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THE SHORT LIFE AND RESURRECTION OF SEC RULE 19C-4

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Shares of common stock represent a bundle of ownership interests: a set of economic rights, such as the right to receive dividends declared by the board of directors; and the right to vote on certain corporate decisions, with one vote per share of common stock being the U.S. norm for over a century. The voting rights part of the bundle typically does not matter very much. Shareholders are entitled to vote on only a small set of corporate actions; the board of directors makes most decisions or delegates them to officers and employees.

Voting rights do matter in one critical context—contests for corporate control.1 If incumbent managers are (or are believed to be) inefficient or self-interested, the value of the corporation's stock should begin to fall. This makes it possible for others to reap capital gains by ousting the incumbents and replacing them with more diligent or trustworthy managers. These gains, however, can be realized only if the challenger controls enough shares to outvote the incumbents.2

During the last two decades, many corporate managers who saw themselves as competent and loyal nevertheless saw their firms subjected to hostile takeover bids.3 Unsurprisingly, many resisted. While the prevailing fashions in defensive tactics change constantly, voting control re-

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While in private practice, I assisted a private lobbying effort before the Securities and Exchange Commission in connection with the rulemaking proceedings leading up to the adoption of rule 19c-4. The opinions expressed herein, however, are solely my own. For helpful comments on earlier drafts of this Article, I wish to thank William J. Davey, Michael P. Dooley, Thomas M. Mengler, Robert D. Rosenbaum, and Stephen F. Ross. I also wish to thank Stephanie Barrick for her excellent research assistance.


2. Id. at 1430-34.

3. While not unmixed, some empirical evidence supports the proposition that well-managed firms, as well as inefficient ones, are subjected to hostile takeover bids. For an exhaustive overview of the empirical and theoretical literature on the motivation for corporate acquisitions, see R. Gilson, The Law and Finance of Corporate Acquisitions 255-500 (1986). More recent developments in this area are summarized in R. Gilson, Supplement to The Law and Finance of Corporate Acquisitions 2-120 (Supp. 1990).
mains the surest takeover defense. An incumbent who cannot be outvoted, after all, cannot be ousted. In the early 1980s, a growing number of companies therefore adopted dual class capital structures (also referred to as disparate voting rights plans) to concentrate voting control in management’s hands. Their effect is most easily demonstrated by considering the simplest type of disparate voting rights plan: a charter amendment creating two classes of common stock. The Class A shares are simply the preexisting common stock, having one vote per share. The newly created Class B shares, distributed to the shareholders as a stock dividend, have most of the attributes of regular common stock, but possess an abnormally large number of votes (usually ten) per share. Class B shares typically are not transferable, but may be converted into Class A shares for sale. Normal shareholder turnover thus concentrates the superior voting shares in the hands of long-term investors, especially incumbent managers, giving them voting control without the investment of any additional funds.

As dual class stock became more common, calls went out for federal regulation. In July 1988, the Securities and Exchange Commission (SEC or Commission) responded by adopting rule 19c-4. In effect, rule 19c-4 amended the rules of the self-regulatory organizations (SROs) to prohibit an issuer’s equity securities from being listed on a national securities exchange or traded through the National Association of Securities Dealers Automated Quotation system (NASDAQ) if the company issued securities or took other corporate action nullifying, restricting, or disparately reducing the voting rights of existing shareholders. While not a strict

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The new listing standards created by rule 19c-4 prohibited a covered exchange from listing or continuing to list the equity securities of an issuer that takes one of the prohibited actions. It likewise prohibited a covered securities association from authorizing the equity securities of such an issuer for quotation and/or transaction reporting on an automated quotation system. The Intermountain and Spokane Stock Exchanges were the only national securities exchanges excluded from coverage. The National Association of Securities Dealers (NASD) was the only securities association affected by the rule, just as the NASDAQ system was the only affected automated quotation
one-share/one-vote standard, rule 19c-4 placed substantial limitations on the ability of U.S. corporations to adopt disparate voting rights plans.

After a brief description in Part I of dual class capital structures, Part II of this Article evaluates rule 19c-4 and the Commission's arguments as to the need for regulation of dual class stock. In essence, the Commission argued that shareholders were being forced to accept certain types of dual class transactions without having any meaningful voice in the matter. Part II demonstrates that dual class transactions are objectionable not because of these so-called collective action problems, but because of the conflict of interest inherent in management’s decision to propose such transactions.

Once dual class stock is seen as a conflict of interest problem, the question arises as to whether the SEC had authority to adopt rule 19c-4. Conflict of interest transactions traditionally are a matter of state law; indeed, rule 19c-4 was the SEC's first substantive regulation of conflict of interest transactions generally applicable to public corporations. More generally, it also was the SEC's most direct regulation of corporate governance to date. In June 1990, the United States Court of Appeals for the District of Columbia invalidated rule 19c-4 on the grounds that the Commission had exceeded the statutory authority delegated to it by Congress. Part III argues that the court of appeals' decision was correct in light of the Exchange Act's literal language, its legislative history, and its historical context. Part III concludes by examining some of the broader implications of the D.C. Circuit's opinion for future SEC regulation of corporate governance, proxies, and takeovers.

Because the SEC decided not to seek en banc or Supreme Court review of the D.C. Circuit panel's decision, the battleground has shifted back to the states and the SROs. As of this writing, two of the principal SROs have adopted listing standards modelled on rule 19c-4. Part IV of this Article argues that the SROs are an appropriate forum in which to ad-

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6. The SEC had previously attempted to substantively regulate the fairness of going private transactions, which raise conflict of interest concerns comparable to those posed by dual class stock. In the face of objections that it lacked statutory authority to do so, the SEC settled for adopting new disclosure rules applicable to such transactions. See Exchange Act Release No. 16,075 (Aug. 2, 1979), 44 Fed. Reg. 46,736 (1979).

dress the conflict of interest potentially present in dual class transactions, but that simply grafting rule 19c-4 into SRO listing standards is the wrong answer to the problem. Instead, Part IV offers an alternative regulatory scheme.

I. MODERN DUAL CLASS STOCK PLANS

While limitations on shareholder voting rights are as old as the corporate form itself, the story of modern dual class capital structures effectively begins in the early years of the 1900s. By 1900, the vast majority of U.S. corporations operated on a one vote per share basis. State corporation statutes of the period, however, merely established the one-share/one-vote principle as a default rule. Corporations were free to deviate from the statutory standard, and a growing number began to do so. Many corporations, for example, issued two classes of common stock: one with full voting rights on a one vote per share basis, the other with no voting rights (but perhaps with greater dividend rights).
While disparate voting rights plans gained popularity with corporate managers, and investors showed a surprising willingness to purchase large amounts of nonvoting common stock, an increasingly vocal opposition also emerged in the 1920s. William Z. Ripley, a Harvard professor of political economy, was the most prominent (or at least the most outspoken) proponent of equal voting rights. According to Ripley, nonvoting stock was the "crowning infamy" in a series of developments designed to disenfranchise public investors. In essence, his was an early version of the conflict of interest argument: promoters used nonvoting common stock as a way of maintaining voting control for themselves. By issuing the voting common stock to insiders and nonvoting common stock to the public, promoters raised considerable sums without losing control of the enterprise.

The opposition to nonvoting common stock came to a head with the New York Stock Exchange's (NYSE) 1925 decision to list Dodge Brothers, Inc. for trading. Dodge sold a total of $130 million worth of bonds, preferred stock, and nonvoting common shares to the public. Dodge was controlled, however, by an investment banking firm, which had paid only $2.25 million for its voting common stock. In January 1926, the NYSE responded to the resulting public outcry by announcing a new position:

Without at this time attempting to formulate a definite policy, attention should be drawn to the fact that in the future the committee, in considering applications for the listing of securities, will give careful thought to the matter of voting control.

This policy gradually hardened, until the NYSE in 1940 formally announced a flat rule against listing nonvoting common stock. Although occasional exceptions arose, the most prominent being the 1956 listing of Ford Motor Company despite its dual class capital structure, the basic policy remained in effect until the mid-1980s.

Ripley had proclaimed the demise of nonvoting common stock as early

17. Id. at 699.
18. The evolution of the NYSE policy is traced in J. SELIGMAN, THE ONE SHARE, ONE VOTE CONTROVERSY 4-8 (1986); Kerbel, supra note 8, at 57-63; Seligman, supra note 15, at 697-700.
as 1926. He was somewhat premature: in the years between 1927 and 1932, at least 288 corporations issued nonvoting or limited voting rights shares (almost the same number as between 1919 and 1926). But the Great Depression, probably with assistance from the opposition led by Ripley and the NYSE, finally killed off most disparate voting rights plans. One comprehensive survey, for example, found only thirty issuers with nonvoting or dual class common stock listed on U.S. secondary markets between 1940 and 1978. Even more striking, in no year during that period were there more than eleven such issuers.

After several decades of non-controversial dormancy, dual class capital structures came back into vogue during the early 1980s. A subsequent survey found that thirty-seven of forty-four publicly-traded firms adopting disparate voting rights plans between 1962 and 1984 did so after January 1980. Another thirty-four corporations created dual class capital structures between March 1986 and May 1987 alone. These modern plans differed from their earlier counterparts in three critical ways: motivation, design, and method of implementation.

A desire to raise additional equity capital and simultaneously retain control in the hands of a founding family or entrepreneurial group, motivated many, if not most, disparate voting rights plans adopted during

19. W. RIPLEY, supra note 13, at 122 ("[n]onvoting common stock, then, bears every appearance of being dead—dead beyond recall."). See also A. BERLE & G. MEANS, supra note 14, at 76.
21. Dewing attributes their demise solely to the Great Depression, id. at 162, but it seems likely that the other factors played a role.
23. Id. at 456 (table 2).
26. Many studies have found that corporations with dual class capital structures, especially those established before the recent wave of recapitalizations, have significant family ownership. E.g., DeAngelo & DeAngelo, Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock, 14 J. FIN. ECON. 33, 50 (1985).
the five decades after the NYSE first announced its policy. The revival of dual class capital structures in the 1980s, however, was almost certainly motivated by managerial concerns about the decade's significant rise in the number of hostile takeovers. For managers of potential takeover targets, the surest takeover defense is possession of voting control. A corporate raider by definition cannot oust incumbents who can outvote it. Even less than majority control may help managers fend off hostile takeovers; for example, by making it easier to obtain shareholder approval of other types of takeover defenses.

Management can obtain voting control in two ways. One is a so-called going private transaction, typically structured as a leveraged buyout, in which management purchases the shareholdings of public investors. This technique, of course, requires management to increase substantially its equity investment in the firm. A less costly alternative from management's perspective is the creation of a disparate voting rights plan. Indeed, proxy statements seeking shareholder approval of a dual class recapitalization routinely admit that the plan will reduce the likeli-

27. See generally id. at 51-55; see also Fischel, Organized Exchanges and the Regulation of Dual Class Common Stock, 54 U. Chi. L. Rev. 119, 136-40 (1987); Kerbel, supra note 8, at 43-46.

28. Professor Fischel has argued that dual class stock should not necessarily be regarded as a species of takeover defenses. Fischel, supra note 27, at 149-51. Cf. Comments of the United States Department of Justice at 15-17, In re Self-Regulatory Organizations; Proposed Rule Change by New York Stock Exchange (SEC 1986) (No. SR-NYSE-86-17) (dual class capital structures should not significantly impede takeover bids) [hereinafter DOJ Comments]. Other commentators, however, are virtually unanimous in regarding the recent wave of dual class recapitalizations as having been inspired by the takeover mania of the 1980s. See, e.g., J. SELIGMAN, supra note 18, at 10; Ruback, Coercive Dual-Class Exchange Offers, 20 J. Fin. Econ. 153 (1988); Buxbaum, The Internal Division of Powers in Corporate Governance, 73 Calif. L. Rev. 1671, 1713-15 (1985); Dent, Dual Class Capitalization: A Reply to Professor Seligman, 54 Geo. Wash. L. Rev. 725, 726 (1986); Gordon, Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 Calif. L. Rev. 3, 4 (1988).

29. See generally Gilson, Evaluating Dual Class Common Stock: The Relevance of Substitutes, 73 Va. L. Rev. 807 (1987) (arguing that in a perfect market leveraged buyouts and dual class recapitalizations are functionally identical).

30. A technique related to dual class recapitalizations involves granting voting rights to holders of debt securities. Although this right is often restricted to voting on acquisitions or other changes in control of the issuer, it may have a takeover deterrent effect if bondholders believe they are systematically disadvantaged by takeovers and thus can be expected to vote against acquisitions. See 2 R. WINTER, R. ROSENBAUM, M. STUMPF, G. HAWKINS & L. PARKER, SHARK REPELLENTS AND GOLDEN PARACHUTES: A HANDBOOK FOR THE PRACTITIONER 262.1-63 (Supp. 1990) [hereinafter SHARK REPELLENTS]; e.g., Proxy Statement of South Carolina Nat'l Corp. (Oct. 26, 1981), reprinted in id. at 306-09 (1983).
hood of a hostile takeover.31

While there are various forms of disparate voting rights plans and various techniques of implementing them, they all share one common theme—concentration of voting power in the hands of incumbent managers and their allies.32 The basic dual class recapitalization is a good example. Shareholders approve a charter amendment creating two classes—typically referred to as Class A and Class B—of common stock. The Class A shares are essentially the preexisting common stock under a new name, retaining all of its former attributes, including the usual one vote per share. The Class B shares possess all of the attributes of common stock, with three exceptions: (1) ownership of Class B stock may not be transferred except to certain specified persons, such as the holder's spouse and heirs; (2) Class B shares, however, may be converted into shares of Class A, which are freely transferable; and (3) the Class B stock has a larger number of votes, usually ten, per share. The Class B shares are then distributed to the shareholders as a stock dividend on their existing common shares.33

Because the Class B shares are not transferable, if a shareholder wishes to sell her shares of Class B stock, she must first convert them into shares of Class A. (An improper transfer automatically results in conversion.) Over time, as public investors adjust their portfolios by selling out of the company, the number of outstanding Class B shares accordingly falls. In contrast, long-term investors—especially incumbent managers—retain their Class B shares, concentrating the superior voting shares in management's hands.34 Management thus may eventually obtain voting control without ever investing any additional equity in the firm.35 Moreover, the

31. Partch, supra note 24, at 315, 312-22 (although noting that few proxy statements said that deterring hostile takeovers was the primary purpose of the proposal).
32. Many studies have found that corporate management tends to own the bulk of the superior voting rights shares and hence to possess voting control after the recapitalization. However, in many companies (especially those adopting dual class capital structures prior to the recent resurgence of such plans), management already owned an unusually large proportion of the voting shares prior to the recapitalization. E.g., DeAngelo & DeAngelo, supra note 26, at 44-45, 61; First SEC Study, supra note 25, at 27-28; Partch, supra note 24, at 314-15, 319-21; cf. Stevens, supra note 9, at 385-86 (dual class plans of 1920s also had the effect of concentrating voting control in hands of insiders). The latter finding may be explained by the possibility that such managers were more confident of obtaining shareholder approval of the recapitalization transaction.
33. SHARK REPELLENTS, supra note 30, at 270.2-70.3 (Supp. 1990); e.g., Proxy Statement of Harper & Row Publishers, Inc. (Feb. 23, 1987), reprinted in id. at 374.50-77-74.50-113 (Supp. 1988).
35. In some cases, the lesser-voting rights class is guaranteed the right to elect a specified
plan's antitakeover effect is immediate, as the restrictions on transferability preclude an offeror from acquiring the Class B stock.

A closely related alternative involves issuing the Class B shares, previously created by appropriate charter amendments, in an exchange offer. Shareholders are invited to exchange their existing Class A stock for the higher-voting rights Class B shares. In these cases, however, the Class B shares typically possess lesser dividend rights and a concomitant lower dividend rate. Accordingly, most public investors will not exchange their shares. If only management and its allies acquire the higher-voting right shares, an exchange offer dual class recapitalization may effectively give management immediate voting control. 36

Other types of disparate voting rights plans produce similar takeover defensive effects. For example, a few corporations revived the concept of imposing a ceiling on the percentage of voting rights that any individual shareholder may possess. Regardless of the number of shares owned by a shareholder, that shareholder is treated as owning not more than the specified percentage of voting power—usually ten percent or less. 37 The intended takeover deterrent effect of such plans is especially apparent in those cases in which the plan provides a waiver of the voting rights cap as to shareholders who make a tender offer, subject to the satisfaction of a number of conditions, at a fair price to all shareholders. Thus, the voting rights cap purportedly assures that any acquirer will pay a fair price. 38

Yet another approach, time-phased voting rights, amends the corporation's articles of incorporation to give the holders of its common stock ten votes per share. However, subsequent purchasers are entitled to only one vote per share until they have held the shares for some specified time.
period (typically several years). Thereafter, the holder becomes entitled to ten votes per share.\textsuperscript{39} Time-phased voting plans have a significant antitakeover effect, as they dramatically increase the number of shares an offeror must acquire to achieve immediate voting control.\textsuperscript{40}

II. RULE 19C-4 AND THE NEED FOR REGULATION

When the rule 19c-4 controversy began, corporate voting rights were subject to two basic sets of rules: state law and SRO listing standards. State law generally provided (as it still does) considerable flexibility. Virtually all states use one vote per common share as the default rule, but allow corporations to depart from the norm by adopting appropriate provisions in their organic documents.\textsuperscript{41} Only two states diverge from this pattern in their corporation statutes,\textsuperscript{42} although the blue sky laws of about one-third restrict the sale of at least some disparate voting rights shares.\textsuperscript{43} Courts have also routinely upheld dual class capital

\textsuperscript{39} Id. at 270.2 (Supp. 1990); e.g., Proxy Statement of American Family Corp. (Apr. 22, 1985) (requiring 48 month holding period), reprinted in id. at 374.16-11-374.23 (Supp. 1988).
\textsuperscript{40} Shark Repellents, supra note 30, at 270.2 (Supp. 1990); Buxbaum, supra note 28, at 1718-19. Additional variants on these basic themes are described in J. SELIGMAN, supra note 18, at 11-15; First SEC Study, supra note 25, at 12-19; Note, Dual Class Recapitalization and Shareholder Voting Rights, 87 Colum. L. Rev. 106, 110-11 (1987).
\textsuperscript{42} Mo. ANN. STAT § 351.180 (Vernon 1966 & Supp. 1990) (prohibiting limitation or denial of voting rights); Neb. Rev. Stat. § 21-2014 (1987) (requiring all holders of common shares to have the right to vote in election of directors, although otherwise permitting variations in voting rights).

