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THE FUTURE OF CORPORATE GOVERNANCE LISTING REQUIREMENTS

*Roberta S. Karmel**

I. INTRODUCTION

THIS paper is addressed to the future of qualitative stock exchange listing requirements; that is shareholder protection or corporate governance standards that go beyond market size or financial criteria for listing. Although some qualitative listing standards became incorporated into the federal securities laws, most standards of this type are considered appropriate to state corporation law, rather than federal law.

This tension between securities law and corporation law is not unique to the United States, but our federal system gives that tension a particular antithetical complexity which frequently has to be resolved by the courts and Congress.

Since most large public companies are listed on a national stock exchange, listing standards have become national, although not necessarily a part of federal law. In this context, since the Nasdaq Stock Market, Inc. ("Nasdaq") is the functional equivalent of a stock exchange, Nasdaq listing requirements will be analyzed as having the same legal status as requirements of the New York Stock Exchange, Inc. ("NYSE") or other national stock exchanges.¹ Part II of this paper will discuss the historical development of qualitative listing standards and their function as a bridge between federal and state law in the corporate governance area. Particular attention will be paid in Part III to the development of standards with regard to audit committees and the one-share, one-vote controversy. The history of these standards highlights the shaky legal footing of listing requirements as "rules" under the Securities Exchange Act of 1934 ("Exchange Act").²

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1. Nasdaq is a partially owned subsidiary of the National Association of Security Dealers, Inc. ("NASD"). Although it has been registered with the Securities and Exchange Commission ("SEC") as an exclusive information processor, it has filed for registration as a securities exchange. See Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40,760, 63 Fed. Reg. 70,844, 70,852 (Dec. 22, 1998).

2. See Securities Exchange Act of 1934, 15 U.S.C. § 78a (1994).

Stock exchange listing requirements have a long history and will probably remain in effect for a long time to come. However, trading market competition and the demutualization and public ownership of stock exchanges could call into question the ability of exchanges to formulate and enforce listing requirements. Part IV will discuss these developments. This could mean that listing standards simply fall by the wayside as casualties of stock market competition and legal uncertainty. That is not a political likelihood, however. Rather, over time demutualization of stock exchanges may lead to more direct government regulation of corporate governance. If such regulation is undertaken by the Securities and Exchange Commission ("SEC"), a significant change in the balance of federal-state power with respect to corporate governance will occur. Currently, there is an upsurge in investor activism fueled by anti-business political agitation. Further, this resurgence of interest in corporate governance matters is leading to the development of some new academic theories about corporate and securities law. Part V will discuss the emergence of a new social protest movement and its possible effect on the policies of the SEC with regard to stock exchange listing requirements.

II. THE DEVELOPMENT AND LEGAL STATUS OF LISTING STANDARDS

A. THE HISTORY OF STOCK EXCHANGE LISTING STANDARDS

1. *The NYSE*

The first NYSE listing standards were not considered a set policy by the exchange but instead were flexible terms inserted in listing agreements negotiated between each issuer and the exchange.³ The contractual flexibility of listing agreements meant that listing standards were not uniformly enforced and were subject to change.⁴ Also, because such standards were not retroactively applied, nonconforming issuers who had obtained listings prior to a new rule were not delisted. Thus, the NYSE employed no uniform set policy which applied to all listed companies.⁵ Nevertheless, this flexibility allowed the NYSE to change its listing agreements according to its economic needs.⁶

As early as 1869, a Committee on Stock List, a subcommittee of the NYSE Board of Governors,⁷ was formed to evaluate applications to list with the NYSE.⁸ The Committee was primarily concerned with the qualitative character of the issuer: "the degree of national interest in the company, its standing in its particular field, the character of the market for its

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

4. *Id.* at 1466.

5. GILBERT W. COOKE, *THE STOCK MARKETS* 215 (1964).

6. CHARLES A. DICE & WILFORD J. EITEMAN, *THE STOCK MARKET* 117 (2nd ed. 1941).

7. GEORGE L. LEFFLER, *THE STOCK MARKET* 414 (1st ed. 1951).

8. COOKE, *supra* note 5, at 215; DICE & EITEMAN, *supra* note 6, at 110.

products, its relative stability and position in the industry, and whether or not it is engaged in an expanding activity and ha[d] prospects of maintaining its position.”⁹ Applicants were required to disclose information including, but not limited to, the history and nature of its business, detailed information regarding management, capitalization structure, stock provisions and business financials, including a description of its accounting policies.¹⁰ However, the NYSE was faced with an uphill battle and achieved little success in regard to obtaining financial information from its listed companies.¹¹

