

## The Scope of the SEC's Authority over Shareholder Voting Rights

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**Abstract:** At a May 2007 Roundtable on “The Federal Proxy Rules and State Corporation Law,” the Securities and Exchange Commission posed the following question for discussion: “What should be the relationship of federal and state law with respect to shareholders’ voting rights and ability to govern the corporation?” To answer that question, this essay reviews the legislative history of Section 14(a) and of the Securities Exchange Act generally, as well as the leading judicial precedents. It concludes that, as a general rule of thumb, federal law appropriately is concerned mainly with disclosure obligations, as well as procedural and antifraud rules designed to make disclosure more effective. In contrast, regulating the substance of corporate governance standards is a matter for state corporation law.

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## The Scope of the SEC's Authority over Shareholder Voting Rights

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In May 2007, the Securities and Exchange Commission (SEC) held a series of roundtables on the proxy process.<sup>1</sup> At the first of those meetings, the SEC posed the following question for discussion:

What should be the relationship of federal and state law with respect to shareholders' voting rights and ability to govern the corporation?

Background: Regulation of the proxy process is a core function of the Commission and one of the original responsibilities assigned to the Commission upon its creation in the Securities Exchange Act of 1934. When Congress charged the Commission with regulating the proxy process, it created a federal role in vindicating shareholders' state law rights. The federal interests include the importance of fair corporate suffrage and the prevention of abuses that would frustrate the free exercise of shareholders' voting rights. At the same time, however, Congress also recognized the traditional role of state corporation law, particularly with respect to the board's powers to manage the company's affairs. While the Commission has sought to use its authority in a manner that does not conflict with the primary role of the states in regulating corporate governance, some observers have expressed concern that federal regulation increasingly intrudes upon corporate matters that historically have been the province of state law. Other commenters believe the federal role should be enlarged.<sup>2</sup>

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<sup>1</sup> SEC Announces Roundtable Discussions Regarding Proxy Process (April 24, 2007), available at <http://www.sec.gov/news/press/2007/2007-71.htm>.

<sup>2</sup> Briefing Paper: Roundtable on the Federal Proxy Rules and State Corporation Law (May 7, 2007), available at <http://www.sec.gov/spotlight/proxyprocess/proxy-briefing050707.htm>.

As an administrative agency, the SEC legitimately may formulate policy and adopt rules to fill statutory gaps.<sup>3</sup> Because the Commission's rules have the full force and effect of federal law, they properly may preempt conflicting state laws.<sup>4</sup> In enacting such rules, however, the SEC must not exceed the scope of its statutory authority.<sup>5</sup> The answer to the question posed by the SEC thus depends on the extent to which Congress has delegated authority to the SEC to regulate corporate voting rights.

This essay therefore reviews the legislative history of Section 14(a) and of the Securities Exchange Act generally, as well as the leading judicial precedents. It concludes that, as a general rule of thumb, federal law appropriately is concerned mainly with disclosure obligations, as well as procedural and antifraud rules designed to make disclosure more effective. In contrast, regulating the substance of corporate governance standards is a matter for state corporation law.

### ***The Historical Background***

Shares of common stock represent a bundle of ownership interests: a set of economic rights, such as the right to receive dividends declared by the board of directors; and a right to vote on certain corporate decisions. For over a century, those rights typically have been packaged in a single class of common stock possessing equal economic rights and one vote per share. Yet, it was not always so, and even today state statutes allow corporations to derogate from the one vote-one share norm.

### **A Brief History of Corporate Voting Rights**

One share-one vote may be the modern standard, but it was not the sole historical pattern. To the contrary, limitations on shareholder voting rights in fact are as old as the corporate form itself. Prior to the adoption of general incorporation statutes in the mid-1800s, the best evidence as to corporate voting rights is found in individual corporate charters granted by legislatures. Three

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<sup>3</sup> *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-44 (1984).

<sup>4</sup> *Fidelity Federal Savings & Loan Ass'n v. De La Cuesta*, 458 U.S. 141, 153-54 (1982).

<sup>5</sup> *Conference of State Bank Supervisors v. Conover*, 710 F.2d 878, 882-83 (D.C. Cir. 1983).

distinct systems were used. A few charters adopted a one share-one vote rule.<sup>6</sup> Many charters went to the opposite extreme, providing one vote per shareholder without regard to the number of shares owned.<sup>7</sup> Most followed a middle path, limiting the voting rights of large shareholders. Some charters in the latter category simply imposed a maximum number of votes to which any individual shareholder was entitled. Others specified a complicated formula decreasing per share voting rights as the size of the investor's holdings increased. These charters also often imposed a cap on the number of votes any one shareholder could cast.<sup>8</sup>

Gradually, however, a trend towards a one share-one vote standard emerged. Maryland's experience was typical of the pattern followed in most states, although the precise dates varied widely. Virtually all charters granted by the Maryland legislature between 1784 and 1818 used a weighted voting system. After 1819, however, most charters provided for one vote per share, although approximately 40 percent of the charters granted between 1819 and 1852 retained a maximum number of votes per shareholder. Finally, in 1852, Maryland's first general incorporation statute adopted the modern one vote per share standard.<sup>9</sup>

Legislative suspicion of the corporate form and fear of the concentrated economic power it represented probably motivated the early efforts to limit shareholder voting rights. A variety of factors, however, combined to drive the

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<sup>6</sup> See 4 Joseph S. Davis, *Essays in the Earlier History of American Corporations* 324 (1912); 1 William R. Scott, *The Constitution and Finance of English, Scottish and Irish Joint-Stock Companies to 1720* 228 (1912).

<sup>7</sup> Samuel Williston, *History of the Law of Business Corporations Before 1800* (Part II), 2 *Harv. L. Rev.* 149, 156 (1888). *Taylor v. Griswold*, 14 N.J.L. 222 (1834), is often cited for the proposition that the common law rule, in the absence of controlling statute or charter provisions, was one vote per shareholder. E.g., Jeffrey Kerbel, *An Examination of Nonvoting and Limited Voting Common Stock—Their History, Legality and Validity*, 15 *Sec. Reg. L.J.* 37, 47 (1987). But see David L. Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote,"* 56 *Cornell L. Rev.* 1, 9-11 (1970) (arguing that the common law in fact had no fixed rule as to corporate voting rights).

