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Special Study on Market Structure, Listing Standards and Corporate Governance

Roberta S. Karmel
Brooklyn Law School, roberta.karmel@brooklaw.edu

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By a Special Study Group of the Committee on Federal Regulation of Securities, American Bar Association, Section of Business Law*

UPDATE

Since the publication of the Study on May 17, 2002, both the New York Stock Exchange, Inc. (NYSE) and The Nasdaq Stock Market, Inc. (Nasdaq) have proposed extensive changes to their respective governance listing standards subject to Securities and Exchange Commission (SEC) authorization. At this time, the proposals by the two markets differ in certain respects. Principally, the proposed listing standards involve mandatory measures that increase the role of independent directors, require that a board have a majority of independent directors, require that only independent directors comprise the audit committee and potentially other committees and provide for other corporate governance matters. On July 24, 2002, the American Bar Association (ABA) Task Force on Corporate Responsibility issued its Preliminary Report containing corporate governance recommendations, including mandatory listing standards that are in many respects similar to those proposed by the NYSE.

In addition, the Sarbanes-Oxley Act of 2002 was enacted which, among other things, mandates certain corporate governance listing standards by directing the SEC to establish rules which prohibit the listing of any securities of an issuer which does not have an audit committee comprised of independent directors with specified oversight and authority in dealing with independent directors.

These initiatives represent an expanded use of listing standards for corporate governance purposes and in that respect differ from the Study's recommended approach. Nevertheless, the Study is pertinent as to the role and authority of the exchanges and the SEC in matters of corporate governance and the exploration of alternatives for establishing corporate governance standards relevant to the integrity of the securities markets and fundamental fairness to investors.

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* Members of the Group are: Robert Todd Lang, Chair, Brandon C. Becker, Roger D. Blanc, Peter C. Clapman, Roberta S. Karmel, John M. Liftin, Jonathan R. Macey, Hugh H. Makens, John F. Olson.

PREFACE

This Study has been undertaken by a Special Study Group of the Committee on Federal Regulation of Securities of the ABA Section of Business Law. It does not represent the official position of the ABA, the Section or the Committee. The views expressed in this Study represent a consensus among members of the Special Study Group but do not necessarily represent the views of any firm or institution with whom any member is affiliated or any client of any such firm. Annex A describes the background and experience of each of the members of the Special Study Group.

As part of the Study, interviews were conducted with members of the staff of the SEC and representatives of the primary U.S. markets, alternative trading systems, institutional investors and others who participate in the securities markets or are otherwise involved in corporate governance. We appreciate greatly the cooperation of those we interviewed and their candid expression of views. Since all the interviews were confidential, no part of this Study should be attributed to anyone who participated in an interview. The interviews themselves, most of which preceded the events of September 11, 2001 and the current concerns as to accounting irregularities and governance practices, were insightful and of considerable assistance to us in formulating market, regulatory and corporate governance perspectives on the subject matter. A summary of the interview results is set forth in Annex B.

The members of the Special Study Group gratefully acknowledge the assistance of Holly J. Gregory, Priya Marwah, Craig N. Meurlin, David Murgio, Stephanie Nicolas, Amy Reynolds, Hochan Rhee, Ashley Wakefield and Hans J. Weinburger. The members of the Special Study Group also appreciate the support of Stanley Keller, Chair of the Committee.

In March 2002, the ABA formed a Task Force on Corporate Responsibility to examine the effectiveness of the governance and disclosure systems applicable to public companies in the United States. Its purpose is to enable the ABA to contribute to the dialogue on legislative and regulatory reform to improve corporate responsibility. Inasmuch as the Study was initiated in November 2000, it is independent of the work of the Task Force, which we support. Members of the Special Study Group are hopeful that this Study will be of value to the efforts of the Task Force.

SUMMARY

In this Special Study on Market Structure, Listing Standards and Corporate Governance (Study), we examine the role of the SEC and exchanges[1] in matters pertaining to corporate governance. We consider this subject in the context of the unique corporate governance system that exists in the United States, where state

1. Except where the context otherwise requires, we use the terms "exchange" and "self-regulatory organizations" (SROs) interchangeably to refer to the registered national securities exchanges and The Nasdaq Stock Market, Inc. (Nasdaq), although at the time of this writing Nasdaq's application for registration as a national securities exchange is pending.

law is the primary source of corporate law and the federal securities laws superimpose a separate layer of regulation on public companies. Listing standards adopted by exchanges deal selectively with corporate governance matters affecting the securities markets and investors. Corporate governance listing standards fill, at least in part, the sizeable gap between state corporate law and the federal securities laws.

When this Study was commenced in November 2000, our primary interest was the future of exchange-listing standards as a means of establishing corporate governance measures in light of the rapidly evolving securities marketplace and the increasing challenges to the primacy of the traditional exchanges. Our primary concern was the extent to which competition from alternative trading systems (ATSs) might undermine the willingness or ability of the exchanges to set governance standards for their listed issuers and the alternatives to the current role of the exchanges in corporate governance.

During the period of this Study, however, a number of well-publicized corporate failures have focused attention on current corporate governance practices and the need to maintain investor confidence in the markets. Various suggestions and proposals, based on a perceived need to improve the corporate governance of public companies, have been articulated by members of the Congress, the SEC, the exchanges, investor groups, trade associations and other interested parties. As a result, the core issues addressed in this Study have become of more immediate import. Although we acknowledge these developments and the perception that improvements in corporate governance processes are needed, this Study does not address specific governance measures.

Rather, as described below, we recommend a proposal involving the development of best practices guidelines and the implementation of a "comply or explain" approach (Proposal). Under the Proposal, the NYSE and Nasdaq would act jointly, subject to SEC authorization, to establish a protocol for the development of nonbinding best practices guidelines limited to those governance matters necessary for, and directly relevant to, the integrity of the securities markets and fundamental fairness to investors. These best practices guidelines would be created jointly by the NYSE and Nasdaq through an open and collaborative process that includes the participation of representatives of the SEC, investors, issuers, member firms and academicians. The protocol should also include provisions to ensure the uniform application and joint interpretation of the best practices guidelines. We believe the SEC should issue an order authorizing these joint activities and establishing procedures for joint action. Finally, the SEC should adopt a rule requiring public disclosure by each listed company as to whether it complies with the exchange-established best practices guidelines or explaining the reasons for any areas of noncompliance. Therefore, although compliance with the governance guidelines would not be mandatory, issuers would be required to provide investors with information concerning their level of compliance (or noncompliance).

This Study recognizes the unique role and interest of exchanges in corporate governance. The operation of successful securities markets depends upon the integrity of listed companies and the fair treatment of investors. These factors are essential to the confidence of investors, the prestige of the exchanges and the ability of the exchanges to be competitive. We believe the exchanges, issuers and investors share a common interest in good governance practices. These conclusions are an important part of the Proposal and our analysis.

As part of the Study, we examine subject matter related to corporate governance and the capital markets. Section I addresses the history and role of corporate governance listing standards in the U.S. markets. Since their inception in the late nineteenth century, corporate governance listing standards have evolved from terms in an individualized written agreement between an issuer and a listing exchange into a set of exchange-established rules that are limited in scope and address a selective group of corporate governance matters. These standards are relatively uniform. Delisting for noncompliance with these standards is rare; the exchanges tend to encourage compliance through negotiation with issuers. Although corporate governance listing standards, historically, have been used by the NYSE to establish a "brand" associated with high quality issuers, at various times, both the American Stock Exchange LLC (Amex) and Nasdaq have adopted less stringent corporate governance listing standards to compete with the NYSE for listings. As a result, since at least the 1970s, the SEC has sought to encourage uniformity among NYSE, Amex and Nasdaq corporate governance listing standards. In addition, during this period, the process by which these standards are adopted has been transformed into a forum for the public debate of governance issues and standards among the exchanges, the SEC, issuers, investors and other interested parties.

In Section II, we examine issues relating to exchange and SEC authority over corporate governance listing standards. Section 19 of the Securities Exchange Act of 1934, as amended (Exchange Act),[2] describes the process for the adoption of self-regulatory organization (SRO) rules, including corporate governance listing standards, whether such rules are proposed by the applicable SRO or imposed by the SEC. These section 19 processes were further defined by the 1990 opinion of the D.C. Circuit Court of Appeals in *Business Roundtable v. SEC*,[3] which rejected the SEC's attempt to invoke section 19(c) to impose a voting rights listing standard. *Business Roundtable* suggests there is no evidence of direct congressional intent to grant the SEC authority to establish a comprehensive federal corporate law through the imposition of listing standards. After *Business Roundtable* the scope of direct SEC authority over corporate governance listing standards pursuant to section 19(c) is uncertain, but in any event, it is limited to matters that are in furtherance of the purposes of the Exchange Act. The SEC has not sought to invoke its section 19(c) authority to require listing standards since *Business Roundtable*, at least in part due to this uncertainty. We also examine the SEC's authority under section 11A of the Exchange Act to "authorize or require" exchanges to take joint action with respect to certain matters relating to the operation of a

2. Securities and Exchange Act of 1934 § 19, 15 U.S.C. § 78f(h)(3) (2000) [hereinafter Exchange Act].
3. 905 F.2d 406 (D.C. Cir. 1990).

national market system. An SEC rule or order authorizing joint action by SROs pursuant to section 11A may support a finding of implied repeal of the antitrust laws with respect to the joint activities of the participating SROs as to these matters.[4]

Section III addresses the recent evolution of the securities marketplace, including market fragmentation caused by the proliferation of ATSs and internationalization and its effect on corporate governance listing standards. As registered broker-dealers, ATSs are exempt from registration as securities exchanges, subject to SEC authority to require a particular ATS to register as an exchange and, therefore, are not obligated to impose substantive regulation on traders using their execution services or on issuers of securities traded in their markets. Moreover, most ATSs do not have any intention or desire to list companies or to establish listing standards. One response to the competitive pressures caused by increasing fragmentation has been the decision by Nasdaq to demutualize. Yet, demutualization raises potential conflicts of interest between profit-seeking and regulatory interests. Accordingly, the SEC has set a number of conditions to its approval of Nasdaq's demutualization that are intended to reduce these conflicts. The extent to which a shift in liquidity from the NYSE and Nasdaq to ATSs or otherwise could undermine the current listing process is not presently determinable.

Section IV examines corporate governance regulation and practices outside the United States in a sample of seven jurisdictions for comparative purposes. We found that the majority of the substantive NYSE and Nasdaq corporate governance listing standards are addressed in each of the analyzed foreign jurisdictions, whether by direct government regulation, nonbinding corporate governance codes or in some cases exchange-established listing standards. With few exceptions (including the recent corporate governance initiatives of the Brazilian Novo Mercado), foreign exchanges generally do not set corporate governance standards for listed issuers. Perhaps as a result, outside of the United States there appears to be a much greater reliance on nonbinding best practices codes to establish corporate governance standards, including recently promulgated rules in the United Kingdom and Germany requiring that public companies disclose whether they comply with a specified code and explain any areas of noncompliance. As in the United States, foreign markets are experiencing fragmentation and ex-

4. Under the doctrine of "implied repeal," a repeal of the antitrust laws may be inferred when "necessary to make the Securities Exchange Act work." Silver v. NYSE, 373 U.S. 341, 357 (1963); *see also* Gordon v. NYSE, 422 U.S. 659, 689-90 (1975) (holding that "[g]iven the expertise of the SEC, the confidence the Congress has placed in the agency, and the active roles the SEC and the Congress have taken, permitting courts throughout the country to conduct their own antitrust proceedings would conflict with the regulatory scheme authorized by Congress [through the Exchange Act] rather than supplement that scheme."); United States v. Nat'l Ass'n of Sec. Dealers, Inc., 422 U.S. 694, 734-35 (1975) (holding that "implied immunity in particular and discrete instances to assure that the federal agency entrusted with regulation in the public interest could carry out that responsibility free from the disruption of conflicting judgments that might be voiced by courts exercising jurisdiction under the antitrust laws."). The court, in *National Association of Securities Dealers, Inc.*, further held that implied immunity also protects regulated entities from being "subjected to duplicative and inconsistent standards." 422 U.S. at 734-35.

changes are demutualizing. These developments present structural issues similar to those we face in this country.

Section V includes an analysis of and various alternatives to the present system and the Proposal. Consideration of alternatives is instructive, both to define what may be available for future action and to evaluate their usefulness on a current basis. We do not expect any of these alternatives to be as immediately effective as the Proposal in connection with governance measures that need to be established. Furthermore, implementation of the Proposal does not preclude the exchanges from taking other action, including the adoption of additional listing standards.

PROPOSAL

On March 13, 2002, we submitted a memorandum to the Chairman of the SEC and to the Chairmen of the NYSE and Nasdaq.[5] In our memorandum, we made an interim proposal that the exchanges recommend a set of appropriate nonbinding best practices designed to deal with current issues in corporate governance, particularly as they pertain to the integrity of the securities markets and fairness to investors. We further recommended that the SEC adopt a rule requiring that listed issuers make public disclosure as to whether they comply with the best practices guidelines of the exchange on which they are listed or explain any areas of noncompliance. Today, having completed our Study and considered the alternatives, we submit the Proposal as set forth below.

We recommend that the NYSE and Nasdaq jointly act, under SEC authorization, to establish a protocol for the ongoing development of best practices guidelines and the interpretation, amendment and repeal of such guidelines in accordance with the following principles:

- The best practices guidelines should be nonbinding and limited to the corporate governance areas that are necessary for and directly relevant to the maintenance of the integrity of the securities markets and fairness to investors.
- The best practices guidelines should, where appropriate, allow for differences among issuers, including size and other relevant factors.
- The NYSE and Nasdaq should act jointly to create the best practices guidelines, and review them on an ongoing basis through a process that includes publication, public comment and the active participation of the SEC, investors, issuers, member firms and academicians.
- The NYSE and Nasdaq should jointly establish a process to ensure the uniform application and joint interpretation of these best practices guidelines.
- The best practices guidelines, as well as all written interpretations of the guidelines, should be publicly available.

5. A copy of this memorandum is annexed to this Study as Annex C.

Moreover, to facilitate the creation of, and compliance with, these best practices guidelines, we recommend that the SEC take the following actions:

- Issue a rule or an order under section 11A of the Exchange Act authorizing this plan for joint action and establishing procedures for the joint action.
- Adopt a rule requiring disclosure by each listed company in its periodic reports, proxy materials or other public filings as to whether it complies with these best practices guidelines or to explain the reasons for its noncompliance. Disclosure of material changes in an issuer's practices may be required in an interim filing.

Under the Proposal, the best practices guidelines would not be binding but compliance would be encouraged through the comply or explain mechanism. It is our view that boards of directors would be motivated to comply substantially with these best practices because of the increased recognition of the benefits of maintaining good governance practices and the likelihood that shareholders will question the reason for noncompliance as a result of disclosure. Existing listing standards would remain in effect unless amended or repealed under current statutory procedures. Additional or amended listing standards could be proposed by the NYSE and Nasdaq, acting singly or through joint action. We believe that best practices, however, should be used for most governance measures.

While we recognize that there are many important differences with respect to the establishment of corporate governance standards outside the United States, we believe that the U.K. comply or explain system (a variation of which has recently been adopted in Germany) serves as a useful precedent for the American capital markets. We note certain differences in the U.K.'s system, including that a British issuer's disclosure must be reviewed by its auditors before publication, and the auditors' report on the financial statements also covers other required disclosures.[6] In addition, the U.K. Combined Code, which is the code referenced by the comply or explain rule,[7] is an "official" code, with a subject matter that greatly exceeds the limited set of best practices guidelines relating to the securities markets that are contemplated by the Proposal. Accordingly, our recommendation that the subject matter of the best practices guidelines be limited would narrow the application of the comply or explain mechanism as compared to the United Kingdom, but at the same time should accomplish the purposes of best practices in relation to the securities markets and the interests of investors.

The disclosure would enable a company to signify compliance with certain of the best practices and explain why noncompliance exists with respect to others. This form of disclosure would be subject to the review and oversight, and be the responsibility of, the board of directors or an appointed committee of the board. While it is contemplated that this disclosure would occur annually, if there are material changes with respect to compliance, it may become reportable in a quarterly report or, depending on its significance, on Form 8-K.

6. FIN. SERVS. AUTH., UNITED KINGDOM LISTING AUTHORITY, LISTING RULES § 12.43A (2002) [hereinafter U.K.L.A. LISTING RULES].

7. *Id.*

An appropriate interest of the securities markets and the SEC is to maintain high governance standards to ensure fairness to investors and the integrity and reliability of the securities markets. The exchanges currently have the experience and the economic incentive to adopt a leadership role in the ongoing development of these standards. Best practices will likely provide more flexibility than listing standards, dispense with issues regarding legal authority and render unnecessary more sweeping changes in the system to accomplish the governance objectives. This approach also is consistent with the development and use of corporate governance codes, which also are nonbinding. Joint action by the NYSE and Nasdaq will promote uniformity in best practices and will facilitate uniform interpretation, amendment and repeal where appropriate. This process also will enable interested parties, including shareholders, issuers and the SEC, to participate actively in the establishment of the guidelines.

The SEC will participate in two ways, namely, the establishment of a protocol under section 11A(a)(3) of the Exchange Act regarding the process to be followed by the exchanges in the exercise of joint action and by adopting a comply or explain rule with respect to compliance with best practices. It also may monitor the process and express views on various best practices proposals. A significant advantage of the Proposal is that it will not involve systemic changes and therefore can be implemented in the near term without the risks and uncertainty that can accompany major changes. Moreover, with the support of the exchanges and other interested groups, it has every prospect of being effective.

Part of our consideration in formulating the Proposal was to avoid the difficulties arising from questions relating to authority. We believe that best practices guidelines established by the NYSE and Nasdaq would not be "rules" under the Exchange Act because they are not binding. Therefore, they would not require SEC approval under section 19 of the Exchange Act. Furthermore, sections 13 and 14 of the Exchange Act provide the SEC with ample authority to adopt rules requiring public disclosure of an issuer's compliance with exchange-established best practices guidelines and an explanation of areas of noncompliance.

The Proposal is intended to build on the most advantageous features of the current system. For example, although the Proposal provides that the NYSE and Nasdaq would voluntarily enter a process that will result in the creation of nonbinding standards, nothing would preclude either of them from adopting or amending their listing standards. Furthermore, by calling on the NYSE and Nasdaq to create these guidelines through an open and collaborative process, a forum would be established to discuss and act upon relevant and current governance matters. Lastly, given the reality that the only existing enforcement mechanism for corporate governance listing standards is the infrequently used delisting process, acceptance of these nonbinding guidelines coupled with required public disclosure would allow market forces to determine the extent to which noncompliance with a given standard is acceptable to investors.

In our view, implementation of the Proposal would provide an effective framework to deal with current governance issues as they relate to the markets and investors while taking advantage of the strengths of and experience with the existing system. Moreover, additional initiatives are not precluded.

Whether or not the Proposal is acceptable to the exchanges, the SEC could adopt a rule requiring disclosure by issuers in their periodic reports, proxy materials or other public filings as to their policies and practices concerning relevant corporate governance matters. We believe as a general matter the SEC likely has such disclosure authority. This approach would provide certain benefits of the Proposal, although it would offer no initial or ongoing benchmark in the sense of an aspirational model.

Alternatively, the exchanges, rather than the SEC, could adopt a listing standard requiring periodic disclosure of essentially the same policies and practices. Such a requirement, upon SEC approval pursuant to section 19(b), would likely withstand any legal challenge.

Should an initiative other than the Proposal be pursued with exchange participation, we would urge that it be consistent, to the extent applicable, with the following principles:

- Care should be taken to minimize systemic change so that the benefits of the existing system are not lost.
- Corporate governance standards should be made uniform wherever possible, both in the interest of fairness and to facilitate compliance and comparability.
- Although each exchange may elect from time to time to establish new or amended governance listing standards in specific areas, they should continue to consider a best practices approach for matters not covered by listing standards.
- In the establishment of governance measures, there should be recognition of the needs and requirements of a wide variety of corporate issuers.
- The exchanges should maintain active participation in the corporate governance process, given their experience in these matters, their incentive to set high standards and their ability to provide a forum for discussion on relevant governance issues.

Section V describes alternatives should the exchanges not be active participants in the process. One alternative would be a private sector initiative which, among other things, could provide structure for a system of codes or best practices to maintain high governance standards. In any event, the principles of uniformity and recognition of the needs of different kinds of issuers should be considered.

SECTION I.
LISTING STANDARDS IN THE U.S. MARKETS

A. The Development of Corporate Governance Listing Standards

Exchange-established requirements for listed securities[8] are designed to promote liquidity and transferability of shares by increasing investor confidence in

8. Except where the context otherwise requires, in this Study all references to securities listed on the NYSE, Amex or quoted on Nasdaq are "listed."

both the markets and listed issuers. Most of these requirements are quantitative standards and focus primarily on numerical indicators and include requirements related to a listed company's public float, annual revenues, assets, cash flow and/or market capitalization.[9] Other standards, however, go directly to a listed company's internal structure and conduct. These requirements, known collectively as corporate governance listing standards, are intended "to encourage high standards of corporate democracy" by mandating that listed companies maintain "appropriate standards of corporate responsibility, integrity and accountability to shareholders."[10] As a result, they are also intended to promote liquidity and transferability.

The historical development of corporate governance listing standards by the NYSE, the Amex and Nasdaq can be attributed to a variety of factors. Clearly a desire on the part of the exchanges to lend stability to the capital markets by permitting access only to issuers with good governance practices has been an important influence in the development of these standards. Perhaps equally important, however, has been the competitive desire of the exchanges to distinguish themselves by the quality, size and number of their issuers and to create a brand name associated with high quality. Accordingly, in considering the history of corporate governance listing standards, it is necessary to remain mindful that both good governance and competitive motives continue to influence their development and use.

1. The New York Stock Exchange

The NYSE traces its origins to 1792, when 24 brokers and merchants signed the Buttonwood Agreement fixing commission rates on trading public stock. In 1817, 27 brokers organized themselves as the New York Stock and Exchange Board, which later became the NYSE.[11] In the early years of its existence, the NYSE did not have established listing standards to determine which stocks it would list.[12] Instead, prior to the twentieth century, the standards applicable to listed companies were flexible terms inserted in listing agreements negotiated between each issuer and the NYSE.[13] This contractual flexibility made listing stan-

9. NYSE, NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 102.01 (1999) [hereinafter NYSE MANUAL]. The NYSE Manual sets forth requirements that issuers with listed equity securities must, subject to certain exceptions have: (a) (i) 2,000 total holders of 100 shares or more, (ii) 2,200 total stockholders and an average monthly trading volume of 100,000 shares or (iii) 500 total stockholders, an average monthly trading volume of 1,000,000 shares and at least 1,100,000 publicly held shares; (b) demonstrate an aggregate market value of publicly held shares of $60 million; and (c) must meet one of three specified earnings or revenue targets. *Id.* Nasdaq has corresponding quantitative requirements for issues listed. NAT'L ASS'N OF SEC. DEALERS, NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL § 4300 (2000) [hereinafter NASD MANUAL].

10. NYSE MANUAL, *supra* note 9, § 301.00.

11. Stuart Banner, *The Origin of the New York Stock Exchange, 1791-1860*, 27 J. LEGAL STUD. 113, 115 (1998).

12. *Id.* at 117 (observing that the "composition of the list of stocks called was apparently set informally in the early years, as the board had no written rules governing the subject.").

13. Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461, 1465 (1992).

dards consistently subject to ad hoc enforcement and substantive alteration.[14] Moreover, new standards were not retroactively applied, permitting issuers to avoid having their securities delisted notwithstanding their noncompliance with standards promulgated after their original listing. During this initial period, the NYSE had no uniform set of listing standards applicable to all listed companies. While as a regulatory policy the lack of uniformity may have been questionable, this flexibility allowed the NYSE to change its listing agreements to meet its economic needs.[15]

As early as 1869, the NYSE Board of Governors formed a Committee on Stock List (Stock List Committee) to evaluate issuer applications to list securities on the NYSE.[16] The Stock List Committee was primarily concerned with the qualitative character of the issuer and, in deciding whether to permit a certain issuer onto the list, it considered such matters as the degree of national interest in the company, its standing in its particular field, the character of the market for its products and its relative stability and position in the industry. Each applicant was required to disclose information including, but not limited to, the history and nature of its business, management, capitalization structure, stock provisions, business financials and its accounting policies.[17]

Although the activities of the Stock List Committee are the predecessors of today's listing requirements, the application of written corporate governance standards to listed issuers did not begin until some three decades later when the NYSE began to secure written agreements with its listed companies to provide substantial financial disclosure and certain safeguards for investors.[18] Accordingly, these early standards were enforceable entirely as a matter of contract law. Initially, the NYSE's primary governance concern was financial disclosure. In time, however, the emphasis expanded to include several corporate governance listing standards. By 1900, NYSE listing agreements included a provision requiring companies to distribute annual reports to stockholders.[19] In 1909, the first direct corporate governance standard, requiring an annual stockholders' meeting, was included as a listing agreement term. This standard was eventually linked to annual reporting requirements.[20] With the abolition of the NYSE's "unlisted" department in 1910, the NYSE began to require additional disclosure from listed corporations. In 1914, listing agreements began to provide that a listed company must notify the NYSE of any change in the rights of stockholders or of redemption of preferred stock.[21] By 1917, listing agreements provided for the disclosure of a semiannual income statement and balance sheet.[22] By 1923, companies agreed to report their earnings

14. *Id.* at 1465-66.

15. CHARLES A. DICE & WILFORD J. EITEMAN, THE STOCK MARKET 117 (2d ed. 1941).

16. *See id.* at 110-16; GILBERT W. COOKE, THE STOCK MARKETS 215 (1964); GEORGE L. LEFFLER, THE STOCK MARKET 414 (1951).

17. DICE & EITEMAN, *supra* note 15, at 111-16.

18. LEFFLER, *supra* note 16, at 430.

19. COOKE, *supra* note 16, at 216.

20. Michael, *supra* note 13, at 1467-68.

21. COOKE, *supra* note 16, at 216.

22. *Id.*

quarterly.[23] In 1926, the NYSE adopted a one share, one vote listing standard.[24] Corporations softened their stance on publishing financial information, and, by 1928, the NYSE established a new policy on corporate publicity.[25]

At approximately the same time, states began to enact statutes regulating securities. Known as "blue sky laws,"[26] these early statutes were "extremely restrictive, allowing few exemptions from registration, and [giving] administrative agencies . . . sweeping enforcement power."[27] As the blue sky laws became increasingly widespread,[28] their constitutional validity was challenged.[29] However, in 1917, the Supreme Court held certain blue sky law provisions to be constitutional, leading to the understanding that blue sky laws were, on the whole, constitutional.[30]

Notwithstanding the NYSE's emphasis on financial disclosure in its early listing agreements and the regulatory impact of blue sky regulation, after the stock market crash of 1929 regulators began to take seriously the need for, and importance of, financial disclosure by listed companies. A new NYSE policy urged, but did not require, companies to prepare financial reports by independent accountants and to prepare detailed income statements.[31] By 1932, independent audits became a part of all new listing agreements and therefore mandatory for all newly listed companies.[32]

The vitality of the NYSE's regulation of issuers through listing requirements was demonstrated with the passage of the Exchange Act. As one commentator has noted, the "Congress closely tracked the NYSE disclosure requirements when it drafted the Exchange Act."[33] Accordingly, many of the matters previously part

23. *Id.*

24. Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 697 (1986).

