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## Qualitative Standards for Qualified Securities: SEC Regulation of Voting Rights

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## ARTICLES

### QUALITATIVE STANDARDS FOR "QUALIFIED SECURITIES": SEC REGULATION OF VOTING RIGHTS\*

Roberta S. Karmel\*\*

The extent to which a federal corporation law has been created by the federal securities laws is an ongoing debate. Perhaps because this is a fundamental but unsettled question, the debate tends to move to new subjects as new investor protection problems emerge. In the past, attention has focused upon the development of a federal common law of fiduciary duty.<sup>1</sup> More recently, attention has focused upon the authority of the Securities and Exchange Commission (SEC) to protect the voting rights of common stockholders in public corporations.<sup>2</sup> This issue has arisen because of charter amendments, adopted as defenses to tender offers, that create two or more classes of common stock with disparate voting rights, contrary to the traditional listing standards of the New York Stock Exchange (NYSE).<sup>3</sup> Yet, changes in the capital structures of corporations, and the institutionalization

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\* The date of this Article is February 1, 1987. See Addendum for subsequent developments.

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1. See Anderson, *The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934*, 70 VA. L. REV. 813 (1984); Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965); Friendly, *In Praise of Erie—and of the New Federal Common Law*, 39 N.Y.U. L. REV. 383 (1964).

2. Compare Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687 (1986) with Dent, *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725 (1986).

3. See Karmel, *Federalizing Shareholder Voting Rights*, N.Y.L.J., Dec. 8, 1986, at 33, col. 3; Karmel, *The SEC's Power to Regulate Stockholder Voting Rights*, N.Y.L.J., Aug. 21, 1986, at 1, col. 1; Karmel, *Is One Share, One Vote Archaic?*, N.Y.L.J., Feb. 26, 1985, at 1, col. 1.

of the public securities markets, make the issues raised more complex and far-reaching than the question of whether the SEC can mandate a one share, one vote rule for publicly traded common stock.

The old shibboleths to the effect that a corporation is managed by its board of directors,<sup>4</sup> for the benefit of the shareholders, who are the owners of the corporation,<sup>5</sup> no longer seem to match economic reality or legal theory.<sup>6</sup> Rather, corporate governance today involves directors of large public corporations in the allocation of economic and political power among management, public, and institutional investors, and other interested constituencies. Both stockholders and bondholders tend to be short term claimants of the assets and cash flow of an enterprise,<sup>7</sup> and the enforcement of corporate governance obligations frequently has political rather than economic objectives.<sup>8</sup>

The author will argue that under the 1975 amendments to the Securities Exchange Act of 1934 (Exchange Act),<sup>9</sup> the SEC has limited, but significant power to regulate corporate governance. The inevitable exercise of this power is likely to alter the balance between federal and state corporate law.

## I. THE SECURITIES LAWS AS A SOURCE OF FEDERAL CORPORATION LAW

In the commercial arena, federalism is a juggling act between the virtues of uniformity and national economic growth on the one hand, and policy experimentation and decentralized power on the other hand. As a general matter, despite repeated clamor for a federal chartering law for large public companies,<sup>10</sup> corporation law has remained the province of state legislatures

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4. See, e.g., N.Y. BUS. CORP. LAW § 701 (McKinney 1986).

5. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931).

6. M. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* (1976); Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395 (1983). But see Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611 (1981); Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561 (1981).

7. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 416 (1986). This was the frequently expressed view of Harold M. Williams when he was Chairman of the SEC. See Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 BUS. LAW. 173, 180 (1981).

8. See, e.g., *Natural Resources Defense Council, Inc. v. SEC*, 606 F.2d 1031 (D.C. Cir. 1979); *Amalgamated Clothing & Textile Workers Union v. J.P. Stevens & Co.*, 475 F. Supp. 328 (S.D.N.Y. 1979); REPORT OF THE SEC ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES TO THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, 94TH CONG., 2ND SESS. (Comm. Print 1976); see also H. KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 18-20 (1979).

9. Securities Exchange Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975).

10. R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* (1976); Cary, *Federalism and Corporate Law: Reflections on Delaware*, 83 YALE L.J. 663 (1974); Ha-

and state corporation law is still the enabling legislation for corporations.<sup>11</sup> However, the federal securities laws have encroached upon state sovereignty to a limited extent, primarily by using disclosure as a regulatory device to influence the conduct of corporate managements and boards.<sup>12</sup>

In addition to federal and state corporation law, state securities regulation supplements federal securities regulation. Securities commissions in every state are permitted to exist by "savings clauses" in both the Securities Act of 1933 (Securities Act)<sup>13</sup> and the Exchange Act.<sup>14</sup> State securities legislation is regulatory rather than enabling and, at least in the "merit" states, addresses governance matters along with matters relating to capital structure.<sup>15</sup>

As if this plethora of law were not sufficient, the scheme of federal securities regulation includes a significant role for self-regulatory organizations (SROs) such as stock exchanges and the National Association of Securities Dealers, Inc. (NASD).<sup>16</sup> Although the primary function of SROs is to license and regulate enterprises and their employees who are participants in the securities markets, SRO rules also address several matters of corporation law. Listing requirements are of particular significance.

#### A. Legislative Provisions

When the first federal securities law, the Securities Act, was passed in 1933, financial regulation seemed a marginal part of the New Deal. Yet, vast sums of money had been lost by the public in the stock market and

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zen, *Corporate Chartering and the Securities Markets: Shareholder Suffrage, Corporate Responsibility and Managerial Accountability*, 1978 WIS. L. REV. 391; Henning, *Federal Corporate Chartering for Big Business: An Idea Whose Time Has Come?*, 21 DE PAUL L. REV. 915 (1972); Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976).

11. J. HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970* (1970); Folk, *State Statutes: Their Role in Prescribing Norms of Responsible Management Conduct*, 31 BUS. LAW. 1031, 1032 (1976).

12. Former SEC Chairman William Cary wrote that "disclosure restrains because of sensitivity to public reaction, caution about response to the 'dissent' shareholder, and the possibility of legal action." Cary, *Corporate Standards and Legal Rules*, 50 CALIF. L. REV. 408, 411 (1962).

13. Securities Act of 1933, § 18, 15 U.S.C. § 77r (1982).

14. Securities Exchange Act of 1934, § 28(a), 15 U.S.C. § 78bb(a) (1982).

15. Brandi, *Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation*, 10 J. CORP. LAW 689 (1985); Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, *Report on State Merit Regulation of Securities Offerings*, American Bar Association 41 BUS. LAW. 785 (1986) [hereinafter ABA Report].

16. See Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 WASH. & LEE L. REV. 853 (1985).

investor confidence was at a low ebb. In order to encourage capital investment in enterprise, federal action was deemed necessary. The Senate Committee on Banking and Currency conducted a highly publicized investigation into stock exchange, banking, and capital markets practices and exposed stock manipulation, insider trading, and breaches of fiduciary duty by corporate managers.<sup>17</sup> Although a consensus in favor of federal legislation was thus formed, there was considerable debate as to the character of such regulation.

One group advocated the full disclosure view, suggested many years before by Louis D. Brandeis: "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."<sup>18</sup> Others argued for more direct control of the sale of securities by the federal government. Early drafts of federal legislation would have prohibited any securities distribution by an issuer if the business of the company or its securities were not sound or the issuer was found to be dishonest or in unsound condition.<sup>19</sup> The Securities Act was a political compromise between critics of bankers, corporate directors, and accountants who questioned the value of the private enterprise system and the business community which strenuously objected to the control of capital raising by a federal bureaucracy. Full disclosure, rather than merit review, was selected as a regulatory model.