<sup>8</sup> For example, a Maryland charter, typical of the period 1784 to 1818, provided: "for one share, and not more than two shares, one vote; for every two shares above two, and not exceeding ten, one vote; for every four shares above ten, and not exceeding thirty, one vote; for every six shares above thirty, and not exceeding sixty, one vote; for every eight shares above sixty, and not exceeding one hundred, one vote; but no person, co-partnership or body politic shall be entitled to a greater number than thirty votes . . . ." Joseph G. Blandi, *Maryland Business Corporations 1783-1852* 66 (1934).

<sup>9</sup> See *id.*

legal system towards the one share-one vote standard. Because reform efforts were almost invariably led by corporations, apparently under pressure from large shareholders, it may be assumed that one factor was a desire to encourage large scale capital investment. The ease with which restrictive voting rules could be evaded also undermined the more restrictive rules. Large shareholders simply transferred shares to straw-men, who thereupon voted the shares as the true owner directed.<sup>10</sup> Finally, while other factors also contributed, the most important factor probably was the fading of public prejudice towards corporations.

By 1900, the vast majority of U.S. corporations had moved to one vote per share.<sup>11</sup> Indeed, contrary to present practice, most preferred shares had voting rights equal to those of the common shares. State corporation statutes of the period, however, merely established the one share-one vote principle as a default rule.<sup>12</sup> Corporations were free to deviate from the statutory standard,<sup>13</sup> and during the first two decades of the 1900s the trend towards one share-one vote began to reverse.

Two distinct deviations from the one share-one vote standard emerged in the years prior to the Great Crash of 1929. One involved elimination or substantial limitation of the voting rights of preferred stock. In particular, it became increasingly common to give preferred shares voting rights only in the event of certain contingencies (such as nonpayment of dividends). While controversial at the time, this practice is the modern norm.

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<sup>10</sup> This practice is noted, for example, in the preamble to an English act of 1766. 7 Geo. III., ch. 48. Apparently, it was (or became) lawful. See, e.g., *Moffat v. Farquhar*, 7 Ch. D. 591 (1878). The same practice arose in the United States, the Maryland legislature going so far as to require each voting shareholder to swear an oath that the shares he was voting were his property and had not been acquired with the intent of increasing the number of votes to which the shares were entitled. 1836 Md. Laws ch. 264. See also *Annals of Cong.* 923 (1819) (resolution proposing to prohibit transfers of stock made for the purpose of evading the limits on voting rights of shares in the first Bank of the United States).

<sup>11</sup> W.H.S. Stevens, *Stockholders' Voting Rights and the Centralization of Voting Control*, 40 Q.J. Econ. 353, 354 (1926).

<sup>12</sup> New York's General Corporation Law of 1909, for example, entitled each shareholder to one vote per share "[u]nless otherwise provided in the certificate of incorporation." 1909 N.Y. Laws, ch. 28, § 23, reprinted in Joseph A. Arnold, *New York Business Corporations* 39 (4th ed. 1911).

<sup>13</sup> E.g., *St. Regis Candies, Inc. v. Hovas*, 3 S.W.2d 429 (Tex. App. 1928); *General Inv. Co. v. Bethlehem Steel Corp.*, 100 A. 347 (N.J. Ch. 1917); *People ex rel. Browne v. Keonig*, 118 N.Y.S. 136 (A.D. 1909); *Bartlett v. Fourton*, 38 So. 882 (La. 1905).

The more important development for present purposes was the emergence of nonvoting common stock. One of the earliest examples was the International Silver Company, whose common stock (issued in 1898) had no voting rights until 1902 and then only received one vote for every two shares. After 1918, a growing number of corporations issued two classes of common stock: one having full voting rights on a one vote per share basis, the other having no voting rights (but sometimes having greater dividend rights). By issuing the former to insiders and the latter to the public, promoters could raise considerable sums without losing control of the enterprise.<sup>14</sup>

While disparate voting rights plans were gaining popularity with corporate managers in the 1920s, and investors showed a surprising willingness to purchase large amounts of nonvoting common stock, an increasingly vocal opposition also began emerging. William Z. Ripley, a Harvard professor of political economy, was the most prominent (or at least the most outspoken) proponent of equal voting rights. In a series of speeches and articles, eventually collected in a justly famous book, he argued that nonvoting stock was the “crowning infamy” in a series of developments designed to disenfranchise public investors.<sup>15</sup> (In essence, this was an early version of the conflict of interest argument made below: promoters were using nonvoting common stock as a way of maintaining voting control for themselves.)

The opposition to nonvoting common stock came to a head with the NYSE’s 1925 decision to list Dodge Brothers, Inc. for trading. Dodge sold a total of \$130 million worth of bonds, preferred stock and nonvoting common shares to the public. Dodge was controlled, however, by an investment banking firm, which had paid only \$2.25 million for its voting common stock.<sup>16</sup> In January 1926, the NYSE responded to the resulting public outcry by announcing a new position: “Without at this time attempting to formulate a definite policy, attention should be drawn to the fact that in the future the [listing] committee, in considering applications for the listing of securities, will give careful thought to the matter of voting control.” This policy gradually hardened, until the NYSE in 1940 formally announced a flat rule against listing nonvoting common stock. Although there were occasional exceptions, the most prominent being the 1956 listing of Ford

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<sup>14</sup> Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* 75-76 (1932).

<sup>15</sup> William Z. Ripley, *Main Street and Wall Street* 77 (1927).

<sup>16</sup> See Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 *Geo. Wash. L. Rev.* 687, 694-97 (1986).

Motor Company despite its dual class capital structure, the basic policy remained in effect until the mid-1980s.

In the years between 1927 and 1932, at least 288 corporations issued nonvoting or limited voting rights shares (almost half the total number of such issuances between 1919 and 1932).<sup>17</sup> But the Great Depression, with an assist from the opposition led by Ripley and the NYSE's growing resistance, finally killed off most disparate voting rights plans. Not until the hostile takeover wave of the 1980s would they again play an important corporate finance role for most companies.