25. LEFFLER, *supra* note 16, at 430.

26. *See generally* LOUIS LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT (1976).

27. 1 HUGH L. SOWARDS & NEIL H. HIRSCH, BLUE SKY REGULATION § 1.02[1] 1-4 to 1-5. (A. A. Sommer, Jr. ed., 2002).

28. Between 1910 and 1933, the blue sky movement failed to take hold in only one state. 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 39 (3rd ed. 1989).

29. SOWARDS & HIRSCH, *supra* note 27, § 1.02[2] 1-5 to 1-6 (noting lower courts held the laws unconstitutional as improper burdens on interstate commerce and as violations of the Due Process Clause).

30. *See id.* § 1.02[2] 1-6. In a trilogy of cases, the Supreme Court upheld the blue sky law provisions. It held that the broad discretionary powers of state securities administrators were both within the police power of the states and within the confines of the Due Process Clause, and it held that the laws regulating sales of securities within a state's borders did not interfere impermissibly with interstate commerce. *See id.* § 1.02[2] 1-6 to 1-9 nn.18-19 (citing Hall v. Geiger-Jones Co., 242 U.S. 539 (1917); Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917); Merrick v. N.W. Halsey & Co., 242 U.S. 568 (1917)). Since the trilogy, the constitutionality of blue sky laws has been accepted. *Id.* § 1.02[2] 1-6 to 1-7 n.18 (citing SEC v. Steadman, 798 F. Supp. 733, 738 (D.D.C. 1991); N. Star Int'l. v. Ariz. Corp. Comm'n, 720 F.2d 578, 583 (9th Cir. 1983)); *see also* 1 LOSS & SELIGMAN, *supra* note 28, at 39-40 (arguing "[o]n the whole, . . . there no longer need be any substantial constitutional doubts about blue sky provisions that are well drafted").

31. *Id.*; *see also* COOKE, *supra* note 16, at 216.

32. LEFFLER, *supra* note 16, at 430.

33. A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 1008 (1999).

of NYSE listing agreements, including quarterly and annual reporting requirements, and the policies of the NYSE regarding independent audits, became a matter of federal law.[34]

Even after the promulgation of the Exchange Act, however, the NYSE remained concerned with the governance practices of its listed companies. Beginning in 1940, minimum voting rights were required for preferred stockholders.[35] In 1955, the NYSE required that listed issuers obtain shareholder approval for any acquisition of assets or securities from a director, officer or major shareholder or an acquisition resulting in an increase greater than 20 percent of its outstanding shares.[36] Then, in 1956, the NYSE required listed companies to have at least two outside directors on their boards.[37]

From the late 1950s until the 1970s, the NYSE's corporate governance listing standards remained relatively static. In fact it was not until the 1970s that the NYSE made a substantive addition to its corporate governance listing requirements when, at the SEC's encouragement, the NYSE required each of its listed issuers to establish an audit committee comprised of independent directors.[38] As this history demonstrates, corporate governance listing standards are deeply rooted in NYSE history.

2. The American Stock Exchange

The New York Curb Market (Curb), which later became the Amex, was formed in 1860.[39] From the time of the Curb's establishment, issuers seeking to avoid the NYSE's more stringent disclosure requirements would trade as an "unlisted" security on the Curb, making the Curb a springboard for many smaller and less established issuers to enter the market.[40] In this role as a seasoner for the NYSE, the Curb listed those securities which could not meet the NYSE's strict listing requirements. Accordingly, for much of its history, the Amex's listing standards have been significantly more lenient than corresponding NYSE standards. One possible explanation for the differences between the NYSE and the Amex listing standards lies in the Amex's historic role as a competitor for NYSE listings.

Because of its desire to maintain a competitive position as the less demanding exchange, the Amex has been forced repeatedly to defend itself from charges that its less stringent requirements harmed investors. In 1933, for example, the New York State Attorney General launched an investigation of the Amex after receiving

34. *See* Securities Act of 1933, 15 U.S.C. § 77aa(25), (26) (2000) [hereinafter Securities Act].

35. LEFFLER, *supra* note 16, at 432.

36. Michael, *supra* note 13, at 1469.

37. *Id.*

38. *Id.* at 1470.

39. *See* ABOUT AMEX HISTORY, INTERACTIVE TIMELINE, *available at* http://www.amex.com/atamex/aboutAmex/history/aboutAmex_history.html (last visited June 15, 2002).

40. *See* 1 LOSS & SELIGMAN, *supra* note 28, at 220. Those exchanges which permitted securities to be traded on an "unlisted" basis were those who campaigned most against the abolishment of unlisted trading. Whereas the NYSE abolished its unlisted trading department in 1910, Amex was steadfast in retaining its unlisted securities and only took its first steps toward dismantlement in 1934. Michael, *supra* note 13, at 1472.

complaints about the laxity of the Amex's listing practices.[41] The Attorney General called for the elimination of unlisted trading because of the widespread belief among investors "that all securities traded on [the Amex] conform to the standards for listed securities" of the NYSE.[42] In his opinion, allowing unlisted trading "presents an opportunity for serious abuses."[43] For example, the Amex had allowed trading in unlisted companies' stock to continue even when it knew the companies had become insolvent or bankrupt.[44] As a result of the investigation, the Amex took some measures of reform, removing some stocks from trading and requiring enhanced disclosure regarding unlisted stocks.[45] Given the limited availability of enforcement resources, the Attorney General was forced to end the investigation.[46]

During the 1960s, however, additional scandals led to reform of the Amex. In 1962, following several scandals, the SEC issued a report criticizing almost every aspect of the Amex's operations, including its methods of stock listing.[47] In sum, the SEC concluded that the Amex failed at achieving any type of self-regulation. After this rebuke, the Amex began to initiate several reforms regarding its organization and listing standards.[48] For example, beginning in 1964, the Amex promulgated listing standards that required proxy solicitations and shareholder approval of certain transactions. In 1968, the Amex published its first edition of the American Stock Exchange Company Guide, which included various listing standards and policies regarding conflicts of interest, directors, quorums and voting rights.[49] Conflicts of interest between shareholders and related parties, such as officers, directors or substantial shareholders, were considered on a case-by-case basis.[50] The size and significance of the conflict as well as its possible resolution were also taken into consideration. Although not required, the Amex policy recommended the appointment of at least two independent directors, a factor also considered when evaluating the significance of a conflict of interest.[51] Except in the areas of voting rights and independent audit committee members, the Amex listings standards have remained relatively static since the 1970s.

Until 1976, the Amex did not have an official policy concerning voting rights. In 1972, the Amex's stated policy was to prohibit all issues of nonvoting common stock, but its practice was to consider each case on an individual basis. Further, on several occasions, the Amex did not refuse to list companies with disparate

41. ROBERT SOBEL, AMEX: A HISTORY OF THE AMERICAN STOCK EXCHANGE 1921-1971, at 99 (1972); *see also*, 6 LOSS & SELIGMAN, *supra* note 28, at 2770.

42. SOBEL, *supra* note 41, at 99.

43. *Id.*

44. *Id.* at 100.

45. *Id.* at 102. According to Loss and Seligman, the investigation led to the removal of almost 1,000 unlisted issues. *See* 6 LOSS & SELIGMAN, *supra* note 28, at 2770.

46. *See* SOBEL, *supra* note 41, at 102. Even after the investigation, the Amex continued to allow trading of unlisted issues and remained the "great unlisted market of the country." 6 LOSS & SELIGMAN, *supra* note 28, at 2770.

47. SOBEL, *supra* note 41, at 293-94.

48. Michael, *supra* note 13, at 1473.

49. *Id.* at 1473 n.78.

50. AMEX, CONSTITUTION AND RULES, LISTING STANDARDS, POLICIES AND REQUIREMENTS § 120 (2000) [hereinafter AMEX LISTING STANDARDS].

51. *Id.* § 121.

voting rights for its shareholders.[52] In particular, as described in the following section, the Amex's 1976 decision to list Wang Laboratories, Inc. (Wang) even though it had been rejected for listing by the NYSE because of unequal shareholder voting rights, evidenced a willingness to list issuers which did not have a one share, one vote common stock capitalization which ultimately provided impetus to a change in the voting rights listing standard of all exchanges.

Similarly, the Amex's independent audit committee standards had been characterized as being "less exacting" than those of the NYSE.[53] Following the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees[54] (Blue Ribbon Committee), more stringent standards with respect to the independence of audit committees and the financial literacy of directors were mandated.

3. The Nasdaq Stock Market

The predecessor to Nasdaq was formed in 1971 by the National Association of Securities Dealers, Inc. (NASD) to increase the efficiency in the over-the-counter (OTC) market for unlisted securities. As a quotation service rather than a securities exchange, Nasdaq historically had not "listed" securities. Instead Nasdaq securities are included for quotation on its system. Although a legal technicality rooted in the Exchange Act, this difference was of great importance to Nasdaq. As a quotation service operated by a "registered securities association," rather than a registered "national securities exchange," Nasdaq was unable, until the 1980s, to obtain exemptions from blue sky laws for the securities it quoted.[55] Although some states do provide an exemption for certain OTC securities,[56] the haphazard application of state blue sky exemptions was not sufficient for Nasdaq. As a result, Nasdaq unsuccessfully sought federal preemption of state blue sky laws for its quoted securities to compete with the NYSE and the Amex. One of the requirements of obtaining this preemption was the establishment of listing requirements. Accordingly, the history of Nasdaq listing requirements is rooted in state blue sky laws.[57]

In 1985, Nasdaq initiated its first corporate governance listing standards in an effort to secure blue sky exemptions in a greater number of states.[58] These standards included the submission of annual and periodic reports to shareholders,

52. 4 LOSS & SELIGMAN, *supra* note 28, at 1839 n.302.

53. 2 LOSS & SELIGMAN, *supra* note 28, at 758-59; *cf.* American Stock Exchange, Inc., Exchange Act Release No. 16,722, 1980 SEC LEXIS 1732 (Apr. 3, 1980).

54. BLUE RIBBON COMM. ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMS., REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES (1999), *reprinted in* 54 BUS. LAW. 1067 (1999) [hereinafter BLUE RIBBON COMM. REPORT].

55. Although the blue sky laws vary from state to state, each contains a registration requirement with respect to securities to be sold in the state.

56. AD HOC SUBCOMM. ON MERIT REGULATION OF THE STATE REGULATION OF SEC. COMM., REPORT ON STATE MERIT REGULATION OF SECURITIES OFFERINGS, *reprinted in* 41 BUS. LAW. 785, 796 (1986).

57. *Id.* at 835.

58. Michael, *supra* note 13, at 1475; Seligman, *supra* note 24, at 705.

the appointment of independent directors, an independent audit committee, required shareholder participation in certain corporate transactions and the execution of a listing agreement.[59]

The extent to which Nasdaq-quoted securities would be exempt from state law registration requirements was ultimately settled by the National Securities Markets Improvement Act of 1996,[60] which preempted state regulation of the securities registration and offering process with respect to "covered securities" which are "nationally tracked securities" or securities listed on the NYSE, the Amex, another national securities exchange or Nasdaq.[61]

B. THE GOVERNANCE LISTING STANDARDS PROCESS

Listing arrangements between an issuer and an exchange are the subject of a private contract. Nevertheless, in recent years with the increased importance of corporate governance, certain governance listing standards have been the subject of public discussion with participation by the exchanges, the SEC, issuers, investors and other interested parties. In addition, the SEC has adopted a practice of encouraging exchanges "voluntarily" to adopt given corporate governance listing standards and in the process has urged the exchanges, listed companies and shareholders to reach consensus on those standards. This mode of activity has been called "regulation by raised eyebrow."[62] The process is exemplified by initiatives involving voting rights, independent audit committees and the current debate over a broad-based option listing standard.

1. One Share, One Vote

The origins of the one share, one vote listing standard are rooted in a 1926 NYSE requirement that the voting rights of common stockholders should not be restricted and all shares of common stock of a listed company should have one vote.[63] During the 1920s, dual class issuances were motivated by the desire to raise additional equity capital and simultaneously retain control in the hands of a founding family or entrepreneurial group. The NYSE, however, was skeptical of listing nonvoting common stock. Disparate voting rights were seen as adverse to notions of investor protection because those who had contributed the most capital often were given the least amount of voting power. However, in 1926 the NYSE decided to list Dodge Brothers, Inc. despite the disproportionate amount of nonvoting common stock in relation to its voting common stock. This decision resulted in much public criticism. The NYSE responded to this criticism by stating: "Without at this time attempting to formulate a definite policy, attention should be drawn to the fact that in the future the committee [on listings], in considering

59. Michael, *supra* note 13, at 1475.

60. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended at 15 U.S.C. § 77r(a)-(b) (2000)).

61. 15 U.S.C. § 77r(b) (2000).

62. Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545, 571 (1984).

63. *See* NYSE MANUAL, *supra* note 9, § 308.00.

applications for the listing of securities, will give careful thought to the matter of voting control."[64] The NYSE enforced this listing policy for more than a half century thereafter.

Until 1976, the Amex followed a similar policy limiting disparate voting rights. In that year, however, the Amex decided to break with this prior policy and list Wang which had been rejected for listing by the NYSE because of its unequal shareholder voting rights. After 1976, listings on the Amex were required to meet the so-called "Wang Formula" which permitted multiple class structures that satisfied the following criteria: (i) disparate voting rights between shareholder classes is not greater than a 10 to 1 ratio; (ii) "the low-vote class has the exclusive right to elect at least [25 percent] of the Board"; and (iii) in the event the high-vote class represents less than 12.5 percent of the equity, "the low-vote shares have the right to vote in the election of the [75 percent] of the Board that they do not elect directly."[65] The willingness by the Amex to list issuers that met the Wang Formula posed a competitive challenge to the NYSE with respect to new listings.

Although the NYSE initially did not seek to eliminate its more rigorous voting rights standard, the hostile takeover boom of the 1980s forced the NYSE to reconsider its position. Specifically, during the 1980s, many NYSE listed issuers sought to engage in defensive recapitalizations to ensure that insiders obtained shares with greater voting rights than public shareholders. Given Amex's use of the Wang Formula and Nasdaq's allowance of unequal voting shares in this new environment, the NYSE proved unable to resist this competition.[66]

General Motors Corporation (GM) provided the catalyst for the NYSE's reexamination of dual class voting shares when it issued a class of lesser weighted voting shares in connection with its 1984 acquisition of Electronic Data Systems, Inc. (EDS). After acquiring EDS, GM refused to comply with the NYSE one share, one vote rule, threatening to list with Amex or Nasdaq. Forced to choose between its one share, one vote rule and GM, the NYSE ignored the rule and permitted GM to remain listed. With the continued listing of GM, the NYSE announced in June 1984 a moratorium on delisting based on dual class capitalizations. Two years later, in 1986, the NYSE officially modified its "long-standing rule mandating a one share, one vote standard for all common stocks listed on the NYSE."[67] As a result, by mid-1988, 55 NYSE listed issuers did not adhere to the one share, one vote rule.[68]

Faced with these developments, the SEC held public hearings to determine whether section 19(c) of the Exchange Act would allow it to impose a uniform

64. Seligman, *supra* note 24, at 697.

65. AMEX, SPECIAL COMMITTEE ON SHAREHOLDER VOTING RIGHTS, REPORT TO THE BOARD OF GOVERNORS OF THE AMERICAN STOCK EXCHANGE 4 (1991) (emphasis omitted); *see also* Seligman *supra* note 24, at 704.

66. *See Study Predicts NYSE Will Permit Dual Classes of Stock with Unequal Voting Rights*, DAILY REPORT FOR EXECUTIVES (BNA) No. 21, at A2 (Jan. 31, 1986).

67. Voting Rights Listing Standards; Disenfranchisement Rule, Exchange Act Release No. 25,891, 53 Fed. Reg. 26,376, 26,379 (July 12, 1988).

68. *Id.* at 26,376; *see also* Nathaniel C. Nash, *Big Board Defends Plan on Two Classes of Shares*, N.Y. TIMES, Dec. 17, 1986, at D1.

voting rights rule on the NYSE and other SROs.[69] Following the hearings, the SEC arranged meetings with the staffs of the NYSE, the Amex and Nasdaq. The objective of these meetings was to reach consensus on a uniform rule restricting shareholder disenfranchisement by companies listed on the NYSE, the Amex and Nasdaq.[70] By advancing a uniform rule, the SEC reasoned, it could prevent the markets from underbidding each other with respect to corporate governance matters—thus avoiding a feared "race to the bottom."[71]

When its efforts to forge consensus failed, the SEC initiated formal proceedings under section 19(c) and adopted Rule 19c-4.[72] This new rule, which applied uniformly to each exchange and Nasdaq, provided that no equity security would be listed if the issuer of that security took any corporate action with the effect of "nullifying, restricting, or disparately reducing the per share voting rights" of holders of an outstanding class or classes of common stock.[73] Although Rule 19c-4 appeared to resolve the question of a one share, one vote listing standard, the SEC's victory was short-lived. On June 12, 1990, the D.C. Circuit Court of Appeals vacated Rule 19c-4 in *Business Roundtable*, holding that the SEC's use of section 19(c) under the Exchange Act to impose a one share, one vote listing standard exceeded its authority.[74]

Following its defeat in the *Business Roundtable* decision, the SEC continued to press for a uniform voting rights policy, albeit through informal means. "After much negotiation with the SEC, [first] the NYSE[,] and [later] Nasdaq[,] adopted a uniform rule that was a . . . modified version of former SEC Rule 19c-4."[75] The NYSE policy prohibited any restriction or disparate reduction in the voting rights of the common stock of public shareholders through any corporate action. In view of changes in the marketplace, the NYSE emphasized the flexibility of the new policy by underscoring its aim to permit those corporate actions previously permitted under Rule 19c-4. As such, the policy did permit disparate voting rights and the listing of nonvoting common stock as long the stockholders were afforded certain safeguards which seek to align (as much as possible) the rights of nonvoting shareholders with voting shareholders. Minimum voting rights were also required for preferred stockholders. Notwithstanding this flexibility, the NYSE rule was perceived as precluding a race to the bottom with respect to a shareholder voting rights policy.

69. 4 LOSS & SELIGMAN, *supra* note 28, at 1840-41.

70. *See id.*

71. For more on the SEC's initial efforts in the "one share, one vote" controversy, see Seligman, *supra* note 24.

72. Voting Rights Listing Standards; Disenfranchisement Rule, 53 Fed. Reg. at 26,376; *see also* Voting Rights Listing Standards; Disenfranchisement, Exchange Act Release No. 24,623, 52 Fed. Reg. 23,665 (June 24, 1987) (proposing Rule 19c-4 under the Exchange Act and summarizing the history of SRO action with respect to the one share, one vote concept).

73. Voting Rights Listing Standards; Disenfranchisement Rule, 53 Fed. Reg. at 26,376. Although Rule 19c-4 embodied a broad standard, it was quite detailed in applying the standard to a wide variety of actions and transactions.

74. This decision is discussed *infra* notes 171-78 and accompanying text.

75. Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 346 (2001).

The Amex, however, rejected the SEC's overtures and instead approved a plan to allow its listed companies to create multiple classes of stock with unequal voting rights subject to certain safeguards. Fearing that the Amex's refusal to adopt the uniform standard would cause the NYSE and Nasdaq to abandon their recently adopted rules, the SEC redoubled its efforts to achieve consensus.[76] Two SEC commissioners sent a letter urging the Amex board to adopt the favored standard. The then-chairman of the SEC testified before a congressional committee, suggesting that the Congress "'consider identifying minimum federal protections for voting rights in any publicly traded corporation or partnership.'"[77]

When, three years later, this issue remained unresolved, the SEC enlisted the support of the Council of Institutional Investors (CII), an organization of large public pension and other funds, which had made a one share, one vote policy the first tenet of its Shareholder Bill of Rights.[78] The CII and several large institutional investors (including the California Public Employees Retirement System or CalPERS) discussed the issue at length and submitted detailed comments to the exchanges. Prodded by investors and then SEC Chairman Arthur Levitt, the NYSE, Nasdaq and the Amex finally agreed to a uniform voting rights standard in 1994.[79] The agreed-upon standard, which was essentially a modified (but more flexible) version of the vacated Rule 19c-4, reflected "the recognition by the trading markets and the shareholder and business communities of the need to achieve a consensual and balanced resolution of issues relative to shareholder disenfranchisement."[80] It also represented an important victory for the SEC after the *Business Roundtable* decision and further entrenched listing standards as an institutional mechanism for selective matters of corporate governance. Moreover, the establishment of uniform voting rights policies demonstrated the efficacy of the forum process, even after the SEC's authority to use section 19(c) to impose corporate governance standards had been restricted by *Business Roundtable.*

2. Audit Committees

The promulgation of the independent audit committee standard provides the most recent example of the forum approach leading to a corporate governance listing standard. Although since the 1940s the SEC recommended that public companies form audit committees comprised of independent directors,[81] the SEC did not attempt to require public companies to have independent audit committees until the 1970s. During this period, widespread scandals concerning

76. *See* Amy L. Goodman, *One Share/One Vote . . . Again*, INSIGHTS, June 1991, at 2.

77. *Id.* (quoting congressional testimony by then SEC Chairman Breeden).

78. *See The IRRC Monitor: Uniform Voting Rights Standard Within Reach*, 2 CORP. GOVERNANCE ADVISOR, Mar./Apr. 1994, at 36.

79. *See* Self-Regulatory Organizations, Exchange Act Release No. 35,121, 59 Fed. Reg. 66,570, 66,570 (Dec. 19, 1994).

80. Robert Todd Lang, *Shareholder Voting Rights—The New Uniform Listing Standard*, INSIGHTS, Feb. 1995, at 4.

81. *See* McKesson & Robbins, Inc., Accounting Series Release No. 19, Exchange Act Release No. 2707, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,020, at 62,104, 62,108 (Dec. 5, 1940).

questionable or illegal payments to domestic and foreign government officials uncovered inadequate or improper corporate accounting and recordkeeping practices.[82] In its report investigating these scandals, the SEC pointed to, among other things, the importance of audit committees in uncovering the falsification of corporate records and the use of "slush" funds and endorsed oversight by audit committees as an appropriate governance institution.[83]

As a result, the SEC urged that the independence and vitality of corporate boards of directors be strengthened and suggested, in a letter to the then-Chairman of the NYSE, that the NYSE revise its listing requirements to provide a practical means of effecting the SEC's objectives without increasing direct governmental regulation.

The NYSE agreed and on March 9, 1977 the SEC approved a new NYSE rule requiring all listed domestic companies to establish and maintain "an audit committee comprised solely of directors independent of management and free from any relationship that . . . would interfere with the exercise of independent judgment as a committee member."[84] In addition, the NYSE rule required that a majority of the audit committee be comprised of directors who were not formerly officers of the issuer or its subsidiaries.[85] Shortly thereafter, the Amex and Nasdaq promulgated listing standards related to audit committees.[86]

Over the next two decades, shareholder activists increasingly argued that not only the audit committees, but also the boards of directors of public companies, should be comprised primarily of persons independent of management. As a result, a steady stream of reports and recommendations by blue ribbon committees and distinguished business and legal bodies argued in support of independent directors.[87] This movement was significantly boosted by a 1998 speech at the New York University Center for Law and Business by then SEC Chairman Levitt expressing growing concern about modern earnings management practices.[88] "The most reliable guardians of the public interest" in this area, the Chairman argued, were "qualified, committed, independent and tough-minded audit committees."[89]

82. REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES (Comm. Print 1976) (submitted to the Sen. Comm. on Banking, Hous. & Urban Affairs, 94th Cong. 2d Sess.), *reprinted in* 353 SEC. REG. & L. REP. (BNA) Special Supplement No. 353, at 2 (May 19, 1976).

83. *See id.* at 2, 6-8.

84. New York Stock Exchange, Inc., Order Approving Proposed Rule Change, Exchange Act Release No. 13,346, 1977 SEC LEXIS 2252, at *1 (Mar. 9, 1977).

85. NYSE MANUAL, *supra* note 9, § 303.01(B)(2)(a), (B)(3)(a).

86. The Amex and Nasdaq standards were less stringent than the NYSE standard requiring only that a majority of the audit committee members be independent. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.05 & cmt. a (1992).

87. *See, e.g.*, BLUE RIBBON COMM. REPORT, *supra* note 54; THE BUSINESS ROUNDTABLE, STATEMENT ON CORPORATE GOVERNANCE (1997), *available at* htp://www.brtable.org/document.cfm.11 (last accessed June 11, 2002); ABA Section of Business Law, *Corporate Director's Guidebook–1994 Edition*, 49 BUS. LAW. 1243 (1994).

88. Securities & Exchange Commission Chairman Arthur Levitt, Jr., The "Numbers Game," Remarks at the N.Y.U. Center for Law and Business (Sept. 28, 1998), *available at* http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt (last accessed June 11, 2002).

89. *Id.*

Chairman Levitt indicated that the SEC stood ready to take action to protect the public interest, but that a private sector response (obviating the need for public sector mandates) seemed wiser.[90] The Chairman then announced that, at the SEC's request, the NYSE and the Nasdaq had agreed to sponsor a blue ribbon panel "to make recommendations on strengthening the role of audit committees in overseeing the corporate financial reporting process."[91] The panel would be drawn from the various constituencies of the financial community, and its recommendations could include changes to exchange-listing standards, amendments to auditing standards, new SEC corporate disclosure requirements and a formulation of best practices.

The Blue Ribbon Committee was a complex, private-sector collaborative effort. The Blue Ribbon Committee held a public hearing that included testimony and written comments from various interested parties.[92] The Blue Ribbon Committee "canvassed its members, all of whom [actively participated] in the private sector," and consulted a number of prior works and reports on the topic of audit committees.[93] After reviewing public comments and suggestions, the Blue Ribbon Committee released a 71-page report of integrated audit committee recommendations just a few months after having been formed.[94]

Included in the Blue Ribbon Committee report were recommendations to the NYSE and Nasdaq to revise the definition of "independent director," require independent audit committees, mandate minimum audit committee size and increased financial literacy, clarify audit committee oversight for outside auditors and require written audit committee charters.[95] Also included were suggestions addressed to the SEC and the accounting profession. In releasing the report, the committee's co-chairman, John Whitehead, stated that the committee viewed its recommendations as "an integrated set of objectives" intended to encourage "effective interrelationships among relevant corporate participants."[96]

Less than one year after the Blue Ribbon Committee released its report, substantially all of its recommendations—with a few significant modifications—were proposed by the NYSE, Nasdaq and the Amex and subsequently approved and adopted by the SEC under section 19(b).[97] The forum approach to corporate

90. *Id.*

91. *See* Press Release, SEC News Release No. 98-96, SEC, NYSE and NASD Announce Blue Ribbon Panel to Improve Corporate Audit Committees (Sept. 28, 1998), *available at* http://www.sec.gov/news/press/pressarchive/1998/98-96.txt.