Yet, when the Exchange Act was passed a year later, substantive corporation law standards were injected into federal law. Short swing profits by officers, directors, and major stockholders in the securities of their companies were prohibited.<sup>20</sup> Federal control was imposed over the proxy solicitations of large public companies.<sup>21</sup> Of great future importance, a catch all antifraud provision was enacted, giving the SEC some rulemaking authority with regard to fiduciary duties.<sup>22</sup>

An accretion of corporate governance standards flowed from subsequent legislation. The Public Utility Holding Company Act of 1935<sup>23</sup> imposed various substantive controls upon capital structure. The Trust Indenture Act of 1939<sup>24</sup> gave substantive protections to the bondholders of public corporations and assured that their rights would be protected by indenture

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17. See F. PECORA, *WALL STREET UNDER OATH: THE STORY OF OUR MODERN MONEY CHANGERS* (1939).

18. L. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* 92 (1914).

19. See D. RITCHIE & J. LANDIS: *DEAN OF THE REGULATORS* 43-52 (1980).

20. Exchange Act, § 16, 15 U.S.C. § 78p (1982).

21. *Id.* § 14, 15 U.S.C. § 78n.

22. *Id.* § 10(b), 15 U.S.C. § 78j(b).

23. 15 U.S.C. §§ 79 to 79z-6 (1982).

24. 15 U.S.C. §§ 77aaa to 77bbbb (1982).

trustees. The Investment Company Act of 1940<sup>25</sup> created a corporate governance structure for mutual funds, and in particular, a requirement for control by independent directors.<sup>26</sup>

The Securities Act gave the SEC direct control of securities distributions, but little other control over day-to-day corporate conduct. However, major amendments to the securities laws in 1964<sup>27</sup> gave the SEC power to direct a continuous disclosure system for all public corporations. The SEC's tendency to use disclosure for its prophylactic effect at times has gone so far as to invite criticism. A 1977 Advisory Committee to the SEC was prompted to recommend that the "Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct."<sup>28</sup>

The 1968 Williams Act amendments to the Exchange Act<sup>29</sup> gave the SEC regulatory authority over tender offers. Although for the most part these amendments followed a disclosure mode of regulation, the legislation also contained substantive provisions dictating the conduct of contests for corporate control.

In the context of a judicial climate that favored implied rights of action and liberal interpretations of remedial statutes,<sup>30</sup> the SEC was able to utilize enforcement cases and disclosure rules to impose its notions about corporate governance on public companies. In a wide variety of management fraud cases,<sup>31</sup> disclosure rules concerning management remuneration,<sup>32</sup> and hearings concerning corporate accountability,<sup>33</sup> the SEC indicated its interest in generally regulating corporate governance. In recent years, the securities laws were amended to give the SEC significant new powers for doing so. In 1977, Congress passed the Foreign Corrupt Practices Act,<sup>34</sup> giving the SEC direct authority to regulate the internal accounting controls of public corpo-

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25. 15 U.S.C. §§ 80a-1 to 8a-64 (1982).

26. Investment Company Act of 1940, § 10(a), 15 U.S.C. § 80a-10(a) (1982).

27. The Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565; see Exchange Act Release No. 7425 (Sept. 15, 1964), 29 Fed. Reg. 13,455 (Sept. 30, 1964).

28. HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., 1ST SESS. 305, REPORT OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SEC (Comm. Print 1977).

29. Exchange Act, §§ 13(d)-(e), 14(d)-(f), 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982).

30. See Loss, *Introduction: The Federal Securities Code—Its Purpose, Plan, and Progress*, 30 VAND. L. REV. 315 (1977).

31. See R. KARMEI, REGULATION BY PROSECUTION 146-53 (1982).

32. Securities Act Release No. 5856 (Aug. 18, 1977); Item 402, Regulation S-K, 17 C.F.R. § 229.402 (1986); see H. KRIPKE, *supra* note 8, at 18-19.

33. Exchange Act Release No. 13,901 (Aug. 29, 1977), 42 Fed. Reg. 44,860 (Sept. 7, 1977); Exchange Act Release No. 13,482 (Apr. 28, 1977), 42 Fed. Reg. 23,901 (May 11, 1977).

34. Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified at 15 U.S.C. §§ 78m, 78dd-1, 78dd-2, 78ff (1982)).

rations. In addition, in 1984 Congress included in the Insider Trading Sanctions Act<sup>35</sup> a new administrative power to sanction corporate officers responsible for false filings with the SEC.<sup>36</sup> It can be anticipated that when the times are politically opportune, the agency will utilize this power to force its corporate governance ideas upon public companies.<sup>37</sup>

Yet, the most powerful weapon which the SEC has for federalizing corporate governance is its power to define "qualified securities" in a national market system,<sup>38</sup> added to the Exchange Act in 1975.<sup>39</sup> In the same statute, Congress gave the SEC plenary power over SRO rulemaking.<sup>40</sup> The potential for utilizing these powers to supplant state corporation and securities laws will be discussed below.

The purpose of this overview of various amendments to the federal securities laws is to point out that, although these are primarily disclosure statutes, they are not exclusively disclosure statutes. Rather, over the course of fifty years, Congress has given the SEC, in bits and pieces, significant substantive power to regulate the relationship between the management of public corporations and their shareholders. Although Congress has resisted federal chartering,<sup>41</sup> this does not mean that no federal corporation law exists. Yet, because the SEC does not have a clear mandate for regulating internal corporate affairs, and because the federal securities laws focus upon investor protection in order to maintain fair and honest securities markets, commentators generally assume the absence of a federal corporation law. Nevertheless, championing the rights of investors against management, and enlisting the services of directors, accountants, and attorneys to do so,<sup>42</sup> is acting to allocate power among various corporate constituencies. This is the essence of corporate governance, and it has been the work of the SEC for over fifty years.

### *B. Limitations on Federal Corporation Law*

The judiciary has found the antifraud provisions of the federal securities

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35. Pub. L. No. 98-376, 98 Stat. 1264-65 (1984) (codified as amended at 15 U.S.C. §§ 78o(d)(2), 78ff(a) (Supp. II 1984)).

36. Exchange Act, § 15(e)(4), 15 U.S.C. § 780(c)(4).

37. See Karmel, *Increasing the SEC's Administrative Authority*, N.Y.L.J., Apr. 19, 1984, at 1, col. 1.

38. Exchange Act, § 11A(c)(2), 15 U.S.C. § 78kl(a)(2).

39. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975) (codified at 15 U.S.C. §§ 77-78, 80 (1982)).

40. Exchange Act, § 19, 15 U.S.C. § 78s.

41. Federal chartering legislation was introduced by Congressman Ben Rosenthal, H.R. 7010, 96th Cong., 2d Sess., 126 CONG. REC. 7489 (1980), but never progressed.

42. See R. KARMEL, *supra* note 31, at 173-83.

laws a tempting source for developing a federal corporation law. Implied rights of action under section 10(b)<sup>43</sup> and section 14(a)<sup>44</sup> of the Exchange Act have been recognized in a variety of cases involving corporate mismanagement. From time to time, the courts countenanced not only cases involving misrepresentation but also cases involving equitable fraud or breaches of fiduciary duty by corporate management in dealing with shareholders.<sup>45</sup> This led one commentator to declare that the federal securities laws had given rise to a federal corporation law.<sup>46</sup>

However, in *Santa Fe Industries, Inc. v. Green*,<sup>47</sup> the Supreme Court attempted to quash the development of a judge made federal law of corporate fiduciary duty. This case was an effort by the minority shareholders in a squeeze out merger, sanctioned by Delaware statute, to contest the appraisal value of their shares by alleging unfairness and overreaching. The United States Court of Appeals for the Second Circuit took the view that rule 10b-5 reached "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure."<sup>48</sup> The Supreme Court reversed on the ground that section 10(b) cases require deception, manipulation, or nondisclosure.