### **State Law Today**

As it has long done, state law today generally provides corporations with considerable flexibility with respect to allocation of voting rights. Virtually all state corporate codes adopt one vote per common share as the default rule, but allow corporations to depart from the norm by adopting appropriate provisions in their organic documents. Hence, for example, dual class capital structures are routinely upheld by courts.<sup>18</sup>

### **Rule 19c-4: The SEC's Failed Attempt to Regulate Voting Rights**

The foregoing historical background set the stage for the SEC's first attempt to regulate directly the substance of shareholder voting rights. To be sure, pursuant to the authority granted it under Securities Exchange Act § 14(a), the SEC had already affected shareholder voting rights to a considerable degree. Even so, however, most of the SEC's proxy rules relate to disclosure.<sup>19</sup> To the extent the SEC proxy rules extend beyond disclosure, they relate mainly to the procedures by which the proxies are to be prepared, solicited, and used.<sup>20</sup> For example, Rule 14a-4 restricts management's use of discretionary power to cast

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<sup>17</sup> 1 Arthur S. Dewing, *The Financial Policy of Corporations* 161 (5th ed. 1953).

<sup>18</sup> E.g., *Groves v. Rosemound Improvement Ass'n, Inc.*, 413 So.2d 925, 927 (La. App. 1982); *Providence & Worcester Co. v. Baker*, 378 A.2d 121, 122-24 (Del. 1977); *Hampton v. Tri-State Fin. Corp.*, 495 P.2d 566, 569 (Colo. App. 1972); *Shapiro v. Tropicana Lanes, Inc.*, 371 S.W.2d 237, 241-42 (Mo. 1963); *Deskins v. Lawrence County Fair & Dev. Corp.*, 321 S.W.2d 408, 409 (Ky. 1959). For an overview of the various forms of dual class stock plans, see Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 Wash. U. L.Q. 565, 568-75 (1991)

<sup>19</sup> Bainbridge, *supra* note 18, at 609.

<sup>20</sup> *Id.* at 609-10.

votes obtained by a proxy solicitation.<sup>21</sup> Rule 14a-7 requires management cooperation in transmitting an insurgent's proxy materials to shareholders.<sup>22</sup> Rule 14a-8 requires management to include qualified shareholder proposals in the corporation's proxy statement at the firm's expense.<sup>23</sup>

In 1988, however, the SEC for the first time attempted to regulate directly the substantive voting rights of shareholders. As we saw above, one vote per share is the norm in the United States, although state law freely allows departures from that norm. During the 1980s, departures from that norm became increasingly common as companies recognized the powerful potential power of dual class stock schemes as a defense against hostile takeover bids.<sup>24</sup> Incumbents who cannot be outvoted, after all, cannot be ousted.

Consider, for example, the simplest type of dual class stock plan; namely, a charter amendment creating two classes of common stock. The Class A shares are simply the preexisting common stock, having one vote per share. The newly created Class B shares, distributed to the shareholders as a stock dividend, have most of the attributes of regular common stock, but possess an abnormally large number of votes (usually ten) per share. Class B shares typically are not transferable, but may be converted into Class A shares for sale. Normal shareholder turnover thus concentrates the superior voting shares in the hands of long-term investors, especially incumbent managers, eventually perhaps even giving them voting control of the company.

In response to the active market for corporate control of the 1980s, managers who saw their firms as being vulnerable to takeovers began lobbying the NYSE and Amex to liberalize their rules on shareholder voting rights. In July 1988, the SEC responded by adopting Rule 19c-4, which effectively prohibited public corporations from issuing securities or taking other corporate action nullifying, restricting, or disparately reducing the voting rights of existing shareholders.<sup>25</sup>

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<sup>21</sup> 17 C.F.R. § 240.14a-4.

<sup>22</sup> 17 C.F.R. § 240.14a-7.

<sup>23</sup> 17 C.F.R. § 240.14a-8.

<sup>24</sup> See generally Bainbridge, *supra* note 18, at 571-75 (discussing the antitakeover potential of dual class stock plans).

<sup>25</sup> As a technical matter, Rule 19c-4 did not directly regulate voting rights. Instead, it added a new rule to the listing standards of each national securities exchange making available transaction reports under Exchange Act Rule 11Aa3-1, 17 C.F.R. § 240.11Aa3-1, and each national securities association registered under Exchange Act section 15A, 15 U.S.C. § 78o-3. (Registered exchanges and securities associations are collectively referred to as self-regulatory organizations (SROs). See 15 U.S.C. § 78c(a)(26).)



While not a strict one-share-one-vote standard, Rule 19c-4 placed substantial limitations on the ability of U.S. corporations to adopt disparate voting rights plans.<sup>26</sup>

The Business Roundtable challenged the Rule, arguing that corporate governance regulation is primarily a matter for state law and that the SEC therefore had no authority to adopt rules affecting substantive aspects of corporate voting rights. The D.C. Circuit agreed, striking down the rule as beyond the Commission's regulatory authority.<sup>27</sup>

The Commission based its authority to adopt Rule 19c-4 on its powers under Securities Exchange Act § 19(c), which permits it to amend exchange rules provided that the Commission's action furthers the Act's purposes. Rule 19c-4 fell because the D.C. Circuit determined that its attempt to regulate corporate voting rights furthered none of the Exchange Act's purposes. In defending Rule 19c-4, the SEC trotted out its long-standing view that § 14(a) was intended to promote corporate democracy. In striking down the Rule, however, the D.C. Circuit adopted a much narrower view of § 14(a)'s purposes. According to the court, federal proxy regulation has two principal goals. First, and foremost, it regulates the disclosures shareholders receive when they are asked to vote. Second, it regulates the procedures by which proxy solicitations are conducted. Section 14(a)'s purposes thus do not include regulating substantive aspects of shareholder voting.<sup>28</sup>

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The listing standards created by Rule 19c-4 prohibited a covered exchange from listing or continuing to list the equity securities of an issuer that takes one of the prohibited actions. The Rule likewise prohibited a covered securities association from authorizing the equity securities of such an issuer for quotation and/or transaction reporting on an automated quotation system. The Intermountain and Spokane Stock Exchanges were the only national securities exchanges excluded from coverage. The National Association of Securities Dealers (NASD) was the only securities association affected by the rule, just as the NASDAQ system was the only affected automated quotation system. Finally, only those issuers registered with the SEC pursuant to Exchange Act section 12, 15 U.S.C. § 781, were covered by the rule. Exchange Act Release No. 25891 (July 7, 1988), [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,247 at 89,208-09 [hereinafter Adopting Release].