92. *See* BLUE RIBBON COMM. REPORT, *supra* note 54, at 1068.

93. *See* Ira M. Millstein, *Introduction to the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 54 BUS. LAW. 1057, 1058 (1999).

94. *See* Press Release, NYSE, NASD & Blue Ribbon Comm., NYSE Chair Richard Grasso, NASD Chair Frank Zarb, and Blue Ribbon Panel Co-Chairs Ira Millstein and John Whitehead Announce "Ten Point Plan" To Improve Oversight of Financial Reporting Process (Feb. 8, 1999), *available at* http://nyse.com/press/NT0000A71A.html.

95. *Id.*

96. *Id.*

97. *See* Gerald S. Backman, *Audit Committees: The Proposed Regulations*, 6 CORP. GOVERNANCE ADVISOR, Nov./Dec. 1999, at 7; *see also* Self-Regulatory Organizations, Exchange Act Release No. 42,231, 64 Fed. Reg. 71,523 (Dec. 14, 1999) (approving Nasdaq rule change); Self-Regulatory Organizations, Exchange Act Release No. 42,232, 64 Fed. Reg. 71,518 (Dec. 14, 1999) (approving Amex rule change);

governance rulemaking, exemplified by "broad-based dialogue . . . between [the SEC], academia, the legal community, and issuers,"[98] had, with the support of the SEC, prevailed over the process of unilateral action by the SEC.

3. Broad-Based Option Plans

The continuing attempts to encourage the exchanges to adopt a listing standard requiring shareholder approval of broad-based option plans represents a third instance in which the listing standard was the subject of what evolved into a collaborative corporate governance forum. Traditionally, shareholder approval was required for any stock option plan under which a listed company's officers may receive stock options or awards, subject to an exception for "broad-based" plans that include both officers and non-officer employees.[99]

In 1998, the NYSE proposed codifying its prior interpretations defining the term "broad-based" which was approved by the SEC in that year. Although the SEC published the proposal for comment before acting on the NYSE proposal, after its adoption representatives of some major institutional investors claimed to be unaware of the proposal.[100] Moreover, several large institutional investors urged the NYSE to "correct" the new rule by addressing cumulative dilution concerns, tightening the participation and nondiscrimination concepts and making the SEC approval process more public.[101] Responding to these complaints, the NYSE issued a broadly disseminated "white paper" requesting additional comments. The NYSE also created a special task force (with equal representation from issuer and shareholder constituencies) to review the comments and make recommendations.[102] The special task force's recommendations included a narrower definition of "broad-based" which was subsequently approved by the SEC on a temporary basis.[103] As of this writing, the temporary standard has been extended and remains in effect at the NYSE. Moreover, it is generally followed by Nasdaq as an unofficial interpretation of its broad-based plan exception.[104]

The NYSE special task force also recommended that the NYSE "set an overall dilution maximum" for certain other stock option plans.[105] When an expanded

Self-Regulatory Organizations, Exchange Act Release No. 42,233, 64 Fed. Reg. 71,529 (Dec. 14, 1999) (approving NYSE rule change).

98. SEC Chairman Arthur Levitt, Jr., An Essential Next Step in the Evolution of Corporate Governance, Address at the Audit Committee Symposium (June 29, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch289.htm.

99. *See id.* Although there are other limited exceptions to the shareholder approval requirements, the broad-based plan exception is the most controversial and widely used.

100. *See Council of Institutional Investors Letter* (Peg O'Hara ed., Vol. 2, No. 15) (Apr. 24, 1998).

101. *Id.*

102. *See Council of Institutional Investors Letter* (Peg O'Hara ed., Vol. 2, No. 18) (May 13, 1998).

103. *See id.*

104. In a recent letter to the SEC, Nasdaq stated that it is considering whether "all stock option plans benefiting officers or directors should be approved by shareholders." Letter from Hardwick Simmons, Chaiman and Chief Executive Officer, The Nasdaq Stock Market, Inc., to The Honorable Harvey L. Pitt, Chairman, U.S. Securities and Exchange Commission 5 (Apr. 11, 2002), *available at* http://www.nasdaqnews.com/.

105. NYSE, REPORT OF THE NEW YORK STOCK EXCHANGE SPECIAL TASK FORCE ON STOCKHOLDER APPROVAL POLICY 3 (Oct. 28, 1999).

task force addressed an overall dilution maximum, it recommended that the NYSE abandon its newly-adopted broad-based plan exemption and adopt a relative (rather than absolute) dilution threshold.[106] More importantly, the task force also cautioned the NYSE against adopting any overall dilution standard before similar standards were approved by Nasdaq and the Amex advocating market coordination "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."[107]

By November 2000 the exchanges had not reached consensus, and the SEC called for a collaborative resolution of the issue. Then SEC Chairman Levitt urged 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" and announced that the SEC would move forward on a rule to require companies to disclose all option grants that dilute existing shareholders' interests.[108] Soon thereafter, the NYSE and Nasdaq began soliciting comments from their listed issuers on an overall dilution standard for stock option plans.[109] To date, however, the issue remains unresolved, causing the newly appointed SEC Chairman, Harvey Pitt, to note publicly, "We will have to make it clear . . . that although it was a request, it was expected to be implemented. They should move with alacrity."[110] More recently, Chairman Pitt explained five components of options that should be emphasized to align management and shareholder interests.[111] Nasdaq has since stated its support for shareholder approval of stock option plans that benefit officers and directors.[112]

C. CURRENT CORPORATE GOVERNANCE LISTING STANDARDS

1. Domestic Issuers

Summarized below are the corporate governance listing standards set forth in the New York Stock Exchange Listed Company Manual (NYSE Manual) and the National Association of Securities Dealers Manual (NASD Manual) and Notices to

106. *Id.* at 2.

107. *Id.* at 18.

108. SEC Chairman Arthur Levitt, Jr., Remarks at the 2000 Annual Meeting of the Securities Industry Association (Nov. 9, 2000), *available at* http://www.sec.gov/news/speech/spch420.htm.

109. Letter from Catherine R. Kinney, Group Executive Vice President, Competitive Position Group, NYSE, to Corporate Secretaries of Listed Companies (Dec. 20, 2000), *available at* http://www.nyse.com/pdfs/policy.pdf.

110. Vicky Stamas, *Options-Disclosure Rule OK'd: SEC Requires Firms To Tell Shareholders More About Stock Offered to Workers in Compensation Plans*, L.A. TIMES, Dec. 20, 2001, at C4.

111. SEC Chairman Harvey L. Pitt, Remarks at the Inaugural Lecture of the JD/MBA Lecture Series, Kellogg Graduate School of Management and Northwestern Law School (Apr. 4, 2002), *available at* http://www.sec.gov/news/speech/spch547.htm. The five components are: (i) shareholder approval of stock option plans; (ii) a committee of independent directors to make any decisions to grant options to senior management; (iii) corporate boards should focus on long-term growth as a prerequisite to the exercise of options; (iv) chief executive officers of issuers should be prepared to certify to shareholders that all relevant information has been disclosed; and (v) "[a]udit committee members should question and test the disclosure and financial reporting process." *Id.*

112. Letter from Hardwick Simmons, *supra* note 104.

Members.[113] Six of the corporate governance listing standards are required by both the NYSE and Nasdaq. The others are solely those of the NYSE.[114]

(i) **Audit Committees.** Companies listed on the NYSE and Nasdaq must have a qualified audit committee established by a formal written charter. The committee must ensure that the outside auditors provide a statement describing all relationships between the auditor and the company. Under both NYSE and Nasdaq rules, audit committees must be comprised of at least three financially literate "independent" directors. The NYSE requires at least one audit committee member to have accounting or related financial management expertise.[115] Nasdaq requires at least one audit committee member to have past employment experience in finance, accounting or a comparable field.[116] Both the NYSE and Nasdaq permit a board of directors to waive certain independence requirements with respect to a single audit committee member under exceptional circumstances, provided such waiver is disclosed in the issuer's next annual proxy statement.

(ii) **Shareholder Approval.** The NYSE requires shareholder approval prior to (i) any issuance of 20 percent or more of common stock or voting power outstanding before the issuance, other than in a public offering for cash or in certain bona fide private financings; or (ii) certain issuances of common stock to specified related parties.[117] The NYSE also provides that when shareholder approval is required prior to the listing of new or additional shares, the total vote cast must represent over 50 percent in interest of all securities entitled to vote on the proposal.[118] Nasdaq requires shareholder approval prior to (i) the acquisition of stock or assets of another company if either (a) any director, officer or substantial shareholder of the issuer has a substantial interest in the target company and the acquisition could result in an issuance that increases the common stock or voting power of the issuer by 5 percent or more, or (b) such acquisition will result in an issuance of 20 percent or more of common stock or voting power outstanding before the issuance; or (ii) any sale, issuance or potential issuance of common stock, other than in a public

113. In addition to the corporate governance listing standards set forth below, NYSE rules also include provisions: (i) requiring the public disclosure of material events and periodic financial information and (ii) establishing procedural requirements with respect to notice of shareholders' meetings and soliciting proxies from shareholders. These requirements both overlap and supplement similar requirements in the Exchange Act. *See generally* NYSE MANUAL, *supra* note 9, §§ 2 (Disclosure and Reporting Material Information), 4 (Shareholders' Meetings and Proxies); *see also* NASD MANUAL, *supra* note 9, § 4350(b) (Distribution of Annual and Interim Reports).

114. The Amex has qualitative listing standards that are substantially similar to those of the NYSE and Nasdaq as follows: audit committees (§ 121(B)), shareholder approval (§§ 710-713), voting rights (§§ 122, 124), annual meetings (§ 704), quorums (§ 123), redemptions (§§ 1001, 1003), related party transactions (§ 120) and consents (§ 706). AMEX LISTING STANDARDS, *supra* note 50; NASD MANUAL, *supra* note 9.

115. NYSE MANUAL, *supra* note 9, § 303.01(B)(2)(c).

116. NASD MANUAL, *supra* note 9, § 4350(d)(2)(A).

117. NYSE MANUAL, *supra* note 9, § 312.03(b), (c).

118. *Id.* § 312.07.

offering, at a price lower than the book or market value for such stock, constituting (together with certain selling shareholders, if any) 20 percent or more of the common stock or voting power outstanding before the issuance.[119] In addition, both the NYSE[120] and Nasdaq[121] require listed companies to obtain shareholder approval prior to (i) the adoption of certain stock option or purchase plans (subject to exceptions, e.g., "broad-based" plans); or (ii) any issuance that results in a change of control of the issuer.

(iii) **Voting Rights.** Subject to certain exceptions, both the NYSE and Nasdaq restrict listed companies from disparately reducing or restricting, through any corporate action or issuance, the "[v]oting rights of existing shareholders of publicly traded common stock registered under Section 12 of the Exchange Act."[122] The NYSE also requires certain safeguards for non-voting common stock and preferred stock (e.g., an annual report submitted to shareholders, preferred stockholders have the right to elect directors upon dividend default and preferred stockholders have minimum voting rights).

(iv) **Special Rights of Certain Shareholders.** The NYSE provides that listed companies should not grant special rights to a shareholder or group of shareholders to the exclusion of the rest of the class of shareholders, just as such companies should not limit the rights of shareholders.[123]

(v) **Annual Meetings.** Companies listed on the NYSE and Nasdaq must hold annual shareholder meetings.[124]

(vi) **Classified Board of Directors.** The NYSE Manual provides that a listed company may have a classified board of directors, provided the directors are not divided into more than three classes. If there are classes, they should consist "of approximately equal size and tenure and directors' terms of office should not exceed three years."[125]

(vii) **Defensive Tactics.** The NYSE Manual provides that defensive tactics that would discriminate among shareholders should be avoided.[126]

(viii) **Insider Stock Purchases.** The NYSE Manual provides that when directors and officers (and their families and close associates) purchase or sell company shares or participate in stock option or employee stock purchase plans, they must avoid the use of inside knowledge and, "be guided by a sense of fairness to all segments of the investing public."[127]

(ix) **Quorums.** Companies listed on the NYSE and Nasdaq must meet quorum requirements for common stockholders. For NYSE-listed companies,

119. NASD MANUAL, *supra* note 9, § 4350(i)(1)(C), (D).
120. NYSE MANUAL, *supra* note 9, § 312.03(a), (d).
121. NASD MANUAL, *supra* note 9, § 4350(i)(1).
122. NYSE MANUAL, *supra* note 9, § 313.00; NASD MANUAL, *supra* note 9, § 4351.
123. NYSE MANUAL, *supra* note 9, § 314.00.
124. *Id.* § 302.00; NASD MANUAL, *supra* note 9, § 4350(e).
125. NYSE MANUAL, *supra* note 9, § 304.00.
126. *Id.* § 308.00.
127. *Id.* § 309.00.

the quorum required for any meeting of common stockholders must be "sufficiently high to insure a representative vote."[128] A company listed on Nasdaq must provide for a quorum as specified in its bylaws for any meeting of common stockholders, provided, however, that in no case may a quorum be less than 33% of the outstanding shares of the company's voting common stock.[129] The NYSE Manual provides that when preferred stockholders, voting as a class, have the right to elect directors when dividends are in default, the NYSE "considers it preferable" that the required quorum for the election of directors by preferred stockholders be equal to or lower than that applicable to common stock.[130]

(x) **Redemptions and Tender Offers.** The NYSE Manual provides that listed companies promptly notify the NYSE with specified information upon taking any action that will result in the full or partial redemption of a listed security. A full call results in trading suspension, whereas a partial call results in the amount of securities authorized to be listed being reduced by the amount redeemed. Additionally, the NYSE may give notice of redemption over its ticker system and issue rulings as to further dealings in the security. Tender offers must be carried out in accordance with specified conditions and be designed to allow all shareholders the opportunity to participate on equal terms when their rights or benefits may be affected.[131]

(xi) **Related Party Transactions.** Companies listed on the NYSE and Nasdaq are expected to conduct appropriate reviews of all related party transactions. Both exchanges suggest that audit committees may be best suited to review potential conflicts of interest. Listed companies must confirm that they will appropriately review and evaluate related party transactions on an ongoing basis.[132]

(xii) **Consents.** The NYSE Manual provides that listed companies may use consents "in lieu of special meetings [of shareholders] as proper authorization for shareholder approval of corporate action . . . under certain circumstances" and subject to the NYSE's review on an individual basis.[133]

Notwithstanding their importance, these corporate governance listing standards address only selectively matters of state corporate law. Audit committees are authorized by state law whereas the listing standard mandates them because of accounting and market considerations. Shareholder approval is probably the most significant of these standards in that there are a number of instances where

128. *Id.* § 310.00(A).
129. NASD MANUAL, *supra* note 9, § 4350(f).
130. NYSE MANUAL, *supra* note 9, § 310.00(B).
131. *Id.* § 311.03.
132. *Id.* § 307.00; NASD MANUAL, *supra* note 9, § 4350(h).
133. NYSE MANUAL, *supra* note 9, § 306.00. The NYSE has recently filed with the SEC a proposed rule change which would permit listed issuers to obtain shareholder approval or consent in any manner consistent with applicable state law and the federal securities laws (on file with the Special Study Group).

corporate action will require such approval when it is not required under state law. Voting rights are consistent with state law, but are included in the standards for the purpose of investor protection. Most of the other governance standards do not impact the overall preeminence of state corporate law. Annual meetings are required by state law and a classified board of directors is generally consistent with the state corporate law standard.[134] The other standards establish various means of investor protection but do not require specific action. While corporate governance listing standards may overlap state corporate law, at the present time they generally do not impose substantial additional obligations on issuers. Notably, current governance listing standards do not in the aggregate constitute a comprehensive addition to state corporate law.

2. Foreign Issuers

Under each of the NYSE, the Amex and Nasdaq rules, foreign issuers can easily obtain an exemption from corporate governance listing requirements. Specifically, foreign issuers can obtain a waiver from many NYSE corporate governance requirements if an independent counsel licensed in the issuer's home country opines that the issuer's governance practices are not prohibited in its domicile jurisdiction. Therefore, in effect, if the laws in the issuer's home country are silent or do not explicitly require standards analogous to a given NYSE listing standard, the foreign issuer is permitted to obtain a waiver from the requirements of that standard.[135] Under the Amex and Nasdaq listing rules, similar exemptions are available. Although historically the NYSE, the Amex and Nasdaq policy was to apply financial reporting and corporate governance requirements to foreign issuers, in 1987 the SEC approved rule changes that permitted the exchanges to waive or modify certain listing standards for foreign issuers on a case-by-case basis.[136] The standards that may be waived or modified in accordance with this provision are: (i) quarterly reporting of interim earnings; (ii) composition and election of the board of directors; (iii) shareholder approval requirements and voting rights; and (iv) quorum requirements for shareholder meetings. Accordingly, a foreign issuer's compliance with the "laws, customs, and practices" of its country of origin became the operative governance standards for a U.S. listing. The more flexible, and at times more relaxed, attitude toward listing standards applicable to foreign issuers is based in part on a recognition of the differences between the corporate governance practices of foreign and U.S. companies and the competitive advantages of the domestic listing of major international corporations.

An additional impetus for these changes, however, was global competition among exchanges. The relaxation of requirements applicable to foreign issuers

134. For example, Delaware General Corporation Law permits Delaware corporations to have no more than three classes of directors of equal size. *See* DEL. GEN. CORP. L. § 141(d) (Repl. Vol. 2001).

135. NYSE MANUAL, *supra* note 9, § 103.00.

136. Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the American Stock Exchange, Inc. and New York Stock Exchange, Inc. To Amend the Exchanges' Listing Standards for Foreign Companies, Exchange Act Release No. 24,634, 52 Fed. Reg. 24,230, 24,230 (June 29, 1987).

was also an SEC response to the needs of the U.S. stock exchanges and their investment banking members to develop a U.S. market for foreign securities. Specifically, they argued that differences between the corporate governance practices of foreign issuers and the corporate governance requirements of the U.S. exchanges would unduly inhibit those companies from listing on U.S. exchanges. Accordingly, the SEC was convinced that the special treatment of foreign issuers was warranted.

3. Enforcement

As the preceding discussion makes clear, competitive pressures and the potential for defections by high-profile companies have often made the exchanges "uncertain champions of reform" in controversial areas.[137] SEC Chairman Harvey Pitt has acknowledged that historically persuading an individual exchange to move forward with unpopular reforms is difficult, given that both the NYSE and Nasdaq are "reluctant to go first for fear of giving the other a competitive advantage in attracting companies to become listed."[138]

To the extent governance listing standards are a matter of private contract between an issuer and the exchange, the sole sanction for noncompliance has been delisting. While delisting has been the exception rather than the rule, when confronted with the possibility of delisting, the directors of a listed company must think carefully before permitting such an event to occur. It would change the market for the company's securities, involve public disclosure and likely attract the concern and interest of institutional and other shareholders. Therefore, it has become the practice of listed companies to negotiate with the staffs of the exchanges regarding compliance with governance listing standards and the resolution of particular issues affecting such issuers. Furthermore, as governance listing standards are reasonably uniform among the primary exchanges, issuers do not have the option of changing their listing to another exchange to avoid a given standard. While this may change in the future if liquidity shifts to other markets, for the time being, the lack of alternatives for listed issuers aids the enforcement of corporate governance listing standards.

As a result, involuntary delisting proceedings are rarely initiated on corporate governance grounds. Of the nearly 2,300 delistings recorded by Nasdaq in 1999, 2000 and 2001, only 15 issuers were delisted for violating corporate governance standards. Of these 15, most were for failure to comply with annual meeting and

137. John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1258 (1984). The SEC staff recognized this limitation in 1980, conceding that the SROs "cannot be expected to be at the forefront of changes in corporate accountability" due to competitive pressures. REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON CORPORATE ACCOUNTABILITY: A RE-EXAMINATION OF RULES RELATING TO SHAREHOLDER COMMUNICATIONS, SHAREHOLDER PARTICIPATION IN THE CORPORATE ELECTORAL PROCESS AND CORPORATE GOVERNANCE GENERALLY H23 (Comm. Print 1980) (prepared for Senate Comm. on Banking, Hous. & Urban Affairs, 96th Cong.).

138. Albert B. Crenshaw, *SEC To Toughen Rule on Option Plans*, WASH. POST, Dec. 20, 2001, at E1.

shareholder approval requirements.[139] However, this year, Nasdaq has delisted 17 issuers for, at least in part, violating corporate governance standards.[140] The NYSE has not delisted any company in recent years solely for failure to meet corporate governance standards.

The courts have generally agreed that a listing agreement is a private contract between the listed company and the exchange. As such, specific listing standards may not be enforced by shareholders or other third parties dissatisfied with exchange inaction.[141] In a few cases, courts have granted injunctions in favor of shareholders seeking to block certain corporate actions deemed likely to result in delisting proceedings.[142] In each of these cases, however, the shareholders' success depended on a showing that the pending corporate action was likely to result in delisting (a substantial harm). An explicit threat by an exchange to delist an offending company has been considered adequate proof of the likelihood of harm; failure to present evidence of such a threat, however, proved fatal to at least one claim.[143] Even private enforcement, therefore, is subject on some level to the discretion of the exchanges.[144]

SECTION II.
REGULATION AND AUTHORITY

The self-regulatory authority of exchanges is primarily concerned with their members and the operation and administration of securities markets. Specifically, sections 6 and 15A, section 11A, and section 19 of the Exchange Act include provisions relative to exchange activities and rulemaking and the oversight role of the SEC. The application of these provisions to corporate governance listing standards is limited and somewhat uncertain, particularly as a result of the 1990 decision of the D.C. Circuit Court of Appeals in *Business Roundtable*, the only decision to address the subject.

139. *See generally* NASDAQ MARKET DATA, *available at* http://www.marketdata.nasdaq.com/mr_module_menu.asp. The most common reason issuers were involuntarily delisted from Nasdaq during this period was for failure to meet minimum quantitative requirements for continued listing.

140. Kate Kelly, *Stock Exchanges Fortify Watchdog Roles*, WALL ST. J., Apr. 30, 2002, at C1.

141. *See, e.g.*, State Teachers Ret. Bd. v. Fluor Corp., 654 F.2d 843, 851-53 (2d Cir. 1981); Salter v. NYSE, No. 98 Civ. 4670, 1999 U.S. Dist. LEXIS 5262 (S.D.N.Y. Apr. 16, 1999); Mackubin v. Curtiss-Wright Corp., 57 A.2d 318, 322 (Md. 1948).

142. *See* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 269 (2d Cir. 1984); Rievman v. Burlington N. R.R., 618 F. Supp. 592, 598 (S.D.N.Y. 1985); United Funds, Inc. v. Carter Prods., Inc., [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91, 288 (Balt. Cir. Ct. May 16, 1963); *cf.* Gearhart Indus., Inc. v. Smith Int'l., Inc., 741 F.2d 707, 726 (5th Cir. 1984).

143. *See* British Printing & Communication Corp. v. Harcourt Brace Jovanovich, Inc., 664 F. Supp. 1519, 1529 (S.D.N.Y. 1987).

144. While section 19(g) of the Exchange Act requires the exchanges and the NASD to enforce their rules with respect to members and persons associated with members, that requirement does not extend to enforcement of listing standards against issuers. *See* Exchange Act § 19(g), 15 U.S.C. § 78s(g)(1)(a) (2000).

A. SECTION 19 AND CORPORATE GOVERNANCE LISTING STANDARDS

1. SEC Authority Over Listing Standards Prior to 1975

Although the provisions contained in current section 19 of the Exchange Act were promulgated as part of the 1975 Amendments, the SEC had power to influence SRO listing standards long before the passage of the 1975 Amendments. From its original enactment in 1934[145] until the 1975 Amendments, the Exchange Act granted the SEC clear authority to abrogate and amend SRO rules, including listing standards. Former section 19(b) of the Exchange Act provided:

> The [SEC] is further authorized, if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the [SEC] determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded on such exchange or to insure fair administration of such exchange, by rules or regulations or by order *to alter or supplement the rules of such exchange* (insofar as necessary or appropriate to effect such changes) in respect of such matters as . . . (3) *the listing or striking from listing of any security*; . . . and (13) *similar matters*.[146]

The SEC never used its section 19(b) authority over listing standards during the period from 1934 to 1975. In fact, during this period, the SEC invoked its section 19(b) authority very few times, and only with respect to the regulation of SRO members.[147]

2. The Securities Acts Amendments of 1975

The 1975 Amendments were intended to harmonize SEC authority over the various SROs by expanding the Exchange Act to cover Nasdaq (through the NASD, a "registered association of securities dealers," as defined in the new section 15A of the Exchange Act) in addition to "registered national securities exchanges."

145. *Id.* § 78a.

146. H.R. REP. NO. 94-123, at 172-73 (1975) (emphasis added); *see* Securities Reform Act of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975) (codified as amended at 15 U.S.C. § 78s). The SEC had more limited powers before the 1975 Amendments with respect to NASD rules than it did over exchange rules. *See* H.R. REP. NO. 94-123, at 150-51.

147. In 1941, the SEC used its section 19(b) authority to disapprove rules adopted by the NYSE that restricted the ability of members to trade NYSE-listed securities on other exchanges. *See* Rules of the New York, Stock Exchange, Exchange Act Release No. 3033, 10 S.E.C. 270 (Oct. 4, 1941) (Multiple Trading Case) (NYSE rule prohibiting dealings on other markets declared to be against public interest and illegal); *see also* Rules of the New York, Stock Exchange, Exchange Act Release No. 3053, 1941 SEC LEXIS 197 (Oct. 23, 1941) (discussion by the SEC of its authority under former section 19(b) to alter exchange rules that impose burdens on competition and have other ill effects). In 1975, the SEC premised the elimination of fixed minimum commission rates on national securities exchanges on its section 19(b) authority by adopting Rule 19b-3. Adoption of Securities Exchange Act Rule 19b-3, Exchange Act Release No. 11,203, 40 Fed. Reg. 7394, 7394 (Jan. 23, 1975); *see also* Rules of the New York, Stock Exchange, Exchange Act Release No. 3053, 1941 SEC LEXIS 197 (Oct. 23, 1941).