In so doing, the Court rejected the notion that the securities laws "federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."<sup>49</sup> That is, since fiduciary self-dealing is traditionally left to state regulation, whatever need may exist for uniform federal fiduciary standards should be specifically addressed by Congress, and not implied by the courts. Whether the SEC can or should articulate such a standard in certain types of corporate transactions is another matter that was not addressed by the Court.

In *Schreiber v. Burlington Northern, Inc.*,<sup>50</sup> the Supreme Court indicated that *Sante Fe* would not be confined to its facts, but rather was a general

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43. These rights of action were first recognized in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), but not specifically approved by the Supreme Court until 1971 in *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971).

44. These rights of action were first recognized by the Supreme Court in 1964 in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964).

45. See, e.g., *Shell v. Hensley*, 430 F.2d 819 (5th Cir. 1970); *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969); *Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964).

46. "[A] federal law of corporations now exists. But it has always existed—since the passage of the Securities Act of 1933." Fleischer, *supra* note 1, at 1179.

47. 430 U.S. 462 (1977).

48. *Green v. Sante Fe Indus.*, 533 F.2d 1283, 1287 (2d Cir. 1976).

49. 430 U.S. at 479.

50. 472 U.S. 1 (1985).

holding concerning corporate fiduciary duty. *Schreiber* raised the issue of whether the withdrawal of a hostile tender offer bid and the substitution of a partial bid, following negotiations with the target company's management, constituted a "manipulative" act under section 14(e) of the Exchange Act. The Court held that the term "manipulative" in sections 10(b) and 14(e) should be similarly interpreted and that manipulative acts require misrepresentation or nondisclosure.

Taken together, *Sante Fe* and *Schreiber* place a breach of fiduciary duty, which is fully disclosed by officers or directors to shareholders, beyond the ambit of implied rights of action under the federal securities laws. Whether the SEC may have more latitude in rulemaking than a private litigant in a damage action is another issue. In *Schreiber*, the Court pointed out that in the 1970 amendments to the Williams Act, Congress gave the SEC "latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts."<sup>51</sup>

## II. REGULATION OF VOTING RIGHTS

The SEC's authority to regulate corporate governance is being seriously tested by changes in the voting rights policy of the NYSE. In response to the threat of hostile tender offers some corporations have recapitalized for the purpose of transferring voting control from public shareholders to insiders, sometimes as a means to maintain control by a management or family group, or sometimes as a means to give management control. Such shareholder disenfranchisement has raised serious legal and policy questions. This Article addresses the question whether the SEC has the authority to mandate a one share, one vote voting rights policy for public corporations.

### A. NYSE Listing Standards

The current minimum NYSE requirement, set forth in section 313 of the NYSE's Listed Company Manual, is that holders of common stock have equal voting rights.<sup>52</sup> Since 1926, the NYSE has refused to list any company with nonvoting common stock or any company with more than one class of common stock having disparate voting rights.<sup>53</sup> This prohibition is known

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51. *Id.* at 11 n.11.

52. NYSE Listed Company Manual § 313.00(A) & (C) (1985).

53. *Id.* Similarly, the Exchange recommends that listed preferred stock have minimum voting rights. *Id.* § 313.00(E). For example, the preferred stock should have the right to elect at least two directors in the event of a default on the equivalent of six quarterly dividends. *Id.* Likewise, 66 2/3% of the preferred stock, voting as a separate class, must approve any charter amendment materially altering the rights associated with the preferred stock. *Id.* However, NYSE policy does not prevent the issuance of preferred stock with full voting rights, assuming

as the "one share, one vote" policy. Moreover, the NYSE will delist the stock of a company that creates a class of nonvoting common stock.<sup>54</sup>

Currently, the NYSE permits a very limited type of "dual class capitalization," called the "proportionate voting power" exception.<sup>55</sup> In this type of capitalization, there is an issuance of a second class of common stock in which the voting rights associated with the second class are reasonably related to that security's equity contribution. However, creation of a second class of common stock with disproportionate voting rights unrelated to equity rights would result in delisting from the NYSE. Similarly, the NYSE objects to the creation of a second class of common stock which tends to restrict or nullify the voting power of the issuer's existing common stock.<sup>56</sup> The most prevalent example is where a second class of common stock, normally privately held or controlled by insiders, has the ability, as a class, to elect a majority of a company's board of directors.

Since June 1984 there has been a moratorium on delistings based on dual class capitalizations which contravene the NYSE's policies on voting rights.<sup>57</sup> Over twenty-five NYSE issuers are now in violation of its listing requirements.<sup>58</sup>

Reacting to such changes in corporate structure and increased competi-

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the security's voting power is in a reasonable relationship to its equity contribution. *Id.* § 313.00(D). Moreover, although nonlisted preferred stock does not have to comply with any minimum voting requirement, the NYSE would review the security's voting provisions to assure that the common shareholders' rights are not being infringed upon, such as disproportionate voting power, or the ability of holders of preferred stock, voting as a class, to block a merger or acquisition.

54. *Id.* § 313.00(A). However, special stock of quasi-governmental corporations, like the Student Loan Marketing Association, are not subject to the voting requirement. *Id.*

55. *Id.* § 313.00(D). The Exchange has not established a fixed standard for making the "reasonable relationship" determination and, therefore, when a proportionate voting issue is before the Exchange, it is analyzed on a case-by-case basis.

56. *Id.* § 313.00(C). Similarly, because certain voting arrangements tend to restrict or nullify voting rights of shareholders, the Exchange also objects to voting trusts, irrevocable proxies and similar provisions. *Id.* § 313.00(B).

57. See Carey, *End of an Era*, FIN. WORLD, Aug. 19, 1986, at 14; see also NYSE *Opens Its Doors With Change In 50-Year Old Rule*, Reuters, July 4, 1986 (article reported on wire service).

58. Nash, *Big Board Defends Plan On 2 Classes of Shares*, N.Y. Times, Dec. 17, 1986, at D1, col. 1; Testimony of John J. Phelan, Jr. before the SEC, Dec. 16, 1986. General Motors Corp., Hershey Corp., Dow Jones & Co., and Coastal Corp. are examples of companies that have issued dual classes of common stock in direct violation of the NYSE's voting rights policy. However, the NYSE has permitted them to continue trading while the rule is under review. See Vise, *NYSE Ends "One-Share, One-Vote Rule": Firms Will Be Allowed to Have 2 Classes of Common Stock with Unequal Voting Rights*, Wash. Post, July 4, 1986, at F1, col. 2; Vise, *GM Runs Afoul of NYSE Rule: Created New Class of Stock to Pay for Hughes Deal*, Wash. Post, June 7, 1985, at B1, col. 4; McMurray, *Big Board Panel Likely to Urge Change in Rules*, Wall St. J., Dec. 28, 1984, at 2, col. 2.

tion among marketplaces, on September 16, 1986 the NYSE filed with the SEC proposed amendments to section 313 of its Listed Company Manual.<sup>59</sup> These proposed changes in the listing standards would allow for a variety of dual class recapitalizations if approved by the owners of a majority of the public shareholders and a majority of the independent directors. Public shareholders would be defined as "beneficial owners of the issuer's voting equity securities who are not directors, officers or members of their immediate families," and who are not beneficial owners of ten percent or more of the voting power of the voting equity securities.<sup>60</sup> Thus, the equity securities of a listed company could have disparate voting rights, concentrating control in a management or insider group. However, shares of common stock could not be nonvoting.<sup>61</sup>

