the market crash and subsequent Great Depression, the federal government mandated disclosure in various securities transactions and established additional regulation of the secondary market in shares.\(^{182}\) As with other New Deal legislation, these statutes were challenged as beyond the federal power. In the first securities case to reach the Supreme Court, *Jones v. SEC*,\(^ {183}\) a 1936 challenge to the SEC’s issuance of a stop order for an initial public offering (IPO), the Court passed by the constitutional claim decided by the court below and confined its decision to the argument that

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181 Bus. Roundtable v. SEC, 905 F.2d 406, 416 (D.C. Cir. 1990) ("To argue that Congress’s ‘equal regulation’ mandate supports SEC control over corporate governance through national listing standards is to gamble that the court will accept a Commission spin on a statutory fragment without even a glance at its context. Wrong court, bad gamble.").


183 298 U.S. 1 (1936).
sought to reject the SEC action on procedural grounds.\(^{184}\) Two years later, in *Electric Bond & Share Co. v. SEC*,\(^ {185}\) the Court again passed by the constitutional challenge made to the SEC’s power over reorganization terms for breaking up public utilities, the most substantive of all the SEC powers under the various New Deal statutes.\(^ {186}\) It was another eight years before the Court subsequently upheld the constitutionality of that statute.\(^ {187}\) And from that point, the SEC’s constitutional position seemed secure. Stanley Reed, who had argued the *Jones* case as solicitor general, and Robert Jackson, who had argued the *Electric Bond* case as solicitor general, were appointed to the Court along with William O. Douglas, the chair of the Securities and Exchange Commission, Felix Frankfurter, who had organized the redrafting of the Securities Act of 1933 in the first weeks of the new administration, and other New Deal economic liberals such as Hugo Black and Frank Murphy. Although *United States v. Lopez*\(^ {188}\) and some other decisions of a more recent vintage suggest that there may be constitutional limits on congressional power under the commerce clause, the regulation of large publicly held corporations seems easily within Commerce Clause authority.\(^ {189}\)

**B. Federalism in the Absence of Specific Congressional Action**

If Congress were to implement the listing standards (or the shareholder access rules discussed below) the federalism issue would likely disappear for the reasons discussed in the previous paragraphs. The more complex question is whether an agency can shift the federalism line as part of its delegated authority in the absence of congressional action. To some extent this is a separation of powers argument as much as a federalism one, but at the intersection of the two doctrines it may be that federalism acts to limit agency actions more than it would if Congress were to take the same action.

The decision in *Business Roundtable* is one of the few federal decisions to address the impact of federalism on the SEC’s authority. That

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\(^{184}\) *Id.* at 26 ("Since here the only disclosed purpose for which the investigation was undertaken had ceased to be legitimate, the power of the commission to proceed with the inquiry necessarily came to an end.").

\(^{185}\) *303 U.S.* 419 (1938).

\(^{186}\) *Id.* at 439–43 (upholding registration requirement of the Public Utilities Holding Company Act, but not resolving constitutional challenges to substantive reorganization powers contained in the Act).

\(^{187}\) *N. Am. Co. v. SEC*, *327 U.S.* 686, 710 (1946) (upholding constitutionality of SEC power to direct the breakup of public utility holding companies).

\(^{188}\) *514 U.S.* 549 (1995).

\(^{189}\) See *id.* at 565–68.
court placed the question within the context of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, the Supreme Court's landmark decision of six years before upholding the EPA's interpretation of "statutory source." The *Business Roundtable* court observed that "we owe the Commission deference under *Chevron*... even though the case might be characterized as involving a limit on the SEC's jurisdiction." That last caveat invokes a controversial limitation that the Supreme Court had left undecided. In a notable set of dueling opinions, Justice Scalia observed "it is plain that giving deference to an administrative interpretation of its statutory jurisdiction or authority is both necessary and appropriate." Justice Brennan responded that deference is not appropriate as to jurisdiction.