After 1869, listing standards developed gradually.¹² The slow rise in standards occurred for two reasons: first, at that time, financial disclosure was seen as antithetical to good business practices,¹³ and second, listing agreements were not binding on future agreements. However, with the abolition of the NYSE’s “Unlisted Department” in 1910, the exchange successfully campaigned for more thorough disclosure from listing companies.¹⁴ Between 1910 and 1929, the NYSE gradually secured agreements with its listed companies to provide substantial financial disclosure and to provide certain safeguards for investors.¹⁵

Historically, listing standards were seen as a substitute for government regulation. The NYSE argued that if its listing standards for securities offered for sale adequately protected the investing public, then government regulation would be unnecessary.¹⁶ Former President of the NYSE, Richard Whitney, stated in a memorandum submitted to the Committee on Banking and Currency of the United States in 1932 the following in support of furthering self-regulation of securities exchanges:

New forms of securities are frequently evolved, and changes in the corporations acts of the states, together with changes in economic conditions, give rise to frequent new problems as to forms of charters, accounting methods, and business practices. The attitude of the exchange is one of constant watchfulness to prevent the admission to its list of securities of corporations the nature of whose business and character of whose charters, or whose business and accounting practices, do not appear to adapt such securities to widely disseminated public ownership.¹⁷

9. DICE & EITEMAN, *supra* note 6, at 110.

10. *Id.* at 111-16.

11. LEFFLER, *supra* note 7, at 429

12. *See id.*; COOKE, *supra* note 5.

13. *See* LEFFLER, *supra* note 7.

14. Prior to 1910, the NYSE maintained “listed” and “unlisted” trading departments. Issuers which did not disclose sufficient information about their issues were carried in the unlisted department. However, with the recommendation of the Hughes Commission, the unlisted department was abolished on April 1, 1910. ROBERT SOBEL, *A HISTORY OF THE NEW YORK STOCK EXCHANGE, 1935 - 1975* (1975).

15. LEFFLER, *supra* note 7, at 430.

16. *See* Max Lowenthal, *The Stock Exchange and Protective Committee Securities*, 33 COLUM. L. REV. 1293, 1294 (1933).

17. *Id.* at 1298 (citing Hearings on S. 84, 72nd Cong., 1st Sess., Part I, at 285-56).

Initially, the NYSE was concerned with financial disclosure,¹⁸ but this emphasis precipitated several corporate governance listing standards. An annual stockholder's meeting, the first corporate governance standard, was imposed as a term within the listing agreement and was eventually linked to annual reporting requirements.¹⁹ By 1900, listing agreements required companies to distribute annual reports to its stockholders.²⁰ By 1909, those reports had to be distributed prior to the stockholders' annual meeting.²¹ By 1914, agreements provided that a listed company notify the exchange of any change in the rights of stockholders or in the redemption of preferred stock.²² By 1917, agreements provided for the disclosure of a semiannual income statement and balance sheet.²³ In 1926, the NYSE adopted a one-share, one-vote listing standard.²⁴ The history of this standard and its demise will be discussed in Part III.

However, it was only after the stock market crash of 1929 that regulators began to take seriously the need for and importance of financial disclosure for listed companies. Changing public attitudes led to the establishment of a new policy on corporate publicity.²⁵ The policy urged, but did not require, companies to prepare financial reports by independent accountants and to prepare detailed income statements.²⁶ By 1932, independent audits became mandatory for all new listed companies.²⁷ Also by 1932, companies agreed to report their earnings quarterly.²⁸ Finally, with the enactment of the Exchange Act, the policies of the NYSE regarding independent audits became a matter of federal law.²⁹ The value of the NYSE's listing requirements was demonstrated by the fact that "Congress closely tracked the NYSE disclosure requirements when it drafted the Exchange Act."³⁰

Prior to the enactment of the Exchange Act, listing agreements required issuers annually to disclose all significant details about their financial condition, such as changes in the character of their business, capitalization, and accounting policies, prior to the stockholders' meeting.³¹ Further, a listed company promised to have its books audited by certified public accountants and to maintain a transfer agent and regis-

18. *Id.*

19. Michael, *supra* note 3, at 1467-68.

20. COOKE, *supra* note 5, at 216.

21. Michael, *supra* note 3, at 1467-68.

22. *Id.*

23. *Id.*

24. See Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 694-98 (1986).

25. LEFFLER, *supra* note 7, at 430.

26. *Id.*; COOKE, *supra* note 5, at 216.