Under the proposed rule change, a grandfather provision would permit listed companies, which have created disparate voting rights since April 1984, two years from the date of effectiveness to achieve compliance with the approval requirements. However, a company requesting to list under the new rules would be required to obtain the requisite approval prior to listing on the NYSE. The proposed rule change also would allow for two exceptions from the approval requirements. First, a company would not be subject to the approval requirements if it distributes pro rata among its common shareholders shares of disparate voting rights stock in a "spin-off" of assets. Second, the approval requirements would not apply to a company with existing disparate voting rights if such stock was outstanding at the time the company first went "public."<sup>62</sup>

In accordance with customary procedures, this proposed change in the rules of an SRO was filed with the SEC in conformity with rule 19b-4, under section 19(b) of the Exchange Act,<sup>63</sup> pursuant to which the SEC is required to follow a notice and comment procedure before acting to approve or disapprove such a rule change. The SEC held public hearings on the NYSE's proposed rule change on December 16 and 17, 1986, indicating the impor-

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59. Amendments to Section 313.00 of the NYSE Listed Company Manual, File No. SR-NYSE-86-17 (proposed Sept. 16, 1986) [hereinafter NYSE 19b-4 Filing]; see *Big Board Agrees to Let Companies List More Than One Class of Stock*, Wall St. J., July 7, 1986, at 2, col. 3; Russell, *Manic Market*, TIME, Nov. 10, 1986, at 70.

60. NYSE 19b-4 Filing, *supra* note 59, at 25.

61. *Id.* at 24.

62. *Id.* at 25-26. A company becomes "public" when it has a class of voting equity security held of record of 500 shareholders. The NYSE selected the 500 shareholder definition because of a company's obligation to register as a public company under section 12(g) of the Exchange Act. *Id.* at 19.

63. 17 C.F.R. § 240.19b-4 (1985) (promulgated pursuant to 15 U.S.C. § 78s(b)(1) (1982)).

tance and difficulty of the issues involved.<sup>64</sup>

In 1985, John Phelan, Chairman of the NYSE, testifying before a congressional panel, stated:

The Exchange believes the qualitative listing standards developed and refined over the past half-century or more—including the “one share, one vote” policy—have been good for its listed companies, good for their shareholders and good for this country. . . . Philosophically, the Exchange still believes in it. . . . But the world is changing very rapidly and the issue transcends the New York Stock Exchange. . . . And the national competitive environment may very well preclude the Exchange from unilaterally retaining one share, one vote.<sup>65</sup>

### B. Amex and NASD Requirements

The NYSE's proposed rule change triggered congressional reaction, including the introduction of legislation that would require companies listed not only on the NYSE, but also on the American Stock Exchange (Amex) and NASDAQ/NMS, to have a single class of common stock with equal voting rights.<sup>66</sup> The stated objective of the proposed legislation was to preserve the one share, one vote concept and thus prevent a “race to the bottom” among the major exchanges.<sup>67</sup>

Arthur Levitt, Jr., Chairman of the Amex, told a House subcommittee that abandonment of the one share, one vote rule by the NYSE would be damaging to the securities markets, and particularly to the Amex.<sup>68</sup> Levitt estimated that if the NYSE abandoned its rule, between 200 to 300 major corporations would adopt dual classes of common stock. He also posited a “substantial” loss of revenue because some companies listed on the Amex

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64. Exchange Act Release No. 23,803 (Nov. 13, 1986) [hereinafter *SEC Voting Rights Hearings*]; see Nash, *supra* note 58, at D1, col. 1; *Raider Repellant*, TIME, Dec. 29, 1986, at 62.

65. NYSE 19b-4 Filing, *supra* note 59, at 17-18.

66. S. 1314, 99th Cong., 1st Sess. (1985); H.R. 2783, 99th Cong., 1st Sess. (1985).

67. Specifically, Senator Alfonse D'Amato (R-N.Y.), Chairman of the Securities Subcommittee of the Senate Banking Committee and sponsor of S. 1314, stated that “[n]ow in the face of strong competitive pressures from the American Stock Exchange and NASDAQ, the New York Stock Exchange is considering lowering its listing standards to match the lower standards of the other exchanges. This race to the bottom must be halted.” 131 CONG. REC. 8318 (1985). In the same vein, Congressman John Dingell (D-Mich.), chief sponsor of H.R. 2783, noted that “[i]f two class common [stock] is permitted, and becomes widely used, one of the market mechanisms for accountability will be removed and the exchanges may find themselves engaged in a ‘race for the bottom’ as marketplaces compete for listings and trading volumes.” The Introduction of Legislation Promoting Shareholder Democracy, Press Release (June 18, 1985).

68. *Amex Chief Says Congress Should Consider One Share/One Vote Rule for Amex, NASD*, Daily Rep. Exec. (BNA) No. 100, at A-3 (May 23, 1985).

would transfer to the NYSE. Levitt, therefore, advocated a uniform one share, one vote requirement for the NYSE, Amex, and NASDAQ listed companies.<sup>69</sup>

Currently, the Amex permits dual class capitalizations that involve unequal voting rights.<sup>70</sup> The Amex rule, known as the "Wang Formula,"<sup>71</sup> theoretically provides that the ratio of differential votes per share cannot be more than one to ten.<sup>72</sup> The Amex will not now approve the listing of non-voting common stock,<sup>73</sup> but it has threatened to eliminate its voting rights policies altogether if the NYSE proposed amendments to its listing standards are approved by the SEC.<sup>74</sup>

By contrast, the NASD, which maintains the NASDAQ trading system for over-the-counter securities that meet certain standards, has no requirement regarding voting rights.<sup>75</sup> Furthermore, the results of an NASD commissioned study conducted by Professor Daniel Fischel of the University of Chicago Law School concluded that the NASD should not consider or adopt requirements with regard to voting stock.<sup>76</sup>

It is noteworthy, however, that the NASD is seeking SEC authority to establish listing criteria for its NMS securities. Under this proposal, the NASD would create listing standards in the same manner as the national

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69. *Id.*; see Ingersoll & Swartz, *Amex Head Warns of Regulatory Excess if Big Board Drops Voting Rule on Stock*, Wall St. J., Dec. 17, 1986, at 36, col. 1. Commentators continue to question Amex's long-term viability as an equities market. See, e.g., Sonenclar, *Hanging on at the Amex*, FIN. WORLD, Sept. 16, 1986, at 82. Company listings on the Amex are one-third lower than ten years ago. *Id.* In equity volume, the Amex placed fifth among the American exchanges in 1985. *Id.*

70. Am. Stock Ex. Guide (CCH) § 122 (1985); Two Class Issues Listed on the Amex, American Stock Exchange, Resource Investment Banking Services (June 1, 1986).

71. See *Study Predicts NYSE Will Permit Dual Classes of Stock With Unequal Voting Rights*, Daily Rep. Exec. (BNA) No. 21, at A-2 (Jan. 31, 1986). The Amex rule was initiated for Wang Corp. Wang's dual class capitalization is designed to prevent management from being ousted. At present the Amex has 91 listed companies with dual class capitalizations.

72. Two Class Issues Listed on the Amex, *supra* note 70. Pursuant to Amex policy, establishment of a two class issue also requires that the limited voting class have the ability to elect not less than 25% of the board of directors. *Id.* In addition, "[i]f the percentage of outstanding common stock represented by the 'super' voting class becomes less than 12 1/2%, then the limited voting class acquires the additional right of voting with the 'super' voting class for the remaining 75% of the directors." *Id.* Although the Amex does not require that a dividend preference be established for the limited voting issue, it is "strongly recommended." *Id.*

73. Am. Stock Ex. Guide (CCH) § 122 (1985).

74. Securities Exchange Act Release No. 23,951 (Jan. 2, 1987); *Amex to Seek SEC Approval of Change to End Curbs on Unequal Voting Rights*, 18 Sec. Reg. & L. Rep. (BNA) 1713 (Nov. 28, 1986).