<sup>26</sup> For an overview of corporate actions prohibited and permitted by the Rule, see Bainbridge, *supra* note 18, at 578-85.

<sup>27</sup> *Bus. Roundtable v. SEC*, 905 F.2d 406 (D.C. 1990).

<sup>28</sup> In *Chevron USA Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), the Supreme Court opined that where Congress has "left a gap for the agency to fill," the agency's regulations will be "given controlling weight unless they are arbitrary,

The remaining sections of this essay argue that the *Business Roundtable* decision stuck the correct balance between the state and federal roles in regulating shareholder voting rights.<sup>29</sup>

### ***The Legislative History of Section 14(a)***

During the litigation over the validity of Rule 19c-4, the SEC conceded that it does not have “unlimited authority to amend SRO rules in areas of ‘corporate governance.’” Nevertheless, the SEC claimed that when Securities Exchange Act § 14(a) and its legislative history are read against the backdrop of the nonvoting common stock controversy of the 1920s, a congressional intent to broadly

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capricious, or manifestly contrary to the statute.” *Id.* at 843-44. The D.C. Circuit questioned whether *Chevron* even applied to the Rule 19c-4 litigation, since the Business Roundtable’s challenge “might be characterized as involving a limit on the SEC’s jurisdiction” as to which deference may be inappropriate. Although the D.C. Circuit nonetheless assumed that the SEC was entitled to deference, it held that the Rule was contrary to the clearly expressed will of Congress and thus invalid even under *Chevron*. *Bus. Roundtable v. SEC*, 905 F.2d 406, 408 (D.C. 1990).

<sup>29</sup> There is a very troubling epilogue to the Rule 19c-4 story. After the Rule was struck down, the Commission invoked informal powers that have been aptly called the “raised eyebrow.” See Donald E. Schwartz, *Federalism and Corporate Governance*, 45 *Ohio St. L.J.* 545, 571 (1984) (explaining that the SEC has considerable informal influence over SRO rulemaking). Specifically, SEC Chairman Arthur Levitt successfully pressured the three principal domestic securities exchanges—NYSE, AMEX, and NASDAQ—to adopt a uniform voting rights policy essentially tracking Rule 19c-4. Stephen M. Bainbridge, *Revisiting the One-Share/One-Vote Controversy: The Exchanges’ Uniform Voting Rights Policy*, 22 *Sec. Reg. L.J.* 175 (1994).

The SEC’s use of its “raised eyebrow” powers in this context is troubling. Rather than obeying the law applicable to it, the Commission chose to end-run *Business Roundtable* by pressuring the exchanges to adopt “voluntary” listing standards modeled on Rule 19c-4. In doing so, the SEC also did an end-run around both Congress and the Supreme Court to create uniform, national corporate governance standards. As *Business Roundtable* confirmed, the SEC lacked authority to directly regulate dual class stock. Suspecting that the front door was locked, the Commission tried using Rule 19c-4 to sneak federal regulation through the back door. In *Business Roundtable*, however, the court squarely barred the Commission from doing indirectly what it could not do directly. Finding the back door to be locked as well, the SEC therefore sneaked through the cellar window. In doing so, it ran rough-shod over the clear Congressional intent that the SEC was not to regulate corporate governance generally or the substance of shareholder voting rights in particular.

authorize the SEC to prevent shareholder disenfranchisement emerges.<sup>30</sup> As specifically applied to Rule 19c-4, Congress in 1934 supposedly adopted the NYSE policy on corporate voting rights as one of the Securities Exchange Act's purposes and gave the SEC authority to prevent subsequent erosion of that policy.

Although Congress did have evidence before it as to the NYSE's policy, references to nonvoting stock in the legislative history of the Securities Exchange Act occur only in the hearings and these are scanty indeed.<sup>31</sup> As for exchange listing standards generally, the Senate Banking and Currency Committee's report on the results of the Pecora Hearings identified the major flaw in this area as the exchanges' laxity in investigating listing applications from dubious companies. In explaining the need for regulation of listing requirements, the Committee focused solely on the need for periodic corporate disclosures from issuers.<sup>32</sup> The Committee simply did not address regulation of exchange listing standards

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<sup>30</sup> Brief for Respondent at 13, *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) [hereinafter SEC Brief]. The legislative history of § 14(a) is relatively sparse, in large part because the controversy over federal proxy regulation was resolved early in the legislative process. As originally introduced, the proxy provision mandated substantial disclosures and gave the SEC authority to adopt additional disclosure requirements. H.R. 7852, 73d Cong., 2d Sess. § 13(a) (1934). The proposal met with substantial criticism. In redrafting § 14(a) in response to these criticisms, Congress did what it often does when it has a tough problem to solve: it told somebody else to solve it. In effect, the Act simply made it unlawful to solicit proxies "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Securities Exchange Act, Pub. L. No. 73-291, § 14(a), 48 Stat. 881, 895 (1934).

<sup>31</sup> Out of the thousands of pages of House and Senate hearings, the sole reference to the NYSE policy is the testimony of Frank Altschul, Chairman of the NYSE Committee on Stock List. *Stock Exchange Practices: Hearings before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 6677-80 (1934) [hereinafter Pecora Hearings]. In colloquy with Altschul, Ferdinand Pecora referred to nonvoting common stock as an "evil." *Id.* at 6679. He had earlier in the hearings also raised questions as to the use of nonvoting preferred stock. *Id.* at 6661-62. Pecora's comments are entitled to some weight in light of the significant role he played in creating the federal securities laws, *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 69 (D.C. Cir.), cert. denied, 449 U.S. 1012 (1980), but not every matter Pecora identified as an evil was subjected to federal regulation.

The Senate Banking Committee's report on the Pecora Hearings contains some widely scattered discussion of voting rights issues, but only in the context of condemning the abuses of investment trusts and holding company structures prevalent at the time. S. Rep. No. 1455, 73d Cong., 2d Sess. 333-91 (1934).

<sup>32</sup> *Id.* at 70-73.

affecting such matters as corporate voting rights.