In so doing, the 1975 Amendments reformulated section 19(b) and added a new section 19(c) to the Exchange Act. As a result, section 19(b) currently defines the process by which SROs can change their rules on their own initiative, while section 19(c) grants the SEC certain authority unilaterally to "abrogate, add to, and delete from"[148] the rules of an SRO.

3. Section 19(b): The Consistency Standard

Section 19(b) provides that, in order to propose new rules or amend existing rules, an SRO must file with the SEC a copy of the proposed rule or amendment for publication by the SEC and the solicitation of comments from interested parties.[149] Once the prescribed comment period lapses:

> The [SEC] shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change *is consistent with the requirements of* [the Exchange Act] and the rules and regulations thereunder applicable to such organization. The [SEC] shall disapprove a proposed rule change . . . if it does not make such finding.[150]

Section 19(b) grants SROs authority with respect to their own rulemaking by requiring the SEC to approve any rule change proposed by an SRO that is consistent with the requirements of the Exchange Act applicable to SROs, i.e., proposals that meet the consistency standard. Conversely, section 19(b) requires the SEC to disapprove a proposed rule if the SEC is unable to make such a finding.[151]

Sections 6(b) and 15A(b) of the Exchange Act set forth requirements relating to the rules of a national securities exchange and a national securities association, respectively.[152] Accordingly, courts have repeatedly held that these sections set forth the requirements of the Exchange Act that are applicable to SROs, as referred to in the section 19(b) consistency standard. For example, in considering a challenge to a rule adopted pursuant to section 19(b) that regulated SRO members, the Seventh Circuit Court of Appeals found that, when applying the section 19(b) consistency standard, "[a]mong the applicable requirements of [the Exchange Act] dealing with securities exchanges, are factors that the [SEC] is required to consider before registering a securities exchange, [section 6(b)]."[153] This use of section 6(b) of the Exchange Act (section 6(b) to interpret the section 19(b) consistency stan-

148. Exchange Act § 19(c), 15 U.S.C. § 78s(c).

149. *Id.* § 19(b)(1), 15 U.S.C. § 78s(b)(1).

150. *Id.* § 19(b)(2), 15 U.S.C. § 78s(b)(2) (emphasis added).

151. When a proposed rule change would have a "significant policy implication," the Congress made it clear that the SEC was not to accede passively, but to issue "its own statement as to the regulatory need for and appropriateness of the self-regulatory rule change." S. REP. NO. 94-75, at 30 (1975) [hereinafter Senate Report]; *see also* New York Stock Exchange, Inc., Exchange Act Release No. 12,249, 1976 SEC LEXIS 2116 (Mar. 23, 1976).

152. Each of sections 6(b) and 15A(b) sets forth nearly identical registration requirements relating to the rules of an exchange or association of brokers and dealers, respectively. These sections provide both affirmative requirements for the rules of national securities exchanges and for a national association of brokers and dealers (i.e., the NASD) and negative injunctions against such rules that would have improper purposes or effects.

153. Clement v. SEC, 674 F.2d 641, 646 (7th Cir. 1982).

dard) followed a precedent set by the Seventh Circuit,[154] and has since been adopted in the District of Columbia Circuit.[155] Moreover, this interpretation is supported by the legislative history of the 1975 Amendments.[156]

Like most of the Exchange Act provisions relating to SROs, however, each of these cases, as well as most of the provisions of sections 6(b) and 15A(b), primarily relates to the regulation of SRO markets, SRO members and their associated persons. In fact, the only provision of section 6(b) or 15A(b) that is likely to be relevant to corporate governance listing standards as rules that affect issuers is the requirement that such rules "not [be] designed to permit unfair discrimination between . . . issuers . . . ."[157] While other provisions in section 6(b) or 15A(b) may also set more generalized conditions on listing standards,[158] the section 19(b) consistency standard appears to give SROs substantial latitude to adopt corporate governance listing standards. Clearly this latitude is subject to the negative injunction that listing standards not be "designed to permit unfair discrimination"

154. Belenke v. SEC, 606 F.2d 193, 197 (7th Cir. 1979) (holding that both sections 6(b) and 11A may be used to interpret section 19(b) with respect to a rule adopted by a national securities exchange that regulated a member).

155. Timpinaro v. SEC, 2 F.3d 453, 459 (D.C. Cir. 1993) (holding section 15A may be used to interpret section 19(b) with respect to an NASD rule that regulated members).

156. *See* Senate Report, *supra* note 151, at 30 (stating that under section 19(b), "no change in the rules of any self-regulatory organization may become effective until the SEC finds it to be consistent with the registration requirements for the organization . . . ."). The SEC has also argued that the "requirements" of the Exchange Act "applicable" to SROs are set forth in sections 6(b) and 15A(b). *See, e.g.*, New York Stock Exchange, Inc., Exchange Act Release No. 12,249, 1976 SEC LEXIS 2116 (Mar. 23, 1976).

> In the view of the [SEC], a proposed rule change would not be consistent with the Act and the rules and regulations thereunder if, among other things, the [SEC] could not make the determinations required under Section 6(b) of the [Exchange] Act with respect to the rules of an exchange which included the proposed rule change prior to registration of an exchange.

Id. at *8; *see also* Nat'l Ass'n of Sec. Dealers, Inc., Exchange Act Release No. 17,371, 45 Fed. Reg. 83,707, 83,715 (Dec. 12, 1980).

157. Exchange Act § 6(b)(5), 15 U.S.C. § 78f(b)(1) (2000); *id.* § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6). The negative injunctions in sections 6(b)(8) and 15A(b)(9) against rules that impose unnecessary or inappropriate burdens on competition could, at least in theory, be relevant, but we are not aware of situations in which listing standards have been deemed to have such potential effects. Sections 6(b)(9) and 15A(b)(12) also provide direct requirements on SRO rules relating to the listing of securities issued in limited partnership rollup transactions. *See id.* § 6(b)(9), 15 U.S.C. § 78f(b)(9); *id.* § 15A(b)(12), 15 U.S.C. §78o-3(b)(12). However, given the specificity of these provisions, they have little applicability to corporate governance listing standards in general. *See id.* § 6(b)(9), 15 U.S.C. § 78f(b)(9); *id.* § 15A(b)(12), 15 U.S.C. § 78o-3(b)(12). While other sections of the Exchange Act also mention issuers, they are not directly relevant to a discussion of listing standards. *See, e.g., id.* § 6(b)(3), 15 U.S.C. § 78f(b)(3); *id.* § 15A(b)(4), 15 U.S.C. § 78o-3(b)(4) (providing that "one or more directors [of each SRO] shall be representative of issuers and investors and not be associated with a member of the [SRO], broker, or dealer."); *id.* § 6(b)(4), 15 U.S.C. § 78f(b)(4); *id.* § 15A(b)(5), 15 U.S.C. § 78o-3(b)(5) (requiring the "equitable allocation of [SRO] dues, fees, and other charges among [its] members and issuers and other persons using [its] facilities") (quoting section 6(b)(4), as the language of sections 6(b)(4) and 15A(b)(5) differs in certain minor respects).

158. For example, sections 6(b)(5) and 15(b)(6) each also requires that the rules of an exchange and an association of dealers be designed "to prevent fraudulent and manipulative acts and practices" and "to protect investors and the public interest." *Id.* § 6(b)(5), 15 U.S.C. § 78f(b)(5). Accordingly, an SRO's authority to adopt corporate governance listing standards may also be subject to these requirements. *See id.* § 6(b)(5), 15 U.S.C. § 78f(b)(5); *id.* § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6).

among issuers as set forth in sections 6(b) and 15A(b). Depending on the subject matter of the listing standard in question, however, additional provisions of the Exchange Act may also set requirements relevant to the application of the section 19(b) consistency standard.

Although the consistency standard has not been judicially addressed with respect to corporate governance listing standards, a Task Force of the American Bar Association found the nondiscrimination standard to be the only restriction on an SRO's authority to adopt corporate governance listing standards under the consistency standard.[159] For example, in a 1987 comment letter respecting the SEC release proposing Rule 19c-4, the ABA asserted that "when proposed exchange rule changes relating to listing standards are filed with the [SEC] under section 19(b), the responsibility of the [SEC] is to ensure that the proposed rule changes do not result in 'unfair discrimination' among issuers and are not inconsistent with the purposes of the [Exchange Act] required to be carried out by the exchanges in establishing their rules."[160] This reading of section 19(b) is also consistent with the premise that listing is ultimately a private agreement between an exchange and an issuer and, if consistent with the terms of the Exchange Act applicable to the SRO, the terms of this agreement should be accepted.[161]

4. Section 19(c): The Purposes Standard

Section 19(c) of the Exchange Act, on the other hand, grants the SEC certain direct authority unilaterally to change SRO rules, providing in pertinent part:

> The [SEC], by rule, may abrogate, add to, and delete from (hereinafter in this subsection collectively referred to as "amend") the rules of a self-regulatory organization (other than a registered clearing agency) as the [SEC] *deems necessary or appropriate* to insure the fair administration of the self-

159. *See, e.g.*, Comment Letter from the ABA Section of Corporation, Banking and Business Law, Federal Regulation of Securities Committee, Task Force on New York Stock Exchange Listing Requirements, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Dec. 31, 1986) [hereinafter 1986 ABA Comment Letter] (on file with the Special Study Group); Comment Letter from the ABA Section of Corporation, Banking and Business Law, Federal Regulation of Securities Committee, Task Force on Disparate Voting Rights, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Aug. 5, 1987) [hereinafter 1987 ABA Comment Letter] (on file with The Special Study Group); Comment Letter from the ABA Section of Corporation, Banking and Business Law, Federal Regulation of Securities Committee, Task Force on Listing Standards of Self-Regulatory Organizations, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (June 13, 1988).

160. 1987 ABA Comment Letter, *supra* note 159, at 14; *see also* 1986 ABA Comment Letter, *supra* note 159, at 4 (arguing that "the structure and content of listing agreements between exchanges and issuers are, except for questions of 'unfair discrimination' among issuers, outside the scope of the [SEC's] oversight and regulatory jurisdiction").

161. *But see, e.g.*, Senate Report, *supra* note 151, at 23:

> The Committee concurs in the need to emphasize the mutual regulatory responsibilities of the industry and the SEC. However, it believes care should be exercised, lest the use of phrases such as "partnership" and "cooperative regulation" lead to the impression that the industry and the government fulfill the same function in the regulatory framework or that they enjoy the same order of authority or deserve the same degree of deference, whether by firms, courts or the Congress. The self-regulatory organizations exercise authority subject to SEC oversight. They have no authority to regulate independently of the SEC's control.

> regulatory organization, to conform its rules to requirements of this chapter and the rules and regulations thereunder applicable to such organization, or otherwise *in furtherance of the purposes of* [the Exchange Act] . . . .[162]

Therefore, under section 19(c) the SEC has authority to impose new SRO rules or amend or delete existing SRO rules whenever it deems it "necessary or appropriate" (i) to "insure the fair administration" of the SRO; (ii) to "conform" the SRO's rules to the "requirements" of the Exchange Act applicable to SROs;[163] or (iii) otherwise "in furtherance of the purposes of" the Exchange Act. Due to its generality, it appears that the purposes standard set forth in the third prong of section 19(c) would define the outer reach of SEC authority to impose corporate governance listing standards.

Use of the word "purposes" by the Congress in the third prong of section 19(c) might be interpreted to be a reference to any of the enumerated policies underlying the Exchange Act, including, most broadly, the "reasons" set forth in section 2 of the Exchange Act. These reasons include the fact that securities transactions are a matter of "national public interest" and the need to protect "interstate commerce, the national credit, the Federal taxing power . . . the national banking system and Federal Reserve System, and . . . the maintenance of fair and honest markets."[164] Therefore, presumably the purposes standard can be met whenever the SEC determines that the imposition of a given SRO rule change facilitates the achievement of any such purpose, or underlying policy, of the Exchange Act, provided the rule change does not violate any of the negative limitations in section 6(b) or 15A(b). However, the breadth and generality of these enumerated purposes combined with the lack of any congressional intent to federalize aspects of corporate law would make it difficult to justify the SEC's use of section 19(c) to impose specific corporate governance listing standards, absent some independent relation to an Exchange Act purpose in addition to the purposes enumerated in section 2. As such, the limits of SEC authority over corporate governance listing standards under the purposes standard of section 19(c) are uncertain.

In the 1986 and 1987 ABA Comment Letters, the ABA took an even narrower view of SEC authority over corporate governance listing standards under section 19(c). In these letters, the ABA asserted that the "unfair discrimination" requirements of sections 6(b)(5) and 15A(b)(6) also limit the SEC's section 19(c) authority under the purposes standard unilaterally to amend corporate governance listing standards. According to this view, section 2 of the Exchange Act is irrelevant

162. Exchange Act §19(c), 15 U.S.C. § 78s(c) (emphasis added).

163. Similar to the language of section 19(b), this authority to "conform" an SRO's rules to the "requirements" of the Exchange Act is likely also a reference to sections 6(b) and 15A(b). *See id.* § 6(b), 15 U.S.C. § 78f(b)(1); *id.* § 15A(b), 15 U.S.C. § 78o-3(b)(2). Accordingly, the SEC's authority under this prong of section 19(c) is likely relevant principally to taking unilateral action to conform an SRO's rules to insure that such rules do not discriminate among issuers unless, in a specific instance, other provisions of the Exchange Act are applicable. *See, e.g.*, *supra* notes 157 and 158 for a discussion of the SEC's authority to prevent SRO rules form discriminating among issuers.

164. Exchange Act § 2, 15 U.S.C. § 78(b). Section 11A also sets forth additional "purposes" underlying the Exchange Act that could be applicable to an interpretation of section 19(c). *See infra* note 180.

to an interpretation of section 19(c). Rather, under both the third "purposes" prong and the second "requirements" prong, section 19(c) grants the SEC authority unilaterally to change an existing corporate governance requirement only where such requirement creates an "'unfair discrimination' among issuers."[165]

There is another interpretation. Prior to the passage of the 1975 Amendments, section 19(b) clearly granted the SEC direct authority to change listing standards (as described above). It has been suggested that the legislative history of the 1975 Amendments indicates that the Congress intended to expand the SEC's authority over SRO rulemaking, as a general matter. According to the Senate Report concerning the 1975 Amendments, "the bill would greatly expand the [SEC's] direct regulatory powers over the nation's trading markets and the participants in those markets."[166] The Senate Report continued:

> [T]here has been a continuing controversy as to the precise scope of the SEC's power to amend the rules of a self-regulatory organization. [Section 19(c) of this] bill would give the SEC clear authority to amend any self-regulatory organization's rules in any respect consistent with the objectives of the Exchange Act . . . .[167]

However, the legislative history of the 1975 Amendments is also clear that the primary congressional concern in amending section 19 related to the SEC's oversight of SRO rules relating to members, not the adoption of corporate governance listing standards or the creation of a comprehensive federal corporate law through listing standards.[168] At the same time, there is no indication in the legislative history that the Congress intended that a different standard apply to SEC authority over corporate governance listing standards than to SEC authority over SRO rules affecting members.

In the years following the 1975 Amendments, the SEC also asserted that these amendments granted it broad authority to amend SRO rules unilaterally. For ex-

165. 1986 ABA Comment Letter, *supra* note 159, at 4; *see also* 1987 ABA Comment Letter, *supra* note 159, at 14 (concluding that SEC "authority and responsibility under Section 19(c) is similarly limited[]" to ensuring that SRO rules do not result in "unfair discrimination" among issuers). The Special Study Group is of the view that, after *Business Roundtable*, the ABA's interpretation in the 1986 and 1987 ABA Comment Letters of section 19(c)'s application to corporate governance listing standards as relating only to the "unfair discrimination" test of sections 6(b) and 15A(b) (rather than the general purposes of sections 2 and 11A) is too limited.

166. *See* Senate Report, *supra* note 151, at 30-31. In addition, the Congress's statements in the legislative history concerning the SEC's ability to deal with situations where its "indirect" section 19(c) authority overlaps its "direct" rulemaking authority under other provisions of the Exchange Act confirms that the Congress knew that the SEC's indirect authority under section 19(c) is broader than the direct authority granted to the SEC under other provisions of the Exchange Act. Indeed the Congress's inclusion of section 19(c)(4) in the 1975 Amendments evidences a recognition that the SEC's indirect authority under section 19(c) is not coterminous with its direct authority under other sections of the Exchange Act. *See* Exchange Act § 19(c)(2)-(4), 15 U.S.C. § 78s(c)(4)(A); *see also* Senate Report, *supra* note 151, at 31-32 ("In order to avoid any doubt as to the SEC's authority in areas where its direct authority overlaps its indirect authority, Section 19(c)(4) would make clear that where the [SEC] has direct authority, it would not be required to proceed under Section 19(c) or to follow the [more rigorous] procedures specified in that section.").

167. Senate Report, *supra* note 151, at 31; *see also* S. Rep. No. 93-13, at 174 (1973).

168. *See, e.g.*, Senate Report, *supra* note 151, at 30-32.

ample, in a 1977 release, the SEC stated that the amended section 19 together with the amended section 6(b) grant the SEC authority to revise any existing exchange rules unilaterally.[169] If correct, this reading of section 19(c) would grant the SEC broad authority over all aspects of SRO rulemaking, including the adoption of corporate governance listing standards.[170] This reading of section 19(c), however, was tested in *Business Roundtable*.

5. The *Business Roundtable* Decision

For all practical purposes, the opinion of the D.C. Circuit Court of Appeals in *Business Roundtable* ended the debate as to SEC authority, by effectively shutting the door on the SEC's use of section 19(c) to impose corporate governance listing standards. In its opinion, the court unanimously held that section 19(c) did not confer authority upon the SEC unilaterally to impose a voting rights listing standard on the exchanges or Nasdaq. Careful analysis of the *Business Roundtable* decision is appropriate to an examination of SEC authority in this area.

As described in the preceding section, in 1987, after failing to convince the NYSE, the Amex and Nasdaq to act uniformly, the SEC invoked its section 19(c) authority and promulgated Rule 19c-4, which barred the exchanges and Nasdaq from listing securities with certain disparate voting rights.

The court in *Business Roundtable* abrogated Rule 19c-4 on the ground that the rule "directly control[led] the substantive allocation of powers among classes of shareholders" and therefore was "in excess of the [SEC's] authority under § 19 of the [Exchange Act]."[171] In reaching this conclusion, the court held first that it was "indisputable" that the listing standard in question was a "rule" covered by sections 19(b) and 19(c).[172] The problem lay, however, in the use by the SEC of section 19(c) with respect to the rule at hand. Specifically, the court quoted section 19(c) and noted that the SEC authority granted pursuant to that section is limited to

169. New York Stock Exchange, Inc., Exchange Act Release No. 13,346, 11 SEC Docket 1945 (Mar. 9, 1977); *see* Promotion of the Reliability of Financial Information and Prevention of the Concealment of Questionable or Illegal Corporate Payments and Practices, Exchange Act Release No. 15,570, 1979 SEC LEXIS 2141 (Feb. 15, 1979); *see also* Roberta S. Karmel, *Qualitative Standards for "Qualified Securities": SEC Regulation of Voting Rights*, 36 CATH. U. L. REV. 809, 829-30 (1987).

170. Although members of the Special Study Group have differing views with respect to this broad subject matter, the members unanimously agree that a resolution of these issues is not relevant to this Study.

171. *Bus. Roundtable*, 905 F.2d at 407.

172. *Id.* at 410. To reach this conclusion, the court relied on section 3(a)(27) of the Exchange Act, which states, in relevant part,

> The term "rules of an exchange", [and] "rules of [the NASD]" means the constitution articles of incorporation, bylaws, and rules, or instruments corresponding to the foregoing, of an exchange, [the NASD], respectively, and such of the stated policies, practices, and interpretations of such exchange, association, or clearing agency as the [SEC], by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules of such exchange, [or the NASD].

Exchange Act § 3(a)(27), 15 U.S.C. § 78c(a)(27).

those actions taken "in furtherance of the purposes of the Exchange Act." Accordingly, the court asked, "What then are the 'purposes' of the Exchange Act?"[173]

The SEC argued that the Exchange Act purposes potentially relevant to Rule 19c-4 were: (i) the proxy rules under section 14 of the Exchange Act; (ii) the grant of authority to the SEC under sections 6(b)(5) and 15A(b)(6) to "protect investors and the public interest;" and (iii) the grant of authority in section 11A(a)(2) to the SEC to "facilitate the establishment of a national market system." In response to the SEC's section 14 argument, the court determined the primary purposes of section 14 to be "adequate disclosure in proxy solicitations" and "voting procedures." With respect to the former, the court found Rule 19c-4 entirely unrelated and, with respect to the latter, the court stated, "With its step beyond control of voting procedure and into the distribution of voting power, the [SEC] would assume an authority that the Exchange Act's proponents disclaimed any intent to grant."[174] The court found the provisions relied on in the SEC's section 6(b)(5)/15A(b)(6) and section 11A(a)(2) arguments as being too tenuous to interpret as an indication of a congressional intent to permit such a broad federal preemption over corporate governance and shareholder voting rights, matters traditionally left to state corporate law.

In an effort to distinguish between Rule 19c-4 and existing corporate governance listing standards approved by the SEC pursuant to section 19(b), the court stated:

> [The] Congress appears to have contemplated exchanges' taking (1) some measures that regulate members with delegated governmental authority and that are required to be, at a minimum, related to the purposes of the [Exchange] Act, and (2) others, that do not regulate members and do not rely on government regulatory authority, for which there is no such requirement. As we read the [Exchange] Act, both categories are subject to [SEC] review under § 19(b) and to amendment under § 19(c), but for some rules in the second category—those which do not regulate members and are not related to the purposes of the [Exchange] Act—the [SEC's authority] will be quite limited.[175]

The court included corporate governance listing standards in the second category on grounds that listing standards do not implicate "any governmental authority to 'regulate' the issuer."[176] Therefore, according to the court, SEC authority either to (i) unilaterally change SRO rules relating to the corporate governance of issuers under section 19(c) or (ii) disapprove of SRO proposed rules relating to the corporate governance of issuers under section 19(b) is "quite limited." Although this limited power was left undefined, the court was clear in holding:

173. *Bus. Roundtable*, 905 F.2d. at 410.
174. *Id.* at 411.
175. *Id.* at 414.
176. *Id.*

> [A validation of the SEC's adoption of Rule 19c-4] would . . . overturn or at least impinge severely on the tradition of state regulation of corporate law. . . . We read the [Exchange] Act as reflecting a clear congressional determination not to make any such broad delegation of power to the [SEC].[177]

A contrary view holds that, rather than rejecting absolutely the use of section 19(c) to impose corporate governance listing standards, *Business Roundtable* actually suggests that section 19(c) grants the SEC authority to impose such standards, provided the use of that authority in a given instance is predicated on a statutory purpose applicable to the specific listing standard. In the case of Rule 19c-4, some have suggested, citing dicta in the *Business Roundtable* opinion,[178] that the SEC should have premised its use of section 19(c) on the Williams Act. However, even if the court upheld the SEC's authority to adopt Rule 19c-4 on the ground that the matters regulated by Rule 19c-4 are included within the purposes of the Williams Act, the court's analysis of the statutory structure, and its requirement that any SEC use of section 19(c) authority must be tied to a clear statutory purpose, might not have changed. Either way, these arguments are of limited practical utility given that *Business Roundtable* is the only judicial interpretation of SEC authority under section 19 over corporate governance listing standards.

Regardless of whether one agrees with the *Business Roundtable* decision, it closed a chapter on the SEC's use of its section 19(c) powers to impose corporate governance standards on public issuers through listing standards. The practical effects of *Business Roundtable* on SRO authority under section 19(b) and SEC authority under section 19(c) over corporate governance listing standards are as follows:

- Corporate governance listing standards are "rules" for purposes of the Exchange Act and, as such, must be adopted pursuant to section 19 of the Exchange Act.
- The Exchange Act does not enable the SEC to establish a comprehensive federal corporate law through listing standards.
- SEC authority over corporate governance listing standards pursuant to section 19(c) is uncertain and limited to matters that are in furtherance of the purposes of the Exchange Act. Therefore, this authority must be considered on a case-by-case basis with respect to a specific purpose of the Exchange Act.

177. *Id.* at 412-13.

178. *See id.* at 417 ("We do not decide whether the [SEC] could invoke other statutory provisions to provide the legal authority for promulgating these or similar regulations. The sections relied on here are insufficient. Even if other statutory provisions could support the [SEC's] asserted authority, we cannot supply grounds to sustain the regulations that were not invoked by the [SEC] below. In any case a change in the jurisdictional basis would almost certainly alter the substantive content of the final regulations.") (citations omitted). The "other statutory provisions" referred to are those other than the ones the SEC cited in its briefs. *Id.* at 417 n.10 ("Some commentators argued that the [SEC] could ground its authority in the Williams Act, but the [SEC] did not rely on these provisions.") (citations omitted).

- Presumably due to these considerations, the SEC has not sought to invoke its section 19(c) authority since *Business Roundtable* was decided but has instead relied on its powers of persuasion, as described above, to enlist the SROs' cooperation in amending listing standards pertaining to, e.g., audit committees.
- Application of the section 19(b) consistency standard requires, at least, that a proposed rule change be consistent with the nondiscrimination requirement in sections 6(b)(5) and 15A(b)(6) and may require consistency with other Exchange Act provisions depending on the subject matter of the proposal.

B. Section 11A: SEC Authority and Joint SRO Action

Section 11A of the Exchange Act provides the SEC with another broad grant of authority over SROs. Specifically, section 11A(a) grants the SEC authority:

> having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under [the Exchange Act] to facilitate the establishment of a national market system for securities . . . by rule or order, to authorize or require self-regulatory organizations to act jointly with respect to matters as to which they share authority under [the Exchange Act] in planning, developing, operating, or regulating a national market system (or a subsystem thereof) or one or more facilities thereof . . . .[179]

Although these provisions appear to provide the SEC with an additional source of authority with respect to SRO corporate governance listing standards, upon closer analysis the ability to draw such a conclusion is less clear. The language of the statute specifically authorizes SEC use of the powers described above "to carry out the objectives set forth in paragraph (1) of [section 11A(a)]," which primarily addresses the creation of technological systems that facilitate investor access to efficient execution in an increasingly electronic securities marketplace.[180]

179. Exchange Act § 11A(a)(2)-(3), 15 U.S.C. § 78k-1(a)(2)-(3)(B) (2000).

180. *Id.* § 11A(a)(2), 15 U.S.C. § 78k-1(a)(2). Section 11A(a)(1) provides as follows:

> The Congress finds that—
> (A) The securities markets are an important national asset which must be preserved and strengthened.
> (B) New data processing and communications techniques create the opportunity for more efficient and effective market operations.
> (C) It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure—
> (i) economically efficient execution of securities transactions;
> (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
> (iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
> (iv) the practicability of brokers executing investors' orders in the best market; and
> (v) an opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer.