75. D. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock 2* (Feb. 1986) (NASD Study); see also *Study Predicts NYSE Will Permit Dual Classes of Stock With Unequal Voting Rights*, *supra* note 71, at A-2.

76. D. Fischel, *supra* note 75.

stock exchanges. Moreover, the NASD has proposed to establish some corporate governance standards, for example, requiring independent directors for NASDAQ issuers.<sup>77</sup>

### C. State Law

A survey of state corporation law provisions regulating voting rights is beyond the scope of this Article. As a general matter, however, articles of incorporation denying voting rights to one class of common stock in the election of directors does not violate the public policy of state corporation laws.<sup>78</sup> However, in certain extraordinary circumstances, nonvoting common stockholders may exercise a limited franchise.<sup>79</sup>

More specific regulation of the voting rights of common stockholders is found in state securities laws rather than in state corporation laws. Every state, the District of Columbia, and Puerto Rico has a securities regulation statute, but not all state "blue sky" regulation is merit regulation. A merit regulator has the authority to prevent an issuer from selling securities in the state because the offering or the issuer's capital structure is substantively unfair or presents excessive risk to the investor.<sup>80</sup>

Although the blue sky laws vary from state to state, they all contain a requirement for registration of securities to be sold in the state. However, most state securities laws currently provide an exemption from their securities registration requirements to issuers which are listed on a national securities exchange. This is known as the "blue chip" exemption. Some states also provide an exemption for certain over-the-counter securities.<sup>81</sup>

Controversy over these exemptions has come from two contradictory developments. First, the NASD has been urging that broader exemptions be

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77. Securities Exchange Act Release No. 22,506 (Oct. 4, 1985), 50 Fed. Reg. 41,769 (Oct. 15, 1985).

78. See, e.g., *Hampton v. Tri-State Fin. Corp.*, 30 Colo. App. 420, 495 P.2d 566 (1972); *General Inv. Co. v. Bethlehem Steel Corp.*, 87 N.J. Eq. 234, 100 A. 347 (1917); 5 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 2026 (perm. ed. 1976 & Supp. 1986); 11 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 5086 (perm. ed. 1986); 1 MODEL BUS. CORP. ACT ANN. 2D § 15 (1971). But see *Stroh v. Blackhawk Holding Corp.*, 117 Ill. App. 2d 301, 307-08, 253 N.E.2d 692, 695-96 (1969) (under Illinois Constitution and Business Corporation Act, the rights of shareholders with respect to different classes of shares of corporate stock can be limited in every way except with respect to voting.), *aff'd*, 48 Ill. 2d 471, 272 N.E.2d 1 (1971). The vitality of this case, however, is questionable. See *Roanoke Agency v. Edgar*, 101 Ill.2d 315, 461 N.E.2d 1365 (1984).

79. See, e.g., *DuVall v. Moore*, 276 F. Supp. 674 (N.D. Iowa 1967).

80. *ABA Report, supra* note 15, at 787.

81. *Id.* at 833-35. Fifteen states have such an exemption: Georgia, Illinois, Kansas, Kentucky, Minnesota, Montana, Nebraska, New Hampshire, New Mexico, North Dakota, Oklahoma, Tennessee, Texas, Washington, and Wyoming.

adopted by states so that securities listed on NASDAQ and/or securities designated as "NMS securities"<sup>82</sup> will be exempt from blue sky registration requirements. Second, the pendency of the NYSE amendments to its listing standards, discussed above, which would permit dual class capitalization resulting in nonvoting or restricted voting stock, has caused some state regulators to consider elimination of the blue chip exemption in view of merit standards addressed to voting rights.

Blue sky provisions dealing with shareholder voting rights generally are promulgated under a fair and equitable standard. Such restrictions are intended to keep promoters from obtaining public financing without relinquishing some company control to the public.<sup>83</sup> States which have rules mandating such rights seek to provide equity between classes of stock, although preferential rights to either dividends or distributions on liquidation may provide the necessary justification for unequal voting rights. Currently, thirteen states have merit restrictions relating to voting rights.<sup>84</sup>

A North American Securities Administrators Association (NASAA) Statement of Policy on Non-Voting Stock places restrictions on the issuance of unequal voting stock. Under the Statement of Policy, unless preferential treatment as to dividends and liquidation is provided with respect to publicly offered securities or the differentiation is otherwise justified, an offering or proposed offering of equity securities by an issuer having more than one class of equity security authorized or outstanding, shall be considered unfair and inequitable to public investors if the class of equity securities offered to the public (a) has no voting rights, or (b) has less than equal voting rights, in proportion to the number of shares of each class outstanding, on all matters, including the election of members to the board of directors of the issuer.<sup>85</sup> This type of merit review has been adopted in Alaska, Indiana, Missouri, and Nebraska.<sup>86</sup>

In March 1986, NASAA approved a Report and Recommendation from the NASAA Committee of State Registration Exemptions on the issues of an

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82. "National Market System Securities" as defined in SEC Rule 11Aa-2-1, 17 C.F.R. § 240.11Aa-2-1 (1986) pursuant to § 11A(a)(2) of the Exchange Act, 15 U.S.C. § 78k-1(a)(2) (1982).

83. H. SOWARDS & N. HIRSCH, BUSINESS ORGANIZATIONS—BLUE SKY REGULATION §§ 7A.02 & 7A.03 (1986); Brandi, *supra* note 15, at 700.

84. The states with voting rights restrictions are: Alaska, Arkansas, California, Florida, Indiana, Kansas, Louisiana, Minnesota, Missouri, Nebraska, Tennessee, Texas, and Washington. Iowa rescinded its restriction on August 21, 1985.

85. NASAA Statement of Policy on Non-Voting Stock, NASAA Reports (CCH) 2401 (adopted Sept. 17, 1980).

86. ALASKA ADMIN. CODE tit. 3, § 3 AAC 08.210, 1 Blue Sky L. Rep. (CCH) ¶ 8434, at 4428 (1984); IND. ADMIN. CODE § 710 IAC 1-12-4, 1A Blue Sky L. Rep. (CCH) ¶ 24,590, at 19,463 (1986); MO. CODE REGS. tit. 15, § 30-52.110, 2 Blue Sky L. Rep. (CCH) ¶ 35,461, at

NMS exemption and an exchange exemption.<sup>87</sup> In the context of controversies over possible changes in listing standards relating to voting rights and any expansion of the blue chip exemption, the NASAA Committee Report recommended that instead of a blue chip exemption (specifying for example, NYSE securities), the blue sky commissioner should designate the criteria for any blue chip exemption in a model rule. Thus, state administrators would have the power to certify appropriate blue chip standards, rather than delegate their ability to set criteria for an SRO. Further, the proposed model rule would require exempt issuers, among other things, to have at least two independent directors and no nonvoting common stock. If two classes of voting stock are outstanding, the class with the lesser voting rights would be required to have the right to elect at least 25% of the directors of the issuer. Further, the voting disparity between the classes could be no greater than ten to one.<sup>88</sup>

As the foregoing indicates, the primary sources of regulatory authority over shareholder voting rights are state blue sky laws and NYSE listing requirements. Because of the blue chip exemption, and the variation in state blue sky laws, the NYSE voting rights policy has become a uniform national standard for large public companies. The extent to which this standard has the dignity of federal law, however, is unclear.