27. LEFFLER, *supra* note 7, at 431.

28. COOKE, *supra* note 5, at 216.

29. See Items 25 and 26 of Schedule A to the Securities Act of 1933 (Securities Act), 15 U.S.C. §§ 77aa(25) and (26) (1994).

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

31. LEFFLER, *supra* note 7, at 425, 430; DICE & EITEMAN, *supra* note 6, at 117; COOKE, *supra* note 5, at 216.

trar.³² Even after the promulgation of the Exchange Act, the NYSE was still concerned with the practices of its listed companies. However, the impetus for these changes may have been “the NYSE’s focus during that time on bolstering trading volume.”³³ The NYSE believed that by appealing to the needs of the individual investor and improving corporate governance practices, it could attract additional investors for already listed shares.³⁴

By 1953, minimum quorum rules were established for shareholder meetings.³⁵ Beginning in 1940, minimum voting rights were also required for preferred stockholders.³⁶ In 1955, the NYSE required shareholder approval for any acquisition resulting in an increase of more than 20% of its shares.³⁷ Then, in 1956, an independence requirement for directors was initiated, a standard of future importance and controversy.³⁸ The NYSE’s emphasis on corporate governance included scrutiny of the financial practices of listed companies. The NYSE’s early statements regarding financial disclosure laid the groundwork for future rules; the NYSE “did not desire to list companies unless their accounting policies were sound and logical and found common acceptance among engineers and accountants.”³⁹ However, it was not until the 1970s that the Exchange required independent audit committee members, and this change was the result of SEC pressure as will be explained in Part III.⁴⁰

Today, the NYSE’s listing standards include policies and requirements regarding “independent audit committees, ownership interests of corporate directors and officers, shareholders’ voting rights, and other matters affecting shareholders’ ownership interests and the maintenance of fair and orderly markets in listed securities,”⁴¹ including the election of independent directors, holding annual shareholders’ meetings, and the solicitation of proxies.⁴² It has been argued that the NYSE’s incentives were disingenuous concerning investor protection, since its primary goal was to successfully compete in the marketplace for listings among the exchanges.⁴³ Notwithstanding those accusations, history illustrates that the NYSE, since its inception, was dedicated to ensuring the integrity of the securities markets and used listing standards as a device to protect investors and the market in general. If the NYSE believed that better listing

32. *Id.*

33. See Michael, *supra* note 3, at 1469.

34. *Id.*

35. *Id.*

36. LEFFLER, *supra* note 7, at 432.

37. See Michael, *supra* note 3, at 1469.

38. *Id.*

39. LEFFLER, *supra* note 7, at 432.

40. See Michael, *supra* note 3, at 1469.

41. NYSE LISTED COMPANY MANUAL, § 301.00 Introduction (1999), available at <http://www.nyse.com/listed/listed.html>.

42. Jay D. Hansen, *London Calling?: A Comparison of London and U.S. Stock Exchange Listing Requirements for Foreign Equity Securities*, 6 DUKE J. COMP. & INT’L L. 197, 207 (1995).

43. See Pritchard, *supra* note 30, at 1001-09.

standards gave it a competitive edge, this does not mean investor protection was an unimportant goal. Stock exchange listing standards are deeply rooted in NYSE history and may not be as easily compromised by competition and demutualization as critics of the NYSE assume. Nevertheless, competition among exchanges and demutualization may reduce the NYSE's bargaining leverage in pushing for higher standards.⁴⁴ These issues will be further discussed in Parts III and IV.

2. *The American Stock Exchange*

Compared to the NYSE, the American Stock Exchange ("AMEX") adopted significantly more lenient listing standards and initiated them at a much later date in history. One possible explanation for this inaction is because throughout AMEX's entire history, it competed with the NYSE for listings. AMEX, previously known as the New York Curb Exchange (the "Curb"), was used as a springboard for many smaller and less established issuers to enter the market. A survey in the 1950s showed that more than half of the securities listed on the NYSE were previously listed on the Curb.⁴⁵ It was because of AMEX's position on many listing standards that it was able to maintain its name as the "great unlisted market of the country."⁴⁶ Although AMEX's listings standards were more competitive than the NYSE's, self-regulatory efforts were dismal and the exchange came under strict scrutiny from the SEC in the early 1960s.