The legislative history of section 11A generally supports this conclusion. For example, in defining the national market system, the Senate Report finds that "communications systems designed to provide automated dissemination of last sale and quotation information with respect to securities will form the heart of the national market system."[181] The Senate Report continues by defining the purposes underlying the section 11A grant of authority to the SEC as follows:

> The goals of this pervasive regulatory authority would be to insure the availability of prompt and accurate trading information, to assure that these communications networks are not controlled or dominated by any particular market center, to guarantee fair access to such systems by all brokers, dealers and investors, and to prevent any competitive restriction on their operation not justified by the purposes of the Exchange Act.[182]

The general grant of authority to take action under section 11A having regard for the public interest, protection of investors and the maintenance of fair and orderly markets is the directive which the SEC must follow in authorizing exchanges to act jointly with respect to exchanges as to which they share authority in planning, developing, operating or regulating a national market system or one or more of its facilities. While there is no precedent, we believe there is a basis upon which the SEC could sanction joint action by the exchanges as described in the Proposal because the best practices established by the exchanges are not binding (and should not be considered binding) and therefore excluded from the *Business Roundtable* holding and the need for SEC approval.[183] It is essentially a procedural mechanism that relates to the operation or regulation of a national market system in the broadest sense. It obviously does not deal with the actual conduct of the national market system, but without issuers and measures that promote the integrity of the markets, the directives of section 11A in the statute might not be achieved.

C. Other

1. SEC Authority Over the Listing Policies of Foreign Exchanges

Underlying the continued primacy of the U.S. securities markets is the SEC's imposition of its views concerning whether a non-U.S. securities exchange is

> (D) The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.

Id. § 11A(a)(1), 15 U.S.C. § 78k-1(a)(1).

Additionally, to date, the SEC has not issued an order pursuant to section 11A with respect to SRO rules applicable to issuers. Of the 34 section 11A orders examined for this report, three related to the creation of a consolidated quotation system, 10 related to the creation of an intermarket options linkage, 16 addressed ITS, five were concerned with decimalization, and one addressed problems raised by the terrorist attacks on September 11, 2001. (One order addressed both ITS and decimalization.)

181. Senate Report, *supra* note 151, at 9.

182. *Id.*

183. In addition, an SEC order pursuant to section 11A may support a finding of implied repeal of the antitrust laws with respect to any joint activities among SROs. *See supra* note 4.

"present" in the United States and is thus required to register as an exchange. If a non-U.S. exchange is required to register in the United States, its listed companies become subject to U.S. reporting standards and U.S. generally accepted accounting principles (U.S. GAAP) by virtue of section 12(b) of the Exchange Act, which imposes those requirements on companies listed on an exchange registered under the Exchange Act. Under current SEC policy,[184] a non-U.S. exchange will be deemed to be "present" in the United States if it directly appeals to U.S. investors or broker-dealers by, e.g., soliciting their order flow. As a result, for example, while broker-dealers are free to have on their desks screens showing trading activity and quotations on non-U.S. exchanges, and they can make that information available to their institutional customers, any resulting orders must be transmitted through a U.S. broker to a non-U.S. broker for transmission to the exchange. If a U.S. broker has a membership on a non-U.S. exchange, it is not permitted to transmit the orders directly to the non-U.S. exchange, but must use another member, perhaps an affiliated company, that is not a U.S. broker to transmit the order to the non-U.S. exchange. The non-U.S. exchange is not permitted to avoid registration in the United States by, for example, registering as a broker-dealer and complying with the SEC's Form ATS.[185] The result of this bulwark against foreign intrusion is to protect the U.S. exchanges from substantial foreign competition and to protect U.S. GAAP from some of the pressure on the Financial Accounting Standards Board and others to conform it to International GAAP. As noted above, as long as the U.S. markets are the only markets that can directly access U.S. brokers, dealers and institutional investors, and foreign markets would have to register as national securities exchanges to compete in that arena, non-U.S. exchanges that sought direct access to the United States would, by registering under the Exchange Act, cause their listed companies to comply with section 12(b) of the Exchange Act. That in turn not only would subject them to SEC oversight of their listing rules, but the listed companies would have to reconcile to U.S. GAAP.

Consequently, the U.S. policy, by excluding non-U.S. exchanges from direct access to U.S. dealers and institutional investors, tends to support U.S. GAAP. It

184. *See* Concept Release on Exchange Regulation, Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485 (May 23, 1997) [hereinafter Regulation ATS Concept Release].

185. In the case of the Tradepoint Exchange (Tradepoint), an electronic exchange regulated under U.K. law as a recognized investment exchange, the SEC determined that a non-U.S. exchange that targeted U.S. investors in its marketing is subject to the registration requirement of the Exchange Act. The SEC nevertheless granted Tradepoint a low-volume exemption from registration. Tradepoint Financial Networks plc, Exchange Act Release No. 41,199, 64 Fed. Reg. 14,953, 14,956 (Mar. 22, 1999). In that release, the SEC articulated more broadly its theory of exchange registration as applied to non-U.S. entities:

> The [SEC] believes that an exchange operated offshore but targeting U.S. persons, which is owned or controlled, directly or indirectly, through a financial interest or otherwise, by a U.S. national securities exchange or national securities association, would be considered a U.S. market operated by an SRO. As such, it would be subject to [SEC] oversight. The [SEC] notes that Tradepoint, as a condition to this Order, has agreed that it is subject to the [SEC's] jurisdiction.

Id.

also protects the SEC's ability to engraft onto a U.S. exchange's listing standards substantive matters affecting corporate governance which the non-U.S. exchanges have traditionally excluded from their listing standards. If it were otherwise, and non-U.S. exchanges could offer access to U.S. investment capital in the secondary markets similar to the access U.S. exchanges offer, many U.S. issuers, particularly start-up companies that do not have an established tradition of NYSE or Nasdaq listing, could be tempted to eschew the U.S. markets and go to non-U.S. exchanges for listings. This might well weaken the U.S. markets' ability to compete for such listings and could, in turn, weaken the SEC's ability to maintain influence over corporate governance through exchange-listing standards.

In a market environment where technological advances make national boundaries increasingly unimportant, it remains to be seen how long the existing regulatory speed bumps, which require broker-to-broker order transmission rather than direct linkages between non-U.S. exchanges and U.S. persons, will continue to have economic significance. It may well be, for example, that as securities transactions are increasingly effected via "straight-through processing," the costs of inserting those mechanical elements will diminish to the point where they no longer present any substantial obstacle to foreign exchange linkages to the United States. That might well necessitate the SEC's rethinking of its policies toward the application of the exchange registration requirements and might weaken further the SEC's ability to require U.S. exchanges and other markets[186] to impose non-financial criteria in their listing and delisting standards.

2. Disclosure

The SEC has broad powers under the Exchange Act to require disclosure in periodic reports, proxy materials or other public filings of matters that are material to shareholder voting, other decisions of investors and certain information respecting governance practices.[187] The SEC has regularly used this authority in connection with corporate governance matters that it deems to be material to shareholders. Relatively recent examples include matters pertaining to audit committee charters, meetings and activities as well as compensation committee reports.

The SEC has the authority to require disclosure in periodic reports, proxy materials or other public filings of a listed company's compliance (or noncompliance) with the best practices guidelines established by its listing exchange. Any such SEC rule would be subject to rulemaking proceedings with the customary opportunity for comment by all interested parties.[188] Although, as a general matter, the SEC has such authority, the extent of SEC authority to require disclosure of any specific item would need to be considered on a case-by-case basis. Therefore

186. Upon the registration of Nasdaq as a national securities exchange, the NASD will have to provide an alternative order display facility that will foster the development of an independent "third" market in Nasdaq securities. On December 7, 2001, NASD filed proposed rule changes looking toward such an alternative display facility. *See* Self-Regulatory Organizations, Exchange Act Release No. 45,156, 67 Fed. Reg. 388 (Dec. 14, 2001).

187. Exchange Act §§ 13-14, 15 U.S.C. § 78m-n.

188. *See id.*; *see also* Administrative Procedures Act § 1, 5 U.S.C. § 551 (2001).

we do not express any view with respect to proposals other than the comply or explain requirement.

SECTION III. CHANGE IN MARKET STRUCTURE

U.S. securities markets have changed dramatically over the past quarter-century. Transformed by technology and greater investor demand, the securities markets have become multifaceted, with the primary markets—the NYSE, the Amex and Nasdaq—competing for market share with an ever-increasing number of alternative market centers, including ATSs. As this competition continues, ATSs and other market participants may attract increasing liquidity from the primary markets. To the extent trades are increasingly executed off the primary markets, the NYSE, the Amex and Nasdaq may have a decreased ability and incentive to establish and maintain corporate governance listing standards.

A. THE U.S. MARKETPLACES FOR SECURITIES

1. The NYSE and the Amex

Together, the NYSE and the Amex largely dominated the market for equity securities of U.S. issuers until the 1970s.[189] During this period, the NYSE was considered the most prestigious exchange, distinguishing itself from its competitors by imposing the most stringent listing standards.[190] Using listing standards to obtain a competitive edge, the NYSE attracted most of the largest commercial and industrial companies in the United States.[191] The NYSE believed that by appealing to individual investors and improving corporate governance standards, it could bolster trading volume by attracting not only new issuers, but also additional investors for already listed shares.[192] Indeed, by 1972, the NYSE's trading volume had grown exponentially to 16 million shares per day, which represented an over fourfold increase from its trading volume the previous decade.[193] Twenty

189. The five regional exchanges (the Boston, Chicago, Cincinnati, Pacific, and Philadelphia Stock Exchanges) compete for order flow with the NYSE and the Amex. At an earlier point in their history, these exchanges served as "incubator" markets for small local companies. For the past 20 years, however, the overwhelming percentage of regional stock exchange business has been in the stocks of companies listed on the NYSE and the Amex that the regional exchanges trade pursuant to grants of unlisted trading privileges (UTP). *See* SECURITIES AND EXCHANGE COMMISSION, DIVISION OF MARKET REGULATION, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS (Jan. 1994) [hereinafter MARKET 2000 STUDY]. In 1992, over 97 percent of volume of the regional stock exchanges derived from issues traded pursuant to UTPs. *See id.* at II-8, 9.

190. *See* John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 37 (2001). Since its inception, the NYSE has been committed to ensuring the quality of its securities market and has used quantitative and qualitative listing standards as a means to achieve this goal. As early as 1869, a Committee on Stock List evaluated applications to list with the NYSE. *See* Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 326 (2001).

191. *See* 5 LOUIS LOSS & JOEL SELIGMAN, V SECURITIES REGULATION 2530 (3d ed., rev. vol. 2001); Michael, *supra* note 13, at 1465.

192. Michael, *supra* note 13, at 1470.

193. *See* MARKET 2000 STUDY, *supra* note 189, at 4.

years later, in 1992, the NYSE's average daily volume exceeded 200 million shares.[194] Today, the NYSE lists almost 3,000 companies, and its average daily share volume for the year 2001 exceeded 1 billion shares.[195]

While the Amex's growth in trading volume during these periods has been impressive, this growth has been less significant when compared with that of the NYSE. For example, in 1972 the Amex's average daily trading volume in equity securities was almost 4.5 million shares per day.[196] By 1992, this figure had increased only to approximately 14 million shares per day.[197] Today, the Amex lists only 761 companies, and its average daily share volume for the year 2001 was approximately 66 million shares.[198]

In addition to these changes in trading volume, both the NYSE and the Amex have significantly updated their technological infrastructure to facilitate trading and enhance market transparency. For example, in 1976, the NYSE introduced the Designated Order Turnaround system, which was a fully automated system for electronically routing smaller orders.[199] Later, in 1984, the NYSE implemented SuperDot 250, an electronic order-routing system that linked member firms to specialists' posts on the trading floor. Also, in 2000, the NYSE introduced NYSE Direct+, a high-speed electronic connection for the immediate, automatic execution of smaller limit orders.[200] More recently, in 2001, the SEC approved the NYSE's OpenBook, a market-data product that enhances transparency by enabling subscribers to view information contained on the NYSE's limit order books.[201]

Likewise, during the 1990s, Amex made substantial investments in technology, introducing wireless handheld terminals on the trading floor, a wireless voice system to facilitate internal broker communications and a data link digital information service.[202] During this period, Amex also established a presence on the World Wide Web, providing investors, shareholders and companies with information and market data on its listed companies and products.[203]

2. Nasdaq

Given the emergence and growth of Nasdaq, the transformation in the markets for securities not listed on an exchange, or over-the-counter securities, has been dramatic. Nasdaq, which is currently operated by the NASD, is an inter-dealer quotation system for the OTC market. Prior to Nasdaq's creation, dealer quota-

194. SEC. INDUS. ASS'N, SELECTED INDUSTRY STATISTICS, *available at* http://www.sia.com/reference_materials/pdf/keystats.pdf.

195. *Id.*

196. THE AMERICAN STOCK EXCHANGE, THE 1986 FACT BOOK (1986).

197. SEC. INDUS. ASS'N, 2000-2001 SEC. INDUSTRY Y.B., MARKET ACTIVITY–1985-1999, at 1002.

198. SELECTED INDUSTRY STATISTICS, *supra* note 194.

199. NYSE, TIMELINE AT A GLANCE, *available at* http://www.nyse.com/about/timeline/161315.html.

200. NYSE, TIMELINE AT A GLANCE, *available at* http://www.nyse.com/about/timeline/161327.html.

201. Press Release, NYSE, NYSE Receives Approval from SEC on NYSE OpenBook (Dec. 12, 2001), *available at* http://www.nyse.com/press/NT00067F26.html.

202. AMEX, ABOUT AMEX-HISTORY, *available at* http://www.amex.com/atamex/aboutamex/history/aboutAmex_history.html.

203. *Id.*

tions were disseminated by paper copy. These copies were printed on pink paper, prompting the reference to OTC securities as "pink sheet" stocks.[204] During this time, the OTC market was highly fragmented and plagued by pricing inefficiency and a lack of transparency. It also lacked any meaningful listing standards for the issuers of securities traded in this market. Initially, Nasdaq was merely a system within the OTC market that publicly displayed representative quotes for certain securities.[205] Dealers could disseminate bid and offer quotes for securities, but were not obligated to execute orders.[206] All actual transactions were agreed upon through telephone communications.

Since its inception in 1971, Nasdaq has taken significant steps in automating OTC market-making and increasing the efficiency and transparency of the OTC market. For example, in 1981, Nasdaq introduced its first automatic execution system, the Computer Assisted Execution System (CAES),[207] which allows market-makers to enter quotes that are automatically executed. Shortly thereafter, in 1984, Nasdaq introduced another automatic execution system, the Small Order Execution System (SOES),[208] to make it easier for small investors to obtain best execution of their orders. In 1990, Nasdaq introduced a third order execution system, SelectNet, which is designed to permit broker-dealers to negotiate transactions through Nasdaq terminals instead of the telephone.[209] Most recently, Nasdaq introduced "SuperMontage," a new order collector, display facility, and trading platform, which was approved by the SEC in 2000.[210] According to some commentators, SuperMontage will significantly enhance transparency in Nasdaq securities by offering NASD members the option of displaying limit orders at additional price levels away from the top of the book (i.e., the inside quote).[211]

With these technological initiatives, Nasdaq's trading volume has grown exponentially over the past two decades. Indeed, by 1994, Nasdaq surpassed the NYSE in annual share volume.[212] Likewise, as of December 2001, almost 5,100 companies traded their securities on Nasdaq, more than two times the 2,500 OTC securities that Nasdaq included for quotation when it commenced trading in

204. *See* NASDAQ, NOT THE OTC, *available at* http://www.nasdaqnews.com/about/backgrnd/page1a.html.

205. *Id.* Indeed, Nasdaq arose out of a study conducted by the SEC in the early 1960s. The study, which was released in 1961, recommended the development of an automated system to address fragmentation in the OTC market.

206. THE NAT'L ASS'N OF SEC. DEALERS, INC., HISTORY OF THE NASD, *available at* http://www.nasd.com/corpinfo/co_ove_histr.html.

207. *See* Intermarket Trading System, Exchange Act Release No. 18,713, 47 Fed. Reg. 20,413, 20,413 (May 6, 1982).

208. HISTORY OF THE NASD, *supra* note 206.

209. *Id.*

210. Self-Regulatory Organizations, Exchange Act Release No. 43,863, 66 Fed. Reg. 8020, 8021 (Jan. 19, 2001) [hereinafter SuperMontage Release].

211. Letter from Mark B. Sutton, Chairman, SIA Market Structure Committee, to The Honorable Arthur Levitt, Chairman, Securities and Exchange Commission (Oct. 16, 2000), *available at* http://www.sia.com/2000_comment_letters/pdf/limit_order_transparency.pdf.

212. NASDAQ, EVOLUTION OF NASDAQ, *available at* http://www.nasdaqnews.com/about/backgrnd/page1a.html.

1971.[213] Today, the NYSE and Nasdaq[214] are the primary markets for trading U.S. equities. Accordingly, based on market value and dollar volume, Nasdaq is the second largest securities market after the NYSE.[215] Indeed, Nasdaq's trading volume dwarfs that of the Amex in terms of both dollar and share volume. As of April 2002, Nasdaq's year-to-date share volume exceeded 148 billion, while the Amex's share volume was less than 5 billion for the same period.[216] It is notable that Amex recently announced that it will permit trading of Nasdaq-listed stocks on its trading floor to provide "access to deep liquidity."[217]

B. Sources of Competition

1. The Proliferation of Alternative Trading Systems

ATSs are electronic trading networks (ECNs) operated as private businesses rather than as SROs. ATSs are not operated as, or affiliated with, SROs. Instead, sponsors operate ATSs as independent for-profit businesses. ATSs currently provide a forum for automated, cheaper trading in a variety of securities, including equities, municipal and government securities, corporate debt and options. In addition to the types of securities traded, these systems vary in the trading approaches they use. For example, systems such as Instinet, Island and Bloomberg Tradebook allow users to enter firm orders at specific prices and execute those orders automatically against other orders that have been entered. Crossing systems, such as those operated by Instinet and POSIT, allow investors to enter orders to execute against corresponding orders at prevailing market prices.[218] However,

213. As of April 2002, the Nasdaq National Market included about 5,100 securities while the Nasdaq SmallCap Market, included just over 1,400 issues. *See* NASDAQ, THE NASDAQ SMALLCAP MARKET *available at* http://www.nasdaqnews.com/about/backgrnd/page1a.html.

214. Today, Nasdaq consists of two distinct separate markets, the Nasdaq National Market and the Nasdaq SmallCap Market. The Nasdaq SmallCap Market is the smaller capitalization tier of Nasdaq and, accordingly, the financial criteria for listing are not as stringent as for the Nasdaq National Market. The corporate governance standards, however, are the same for the National and SmallCap Markets. Currently, stocks that cannot satisfy the listing requirements of the exchanges or Nasdaq can be traded through the OTC bulletin board. NOT THE OTC, *supra* note 204. In addition, NASD acquired Amex in 1998, which it currently operates as a wholly-owned subsidiary.

215. In April 2002, the NYSE's market value exceeded $11 trillion, while Nasdaq's market value was $2.5 trillion. The Nasdaq Stock Market, *Monthly Market Data, Comparing Three Markets—Nasdaq, NYSE, Amex*, *available at* http://www.marketdata.nasdaq.com/asp/Sec1Summary.asp (last visited June 2, 2002). In that month, the NYSE's dollar volume was about $932 billion, while Nasdaq's dollar volume was about $705 billion. *Id.* The Amex's dollar volume, in contrast, was less than $52 billion. *Id.*

216. *Id.*

217. News Release, Amex, Six Leading Wall Street Firms Commit To Trading Nasdaq Stocks on the American Stock Exchange (Apr. 9, 2002), *available at* http://www.amex.com/atamex/news/press/sn_AmexNasdaq_040902.htm.

218. This Study uses the term "alternative trading system" or "ATS" to refer generally to automated systems that centralize, display, match, cross or execute trading interest, but that are not registered with the SEC as national securities exchanges or operated by a registered securities association. In previous releases, the SEC has referred to trading systems not registered as exchanges as "proprietary trading systems," "broker-dealer trading systems" and "electronic communications networks." Regulation ATS Concept Release No. 38,672, 62 Fed. Reg. 30,485, 30,486 n.1 (May 23, 1997).

ATSs do not list, nor have they expressed any intention to list, issuers or to set corporate governance standards, as exchanges do.

ATSs incorporate features of both traditional markets and broker-dealers. Like traditional markets, they may:

- Centralize trading interest, providing the opportunity for multiple parties to participate in trading;
- Specify time, price, size or other priorities governing the sequence or interaction of orders;
- Provide an opportunity for active price formation (either through interaction of buy and sell interest or through competing dealer quotes);
- Specify material conditions under which participants may post quotations or trading interest (such as requiring participants to maintain firm, two-sided or continuous, quotes);
- Create mechanisms for enhancing liquidity, such as giving certain participants special privileges in exchange for assuming market obligations; and
- Impose "non-discretionary" trading rules on order interaction (e.g., time and price priority).[219]

Like traditional broker-dealers, however, ATSs are proprietary and may maintain trading desks to facilitate participant trading.[220] Increasingly, market participants have used ATSs as the functional equivalents of the self-regulated markets. In its adopting release on Regulation ATS, the SEC discussed this trend, noting that "[o]ver time, [ATSs] may become the primary market for some securities."[221]

Notwithstanding the indisputable status of the NYSE and Nasdaq as the largest markets for U.S. securities, over the past decade ATSs have presented an increasing competitive challenge to the self-regulated markets. In particular, advancements in technology have fueled this growth. In 1994, the SEC's Division of Market Regulation reported that ATSs accounted for 13 percent of the volume in Nasdaq securities and 1.3 percent of the trading volume in NYSE-listed securities.[222] Four years later, in 1998, ATSs accounted for more than 20 percent of orders for Nasdaq securities and almost 4 percent of orders for exchange-listed securities.[223] By 2000, these systems attracted approximately 30 percent of Nasdaq's business.[224] According to Nasdaq's market data, in January 2001, ECNs accounted for 39.9 percent of Nasdaq trading volume and 28.5 percent of Nasdaq's share volume. Just one year later, in January 2002, ECNs accounted for 53 percent of Nasdaq's

219. *Id.* at 30,486.

220. *Id.*

221. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40,760, 63 Fed. Reg. 70,844, 70,845 (Dec. 8, 1998) [hereinafter Regulation ATS Release].

222. *See* MARKET 2000 STUDY, *supra* note 189, at App. IV.

223. *See generally* Regulation ATS Release, 63 Fed. Reg. at 70,844.

224. *See* Disclosure of Order Execution and Routing Practices, Exchange Act Release No. 43,590, 2000 SEC LEXIS 2518, at *9 (Nov. 17, 2000) [hereinafter Order Disclosure Release].

trading volume and 35.1 percent of its share volume.[225] In addition to gaining an increased share of trading volume, ATSs have proliferated in number. In 1991, the SEC was aware of only a few alternative systems.[226] By 1997, more than 140 broker-dealers had notified the SEC that they operated some form of ATS.[227] Currently, ATSs execute an increasing percentage of the total volume of trades executed in Nasdaq and NYSE securities; however the incursion into NYSE shares has been relatively limited.[228]

ATS trading innovations have had an impact on the U.S. markets, particularly on the cost of transacting by institutional investors. In the words of then SEC Chairman Levitt:

> Electronic communication networks have been one of the most important developments in our markets in years—perhaps decades. But exactly what are ECNs, and what are we to make of their impact on our markets? In simplest terms, ECNs bring buyers and sellers together for electronic execution of trades. They have provided investors with greater choices, and have driven execution costs down to a fraction of a penny. As a result, these networks present serious competitive challenges to the established market centers. More fundamentally, they illustrate the breath-taking pace of change that results when technology and competition coalesce.[229]

Given this success, even more recently, several buy-side market participants have begun to create their own proprietary trading systems, which could further challenge the traditional market structure.[230]

Among other things, the recent explosion of volume in Nasdaq securities traded via the ATSs raises the question as to whether the current uniformity of listing standards may break down over time. Unlike self-regulated market centers, ATSs do not set "listing" standards for issuers whose securities trade in their markets. While ATSs limit trading to securities listed on an exchange, they do not evaluate and accept issuers or enforce qualitative or quantitative listing standards.[231] As

225. These statistics provide estimated counts of Nasdaq trading activity occurring on ECNs and reported to Nasdaq. These estimates are drawn from Nasdaq trade report information submitted by ECNs, their customers, and counterparties. *See* THE NASDAQ STOCK MARKET, INC., NASDAQ MARKET DATA, *available at* http://www.marketdata.nasdaq.com/asp/MpECNMonth.asp.

226. *See generally* Regulation ATS Release, 63 Fed. Reg. at 70,844.

227. *See* Regulation ATS Concept Release No. 38,672, 62 Fed. Reg. 30,485, 30,489 n.14 (May 23, 1997).

228. These volume statistics represent trades in securities, whereby each trade accounts for a buy and sell of a security.

229. SEC Chairman Arthur Levitt, Dynamic Markets, Timeless Principles, Remarks at Columbia Law School (Sept. 23, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch295.htm. Note that Chairman Levitt refers to electronic communications networks, or ECNs, which are ATSs into which, under the SEC's Order Execution Rules (Rules 11Ac1-1 and 11Ac1-4 under the Exchange Act), market-makers and exchange specialists are permitted to insert quotations anonymously at better prices and/or larger sizes than their published quotations without updating their own published quotations.

230. *See, e.g.*, Rich Blake & Justin Schack, *The Buy Side Wakes Up*, INSTITUTIONAL INVESTOR, Apr. 2002, at 58; *see also* Thomas G. Donlon, *A New Law of Large Networks*, BARRONS, May 6, 2002, at 50.

231. Regulation ATS Concept Release No. 38,672, 62 Fed. Reg. 30,485, 30,507 n.130 (May 23, 1997).

ATSs gain market share, an increasing number of shares may trade in markets that are neither required to impose, nor have any interest in imposing, substantive corporate governance standards.

Given that the Exchange Act, when adopted in 1934, did not envision the variety of alternative trading systems that currently provide services traditionally provided by the self-regulated markets and the 1975 Amendments did not fully integrate ATSs into the national market system, a regulatory response to the increasing significance of ATSs as alternative market centers was required. Accordingly, in 1998, the SEC adopted Regulation ATS to establish a regulatory framework for ATSs and more fully integrate them into the national market system.[232]

In its release adopting Regulation ATS, the SEC noted that, although ATSs are markets, the SEC historically regulated them as traditional broker-dealers, resulting in certain regulatory gaps.[233] Specifically, for ATSs with significant trading volume, a traditional broker-dealer regulatory approach did not provide investors with access to the best prices, failed to provide a complete audit trail or adequately surveil trading on alternative trading systems, and created the potential for market disruption due to system outages.[234] By adopting Regulation ATS, the SEC sought to close these regulatory gaps.