### III. SEC REGULATION OF CORPORATE CONTROL

Although the allocation of power among management, boards, and shareholders is generally regulated by state law, in contests for control of large

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30,532 (1986); NEB. SECURITIES RULES, tit. 48, ch. 8, 2 Blue Sky L. Rep. (CCH) ¶ 37,408, at 32,505-06 (1984).

The Minnesota regulations go one step further to say that there will be no registration of securities with unequal voting rights, unless the commissioner in his discretion deems such substitutes satisfactory. MINN. R. 2875.3080, 1A Blue Sky L. Rep. (CCH) ¶ 33,501, at 28,436 (1984). Similarly, Texas and Wyoming permit the commissioner to determine that preferential treatment justifies unequal voting rights. TEX. ADMIN. CODE tit. 7, § 113.3(6), 3 Blue Sky L. Rep. (CCH) ¶ 55,583, at 49,251 (1986); WYO. SECURITIES RULE § 3(j), 3 Blue Sky L. Rep. (CCH) ¶ 66,433, at 57,507 (1986).

Another slight modification to the NASAA statement exists in the WIS. ADMIN. CODE § 3.07, 3 Blue Sky L. Rep. (CCH) ¶ 64,527, at 56,520-21 (1986). Whereas the NASAA statement provides the offering shall be deemed unfair and inequitable if voting rights are unequal and preferential treatment is absent, the Wisconsin statute states the offering may be deemed unfair and inequitable if common stock has no voting rights. Less than equal voting rights may be justified by preferential treatment. *Id.*

87. *NASAA Agrees to Propose Amendments to '56 Uniform Act at Spring Meeting*, 18 Sec. Reg. & L. Rep. (BNA) 399 (Mar. 21, 1986); *NASAA Committee Report on State Registration Exemptions*, 18 Sec. Reg. & L. Rep. (BNA) 206 (Feb. 7, 1986).

88. *NASAA Agrees to Propose Amendments to '56 Uniform Act at Spring Meeting*, *supra* note 87.

public companies, the federal securities laws and in particular the SEC's proxy and tender offer rules, regulate the conduct of the players. In view of the enormous aggregations of power and wealth that are transferred in the market for corporate control, and the impact of such transfers upon the national economy, federal regulation of this process is not inappropriate.

### A. Proxy Regulations

The federal securities laws, which were enacted in 1933 and 1934, did not provide specifically that common stockholders should enjoy voting rights commensurate with their economic investment in a public company. However, the laws arguably presumed the existence of a vote by shareholders by granting the SEC power, specifically in section 14(a) of the Exchange Act, to regulate proxy solicitations "as necessary or appropriate in the public interest or for the protection of investors."<sup>89</sup> Congress was of the view that individuals involved in the management of companies owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies.<sup>90</sup>

Rather than regulate proxy solicitations directly, however, Congress entrusted the exchanges, subject to somewhat limited SEC review, with the task of according fair suffrage to shareholders, on the theory that exchanges are public institutions which make possible wide distributions of securities.<sup>91</sup> When the Exchange Act was broadened in 1964 to permit the SEC to regulate securities traded over-the-counter in some of the same ways that exchange traded securities had been regulated, the SEC urged that section 14(a) be extended to over-the-counter securities as one means of insuring annual shareholder elections.<sup>92</sup>

The legislative history of the Exchange Act indicates that Congress had two goals in mind in adopting section 14(a): to promote fair corporate suffrage and to curtail management's dominance of the proxy process. Notwithstanding its potential breadth, section 14(a) generally has been regarded primarily as a disclosure rather than a regulatory provision.

Nevertheless, from the time the SEC was established, some of its leaders have taken the position that the Commission could utilize its powers to make directors more responsive to the public interest. For example, William O. Douglas, an early Chairman of the SEC and then Justice of the Supreme Court, wrote: "Both prior to and during my SEC days I had promoted the

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89. 15 U.S.C. § 78n(a) (1982).

90. See *SEC v. Transamerica Corp.*, 163 F.2d 511, 518 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948).

91. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13-14 (1934).

92. Seligman, *supra* note 2, at 689.

idea of having 'public' directors of our large corporations. . . . [A]t least some of the directors of our large corporations must not be subservient to management. This was a policy which the SEC had power to enforce."<sup>93</sup>

In the late 1960's and early 1970's the SEC capitalized on a general anti-business sentiment by devoting significant resources to its management fraud and sensitive payments programs. The publicity that these programs generated placed the SEC in the forefront of the corporate governance movement. In April 1977, the SEC announced public hearings "concerning shareholder communications, shareholder participation in the corporate electoral process and, more generally, corporate governance."<sup>94</sup> These hearings were part of a campaign against abusive corporate power and corporate management misconduct in which the SEC's political range was much broader than investor protection. In shaping its public hearings, the Commission stated:

While the proxy solicitation process is indeed a central focus of the present inquiry, it is clear that the issues being studied transcend the proxy rules in significance, and include the broader and more fundamental question of how corporations can best be made more responsive to their shareholders and the public at large.<sup>95</sup>

Among the rulemaking proposals generated by the SEC's corporate governance program of the late 1970's was a proposed management affiliation disclosure rule which would have required all corporations subject to the SEC's proxy rules to label directors as "independent" or "affiliated."<sup>96</sup> While the final rules that the SEC adopted were limited to more general disclosure about directors, boards, and board committees, there was an obvious effort by the SEC to use such disclosure as a prophylactic device to force management to include more outside directors on boards.<sup>97</sup> The SEC staff report on corporate accountability which followed the SEC's hearings and rulemaking proceedings concluded that, although corporate accountability includes the various ways in which corporations seek to justify actions to all those affected by corporate activities, including communities, federal, state and local governments, and the public generally, the SEC could not address the adequacy of existing accountability mechanisms in serving noninvestor constituencies. Rather, these "larger corporate accountability issues transcend the jurisdiction and expertise of this Commission and appropriately

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93. W. DOUGLAS, *GO EAST YOUNG MAN* 272 (1974).

94. Exchange Act Release No. 13,482 (Apr. 28, 1977).

95. Exchange Act Release No. 13,901 (Aug. 29, 1977).

96. Exchange Act Release No. 14,970 (July 18, 1978).

97. See Address by Harold M. Williams, Corporate Accountability, Fifth Annual Securities Regulation Meeting, San Diego, Calif. (Jan. 18, 1978).

should be considered by others."<sup>98</sup>

Reacting to the SEC's corporate governance hearings and threats of corporate chartering legislation, the business community and corporate lawyers began considering voluntary measures that might ward off federal legislation. In November 1976, a subcommittee of the Corporation Banking and Business Law Committee of the American Bar Association issued the *Corporate Director's Guidebook* designed to assist corporate directors in performing their duties.<sup>99</sup> In addition, the Business Roundtable issued a report on the composition of corporate boards of directors in 1978.<sup>100</sup>

During this debate over corporate governance and reform, the American Law Institute (ALI) authorized a Corporate Governance Project (the Project) under the leadership of former SEC Chairman Ray Garrett, Jr.<sup>101</sup> The Project has been continuing and has generated considerable controversy. In part, this is because much of the Project has articulated corporate governance principles in a statutory format and, therefore, would appear to be a predicate for federal corporate charter and legislation. Although the Project does not recommend statutory revision of the proxy provisions of the Exchange Act, the thrust of the Project's provisions on board structure and composition could ultimately federalize corporate governance to an extent beyond existing law.<sup>102</sup>

### B. The Tender Offer Regulations

The Williams Act was added to the Exchange Act in 1968 to enable the SEC to regulate tender offers, corporate repurchases, and certain related matters.<sup>103</sup> One of the purposes of the Williams Act was to establish a principle of neutrality between the bidder and the target in a contested tender offer. This principle was utilized in *Edgar v. MITE Corp.*<sup>104</sup> to invalidate state legislation that appeared to tip the balance improperly in a contest for corporate control in favor of the target company.