A seasoner for the Big Board, the AMEX listed those securities which could not meet the strict listing requirements of the NYSE.⁴⁷ Issuers trying to avoid making corporate disclosures under the NYSE's disclosure requirements would trade as an "unlisted" security on the Curb.⁴⁸ The 1936 Amendments to Section 12 of the Exchange Act extended unlisted trading privileges and enabled the Curb to survive since most of its issues consisted of unlisted securities which could not meet the registration requirements.⁴⁹ The 1936 amendments also brought added competition from regional stock exchanges.⁵⁰ As a result, the Curb, as well as other exchanges, sought additional listings during the 1930s, with scant attention to regulatory concerns. Despite the effects of new legislation and increased competition, "the Curb remained the great unlisted market of the country."⁵¹ But "it was clear that the AMEX's campaign for more

44. *Id.* at 1008.

45. *Id.* at n.72.

46. LOUIS LOSS & JOEL SELIGMAN, VI SECURITIES REGULATION 2770 (3d ed. 1990).

47. *Id.* at vol. I, 220.

48. *Id.* Those exchanges which permitted securities to be traded on a "unlisted" basis were those who campaigned most against the abolishment of unlisted trading. Whereas the NYSE abolished its unlisted trading department in 1910, AMEX was steadfast in retaining its unlisted securities and only took its first steps toward dismantlement in 1934. Michael *supra* note 3, at 1472.

49. ROBERT SOBEL, A HISTORY OF THE AMERICAN STOCK EXCHANGE, 1921-1971 129 (1972).

50. *Id.*

51. LOSS & SELIGMAN, *supra* note 46, at vol. VI, 2770.

listings in the 1950s resulted in a higher quantity but arguably lower quality of listed companies.”⁵²

During the 1960s, reforms swept through the AMEX.⁵³ In 1962, following the exposure of several scandals, the SEC issued a report criticizing almost every aspect of the AMEX’s operations, including its board, methods of stock listing and retention, and trading methods.⁵⁴ The SEC concluded that the AMEX failed at achieving any type of self-regulation.⁵⁵ Only then, the AMEX began to initiate several reforms regarding its organization and listing standards.⁵⁶ Soon thereafter, AMEX listing standards required proxy solicitations and shareholder approval of certain transactions.⁵⁷ In 1968, AMEX published its first edition of the AMEX Company Guide, which included policies regarding conflicts of interests, directors, and voting rights. Conflicts of interest between shareholders and their officers, directors, or substantial shareholders were considered on a case-by-case basis.⁵⁸ The size and significance of the conflict as well as its possible resolution were also taken into consideration. Although not required, the AMEX policy “recommended” the appointment of at least two independent directors,⁵⁹ a factor also considered when evaluating the significance of a conflict of interest. The AMEX Company Guide also included minimum quorum requirements.⁶⁰ Except in the areas of voting rights and independent directors and audit committees, AMEX listings standards have remained relatively static since the 1970s.

Until 1976, the AMEX did not have an official policy concerning voting rights. In 1972, AMEX’s stated policy was to prohibit all issues of non-voting common stock, but its practice was to consider each case on an individual basis. Further, on several occasions, the AMEX did not refuse to list such companies with disparate voting rights for its shareholders.⁶¹ In particular, the AMEX decided to list Wang Laboratories, Inc. (“Wang”) even though it had been rejected for listing by the NYSE because of unequal shareholder voting rights. In 1976, the AMEX published the listing agreement with Wang, permitting a capitalization which included a Class B common stock having one-tenth of one vote per share. After 1976, listings on the AMEX were held to this so-called “Wang Formula.”⁶² As will be described in Part III, this willingness by the AMEX to list issuers which did not have a one-share, one-vote common stock capitalization led to a race to the bottom between exchanges with

52. Michael, *supra* note 3, at 1473.

53. *Id.*; SOBEL, *supra* note 49, at 280-85.

54. SOBEL, *supra* note 49, at 297.

55. *Id.*

56. Michael, *supra* note 3, at 1473.

57. *Id.* at 1474.