A few federal statutes also regulate the use of dual class stock, but these statutes are limited to a relatively small number of companies. E.g., 11 U.S.C. § 1123(a) (1988) (companies reorganizing under the Bankruptcy Act must prohibit nonvoting equity stock and provide an appropriate distribution of voting power among all equity classes); 15 U.S.C. § 79g(a) (1988) (requiring fair distribution of voting power among classes of stock issued by registered public utility holding companies); 15 U.S.C. § 80a-18(i) (1988) (certain registered investment companies must provide equal voting rights to all shares, absent SEC exemption). In contrast, a few federally chartered corporations are prohibited from issuing voting shares to the public; this class, however, is limited to a select group of firms that are really quasi-governmental agencies, such as the Student Loan Marketing Association. See Kerbel, supra note 8, at 39.

structures.44

SRO listing standards thus provided the major restraint on dual class capitalizations prior to the adoption of rule 19c-4. In addition to its policy of not listing nonvoting common stock, the NYSE refused to list the voting common stock of any issuer having a class of nonvoting common stock outstanding and, in effect, refused to list issuers having two or more classes of common stock with disparate voting rights.45 The AMEX likewise refused to list nonvoting common stock,46 but it adopted a more flexible policy with respect to disparate voting rights plans. Issuers adopting such plans would be listed as long as the plan satisfied certain guidelines designed to create a minimum level of participation to which the lesser voting rights class was entitled.47 In contrast, the National Association of Securities Dealers (NASD) imposed no voting rights listing standards in either the over-the-counter market or the NASDAQ system.48

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45. NYSE Listed Company Manual §§ 308.00, 313.00 & 802.00 (1983).


47. The most important of these policies requires that the lesser-voting rights class, voting as a class, must have the ability to elect not less than one quarter of the board of directors and that the voting ratio on other matters may not exceed ten to one. The full policy statement is reprinted in J. SELIGMAN, supra note 18, at 9.

48. Shortly before rule 19c-4 was proposed, the NASD began considering voting rights listing standards. Memorandum from NASD to All NASD Members and Other Interested Persons, Request for Comments on Shareholder Voting Rights Proposal for NASDAQ Companies (May 28, 1987) (copy on file with Washington University Law Quarterly); see also NASD Governors Clear Voting Rule for Shareholders, Wall St. J., May 18, 1987, at 30, col. 3. This development was largely motivated by the NASD's desire to obtain an exemption for NASDAQ securities, comparable to...
The NYSE's refusal to list dual class shares almost certainly was the major factor in enforcing their long sojourn in obscure corners of corporate financing. Until quite recently, the NYSE possessed significant advantages over all of its competitors. The greater liquidity of NYSE securities probably lowered listed issuers' cost of capital. Listing also conferred considerable prestige on the firm and its managers. Listed companies desired to remain so, while many unlisted firms sought eligibility for listing as their primary goal. As a result, few companies challenged the Exchange's policy on disparate voting rights. Changes in the secondary trading market during the 1980s, however, dramatically enhanced the feasibility of disparate voting rights plans. The emergence of NASDAQ as a viable alternative to exchange listing initiated the closing of the liquidity and prestige gap between the exchanges and the over-the-counter market. Indeed, a growing number of companies that became eligible for NYSE or AMEX listings chose to remain on NASDAQ.

Given the ability of disparate voting rights plans to insulate management from the threat of hostile takeovers, it was not surprising that a substantial number of NYSE-listed firms demanded the right to adopt such plans. Given the NYSE's weakened competitive posture vis-a-vis that enjoyed by NYSE and AMEX securities, from state blue sky laws. See Seligman, supra note 15, at 705-06.


50. Gordon, supra note 28, at 6; Kerbel, supra note 8, at 62.

51. All securities transactions that do not take place on a stock exchange are said to occur in the over-the-counter (OTC) market. Bid and asked quotations for OTC securities traditionally were listed only daily in a publication known as the sheets or pink sheets. As a result, OTC stocks were less liquid than exchange securities. The NASDAQ is a computer network providing access (depending on the level of service chosen) to quotations and transaction reports for many OTC securities and allowing market makers to change quotations. It has thereby made NASDAQ shares much more liquid. The development of improved telephone and computerized communication networks between brokers has even further enhanced the liquidity of the OTC market. But some OTC shares continue to be listed on the old pink sheets and thus remain relatively less liquid.

52. According to one post-NASDAQ study, NYSE listing no longer conferred statistically significant stock price benefits on shareholders. Sanger & McConnell, supra note 49, at 19.


54. The initial, or at least the most prominent, action by a NYSE-listed issuer was General Motors Corporation's 1984 announcement that it intended to issue a class of stock having one-half vote per share as consideration in its acquisition of Electronic Data System. A number of other
its less restrictive competitors, it was also not surprising that the NYSE reconsidered its policy against dual class stock.\(^{55}\) In 1984, the NYSE announced a moratorium on enforcement of the relevant listing standards and established a committee to study the problem.\(^{56}\) In 1986, pursuant to Exchange Act section 19(b),\(^ {57}\) the Exchange requested SEC approval of a modified rule allowing the NYSE to list dual class stock if a majority of the issuer's independent directors and "public" shareholders approved the recapitalization.\(^ {58}\)

At this point, the SEC had at least three options: (1) approve the NYSE's request, allowing greater competition amongst the SROs for listings; (2) disallow the proposed change, probably doing further damage to the NYSE's competitive position; or (3) adopt a single rule applicable to all SROs.\(^ {59}\) After hearings, and a failed effort to reach a voluntary compromise,\(^ {60}\) the Commission chose the third route. It declined to act on

NYSE companies shortly thereafter proposed to adopt disparate voting rights plans. Adopting Release, supra note 5, at 89,209.

55. The NYSE admitted that the growing competition for listings among the major SROs was a motivating factor behind its proposal. Adopting Release, supra note 5, at 89,209. Most commentators also saw competition with the other SROs as an important (if not the) motivating factor behind the Exchange's action. See Gordon, supra note 28, at 6; Harris, SEC Holds Hearing on Proposal to Alter Rule on Voting Stock, Legal Times, Dec. 22, 1986, at 16; Kerbel, supra note 8, at 63; Seligman, supra note 15, at 700-01; Troy, Is a "One Share, One Vote" Rule a Good Idea?, Nat'l L.J., July 6, 1987, at 32.


57. Section 19(b) requires SEC approval of any proposed new SRO rules or changes to existing SRO rules. 15 U.S.C. § 78s(b) (1988).


59. Actions by other SROs briefly complicated the SEC's options, although in both cases the situation was resolved fairly easily. In December 1986, the AMEX filed a proposed rule change eliminating its partial restrictions on dual class stock. The filing was withdrawn in April 1987. The Pacific Stock Exchange likewise filed a proposed rule allowing dual class stock. Its proposal was mooted by the adoption of rule 19c-4. Adopting Release, supra note 5, at 89,209-10, nn.11 & 19.

60. Beginning in March 1987, several months before rule 19c-4 was proposed, members of the SEC staff met with representatives of the AMEX, NASD, and NYSE. They considered an approach
the NYSE proposal, instead proposing rule 19c-4 as a uniform standard applicable to all securities markets.61 In July 1988, after more than a year's deliberation, the SEC finally adopted a modified version of rule 19c-4.62

Acknowledging that dual class stock had some legitimate (or, at least, unobjectionable) uses, the SEC rejected proposals for a strict one-share/one-vote standard. Undoubtedly, this was the correct decision, although for reasons different than those advanced by the Commission. The SEC's position rested on two basic grounds. First, the empirical evidence as to the effect of dual class stock on shareholder wealth was unclear and, at best, inconclusive. Second, the Commission appeared unpersuaded by the various theoretical arguments in favor of a flat prohibition.63 In contrast, this Article reaches the same result on the different ground that dual class stock transactions should be regulated only when they pose a significant conflict between the interests of managers and shareholders. Because some dual class transactions do not raise such concerns, a flat prohibition is unwarranted. Interestingly, however, as the following sections demonstrate a conflict of interest-based sieve would pick up most of the same transactions regulated by rule 19c-4.

As adopted, rule 19c-4 prohibited only those corporate actions having the effect of nullifying, restricting, or disparately reducing the per share voting rights of existing common stock shareholders of the company.64 In addition, the Commission specifically addressed a number of plan

pursuant to which all of the major SROs would voluntarily adopt rules comparable to that then under consideration by the NASD. Memorandum from Brandon Becker, Assoc. Director, Division of Market Regulation, to SEC File Nos. 4-308 and S7-22-87, Meetings Between the Self-Regulatory Organizations Staff and the Commission Staff to Discuss a Rule Regarding Shareholder Voting Rights (June 23, 1987) (copy on file with Washington University Law Quarterly). Like earlier efforts in this vein during 1985, see Phelan Testimony, supra note 58, at 7, the negotiations eventually collapsed—reportedly because of resistance by AMEX. See 2 Corp. Couns. Weekly (BNA) No. 23, at 1 (June 10, 1987); 2 Corp. Couns. Weekly (BNA) No. 22, at 1 (June 6, 1987); 19 Sec. Reg. & L. Rep. (BNA) 667-68 (May 8, 1987); see generally Proposing Release, supra note 56, at 88,770-71. 61. Proposing Release, supra note 56. 62. Adopting Release, supra note 5. 63. The SEC's arguments are not addressed in detail, as they raise questions largely beyond the scope of this Article. The major empirical studies of dual class stock include: FIRST SEC STUDY, supra note 25; Gordon, supra note 28; Lease, McConnell & Mikkelson, supra note 22; Partch, supra note 24; SECOND SEC STUDY, supra note 25. The major theoretical analyses of a flat prohibition include: DeAngelo & DeAngelo, supra note 26; Fischel, supra note 27; Gilson, supra note 29; Gordon, supra note 28; Grossman & Hart, One Share-One Vote and the Market for Corporate Control, 20 J. FIN. ECON. 175 (1988); Harris & Raviv, Corporate Governance: Voting Rights and Majority Rules, 20 J. FIN. ECON. 203 (1988). 64. 17 C.F.R. § 240.19c-4 (1990). In general, implementation and subsequent interpretation of
types: presumptively prohibiting some, presumptively permitting others, and leaving still more for case-by-case analysis.\footnote{55}{In addition, it should be noted that the rule entirely exempted foreign issuers and grandfathered domestic issuers which adopted disparate voting rights capital structures prior to July 7, 1988. \textit{Id.} at 89,222-23. Grandfathered plans were not to operate so as to exacerbate the disparity in relative voting power. Thus, issuances of additional shares under such plans generally were required to maintain the existing proportional voting rights of all classes. \textit{Id.} at 89,223.}

\textbf{A. Prohibited Transactions}

The types of dual class transactions presumptively prohibited by the rule included time-phased voting rights plans, capped voting plans, issuances of shares with per share voting rights greater than those of existing common shares, and exchange offers in which full voting common stock was exchanged for lesser-voting common shares.\footnote{56}{\textit{Id.} at 89,220-22.} Although transferability restrictions are generally regarded as critical to their antitakeover effect, rule 19c-4 presumptively prohibited super-voting shares even in the absence of such restrictions.\footnote{57}{\textit{Id.} at 89,221.} Likewise, it prohibited exchange offers even when the lesser-voting rights shares carried a dividend preference; exchange offers in which common shares were exchanged for non-voting debt securities or preferred stock, however, were to be analyzed on a case-by-case basis, and only those transactions determined to produce the prohibited "disenfranchising" effects would trigger the rule.\footnote{58}{\textit{Id.} at 89,221-22 & n.105.}

While most such plans create pronounced anti-takeover effects, collective shareholder action problems were the stated justification for prohibiting them.\footnote{59}{See \textit{id.} at 89,216; see also \textit{id.} at 89,235 (Grundfest, C., concurring); Proposing Release, \textit{supra} note 56, at 88,773-74. For purposes of this Article, the term "collective action problem" shall refer collectively to shareholder apathy, coercion, and valuation concerns.} For example, some transactions, especially exchange offers, were said to involve direct shareholder coercion. A rational shareholder faced with a dual class exchange offer knows that corporate insiders likely will obtain voting control if it is successful. However, the restrictions on transferability often placed on the super-voting shares and their lower dividend rate make exchanging her shares unattractive. If the shareholder retains her shares, she at least obtains the substantial dividend typically granted to the lesser-voting rights shares. Retaining her shares is thus in her best interest. If all shareholders are
rational, all will reach the same conclusion and will approve the transac-
tion, even though it may not be in the best interests of the outside share-
holders collectively.\(^7\)

Proponents of rule 19c-4 argued that collective action problems also
arose in other types of dual class recapitalizations. In many recapitaliza-
tions, outside investors hold a majority of the firm's ex ante voting
power; in many more, outsiders could expect to achieve aggregate voting
control in the future via sales by insiders and additional equity offer-
ings.\(^7\) A recapitalization may transfer voting control to insiders, how-
ever, without the outside common shareholders having any meaningful
say in the matter. Rational shareholder apathy supposedly results in
routine approval of dual class recapitalizations despite the subsequent
loss of voting rights.\(^7\) According to the theory, a rational shareholder
will expend the effort to make an informed decision only if the expected
benefits of doing so outweigh its costs. Given the length and complexity
of proxy statements, the opportunity cost entailed in reading them before
voting is quite high and very apparent, while few apparent benefits are
received. Accordingly, shareholders can be expected to assign a rela-
tively low value to the expected benefits of careful consideration. The
necessary investment of time and effort in making informed voting deci-
sions simply is not worthwhile. Most shareholders will therefore vote to
approve a dual class transaction regardless of its impact on their inter-
est. An informed, objecting minority supposedly is thus effectively dis-
enfranchised, even though they purchased their shares with the
expectation of full voting rights.\(^7\)

This concern is inconsistent with corporate law's historic focus on ma-
jority rule. Collective action problems are present virtually whenever
shareholders are asked to make decisions. Yet the majority has long

\(^{70}\) The coercive effect of dual class exchange offers is thus quite similar to that of two-tier
offers. See generally Adopting Release, supra note 5, at 89,221-22; FIRST SEC STUDY, supra note
25, at 8; Gilson, supra note 29, at 832-40. But see Dent, supra note 28, at 740-41.

\(^{71}\) Proposing Release, supra note 56, at 88,778. A proponent of dual class stock might argue
that rational shareholders would have anticipated the possibility of being disenfranchised and dis-
counted it in determining whether or not to purchase shares. However, given the difficulty of pre-
dicting the likelihood of a dual class recapitalization and the difficulty of measuring its effect on
share prices, it seems unlikely that shareholders would be able to fully discount the stock price ex
ante.

\(^{72}\) E.g., Adopting Release, supra note 5, at 89,235-36 (Grundfest, C., concurring); Gordon,
supra note 28, at 43-47; Note, supra note 40, at 117-120. For a general discussion of rational share-
holder apathy, see R. CLARK, CORPORATE LAW 390-92 (1986).

\(^{73}\) Adopting Release, supra note 5, at 89,216; Proposing Release, supra note 56, at 88,778.
been allowed to impose its will on a strenuously objecting minority, absent some conflict of interest, even in transactions as fundamental as changes in control. Moreover, the existence of a supposedly informed, objecting minority seems inconsistent with the shareholder apathy theory on which the argument is based. The SEC, nevertheless, accepted the collective action argument. It therefore chose to prohibit not only exchange offers and super-voting blank check preferred, but also many types of recapitalizations effected by charter amendments approved by shareholders.

The SEC's decision appeared to rest on two additional grounds. Upon close examination, however, neither justified the SEC's decision to reject the traditional focus on majority rule. First, the SEC noted that management is able to pressure large holders into supporting the transaction. A number of corporate managers have exerted significant pressure on institutional investors to support dual class recapitalizations and other anti-takeover measures. In addition, management's power to set the agenda and use corporate funds to solicit proxies helps it obtain approval of a recapitalization. These forms of coercion, however, do not justify a prohibition of dual class stock (they are potentially present any time shareholders are asked to vote on any issue), as they can be addressed via the fiduciary duties of managers and institutional investors.

Second, the SEC and some commentators appear to view the higher dividends often paid on lesser-voting stock as, in effect, a bribe to coerce shareholders to vote for a proposal they would otherwise reject. Grant-
ing that "dividend sweeteners" may result in some favorable votes that otherwise might have been unfavorable, I confess to not understanding the objection. Sweeteners are not uncommon in transactions restructuring the rights of parties, especially when collective action problems must be overcome. Accordingly, if the dividends fully compensate the shareholders, why should they not be allowed to make that choice?

The answer may be that the higher dividend rate is unlikely to be fully compensatory, because its value is difficult to measure. Dual class stock would be unobjectionable if outside shareholders were fully compensated for any losses they suffer because of their lesser-voting rights. However, while higher dividends payable on the lesser-voting stock partially compensate shareholders, that compensation may not account fully for the loss of their voting rights. In any event, it would be very difficult indeed to measure accurately the transaction's effect on shareholders.

None of the SEC's arguments persuasively answered the question of why dual class stock should be regulated in the first place. Instead, the strongest argument against dual class stock rests on conflict of interest grounds. There is good reason to be suspicious of management's motives and conduct in certain dual class recapitalizations. Dual class transactions motivated by their antitakeover effects, like all takeover defenses, pose an obvious potential for conflicts of interest. If a hostile bidder succeeds, it is almost certain to remove many of the target's incumbent directors and officers. 79 On the other hand, if incumbent management defeats the bidder, target shareholders are deprived of a substantial premium for their shares. 80 A dual class capital structure, of course, effectively assures the latter outcome. 81

81. In recent years, courts have imposed increasingly onerous restrictions on management's ability to fend off hostile takeovers. E.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). This rule could, and perhaps should, be extended to

http://openscholarship.wustl.edu/law_lawreview/vol69/iss2/6
In addition to this general concern, a distinct source of potential conflict between managers' self-interest and the best interests of the shareholders arises in dual class recapitalizations. An analogy to management-led leveraged buyouts (MBOs) may be useful. In these transactions, management has a clear-cut conflict of interest. On the one hand, they are fiduciaries of the shareholders, charged with getting the best price for the shareholders. On the other, as buyers, they have a strong self-interest in paying the lowest possible price.

In dual class recapitalizations, management has essentially the same conflict of interest. Although they are fiduciaries charged with protecting the shareholders' interests, the disparate voting rights plan typically will give them voting control. The managers' temptation to act in their own self-interest is obvious. Yet, unlike MBOs, in a dual class recapitalization, management neither pays for voting control nor is its conduct subject to meaningful judicial review. As such, the conflict of interest posed by dual class recapitalizations is even more pronounced than in MBOs. On the other hand, it must be recognized that only a potential conflict of interest exists. Accordingly, while rule 19c-4's prohibition of certain dual class transactions probably was unnecessary, some restrictions on dual class recapitalizations are desirable in order to discourage management's self-interested behavior.