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98. SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 96TH CONG., 2D SESS., SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY 33 (Comm. Print 1980).

99. American Bar Ass'n Comm. on Corp. Laws, *The Corporate Director's Guidebook*, 32 BUS. LAW. 5 (1976).

100. Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2105 (1978).

101. See American Law Institute, *Principles of Corporate Governance and Structure: Restatement and Recommendations* (Tent. Draft No. 1, May 1982).

102. See Karmel, *The Independent Corporate Board: A Means to What End?*, 52 GEO. WASH. L. REV. 534 (1984).

103. The Williams Act added §§ 13(d)-(e) and 14(d)-(f) to the Exchange Act (codified at 15 U.S.C. §§ 78m(d)-(e) and 78n(d)-(f) (1982)).

104. 457 U.S. 624 (1982).

More recently in *Dynamics Corp. v. CTS Corp.*,<sup>105</sup> the United States Court of Appeals for the Seventh Circuit held an Indiana tender offer statute, which provided for shareholder and disinterested shareholder approval for voting share acquisitions of 20% or more, unconstitutional on interstate commerce grounds. This case suggests that the SEC may have the power to regulate voting rights of common stockholders in contests for corporate control.

Indeed, the Williams Act may give the SEC considerably more substantive authority with regard to corporate governance; for example, the ability to outlaw various types of poison pills.<sup>106</sup> Moreover, the all-holders and best price rules adopted by the SEC go beyond disclosure and impinge upon corporate governance.<sup>107</sup>

Federal bills have been introduced in both the House and Senate which would give the SEC explicit authority over corporate voting rights. Some bills would compel all public companies to conform to a one share, one vote standard.<sup>108</sup> Whether the SEC already has the power to compel a one share, one vote rule for publicly traded securities in the absence of such legislation is the subject of the SEC proceedings on the NYSE's voting rights proposal.<sup>109</sup> Other bills would make tender offers subject to a shareholder vote and would then prevent arbitrageurs from voting on tender offers.<sup>110</sup>

The ALI Corporate Governance Project would strike an interesting balance between further regulation, presumably federal, and a market-oriented approach. This proposal would adopt more rigorous requirements for the market for corporate control, for example, with respect to safeguarding shareholder voting rights, but would also permit private ordering, allowing corporations to adopt charter provisions contrary to such new regulations.<sup>111</sup> This approach also was suggested by recent SEC rulemaking in the tender offer area.<sup>112</sup>

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105. 794 F.2d 250 (7th Cir.), *judgment amended*, 805 F.2d 705 (7th Cir. 1986), *rev'd*, 107 S.Ct. 1637 (1987).

106. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offerer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984); see Exchange Act Release No. 23,486 (July 31, 1986).

107. Exchange Act Release No. 23,421 (July 11, 1986). Compare Exchange Act Release No. 17,120 (Sept. 4, 1980) with *Chiarella v. United States*, 445 U.S. 222 (1980).

108. S. 1314, 99th Cong., 1st Sess. (1985); H.R. 2783, 99th Cong., 1st Sess. (1985).

109. Exchange Act Release No. 23,803 (Nov. 13, 1986).

110. Ingersoll, *Political Pressures Building to Stem Trading Excesses*, Wall St. J., Nov. 17, 1986, at 29, col. 5.

111. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 6.01-.04 (American Law Institute Advisory Group Draft No. 7, Sept. 17, 1986).

112. Exchange Act Release No. 23,486 (July 31, 1986).

#### IV. NATIONAL MARKET SYSTEM REGULATION

The NYSE listing agreement dates back to 1899, and certain requirements for listing are even older.<sup>113</sup> This body of shareholder protection requirements has served as a national standard for large public companies in lieu of any federal or state corporation law regulating a variety of structural governance matters.

Until 1975, exchange listing standards were clearly the subject of private or contract law between an SRO and listed companies. The amendments to the federal securities laws in 1975 gave the SEC certain new powers over SROs and raise the question of whether shareholder protection features of listing requirements can be mandated by the SEC. This is a result of the requirement that the SEC is required to approve or disapprove any proposed rule or rule change of any SRO,<sup>114</sup> and may also amend and mandate SRO rules on its own initiative.<sup>115</sup> Although this plenary power over SRO rulemaking includes passing upon changes in listing requirements,<sup>116</sup> the SEC must exercise this power with reference to the purposes of the Exchange Act.<sup>117</sup>

In addition to the SEC's power over SRO rulemaking, the SEC has authority with respect to defining securities qualified for trading in a national market system (NMS), which also would appear to give the SEC authority to mandate corporate governance mechanisms for public corporations.

##### A. SEC Power Over SRO Rulemaking

In 1975, Congress laid the foundation for the establishment of the NMS in amendments to the Exchange Act. "The rapid attainment of a national market system . . . is important . . . to assure that the country maintains a strong, effective and efficient capital raising and capital allocating system in the years ahead."<sup>118</sup>

Without mandating specific components of the NMS or even defining the term, Congress vested the SEC with broad flexible authority to design, implement, and regulate the NMS. In the statute, two significant new powers were given to the SEC: the power in sections 19(b) and (c) of the Exchange

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113. Exchange Act Release No. 13,346 (Mar. 9, 1977).

114. Exchange Act, § 19(b), 15 U.S.C. § 78s(b) (1982).

115. Exchange Act, § 19(d), 15 U.S.C. § 78s(c) (1982).

116. Rule 19b-4 under the Exchange Act, 17 C.F.R. § 240.19b-4 (1986); see *In re Torrington*, 19 S.E.C. 39 (1945); see also § 11A(c)(4)(A) of the Exchange Act, 15 U.S.C. § 78k-l(c)(4)(A) (1982).

117. Exchange Act, §§ 19(b)(2) & 19(c), 15 U.S.C. §§ 78s(b)(2) & 78s(c) (1982).

118. S. REP. NO. 75, 94th Cong., 1st Sess. 3 (1975) [hereinafter Senate Report].

Act<sup>119</sup> to approve, disapprove, abrogate, add to or delete from rules adopted by SROs, and the power in section 11A(a)(2) of the Exchange Act to “designate the securities . . . qualified for trading in the national market system . . . (qualified securities).”<sup>120</sup>

The SEC’s authority under section 19 is limited to actions in “furtherance of the purposes” of the Exchange Act.<sup>121</sup> If the SEC should determine that voting rights for common stockholders are in furtherance of the objectives of the proxy and tender offer regulations, a rule for all SROs on the subject presumably would be in furtherance of the purposes of the Exchange Act. It should be noted that any amendments to any SRO rules mandated by the SEC remain rules of the SRO and do not become SEC rules.<sup>122</sup>

Although some commentators have questioned whether the SEC has the authority to require SROs to adopt qualitative governance standards for listed securities, as Justice Holmes once regarded, “a page of history is worth a volume of logic.”<sup>123</sup> Where Congress has presumed regulatory authority to exist at the SRO level, subject to SEC oversight, it would be anomalous for the SEC not to be able to act to maintain the viability of prior regulatory requirements. Furthermore, in the case of certain new substantive regulations, such as the requirement for independent directors on audit committees, the SEC previously has taken an active role in the formulation of SRO rules which regulate corporate structure.<sup>124</sup>

### B. Definition of Qualified Securities

In addition to the generalized power over SRO rulemaking contained in section 19, the SEC has the authority to establish criteria for “qualified securities.” Although this authority is not limited by the statute on its face, it is limited implicitly by the objectives of the NMS. One of these principles is that the securities qualified to be included in the NMS should depend primarily on their trading characteristics, rather than where they happen to be traded. The Senate Report accompanying the 1975 amendments, for example, noted that “many securities do not have the characteristics—e.g., trading volume, price, and number of stockholders—which would justify auction-type trading.”<sup>125</sup>

Also, one of the statutory findings added to the Exchange Act in 1975

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119. Exchange Act, §§ 19(b)-(c), 15 U.S.C. §§ 78s(b)-(c) (1982).