In defending Rule 19c-4, the Commission argued that Congress did not need to address regulation of corporate voting rights in light of the NYSE's policy against nonvoting common stock. As the NYSE was the principal secondary trading market, Congress could assume that shareholders would have effective voting rights. The SEC thus read Congress' silence on dual class stock as reflecting an implicit assumption that shareholders would not be disenfranchised and an implicit intent to prevent shareholder disenfranchisement.<sup>33</sup>

The Commission's interpretation of the legislative history was flawed on several grounds. If true, it would suggest only that the SEC has authority over voting rights to the extent of requiring NYSE to maintain its 1934 policy intact or to force other SROs to adopt the NYSE's 1934 policy (neither of which is what Rule 19c-4 did, of course). More important, the SEC's argument was inconsistent with the attitudes of the Exchange Act's drafters towards exchange regulation. If Congress was concerned with dual class stock, it undoubtedly would have thought the mere use of SRO rules would not achieve the desired result. In the House debates, for example, Chairman Rayburn recognized that many exchanges did not have the same bargaining power vis-à-vis issuers as the NYSE. He further observed that exchange regulation could "only go so far before selfish managements" refused to comply.<sup>34</sup> While he made these observations in the context of disclosure obligations, they are consistent with the then prevailing view that self-regulation by the exchanges was inadequate to resolve the economic problems Congress had identified. If Congress had wanted to graft the NYSE's nonvoting common stock policy onto the Act, it therefore would have said so explicitly. Congress' inaction, accordingly, should be read as leaving voting rights in the hands of the states and the exchanges, especially when considered in light of the repeated congressional rejections of proposals to federalize corporate law discussed below.

This conclusion receives additional support from subsequent developments. In 1937-38, the Senate held extensive hearings on proposals to federalize corporate law.<sup>35</sup> Mandating a federal one-share/one-vote standard was among the items under consideration.<sup>36</sup> At one of the hearings, the SEC's Assistant Director of

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<sup>33</sup> Adopting Release, *supra* note 25, at 89,231.

<sup>34</sup> 78 Cong. Rec. 7698 (1934).

<sup>35</sup> Federal Licensing of Corporations: Hearings Before the Senate Judiciary Comm., 75th Cong., 1st & 3d Sess. (1937 & 1938) [hereinafter *Federal Licensing of Corporations*].

<sup>36</sup> S. 3072, 75th Cong., 3d Sess. § 5(g) (1938).

Registration was asked whether the federal securities laws prohibited the use of nonvoting stock. He replied that “they only require that an adequate disclosure of the material facts concerning that structure be made.”<sup>37</sup> As the Business Roundtable therefore bluntly stated, the SEC staff “most familiar with the events of 1934 ... had no illusions that Congress had somehow sought to preserve the NYSE’s 1926 so-called ‘policy’ concerning nonvoting stock or that Congress had authorized the Commission to do.”<sup>38</sup>

In assessing Congress’ intentions in 1934 one also should consider what it was actually told about shareholder voting rights during the hearings that lead up to the Securities Exchange Act. Recall that Ripley and others had announced the demise of nonvoting common stock as early as 1926. Frank Altschul, the Chairman of the NYSE’s Committee on Stock List, repeated that claim before Congress, claiming that “the period of the creation of nonvoting common stocks came to an end” with the NYSE’s action in 1926.<sup>39</sup> As far as Congress knew in 1934, nonvoting stock was a dead issue. On the other hand, Altschul’s testimony made clear that the NYSE continued to list voting trust certificates.<sup>40</sup> As influential Senate Banking and Currency Committee chief counsel Ferdinand Pecora pointed out, they were a device used to deprive stockholders of an effective voice in management—“an evil comparable to that of nonvoting stock, except that the evil is limited as to time.”<sup>41</sup> Accordingly, it is quite striking that Congress did not attempt to regulate the voting rights. If Congress had been concerned with protecting the substance of shareholder voting rights, surely it would have struck at those perceived abuses permitted by the NYSE’s policy. Again, the more logical reading of Congress’ silence on voting rights thus is that it simply did not intend to regulate the substance of voting rights.

Turning from the specifics of stock exchange listing standards to the legislative history of § 14(a) generally, proponents of an expansive federal role in regulating stockholder voting rights long have placed great weight on a House Committee Report statement that “[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange.”<sup>42</sup> The same report also stated: “Inasmuch as only the exchanges make it possible for

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<sup>37</sup> Federal Licensing of Corporations, *supra* note 35, at 373.

<sup>38</sup> Reply Brief for Petitioner at 9, *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (No. 88-1651) [hereinafter BRT Reply Brief].

<sup>39</sup> Pecora Hearings, *supra* note 31, at 6677

<sup>40</sup> *Id.* at 6679.

<sup>41</sup> *Id.*

<sup>42</sup> H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934).

securities to be widely distributed among the investing public, it follows as a corollary that the use of the exchanges should involve a corresponding duty of according shareholders fair suffrage.”<sup>43</sup> While it is indisputable that Congress intended for § 14(a) to give the SEC broad powers over corporate proxy solicitations, it is reasonable to believe that references to fair corporate suffrage in fact referred to an entirely different set of issues than the substance of shareholder voting rights. Specifically, as the D.C. Circuit recognized, Congress was talking about the need for full disclosure and fair solicitation procedures.<sup>44</sup>

The passage from which the fair corporate suffrage language is torn emphasized that management should not be able to perpetuate itself in office through “misuse” of corporate proxies.<sup>45</sup> It noted that insiders were using the proxy system to retain control “without adequate disclosure.”<sup>46</sup> It protested that insiders were soliciting proxies “without fairly informing” shareholders of the purpose of the solicitation.<sup>47</sup> The passage concludes by stating that in light of these abuses § 14(a) gives the “Commission power to control the conditions under which proxies may be solicited ....”<sup>48</sup> In sum, the passage says nothing about the substance of the shareholders’ voting rights. Instead, the focus is solely on enabling shareholders to make effective use of whatever voting rights they possess by virtue of state law.<sup>49</sup>

The historical context in which § 14(a) was adopted supports this interpretation. When the Securities Exchange Act was first being considered, state corporate law was largely silent on the issue of corporate communications with

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<sup>43</sup> *Id.* at 14.

<sup>44</sup> Business Roundtable, 905 F.2d at 410-11.

<sup>45</sup> H.R. Rep. No. 1383, *supra* note 42, at 13.