In a subsequent case the Court expressed a preference for strict statutory interpretation so as to avoid constitutional issues. There the Court concluded that an agency interpretation of "navigable waters" to include an abandoned gravel pit because it was used as a habitat for migratory birds was not fairly supported by congressional legislation. The Court started from the assumption that that Congress does not casually authorize the administrative agencies to push the limits of congressional authority. The opinion by Chief Justice Rehnquist noted that this concern is particularly heightened when an "administrative interpretation alters the federal-state framework by permitting federal encroachment upon a traditional state power."

This suggests that the corporate governance rules via listing standards may be vulnerable to attack as inappropriate agency action. Because of this federalism aspect the arguments that can be made against these governance rules are stronger than those made against mutual funds and hedge fund rules that were recently invalidated by federal appellate courts. In those cases, plaintiffs argued the agency had gone beyond the congressionally provided authority, but

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191 *Id.* at 857–63.
195 *Solid Waste Agency of N. Cook County v. U.S. Army Corps of Eng'rs*, 531 U.S. 159, 172 (2001) ("Where an administrative interpretation of a statute invokes the outer limits of Congress' power, we expect a clear indication that Congress intended that result.").
196 *Id.* at 173.
197 *See supra* note 2.
neither court adopted a federalism argument. At the same time, the barriers to judicial invalidation occurring are significant. There is likely to be a standing question. If the SEC approves stock exchange rules via Section 19(b), who will have standing to question the action? The appellate courts in the mutual fund and hedge fund cases have given parties such as the Chamber of Commerce substantial latitude to advance the arguments and that reasoning could apply to a challenge against the governance rules as well.

Substantial corporate law has been made in the other gray areas between federal and state law where standing is difficult, such as the shareholder proxy rules. As previously noted, Congress chose to confine the federal role in corporate governance to disclosure that would make the shareholder power as given by state law more informed. If state law did not give shareholder substantive rights vis-à-vis directors, federal law would not override that governance choice.

Yet, from the early 1940s, the SEC passed rules that made the line between state and federal regulation fuzzy. The earliest iteration of Rule 14a-8 permitted individual shareholders to submit proposals that would be voted on via management’s proxy solicitation prior to the corporation’s annual meeting. The rule requires that such a proposal be “a proper subject for action by security holders” and since

198 Another example is the challenge to the agency’s action enacting Regulation FD. See Final Rule: Selective Disclosure and Insider Trading, Exchange Act Release No. 43154, 65 Fed. Reg. 51,716, 51,716 (Aug. 15, 2000). In SEC v. Siebel Systems, Inc., 384 F. Supp. 2d 694 (S.D.N.Y. 2005), the court declined to rule on the question that the regulation was beyond the authority provided in the statute, a question that turned on the meaning of “filing” versus “disclosures to the public” without any additional element of whether the agency was intruding into the state realm. Brief of Chamber of Commerce of the United States as Amicus Curiae in Support of Motion to Dismiss at 4–11, SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694 (S.D.N.Y. 2005) (No. 94 CV 5130) (arguing that expanding the obligation of corporate executives beyond fiduciary or similar relationship is a major policy decision properly made by Congress and not the SEC). The trial court did not rule on this claim. See Siebel Sys., Inc., 384 F. Supp. 2d at 709 n.16.

199 See, e.g., Chamber of Commerce v. SEC, 443 F.3d 890, 896–97 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 412 F.3d 133, 138 (D.C. Cir. 2005).

200 But Business Roundtable did suggest that the SEC could do more than mandate information and still stay within existing boundaries. Bus. Roundtable v. SEC, 905 F.2d 406, 411 (D.C. Cir. 1990) (“Rule 14-4(b)(2) requires a proxy to provide some mechanism for a security holder to withhold authority to vote for each nominee individually. . . . It thus bars a kind of electoral tying arrangement, and may be supportable as a control over management’s power to set the voting agenda, or . . . voting procedure.”). The SEC’s recent proposals to require shareholder nominations in some situations could come within that opening.