B. Permitted Transactions

The Commission identified a number of dual class transactions as to which it believed collective action problems were unlikely. These types of plans, which rule 19c-4 presumptively permitted, include issuance of disparate voting rights stock in an initial public offering (IPO); subsequent issuances of a new class of lower voting stock; and issuance of lower voting rights stock in a bona fide merger or acquisition.\(^2\) Interest-the use of dual class stock as a hostile takeover defense. Cf. Berle, Non-Voting Stock and "Bankers' Control," 39 HARV. L. REV. 673 (1926) (arguing that fiduciary duties should be imposed on supervoting rights shareholders).

82. Adopting Release, supra note 5, at 89,219-20. The SEC left for subsequent interpretations the question of whether a company could issue lower voting rights stock and thereafter issue additional shares of the original, higher voting rights stock. Id. at 89,219.

The exemption for IPOs would have been of limited utility to those companies most likely to be subject to a hostile acquisition effort, namely, established publicly-held corporations. However, the SEC's adopting release took the position that a company, without violating the rule, could be taken private and subsequently go public in an offering that included a disparate voting rights plan. See id. at 89,227. This would allow, for example, a company's management to obtain control in a leveraged
ingly, none of these transactions pose serious risks of self-interested behavior by managers.

Dual class IPOs present the clearest case. Public investors who do not want lesser voting rights stock simply will not buy it. Those who are willing to purchase it presumably will be compensated by a lower per share price than full voting rights stock would command and/or by a higher dividend rate. In any event, assuming full disclosure, they become shareholders knowing that they will have lower voting rights than the insiders and having accepted as adequate whatever trade-off the firm offered in recompense. Thus, a form of market review effectively constrains management's conflict of interest.

The other types of permitted dual class transactions also do not raise collective action or conflict of interest concerns. For example, a subsequent issuance of lesser-voting rights shares does not disenfranchise existing shareholders, because they retain their full voting rights shares. Nor are the purchasers of such shares harmed; as in an IPO, they take the shares knowing that their rights will be less than those of the existing shareholders. Likewise, issuance of lesser-voting rights shares as consideration in a merger or other corporate acquisition should not be objectionable. Shareholders who object to the form of consideration often will be able to demand their statutory appraisal rights and receive payment in cash.

C. Dual Class Stock Dividends

Rule 19c-4 handled stock dividends of disparate voting rights shares in a variety of ways. It prohibited dividends of super-voting rights shares, regardless of whether or not the plan included transferability restrictions. On the other hand, the rule presumptively permitted dividends of shares with voting rights equal to those of the common (including buyout and thereafter raise new public equity capital, while still retaining effective control through a dual class capital structure.


84. Proposing Release, supra note 56, at 88,777-78; Dent, supra note 28, at 741.

85. It is possible that a merger could be effected for the sole purpose of disenfranchising existing shareholders by creating a dual class capital structure. The Commission recognized this possibility by suggesting that in such cases the presumption of validity would not apply. Adopting Release, supra note 5, at 89,220 n.94.

86. Id. at 89,221.
standard stock dividends of additional common shares). Although it is hard to see why, stock dividends of lesser-voting rights shares raised some concerns. These types of transactions involve no coercion, but the SEC feared that insiders might obtain disproportionate voting control via systematic purchases of the greater-voting rights shares. But so what? In the absence of coercion, shareholders interested in voting rights can freely compete for the full voting rights shares. In any event, the SEC permitted this type of stock dividend subject to case-by-case review for consistency with the rule's intent.87

D. Other Interpretive Issues Raised by Rule 19c-4

When the Commission first proposed rule 19c-4, many commentators argued that it appeared to cover a variety of corporate actions not involving the abuses identified by the Commission. In adopting the rule, the Commission specifically addressed certain of the commentators' breadth concerns, asserting that the rule was not intended "as a means to prohibit corporate defensive tactics in general, but merely as a prohibition against the disenfranchisement of existing shareholders' voting rights."88 Nevertheless, even as modified, rule 19c-4 still would have affected a number of transactions outside the confines of disparate voting rights plans. Three areas were of particular concern: state takeover laws, poison pills, and lock-ups.

Control share acquisition statutes, which many states have adopted, typically provide that a takeover bidder's shares will be deprived of voting rights if target company shareholders fail to approve the acquisition proposal.89 Although the Supreme Court upheld the constitutionality of

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87. Id. at 89,220.
89. 3 R. WINTER, R. ROSENBAUM, M. STUMPF & L.S. PARKER, SHARK REPELLENTS AND GOLDEN PARACHUTES: STATE TAKEOVER STATUTES AND POISON PILLS 17 (Supp. 1990) [hereinafter STATE TAKEOVER STATUTES]. If the would-be acquirer so requests, the target company must call a shareholders' meeting (usually within 50 days after the request) to vote on the acquisition. The shares owned by the acquirer, officers of the target, and directors who are also employees of the target may not be counted in that vote. Id. at 18. Ohio, Hawaii, and Missouri have taken a slightly different approach, under which the shareholders determine whether or not the proposed acquisition may be made, in contrast to the more usual approach, which simply requires shareholder approval
an Indiana control share acquisition statute, proposed rule 19c-4 appeared to require delisting of a corporation's stock if its shareholders failed to approve a control acquisition. In such cases, it was argued, the bidder's voting rights would be "disparately reduced."

The original version of rule 19c-4 would also have significantly affected certain forms of shareholder rights plans (a/k/a poison pills). A flip-over pill effectively gives target shareholders the right to purchase acquiring company shares at a steep discount (usually fifty percent). Because the pill makes this right available only to target shareholders, the right's exercise will cause dilution for the bidder's preexisting shareholders and undesirable balance sheet effects. Conversely, flip-in plans enable target shareholders to purchase target stock, again at a steep discount. Because the plan discriminates against the acquirer, as the voting rights are not exercisable by it, the pill significantly dilutes the acquirer's holdings of target shares. These inherent dilutive effects raised concerns about rule

for voting rights to be accorded to the acquirer's shares. See STATE TAKEOVER STATUTES, supra, at 19; Bainbridge, State Takeover and Tender Offer Regulations Post-MITE: The Maryland, Ohio and Pennsylvania Attempts, 90 DICK. L. REV. 731, 749-50 (1986).


91. E.g., BRT Comments, supra note 88, at 22-25; see Adopting Release, supra note 5, at 89,225. The Business Roundtable advanced several related arguments against applying rule 19c-4 to corporate actions taken pursuant to a control share acquisition statute. First, the rule might coerce shareholders of affected corporations into voting in favor of any control share acquisition proposal, regardless of its merits, due to the threat of delisting in the event of an unfavorable vote. Second, it asserted that control share acquisition statutes furthered shareholder rights by protecting them from the coercive effects of some tender offers. Moreover, it pointed out that bidders could not be said to have purchased target securities without adequate notice of the possible consequence of doing so prior to obtaining shareholder approval. Finally, it suggested that because a defeated bidder was free to resell its shares to any other bidder who obtained shareholder approval, in which event such shares would again carry full voting rights, the defeated bidder was not deprived of any share of the control premium, and the deprivation of voting rights was not permanent. BRT Comments, supra note 88, at 23-25; Testimony of Clifford L. Whitehill on Behalf of the Task Force on Corporate Responsibility of the Business Roundtable, Hearings Before the Securities and Exchange Commission on Proposed Rule 19c-4 at 12-13 (July 22, 1987) (copy on file with Washington University Law Quarterly) [hereinafter Whitehill Testimony].


93. It is possible to eliminate this discrimination by putting antidilution provisions into the bidder's corporate charter. This would involve the issuance of shares to preexisting acquirer shareholders in proportion to the shares issued to target shareholders exercising their flip-over rights. Another possible defense to the flip-over pill involves the acquirer's giving itself a call on any shares issued in a merger at below-market prices. POISON PILLS, supra note 92, at 571-74 (Supp. 1989).

94. For example, in Grand Metropolitan's acquisition of Pillsbury, Pillsbury's flip-in plan would have reduced Grand Metropolitan's interest in Pillsbury from 85 to 56 percent. The value of
19c-4's possible application to pills; the argument being that their discrimination and discount features disparately reduced the voting rights of the acquirer or its shareholders.95

Finally, the effect proposed rule 19c-4 would have had on stock lock-ups was unclear. In a stock lock-up, the target company issues common stock, preferred stock having super-voting rights, or stock options to a prospective acquirer. They are a common device in friendly corporate acquisitions because they are designed to assure that a contemplated business combination will be consummated or, at the least, to assure the potential acquirer that it will receive some return on its investment in the target.96 As proposed, the rule seemed to preclude at least the issuance of preferred stock with multiple voting rights.

As adopted, the rule was revised to make clear that it would have only a limited impact on these transactions. Corporate actions taken pursuant to control share acquisition statutes and poison pills were essentially removed from the rule's coverage.97 In addition, while the rule prohibited lock-ups effected by means of super-voting shares, it presumptively permitted other types of lock-ups.98 This decision was perfectly defensible. While each of these transactions raises significant conflict of interest concerns, as each is mainly used to ward off unwanted takeover bids, each is also subject to judicial scrutiny under existing state law fiduciary duty principles.99 As such, further safeguards were unnecessary.

Grand Metropolitan's holdings would have declined by more than $700 million. Grand Metropolitan Public, Ltd. v. Pillsbury Co., 558 A.2d 1049, 1051 n.2 (Del. Ch. 1988).

96. See generally Bainbridge, Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions, 75 MINN. L. REV. 239 (1990).
97. Adopting Release, supra note 5, at 89,225-26. The SEC, however, reserved the right to continue litigating the constitutionality of state takeover statutes and further warned that takeover defenses "designed specifically to transfer voting control from existing shareholders to insiders, or a group favored by insiders," might violate rule 19c-4 even if they were called poison pills. Id.
98. Id. at 89,226. It is not entirely clear why the SEC believed even this prohibition to be necessary. Suppose an investor purchased a single share of preferred stock with one million votes. As long as the investor pays a price commensurate with the economic and voting power of that share, the existing stockholders' voting rights are no more diluted than they would be by the issuance of one million shares of common stock with one vote each. Lock-up shares thus do not necessarily disenfranchise shareholders unless they are issued at an excessively low price. BRT Comments, supra note 88, at 28-29. One justification for the SEC's position may be the difficulty of assuring that the price paid by the prospective acquirer is indeed fully compensatory.
E. Summary

During the first debate over nonvoting common stock, the New York World published a wonderful poem entitled "On Waiting in Vain for the New Masses to Denounce Nonvoting Stocks":

Then you who drive the fractious nail,  
And you who lay the heavy rail,  
And all who bear the dinner pail  
And daily punch the clock —  
Shall it be said your hearts are stone?  
They are your brethren and they groan!  
Oh, drop a tear for those who own  
Nonvoting corporate stock.100

Ripley evidently believed this evidenced the public's outrage over nonvoting shares. However, I think that the poet was being ironic, mocking the teapot tempest Ripley and others had created—which raises some interesting questions about the need for regulation in this area. As Michael Dooley nicely observes, "poets, at times, and markets, over time, are more perceptive than lawyers about the need for prohibitory regulations."101

The evidence on the merits of dual class stock generally is far from conclusive. In some circumstances, however, virtually all observers, except the hard-core proponents of one-share/one-vote, agree that dual class stock is unlikely to injure investors; IPOs are the most prominent example. In other circumstances, substantial agreement exists that dual class stock will likely injure shareholders; exchange offers being the most prominent example.

In one sense then, even though one can quibble with many of its provisions, rule 19c-4 was a not unreasonable attempt to address the problem posed by disparate voting rights plans. In general, the rule permitted such plans in cases in which a conflict of interest is unlikely, while prohibiting them in those cases in which it is more likely. Conceding that rule 19c-4 addressed the right problems, however, does not compel the conclusion that the SEC was the appropriate regulatory body or that rule 19c-4 was the right solution. Parts III and IV turn to those questions.

100. Quoted in W. Ripley, supra note 13, at 121.  
III. SEC Rulemaking Authority and Dual Class Stock

Conceding the necessity of some form of regulation, the next question becomes who should regulate disparate voting rights plans. There are at least four regulators besides the SEC: state legislatures, state securities (blue sky) commissions, SROs, and Congress.102 Because none of them showed any signs of movement, however, the SEC apparently believed it had no choice but to act.

As we have seen, state legislatures traditionally have taken a laissez faire attitude towards corporate capital structure. Proponents of dual class stock might argue that this is yet more evidence of its appropriateness.103 Its opponents might argue that the lack of state regulation is yet more evidence of the so-called race to the bottom.104 In any event, in the late 1980s state legislatures seemed unlikely to adopt meaningful limits on disparate voting rights plans in the near future.

The North American Securities Administrators Association (NASAA) has long advocated prohibiting the sale of nonvoting and lesser-voting stock.105 Implementing this policy, the blue sky rules of many states place at least some restrictions on the sale of dual class stock.106 Blue sky commissions, nevertheless, were unlikely to provide directly effective regulation. Among other things, coordination problems might have led

102. An additional, but as yet largely untapped, source of regulation would arise from judicial interpretations of management fiduciary duties under state corporate law. See supra note 81.

103. Cf. Haddock, Macey, & McChesney, Property Rights in Assets and Resistance to Tender Offers, 73 VA. L. REV. 701, 730-31 (1987) (states' failure to restrict corporate takeover defenses may suggest that the latter are efficient).

104. The race to the bottom theory posits that state competition for corporate franchise revenues results in laws attractive to the corporate managers who make the decision of where to incorporate. Its classic statement is Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 YALE L.J. 663 (1974). In recent years, a variant on the theory took on new prominence as the central argument for federal preemption of state takeover laws. State legislators supposedly are target management's strongest allies in attempting to deter hostile takeovers. See Romano, The Political Economy of Takeover Statutes, 73 VA. L. REV. 111 (1987) (states adopted many, if not most, of their takeover laws at the request of embattled corporate managers). Holders of this view presumably would argue that states are unlikely to restrict significantly dual class stock even after rule 19c-4's demise.


106. See supra text accompanying note 43.
to a patchwork regulatory system that would significantly complicate securities offerings.

The SROs can regulate dual class stock through their listing standards, as the NYSE has done for over sixty years. Proponents of federal regulation believed that SRO competition for listings made this a most unlikely prospect. As management decides on which exchange to list the firm’s securities, so the theory goes, the SROs have an incentive to adopt regulations favored by management.107 Supposedly, the trend was towards freely allowing dual class stock, as evidenced by the NYSE’s initial proposal. In any event, while they disagreed on many issues, the major SROs all testified that they looked to the SEC for leadership in adopting some form of uniform regulation.108

Congress unquestionably has the power to prohibit or limit disparate voting rights stock. While there has been a long-standing debate over whether Congress, as a matter of sound policy, should adopt federal corporate governance standards,109 no one seriously doubts its ability to do so under the commerce clause.110 On the other hand, during the 1980s, Congress twice failed to act on proposed federal one-share/one-vote standards.111


108. See Adopting Release, supra note 5, at 89,218; e.g., Statement of Joseph P. Hardiman, Chairman of the Board of Governors of the National Association of Securities Dealers, Hearing Before the Securities and Exchange Commission (July 22, 1987) (preferring voluntary SRO agreement, but otherwise supporting rule 19c-4); Statement of Arthur Levitt, Jr., Chairman, American Stock Exchange, Hearings Before the Securities and Exchange Commission (July 22, 1987) (arguing against rule 19c-4 on grounds that the SEC should impose a uniform one-share/one-vote rule on all SROs). Recall that, despite SEC efforts, the SROs also had failed to agree voluntarily on a uniform regulatory system.

109. A voluminous literature is available on the federal incorporation debate, a matter well beyond the scope of this Article. For useful compilations of the major arguments, see Symposium, Current Issues in Corporate Governance, 45 OHIO ST. L.J. 513 (1984); An In-Depth Analysis of the Federal and State Roles in Regulating Corporate Management, 31 Bus. LAW. 863 (1976) [hereinafter Business Lawyer Symposium].


Press reports shortly after the D.C. Circuit’s invalidation of rule 19c-4 indicated that House
The regulatory buck thus stopped with the SEC. To its credit, the SEC stood up and was counted. But having the will to act is not the *sine qua non* for having the right to act under our political system. The question thus remained whether the SEC had the authority to adopt rule 19c-4.

A. Agency Rulemaking Power

Administrative agencies obviously have a lawmaking function. They formulate policy and adopt rules to fill statutory gaps. Those rules may legitimately preempt state law. However, the agency must neither act arbitrarily nor exceed its statutory authority. The central question thus was whether Congress had delegated authority to the SEC over corporate voting rights. For purposes of judicial review, rule 19c-4 was one of the hard cases: the statute is silent on the relevant issues. In such cases, a reviewing court will defer to the agency's interpretation of the statute so long as it constitutes a permissible construction of the statute. However, while courts accord considerable weight to the agency's views, they will not defer to an interpretation contrary to the clearly expressed intent of Congress.

Energy and Commerce Committee Chairman John D. Dingell was considering a legislative response to the decision. See Sontag, *SEC Rule-Making Clout Limited*, Nat'l L.J., June 25, 1990, at 3, col. 15. As of this writing, however, it appears unlikely that any new congressional legislation will be forthcoming in the near future.


113. *Fidelity Federal Savings & Loan Ass'n v. De La Cuesta*, 458 U.S. 141, 153-54 (1982). It is true that Commission action designed to create SRO listing standards, such as rule 19c-4, differs from direct preemption of state corporate law. The former are not enforceable against issuers directly, but rather merely have "trading market consequences." Letter from Andrew M. Klein to John S.R. Shad, Chairman, SEC, at 7 (Feb. 19, 1987) (copy on file with *Washington University Law Quarterly*). In theory, if an issuer did not want to comply with rule 19c-4, it could simply delist and trade its stock in the over-the-counter market by means of the pink sheets. In reality, by relegating noncomplying issuers to the sheets, rule 19c-4 amounted to a de facto preemption of state corporate law on the subject of voting rights. Securities listed on the pink sheets are substantially less liquid than those traded on the exchanges or NASDAQ. As such, the threat of delisting effectively forces issuers to comply. Rule 19c-4 thus amounted to de facto preemption of the capital structure provisions of state corporate law.