<sup>46</sup> *Id.*

<sup>47</sup> *Id.* at 14.

<sup>48</sup> *Id.*

<sup>49</sup> The Senate Committee’s report on stock exchange practices likewise focused on disclosure concerns. It noted that management frequently asked shareholders to grant proxies without explanation of the matters to be acted upon. S. Rep. No. 1455, *supra* note 31, at 74. See also S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934) (“Too often proxies are solicited without explanation to the shareholder of the real nature of the questions for which authority to cast his vote is sought.”). The report emphasized the need for adequate shareholder knowledge about both the company’s financial position and matters of policy. S. Rep. No. 1455, *supra* note 31, at 74. Finally, in describing the intent of section 14(a), the report contemplated that the SEC’s rules thereunder would “protect investors from promiscuous solicitation of their proxies.” *Id.* at 77.

shareholders. It only required that the corporation send shareholders a notice of a shareholders meeting, stating where and when the meeting would be held and briefly stating the issues to come before the meeting. By that time, of course, the proxy system of voting was well-established; so too were complaints about its operation. One common concern was that corporate managers were soliciting proxies from shareholders without giving shareholders enough information on which to make an informed voting decision. Another was that management used its control of the proxy process to ensure that only those directors who were acceptable to management were elected. Finally, there were a variety of widespread procedural abuses. For example, proxy cards often failed to give shareholders the option of voting against a proposal. If the shareholder did not wish to support the proposal, his only option was to refrain from returning the proxy.

Congress was made aware of these concerns in some detail. Thomas Corcoran, for example, told the House Committee that “[p]roxies, as solicitations are made now, are a joke.”<sup>50</sup> He testified at length about the lack of disclosure provided to shareholders and abuses of the proxy solicitation process.<sup>51</sup> In answer to a question as to how these abuses could be prevented, he referred solely to the need for better disclosures.<sup>52</sup> Similarly, in a brief supporting the Exchange Act’s constitutionality, Corcoran and Benjamin Cohen stated that the proxy provisions were “designed to make available to the investor reasonable information regarding the possibility of control of the corporation ....”<sup>53</sup> Other favorable references to § 14 in the hearings are to like effect.<sup>54</sup> In sum, the fairest reading of the relevant legislative history thus strongly supports the line drawn in *Business Roundtable*.<sup>55</sup>

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<sup>50</sup> Stock Exchange Regulation: Hearings Before the House Interstate and Foreign Commerce Comm., 73d Cong., 2d Sess. 140 (1934) [hereinafter House Hearings].

<sup>51</sup> Id. at 138-49.

<sup>52</sup> Id. at 140.

<sup>53</sup> Id. at 937.

<sup>54</sup> E.g., Pecora Hearings, *supra* note 31, at 6543-46 (comments of Thomas Corcoran); id. at 6697 (comments of Frank Altschul); see also id. at 7710-18 (testimony of Samuel Untermyer).

<sup>55</sup> Cf. *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 504 (7th Cir. 1989) (dictum to the effect that the proxy rules do not preempt state laws permitting dual class stock).

***Corporate Governance and the Legislative History of the Securities  
Exchange Act***

In striking down Rule 19c-4, the D.C. Circuit closely tied the question of the scope of the SEC's authority over voting rights to the broader question of the SEC's authority over the substance of corporate governance generally. As the court observed, nothing in the legislative history "comes near to saying, 'The purposes of this act, although they generally will not involve the Commission in corporate governance, do include preservation of the one share/one vote principle.' And even [if any did] we doubt that such a statement in the legislative history could support a special and anomalous exception to the Act's otherwise intelligible conceptual line excluding the Commission from corporate governance."<sup>56</sup> Accordingly, it is appropriate to devote some attention to the evidence supporting that "conceptual line."

On its face, the Securities Exchange Act says nothing about regulation of corporate governance. Instead, the Act's focus is on trading of securities and securities pricing. Virtually all of its provisions address such matters as the production and distribution of information about issuers and their securities, the flow of funds in the market, and the basic structure of the market.

This approach resulted from Congress' interpretation of the Great Crash and the subsequent Depression. Rightly or wrongly, many people believed that excessive stock market speculation and the collapse of the stock market had caused the Great Depression. The Securities Exchange Act's drafters thus were primarily concerned with preventing a recurrence of the speculative excesses that they believed had caused the market's collapse.<sup>57</sup>

Disclosure was the chief vehicle by which the Act's drafters intended to regulate the markets. Brandeis' famous dictum—"Sunlight is . . . the best of disinfectants; electric light the most efficient policeman"<sup>58</sup>—was well accepted by the 1930s; indeed, it was the basic concept around which the federal securities

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<sup>56</sup> Business Roundtable, 905 F.2d at 413.

<sup>57</sup> See Securities Exchange Act, Pub. L. No. 73-291, § 2, 48 Stat. 881, 881-82 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934) (need to control excessive stock market speculation that had "brought in its train social and economic evils which have affected the security and prosperity of the entire country."); 78 Cong. Rec. 7921-22 (1934) (Rep. Mapes) (the Act had two objectives: to prevent excessive speculation and to provide a fair and honest market for securities transactions).

<sup>58</sup> Louis D. Brandeis, *Other People's Money* 92 (1914).



laws were ultimately drafted.<sup>59</sup> Because state securities laws could not effectively assure full disclosure, federal intervention was widely accepted as essential to maintaining the national capital markets.

Opponents of the Securities Exchange Act, however, quickly claimed that it went far beyond its stated purposes. According to Richard Whitney, President of the NYSE and a leading opponent of the bill, a number of provisions, including the predecessor to Section 19(c), collectively gave the Commission “powers . . . so extensive that they might be used to control the management of all listed companies,”<sup>60</sup> a charge repeated by Congressional opponents of the bill.<sup>61</sup>

The bill’s supporters strenuously denied that they intended to regulate corporate management. The Senate Banking and Currency Committee went to the length of adding a proposed Section 13(d) to the bill, which provided: “[n]othing in this Act shall be construed as authorizing the Commission to interfere with the management of the affairs of an issuer.”<sup>62</sup> The Conference Committee deleted the provision because it was seen “as unnecessary, since it is not believed that the bill is open to misconstruction in this respect.”<sup>63</sup>

Admittedly, this debate need not be read as going to preemption of state corporate law. After all, interference with management might mean a variety of things. Perhaps the debate was really about charges of creeping socialism. Opposition to New Deal legislation typically included charges of radicalism and collectivism. The Exchange Act was no different. Even with this gloss, however, the legislative history still suggests that Congress’ focus was mainly on regulating the securities industry, not listed companies. Moreover, the same Congress that insisted it was not trying to regiment industry also rejected explicit proposals for establishing a federal law of corporations.