Under Regulation ATS, most ATSs must choose whether to register as a broker-dealer pursuant to section 15 of the Exchange Act and comply with Regulation ATS or register as a national securities exchange under section 6 of the Exchange Act and undertake the many self-regulatory functions that accompany exchange registration (e.g., Island or Archipelago Exchange).[235] ATSs that exercise self-regulatory powers, such as regulating its members or subscribers' conduct outside its trading system, must register as an exchange or be operated by a national securities association. Also, if a dominant ATS exceeds certain preestablished volume thresholds, the SEC has authority to determine that it must register as an exchange.

Regulation ATS imposes additional obligations on ATSs that have substantial trading volume, but choose to register as broker-dealers instead of exchanges. For example, if an ATS has 5 percent or more of the trading volume in any exchange-listed or Nasdaq security, it must link with the exchange or Nasdaq and publicly display its best priced orders (including institutional orders) for those exchange-listed securities. In addition, such an ATS must allow members of the registered

232. *Id.* at 30,507 n.130.

233. *Id.* at 30,490.

234. *Id.* at 30,491-94.

235. To date, only two ATSs have indicated a desire to be registered as an exchange. In December 2001, Island indicated that it will file for exchange registration. *See* Isabelle Clary, *Fast-Growing Island Closer To Exchange Filing*, SEC. INDUS. NEWS, Dec. 10, 2001. Archipelago, in contrast, has chosen not to actually apply directly for registration as a national securities exchange, but rather ally itself with the PCX to create a new trading facility. *Id.* On October 25, 2001, the SEC approved the PCX's proposal to create the Archipelago Exchange (ArcaEx), which is the first fully open, fully electronic stock market for NYSE, Amex and Nasdaq equities in the United States. As a facility of the PCX, ArcaEx will be subject to the SEC's oversight and examination. In addition, the PCX will be fully responsible for all activity that takes place through ArcaEx. Persons using ArcaEx will be subject to PCXE rules and securities traded on ArcaEx will be subject to the PCX's listing standards. Self-Regulatory Organizations, Exchange Act Release No. 44,983, 66 Fed. Reg. 55,225, 55,229 (Oct. 25, 2001).

exchanges and Nasdaq to execute against those publicly displayed orders. If an ATS has 20 percent or more of trading volume, it also must ensure that its automated systems meet certain capacity, integrity and security standards. Such an ATS must also refrain from unfairly denying investors access to its systems.[236]

Significantly, ATSs that choose to register as broker-dealers under Regulation ATS, instead of exchanges, are not obligated to impose substantive regulation on traders or the issuers of securities traded in their markets. Also, as more trading moves to ATSs, the importance of the exchanges as sources of liquidity could diminish as could their leverage in imposing corporate governance on issuers. Even if the exchanges remain able to impose such listing standards on issuers as liquidity shifts to ATSs, increased competitive pressure could undermine the desire and ability of these markets to establish and maintain corporate governance listing standards.

2. Other Sources of Competitive Pressure

In addition to competing for order flow with ATSs, the NYSE and Nasdaq increasingly lose order flow to broker-dealers that execute orders in-house (i.e., internalize order flow). Generally, internalization is the routing of orders by a broker to a market-maker that is an affiliate of the broker. In the case of an integrated broker-dealer, internalization occurs where the firm's broker routes customer orders to its market-making desk for execution.[237] Even if internalization increases, however, it will likely not signal the demise of exchange-listing because it depends on independent pricing information.[238]

The OTC market for exchange-listed securities, or the so-called "third market," presents further competition for trading in listed stocks. Third market-makers act much like market-makers in Nasdaq securities, seeking orders of a few thousand shares or fewer in the most active listed stocks from retail firms or discount brokers. In 1989, the third market accounted for 3.2 percent of reported NYSE share volume and 5 percent of reported trade volume.[239] By 1993, third market volume had doubled to 7.4 percent of reported NYSE share volume and 9.3 percent of reported trade volume.[240] More recently, in 2000, the third market accounted for about 8 percent of reported NYSE share volume and about 11 percent of reported trade volume.[241]

236. The fair access requirement only prohibits unfair discrimination among persons seeking access. ATSs may establish fair and objective criteria for participation, such as creditworthiness, to differentiate among potential participants.

237. Self-Regulatory Organizations, Exchange Act Release No. 42,450, 65 Fed. Reg. 10,577, 10,582 (Feb. 23, 2000).

238. Historically, market data on broker-dealer's internalization practices has not been readily available. The SEC's recently adopted rule, Exchange Act Rule 11Ac1-5, however, should make this information more readily available. *See* Order Disclosure Release No. 43,590, 2000 SEC LEXIS 2518, at *22-*23 (Nov. 17, 2000).

239. *See* MARKET 2000 STUDY, *supra* note 189, at 9.

240. *See id.*

241. *See* JB, *Nasdaq Takes Another Step into Listed Arena with ECN Links*, SEC. WK., June 19, 2000, at 3; *see also* Jack Willoughby, *Generation Gap*, INSTITUTIONAL INVESTOR, Feb. 1, 1999 (reporting that "[i]n the first quarter of [1998], third-market trades represented about 16 percent of the trade reports in NYSE and [Amex] stocks, . . . or 6 percent of total dollar volume.").

In addition to the competition presented by third market-makers, the competitive positions of the self-regulated markets are increasingly threatened by the globalization of trading in U.S. securities. Rapid advancements in technology have facilitated the trading of securities around the world. As a result, the securities of hundreds of U.S. companies listed on the NYSE and Nasdaq are traded on foreign stock exchanges.[242] A significant portion of this trading occurs on the London Stock Exchange (LSE).[243] In addition to the LSE, the NYSE and Nasdaq compete for capitalization value with exchanges in Paris, Tokyo and Germany.[244] According to one source, "[t]wenty-five years ago, the companies traded on the NYSE accounted for [about 80] percent of the world's capitalization value."[245] In 2000, the North American region accounted for approximately 50 percent of the world's capitalization value.[246]

In its consideration of the Nasdaq application for registration as an exchange, the SEC has indicated that a precondition to effectiveness of the registration is the creation of a workable alternative display facility, that is, an alternative quotation and transaction reporting facility for NASD members that will permit market-makers to display bids and offers in Nasdaq securities. The facility also will provide a market neutral linkage to the Nasdaq and other marketplaces, but will not provide an execution service. The NASD has filed rules to create such a facility.[247]

Additionally, there is a view that the continuing market evolution has challenged the exchanges' ability to make available the complex arrangement of products and services that they have traditionally provided to issuers and other market participants. Specifically, many of the services exchanges have historically been in a unique position to provide—including clearing and settlement, market oversight and regulation, brand recognition and market liquidity—are being increasingly provided by other market participants. How well the exchanges will be able to react to this evolution, and maintain their market share by continuing to list issuers and execute trades, may help determine the continuing effectiveness of exchanges in establishing corporate governance standards.[248]

242. *See* MARKET 2000 STUDY, *supra* note 189, at II-7.

243. *See id*; *see also* LONDON STOCK EXCHANGE, SECONDARY MARKET FACT SHEET (Dec. 2001), *available at* http://www.londonstockexchange.com/market/pdfs/Fsto0112.pdf; *see also* Sylvia Ascarelli & Kate Kelly, *Nasdaq, London Stock Markets Revive Talks of Possible Merger*, WALL ST. J., Apr. 25, 2002, at C12 (Nasdaq and the London Stock Exchange (LSE) have been considering a merger of equals to permit trading of U.S. securities in Europe).

244. *See* NASDAQ, NASDAQ IN BLACK AND WHITE, SECTION 3: GLOBAL RANKING (2001), *available at* http://www.nasdaq.com/about/black_white.stm.

245. Noelle Knox, *NYSE Expects More Foreign Stocks*, AP ONLINE, Jan. 13, 1999; *see also* Len A. Costa, *They List in the United States But Trade at Home*, FORTUNE, July 5, 1999, at 198.

246. *See* INT'L. FED'N OF STOCK EXCHS., EVOLUTION OF MARKET CAPITALIZATION BY TIME ZONE 73, *available at* http://www.fibv.com (North America represented 51.9 percent of the market capitalization in a comparison of the ten largest stock markets in the world).

247. *See generally* Self-Regulatory Organizations, Exchange Act Release No. 45,156, 67 Fed. Reg. 388 (Dec. 14, 2001); Self-Regulatory Organizations, Exchange Act Release No. 45,501, 2002 SEC LEXIS 500 (Mar. 4, 2002).

248. *See, e.g.*, Jonathan R. Macey & Maureen O'hara, *Globalization, Exchange Governance, and the Future of Exchanges*, *in* BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 1 (Robert E. Litan &

C. Demutualization

In its adopting release to Regulation ATS, the SEC laid the groundwork for demutualization by expressing its view that registered exchanges may structure themselves as for-profit organizations and that currently registered exchanges, which are all membership organizations, could choose to demutualize by becoming for-profit entities.[249] Shortly thereafter, responding to competitive pressures from alternative market centers and abroad, both Nasdaq and the NYSE announced plans for public offerings that would make them for-profit entities.[250] Although the NYSE subsequently reconsidered its plan to demutualize, the NASD has proceeded with demutualization. By 2000, the NASD had sold approximately 40 percent of Nasdaq to investors in a private placement of securities.[251] The NASD completed a second private placement of shares in Nasdaq in January 2001, and has committed to divest itself of its remaining shares of Nasdaq.[252]

Since the NASD first announced its plans to demutualize the Nasdaq market, controversy has hampered Nasdaq's efforts to become a for-profit exchange. As early as 1999, when the demutualization plans were first announced, then SEC Chairman Levitt cautioned that the possibility of for-profit exchanges raises a number of questions and some concerns, including "how . . . conflicts of interest might change or grow in a for-profit environment."[253] Given these conflicts of interest, Chairman Levitt concluded in testimony before the Congress, "At a minimum, there must be strict corporate separation of the self-regulatory role from the marketplace it regulates[,]"[254] a view that was shared by other commentators.[255]

Anthony M. Santomero eds., 1999); Jonathan R. Macey & Maureen O'hara, *Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective*, 28 J. Legal Stud. 17 (1999); *see also* Ruben Lee, What is an Exchange? (Oxford University Press 1998).

249. *See* Regulation ATS Release No. 40,760, 63 Fed. Reg. 70,844, 70,880 (Dec. 8, 1998) (stating that the SEC "believes that it is possible for a for-profit exchange to meet the standards set forth in Section 6(b) of the Exchange Act").

250. *See* New York Stock Exchange, Inc. Chairman and Chief Executive Officer Richard A. Grasso, Statement at Senate Banking Committee Hearing on Public Ownership of the U.S. Stock Markets (Sept. 28, 1999), *available at* http://www.nyse.com/speech/NT000245A2.html (discussing the NYSE's contemplation of demutualization and the benefits and implications of for-profit status). In May 2000, the Pacific Stock Exchange became the first U.S. stock exchange to demutualize part of its business. *See* Self-Regulatory Organizations, Exchange Act Release No. 42,759, 2000 SEC LEXIS 928 (May 5, 2000).

251. *See* Press Release, Nasdaq, Nasdaq Completes the First Phase of its Private Placement (June 28, 2000), *available at* http://www.nasdaqnews.com/new/pr2000/ne_section.html (last visited June 2, 2002).

252. Self-Regulatory Organizations, Exchange Act Release No. 43,863, 66 Fed. Reg. 8020, 8021 (Jan. 19, 2001). The investors in Nasdaq include all of Nasdaq's largest market-makers, issuers, over 50 percent of its membership, and several large institutional buy-side firms.

253. *Concerning Market Structure Issues Currently Facing the Commission: Hearing Before the Subcomm. on Sec., Comm. on Banking, Hous. & Urban Affairs*, 105th Cong. (Oct. 27, 1999) (statement of SEC Chairman Arthur Levitt), *available at* http://www.sec.gov/news/testimony/testarchive/1999/tsty2599.txt.

254. *See id.*

255. *See, e.g.*, Comment Letter from Bloomberg L.P. and Bloomberg Tradebook LLC, to Jonathan Katz, Secretary, Securities and Exchange Commission (Aug. 28, 2001), *available at* http://www.sec.gov/rules/other/10-131/foley1.htm (arguing that if the SEC permits Nasdaq to become a demutualized exchange Nasdaq "will owe duties to its shareholders, primarily driven by a desire to increase profits and maximize share value, and under the Exchange Act it will owe duties to its members and to investors.").

Taking into consideration these views, demutualization by the self-regulated markets could exacerbate concerns about the ability or willingness of self-regulated markets to continue to develop and maintain high listing standards. Traditionally, such concerns about self-regulation have been tempered by the argument that SROs have strong incentives to preserve their reputations as fair and prestigious markets through requirements such as corporate governance listing standards.[256] However, where such standards are unpopular with an SRO's listed issuers, they could present a distinct challenge to markets operating as for-profit entities.

Nevertheless, Nasdaq has made an application to the SEC for registration as a national securities exchange, which is currently pending.[257] Approval of the application (and, consequently, Nasdaq's demutualization) has been conditioned by the SEC on various factors, including (i) the separation in ownership of Nasdaq's for-profit market functions (e.g., the listing and delisting of issuers) from its self-regulatory functions (e.g., the regulation of members) and (ii) the creation by the NASD of a residual OTC (ROTC) market to replace Nasdaq as a market for unlisted securities. As of this date, Nasdaq has entered into a long-term contract with the NASD to provide Nasdaq with self-regulatory services after demutualization is complete. Whether these demands and others will sufficiently guard against the potential conflicts of interest arising from the establishment of a for-profit securities exchange is yet to be seen.

SECTION IV. GOVERNANCE REGULATION AND PRACTICES OUTSIDE THE UNITED STATES

This section compares certain systemic differences between the U.S. hybrid system of regulation and corporate governance listing standards with the corporate governance regimes in seven other jurisdictions: the United Kingdom, Germany, Poland, Japan, Malaysia, South Korea and Brazil. In each of these countries, corporate governance standards are derived from four potential sources: corporate law, securities law, voluntary corporate governance codes and listing standards.

A. Contextual Differences

1. Concentrated Ownership and Control

In many foreign jurisdictions, corporate ownership is much more highly concentrated than in the United States. In much of Europe outside the United King-

256. *See* Karmel, *supra* note 75, at 329-30.

257. Presently, because Nasdaq is operated by the NASD, it is exempt from the definition of exchange and does not require registration as a national securities exchange under section 6 of the Exchange Act. Accordingly, the SEC must approve Nasdaq's application as a national securities exchange before Nasdaq can be fully divested from the NASD. Although Nasdaq submitted its application for such registration to the SEC on November 9, 2000, it was incomplete; Nasdaq's completed application was officially filed on March 15, 2001. *See* The Nasdaq Stock Market, Inc.; Notice of Filing of Application for Registration as a National Securities Exchange Under Section 6 of the Securities Exchange Act of 1934, Exchange Act Release No. 44,396, 2000 SEC LEXIS 1097, at *1 n.2 (June 7, 2001) [hereinafter Notice of Filing of Nasdaq's Application Release].

dom, large banking institutions combine their direct stockholdings with those of investment companies controlled by them and holdings voted on behalf of their brokerage customers to exert great influence over corporate managers.[258] In many Asian jurisdictions, corporations are characterized by family ownership (e.g., Korean *chaebols*) or by a parent-subsidiary structure using cross-shareholding among conglomerate members (e.g., Japanese *keiretsu*).[259] Government ownership of large blocks of shares, even after privatization, can also be found in a number of jurisdictions.[260]

2. Capital Raising

Whereas U.S. corporations tend to "collect capital directly from the public" through the financial markets, their European and Asian counterparts "collect capital primarily through banks."[261] In such foreign jurisdictions, contractual lending arrangements and highly concentrated ownership give banks the ability to monitor and control corporate managers beyond that of the relatively dispersed U.S. shareholders which are in a market-based corporate governance system.[262]

3. Culture

In many foreign jurisdictions, the corporation as a vehicle primarily for the benefit of the shareholders is superseded by broader notions of the corporation's relationship to society and the need to balance the interests of other stakeholders, including employees, suppliers, customers and the public. As a result, many non-U.S. corporate governance codes include stakeholder provisions that call on corporate managers to take these varied interests into account in corporate decision making.[263] Related to this emphasis on stakeholders is the "relational" nature of Asian culture, in which loyalty to friends and family is highly valued. Insiders, which may include managers, employees, creditors, suppliers, customers and even regulators, are required to keep strictly confidential the internal affairs of the

258. *See* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 340 (2001); THE CONTROL OF CORPORATE EUROPE (Fabrizio Barca et al. eds., 2001); Gustavo Visentini, *Compatibility and Competition Between European and American Corporate Governance: Which Model of Capitalism?*, 23 BROOK. J. INT'L L. 833, 836-37 (1998).

259. *See* Stijn Claessens et al., *Who Controls East Asian Corporations–and the Implications for Legal Reform*, PUBLIC POLICY FOR THE PRIVATE SECTOR, Sept. 1999, at 2, *available at* http://www.worldbank.org/html/fpd/notes/195/95claes.pdf; HONG KONG SOCIETY OF ACCOUNTANTS, 1997 CORPORATE GOVERNANCE REPORTS (1998); *see also* Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

260. In Singapore, as of the end of the 1980s, companies representing approximately 69 percent of the assets and 75 percent of the profits of the Singaporean public market were government linked companies (GLCs), in which the government directly or indirectly owned or controlled up to 70 percent of the stock. Mak Yuen Teen & Phillip H. Phan, CORPORATE GOVERNANCE IN SINGAPORE: CURRENT PRACTICE AND FUTURE DEVELOPMENTS (1999) (prepared for the Organization for Economic Cooperation and Development (OECD) Conference on "Corporate Governance in Asia: A Comparative Perspective" held in Seoul from Mar. 3-5, 1999). Throughout the 1990s, the 70 percent ownership was reduced through privatization; however, it remains in excess of 50 percent. *Id.*

261. *See* Visentini, *supra* note 258, at 836-37.

262. Each of these systems has its weaknesses, as recent corporate failures have made clear.

263. *See infra* note 264 and accompanying text (description of corporate governance codes).

unit. Conflicts within the unit are resolved internally and confidentially through arbitration, and disclosures of internal information to outsiders is regarded as a betrayal of the unit's interests. Such tendencies help explain the historical lack of independent directors and inadequate disclosure practices of many Asian corporations.[264]

4. Legal System

Systemic differences among legal systems also present important contextual differences. For example, compliance with corporate governance standards when taking fundamental corporate actions in many European civil law jurisdictions requires prior court approval, whereas compliance in common law jurisdictions is often enforced retrospectively through litigation. In Asia, there is often only limited development of certain Anglo-American corporate governance concepts, such as the fiduciary duties of directors,[265] and the government typically regulates public corporations heavily. Corporate governance listing standards are largely nonexistent outside the United States.

B. Comparative Analysis of Foreign Jurisdictions

The following summary and table compare NYSE qualitative listing standards with those in the United Kingdom, Germany, Poland, Japan, Malaysia, South Korea and Brazil.

1. Audit Committees

Outside the United States, audit committee requirements are generally included in nonbinding corporate governance codes. The U.K. Combined Code recommends that each U.K. listed company establish an audit committee consisting of at least three directors, a majority of whom should be "independent non-executive directors." The German Cromme Commission Code recommends that companies establish an audit committee consisting of supervisory board members. The Revised Japanese Corporate Governance Principles recommend that an audit committee be created within a company's board of directors and be comprised of majority of non-executive directors.[266] Once this takes place, companies would be allowed to eliminate the statutory board of auditors.[267] The Kuala Lumpur

264. Organization for Economic Cooperation and Development, A Consolidated Report on Corporate Governance and Financing in East Asia 4-5 (2000).

265. *See* Cally Jordan, Corporate Governance in Asia and the Asian Financial Crisis: Evidence of the Impact and Current Trends 5 (1999) (quoting from a recent OECD conference, "To drop a concept such as the fiduciary duty of directors into a legal system which does not have the trust as an underlying fundamental legal institution . . . is dropping the concept into the void.").

266. Japan Corp. Governance Comm., Revised Corporate Governance Principles 14 (2001), *available at* http://www.ecgi.org/codes/country_documents/japan/revised_corporate_governance_principles.pdf. These Principles have not yet been adopted by the Tokyo Stock Exchange.

267. This would require a change in the commercial code that currently requires a Board of Statutory Auditors. Alternative proposals would expand the independence of the Board of Statutory Auditors.

Stock Exchange Revamped Listing Requirements were issued in 2001 and require listed companies to establish audit committees comprised primarily of independent directors, with one member to be a qualified Malaysian accountant.[268] The Korean Code of Best Practice recommends that boards establish and maintain an audit committee consisting of at least three directors, two-thirds of whom (including the chairperson) should be "outside directors" and at least one of whom should be a person "possessing professional knowledge of auditing."[269] Audit committees are not addressed by any source of governance standards in either Poland or Brazil.

2. Shareholder Approval

The NYSE and Nasdaq require shareholder approval for certain issuances of securities that are not generally required with state corporate law. In jurisdictions outside the United States, shareholder approval requirements are generally addressed solely in the corporation law. The U.K. Companies Act requires U.K. companies to grant preemptive rights to its shareholders upon any issuance of equity for cash. A majority of shareholders can waive these rights with respect to a specific issuance or at an annual meeting with respect to a specific kind of issuance (e.g., acquisitions). Additionally, the U.K. Financial Services Authority (FSA) listing rules require shareholder approval of all option plans and stock issuances to insiders.

In Germany, the Stock Corporation Act (SCA) requires shareholder approval prior to stock issuances. Furthermore, the SCA grants all shareholders automatic preemptive rights upon all share issuances, which rights can be waived only by a two-thirds vote of shareholders. The SCA also recommends general shareholder approval for a "contingent capital increase" to issue options or shares to directors and employees as future compensation.

The Polish Commercial Code, the South Korean Commercial Code and the Brazilian Corporation Law each permits boards to issue shares freely up to a company's authorized capital without shareholder approval. In all three jurisdictions, however, shareholder approval is required to increase a company's authorized capital.[270] The Polish Commercial Code also grants all shareholders automatic preemptive rights upon new issuances of shares, which rights can be waived only by a vote of 80 percent of the votes cast at a shareholders' meeting.[271]

The Korean Securities and Exchange Act requires specific shareholder approval of option plans. The Korean Best Practice Code recommends that "shareholders

268. KUALA LUMPUR STOCK EXCHANGE, LISTING REQUIREMENTS § 15.10 (2001), *available at* http://www.klse.com.my/website/documents/KLSE_ListReq2001.pdf.

269. SOUTH KOREAN COMM. ON CORP. GOVERNANCE, CODE OF BEST PRACTICES FOR CORPORATE GOVERNANCE § III.1.2 (1999) [hereinafter SOUTH KOREAN CODE OF BEST PRACTICES].

270. The Polish Commercial Code limits the amount of shares a company can authorize but not issue to 75 percent of the outstanding share capital. *See* THE POLISH CODE OF COMMERCIAL PARTNERSHIPS AND COMPANIES arts. 444, 448 (Warsaw 2001).

271. The Polish Commercial Code permits the waiver of preemptive rights with respect to a specific share issuance or as part of the authorization of additional capital. *See id.* arts. 433, 447 (Pol.).

TABLE: Corporate Governance Standards in Comparative Perspective

	United States[1]	United Kingdom[2]	Germany[3]	Poland	Japan	Malaysia	South Korea	Brazil
Corporate Governance Listing Standards	Annual Meetings Audit Committee Classified Boards Consents Defensive Tactics Insider Stock Purchases Quorums Redemption and Tender Offers Related Party Transactions Shareholder Approval Special Rights of Certain Shareholders Voting Rights	None	None	None	Disclosure Related Party Transactions	Audit Committee Independent Directors Disinterested Shareholders Related Party Transactions	None	Novo Mercado Classified Boards Insider Stock Purchases Redemption and Tender Offers Related Party Transactions Voting Rights
Corporate Governance Codes		Audit Committee Insider Stock Purchases Special Rights of Certain Shareholders	Annual Meetings Audit Committee Defensive Tactics Insider Stock Purchases Related Party Transactions Special Rights of Certain Shareholders Voting Rights	None[4]	Audit Committee and Board of Auditors Disclosure Majority of Board Independent Directors Proactive Shareholder Meeting	Independent Directors Remuneration & Nominating Committees Voting Rights	Audit Committee Defensive Tactics Insider Stock Purchases Redemption Voting Rights	None[5]
Securities Law and Regulation		Insider Stock Purchases Related Party Transactions Shareholder Approval (Preemptive Rights & Option Plans)	Insider Stock Purchases Related Party Transactions	Insider Stock Purchases Related Party Transactions	Auditing Principles	Criminal Enforcement Disclosure	Insider Stock Purchases Related Party Transactions Shareholder Approval (Option Plans)	None
Corporation Law		Annual Meeting Redemption and Tender Offers Related Party Transactions Shareholder Approval (Preemptive Rights) Voting Rights	Annual Meeting Redemption and Tender Offers Shareholder Approval Voting Rights	Annual Meeting Redemption and Tender Offers Shareholder Approval (Preemptive Rights) Voting Rights	Accounting Principles Board of Statutory Auditors Independent Directors	Directors' Duties Disclosure Related Party Transactions Shareholder Approval Voting Rights	Redemption and Tender Offers Voting Rights	Annual Meetings Redemption and Tender Offers Related Party Transactions Shareholder Approval

1. In the United States, many of the matters listed above under corporate governance listing standards also involve state corporate law, U.S corporate codes of best practice and federal securities law. The overlapping and/or additional substantive standards, some of which are permissive, are not reflected in the Table.
2. Section 12.43A of the U.K. Financial Services Authority's Listing Rules requires listed issuers to disclose the extent of compliance with the U.K. Combined Code and explain any noncompliance. *See* U.K.L.A. Listing Rules, *supra* note 6. Due to the special status of the U.K. Combined Code, the information under corporate governance codes in the United Kingdom refers to the U.K. Combined Code.
3. The newly adopted German Transparency and Disclosure Law requires listed issuers, in their periodic public reports, disclose the extent of compliance with the Cromme Commission Corporate Governance Code and explain any noncompliance. German Corporate Governance Code § 3.10, *available at* http://www.corporate-governance-code.de/eng/kodex/3.html. Due to the special status of the Cromme Commission Code, the information under corporate governance codes in Germany refers to the Cromme Commission Code.
4. Although no completed corporate governance codes have been published in Poland, both the Gdansk Institute for Market Economics and the Warsaw Corporate Governance Forum have recently published draft codes.
5. The only Brazilian corporate governance code, the Brazilian Institute of Corporate Governance Code of Best Practice, does not address any of the matters governed by U.S. corporate governance listing standards.

be allowed to make decisions directly on issues which carry weighty influence on the corporation's very existence and the rights of shareholders."[272]

In Japan, the Corporate Governance Principles call for a more proactive role for shareholder meetings. Historically, most Japanese companies held their shareholder meetings on the same day, significantly reducing attendance; the Principles would change that.[273] In Japan, shareholder activism is a recent phenomenon; Japanese institutional investors are only now beginning to vote their shares.