Given that congressional intent is the dispositive factor, a problem tangential to the basic thesis of this Article must be briefly addressed; namely, how to identify that intent. While it is here inappropriate to rehash the extensive and growing literature on statutory interpretation, this Article endeavors to apply the Supreme Court's methodology in the recent securities law cases. The Court routinely states that the starting point for its analysis is the statutory language, but the Court rarely stops there. Instead, the Court also looks to the legislative history and to judicial and administrative interpretations of the relevant provisions. All of those sources, with appropriate caution, will thus be treated as grist for the mill.

B. Regulating Corporate Governance Through the Back Door

The Commission based its authority to adopt rule 19c-4 on its powers under Exchange Act section 19(c), which provides in pertinent part:

The Commission, 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 Commission deems necessary or appropriate to insure the fair administration of the self-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 this

117. For useful summaries of current theories of statutory interpretation, see W. Eskridge & P. Frickey, Cases and Materials on Legislation: Statutes and the Creation of Public Policy 569-828 (1988); Ross, Reaganist Realism Comes to Detroit, 1989 U. Ill. L. Rev. 399, 404-16.


119. Caution would seem particularly appropriate with respect to the use of legislative history for a variety of reasons, such as the potential for manufacturing it. Ross, supra note 117, at 423-24. As a rule of thumb, this Article follows Professor Eskridge in assuming that the importance of legislative history descends in the following order: committee reports; sponsor statements; rejected proposals; floor and hearing colloquy; views of nonlegislator drafters; legislative inaction; and subsequent legislative history. Eskridge, The New Textualism, 37 UCLA L. Rev. 621, 636-40 (1990).

120. Adopting Release, supra note 5, at 89,228.
While opponents of rule 19c-4 made some technical arguments to the contrary, the Commission concluded that listing standards are SRO rules and, therefore, it has the power to amend them if its action furthers the purposes of the Exchange Act. The problem thus narrows to identifying the relevant purposes of the Act and then asking whether rule 19c-4 in fact furthers any of them. However, before examining the purposes upon which the Commission relied—protecting investors, preserving fair corporate suffrage, and assuring fair competition between SROs, it is necessary to discuss briefly one potential source of authority the Commission studiously ignored—the Williams Act.

I. Rule 19c-4 and The Williams Act

Rule 19c-4 was effectively the first substantive federal regulation of corporate takeover defenses. It essentially precluded those disparate voting rights plans most likely adopted as a takeover defense, while allowing companies some flexibility in implementing dual class capital structures motivated by nondefensive considerations. The Commission recognized,

[121] The American Bar Association Task Force on New York Stock Exchange Listing Requirements argued 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 Commission’s oversight and regulatory jurisdiction.” Comments of the American Bar Association Task Force on New York Stock Exchange Listing Requirements of the Federal Regulation of Securities Committee, Section of Corporation, Banking and Business Law submitted to the Securities and Exchange Commission at 4 (Dec. 31, 1986) (copy on file with Washington University Law Quarterly) [hereinafter ABA 1986 Comments]; see generally id. at 3-14; see also ABA 1987 Comments, supra note 88, at 12-14; cf. Brief of Petitioner at 17-31, Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (arguing that Section 19(c) only authorized the Commission to regulate the securities industry and thus did not authorize interference with corporate governance listing standards) [hereinafter BRT Brief]. Still other commentators suggested that SROs would not be obliged to enforce their voting rights listing standards against issuers. Adopting Release, supra note 5, at 89,230. As the Commission pointed out, however, the SEC has the power to discipline a SRO for failing to enforce its own rules. Id.

[122] The D.C. Circuit in fact so held. Business Roundtable, 905 F.2d at 408-09. The Commission did not rely on a claim that rule 19c-4 was, in section 19(c)'s terms, “necessary or appropriate to insure the fair administration of the self-regulatory organization [or] to conform its rules to requirements of” the Act. Rather, it relied exclusively on a claim that the rule was necessary and appropriate in the furtherance of sections 6, 11A, 14A, 15A, and 23 of the Act. Adopting Release, supra note 5, at 89,230. See also Business Roundtable, 905 F.2d at 409 (“As no one suggests that either of the first two purposes justifies Rule 19c-4, the issue before us is the scope of the third, catch-all provision.”).
and undoubtedly intended, that the rule would thereby eliminate an important antitakeover device. Surprisingly, however, the Commission did not claim that rule 19c-4 advanced the purposes of the Williams Act, the 1968 amendments to the Exchange Act regulating tender offers. Indeed, commentators had previously suggested that the Williams Act would justify a rule like 19c-4, a suggestion later echoed by the D.C. Circuit. As such, the scope of the Commission’s authority under the Williams Act is worth exploring. Once one does so, the Commission’s reticence no longer proves quite so surprising.

The critical provisions are Exchange Act sections 13(e) and 14(e), which in pertinent part prohibit manipulative practices in connection with tender offers. During the early 1980s, a number of corporate raiders argued that lock-ups granted to white knights violated this prohibition. This argument met with some initial success, most notably in a Sixth Circuit Court of Appeals decision holding that lock-up options violated section 14(e) because they set an artificial ceiling on the price of a target’s stock. If this interpretation had attained widespread acceptance, it would have justified Commission regulation of takeover defenses. Any defensive tactic precluding the shareholders from deciding whether or not to accept a takeover bid in a sense sets an artificial cap on the firm’s stock price and thus could be viewed as a manipulative device prohibited by section 14(e).

Ultimately this interpretation of section 14(e) did not prevail. Most lower courts rejected it. In Schreiber v. Burlington Northern, Inc., the Supreme Court confirmed the developing lower court majority, hold-

129. 15 U.S.C. §§ 78m(e), 78n(e) (1988).
131. See Note, Target Defensive Tactics as Manipulative under Section 14(e), 84 Colum. L. Rev. 228 (1984).
ing that misrepresentation or nondisclosure is an essential element of a manipulation claim under section 14(e). So it matters not that disparate voting rights plans make takeovers more difficult. They violate the prohibition of manipulative devices only if adopted without full and fair disclosure.\footnote{134} Accordingly, despite the D.C. Circuit's passing reference to the Williams Act, the SEC has no authority under the Williams Act to regulate substantively dual class transactions. Instead, its authority is limited to enforcing applicable disclosure obligations.\footnote{135}

2. Rule 19c-4 and Investor Protection

Protection of investors is indisputably one of the principal purposes of the Exchange Act. In stating the reasons for the Act's adoption, section two focuses mainly on protecting investors from various abuses.\footnote{136} Moreover, sections 6(b)(5) and 15A(b)(6) expressly require SROs to have rules that are designed to protect investors and the public interest.\footnote{137}

The Commission appeared to claim that rule 19c-4 advanced this purpose in two ways. First, it supposedly protected shareholders from the risk of disenfranchisement.\footnote{138} This argument essentially restates the as-

\footnote{134. Cf. Steinberg, Tender Offer Regulation: The Need for Reform, 23 WAKE FOREST L. REV. 1, 17-22 (1988) (legitimacy of takeover defenses solely a matter of state law); Note, Down but Not Out—The Lock-up Option Still has Legal Punch When Properly Used, 43 WASH. & LEE L. REV. 1125, 1127-28 (1986) (lock-ups valid under section 14(e) if fully disclosed).

135. It is true that the Williams Act gives the Commission "latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts . . . ." Schreiber, 472 U.S. at 11 n.11. It is difficult to see, however, what manipulative acts would be prevented by a prohibition of dual class stock. Cf. Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496, 504 (7th Cir.), cert. denied, 110 S. Ct. 367 (1989) (dictum to the effect that the Williams Act does not preempt state laws permitting dual class stock).


137. 15 U.S.C. §§ 78f(b)(5), 78o-3(b)(6) (1988). The D.C. Circuit took a narrow view of the Commission's authority under these sections. Otherwise, the SEC could use its regulatory powers to "circumvent the legislative process that is virtually the sole protection for state interests." The broad terms they use therefore must be limited to areas contemplated by Congress. As such, they do not provide independent support for rule 19c-4. Business Roundtable, 905 F.2d at 413.

138. SEC Brief, supra note 124, at 39-40; Adopting Release, supra note 5, at 89,232. The Commission might have made broader investor protection claims. For example, it might have claimed that federal regulation of matters of corporate governance was essential to protect shareholders. If made, this claim should have been rejected in light of the Exchange Act's legislative history. See infra note 148 and accompanying text. The SEC might also have suggested that the injury caused by dual class stock recapitalizations justified the rule. However, given the mixed empirical evidence for those claims, premising the rule's validity on those grounds might have led a court to strike it down as not based on substantial evidence. See 5 U.S.C. § 706(2)(E) (1988) (requiring agency action to be supported by substantial evidence).

The delegation doctrine may also have constrained the SEC from making more sweeping investor
sertion that the Act was intended to assure fair corporate suffrage and is therefore considered in the next section.

In litigation over the validity of rule 19c-4, the Commission also argued that the Business Roundtable’s very challenge to the rule implicated investor protection concerns. The SEC has frequently used its section 19(b) oversight powers to review SRO listing standards, many of which affect matters of corporate governance. The Business Roundtable, however, argued that the SEC simply has no power with respect to corporate governance listing standards under section 19(b) or 19(c). The Commission contended that accepting the Roundtable’s position would undermine investor protection by depriving the Commission of oversight authority under Section 19(b) in this area. Moreover, the SEC argued that the Roundtable’s position would effectively preclude the SROs from addressing corporate governance issues in their listing standards.

Section 19(b) requires an SRO to file proposed rules or changes to existing rules with the SEC. The Commission must thereupon determine whether the proposal is consistent with the requirements of the Act. If so, the proposal must be approved; if not, it must be rejected. In contrast, before the Commission may affirmatively impose SRO rules, section 19(c) requires that the proposal be necessary or appropriate to further the purposes of the Act.

The plain language of the statute thus suggests a critical distinction between the Commission’s powers under sections 19(b) and 19(c). As protection claims. While the delegation doctrine has been a dead letter for more than 50 years, the Supreme Court has sometimes adopted a narrow construction of the statute to avoid delegation doctrine problems, with the result that the challenged regulations were held invalid as not authorized by the pertinent statute. E.g., National Cable Television Ass’n v. United States, 415 U.S. 336 (1974); Kent v. Dulles, 357 U.S. 116 (1958); see Dent, supra note 28, at 736; Schoenbrod, The Delegation Doctrine: Could the Court Give It Substance?, 83 Mich. L. Rev. 1223, 1233 (1985). Investor protection is just the sort of amorphous standard that might have encouraged such an approach. Indeed, the Business Roundtable’s argument that rule 19c-4 violated the delegation doctrine, BRT Brief, supra note 122, at 46-49, may have contributed to the D.C. Circuit’s decision.

139. Examples are cited in SEC Brief, supra note 124, at 32 n.45.
140. See BRT Brief, supra note 122, at 23-25.
141. SEC Brief, supra note 124, at 31-33.
143. Professor Karmel asserts that “[w]here 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.” Karmel, supra note 126, at 829. Perhaps so, but then why did Congress set different standards for SEC action under the two sections?

The conference and committee reports on the 1975 legislation creating sections 19(b) and 19(c) are silent on the question of whether the two standards are substantively different. The Business
nothing in the Exchange Act prohibits an SRO from regulating internal corporate affairs and management through its listing standards, proposals to do so are not inconsistent with the Act. The SROs could therefore continue to adopt corporate governance listing standards, and the SEC could continue to review them under section 19(b). Of course, under the statutory standard, such proposals must be approved, but that is true of all SRO proposals that are consistent with the Act. As such, rule 19c-4 could be invalidated without affecting the SEC's oversight powers under section 19(b).

Which interpretation the D.C. Circuit adopted is not entirely clear. On the one hand, the court reaffirmed "that the 'rules of a self-regulatory organization' required to be vetted by the Commission under § 19(b) are all-encompassing . . . ." Moreover, the court recognized that SROs have the right to adopt listing standards affecting corporate governance matters. However, it then appeared to suggest that the SEC had little, if any, oversight authority with respect to such rules:

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 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 Act, both categories are subject to Commission 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 Act—the Commission's § 19 powers will be quite limited.

But limited how? Perhaps the court meant nothing more than the analysis suggested above; namely, that the Commission must review SRO corporate governance standards, but also must routinely approve them absent some clear conflict with the Exchange Act. Or perhaps not.

The differences between the Roundtable's, the court's, and my inter-

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Roundtable contended that Congress in fact viewed the two sections as having different intent, with the Commission's powers under section 19(c) being more intrusive and thus also more limited. It pointed out that section 19(c) imposes much more rigorous procedural requirements. Reply Brief for Petitioner at 16 n.25, Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (No. 88-1651) [hereinafter BRT Reply Brief]. It also pointed out that in drafting the 1975 amendments creating the present statutory scheme, the House suggested that some SRO regulatory action would lie outside the scope of the SEC's powers. BRT Brief, supra note 122, at 24 (citing H.R. REP. No. 123, 94th Cong., 1st Sess. 62-63 (1975)).

144. Business Roundtable, 905 F.2d at 410.
145. Id. at 414.
146. Id.
pretation are important mainly because they may affect the SROs' ability to develop collectively a uniform standard. SRO actions are only exempt from the antitrust laws when they are carried out under SEC oversight.147 Because the SEC would retain its section 19(b) oversight authority under my analysis, collective action by the SROs would remain permissible. If, however, the court meant to limit significantly the SEC's section 19(b) oversight powers with respect to corporate governance listing standards, joint SRO action becomes subject to challenge under the antitrust standards.

3. Rule 19c-4 and Fair Corporate Suffrage

The Commission's central, and strongest, argument was that the Exchange Act was intended to assure "fair corporate suffrage." In other words, the Act purportedly assumes and was intended to ensure that shareholders would have meaningful voting rights. Rule 19c-4 supposedly advances this goal "by preventing the disenfranchisement of existing shareholders through transactions that are not fully subject to market discipline."148

a. The SEC's Authority Over Corporate Governance

When present section 19(c) was adopted, some commentators suggested that it effectively gave the SEC power to adopt a federal law of corporations by mandating SRO listing standards. Indeed, some observers saw rule 19c-4 as the first step towards broad federal regulation of corporate governance.149 Although the Commission disclaimed any such intent, it nevertheless argued that section 19(c) empowers it to amend all

148. Adopting Release, supra note 5, at 89,231. The drafters of the Exchange Act believed the legislation was necessary precisely because they also believed market discipline was not an effective check on the abuses they were trying to prevent. E.g., H.R. REP. NO. 1383, 73d Cong., 2d Sess. 3 (1934). Even assuming that the drafters of the Exchange Act meant to prevent shareholder disenfranchisement when they referred to fair corporate suffrage, the SEC's decision to permit disenfranchising transactions that are subject to market discipline seems inconsistent with the Act's overarching intent.
149. E.g., Whitehill Testimony, supra note 91, at 8-10. Calls for a federal corporate law are not new. Madison, for example, proposed that the Constitution give the federal government power to grant charters of incorporation, which presumably would have led to the development of a detailed body of federal statutory and common law. Boyer, Federalism and Corporation Law: Drawing the Line in State Takeover Regulation, 47 OHIO ST. L.J. 1037, 1041 (1986); Schwartz, supra note 107, at 547. More to the point, just 20 years prior to the adoption of the Exchange Act, the Pujo Committee suggested that "much-needed reforms in the organization and methods of our corporations" could be affected through exchange listing standards. H.R. REP. NO. 1593, 62d Cong., 3d Sess. 114-15
SRO rules, including corporate governance listing standards, subject only to the limitation that the rule further one of the purposes of the Act. 150 The broader the reading one gives to those purposes, the broader will be the Commission's authority to displace state law. Indeed, the D.C. Circuit held that the Commission's reading of the Exchange Act's purposes was broad enough to justify establishing a comprehensive federal corporate law under section 19(c). 151 Despite the SEC's denials, defining the limits on its general powers with respect to matters of corporate governance thus is an appropriate starting point for analysis.

The predecessor to present section 19(c) authorized the SEC to amend exchange rules in twelve specific areas, including the listing or striking from listing of any security, with a final catch-all clause covering "similar matters." 152 When the current, facially more inclusive language was adopted, Congress indeed intended to broaden substantially the Commission's authority over SRO rules. As the Senate Banking, Housing and Urban Affairs Committee explained, the changes gave the Commission plenary "power to change the rules of a self-regulatory organization in any respect, not just with respect to [the previously] enumerated areas." 153 The Commission heavily relied upon this language to support its claim that section 19(c) authorizes it to mandate SRO listing standards affecting shareholder voting rights. 154

The 1975 legislative history is silent as to whether the Commission's powers are so broad as to encompass matters of corporate governance. Shortly after the 1975 amendments were adopted, some commentators suggested that section 19(c) effectively authorized the SEC to promulgate a federal corporate law by appropriate amendments to SRO listing standards. 155 On the other hand, a number of other commentators argued that the SEC's powers under section 19(c) did not extend to corporate

(1913). For overviews of the federal incorporation debate during the latter part of the 1800s and early 1900s, see Boyer, supra, at 1048-50; Loomis & Rubman, supra note 15, at 158-61.

150. SEC Brief, supra note 124, at 17-19.

151. Business Roundtable, 905 F.2d at 412.


155. E.g., Business Lawyer Symposium, supra note 109, at 1095-96 (comments of Lee Pickard); see also Letter from Andrew M. Klein to John S.R. Shad, Chairman, SEC (Feb. 19, 1987) (copy on file with Washington University Law Quarterly) (Klein was the SEC Director of Market Regulation in 1975).
governance issues. As post-enactment statements by nonlegislators, however, neither set of comments is very compelling.

The argument that the 1975 amendments did not give the SEC authority over corporate governance listing standards, nevertheless, receives some support from the historical context. As the Business Roundtable pointed out, the 1975 legislation was triggered by the so-called "back office" crisis of the late 1960s and a simultaneous wave of broker-dealer financial scandals and failures. The crisis led to a study by the Senate Securities Subcommittee, which identified various flaws in the self-regulatory system. Corporate governance reform through SEC exercise of its 19(c) powers simply was not on Congress' mind in 1975. Congress was concerned with modernizing the securities industry to account for recent technological developments and with preventing a recurrence of the back office crisis by strengthening the SEC's regulatory powers with respect to the SROs and their member broker-dealers. As such, the 1975 amendments to section 19 provide little affirmative support to rule 19c-4.

Regardless of just how far Congress broadened the SEC's powers in 1975, Congress clearly did not intend for the legislation to narrow the SEC's existing authority over SROs. The question therefore arises as to whether the powers delegated to the Commission in 1934 included authority over corporate governance matters. If so, that power certainly survived the 1975 amendments. The answer, however, is that Congress gave no such authority.