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<sup>59</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

<sup>60</sup> Letter from Richard Whitney to all NYSE members (Feb. 14, 1934), reprinted in 78 Cong. Rec. 2827 (Feb. 20, 1934).

<sup>61</sup> E.g., 78 Cong. Rec. 8271 (1934) (Sen. Steiwer); *id.* at 8012 (Rep. McGugin); *id.* at 7937 (Rep. Bakewell); *id.* at 7710 (Rep. Britten); *id.* at 7691 (Rep. Crowther); *id.* at 7690 (Rep. Cooper). Others Congressional leaders acknowledged that early drafts of the legislation had justifiably raised such concerns, but argued the legislation had been redrafted so as to eliminate any legitimate fears on this score. E.g., 78 Cong. Rec. 7863 (1934) (Rep. Wolverton); *id.* at 7716-17 (Rep. Ford); *id.* at 7713 (Rep. Wadsworth).

<sup>62</sup> S. 3420, 73d Cong., 2d Sess. § 13(d) (1934).

<sup>63</sup> H.R. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 35 (1934).

During the New Deal era there were a number of efforts to grant the SEC authority over corporate governance. While the Exchange Act was being drafted, the Roosevelt administration considered developing a comprehensive federal corporation law. The Senate Banking and Currency Committee's report on stock exchange practices also suggested that the cure for the nation's "corporate ailments . . . may lie in a national incorporation act."<sup>64</sup> In the late 1930s, then SEC Chairman William O. Douglas orchestrated yet another effort to replace state corporate law with a set of federal rules administered by the SEC. In this, he was anticipated and assisted by Senators Borah and O'Mahoney who introduced a series of bills designed to regulate corporate internal affairs.<sup>65</sup>

Proposals for a federal corporation statute did not stop when the New Deal ended.<sup>66</sup> In the 1970s, the SEC considered imposing a variety of corporate governance reforms, as a matter of federal law.<sup>67</sup> After vigorous objections that the Commission had exceeded its statutory authority, the rules were substantially modified before adoption.<sup>68</sup>

Consequently, none of these proposals ever came to fruition. Legislative inaction is inherently ambiguous, even when that inaction takes the form of rejecting a specific proposal. All that can be said with certainty is that Congress chose not to act. However, while the evidence admittedly is not conclusive, there is considerable reason to believe that the Seventy-third Congress did not intend for the SEC's power over listing standards to extend to matters of corporate governance. Granted Congress did not expressly state any such limitation. But Congress apparently did not believe it was necessary to do so. True, arguments based on rejections of proposed amendments must be taken with a grain of salt, especially those made after enactment of the original legislation. But surely the Congress that repeatedly denied any intent to regiment corporate management, and later repeatedly rejected proposals to federalize corporate law, did not intend

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<sup>64</sup> S. Rep. No. 1455, 73d Cong., 2d Sess. 391 (1934).

<sup>65</sup> Joseph C. O'Mahoney, *Federal Charters to Save Free Enterprise*, 1949 *Wis. L. Rev.* 407.

<sup>66</sup> E.g., *Protection of Shareholders' Rights Act of 1980: Hearing before the Subcomm. on Securities of the Sen. Comm. on Banking, Housing, and Urban Affairs*, 96th Cong., 2d Sess. (1980); *The Role of the Shareholder in the Corporate World: Hearings before the Subcomm. on Citizens and Shareholders Rights and Remedies of the Sen. Comm. on the Judiciary*, 95th Cong., 1st Sess. (1977).

<sup>67</sup> Exchange Act Rel. No. 14,970 (July 18, 1978).

<sup>68</sup> Exchange Act Release No. 15,384 (Dec. 6, 1978). See generally Homer Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 *Bus. Law.* 173 (1981).

to sneak those powers back into the bill through the back door by authorizing the SEC to adopt corporate governance rules. More important for present purposes, however, there is no reason to believe that Congress intended to carve out the substance of voting rights as a single exception to this general rule.

### ***The Pertinent Case Law***

There is some loose language in a few judicial opinions interpreting § 14(a) that some read as supporting an expansive federal role in regulating shareholder voting rights. In *Medical Committee for Human Rights v. SEC*,<sup>69</sup> for example, the D.C. Circuit opined that § 14(a)'s principal purpose is assuring "corporate shareholders the ability to exercise their right—some would say their duty—to control the important decisions which affect them in their capacity as stockholders and owners of the corporation."<sup>70</sup> This comment was made in the context of the shareholder proposal rule, however, which does give the shareholders some control over the agenda. The court's emphasis on the shareholder's ability to exercise voting rights, moreover, seems consistent with the view that § 14 was intended solely to assure that shareholders could make effective use of whatever voting rights state law provides.<sup>71</sup>

This view is also confirmed by judicial opinions providing more general interpretations of the Securities Exchange Act's scope. As the D.C. Circuit observed, validating rule 19c-4 would have overturned or at least impinged

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<sup>69</sup> *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970), vacated as moot, 404 U.S. 403 (1972).

<sup>70</sup> *Id.* at 680-81.

<sup>71</sup> As the Supreme Court once put it: "The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation." *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964). Other judicial interpretations of section 14 are also consistent with the notion that it was directed at assuring full disclosure and a fair opportunity to exercise corporate voting rights (of course, these decisions were rendered in cases in which it was those aspects of the rules that were at issue). E.g., *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 381 (1970); *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 795 (8th Cir. 1967); *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201, 208 (6th Cir. 1961); *SEC v. Transamerica Corp.*, 163 F.2d 511, 518 (3d Cir. 1947), cert. denied, 332 U.S. 847 (1948); *NUI Corp. v. Kimmelman*, 593 F. Supp. 1457, 1469 (D.N.J. 1984), rev'd, 765 F.2d 399 (3d Cir. 1985); *Freedman v. Barrow*, 427 F. Supp. 1129, 1145 (S.D.N.Y. 1976); *Leighton v. American Telephone & Telegraph Co.*, 397 F. Supp. 133, 138 (S.D.N.Y. 1975); *Studebaker Corp. v. Allied Products Corp.*, 256 F. Supp. 173, 188-89 (W.D. Mich. 1966).