120. Exchange Act, § 11A(a)(2), 15 U.S.C. § 78kA(a) (1982).

121. Exchange Act, § 19(c), 15 U.S.C. § 78s(c) (1982).

122. Exchange Act, § 19(c)(4)(C), 15 U.S.C. § 78a(c)(4)(C) (1982).

123. *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921).

124. See SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY, *supra* note 98, at 642-47.

125. Senate Report, *supra* note 118, at 16.

states that it is in the "public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . fair competition . . . among exchange markets, and between exchange markets and markets other than exchange markets."<sup>126</sup>

In giving the SEC authority to define "qualified securities" it would appear that Congress intended the SEC to equalize listing standards of competing marketplaces, if this were necessary to achieve the statutory purposes enumerated above. To the extent that such traditional standards are qualitative and relate to corporate governance matters, the SEC would appear to have the capacity to establish standards on voting rights for publicly traded securities.<sup>127</sup>

Recently, much focus has been on the one share, one vote NYSE listing standard. However, the foregoing analysis would apply to certain other corporate governance rulemaking as well; for example, the NYSE requirement that public companies have a minimum number of independent directors generally and on audit committees. In that connection, the NASD has proposed to establish certain corporate governance standards pertaining to independent directors.<sup>128</sup>

### C. *Additional Sources of Authority*

Finally, some mention should be made of section 23(a) of the Exchange Act, which authorizes the SEC to adopt such rules and regulations as may be necessary or appropriate to implement the provisions of that Act, as well as section 14(e) of the Exchange Act, which similarly gives the SEC authority to promulgate rules designed to prevent violations of the Williams Act. So long as a rule promulgated pursuant to such general rulemaking authority is "reasonably related to the purposes of the enabling legislation it will be sustained."<sup>129</sup> The SEC could utilize this authority to pass regulations affecting corporate governance if the rules were designed to implement the proxy, tender offer, or national market system provisions of the Exchange Act, all of which are predicated upon fairness to investors. The extent to which such rulemaking could impose substantive fairness requirements that go beyond disclosure and exceed the requirements of state law is, however, a perplexing question.<sup>130</sup>

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126. Exchange Act, § 11A(a)(1)(C)(ii), 15 U.S.C. § 78k-1(a)(1)(C)(ii) (1982).

127. Letter from Milton H. Cohen to John P. Wheeler, Secretary SEC, File S7-37-84, Feb. 8, 1985, discussed in Exchange Act Release No. 22,412 (Sept. 16, 1985).

128. Exchange Act Release No. 22,506 (Oct. 4, 1985).

129. *Mourning v. Family Publications Serv.*, 411 U.S. 356, 369 (1973).

130. *See Burks v. Lasker*, 441 U.S. 471 (1979).

## V. CONCLUSION

Although the SEC has ample authority to formulate a voting rights policy for public companies, the exercise of such authority would be an unprecedented regulation of corporate governance. Therefore, although the permanent management entrenchment which dual class capitalizations permit is contrary to the principle of investor protection in the federal securities laws, the SEC perhaps will not go so far as to mandate a one share, one vote rule. In its release ordering hearings on the NYSE's proposed listing standard changes, the SEC suggested a number of possible regulations which might permit some public companies to have dual class capitalizations, but require companies which have an existing one share, one vote standard to maintain such a capitalization.

The difficult public policy question that the SEC must confront is whether shareholders should be denied the freedom to bargain away their voting rights. Although state blue sky merit statutes have so limited corporate capitalizations, it can be anticipated that the SEC will approach such regulation cautiously and formulate a federal voting rights policy with extreme reluctance.

## VI. ADDENDUM

In the five months since the completion of this article the SEC encouraged voluntary SRO rulemaking in an attempt to resolve the difficult legal and political problems involved in formulating a federal voting rights standard.<sup>131</sup> Although the NASD was willing to promulgate a voting rights rule, the Amex refused to compromise its position. As a result, no uniform rule across all public marketplaces was achieved.<sup>132</sup>

In the meantime, shareholder voting rights have been further undermined by an increasing number of dual class recapitalizations involving shareholder disenfranchisement and rule proposals by the NYSE and the Pacific Coast Stock Exchange to amend their voting rights listing standards.<sup>133</sup> Also, the Supreme Court reversed the Seventh Circuit in *CTS Corp. v. Dynamics Corp. of America*<sup>134</sup> and upheld the Indiana antitakeover law at issue. The Court did not overrule *Edgar v. MITE Corp.*,<sup>135</sup> but rather distinguished it, on the ground that the Indiana statute "protects the independent shareholder

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131. Ingersoll, *SEC Chief Says Voting-Rights Pact Is Near*, Wall St. J., June 1, 1987, at 4, col. 1.

132. See Voting Rights Listing Standards, Exchange Act Release No. 24,623, 52 Fed. Reg. 23,665, 23,666-67 (June 24, 1987).

133. *Id.* at 23,666.

134. 107 S. Ct. 1637 (1987).

135. 457 U.S. 624 (1982).

against both of the contending parties" in a takeover.<sup>136</sup> Thus, the principle of neutrality upon which the Williams Act rests was not offended. Nevertheless, the Court underlined the interests of the states in corporate governance by asserting that "[n]o principle of corporation law and practice is more firmly established than a state's authority to define the voting rights of shareholders."<sup>137</sup> The reality, however, is that state corporate law does not protect shareholder voting rights.<sup>138</sup>

Confronted with the need to take some action with respect to the NYSE's proposed change in its listing requirements, the SEC finally instituted proceedings to "consider whether to adopt a rule which would have the effect of amending the rules of" national stock exchanges and the NASD to prohibit publicly traded companies from "issu[ing] securities or taking other corporate action that would have the effect of nullifying, restricting or disparately reducing the voting rights of existing shareholders of the company."<sup>139</sup> Much of the SEC's notice of proposed rulemaking was devoted to a discussion of its legal authority to intrude into corporate governance by passing a voting rights rule. Although the Commission concluded that it has such authority under section 19(c) of the Exchange Act, it also relied heavily upon its powers under the proxy provisions.<sup>140</sup> Interestingly, the SEC's release does not rely upon or even discuss its powers under the Williams Act. Accordingly, the question of whether, under the rationale of the Supreme Court in *CTS*, proposed rule 19c-4 would preempt a state antitakeover law will have to wait for another day.

Because rulemaking under section 19(c) of the Exchange Act requires public hearings, which the SEC scheduled for July 11, 1987, it can be anticipated that the debate over whether the SEC has the authority to pass a voting rights rule, and the form any such rule should take, can be expected to continue until after the publication of this article.

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136. *CTS Corp.*, 107 S. Ct. at 1645.

137. *Id.* at 1649.

138. See Karmel, *Shareholder Voting Rights Diminishing Under State Law*, N.Y.L.J., June 18, 1987, at 1, col. 1.

139. See Voting Rights Listing Standards, *supra* note 132.

140. *Id.* at 23,675-76; see also *id.* at 23,678 (concurring statement of Commissioner Fleischman).