Both the text of the Exchange Act and its historical context lend support to this conclusion. The Exchange Act on its face says nothing about

156. See Business Lawyer Symposium, supra note 109, at 1096 (comments of Stephen Paradise, Senate Banking Committee counsel in 1975); id. at 1111 (comments of former SEC Chairman William Cary); See also BRT Brief, supra note 122, at 30-31 & n.42 (citing statements from 1977 congressional hearings); Testimony of A.A. Sommer on Behalf of Alliance for Corporate Growth, Hearings Before the Securities and Exchange Commission 3 (Dec. 17, 1986) (copy on file with Washington University Law Quarterly) (Sommer was an SEC Commissioner in 1975).


regulation of corporate governance. Instead, the Act focuses primarily on securities trading and securities pricing. Thus, virtually all of its provisions address such matters as the production and distribution of information about issuers and their securities, the flow of funds in the market, and the market's basic structure. This approach resulted from Congress' interpretation of the Great Crash and the subsequent Depression. Rightly or wrongly, many people believed that excessive stock market speculation and the collapse of the stock market had caused the Great Depression. The drafters of the Exchange Act were thus primarily concerned with preventing a recurrence of the speculative excesses they believed had caused the market's collapse.

Opponents of the legislation, however, quickly claimed that it went far beyond its stated purposes. According to Richard Whitney, president of the NYSE and a leading opponent of the bill, a number of provisions, including the predecessor to section 19(c), collectively gave the Commission "powers . . . so extensive that they might be used to control the management of all listed companies," a charge repeated by congressional opponents of the bill.

The bill's supporters strenuously denied that they intended to regulate corporate management. The Senate Banking and Currency Committee went to the length of adding a proposed section 13(d) to the bill, which provided: "[n]othing in this Act shall be construed as authorizing the Commission to interfere with the management of the affairs of an is-


162. See Securities Exchange Act, Pub. L. No. 73-291, § 2, 48 Stat. 881, 881-82 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934) (need to control excessive stock market speculation that had "brought in its train social and economic evils which have affected the security and prosperity of the entire country."); 78 Cong. Rec. 7921-22 (1934) (Rep. Mapes) (the Act had two objectives: to prevent excessive speculation and to provide a fair and honest market for securities transactions); see also Dann v. Studebaker-Packard Corp., 288 F.2d 201, 207 (6th Cir. 1961).


164. E.g., 78 Cong. Rec. 8271 (1934) (Sen. Steiwer); id. at 8012 (Rep. McGugin); id. at 7937 (Rep. Baekwell); id. at 7710 (Rep. Britten); id. at 7691-92 (Rep. Crowther); id. at 7690 (Rep. Cooper). Others suggested that while early drafts of the legislation had perhaps justifiably raised such concerns, they believed the legislation had been redrafted so as to eliminate any legitimate fears on this score. E.g., 78 Cong. Rec. 7863 (1934) (Rep. Wolverton); id. at 7716-17 (Rep. Ford); id. at 7713 (Rep. Wadsworth).
The conference committee deleted the provision because it was seen "as unnecessary, since it is not believed that the bill is open to misconstruction in this respect." The debates contain numerous similar denials, some of the most emphatic coming from House Interstate and Foreign Commerce Committee Chairman Sam Rayburn. For present purposes, the most interesting of these denials is Representative Mapes' observation that nothing in section 19(c)'s predecessor authorized the Commission to "control in any way any corporations except stock exchanges."

This debate admittedly need not be read as going to preemption of state corporate law. As the D.C. Circuit observed, interference with management might mean a variety of things. While the Business Roundtable and the D.C. Circuit believed Congress intended to avoid corporate governance regulation, proponents of a broad SEC power could plausibly argue that the New Deal Congress was really denying charges of creeping socialism. Opposition to New Deal legislation typically included charges of radicalism and collectivism. The Exchange Act was no different. Even with this gloss, however, the legislative history still suggests that Congress focused mainly on regulating the securities industry, not listed companies. Moreover, the New Deal Congresses later rejected explicit proposals for establishing a federal law of corporations.

During the New Deal era a number of efforts were made to grant the SEC authority over corporate governance. While the Exchange Act was being drafted, the Roosevelt administration considered developing a comprehensive federal corporation law. The Senate Banking and Cur-

165. S. 3420, 73d Cong., 2d Sess. § 13(d) (1934). While proposed section 13(d) specifically responded to objections to the issuer reporting provisions of the bill, see S. REP. No. 792, supra note 162, at 10, the provision on its face applied to the entire bill.


168. 78 Cong. Rec. 8088 (1934) (Rep. Mapes). The context of this comment was a debate over the Commission's powers with respect to the internal operations of exchange members, but Mapes' comments appear to have a more global application. Richard Whitney also seemingly recognized that the provision which became section 19(e) applied mainly to regulation of the exchanges and their member broker-dealers. Stock Exchange Practices: Hearings before the Senate Comm. on Banking and Currency, 73d Cong, 1st Sess. 6638 (1934) [hereinafter Pecora Hearings].

169. Business Roundtable, 905 F.2d at 411-12.

170. Id.


172. J. SELIGMAN, supra note 158, at 87.
rency Committee’s report on stock exchange practices also suggested that the cure for the nation’s “corporate ailments ... may lie in a national incorporation act.”173 Richard Whitney made the same suggestion in an unsuccessful effort to shift the focus of regulation from the exchanges to listed issuers.174 In the late 1930s, then SEC Chairman William O. Douglas orchestrated yet another effort to replace state corporate law with a set of federal rules administered by the SEC.175 In this, he was anticipated and assisted by Senators Borah and O’Mahoney who introduced a series of bills designed to regulate corporate internal affairs.176

None of these proposals ever came to fruition. Legislative inaction is inherently ambiguous, even when that inaction takes the form of rejecting a specific proposal.177 “All that can be stated with certainty is that Congress chose not to act.”178 However, while the evidence admittedly is not conclusive, there is considerable reason to believe that Congress did not intend for the SEC’s power over listing standards to extend to matters of corporate governance. Granted Congress did not expressly state any such limitation, but Congress apparently did not believe it was necessary to do so. Surely the Congress that repeatedly denied any intent to regiment corporate management, and later repeatedly rejected proposals to federalize corporate law, did not intend to sneak those powers back into the bill through the back door provided by section 19(c) and its

175. J. SELIGMAN, supra note 158, at 156.


178. Boyer, supra note 149, at 1053.
predecessors. It is thus not surprising that fifty years later, during the SEC rulemaking proceedings on rule 19c-4, it took "surviving members" of the SEC's 1930s "staff somewhat askance—even to be asked whether [the Commission] has the capacity to pronounce affirmative governance standards."  

b. The SEC's Authority Over Corporate Voting Rights

While the Commission admits that it does not have "unlimited authority to amend SRO rules in areas of 'corporate governance,'" it claims that its authority extends to any such areas in which action would further a specific purpose of the Act. In particular, the Commission contends that when sections 14 and 19 are read against the backdrop of the nonvoting common stock controversy of the 1920s, a congressional intent to prevent shareholder disenfranchisement emerges. In effect, Congress supposedly adopted the NYSE policy on corporate voting rights as one of the Exchange Act's purposes and gave the SEC authority to prevent subsequent erosion of the policy. The absence of express limitations on the Commission's authority over listing standards lends some support to this reading. However, in order for it to prevail, the Commission must establish that Congress was both aware of the NYSE's policy and consciously intended to effectuate it by delegating authority to the agency.

Admittedly, Congress had evidence before it as to the NYSE's policy.

179. The D.C. Circuit "read the Act as reflecting a clear congressional determination not to make any such broad delegation of power to the Commission. If the Commission's one share/one vote rule is to survive, then, some kind of firebreak is needed to separate it from corporate governance as a whole." The court was unable to find any such firebreak and therefore invalidated the rule. Business Roundtable, 905 F.2d at 413. See also BRT Reply Brief, supra note 143, at 7-9.

180. Proposing Release, supra note 56, at 88,786 (Fleischman, C., concurring) (his comment is based on personal discussions with those surviving members). New Deal era commentators also recognized that the Exchange Act did not regulate corporate governance. E.g., Brown, supra note 176, at 1098.

181. SEC Brief, supra note 124, at 13 (emphasis in original).

182. See id. at 25-26.

183. As the Commission put it, "[i]t is most unlikely that Congress, in giving the Commission authority to amend exchange listing rules, intended to deprive the Commission of authority over the one listing rule that, in view of the public uproar in the 1920s, was almost certainly the most widely-known by members of Congress." Id. at 29-30.

184. The SEC's claim of implied incorporation is similar to the assertion that congressional silence in the face of an administrative practice or regulation should be interpreted as constituting congressional approval of the practice or regulation. The D.C. Circuit has applied the test set forth in the text to measure the relevance of congressional silence in the latter context. E.g., Inner City Broadcasting Corp. v. Sanders, 733 F.2d 154, 160 (D.C. Cir. 1984).
However, the references to nonvoting stock occur only in the hearings and these are scanty indeed. 185 As Pecora's history of the Senate hearings treats in detail many of the practices he saw as abusive, it is also noteworthy that it includes no references to the NYSE's policy. 186 Lastly, none of the committee reports even mention the issue. 187 One should therefore hesitate before presuming widespread congressional awareness and concern about dual class stock. 188

The legislative history also raises doubts as to whether Congress intended to incorporate the NYSE's policy into the Exchange Act. The Senate Banking and Currency Committee's report on the results of the Pecora Hearings contains the most detailed committee discussion of exchange listing standards. The Committee identified the major flaw in this area as the exchange's laxity in investigating listing applications from dubious companies. Moreover, in explaining the need for regulation of listing requirements, the Committee focused solely on the need for periodic corporate disclosures from issuers. 189 The Committee simply did not address regulation of exchange listing standards affecting such matters as corporate voting rights.

The Commission admitted that Congress did not directly regulate shareholder voting rights, but argued that it did not need to do so in light of the NYSE's policy against nonvoting common stock. As the NYSE was the principal secondary trading market, Congress could assume that shareholders would have effective voting rights. The SEC thus read Congress' silence on dual class stock as reflecting an implicit assumption that

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185. Out of the thousands of pages of House and Senate hearings, the only reference to the NYSE policy that I found is the testimony of Frank Altschul, Chairman of the NYSE Committee on Stock List. *Pecora Hearings*, supra note 168, at 6677-80. In colloquy with Altschul, Ferdinand Pecora referred to nonvoting common stock as an "evil." *Id.* at 6679. He had earlier in the hearings also raised questions as to the use of nonvoting preferred stock. *Id.* at 6661-62. Pecora's comments are entitled to some weight in light of the significant role he played in creating the federal securities laws, SEC v. Falstaff Brewing Corp., 629 F.2d 62, 69 (D.C. Cir.), *cert. denied*, 449 U.S. 1012 (1980), but not every matter Pecora identified as an evil was subjected to federal regulation.


187. The Senate Banking Committee's report on the Pecora Hearings contains some widely scattered discussion of voting rights issues, but only in the context of condemning the abuses of investment trusts and holding company structures prevalent at the time. *See S. REP. No. 1455, supra* note 173, at 333-91.

188. BRT Reply Brief, *supra* note 143, at 4-5 (citing SEC v. Sloan, 436 U.S. 103, 121 (1978)) (one should be "extremely hesitant to presume congressional awareness of the Commission's construction based only upon a few isolated statements in the thousands of pages of legislative documents.").

shareholders would not be disenfranchised and an implicit intent to pre-
vent disenfranchisement.\textsuperscript{190}

The Commission's interpretation of the legislative history is flawed on
several grounds. If true, it suggests only that the SEC might have au-
thority to force the NYSE to maintain its 1934 policy intact, or to force
other SROs to adopt the NYSE's 1934 policy, neither of which is what
rule 19c-4 does.\textsuperscript{191} Moreover, the argument is inconsistent with the atti-
ditudes of the Act's drafters towards exchange regulation. If Congress was
concerned with dual class stock, it undoubtedly would have thought the
mere use of SRO rules would not achieve the desired result. In the
House debates, for example, Chairman Rayburn recognized that many
exchanges did not have the same bargaining power vis-a-vis issuers as the
NYSE. He further observed that exchange regulation could "only go so
far before selfish managements" refused to comply.\textsuperscript{192} While he made
these observations in the context of disclosure obligations, they are con-
sistent with the then prevailing view that self-regulation by the exchanges
was inadequate to resolve the economic problems Congress had identi-
fied.\textsuperscript{193} If Congress had wanted to graft the NYSE's nonvoting common
stock policy onto the Act, it would have said so explicitly. Congress'
inaction, therefore, should be read as leaving voting rights in the hands of
the states and the exchanges, especially when considered in light of the
repeated congressional rejections of proposals to federalize corporate
law. In assessing Congress' intentions one also should consider what it
was actually told about dual class stock. Recall that Ripley and others
had announced the demise of nonvoting common stock as early as 1926.
Frank Altschul, the Chairman of the NYSE's Committee on Stock List,
repeated that claim before Congress, stating that "the period of the crea-
tion of nonvoting common stocks came to an end" with the NYSE's ac-
tion in 1926.\textsuperscript{194} As far as Congress knew in 1934, nonvoting stock was a

\textsuperscript{190} Adopting Release, \textit{supra} note 5, at 89,231. The Business Roundtable argued that the 1964
amendments to section 14 also undercut the SEC's argument. Those amendments were intended to
extend the proxy rules to the OTC market. At that time, issuers trading in the OTC market were
subject to no listing standards on dual class stock. Yet Congress failed to make any effort to estab-
lish policies comparable to that of the NYSE for OTC securities. \textit{See} BRT Comments, \textit{supra} note
88, at 12-15.

\textsuperscript{191} Whitehill Testimony, \textit{supra} note 91, at 4.

\textsuperscript{192} 78 CONG. REC. 7698 (1934).

\textsuperscript{193} \textit{E.g.}, S. REP. NO. 792, \textit{supra} note 162, at 4-5.

\textsuperscript{194} \textit{Pecora Hearings}, \textit{supra} note 168, at 6677. Altschul plainly overstated the case; dual class
and nonvoting stock did not die in 1926. Moreover, the NYSE did not formalize its policy until
1940. Finally, the NYSE continued thereafter to list some dual class shares.
dead issue. On the other hand, Altschul's testimony made clear that the NYSE continued to list voting trust certificates. 195 As Pecora pointed out, they were a device used to deprive stockholders of an effective voice in management—"an evil comparable to that of nonvoting stock, except that the evil is limited as to time." 196 While Altschul tried to distinguish between nonvoting stock and voting trusts, 197 it is striking that Congress did not attempt to regulate the latter. If Congress had been concerned with protecting the substance of shareholder voting rights, surely it would have struck at those perceived abuses permitted by the NYSE's policy. Again, the more logical reading of Congress' silence on voting rights thus is that it simply was not taking a position on the validity of nonvoting and dual class stock. 198

This interpretation receives additional support from the legislative history of section 14(a). The Commission placed great weight on a House Committee Report statement that "[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange." 199 The same report also stated: "Inasmuch as only the exchanges make it possible for securities to be widely distributed among the investing public, it follows as a corollary that the use of the exchanges should involve a corresponding duty of accorting shareholders fair suffrage." 200 While it is indisputable that Congress intended for section 14(a) to give the SEC broad powers over corporate proxy solicitations, it is reasonable to believe that Congress had in mind an entirely different set of issues than those raised by nonvoting stock when it referred to fair corporate suffrage.

The legislative history of section 14(a) is relatively sparse, in large part

195. Id. at 6679.
196. Id. Voting trusts were then, as now, usually limited by statute to a set period of time. 2 RMBCA Ann., supra note 41, at 688-89.
197. Pecora Hearings, supra note 168, at 6679-81.
198. As the D.C. Circuit observed, nothing in the legislative history "comes near to saying, 'The purposes of this act, although they generally will not involve the Commission in corporate governance, do include preservation of the one share/one vote principle.' And even [if any did] we doubt that such a statement in the legislative history could support a special and anomalous exception to the Act's otherwise intelligible conceptual line excluding the Commission from corporate governance." Business Roundtable, 905 F.2d at 413. Cf. Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496, 504 (7th Cir. 1989) (dictum to the effect that the proxy rules do not preempt state laws permitting dual class stock).
199. H.R. REP. No. 1383, supra note 148, at 13, quoted in Adopting Release, supra note 5, at 89,231.
200. Id. at 14, quoted in Adopting Release, supra note 5, at 89,231.
because the controversy over federal proxy regulation was resolved early in the legislative process. As originally introduced, the proxy provision mandated substantial disclosures and gave the SEC authority to adopt additional disclosure requirements. The proposal met with substantial criticism. For example, AT&T pointed out that the bill required the proxy statement to include a list of all shareholders being solicited, which would force AT&T to prepare three large volumes, at a total cost of $950,000, every time proxies were solicited.

Congress redrafted section 14(a) in response to these criticisms. In doing so, Congress did what it often does when it has a tough problem to solve: it told somebody else to solve it. In effect, the Act simply made it unlawful to solicit proxies "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Congress clearly intended to give the SEC sweeping power over corporate proxy solicitations. Once again, we therefore face a broad grant of authority and the question of whether the historical context suggests a congressional intent to narrow the facially sweeping statutory language.

203. House Hearings, supra note 163, at 527-29. For like criticisms, see id. at 917 (statement of National Automobile Chamber of Commerce); Pecora Hearings, supra note 168, at 6673 (testimony of Richard Whitney).
204. Securities Exchange Act, Pub. L. No. 73-291, § 14(a), 48 Stat. 881, 895 (1934). As originally adopted, section 14(a) applied only to securities registered on a national securities exchange. In 1964, it was amended to apply to OTC issuers as well. Otherwise, it remains largely intact.
205. Medical Comm. for Human Rights v. SEC, 432 F.2d 659, 671 (D.C. Cir. 1970), vacated as moot, 404 U.S. 403 (1972). The debates suggest that key congressmen expected some limitations on the exercise of the Commission's powers under section 14(a). Representative Snell recalled the expense and "real trouble" that the original draft might have caused and asked how the new draft differed. In responding, Representative Mapes noted that the final language clothed the Commission "with very broad discretionary powers," but did "not bind the Commission to any specific form of control." 78 CONG. REC. 7923 (1934). Representative Snell asked whether this meant the Commission could adopt rules imposing the same sort of requirements that had led to the section's redrafting. Mapes said that "if we assume the Commission is going to be unreasonable, I presume that is true." Id. Chairman Rayburn thereupon intervened to point out that the Commission's interpretation of its powers, and judicial review of its exercise of those powers, would certainly take the decision to revise the bill into account. Id. at 7924.
206. In Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984), the Supreme Court suggested that where Congress has "left a gap for the agency to fill," id. at 843-44, as it has done here, the agency's regulations will be "given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." Id. at 844. The D.C. Circuit questioned whether Chevron even applied to the rule 19c-4 litigation, since the Business Roundtable's
In implementing section 14(a), the SEC has affected corporate governance to a greater extent than under any other provision of the Exchange Act: rule 14a-4 restricts management's use of discretionary power to cast votes obtained by a proxy solicitation; rule 14a-7 requires management cooperation in transmitting an insurgent's proxy materials to shareholders; and rule 14a-8 requires management to include qualified shareholder proposals in the corporation's proxy statement at the firm's expense. Although some opponents of the legislation anticipated these sorts of intrusions into internal corporate affairs, section 14(a) actually has a rather narrow impact on corporate governance. Most of the SEC's proxy rules relate to disclosure. Full disclosure of matters to come before a shareholder meeting, for example, was the original justification for the shareholder proposal rule. While the Commission's authority under section 14(a) is not limited to disclosure issues, its other proxy challenge "might be characterized as involving a limit on the SEC's jurisdiction" as to which deference may be inappropriate. Business Roundtable, 905 F.2d at 408. Although the D.C. Circuit nonetheless assumed that the SEC was entitled to deference, it held that the rule was contrary to the clearly expressed will of Congress and thus was invalid even under Chevron. Id.