The listing rules of the Kuala Lumpur Stock Exchange were recently amended to require approval by a majority of the disinterested shareholders of related party transactions of a certain size.[274] The Malaysian Companies Act requires shareholder approval for the disposal of property to directors and for the issuance of shares to directors.[275]

3. Voting Rights

The U.K. Companies Act permits the issuance of nonvoting or restricted voting ordinary and preference shares without limitation, unlike the NYSE and Nasdaq. Although the U.K. Combined Code does not address voting rights, other U.K. governance codes[276] recommend that all ordinary shares have equal voting rights. Neither of these codes, however, is incorporated into the comply or explain regulatory framework applicable to companies listed on the LSE (or other relevant U.K. exchange).

While the German Stock Corporation Act permits the issuance of nonvoting preferred shares, it mandates a one share, one vote rule for ordinary shares. The German Cromme Commission Code also states that each share should carry one vote and that there should be no shares with multiple voting or preference voting rights.

The Polish Commercial Code also permits the issuance of nonvoting preferred shares but mandates a one share, one vote rule for ordinary shares of public companies. Similarly, the Korean Commercial Code permits the issuance of nonvoting preferred shares, but mandates a one share, one vote policy for common shares. The Code of Best Practice supplements the Korean Commercial Code by recommending that all shares have equal voting rights (notwithstanding the provision permitting the issuance of nonvoting preferred shares) absent extenuating circumstances. The principle of one share, one vote has also been established in Malaysia and Japan.

272. SOUTH KOREAN CODE OF BEST PRACTICES, *supra* note 269, § I.1.2.

273. JAPAN CORP. GOVERNANCE COMM., CORPORATE GOVERNANCE PRINCIPLES: A JAPANESE VIEW (FINAL REPORT) 53 (1998), *available at* http://wb-cu.car.chula.ac.th/papers/corpgov/cg073.taf.

274. KUALA LUMPUR STOCK EXCHANGE, LISTING REQUIREMENTS, *supra* note 268, § 10.08.

275. Malaysian Companies Act of 1965 §§ 132C, 132D (2000).

276. *See* WEIL, GOTSHAL & MANGES LLP, EUROPEAN COMM'N, INTERNAL MKT. DIRECTORATE GEN., DISCUSSION OF INDIVIDUAL CORPORATE GOVERNANCE CODES RELEVANT TO THE EUROPEAN UNION AND ITS MEMBER STATES, ANNEX IV, 247-50, 258-62 (2002) (prepared in consultation with the European Ass'n of Sec. Dealers & the European Corporate Governance Network), *available at* http://www.europa.eu.int/comm/internal_market/en/company/company/news/corp-gov-codes-rpt_en.htm (PIRC Shareholder Voting Guidelines and Hermes Statement).

The issuance of shares with disparate voting rights is permitted under the Brazilian Corporation Law; however, listing on the Novo Mercado requires adherence to a covenant not to issue nonvoting shares.

4. Other Standards

While none of these jurisdictions has laws similar to the NYSE listing standard against granting special rights to certain shareholders, the U.K. Combined Code, the German Cromme Commission Code and the Korean Code of Best Practice each identifies the importance of not disenfranchising shareholders as a fundamental policy. While the securities law of each of the jurisdictions includes the regulation of insider trading, the Korean Code of Best Practice supplements Korean law in stating that "[s]hareholders shall be protected from unfair conduct[ ] of insider trading and self-dealing."[277] Likewise, the U.K. Combined Code and the German Cromme Commission Code include general principles regarding the duties of directors and officers that preclude insider trading and guard against other conflicts of interest. The Brazilian Corporation Law has recently broadened minority shareholder rights for both existing and newly issued preferred shares, including caps on the issuance of nonvoting preferred shares, the right of preferred shares to receive dividends or to receive tagalong rights in a change of control event.[278]

The U.K. Companies Act, the German Securities Trading Act, the South Korean Securities and Futures Commission regulations, the Polish Securities Law, the Malaysian Companies Act and the Brazilian Securities Commission Law require the disclosure of transactions with related parties. In the United Kingdom, the FSA listing rules provide that, subject to certain exceptions, any transaction with a substantial shareholder or a director must be negotiated at arm's length, consummated at market terms and approved by disinterested shareholders not party to the transaction.[279] The German Panel Code recommends that all related party transactions be negotiated at arm's length, consummated at market terms approved by disinterested members of the supervisory board and suggests that companies establish precautionary procedures regarding possible insider trading and self-dealing by supervisory and management board members. The Tokyo Stock Exchange prohibits certain related party transactions and has strengthened its disclosure requirements. The Malaysian Companies Act has provisions preventing certain types of self-dealings by directors.[280] The South Korean Best Practice Code supplements the disclosure requirement of Korean law by stating that, "Shareholders shall be protected from unfair conduct[ ] of insider trading and self-

277. SOUTH KOREAN CODE OF BEST PRACTICES, *supra* note 269, § I.2.3.

278. Namrata Savoor, *Amendments to Brazilian Corporation Law Enhance Minority Shareholder Rights*, INT'L. SEC. OUTLOOK, Apr. 22, 2002, at 4.

279. *See* FIN. SERVS. AUTH., LISTING RULES § 11.4 (2000).

280. Malaysian Companies Act §§ 132E-132G, 133, 133A (2000). The Listing Requirements of the Kuala Lumpur Stock Exchange also requires disclosure of, in certain instances shareholder approval of, related party transactions. KUALA LUMPUR STOCK EXCHANGE, LISTING REQUIREMENTS, *supra* note 268, § 10.08.

dealing."[281] Finally, the Brazilian Corporation Law imposes an additional duty on controlling shareholders not to abuse control positions to the detriment of other shareholders through transactions with the corporation.

With respect to defensive tactics, the German Cromme Commission Code echoes the corresponding NYSE listing standard in stating that shareholders should decide whether to accept or reject acquisition offers and that defensive tactics should be taken only after consideration of the best interests of shareholders. Similarly, the Korean Code of Best Practice advises directors not to engage in defensive tactics that "involve sacrificing the profit of corporations and shareholders to maintain corporate control for only some shareholders or management."[282] No other sources in any of the other jurisdictions analyzed address standards applicable to defensive tactics in contests for corporate control.[283]

In each of the jurisdictions (except South Korea), corporation law requires that annual meetings be held, while no source in any of the jurisdictions analyzed imposes special quorum requirements or places restrictions on the classification of boards of directors. Similarly, in none of the jurisdictions does corporation law provide public companies with a mechanism for obtaining shareholder consents in lieu of a shareholders' meeting, effectively prohibiting this practice. Corporation law in each of the jurisdictions regulates the extent to which companies can redeem or repurchase shares.

C. Sources of Corporate Governance Standards

Corporate governance standards are derived from four potential sources: corporate law, securities law, voluntary corporate governance codes and listing standards. The determination as to which source is used, and where it places emphasis, is a function of the particular conditions within each country. In many of the Asian countries, for example, where transparency and protecting the rights of individual minority shareholders were not historically viewed as essential, significant pressure for change is coming from the governments.[284] In the United States, this historically has in part been the responsibility of the exchanges (through their listing standards). A table of specific sources of foreign corporate governance standards is attached as Annex D.

281. South Korean Code of Best Practices, *supra* note 269, § I.2.3.

282. *Id.* § V.1.2.

283. The U.K. City Code on Takeovers and Mergers (Takeover Code), however, is an additional source of guidance for public companies engaging in change of control transactions and includes recommendations relating to defensive tactics. Although the Takeover Code is not binding law, U.K. companies almost uniformly follow the rules proscribed therein when engaging in such transactions. *See* The Panel on Takeovers and Mergers, The City Code on Takeovers and Mergers and The Rules Governing Substantial Acquisitions of Shares (6th ed. 2000).

284. The Conference Board, Corporate Governance: Global Trends Examined From an Asian Perspective 12 (2001). Outside pressure from the World Bank and the OECD, together with the Asian Financial Crisis, contributed to the pace of change in Asia.

1. Corporate Laws and Securities Laws

While corporate laws and securities laws are wide in scope and establish a range of regulatory requirements, they often are permissive, particularly when corporate managers make a decision in the exercise of their business judgment or shareholders approve a particular action. In addition, at least two European Community (EC) directives require that EC Member States amend their national laws to harmonize certain listing requirements.[285]

2. Corporate Governance Codes

Corporate governance codes have become nearly universal as a source of non-binding governance standards.[286] Because corporate governance codes have no legal force they do not require corporate managers to comply with the specified governance practices. They are generally issued by bodies that are not regulatory in nature, including government commissions; stock exchange committees; business, industry and academic associations; and director and investor groups.

The U.K. Cadbury Report in 1992 was one of the first corporate governance codes. Today there are close to 100 such codes, and they emanate from every part of the world.[287] While most codes tend to be country-specific, in 1999 the Organization for Economic Co-operation and Development adopted a set of general principles for wide geographic application. The Commonwealth Association for Corporate Governance and the International Corporate Governance Network quickly followed with similarly broad statements of corporate governance principles. Many of the guidelines included in these foreign codes address similar issues as those addressed in the NYSE and Nasdaq listing standards. However the foreign codes are much broader in scope.

Foreign corporate governance codes address a broad range of corporate governance matters. For example, each of the U.K. Combined Code, the German Cromme Commission Code,[288] the Japanese Corporate Governance Princi-

285. *See* Council Directive 80/390/EEC, 1980 O.J. (L 100) 1 (Coordinating the Requirements for the Drawing Up, Scrutiny and Distribution of the Listing Particulars To Be Published for the Admission of Securities to Official Stock Exchange Listing, art. 54(3)(g) and 100); Council Directive 79/279/EEC, 1979 O.J. (L 66) 21 (Coordinating the Conditions for the Admission of Securities to Official Stock Exchange Listing, art. 54(3)(g) and 100). These Directives deal with both disclosure requirements and listing standards.

286. For a discussion of corporate governance codes in European Union Member States, see WEIL, GOTSHAL & MANGES LLP, EUROPEAN COMM'N, INTERNAL MKT. DIRECTORATE GEN., COMPARATIVE STUDY OF CORPORATE GOVERNANCE CODES RELEVANT TO THE EUROPEAN UNION AND ITS MEMBER STATES (2002) (prepared in consultation with the European Ass'n of Sec. Dealers & the European Corporate Governance Network), *available at* http://europa.eu.int/comm/internal_market/en/company/company/news/corp-gov-codes-rpt_en.htm.

287. According to the EC Corporate Governance Code Comparative Study, there are currently some 35 documents that constitute corporate governance codes applicable to issuers domiciled in various EU member states. *See id.* at 2.

288. In Germany, as in most civil law countries, companies are governed by a two-tier board structure, consisting of a supervisory board, charged with general strategic oversight of the company's affairs, and a management board (usually consisting entirely of officers), which is responsible with the day-to-day operation of the company.

ples,[289] the Malaysian Code of Corporate Governance (Principles and Best Practices),[290] the Korean Code of Best Practice for Corporate Governance and the Brazilian Code of Best Practice provides guidelines with respect to board composition and practices, a minimum number of directors that can be characterized as independent of management, and any material relationship with the company. Each of these codes makes specific recommendations as to the disclosure to shareholders of information regarding the corporation. Additionally, the U.K. Combined Code provides that specific procedures of remuneration and nominating committees be established; and the Japanese Principles separates the functions of the board of directors from that of executive management. Finally, the Principles and the South Korean Code each includes provisions encouraging management to act in the interest of all corporate stakeholders.[291]

3. Listing Standards

While in Europe exchange-listing agreements do not generally include corporate governance requirements, certain Asian stock exchanges have begun to incorporate corporate governance listing measures into their agreements. For example, in addition to the nonbinding guidelines set forth in the Malaysian Code of Best Practices, the Kuala Lumpur Stock Exchange's listing rules include binding requirements with respect to certain governance matters.[292] The Hong Kong Stock Exchange also requires heightened corporate governance standards.

D. ENFORCEMENT

Compliance with corporate governance standards can be encouraged by aspirational guidelines, the disciplining processes of the marketplace, actions taken by the various exchanges and legal proceedings (civil or criminal). In the United States and abroad, the corporate governance requirements in corporation and securities laws are generally enforceable through legal and/or regulatory action.

289. The Japanese Corporate Governance Principles were adopted by the Corporate Governance Forum of Japan, a corporate and academic non-governmental advisory group. While influential, their goals are aspirational at best. The Principles recommend a number of changes that would be quite significant to corporate Japan.

290. The Malaysian Code of Corporate Governance (Principles and Best Practices), first published in 1999, includes 13 broad principles and 33 best practices. They, in combination with the Listing Requirements of the Kuala Lumpur Stock Exchange, reflect the movement, common to a number of Asian countries, from a merit-based regulatory framework to a disclosure-based framework. While actual compliance with the Malaysian Code is technically voluntary, the listing rules also require companies to make a number of expansive disclosures in their annual reports as to the state of their compliance with the principles and best practices. The presence of these disclosure requirements is (practically) forcing compliance by companies. Failure to make those disclosures or making a false or misleading disclosure can result in serious penalties, including delisting, fines, and jail sentences.

291. For example, the Japanese Principles indicates that directors bear "the important responsibility of coordinating the various interests of all the other stakeholders." CORPORATE GOVERNANCE PRINCIPLES, *supra* note 273, at 46 (Principle 4A). Likewise, the South Korean Code states that a "corporation shall not be negligent in its social responsibilities, such as consumer protection and environmental protection." SOUTH KOREAN CODE OF BEST PRACTICES, *supra* note 269, § IV.1.3.

292. *See* KUALA LUMPUR STOCK EXCHANGE, LISTING REQUIREMENTS, *supra* note 268, at ch. 2.

As a result, enforcement is a function both of the capability and will of the government or shareholders to act. In some countries, the government itself has been and continues to be a stakeholder (and sometimes a shareholder) in numerous companies raising practical difficulties with respect to enforcement. Civil law countries often have an additional enforcement mechanism whereby many corporate actions only become effective after a court has determined that the action was taken in compliance with the relevant statutory provisions. In jurisdictions where class actions and derivative litigation are allowed, the private bar can be a powerful incentive for compliance.[293]

An additional complication in the international context relates to the difficulty in enforcing compliance across borders. For example, the typical U.S. investor faces significant burdens trying to litigate in foreign jurisdictions. In addition, the kind of plaintiffs' bar that exists in the United States that brings these cases does not exist abroad. Nor are U.S. attorneys typically willing to move offshore to bring their cases due to the significantly higher costs and potentially lower returns.

In contrast, market participants are strong encouragers of compliance. The rapid movement toward adoption of improved corporate governance standards in Asia in the late 1990s was in part a reaction to the need for foreign capital. Just recently, CalPERS announced that it was pulling its investments out of three Asian markets (Indonesia, Malaysia and Thailand) after giving them low marks on either or both of market and country factors.[294]

As described above, corporate governance codes play an increasingly important role in encouraging compliance with corporate governance standards. Although they are largely aspirational and, as such, are not legally enforceable, the standards set forth in corporate governance codes increasingly influence corporate behavior due to the significant economic power of investor groups in the capital markets and the voting power associated with their holdings. In addition, many corporate governance codes suggest that companies disclose their level of compliance. Moreover, at least six countries, the United Kingdom, Germany, Canada, Italy, Malaysia and Australia, have incorporated such disclosure requirements into their regulatory regime. Most notably, since the early 1990s, the U.K. listing rules (now

293. Class actions and derivative litigation historically have not been available in much of Asia in a form that provides significant benefit to the shareholders. However, the Supreme People's Court in China, while expressly saying that class actions would not be allowed in the context of a securities fraud case, recently suggested that shareholders can file collective actions in cases involving civil rights violations in the securities market. Accordingly, the Harbin Intermediate People's Court recently accepted a case in which a Beijing lawyer, as counsel to over 400 shareholders of a Shanghai-listed company (Daqing Lianyi), alleged that the company had made insufficient disclosure. *See* Shao Zongwei & Zhou Wanfeng, *Court Takes Fraud Case*, CHINA DAILY (Hong Kong Ed.), Jan. 26, 2002, at 4. Singapore also recently amended its corporation law to permit shareholder derivative actions, and Malaysia and Korea are considering amending their relevant codes to include specific authorization of class action lawsuits. *See* The Singapore Companies Act §§ 216A, 216B (2002).

294. CalPERS also does not invest in other emerging markets that do not meet its standards for regulation, liquidity, openness, settlement and costs, such as India and China. *See* Cathy Holcombe et al., *U.S. Pension Fund Quits Four Problem Asian Markets*, S. CHINA MORNING POST, Feb. 22, 2002, at 1.

enforced by the FSA) have included a comply or explain requirement.[295] Listed companies must disclose their compliance with the U.K. Combined Code (previously the Cadbury Code) and explain any areas of noncompliance. A violation of this disclosure requirement could lead to delisting. Accordingly, although compliance with the substantive guidelines of the U.K. Combined Code is voluntary, the majority of U.K. listed companies comply in all substantive respects.

E. Foreign Market Change

The continuing fragmentation and demutualization of foreign securities markets has a potential impact on corporate governance in these jurisdictions.

1. Fragmentation

Similar to the effect of the proliferation of ATSs in the United States, many foreign jurisdictions are experiencing the increasing fragmentation of their traditional securities markets. In order to provide access to capital for higher risk companies, many Asian countries have opened markets intended to fill Nasdaq's historical role as a market for emerging issuers.[296] These specialized markets have been designed to avoid the quantitative listing standards of the local traditional exchanges, but also generally incorporate less stringent corporate governance standards due to the perception that strong corporate governance standards are more costly for new companies.

Conversely, the São Paulo Stock Exchange, or Novo Mercado, has moved in the opposite direction by initiating an alternative exchange-based corporate governance regime. In an effort to "better advertise[ ] the efforts of [issuers] to improve relations with [their] investors and increase[ ] the potential for appreciation in the value of its asset,"[297] the Novo Mercado invited issuers to seek inclusion in one of three special tiers marked by increasingly rigorous corporate governance rules.[298] Issuers failing to meet the requirements of their tier may be subject to

295. *See* U.K.L.A. Listing Rules, *supra* note 6, § 12.43A(a)-(b). As noted above, the recently adopted German Transparency and Disclosure Law sets forth a binding comply or explain requirement for public issuers with respect to the provisions of the German Cromme Commission Code. *See* German Corporate Governance Code § 3.10, *available at* http://www.corporate-governance-code.de/eng/kodex/3.html; *see also supra* Table: Corporate Governance Standards in Comparative Perspective n.3. The Hong Kong Stock Exchange also requires disclosure as to compliance or noncompliance, but it does not take the additional step of requiring disclosure as to how the company has complied with the principles contained in the Code. The Korean Code of Best Practice recommends that issuers disclose their level of compliance and explain any areas of noncompliance, however, South Korea has codified this suggestion in binding law.

296. Hong Kong (Growth Enterprise Market), South Korea (Kosdaq), Singapore (Sesdaq), Malaysia (Mesdaq) and Japan (Jasdaq) have all opened within the past three years. In Japan, the Tokyo Stock Exchange opened the "Market of the High Growth and Emerging Stocks" or Mothers market in December of 1999. The bursting of the technology bubble in the United States and the recession that followed slowed the growth of these new markets.

297. BOVESPA: Sao Paulo Stock Exchange, Differentiated Corporate Governance Practice Rules 3 (2001).

298. The corporate governance criteria of the three tiers relate to, among other things, public float, increased public disclosure, use of GAAP and the treatment of minority shareholders upon a change of control. BOVESPA-Brazil, Novo Mercado, Listing Rules 3.1(vii), (viii) (2002).

fines and/or non-cash penalties, including the suspension or cancellation of the issuers' inclusion in the given tier. If an issuer's inclusion in a tier is cancelled, controlling shareholders are obligated to make a public offer to acquire all outstanding shares held by other shareholders at a purchase price determined by an outside appraisal.[299] Even the voluntary movement to a lower tier requires both shareholder approval and a tender offer for all outstanding shares by controlling shareholders.

2. Demutualization

While Nasdaq's demutualization is in progress, exchanges in Frankfurt, Stockholm, Amsterdam, Australia, London, Hong Kong and Singapore have recently completed their demutualization, which has also frequently led to consolidation among markets. For example, exchanges in Amsterdam, Brussels and Paris have recently combined to form Euronext; the Singapore Stock Exchange has an existing alliance with the Australian Stock Exchange and has recently announced plans to pursue such a linkage with the Tokyo Stock Exchange; and the Hong Kong Exchange is currently expanding its linkages with the Chinese exchanges.

The demutualization of foreign exchanges has raised the conflict of interest concerns articulated by the SEC with respect to Nasdaq's planned demutualization.[300] The response of foreign regulators to these developments has generally been the same as that of the SEC. In the United Kingdom, for example, regulators sought to avoid these conflicts of interest by shifting authority over corporate governance listing standards from a demutualized LSE to the FSA.[301] In Australia, the conflicts of interest were deemed less severe when the Australian Stock Exchange (ASX) voted to demutualize. Accordingly, the Australian Securities and Investments Commission assumed direct listing authority over the ASX, as a listed issuer of securities, but permitted the ASX to retain listing authority over all other listed issuers.[302] As demonstrated by the demutualization of Nasdaq, the LSE and the ASX, the regulatory solution to demutualization "may lie in creating and maintaining a sufficient degree of separation between the market-place and the

299. As of March 2001, Deutsche Banc Alex. Brown estimated that approximately 51 Brazilian issuers were eligible for inclusion in the least stringent tier; approximately 30 issuers were eligible for inclusion in the next stringent tier; and approximately six issuers were eligible for inclusion in the Novo Mercado. Deutsche Banc Alex. Brown, *Latin America Strategy, Brazil: Focusing on Corporate Governance* (Mar. 5, 2001). As of December 13, 2001, only 19 issuers had executed contracts to enter the least stringent category; as of December 13, 2001, no issuers had entered either of the two more stringent categories.

300. *See Concerning Market Structure Issues Currently Facing the Commission*, *supra* note 253.

301. *See* LONDON STOCK EXCHANGE, ADMISSION AND DISCLOSURE STANDARDS (2001), *available at* http://www.londonstockexchange.com/about/pdfs/admiss_standards_2002.pdf. The LSE has retained authority to determine whether issuers meet the quantitative requirements that make them "eligible for trading."

302. Jillian Segal, Market Demutualisation and Privatisation: The Australian Experience, Address at the 26th IOSCO Annual Conference, Stockholm (June 28, 2001), *available at* http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/IOSCOSpeechJune2001.pdf/$file/IOSCOSpeechJune2001.pdf.

exchange's regulatory units or in hiving off some regulatory functions to the lead regulator."[303]

Consideration of corporate governance regulation and practices outside the United States is helpful for comparative purposes. In general, the majority of the substantive matters covered by NYSE corporate governance listing standards are addressed in each of the analyzed jurisdictions, whether by direct government regulation, nonbinding corporate governance codes or exchange-established listing standards. Therefore, to the extent corporate governance listing standards in the United States address matters relevant to the integrity of securities markets, each of the analyzed jurisdictions do so as well. However, with few exceptions (including the recent corporate governance initiatives of the Brazilian Novo Mercado), foreign exchanges generally do not set corporate governance standards for listed issuers.

SECTION V. ANALYSIS AND ALTERNATIVES

A. Analysis

The role of exchanges and the SEC in corporate governance is best viewed from the perspective of the unique corporate governance system in the United States. Each state establishes corporate law and its judiciary interprets that law. This process provides minimal standards of conduct for corporations and their officers, directors and shareholders and allocates power among shareholders, directors and management.[304] State corporate law, however, is not as a general matter directly concerned with issues affecting the public markets for securities and the related needs and interests of public securities holders. The federal securities laws provide another regulatory layer but do not, in general, address rules of corporate conduct affecting the marketplace, except as to matters such as disclosure and fraud. While qualitative corporate governance listing standards initially were adopted for the branding and related marketing purposes of the NYSE, they have evolved in part to fill a gap between state corporate law and the federal securities laws in matters of concern to the exchanges, namely, the operation of securities markets with selective but high governance and fairness standards for listed companies.

To date, the governance initiatives of the exchanges have been selective. There are twelve corporate governance listing standards of the NYSE, of which only two have been adopted in the last eight years.[305] In 1994 the uniform voting rights listing standard was adopted by the NYSE, Nasdaq and the Amex and in 1999 audit committee listing standard amendments were adopted by the exchanges. The most recent effort by shareholders to have the NYSE and Nasdaq adopt a listing standard requiring shareholder approval of broad-based option plans and

303. Gwen Thomas, *Stock Exchanges, ATSs and Privatisation: The Regulatory Reaction to Growing Competition from On-line Securities Trading*, SEC. & BANKING, Dec. 23, 1999.

304. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977).

305. *See* NYSE MANUAL, *supra* note 9, §§ 302.00, 303.01, 304.00, 306.00, 307.00, 308.00, 309.00, 310.00, 311.00, 312.03, 312.07, 313.00, 314.00.

establishing a dilution standard has been controversial and thus far unsuccessful. Nevertheless, Chairman Pitt's letter to the NYSE and Nasdaq of February 12, 2002 strongly recommends that the exchanges strengthen listing standards and enumerates a number of possible areas of focus. In an April 11, 2002 letter, Nasdaq responded with a variety of suggestions.[306] It is therefore likely that there will be accelerated initiatives to use listing standards to remedy perceived governance deficiencies in publicly-owned companies. This, in turn, raises two issues: the legal limitations on the authority of the SEC and the exchanges to approve or adopt particular corporate governance listing standards and the appropriate role of the SEC and the exchanges in corporate governance generally.

As discussed earlier in this report, the *Business Roundtable* decision is the sole judicial holding that deals directly with the authority of the SEC and the exchanges in relation to corporate governance. Significantly, the court found that corporate governance listing standards are "rules" under the Exchange Act and therefore require approval, or no disapproval, by the SEC before they can become effective. Furthermore, since these rules affect issuers and not members, the SEC's authority to approve a governance standard is limited, but the limitations are not defined. The court said the Congress had not intended that state corporate law could be preempted on a comprehensive basis through the use by the SEC of the listing standard mechanism. Under section 19(b) of the Exchange Act, the SEC would need to find consistency with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the SRO to justify approval of an exchange-initiated governance listing standard.