“severely on the tradition of state regulation of corporate law.”<sup>72</sup> In a series of cases, the Supreme Court has made clear that this is not a step to be taken lightly.

In *Santa Fe Industries v. Green*, the Supreme Court applied the brakes to efforts to give SEC Rule 10b-5 an increasingly expansive reading that in time might have led to a federal common law of corporations. The Court did so by holding that the fundamental purpose of the Securities Exchange Act is to assure full disclosure.<sup>73</sup> Once complete disclosure is made, the transaction’s fairness and terms do not become issues under federal law, instead they are a matter for state corporate law.<sup>74</sup> The Court’s analysis was driven by a concern that a broader view of the Act’s purposes would result in federalizing much of state corporate law, overriding well-established state policies of corporate regulation.<sup>75</sup>

In *CTS Corp. v. Dynamics Corp.*,<sup>76</sup> the Supreme Court again drew a sharp line between the state and federal role, this time with specific application to the problem at hand. The Court recognized that states have a legitimate interest in defining the attributes of their corporations and protecting shareholders of their corporations.<sup>77</sup> Specifically, the Court strongly indicated that the substance of corporate voting rights is solely a matter of state concern: “No principle of corporation law and practice is more firmly established than a State’s authority to regulate domestic corporations, including the authority to define the voting rights of shareholders.”<sup>78</sup>

The cases in this line of precedent confirm the Supreme Court views the states as the principal regulators of corporate governance.<sup>79</sup> Federal law is seen as placing a gloss on the underlying background of state corporate law, but not as replacing it.<sup>80</sup> Absent a clear expression of congressional intent, the Court has been reluctant to federalize questions traditionally within the state sphere.<sup>81</sup> Given

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<sup>72</sup> Business Roundtable, 905 F.2d at 413.

<sup>73</sup> Id. at 477-78.

<sup>74</sup> Id. at 478-80.

<sup>75</sup> See id. at 478-79.

<sup>76</sup> 481 U.S. 69 (1987).

<sup>77</sup> Id. at 90-92.

<sup>78</sup> Id. at 89.

<sup>79</sup> “[S]tate regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law.” Id.

<sup>80</sup> *Burks v. Lasker*, 441 U.S. 471, 478 (1979).

<sup>81</sup> *Santa Fe Indus., v. Green*, 430 U.S. 462, 479 (1977); *Cort v. Ash*, 422 U.S. 66, 84 (1975); Business Roundtable, 905 F.2d at 413.

the absence of any indication of congressional intent to preempt state laws governing shareholder voting rights, it is therefore unlikely that the Supreme Court would support an expansive view of the SEC's authority to regulate the substance of shareholder voting rights. To the contrary, it seems far more likely that the Court would embrace the line drawn by *Business Roundtable*.

Does the Supreme Court's defense of what might be called "corporate federalism" make policy sense? Those who believe in the so-called "race to the bottom" hypothesis will argue that it does not, but the empirical evidence on that purported race, while mixed, tends to favor the competing race to the top hypothesis. In the absence of compelling evidence on the competing race hypotheses, we do well to consider the Supreme Court's argument that states have a number of legitimate interests in regulating such matters. The corporation is a creature of the state, "whose very existence and attributes are a product of state law."<sup>82</sup> States therefore were said to have an interest in overseeing the firms they create. States also have an interest in protecting the shareholders of their corporations. Finally, states have a legitimate "interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs." If so, state regulation not only protects shareholders, but also protects investor and entrepreneurial confidence in the fairness and effectiveness of the state corporation law.<sup>83</sup>

The Supreme Court has suggested that the country as a whole benefits from state regulation in this area, as well. The markets that facilitate national and international participation in ownership of corporations are essential for providing capital not only for new enterprises but also for established companies that need to expand their businesses. This beneficial free market system depends at its core upon the fact that corporations generally are organized under, and governed by, the law of the state of their incorporation.<sup>84</sup>

This is so in large part because ousting the states from their traditional role as the primary regulators of corporate governance would eliminate a valuable

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<sup>82</sup> *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987).

<sup>83</sup> Some argue that the state also has an interest in corporations that make a substantial contribution to the state. Corporations provide employment and a crucial tax base, sell and purchase goods and services, and supply support for community activities. This interest in any corporation will vary from case to case, but it is a real interest, deriving from the corporation's existence as a tangible economic entity created by state law. See Mark A. Sargent, *Do the Second Generation State Takeover Statutes Violate the Commerce Clause?*, 8 *Corp. L. Rev.* 3, 23 (1985).

<sup>84</sup> *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 90 (1987).

opportunity for experimentation with alternative solutions to the many difficult regulatory problems that arise in corporate law. As Justice Brandeis pointed out many years ago, “It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of country.”<sup>85</sup> So long as state legislation is limited to regulation of firms incorporated within the state, as it generally is, there is no risk of conflicting rules applying to the same corporation. Experimentation thus does not result in confusion, but may well lead to more efficient corporate law rules.

Where then do we draw the line between the state and federal regulatory regimes? As a general rule of thumb, federal law appropriately is concerned mainly with disclosure obligations, as well as procedural and antifraud rules designed to make disclosure more effective. In contrast, regulating the substance of corporate governance standards is appropriately left to the states.

### ***Conclusion***

Slippery slope arguments are often the last refuge of those with no better case, but Rule 19c-4 was indeed the proverbial camel’s nose. There simply was no firebreak between substantive federal regulation of dual class stock and a host of other corporate voting issues raising similar concerns. Nor did laws affecting shareholder voting rights differ in principle or theory from any other corporate governance rules. Having once entered the field of corporate governance regulation, the SEC would have been hard-pressed to justify stopping with dual class stock. Creeping federalization of corporate law was a plausible outcome. The D.C. Circuit quite properly foreclosed this possibility. The SEC therefore must continue respecting the line drawn by *Business Roundtable*.

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<sup>85</sup> *New State Ice Co v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).