210. Senator Gore, for example, inserted into the record of the debates a New York Times news article quoting a letter from 28 "prominent industrialists" stating that section 14(a) "does not in any way relate to speculation or regulation of security exchanges. It gives the Commission a broad power to regulate stockholders' proxies and so to interfere in the conduct of business corporations." 78 CONG. REC. 8580 (1934). In arguing that the SEC had the authority to adopt its shareholder proposal rule, one commentator concluded "that Congress was aware that the proxy regulation section of its exchange bill extended to internal corporate affairs and that, at least to its proponents, this was necessary and proper." Ryan, supra note 201, at 135. Perhaps so, but Congress intended that section 14 affect such matters in a way very different than that necessary to validate rule 19c-4.

Moreover, criticisms of the proxy provisions went almost solely to the extensive requirements of the initial draft. E.g., Pecora Hearings, supra note 168, at 6636 (statement of Richard Whitney); id. at 6839 (testimony of Frank Shaughnessy); id. at 6913 (testimony of Frank Hope); id. at 6991 (testimony of Eugene Thompson); id. at 7050 (testimony of R.V. Fletcher); id. at 7566 (statement of Roland Redmond); House Hearings, supra note 162, at 224 (statement of Richard Whitney); id. at 261-62 (testimony of Eugene Thompson); id. at 666 (statement of Merchants' Association of New York). While section 14 thus received sparse treatment in the debates, Representative Wadsworth, in one noteworthy observation, stated that the proxy provision had been toned down and, while regarding it as unnecessary and having nothing to do with the regulation of stock exchanges, he supposed that it was "not going to impose much hardship or annoyance on anybody." 78 CONG. REC. 7715 (1934) (Rep. Wadsworth). Given that Wadsworth noted the business community's objection that the bill would allow federal interference with corporate management and suggested that those objections had been cured by the new draft, id. at 7713, query whether he would have thought that the proxy provisions would not result in "annoyance" if he thought they authorized the SEC to regulate the substance of corporate voting rights?

211. Medical Committee for Human Rights, 432 F.2d at 677.
rules relate to the procedures by which the proxies are to be prepared, solicited, and used.

The proper interpretation of "fair corporate suffrage" now becomes evident. In using that term, Congress did not mean to address the substantive question of how many votes per share to which a stockholder is entitled. Instead, as the D.C. Circuit recognized, Congress was talking about an entirely different concern: the need for full disclosure and fair solicitation procedures.\(^{212}\)

The historical context in which section 14(a) was adopted supports this interpretation. When the Exchange Act was first being considered, state corporate law was largely silent on the issue of corporate communications with shareholders. It only required that the corporation send shareholders a notice of a shareholders meeting, stating where and when the meeting would be held and briefly stating the issues to come before the meeting.\(^{213}\) By that time, of course, the proxy system of voting was well-established; so too were complaints about its operation. One common concern was that corporate managers were soliciting proxies from shareholders without giving shareholders enough information on which to make an informed voting decision. Another was that management used its control of the proxy process to ensure that only those directors who were acceptable to management were elected.\(^{214}\) Finally, there were a variety of widespread procedural abuses. For example, proxy cards often failed to give shareholders the option of voting against a proposal.

\(^{212}\) Business Roundtable, 905 F.2d at 410-11. BRT Brief, supra note 122, at 32-37; ABA 1987 Comments, supra note 88, at 15-18. Professor Ryan read the legislative history very broadly in arguing that section 14(a) authorized the shareholder proposal rule. While one commentator has questioned his conclusions on this score, Dent, Proxy Regulation in Search of a Purpose: A Reply to Professor Ryan, 23 GA. L. REV. 815 (1989), Ryan also observed that the SEC's proxy "rules are not the source of a shareholder's voting rights relative either to management or to other classes of shareholders. Rather, the federal proxy rules act upon voting patterns already established by the state's corporations statutes and a company's articles and by-laws." Ryan, supra note 200, at 106. For an interpretation of section 14(a)'s legislative history supporting the SEC's position, see Seligman, supra note 15, at 717-19.


\(^{214}\) In 1933, Berle and Means observed that the proxy machinery had "become one of the principal instruments not by which a stockholder exercises power over the management of the enterprise, but by which his power is separated from him." A. BERLE & G. MEANS, supra note 14, at 139. While it is thus true that concerns were raised about management perpetuating itself in office, a task which the nonvoting stocks of the time could also accomplish, those concerns were phrased in terms of abuses of the process by which proxies were solicited.
If the shareholder did not wish to support the proposal, his only option was to refrain from returning the proxy.\textsuperscript{215}

Congress was made aware of these concerns in some detail. Thomas Corcoran, for example, told the House Committee that "[p]roxies, as solicitations are made now, are a joke."\textsuperscript{216} He testified at length about the lack of disclosure provided to shareholders and abuses of the proxy solicitation process.\textsuperscript{217} In answer to a question as to how these abuses could be prevented, he referred solely to the need for better disclosures.\textsuperscript{218} Similarly, in a brief supporting the Exchange Act's constitutionality, Corcoran and Benjamin Cohen stated that the proxy provisions were "designed to make available to the investor reasonable information regarding the possibility of control of the corporation . . . ."\textsuperscript{219} Other favorable references to section 14 in the hearings are to like effect.\textsuperscript{220} Interestingly, none of the references to nonvoting stock in the legislative history were made in connection with section 14.

Read in context, the reference to fair corporate suffrage in the House Report also relates solely to disclosure and procedural issues. The Committee, for example, believed that management should not be able to perpetuate itself in office through "misuse" of corporate proxies.\textsuperscript{221} It noted that insiders were using the proxy system to retain control "without adequate disclosure."\textsuperscript{222} It protested that insiders were soliciting proxies "without fairly informing" shareholders of the purpose of the solicitation.\textsuperscript{223} The passage concludes by stating that in light of these abuses section 14(a) gives the "Commission power to control the conditions under which proxies may be solicited . . . ."\textsuperscript{224} In sum, the passage says nothing about the substance of the shareholders' voting rights. Instead, the focus is solely on enabling shareholders to make effective use of whatever voting rights they possess by virtue of state law.

The Senate Committee's report on stock exchange practices likewise

\textsuperscript{215} Stevens, supra note 9, at 384 n.1.
\textsuperscript{216} House Hearings, supra note 163, at 140.
\textsuperscript{217} See id. at 138-49.
\textsuperscript{218} Id. at 140.
\textsuperscript{219} Id. at 937.
\textsuperscript{220} E.g., Pecora Hearings, supra note 167, at 6543-46 (comments of Thomas Corcoran); id. at 6697 (comments of Frank Altschul); see also id. at 7710-18 (testimony of Samuel Untermyer).
\textsuperscript{221} H.R. REP. NO. 1383, supra note 148, at 13.
\textsuperscript{222} Id.
\textsuperscript{223} Id. at 14.
\textsuperscript{224} Id.
focused on disclosure concerns. It noted that management frequently asked shareholders to grant proxies without explanation of the matters to be acted upon.\footnote{225} The report emphasized the need for adequate shareholder knowledge about both the company's financial position and matters of policy.\footnote{226} Finally, in describing the intent of section 14(a), the report contemplated that the SEC's rules thereunder would "protect investors from promiscuous solicitation of their proxies."\footnote{227}

Subsequent developments are consistent with this pattern. Senator O'Mahoney's efforts to federalize corporate law again are particularly relevant. He held extensive hearings on that topic in 1937 and 1938.\footnote{228} Mandating a federal one-share/one-vote standard was among the items under consideration.\footnote{229} The SEC's Assistant Director of Registration was asked at one of the hearings whether the federal securities laws prohibited the use of nonvoting stock. He replied that "they only require that an adequate disclosure of the material facts concerning that structure be made."\footnote{230} The hearings made no mention of the NYSE policy or the SEC's powers under either section 14 or section 19. As the Business Roundtable bluntly stated, after detailing this legislative history, "The Commission most familiar with the events of 1934... had no illusions that Congress had somehow sought to preserve the NYSE's 1926 so-called 'policy' concerning nonvoting stock or that Congress had authorized the Commission to do."\footnote{231}

In addition to the legislative history and prior administrative practices, the SEC pointed to some loose language in a few cases suggesting a broad reading of the congressional intent for section 14(a). Of course, prior to the D.C. Circuit's decision to invalidate rule 19c-4, there were no judicial

\footnote{225} S. REP. NO. 1455, supra note 173, at 74. See also S. REP. NO. 792, supra note 162, at 12 ("Too often proxies are solicited without explanation to the shareholder of the real nature of the questions for which authority to cast his vote is sought.").

\footnote{226} S. REP. NO. 1455, supra note 173, at 74.

\footnote{227} Id. at 77.


\footnote{229} S. 3072, 75th Cong., 3d Sess. § 5(g) (1938). The one-share/one-vote requirement was qualified by allowing corporations to resurrect voting caps restrictions. Id.

\footnote{230} Federal Licensing of Corporations, supra note 228, at 375.

\footnote{231} BRT Reply Brief, supra note 143, at 9. In 1942, Professor Reuschlein (a proponent of a federal corporation law) also recognized that neither state laws on dual class stock nor the NYSE's policy had been incorporated into "an all-pervasive federal scheme." Reuschlein, supra note 176, at 93.
interpretations of the Act squarely on point. Moreover, when the cases upon which the SEC relied are read in context, they too support the conclusion that section 14(a) was narrowly drawn to deal with disclosure and procedural abuses. The Commission, for example, placed great emphasis on a prior D.C. Circuit decision describing the principal purpose of section 14 as assuring "corporate shareholders the ability to exercise their right—some would say their duty—to control the important decisions which affect them in their capacity as stockholders and owners of the corporation." This comment, however, was made in the context of the shareholder proposal rule. Notice, moreover, the court's emphasis on the ability to exercise voting rights, which seems consistent with the interpretation that section 14 was intended solely to assure that shareholders could make effective use of whatever voting rights state law provides.

More general judicial interpretations of the Exchange Act's scope also confirm this view. As the D.C. Circuit observed, validating rule 19c-4 would "overturn or at least impinge severely on the tradition of state regulation of corporate law." In a series of cases, the Supreme Court has made clear that this is not a step to be taken lightly.

In the early 1970s, courts gave SEC rule 10b-5, designed originally as a catch-all anti-fraud provision, an increasingly expansive reading that in time might have led to a federal common law of corporations. The Supreme Court applied the brakes in a series of cases, most notably Santa Fe Industries v. Green. Santa Fe attempted to freeze out minority shareholders of one of its subsidiaries by means of a statutory short-form

233. As the Supreme Court once put it: "The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation." J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964). Other judicial interpretations of section 14 are also consistent with the notion that it was directed at assuring full disclosure and a fair opportunity to exercise corporate voting rights (of course, these decisions were rendered in cases in which it was those aspects of the rules that were at issue). E.g., Mills v. Electric Auto-Lite Co., 396 U.S. 375, 381 (1970); Greater Iowa Corp. v. McLendon, 378 F.2d 783, 795 (8th Cir. 1967); Dann v. Studebaker-Packard Corp., 288 F.2d 201, 208 (6th Cir. 1961); SEC v. Transamerica Corp., 163 F.2d 511, 518 (3d Cir. 1947), cert. denied, 332 U.S. 847 (1948); NUI Corp. v. Kimmelman, 593 F. Supp. 1457, 1469 (D.N.J. 1984), rev'd, 765 F.2d 399 (3d Cir. 1985); Freedman v. Barrow, 427 F. Supp. 1129, 1145 (S.D.N.Y. 1976); Leighton v. American Telephone & Telegraph Co., 397 F. Supp. 133, 138 (S.D.N.Y. 1975); Studebaker Corp. v. Allied Products Corp., 256 F. Supp. 173, 188-89 (W.D. Mich. 1966).
234. Business Roundtable, 905 F.2d at 413.
235. Boyer, supra note 149, at 1054.
merger. The plaintiffs had state law appraisal rights available, but chose to seek redress under rule 10b-5. Plaintiffs claimed a rule 10b-5 violation arose because the minority shareholders did not receive prior notice and the merger lacked any legitimate business purpose. They also claimed that their shares had been fraudulently undervalued. 237

The Supreme Court held that plaintiffs had not stated a cause of action under rule 10b-5. 238 For present purposes, however, Santa Fe's significance derives from its recognition that the fundamental purpose of the Exchange Act is to assure full disclosure. 239 Once complete disclosure is made, the transaction's fairness and terms do not become issues under federal law, instead they are a matter for state corporate law. 240 The Court was seemingly concerned that a decision in favor of plaintiffs would result in federalizing much of state corporate law; in many cases overriding well-established state policies of corporate regulation. 241 This concern was well-founded, for if the Court gave these plaintiffs a federal cause of action, it could not meaningfully justify denying a federal claim in any breach of fiduciary duty case. The Court simply refused to give rule 10b-5 such an expansive reach. 242

In the 1980s, the Court once again faced the need to draw lines between the state and federal roles in regulating public corporations. At about the same time as Congress adopted the Williams Act to regulate cash tender offers, the states also began adopting tender offer statutes.

237. Id. at 466-68.
238. Id. at 470-71. The Court rested its holding on several bases. First, section 10(b) and rule 10b-5 were only intended to reach deception and manipulation. Neither was present on these facts. Id. at 471-77. Second, the implied private right of action under rule 10b-5 should not be extended to cases that do not involve deception or manipulation. Id. at 477-80.
239. Id. at 477-78.
240. Id. at 478-80.
241. See id. at 478-79.
242. Id. at 479. It is, of course, still possible to state a federal claim in some breach of duty cases. However, the correct allegation in such cases derives not from the breach itself, but rather from the failure to disclose the breach. E.g., Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978); see generally Ferrara & Steinberg, A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism, 129 U. PENN. L. REV. 263, 282-94 (1980).

It is conceivable that Congress or the SEC might use disclosure rules to accomplish indirectly what rule 19c-4 tried to do directly. For example, the Commission could expand existing requirements to mandate full disclosure of the probable effects of a dual class transaction and also impose a fairness disclosure obligation comparable to that applied to going private transactions under SEC rule 13e-3. I reject this approach at the federal level. It simply elevates form over substance. Moreover, the very concept of federal therapeutic disclosure requirements has been subjected to substantial criticism. See Kripke, supra note 175, at 189-93; Sommer, Therapeutic Disclosure, 4 SEC. REG. L.J. 263 (1976).
This first generation of state takeover laws placed significant obstacles in the bidder's path. The Supreme Court's decision in Edgar v. MITE Corp.\textsuperscript{243} however, rendered these laws invalid. The MITE decision, nevertheless, suggested one loophole through which state regulation might pass constitutional muster: the internal affairs doctrine.\textsuperscript{244} The states picked up on this hint and quickly began adopting a second generation of takeover laws, this time focusing on matters traditionally viewed as falling within the sphere of state corporate governance regulation: shareholder voting rights, shareholder approval of changes in corporate control, the fairness of post-tender offer mergers, and the like.\textsuperscript{245}

In CTS Corp. v. Dynamics Corp.,\textsuperscript{246} the Supreme Court for the first time addressed the validity of one of these statutes. When Dynamics made a tender offer for CTS, it challenged the Indiana control share acquisition statute on both preemption and commerce clause grounds. The Seventh Circuit struck down the Indiana Act on both grounds, but a majority of the Supreme Court reversed. In doing so, the Court made a number of observations directly relevant to the rule 19c-4 controversy. The Court recognized that states have a legitimate interest in defining the attributes of their corporations and protecting shareholders of their corporations.\textsuperscript{247} It also strongly indicated that the substance of corporate voting rights is solely a matter of state concern: "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."\textsuperscript{248}

These two lines of cases suggest that the Supreme Court views the states as the principal regulators of corporate governance.\textsuperscript{249} Federal law is seen as placing a gloss on the underlying background of state corporate law, but not as replacing it.\textsuperscript{250} Absent a clear expression of congressional

\textsuperscript{243} 457 U.S. 624 (1982) (striking down an Illinois takeover statute as violating the commerce clause and, by plurality, the supremacy clause). For an analysis of MITE and its effect on the first generation statutes, see Bainbridge, supra note 89, at 738-43.

\textsuperscript{244} See 457 U.S. at 645-46.

\textsuperscript{245} See S. REP. NO. 265, 100th Cong., 1st Sess. 50 (1987). The Report accompanied S. 1323, 100th Cong., 1st Sess. (1987), which proposed a wide range of amendments to the federal tender offer laws. While the bill was reported out of committee, it died without action by the full Congress.

\textsuperscript{246} 481 U.S. 69 (1987).

\textsuperscript{247} Id. at 90-92.

\textsuperscript{248} Id. at 89.

\textsuperscript{249} "[S]tate regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law." Id.

intent, the Court has been reluctant to federalize questions traditionally within the state sphere. Given the absence of any indication of congressional intent to preempt state laws governing shareholder voting rights, it was unlikely that the Supreme Court would uphold rule 19c-4.

4. Rule 19c-4 and Fair SRO Competition

The Commission's final gambit deserves brief mention. Section 11A, among other things, gives the SEC power to designate those securities eligible for trading in the national market. It was added to the Exchange Act in 1975 to facilitate the creation of a national securities market and thus help alleviate some of the problems that had caused the back office crisis. Among its purposes were equal regulation of SROs and fair competition among them. Rule 19c-4 supposedly furthered these goals by preventing the SROs from competing for listings through their voting rights listing standards.