The authority of the exchanges and the SEC to establish or approve further corporate governance listing standards is uncertain and if challenged likely will be decided on a case-by-case basis. For example, we believe that the statutory test of "consistent with the requirements" is satisfied with respect to the audit committee listing standards, given the provisions of the Exchange Act that relate to internal accounting controls and audited financial statements.[307] It is unlikely that existing corporate governance listing standards could be overturned at this juncture, although they could be subject to collateral attack in the event of a delisting proceeding.[308]

Exchanges operate securities markets and they have a bona fide interest in the standards of conduct of listed companies, including fairness to investors. They have the right to establish quantitative and qualitative standards for their respective markets. While exchanges are competitive, it is generally acknowledged that a "race to the bottom" from a governance listing standard perspective would be unacceptable as a matter of national policy. Furthermore, there is a view that

306. *See* Letter from Hardwick Simmons, *supra* note 104; *see also* Letter from Harvey L. Pitt, SEC Chairman, to Richard Grasso, NYSE Chairman and Chief Executive Director and Hardwick Simmons, Nasdaq Chairman and Chief Executive Officer (Feb. 12, 2002) (on file with the Special Study Group); Press Release, SEC, Pitt Seeks Review of Corporate Governance, Conduct Codes (Feb. 13, 2002), *available at* http://www. sec.gov/news/press/2002-23.txt.

307. *See* Exchange Act § 10A, 15 U.S.C. § 78j-1(a)(2000); *id.* § 13, 15 U.S.C. § 78m(b).

308. *See* Michael, *supra* note 13, at 1498.

compliance with high standards can favorably affect the price of an issuer's securities as well as the prestige of the exchange—the so-called "branding" effect.

There are many positive features to the role of the exchanges in terms of corporate governance. The exchanges are able to interpret listing standards and negotiate with issuers with respect to compliance. In practice, this is effective since most companies and their directors do not wish to become the subject of a public controversy as to noncompliance, even though delisting is rarely used. The staff at each of the principal markets spends a good deal of time in dealing with issuers on these matters.

When governance listing standards, including amendments, are proposed, publication for comment often results in debate and controversy among shareholder groups, issuers, regulators and the exchange itself. While issuers have significant influence on exchange-listing standards policy, in this area shareholder activism and the SEC provide the additional participation necessary for a useful forum on corporate governance key issues. The exchanges also seek advice from legal and other experts on the subject matter of corporate governance standards, which adds significantly to their capability. This forum approach is constructive in that it frequently results in a collaborative solution, and, at a minimum, establishes publicly the points of view of interested participants. This feature should be preserved despite any future systemic change.

Not all aspects of corporate governance are relevant to the interests of the exchanges in operating securities markets; nor do the exchanges have the authority or the expertise to act as arbiters on a full range of corporate governance matters. While it is difficult to define with precision the appropriate interest of the exchanges, it should substantively relate to the operation of securities markets so as to promote investor confidence and provide reliability.

Listing standards are not the only source of rules respecting governance outside of state corporate law. Corporate governance codes of different kinds have proliferated throughout the world. Many of them are comprehensive. However, the best practices guidelines contemplated by the Proposal should be limited to the corporate governance areas that are necessary for and directly relevant to the maintenance of integrity in the securities markets and fairness to investors.

In light of recent widely publicized corporate failures, the issue of defining the most effective approach to improving corporate governance as it affects markets is squarely presented at this time. It is not necessary or even desirable to redesign the current system to achieve ongoing improvement in the process. Improvement should be built on the strengths of the existing system. Any significant change in the system creates the potential of new risks to the capital markets, issuers and investors, and should only be established after careful and focused study. Any systemic change should take into account the role of state corporate law in governance, corporate governance codes and practices and the appropriate areas of concern to and interest of the exchanges.

For all of these reasons, and in light of this analysis, we recommend the Proposal as a most appropriate response to current governance needs. An analysis of the alternatives without active exchange participation further supports this conclusion.

B. Alternatives

We have considered various alternatives. These may be applicable in two events: (i) primary exchanges are unable to continue a meaningful role in the corporate governance process principally because changes in the securities markets limit their influence through the use of listing standards and best practices; or (ii) a primary exchange elects, for whatever reason, not to maintain its involvement in the corporate governance process on a comprehensive basis. In either such event, with the absence of a prominent and influential role for the exchanges, corporate governance measures may need to be addressed through other means. Set forth below is a brief description of the principal alternatives we have considered:

1. Unofficial Codes

Without the active participation of the exchanges, there could be a meaningful loss of structure in connection with the adoption, amendment, repeal and interpretation of the provisions that currently are the subject of listing standards or best practices guidelines. In any event, nonbinding corporate governance codes should continue to be available for use by issuers. Should the SEC adopt a disclosure rule respecting governance practices, transparency with respect to governance matters would increase.

Absent, however, would be some structure to provide uniformity for, and the means of, adopting, amending, interpreting and repealing the various codes. This might be achieved through one or more entities established by the private sector which could seek to assume primary responsibility for governance matters. Presumably, such an entity would sponsor dialogue among shareholder groups, issuers, regulators and other interested parties respecting governance matters. If the private sector is unable or fails to provide the necessary structure to satisfy the needs of issuers and investors, the SEC could become more directly involved or one of the other alternatives described below may be adopted.

In recommending the desirability of some structure to the process, we are mindful of the fact that many issuers deem the maintenance of good governance practices as desirable partly as a result of the influence of shareholder groups and the SEC. Furthermore, current events affecting corporate governance could increasingly persuade boards of directors to enhance their governance practices and corporate transparency, thereby facilitating a "flight to quality."

2. State Corporate Law

Alternatively, state corporate law could be strengthened with respect to governance matters to the extent the exchanges become unable or unwilling to maintain their role with respect to corporate governance. It is doubtful, however, state action could be coordinated on a uniform basis. Additionally, state corporate law is enforced in court and provides a very cumbersome mechanism for uniform interpretation or exemption. Moreover, state corporate law normally is not changed promptly nor does it ordinarily address current issues affecting the integrity of the public markets and the protection of public investors. For all of these reasons, we believe, reliance on state law would be insufficient.

3. Expand SEC Authority

The authority of the SEC to approve or impose corporate governance listing standards or their equivalent could be increased or clarified by legislation. SEC authority over corporate governance measures could extend both to issuers whose securities are listed on an exchange and those who are not listed but whose securities are publicly traded. Such an approach, however, would clearly federalize significant aspects of corporate law. To the extent that the listing process continues in its present form, the expansion of SEC authority by legislation could reverse or revise elements of the *Business Roundtable* decision, or establish a new approach to the SEC role in corporate governance. This would involve a significant change in the system with far-reaching consequences for the current balance between federal and state regulation. We believe that the longstanding controversy as to the desirability of federalizing significant aspects of corporate law need not be revisited at this time. Private initiatives are better suited to the task under current circumstances.

4. Special Entity

A special SRO-type entity could be authorized by an act of Congress. While the activities of such an entity would not be regulatory in nature, its purpose would be to fill a void in the governance process. It could be authorized to establish or recommend corporate governance requirements applicable to public issuers or identify corporate governance codes which may be applicable to public companies. Presumably, it would have an independent staff and funding and would be subject to SEC oversight. Its role in the governance process would need to be carefully defined including any interpretive authority, whether it should be limited to defining best practices, and the consequences to issuers who fail to adopt its recommended practices. The independence of this entity and the role of the SEC would also have to be defined.

We do not suggest that the establishment of such an entity would be a suitable substitute for the exchanges which have a business incentive to maintain the integrity of the markets and provide for the fair treatment of investors. An SRO-type entity would be more quasi-governmental in nature but without delegated federal authority. In addition, the governance of this entity could involve substantial issues of federalization of areas of corporate law. The only historic model for such an entity is the Municipal Securities Rulemaking Board (MSRB), which was established by the 1975 Amendments to write rules related to municipal securities, but the MSRB is subject to significant SEC influence. We do not believe that the MSRB is a suitable model for the oversight of corporate governance matters, which requires the willing participation of interested parties to be successful. Finally, such an entity may not be in a position to build upon or take advantage of the strengths of the existing system.

Accordingly, we believe that the establishment of this type of entity is inadvisable and might not be the most effective means of dealing with issues of corporate governance that continue to arise and are of increasing importance.

5. Other

There may be other alternatives to accomplish the objective of enhancing corporate governance for the protection and interests of investors. One possibility is that a rating system be adopted as part of one of the other programs so that an independent rating agency or other entity is entitled to grade the corporate governance compliance of the particular entity with the best practices. While we do not recommend this process at this time, it is something that may materialize in the future provided that the identity of the rater and the definition of the systems for rating are clearly established and are impartial. Protection would need to be applied to any such process to make certain that the system could not be abused or be subject to the control or influence of particular groups that have a special agenda. We do not pass upon the desirability of this process for corporate governance generally. Our focus is with respect to the securities markets and the interests of investors as participants in those markets. The purpose of a rating system would be to provide investors with a governance evaluation which is comprehensive and fair and measured against objective criteria.

* * *

We recognize that a combination of these alternatives could be adopted in the future. For the present, our recommendation is to adopt the best practices and disclosure program and permit matters to evolve. Should there be shortcomings as a result of experience, other alternatives may be considered.

CONCLUSION

The current environment provides an opportunity for the exchanges, with the cooperation of their members, investors, issuers and the SEC, to improve corporate governance practices as they relate to the protection of investors and the integrity of the securities markets. With this in mind, as well as the need to promote investor confidence, we have undertaken this Study and made a series of recommendations, including the Proposal, for prompt action without significant change in the existing system. We arrived at these recommendations after identifying and considering various alternatives, the problems associated with each of the alternatives and the risks associated with systemic change.

May 17, 2002

SPECIAL STUDY GROUP
Robert Todd Lang, *Chair*

Brandon C. Becker	John M. Liftin
Roger D. Blanc	Jonathan R. Macey
Peter C. Clapman	Hugh H. Makens
Roberta S. Karmel	John F. Olson

ANNEX A

MEMBERS OF THE SPECIAL STUDY GROUP

Robert Todd Lang, Senior Partner, Weil, Gotshal & Manges LLP, New York, N.Y., Chair: Special Study on Market Structure, Listing Standards and Corporate Governance, Task Force on Listing Standards of Self-Regulatory Organizations, and the Subcommittee on Private Investment Entities of the Committee on Federal Regulation of Securities, Section of Business Law, American Bar Association; Chairman of the Board of Advisors at the Center for the Study of Corporate Law at the Yale Law School; member and formerly Chair, Committee on Corporate Governance of the Section; formerly Chair, Subcommittee on Proxy Solicitations and Tender Offers of the Committee; formerly Chairman of the Legal Advisory Board of the National Association of Securities Dealers; and formerly member of the Special Committee on Shareholder Voting Rights of the American Stock Exchange.

Brandon C. Becker, Partner, Wilmer, Cutler & Pickering, Washington, D.C., focusing on broker-dealer regulatory issues, capital markets and related issues; formerly Director, U.S. Securities and Exchange Commission Division of Market Regulation; formerly staff member, President's Working Group on Financial Markets and the Commodity Futures Trading Commission Financial Products Advisory Committee. He has taught courses on Corporations, Securities Regulation, Broker-Dealer Regulation, and Global Securities Markets at several law schools.

Roger D. Blanc, Partner, Willkie Farr & Gallagher, New York, N.Y., engaged in a general practice of law emphasizing financial transactions and advice to broker-dealers, other financial intermediaries, and securities trading systems; member and formerly Chairman, American Bar Association Subcommittee on Market Regulation; formerly member, Legal Advisory Board of the National Association of Securities Dealers, Inc; and formerly Associate Director and Chief Counsel of the Division of Market Regulation at the U.S. Securities and Exchange Commission.

Peter C. Clapman, Senior Vice President and Chief Counsel, Corporate Governance TIAA-CREF (including managing the corporate governance program and developing corporate governance policies and strategies) New York, N.Y., and formerly Chief Counsel, TIAA-CREF Investments; member, Association of the Bar of the City of New York, Committee on Mergers, Acquisitions and Corporate Control Contests and the Committee on Securities Regulation; elected member, American Law Institute; member, Primary Markets Group and Advisory Committee of the London Stock Exchange; member, Legal Advisory Committee of the New York Stock Exchange, Inc.; Board Member, National Committee for Quality Assurance; Chairman, International Corporate Governance Network (ICGN); co-chair; Investor Responsibility Task Force, the World Bank Global Corporate Governance Forum; Board Member, Investor Responsibility Research Center; member, Advisory Board of the Global Corporate Governance Research Center of the Conference Board; and formerly ICGN representative, Task Force of the Office of Economic Cooperation and Development; and on the Editorial Board of the *Corporate Governance Advisor.*

Roberta S. Karmel, Professor and Chairman of the Steering Committee and Co-Director, Center for the Study of International Business Law at Brooklyn Law School, Brooklyn, N.Y.; Director, the Kemper Insurance Companies; formerly Commissioner, U.S. Securities and Exchange Commission; formerly Director, the New York Stock Exchange, Inc., formerly member, National Adjudicatory Council, NASD; Trustee, Practising Law Institute; engaged in the private practice of law for over thirty years; and columnist on securities regulation, *The New York Law Journal.*

John M. Liftin, Senior Vice President and General Counsel, Prudential Financial, Inc, Newark, N.J.; member, New York Stock Exchange Legal Advisory Committee; formerly Chair, Committee on Federal Regulation of Securities, American Bar Association; formerly General Counsel, Kidder, Peabody Group, Inc.; formerly President and Chief Operating Officer, Quadrex Securities Corporation; formerly Partner, Rogers & Wells; and formerly Associate Director, Division of Market Regulation and Special Counsel to Chairman William J. Casey, U.S. Securities and Exchange Commission.

Jonathan R. Macey, J. DuPratt White Professor of Law and Director, John M. Olin Program in Law & Economics, Cornell Law School, Ithaca, N.Y.; member, Legal Advisory Committee to the Board of Directors of the New York Stock Exchange, Inc.; member, Executive Committee, Association of American Law Schools Section on Corporate Law; and formerly Reporter to the American Bar Association Committee on Corporate Laws.

Hugh H. Makens, Partner, Warner Norcross & Judd LLP, Grand Rapids, M.I., specializing in securities law; Chair, Institutes and Seminars Committee of the Business Law Section of the American Bar Association; member, North American Securities Administrators Association Ombudsman Advisory Committee; formerly Director, Michigan Corporation & Securities Bureau; appointed member, The Nasdaq Stock Market, Inc. Market Operations Review Committee; formerly President, North American Securities Administrators Association; formerly member, Legal Advisory Board to the National Association of Securities Dealers; formerly trial attorney, Enforcement Division of the U.S. Securities and Exchange Commission; formerly appointed member, North American Securities Administrators Association Task Force on The Future of Shared State and Federal Securities Regulation; and formerly Chair, State Regulation of Securities Committee and of the Meetings Committee of the Section of Business Law of the American Bar Association.

John F. Olson, Senior Partner, Gibson, Dunn & Crutcher LLP, Washington, D.C.; Chair, Committee on Corporate Governance; formerly Chair, Committee on Federal Regulation of Securities, member, Council, Section of Business Law, American Bar Association; member, Task Force on Corporate Responsibility, American Bar Association; member and formerly Chair, Corporate Governance Subcommittee, Legal Advisory Committee and Chair, Task Force on Shareholder Approval Policy, the New York Stock Exchange, Inc.; member, American Law Institute; and formerly member, Legal Advisory Board, National Association of Securities Dealers.

ANNEX B

SUMMARY OF INTERVIEWS

As part of the study, separate interviews were conducted with representatives of regulators, primary markets, alternative trading systems, investment banks and institutional shareholders. The discussions were free-ranging, precise conclusions were neither sought nor obtained and there was no effort to reach consensus on issues. Many of the participants emphasized subject matter which was of particular interest to them. Many of the interviews took place before September 11, 2001 and therefore neither (i) the impact on the markets of damage from future terrorist activities or other catastrophic events nor (ii) current accounting and other irregularities and practices were reflected in most of these discussions. We derived the following from the interviews:

1. The role of exchanges and particularly the increased use of corporate governance listing standards need to be clarified.
2. The full extent of authority of the SEC in this area is unclear but as a practical matter the SEC can and does influence the adoption or amendment of corporate governance listing standards by the exchanges.
3. The scope of corporate governance listing standards has yet to be determined both as a legal matter and through the appropriate allocation of authority among the states, the markets, the SEC, and the private sector.
4. There is concern about the potential federalization of aspects of corporate law should the SEC or other federal agency assume expanded powers over corporate governance through listing standards or otherwise. Listing standards fill a gap between state law and the federal securities laws with respect to important, but selective, matters of corporate governance.
5. Corporate governance listing standards constitute an opportunity for issuers and institutional and other shareholders to communicate concerning governance issues. This is achieved through a "forum" provided by the primary market.
6. Uniformity of such listing standards is desirable to avoid a "race to the bottom" but there is some support for the notion that higher standards attract investors and are part of the "branding" initiatives of the primary markets. However, certain of the participants suggested that different issuers may appropriately have different governance requirements and therefore uniformity may not be desirable in many instances.
7. Overseas listing and globalized trading are a "work in progress" and over time will have a significant impact on the U.S. markets and the corporate governance processes. Foreign markets may continue to have difficulty in applying uniform standards notwithstanding many of the current initiatives in Europe and elsewhere. The status of foreign issuers under the U.S. securities laws for listing and trading purposes should be considered further as markets, systems, regulatory structures, and investor safeguards change.

8. Some believe that alliances and mergers between U.S. and foreign markets are essential for the future. Others see a limited advantage for U.S. markets to merge although alliances as well as consolidation abroad will continue.
9. Some participants endorsed the notion that a "best practices" approach could be effective in place of certain corporate governance listing standards. This is based on the premise that rarely is there a delisting because of noncompliance with such listing standards. There is a market expectation that companies will comply with acceptable, if not best, practices. Shareholder activism, the need for market acceptance and the watchdog activities of the SEC and markets motivate listed companies to observe good governance practices.
10. While Regulation ATS does not require alternative trading systems to have listings (and some believe the SEC may not currently have authority to require them to do so), there are issues as to whether a market which registers as an exchange needs listings and therefore listing standards. No views were expressed as to whether corporate governance listing standards would be required.
11. While many of the participants expressed individual views on the evolving market structures and competition among exchanges and other market systems, the only broad consensus was that under current circumstances it was not likely that there would be a near term liquidity shift. However, there were diverse views on how, over time, the markets and regulation will adjust to technological change and globalization. Further, some suggest market competition could be significantly affected by a large technology company becoming a competitor, particularly in actively traded securities, although there was no suggestion that this will occur in the foreseeable future, or regarding what conditions the SEC might impose in such event.
12. Securities markets are a brand name business. Listings are important sources of earnings to the markets but the fees represent a relatively low cost to the issuer. Competition among markets will increase. Electronic trading will accelerate. The NYSE and Nasdaq are adapting to technological change. The advent of Archipelago Exchange may stimulate this process.
13. The alternatives to be considered should there be a change in the listing process had not been the subject of meaningful thought by certain of the participants. However, there was virtual unanimity that should listing diminish in importance for whatever reason the federal government would not abide the elimination of corporate governance listing standards. The use of best practices codes as a substitute for some or all corporate governance listing standards had not been given extensive consideration but some participants believe that certain existing standards could be replaced by a system of best practices.
14. There were divergent views and uncertainty as to the regulation and self-regulation of the markets in the future, particularly in relation to demutualization and the need for transparency and best execution in the markets. However, it was generally agreed that listing standards should be adopted and administered by the markets and not by those responsible for regulation or compliance.

15. The preemption of state blue sky laws under the federal securities laws is based on listing and good governance. Should listings diminish, this preemption would need to be reexamined.
16. Demutualization and shareholder ownership are considered likely for most markets but it should be assumed the NYSE decision to remain member-owned will remain unchanged for the present.

ANNEX C

Memorandum Submitted to the SEC, the NYSE and NASDAQ

March 13, 2002

SPECIAL STUDY ON MARKET STRUCTURE, LISTING STANDARDS AND CORPORATE GOVERANCE

This memorandum has been prepared by a Special Study Group of the Committee on Federal Regulation of Securities of the Section of Business Law of the American Bar Association. For the past sixteen months we have been engaged in a study of the interrelationship of market structure, corporate governance and listing standards. We have examined the background, nature and use of corporate governance listing standards; the authority of the Securities and Exchange Commission and the exchanges to adopt them; the role of the exchanges fostering improvement in corporate governance; the relationship of this process to state corporate law and the federal securities laws; present and potential changes in market structure; and governance practices and regulation abroad. Our report is scheduled to be completed in the next two months and will contain an analysis of these matters and alternatives to be considered for the future.

Based on our study to date, we believe any significant change in the current system requires careful thought and discussion and would likely take place over time. We have a specific recommendation with respect to an interim process through which measures might be adopted and implemented to deal with governance issues currently being considered by the Commission, the Congress, the exchanges and others.

Over time and with Commission approval the exchanges have selectively adopted corporate governance measures as listing standards. Many of these governance standards have focused on matters that pertain to the integrity of the securities markets and fairness to investors. Some overlap provisions of state corporate law. The authority of the Commission and the exchanges to adopt standards such as these in the future is uncertain. We discuss this at length in our report.

We suggest, therefore, that the exchanges consider recommending a set of appropriate best practices designed to deal with current issues in corporate governance, particularly as they pertain to the integrity of the markets and fairness to investors. They should be broad in scope and flexible in relation to the circumstances of particular kinds of companies. These best practices would be endorsed by the exchanges after soliciting the views of interested parties, including shareholder groups, listed companies, the Commission and outside experts. They would not be binding and would not take the form of listing standards. Further, we recommend that the Commission require annual disclosure by each listed company in its periodic reports, proxy materials or other public filings as to whether it complies with these best practices or the reason for noncompliance. This mechanism would enhance compliance with best practices, particularly since delisting, which is the sole sanction for noncompliance with a governance listing standard, rarely occurs.

This action could be taken by coordination among the exchanges similar to the manner in which the audit committee standards and related Commission rules were adopted several years ago. There are other possible means of conducting this activity, including the establishment of a joint entity to consider and adopt best practices. We discuss this in our report and will be prepared to meet with the Commission and the exchanges concerning certain issues that need to be resolved before a joint entity could be organized for this purpose to function on an ongoing basis. We believe generally that uniformity in governance best practices is desirable, although in the first instance each exchange could vary its formulation of practices, much as there are some variations in the audit committee listing standards. Over time, however, we believe that there are significant advantages to uniformity in terms of achieving good governance practices. Accommodation could be made in the uniform best practices for differences in types of issuers.

Our recommendation is intended to enable focused corporate governance measures to be adopted promptly with participation by all interested groups. It is also intended to be responsive to Chairman Pitt's letter of February 12, 2002 to the New York Stock Exchange, Inc. and The Nasdaq Stock Market, Inc. relative to the strengthening of governance listing standards. The exchanges should be at the center of the discussions on relevant governance issues for listed companies. Any legal issues concerning the authority of the Commission and the exchanges need not be resolved at this time. Neither the Commission nor any of the exchanges would be precluded from seeking to adopt listing standards under established procedures. It is in the public interest that any systemic change be considered in a deliberate and thoughtful manner over time.

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SPECIAL STUDY GROUP
Robert Todd Lang, *Chair*

Brandon C. Becker	John M. Liftin
Roger D. Blanc	Jonathan R. Macey
Peter C. Clapman	Hugh H. Makens
Roberta S. Karmel	John F. Olson

The study has been undertaken by a Special Study Group of the Committee on Federal Regulation of Securities of the Section of Business Law of the American Bar Association but neither the study nor this memorandum represents an official position of the American Bar Association, the Section or the Committee.

ANNEX D

SOURCES OF CORPORATE GOVERNANCE STANDARDS IN THE UNITED KINGDOM, GERMANY, POLAND, JAPAN, MALAYSIA, SOUTH KOREA AND BRAZIL

	Corporation Law	Securities Law (Regulatory Body)	Corporate Governance Code (Issuing Body)	Primary Exchange
United Kingdom	Companies Act 1985	Financial Services and Markets Act 2000 (Financial Services Authority)	U.K. Combined Code: Principles of Good Governance and Code of Best Practice (Committee on Corporate Governance, 1998)[1]	London Stock Exchange
Germany	Stock Corporation Act[2]	Securities Trading Act (Federal Securities Supervisory Office)	Cromme Commission Code: German Corporate Governance Code (Government Commission, February 2002)[3]	Frankfurt Stock Exchange
Poland	Commercial Code	Securities Code (Securities and Exchange Commission)	None[4]	Warsaw Stock Exchange
Japan	Commercial Code	Securities and Exchanges Law (Ministry of Finance)	Corporate Governance Principles (Japan Corporate Governance Forum)	Tokyo Stock Exchange[5]
Malaysia	Companies Act	Securities Industries Act (Malaysia Securities Commission)	Code of Principles and Best Practices (High Level Finance Committee on Corporate Governance)	Kuala Lumpur Stock Exchange
South Korea	Commercial Code	Securities and Exchange Act (Financial Supervisory Commission)	Code of Best Practice for Corporate Governance (Committee on Corporate Governance, 1999)	Korean Stock Exchange
Brazil	Corporation Law	Securities Commission Law (Securities Commission)	Code of Best Practice (Brazilian Institute of Corporate Governance, 1999)	Sao Paulo Novo Mercado

1. In addition to the U.K. Combined Code, the following corporate governance codes have been issued in the United Kingdom: The Institute of Chartered Secretaries and Administrators Code (Feb. 1991), the Institutional Shareholders' Committee Statement of Best Practice (Apr. 1991), the Cadbury Report (Dec. 1992), the Greenbury Report (July 1995), the Hampel Report (Jan. 1998), the Turnbull Report (Sept. 1999), the Hermes Investment Management Ltd. Statement on U.K. Corporate Governance & Voting Policy 2001 (Jan. 2001), the Association of Unit Trusts and Investment Funds Code of Good Practice (Jan. 2001), and the Pensions Investment Research Consultants Ltd. Shareholder Voting Guidelines (Mar. 2001). The comply or explain requirement under U.K. listing rules relates to the U.K Combined Code.
2. Germany also has a limited liability company law, however, because only stock corporations can become public companies, this section will only address matters under the Stock Corporation Act.
3. In addition to the German Cromme Commission Code, the following corporate governance codes have been issued in Germany: The Berlin Initiative Code of Corporate Governance (Berlin Initiative Group, 2000) and the German Panel Corporate Governance Code (German Panel on Corporate Governance, 2000). The comply or explain requirement under the German Transparency and Disclosure Law relates only to the German Cromme Commission Code.
4. Although no completed corporate governance codes have been published in Poland, both the Gdansk Institute for Market Economics and the Warsaw Corporate Governance Forum have recently published draft codes.
5. The Tokyo Stock Exchange has historically been the dominant exchange in Japan despite the existence of many regional exchanges. However, there has been considerable consolidation among those regional exchanges and the emergence of new exchanges like JASDAQ, NASDAQ Japan, and others.