1954 has included the provision that such questions are to be determined "under the laws of the issuer's domicile." By a regulatory sleight of hand, the agency avoided any direct challenge to what has become a strong empowerment of shareholders and a resetting of the shareholder/director relationship. It added a note that while mandatory provision that sought to require directors to do something may well not be permissible under state law, precatory provisions would be permissible. More recently the note was expanded to erect a presumption that a proposal phrased as a suggestion or recommendation would be proper. The result has been to shift to federal law the resolution of hundreds of issues that are realistically little more than fights between shareholders and directors as to control of the corporation. If courts have not been willing to use federalism as a limit in that context, they may be more reluctant in a setting where the SEC can argue it was merely discussing corporate governance with the exchanges or lobbying for private action.

After Enron the SEC proposed but never enacted an expansion of the proxy rules that would have permitted shareholders to nominate directors if certain triggers occurred. One of those triggers is if the directors had refused to act on one of those precatory proposals that achieve a majority vote (even though the vote is only a suggestion). The bottom line would be to move into the shareholder realm additional matters that traditionally have been done by directors. The SEC has considered such a use of the proxy rules at several times in its history, but each time has stopped short of intruding further into state law. Its most recent proposals provoked a strong reaction from the business community which seems to have stalled additional agency action. The question relevant for this Article is how courts should react to challenges built along the lines of the Business Roundtable argument that seeks to challenge such a rule. To the extent that the agency is approaching the outer limits of the authority

206 Id.
given by Congress, federalism likely will become a part of judicial consideration and a barrier to agency action.  

C. A Peek at the Future

How might the history of corporate governance via stock exchange listing standards interact with the new realities in the market of exchanges and in litigation? Three observations seem pertinent. First, we are in the twilight of corporate governance via stock exchange action. The independent director requirements of 2002–2003 will likely be the last important American governance rules to arise from the exchanges. In the new world of for-profit exchanges that have arisen in the last few years, there is simply no longer the economic incentive for exchanges to spend resources on such rules or even for constituencies around the exchange to use the exchange as a vehicle for working out these issues. Second, even the existing rules are vulnerable to legal attack in the current legal environment where federal appellate courts have been aggressive in limiting SEC rule-making. There are questions about standing and how to sufficiently link the federal hand to these rules, but the factual history provides a good bit of room for a challenge. Third, and a result of the first two, this may well lead to more explicit and direct federal intervention in corporate governance, probably with the SEC taking over listing standards and their enforcement, as has occurred in some other countries in the wake of the worldwide demutualization of stock exchanges. It may be that this link via reform of stock exchanges to keep the United States competitive will become the legislative vehicle approving direct federal regulation of corporate governance.

207 The argument may be different than in previous debates over SEC action relating to shareholder access. In 1961 in his path-breaking treatise on Securities Regulation, Harvard professor Louis Loss first observed that “[i]f Congress had intended to give the Commission power to reallocate functions between the two corporate organs, so revolutionary a federal intervention would presumably been more clearly expressed.” 2 Louis Loss, SECURITIES REGULATION 902–03 (2d ed. 1961). But he then observes that given the broad power in state law allocating power to directors, there are seldom opportunities for judicial decision barring shareholder action on a particular matter. “Inevitably the Commission, while purporting to find and apply a generally nonexistent state law, has been building up a ‘common law’ of its own as to what constitutes a ‘proper subject’ for shareholder action. . . . [This common law may] influence the state courts themselves . . . .” Id. at 906.

208 See Macey & O'Hara, supra note 159, at 599.
The seemingly relentless expansion of federal law at the expense of the states found across our society shows up in corporate law as well. Yet Congress has not enacted a federal incorporation statute and the federal courts have been firm in curbing either judicial or agency action that would overrun established state areas of regulation. The flurry of reform that followed the Enron and WorldCom scandals has exposed new strains on federalism in corporate and securities laws. In addition to the Congressional action in Sarbanes-Oxley, the stock exchanges, in what I have argued is indirect federal agency action, have overrun a substantial area of state law. The recently proposed SEC proposals on shareholder access to the director nomination process similarly are open to attack as inappropriate agency movement of the boundary between state and federal regulation. But as the changing economics of operating a stock exchange take away traditional economic incentives for governance rule-making from the exchanges, the next point of discussion for corporate law federalism may well arise from the movement of listing standards for national securities markets into the federal government.