The exchanges, especially the NYSE, have a long tradition of regulating a wide variety of corporate governance matters through their listing standards. Issuers presumably take those standards into account when choosing amongst the various trading markets. Competition for listings thus occurs with respect to a whole host of corporate governance issues. Accordingly, the SEC's position would support federalizing corporate law as to all companies seeking access to the national securities market.

Nothing in the legislative history supported a reading of the statute

251. Santa Fe Indus., v. Green, 430 U.S. 462, 479 (1977); Cort v. Ash, 422 U.S. 66, 84 (1975); Business Roundtable, 905 F.2d at 413; BRT Brief, supra note 143, at 37.

252. As Professor Coffee observed of Santa Fe, "If this deference to federalism still dominates the Supreme Court's current thinking about the reach of the federal securities laws, it cannot be trivialized by the simple expedient of using stock exchange rules to do what cannot be done under Rule 10b-5. Otherwise, federal chartering of corporations could arrive tomorrow based only on SEC manipulation of stock exchange rules." Coffee, supra note 53, at 1267. In light of CTS, such deference plainly still dominates the Supreme Court's thinking.


255. Adopting Release, supra note 5, at 89,233.

256. Business Roundtable, 905 F.2d at 416.
giving the SEC such sweeping powers to equalize listing standards.257 Rather, fair competition within the meaning of section 11A related mainly to the need to eliminate regulatory restrictions that unfairly impeded competition among markets and market makers.258 Yet, rule 19c-4 did not eliminate any anti-competitive regulatory restrictions. It did not promote competition; it merely shielded the NYSE from competition.259

The equal regulation goal of section 11A likewise does not require uniform listing standards. It is intended to assure that no one receives a competitive advantage through disparate regulation.260 Prior to rule 19c-4, disparate standards existed, but the SROs had created them. No government rules created unequal regulation. Thus, this aspect of section 11A was simply inapplicable.261 As the D.C. Circuit bluntly stated: "To argue that Congress's 'equal regulation' mandate supports SEC control over corporate governance through national listing standards is to gamble that the court will accept a Commission spin on a statutory fragment without even a glance at its context. Wrong court, bad gamble."262

C. The Wider Implications of Rule 19c-4's Demise

The Exchange Act and its legislative history are frustratingly silent on many key points. Congress certainly intended to delegate broad powers to the SEC under both sections 14 and 19. After the Act's passage, "[t]he cops were on Wall Street's corner, and they were well armed."263 But the legislative history provides virtually no support for the Commission's attempt to incorporate the NYSE's 1926 policy on nonvoting common stock into the Exchange Act's provisions on proxies and exchange listing standards. In contrast, as the D.C. Circuit concluded, the Act denies the Commission authority over corporate governance generally or the substance of shareholder voting rights specifically. As such, the D.C. Circuit's opinion ultimately may have a much broader impact on the SEC's regulatory authority than was anticipated when the litigation began. While these interesting questions are generally beyond the scope of

257. Id.
259. BRT Comments, supra note 88, at 18; BRT Brief, supra note 122, at 39-40.
261. BRT Comments, supra note 88, at 18.
262. Business Roundtable, 905 F.2d at 416.
263. J. BROOKS, supra note 163, at 205.
this Article, three of the opinion’s more important implications deserve to be examined briefly.\textsuperscript{264}

1. SEC Oversight of SRO Rulemaking and Corporate Governance

Had the D.C. Circuit explicitly adopted the interpretation of sections 19(b) and 19(c) advanced by this Article, there would be no question of whether it removed SRO corporate governance listing standards from section 19(b)’s grant of oversight authority to the SEC. In theory, at least, the ambiguities in the Court’s analysis discussed above raise some questions in this area. As a practical matter, however, the \textit{Business Roundtable} decision should not significantly affect either SRO or SEC conduct under section 19(b). Individual SROs still have the power to adopt voting rights listing standards. They still must submit listing standards for SEC review. At most, the decision may affect the SROs’ ability to arrive collectively at uniform standards. In any event, as the scope of the Commission’s section 19(b) powers was not at issue, the court’s comments are merely dictum.

The decision clearly places boundaries on the Commission’s section 19(c) authority to compel affirmatively SRO rulemaking. Although the D.C. Circuit recognized that the SEC has some regulatory authority over corporate governance matters, an exercise of that authority must be supported by a showing that the proposed rule furthers some purpose of the Act. Moreover, the decision reaffirmed that the SEC may not regulate corporate governance through section 19(c)’s back door. If the Commission has no authority to regulate directly some aspect of corporate governance, it may not do so indirectly by mandating SRO listing standards. Although this aspect of the opinion undoubtedly will have its detractors amongst those who favor expansive SEC powers, it was unquestionably the right result. While this Article is not intended as an extended treatise on federalism, one of the thorniest of legal questions, it seems appropriate to identify briefly the good and sufficient reasons for adherence to the tradition of state preeminence in the corporate governance area.

Although arguing from legislative inaction is a process fraught with hazards, the New Deal Congresses’ rejection of a federal corporation law was probably the result of its satisfaction with the balance created by the securities laws. Federal law was to impose disclosure obligations, along

\textsuperscript{264} See also Rosenbaum & Swenson, \textit{The Demise of Rule 19c-4}, 4 INSIGHTS, Sept. 1990, at 3, 5-7.
with procedural and anti-fraud rules designed to make the disclosure requirements more effective. In contrast, corporate governance standards were left to the states.265

Allocating primary responsibility over corporate disclosure to the federal government was essential. That "sunlight is . . . the best of disinfectants; electric light the most efficient policeman"266 was well accepted by the 1930s; indeed, it was the basic concept around which the federal securities laws were ultimately drafted.267 However, the states faced serious obstacles in attempting to regulate corporate disclosure. Although the Supreme Court had upheld the constitutionality of state blue sky laws,268 the commerce clause limited the states' ability to apply those laws extraterritorially. As a result, most blue sky laws did not regulate out-of-state transactions. The difficulty of attaining uniformity and coordination among the states exacerbated the problem.269 Promoters could evade restrictive state laws simply by limiting their activities to more permissive jurisdictions. Because state securities laws thus could not effectively assure full disclosure, federal intervention was essential to maintaining the national capital markets.270

The states nevertheless had, and still have, a number of legitimate interests in regulating corporate governance. The corporation is a creature of the state, "whose very existence and attributes are a product of state law."271 States have an interest in overseeing the firms they created.272 They also have an interest in protecting the shareholders of their corporations.273 Our economic history reflects these facts in its long tradition of leaving corporate governance regulation to the states.

The New Deal balance thus remains sound. Yet had rule 19c-4 been

266. L. Brandeis, Other People's Money and How the Bankers Use It 92 (1933).
270. Congress, nevertheless, specifically provided that the federal securities laws should not preempt state blue sky statutes. See 15 U.S.C. §§ 77r, 78bb (1989). Presumably it did so in order to (1) respect the rights of the states to regulate transactions taking place within their borders and (2) to obtain an additional level of protection for investors. See H.R. Rep. No. 85, 73d Cong., 1st Sess. 10-11 (1933).
272. Id. at 89.
273. Id. at 91-93.
upheld, it would have marked the end of that balance. Slippery slope arguments are often the last refuge of those with no better case, but rule 19c-4 was indeed the proverbial camel's nose.274 No firebreak existed between substantive federal regulation of dual class stock and a host of other transactions raising like concerns. Nor did laws affecting shareholder voting rights differ in principle or theory from any other corporate governance rules.275 Having once entered the field of corporate governance regulation, the Commission would have been hard-pressed to justify stopping with dual class stock. Creeping federalization of corporate law would have been the most likely result. The D.C. Circuit quite properly foreclosed this possibility.

2. Effect on Existing and Proposed Proxy Rules

The Business Roundtable decision drew somewhat less clear boundaries in another critical area of SEC regulatory authority. The SEC has always regarded its powers under section 14(a) as being very broad. The D.C. Circuit confirmed that the Commission has extensive authority to adopt rules assuring full disclosure and fair solicitation procedures. However, it also drew a critical distinction between substantive and procedural regulation of shareholder voting. As to the former, the SEC has little, if any, authority.

This holding has important implications for the SEC's scheme of proxy regulation. As we have seen, the SEC's existing proxy rules affect corporate governance in a variety of ways. Among these are the restrictions on the form of proxies and the use of discretionary voting authority, the requirement of management cooperation in disseminating an insurgent's proxy materials, and the obligation to include shareholder proposals in the company's proxy statement.276

The Business Roundtable decision also has important implications for pending proxy reform proposals. The SEC is currently considering a variety of suggestions from shareholder and institutional investor groups, such as requiring shareholder approval of takeover defenses and confi-

274. Cf. Business Lawyer Symposium, supra note 109, at 1095 (former—then future—SEC Chairman David Ruder observed that once the SEC begins regulating matters of corporate governance "there will be no turning back").


276. See supra notes 207-09 and accompanying text.
The latter appears to be attracting particular support, largely due to allegations of improper management pressure on institutional investors, but both arguably intrude on substantive matters that fall within the corporate governance sphere.

The Commission’s authority to adopt both its existing rules, especially the shareholder proposal rule, and the recently proposed reforms has been questioned. The Business Roundtable decision provides potent support for these challenges. It requires courts to determine whether a challenged rule is substantive or procedural. The court recognized the existence of a “murky area between substance and procedure,” which may resist classification. Nonetheless, the opinion offers a few signposts by which to resolve future cases. In particular, consider the distinction the court drew between rule 19c-4 and rule 14a-4(b)(2)’s requirement that proxies give shareholders an opportunity to withhold authority to vote for individual director nominees. In the court’s view, the latter “bars a kind of electoral tying arrangement, and thus may be supportable as a control over management’s power to set the voting agenda, or, slightly more broadly, voting procedures,” while “Rule 19c-4 much more directly interferes with the substance of what shareholders may enact.”

Rules addressing unfair solicitation procedures thus should pass muster. The rules on the form of a proxy card, discretionary authority, and mailing of insurgent materials, for example, plausibly relate to the Congressional goal of assuring procedural fairness in proxy contests. Each prevents management from using its control of the proxy solicitation process to manipulate the result of shareholder elections. As a means of preventing management coercion of voters, a confidential voting rule might pass muster as relating to the same sort of procedural unfairness.

The shareholder proposal rule presents a somewhat less compelling case. Even though full disclosure of all matters to come before a share-

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278. E.g., J. Heard & H. Sherman, supra note 76, at 58-63; P. McGurn, supra note 76.
279. Rosenbaum & Swenson, supra note 264, at 6.
280. For arguments against rule 14a-8 based both on authority and policy grounds, see Dent, SEC rule 14a-8: A Study in Regulatory Failure, 30 N.Y.L. Sch. L. Rev. 1 (1985); Liebler, A Proposal to Rescind the Shareholder Proposal Rule, 18 Ga. L. Rev. 425 (1984). But see Ryan, supra note 201, at 123-47, 164-83 (arguing that SEC had authority to adopt rule 14a-8 and that the rule is sound as a matter of policy).
281. Business Roundtable, 905 F.2d at 411.
282. Id.
holders meeting was its original justification, at first blush the rule does not seem to advance either purpose of section 14(a). However, absent the rule, shareholders have no practical means of holding management accountable through the voting process or even affecting the agenda. As such, it too may be supportable “as a control over management’s power to set the voting agenda.”

In contrast, proposals calling for the SEC to require shareholder approval of takeover defenses clearly fall over the line into substance. State corporate law currently governs whether shareholder approval of defensive tactics is required; indeed, this is precisely the sort of issue that falls at the heart of the states’ regulatory sphere. 283 Again, this may be an area in which SRO regulation is possible, but direct or indirect SEC action should be barred.

In sum then, rule 19c-4’s invalidation probably does not presage wholesale restrictions on the SEC’s power to regulate proxy solicitations. The decision merely reaffirms that the SEC must be able to identify purposes of the Act that its rules in fact further. Rule 19c-4 was invalidated simply because it did not further any of the Act’s goals. As long as the SEC stays on the procedural side of the line, its rules will remain valid.

3. Takeovers Defenses and State Takeover Laws

In the last year or two, a variety of factors have combined to make hostile tender offers a much less attractive acquisition technique than they were during most of the 1980s. The junk bond market’s woes complicated raising financing for hostile bids. Since the CTS decision, tough state anti-takeover laws have regularly passed constitutional muster. 284 In the last year or two, state courts have also appeared more receptive to target efforts to defend themselves against hostile tender offers. 285 In response, the proxy contest again became an attractive hostile acquisition method. 286 Indeed, many statutes and defenses effectively force a prospective acquirer to undertake a proxy contest. A bidder seeking control of a target covered by a control share acquisition statute, for example,


285. Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989), may signal a more receptive attitude towards defenses on the part of the Delaware Supreme Court.

necessarily must solicit proxies in support of its bid. All of which raises the question of whether the Business Roundtable case will permit corporate defensive tactics and state takeover statutes to be redirected towards deterring proxy contests.

A fear that anti-proxy contest statutes and tactics would run afoul of section 14(a) long constrained defensive efforts directed at proxy contests. Consider Moran v. Household International, Inc.,287 the Delaware Supreme Court's first poison pill decision. If any party made a tender offer for thirty percent or more of Household's shares, the pill would cause each Household shareholder to be issued one "right" per common share of stock owned by the shareholder. The rights would be immediately exercisable and would entitle the holders to purchase 1/100th of a share of Household preferred stock at a price of $100. The board would be permitted to redeem the rights at a price of 50 cents per right at any time prior to their exercise. If any party acquired twenty percent of Household's stock the rights likewise would be issued on comparable terms, but would be nonredeemable. In the event of a later merger between Household and the bidder, Household's shareholders (excepting the bidder) would be entitled to purchase $200 worth of bidder shares for $100.288

Plaintiff advanced two relevant arguments in opposition to the pill. First, he suggested that it would preclude shareholders from exercising their right to conduct a proxy contest. By effectively prohibiting a proxy insurgent from purchasing more than twenty percent of the shares before conducting a proxy contest, the pill supposedly deterred such contests. The court, however, concluded that the pill would not have a significant impact on the insurgent's chances for success. Second, both plaintiff and the SEC, as amicus curiae, suggested that the mere acquisition of the right to vote twenty percent of the shares through a proxy solicitation triggered the pill—thereby resulting in it being triggered in every proxy contest. The court agreed that a literal reading of the pill supported this interpretation, but neatly avoided the problem by rejecting a literal reading of the pill's terms, holding that a proxy solicitation would not trigger the pill.289 As interpreted by the court, the pill thus prevented a proxy insurgent from purchasing more than twenty percent of Household's shares, but did not interfere with the insurgent's solicitation of proxies.

287. 500 A.2d 1346 (Del. 1985).
288. Id. at 1349.
289. Id. at 1355.
A more recent example of state efforts to avoid possible conflicts with section 14(a) is Pennsylvania’s new takeover law. It requires a controlling person or group to disgorge any profits realized upon disposition of their target shares if the disposition occurs within eighteen months after the person or group achieved control status. As originally proposed, the legislation’s operative language appeared to apply not only to tender offerors, but also to anyone soliciting proxies for any purpose from more than twenty percent of the target’s shareholders. As finally adopted, the statute provides a safe harbor for many proxy solicitations conducted under the Exchange Act.

In both of these instances, section 14(a)’s potential application to the issues at hand seemingly troubled decisionmakers. Indeed, SEC Chairman Richard C. Breeden told the Pennsylvania legislature that the bill “could do substantial damage to the shareholders’ well-established federal right to use the proxy machinery to replace the board of directors.” The threat of SEC efforts to preempt the Pennsylvania statute was quite clear.

As with any federal statute, section 14(a) preempts state laws that stand “as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.” Under the SEC’s broad reading of section 14(a)’s purposes, any significant state interference with proxy solicitations would run afoul of a “well-established federal right” and thereby face preemption. The D.C. Circuit’s rule 19c-4 opinion, how-


292. The statute does not exempt proxy contests by persons seeking control of the target. As such, the disgorgement remedy will still apply to insurgents seeking to elect a majority of the firm’s directors and to announced bidders conducting a solicitation on any issue. Id. at 13-15.

293. Id. at 21 (emphasis deleted).


295. Hines v. Davidowitz, 312 U.S. 52, 67 (1941). Federal law may preempt state law on two other grounds. First, state law will be preempted when federal regulation is “so pervasive as to make reasonable the inference that Congress left no room for the States to supplement” federal law. Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947). Second, when “compliance with both federal and state regulations is a physical impossibility for one engaged in interstate commerce,” the supremacy of federal law requires that the actor comply with the federal rule. Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142-43 (1963). Neither seems applicable to the sorts of issues raised herein.
ever, opens the possibility of state regulation of proxy contests. By rather clearly allocating responsibility over the substance of shareholder voting rights to the states and limiting the SEC's authority to matters of disclosure and procedure, the decision may well alleviate the concerns that previously constrained state regulation in this area.296

If the Business Roundtable decision in fact encourages greater state regulation,297 the dual class stock controversy shall have achieved a most ironic result. It began because disparate voting rights plans were the most effective available takeover defense, yet the decision resolving the controversy may well have opened the door to a new generation of even more effective weapons in the target’s arsenal.

IV. WHAT NEXT?

The D.C. Circuit’s decision restored the status quo ante. Regulation of dual class stock is now back in the hands of the states and the SROs. While the states have done little in response to rule 19c-4's invalidation, the SROs have been very active indeed. As of this writing, the NYSE and NASD have adopted listing standards, with SEC approval under section 19(b), that are essentially identical to rule 19c-4. The NYSE version was adopted in December 1989, well before the Business Roundtable decision.298 Shortly after the D.C. Circuit’s decision, the NASD proposed a listing standard substantively identical to rule 19c-4.299 The SEC solicited comments on the proposal under section 19(b) and, moreover, gave the NASD temporary approval to implement it for a ninety day period.300

296. See R. ROSENBAUM & S. PARKER, supra note 290, at 21 (“If . . . a court accepts the view that section 14(a) is intended only to regulate disclosure and certain procedures regarding proxy voting, it is not clear how [the new Pennsylvania statute] would be relevant to that purpose.”); Rosenbaum & Swenson, supra note 263, at 6.

297. It may not, at least not immediately. After the Business Roundtable decision, albeit without discussing its possible implications, the Delaware Chancery Court reaffirmed that poison pills as a matter of state law may not interfere with the solicitation of revocable proxies. Stahl v. Apple Bancorp, Inc., No. 11510, slip op. (Del. Ch. August 9, 1990).

298. Rosenbaum & Swenson, supra note 264, at 3, 5. However, the NYSE reserved the right to review the status of that standard after the rule 19c-4 litigation concluded. That review presently is underway. Id.


300. Exchange Act Release No. 28276 (July 27, 1990), 46 SEC Docket 1201 (1990). AMEX continues to study the problem and, as yet, has not announced a decision. As this Article went to press, however, the Exchange’s Special Committee on Shareholder Voting Rights issued its report of
While this Article has argued that it is appropriate for SROs to regulate dual class stock and for the SEC to review such proposals under section 19(b), are SRO rules modelled on rule 19c-4 an appropriate solution to the dual class stock problem? This Part argues that they are not and therefore proposes an alternative regime for adoption by the SROs. We can expect predictions that rule 19c-4's invalidation will produce a race to the bottom amongst the SROs in which investor protection is ignored. As management decides on which exchange the firm's securities will be listed, so the theory goes, the SROs will adopt regulations favored by management. Instead of using their voting rights rules to protect investors, the SROs will use them to compete for listings.

The outlook in fact is far less gloomy. In the first place, the doom-sayers operate on a flawed theory of SRO behavior. Essentially they advance the old race to the bottom theory in new clothing. And it remains wrong for the same reasons. In the long run, investors will not purchase, or at least not pay as much for, securities of firms listed on markets that cater too excessively to management. Nor will lenders lend to such firms without compensation for the risks posed by management's lack of accountability. Those firms' cost of capital will rise, while their earnings will fall. Among other things, they thereby become more vulnerable to a hostile takeover and subsequent managerial purges. Corporate managers therefore have strong incentives to assure that both their state of incorporation and SRO offer rules preferred by investors. Competition should thus force excessively pro-management rules to gradually fall by the wayside. Indeed, empirical research in the state law context suggests that efficient solutions to corporate law problems win out over recommendations. Although the Committee Report does not fully track this Article's recommendations, its broad outline is consistent with the latter. Like this Article, the Special Committee rejects the NYSE and NASD approach of simply incorporating the substance of Rule 19c-4 into the Exchange's listing standards. Instead, again like this Article, the Committee report proposes a regime under which dual class shares may be listed if they are issued in an initial public offering or, for existing public corporations, adopted pursuant to specified shareholder voting procedures. SPECIAL COMMITTEE ON SHAREHOLDER VOTING RIGHTS, REPORT TO THE BOARD OF GOVERNORS OF THE AMERICAN STOCK EXCHANGE (Feb. 14, 1991). Unsurprisingly, one SEC Commissioner has already publicly taken AMEX to task for even considering a departure from Rule 19c-4. 23 Sec. Reg. & L. Rep. (BNA) 408-10 (Mar. 15, 1991).

301. See Fischel, supra note 27, at 127-32; see also DOJ Comments, supra note 28, at 17-18. But cf. Coffee, supra note 53, at 1257-58 (SRO race to the bottom precludes exchange regulation of takeover defenses); Schwartz, supra note 107, at 574 (competition limits SRO ability to regulate corporate governance).

302. For this and other arguments against the race to the bottom thesis, see Amanda Acquisition Corp. 877 F.2d at 507-08; R. Winter, GOVERNMENT AND THE CORPORATION (1978); Fischel, The
time. We can expect SRO competition to produce similar results.

Even if one accepts the race to the bottom hypothesis, however, several factors exert considerable pressure on the SROs to maintain restrictions on dual class stock. The SEC retains considerable informal influence over SRO rulemaking; in Professor Schwartz's apt phrase, the SEC often regulates "by raised eyebrow." The Commission is using just that sort of influence to urge the SROs to adopt listing standards restrictions based on rule 19c-4.

Other pressures also exist. The NASD has long wanted a state blue sky law exemption for NASDAQ securities comparable to that available to NYSE and AMEX listed securities. The pressure state blue sky commissions are attempting to exert on the NYSE and AMEX suggests that restrictive voting rights listing standards will be part of the quid pro quo for such an exemption. During the SEC's 19c-4 hearings, for example, a California blue sky commissioner threatened to seek revocation of NYSE's and AMEX's long-standing exemption from state blue sky laws if they diluted their voting rights standards. Shortly before rule 19c-4 was invalidated, for another example, the North American Securities Administrators Association, the NASD, AMEX, NYSE, and SEC promulgated a Memorandum of Understanding in which they agreed that a blue sky exemption would be granted to NASDAQ and exchange securities only if the SROs adopted voting rights listing standards tracking rule 19c-4. In the aftermath of the Business Roundtable decision, for a final example, California required the exchanges and NASD to file annual reports containing, among other things, data on variances granted to an issuer from their corporate governance and voting rights listing standards. The legislation was widely seen as a response to the freedom given SROs by rule 19c-4's invalidation.

The significant question then is not whether the SROs will continue to

"Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U.L. Rev. 913 (1982).


304. Schwartz, supra note 107, at 571.

305. Shortly after the D.C. Circuit's decision, for example, SEC Director of Market Regulation Richard Ketchum expressed hope that the other SROs would follow the NYSE in adopting rules tracking rule 19c-4. 22 Sec. Reg. & L. Rep. (BNA) 895-96 (1990).


regulate dual class stock; they will do so. The significant question is how they ought to go about it.

Several alternative regulatory schemes now present themselves. Any legitimate analytical framework starts with the form of the transaction. Here the spadework done by the SEC provides valuable guidance. As we saw in Part II, rule 19c-4 provides a useful starting point in determining which types of dual class plans require regulation. Rule 19c-4, however, is not a sound model for SRO rulemaking, as demonstrated by the three major objections raised to rule 19c-4 in Part II.

First, the rule was based on the flawed rationale of solving collective action problems. As such, it prohibited some types of dual class transactions that did not raise serious conflicts of interest problems. Among these were super-voting stock having no transfer restrictions, certain stock dividends, and lock-ups. Second, while rule 19c-4 provided a reasonable degree of certainty as to when dual class stock plans were permissible, some uncertainty remained as to the rule's effect on other types of corporate transactions. SRO listing standards based on it likewise threaten to affect a whole host of state laws and corporate transactions having nothing to do with dual class stock.309

Finally, and most important, rule 19c-4's prohibitory approach was inconsistent with general corporate law principles. Corporate law, and SRO listing standards for that matter, permits a variety of transactions posing collective action problems. The coercive nature of exchange offer recapitalizations, for example, is quite similar to the coercion present in two-tier tender offers. A host of corporate transactions besides dual class recapitalizations likewise present shareholder apathy and valuation difficulties. Going private transactions, their leveraged buyout variants, and freeze out mergers each raise the same sorts of concerns.310 More important, each presents the same sort of management conflicts of interest present in dual class recapitalizations. In general, however, corporate law does not prohibit transactions simply because they potentially involve conflicts of interest. Instead, it regulates them in ways designed to constrain management's self-interested behavior. Unless one makes a liv-

309. It is worth noting that a strict one-share/one-vote rule raises comparable questions. For example, would the potential for depriving a large shareholder of its voting rights created by state control share acquisition statutes conflict with a requirement that each share of common stock carry one vote?

310. R. CLARK, supra note 72, at 504-18; Brudney & Chirlstein, A Restatement of Corporate Freezeouts, 87 YALE L.J. 1354 (1978).
ing on the buy-side of corporate takeovers, it is not clear why dual class recapitalizations should be treated differently.

Although SRO listing standards incorporating the substance of rule 19c-4 are the wrong solution, the ideal regulatory system is probably unobtainable. Ideally one would permit dual class recapitalizations, while using market forces to test their fairness. A market test of a transaction’s fairness is usually preferable to review by courts, independent directors, or shareholders.311 Consider, for example, the analogous problem of management-led leveraged buyouts. The market for corporate control provides an effective constraint on management’s conflict of interest in this context. If management offers too low of a price, a competing bidder may emerge and prevail simply by offering a fair price. This process gives management an incentive to avoid low-ball offers. By definition, however, no comparable market check exists in a dual class recapitalization. As such, one must seek alternative mechanisms of dissipating the conflict of interest.

Imposing a requirement that the disparate voting rights plan fully compensate shareholders for the loss of their voting rights provides one possible solution. Dual class stock would be unobjectionable if management provided such compensation. However, the difficulty of measuring the voting rights’ value makes this solution impractical. One simply could not confidently believe that the plan fully compensated the minority.

In light of the difficulties posed by the foregoing solutions, this Article proposes an SRO listing standard based on two principal models. First, it draws extensively on the original dual class stock listing standard proposed by the NYSE in 1986.312 Second, it also draws on state law solutions developed for comparable transactions posing conflict of interest concerns similar to dual class recapitalizations. In particular, the proposal focuses on solutions developed in the context of two-tier tender offers, freezeout mergers, and interested director transactions.

The proposal looks first to the type of transaction in question. Any rule should be limited to true dual class stock transactions, thereby eliminating any possible side effects on other corporate actions. Second, for the reasons discussed in Part II, no safeguards over and above those provided by state law are necessary with respect to dual class stock issued in

311. See Bainbridge, supra note 96, at 273-81.
an IPO, a subsequent offering or dividend of lesser-voting stock, or an acquisition. Nor are any additional safeguards necessary with respect to super-voting rights shares issued without transfer restrictions or in a lock-up. SRO listing standards should therefore permit issuers to adopt those plans freely.

It is true that blatant forms of coercion, such as pressure on institutional shareholders, may occur in these sorts of transactions. However, blatant coercion need not be addressed directly, as it is undoubtedly illegal under existing state law. In *Lacos Land Co. v. Arden Group, Inc.*, \(^{313}\) for example, a firm's chief executive officer and largest shareholder threatened to block acquisitions of the firm unless the shareholders approved a dual class recapitalization giving him voting control. The Delaware Chancery Court held that he thereby violated his fiduciary duty as an officer and director of the firm. \(^{314}\) The logic of this holding suggests that managerial pressure on institutional and other shareholders will likewise violate these duties.

In contrast, transactions involving more subtle conflicts require some additional safeguards. Among these are exchange offers and recapitalizations creating super-voting rights stock bearing transfer restrictions. In order to dissipate the conflicts of interest they raise, the proposal permits them only if the corporation's independent directors and disinterested shareholders approve them. Requiring approval by a committee of independent board members created to negotiate with management and/or the controlling shareholder is common in conflict of interest transactions. In the freeze out merger context, the Delaware Supreme Court has made clear that this procedure is "strong evidence that the transaction meets the test of fairness." \(^{315}\) Statutes governing interested director transactions and two-tier tender offers effectively presume that the transaction is fair if approved by the independent directors. \(^{316}\) Of course, some risk that purportedly independent directors will be biased in favor of their compatriots always exists; but courts give greatest deference to independent directors in contexts like this one in which a market test of the trans-

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313. 517 A.2d 271 (Del. Ch. 1986).
314. *Id.* at 276-79.
316. *E.g.*, Md. Corps. & Ass'ns Code Ann. §§ 3-202, 3-601 to -603 (Michie Supp. 1990) (requirement that bidder pay statutorily defined fair price in back end merger will be waived if transaction approved by continuing, disinterested directors); Pogostin v. Rice, 480 A.2d 619 (Del. 1984) (disinterested director approval of interested director transaction shifts burden of proof to plaintiff to show transaction amounts to waste).
action proves impractical. Guided by outside counsel and financial advisers and facing the risk of personal liability for uninformed or biased decisions, disinterested directors should act as an effective check on unfairness in a dual class recapitalization.

Majority approval of the disinterested shares likewise is a common feature of the models on which this proposal is based. Approval of a freezeout merger or interested director transaction by a majority of the disinterested shareholders, for example, shifts the burden of proof with respect to fairness back to the complaining shareholder. Under so-called fair price statutes, the obligation to pay a statutorily defined fair price in the second-step of a two-tier offer will be waived if the disinterested shareholders approve the transaction. These rules give the shareholders a collective opportunity to reject unfair proposals, thereby helping to eliminate the pressure on individual shareholders to accept the offer. The shareholder approval requirement proposed herein should likewise help remove the coercive aspects of dual class recapitalizations.

In addition, of course, the vote must be an informed one. In particular, the board should disclose the anticipated effects of the transaction. The transaction’s impact on the allocation of voting power within the

317. Bainbridge, supra note 96, at 276-79.
318. Although many states have limited or eliminated personal monetary liability for directors who violate their duty of care, most (including Delaware) have retained personal liability for breaches of the duty of loyalty. See Steinberg, The Evisceration of the Duty of Care, 42 Sw. L.J. 919, 920-22 (1988).
319. For this purpose, interested shareholders should include controlling shareholders, if any, all directors and officers of the firm, and any persons affiliated with them through family or other relationships. Cf. Dent, supra note 28, at 752-55 (also calling for approval by “disinterested” shareholders).
320. Weinberger, 457 A.2d at 703 (freezeouts); Pogostin v. Rice, 480 A.2d 619 (Del. 1984) (interested director transactions).
321. E.g., Md. CORPS. & ASS'NS CODE ANN. § 3-603(b) (Michie Supp. 1990).
firm and on a potential hostile bidder for the firm are the key concerns.\footnote{This obligation is similar to one already imposed by federal law. Item 202(a)(5) of Regulation S-K requires disclosure of any anti-takeover charter or by-law provisions.}

In addition, if the transaction includes dividend or other sweeteners, the board ought to disclose the basis on which they were chosen.

Admittedly, this proposal does not cure the problem of rational shareholder apathy. However, excluding management's shares from the count does eliminate the possibility of a proposal being approved over the objections of a majority of outside shareholders. Dissenting shareholders thus have a fighting chance to defeat the proposal.

The disclosure aspects of the proposal also help counterbalance the shareholder apathy problem. By requiring management to set forth the anticipated effects of the plans, the proposal should deter some of the more egregious types of plans. Management may be less likely to put forth plans causing a dramatic, yet uncompensated shift in the firm's voting-control when they must justify doing so in print.

Finally, it is perhaps easy to overstate the importance of shareholder apathy.\footnote{In this regard, consider the following summary of the SEC's argument in favor of rule 19c-4: (1) voting rights are important; (2) therefore we are going to prohibit certain types of dual class transactions; but (3) because shareholders are so apathetic about their voting rights that they routinely approve dual class stock plans, we aren't going to create an exception for shareholder approved transactions. In this admittedly sarcastic light, the case that rule 19c-4 was really directed at the use of dual class stock as a takeover defense becomes quite convincing. For an excellent critique of the shareholder apathy theory, see Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 570 (1990).} The growing prevalence of sophisticated institutional investors in the shareholder community will help prevent shareholder coercion.\footnote{See BRT Comments, \textit{supra} note 88, at 32-35; DOJ Comments, \textit{supra} note 28, at 11-13, 16-17.} Institutions now control over forty-three percent of all NYSE-listed securities, and it is estimated that by the year 2000 pension funds alone will control fifty percent of all corporate stocks.\footnote{Corporate Takeovers: Public Policy Implications for the Economy and Corporate Governance Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 99th Cong., 2d Sess. 112 (Comm. Print 99-QQ 1986).} Institutions also are becoming more active, "taking their voting rights more seriously and using the proxy process to defend and promote their interests."\footnote{P. Bergin, \textit{Voting by Institutional Investors on Corporate Governance Issues in the 1988 Proxy Season} 1 (1988).} Increasingly, they vote against takeover defenses proposed by management and in favor of shareholder proposals recommending removal of existing defenses. Most important for present purposes, only four per-
cent of the institutions responding to one industry survey favored dual class plans, while nearly two-thirds voted against them as a matter of policy.\textsuperscript{330} These data suggest that a requirement of disinterested shareholder approval in fact will have real teeth.\textsuperscript{331}

In sum, this approach offers a number of advantages. In the absence of compelling evidence that dual class stock always harms shareholders, they should be free to approve disparate voting rights plans provided that the decision is in fact a truly free one. By presumptively permitting dual class IPOs and other non-coercive transactions, the proposal allows those disparate voting rights plans that, if not clearly beneficial to the shareholders, are at least unobjectionable. As to transactions that are potentially objectionable, the proposal eliminates the principal ground for objection by assuring meaningful shareholder review.

V. CONCLUSION

For over 200 years proponents of corporate reform have sought to create a federal law of corporations. Each frontal assault on the citadel of state primacy failed. In section 19(c), however, the Commission found a back door through which corporate law might have been federalized. The implications for our dual system of state and federal regulation were substantial.

If the D.C. Circuit had upheld rule 19c-4, the Commission soon would have faced claims that other matters of corporate governance should be subjected to federal regulation. Takeover defensive tactics, for example, were a prime candidate. The Williams Act was intended to protect shareholders from both management and bidders.\textsuperscript{332} As some takeover defenses are said to coerce shareholders into rejecting a hostile offer, the Commission could have readily argued that exchange listing standards precluding such defenses furthered the Williams Act's purpose and were thus appropriate under section 19(c).\textsuperscript{333}

\textsuperscript{330} \textit{Id.} at 25.  
\textsuperscript{331} The institutional investor community was virtually unanimous in supporting rule 19c-4. The SEC chose to interpret this support as indicating that institutional investors can be disenfranchised by dual class recapitalizations. Adopting Release, \textit{supra} note 5, at 89,216 n.75. A cynic might interpret it as meaning that institutional investors were simply trying to get rid of a strong takeover defense in order to continue bolstering their quarterly performance statistics by reaping short-term profits from corporate acquisitions.  
\textsuperscript{332} CTS Corp. v. Dynamics Corp., 481 U.S. 69, 82-83 (1987).  
\textsuperscript{333} BRT Brief, \textit{supra} note 122, at 45-46. The objection that the SEC as a practical matter would not seek broad federal regulation of corporate governance may or may not be true of the
The D.C. Circuit's decision rather clearly holds that the Commission may not use its section 19(c) powers to federalize corporate governance regulation generally. Instead, before the Commission can mandate SRO corporate governance listing standards it will have to show that Congress clearly intended to displace the relevant state law. If the back door has not been locked, it at least is no longer wide open. Corporate governance standards are thus back where they belong—in the hands of the states and SROs.

334. "The reasoning supporting rule 19c-4 would . . . not necessarily support future Commission rulemakings imposing uniform listing standards regulating other aspects of corporate governance." Adopting Release, supra note 5, at 89,234 (Grundfest, C., concurring). It is true, however, that the Commission on a number of occasions has tried to implement sweeping reforms in this area. For a vigorous critique of one such effort, see Kripke, supra note 176, at 187-205. Nothing guaranteed that the Commission would exercise restraint in its future interpretations of section 19(c).


336. Id. at 96,343.