58. AMERICAN STOCK EXCHANGE COMPANY GUIDE, § 121 Conflicts of Interest (1968).

59. AMERICAN STOCK EXCHANGE COMPANY GUIDE, § 122 Outside Directors (1968).

60. Michael, *supra* note 3, at 1473.

61. LOSS & SELIGMAN, *supra* note 46, at vol. IV, 1839 n.302.

62. See Seligman, *supra* note 24, at 704.

regard to a voting rights listing standard. However, in 1994, the NYSE, AMEX, and the National Association of Securities Dealers, Inc. ("NASD") jointly adopted a minimum voting rights rule which prohibits any reduction or restriction of shareholder voting rights through corporate action.⁶³

The AMEX has similar, but "less exacting" independent audit committee standards than the NYSE.⁶⁴ The independence of audit committee members, originally a recommendation for listing in 1980, became a mandatory listing requirement in the early 1990s. Following the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, the independence of those audit committees and the financial literacy of directors were mandated, as will be more fully explained in Part III.

3. *Nasdaq*

The history of Nasdaq listing requirements is rooted in state blue sky merit regulation. Every state, the District of Columbia, and Puerto Rico has a securities regulation statute. Some state blue sky regulation is merit regulation. A merit regulator has the authority to prevent an issuer from selling securities in the state because the offering or the issuer's capital structure is "substantively unfair or presents excessive risk" to investors.⁶⁵ Although the blue sky laws vary from state to state, they all contain a requirement for registration of securities to be sold in the state. However, most state securities laws traditionally provided an exemption from their securities registration requirements to issuers which were listed on a national securities exchange. This was known as the "blue chip" exemption. Some states also provided an exemption for certain over-the-counter securities.⁶⁶

In 1985, the Nasdaq initiated its first corporate governance listing standard in an effort to secure blue sky exemptions in a greater number of states.⁶⁷ These standards included the submission of annual and periodic reports to shareholders, appointment of independent directors, an independent audit committee, required shareholder participation in certain corporate transactions, and execution of a listing agreement.⁶⁸ This was part of a campaign for broader exemptions from state registration so that securities listed on Nasdaq or designated as "National Market System Securities"⁶⁹ would be exempt from state blue sky registration requirements.

63. LOSS & SELIGMAN, *supra* note 46, at vol. IV, 1848-50.

64. See Seligman, *supra* note 24, at 690-92; see also In the Matter of the American Stock Exchange, Inc., Exchange Act Release No. 16,722, 19 S.E.C. 1106 (1980).

65. Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW 785, 787 (1986).

66. *Id.* at 833-35.

67. Michael, *supra* at note 3, at 1475; Seligman, *supra* note 24, at 705.

68. Michael, *supra* note 3, at 1475.

69. See Exchange Act Rule 11Aa-2-1, 17 C.F.R. § 240.11Aa-2-1.

This controversy concerning the merit of Nasdaq listing standards in contrast to the standards of national securities exchanges was settled by the National Securities Markets Improvement Act of 1996,⁷⁰ which preempted state regulation of the securities registration and offering process for "covered securities."⁷¹ This means merit review is not applicable to nationally traded securities, including Nasdaq listed securities. As a result, competition was eliminated between the NYSE, AMEX, and Nasdaq for better listing standards where this competition was an effort to exempt issuers from state blue sky merit review.

4. Foreign Issuers

Foreign issuers can obtain a waiver from many NYSE corporate governance requirements if an independent counsel licensed in the issuer's home country opines that its practices are not prohibited by the issuer's domicile. This means, in effect, that if the laws in the issuer's home country are silent or do not explicitly require the standard, the foreign issuer will be able to obtain a waiver.⁷² Under the AMEX and Nasdaq listing rules, similar exemptions are available.⁷³

Although the NYSE, AMEX, and Nasdaq all purport to apply financial reporting and corporate governance requirements to foreign issuers, in 1987, the SEC approved rule changes which allowed the exchanges to waive or modify certain enumerated listing standards for foreign issuers on a case-by-case basis.⁷⁴ Instead, a foreign issuer's compliance with the "laws, customs, and practices" of its country of origin became determinative for a U.S. listing.⁷⁵ Those enumerated standards which may be waived or modified include: "(1) [q]uarterly reporting of interim earnings; (2) composition and election of the Board of Directors; (3) shareholder approval requirements and voting rights; and (4) quorum requirements for shareholder meetings."⁷⁶ The relaxed foreign issuer

70. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

71. Securities Act, § 18(a)(3), 15 U.S.C. § 77r(a)(3).

72. NYSE LISTED COMPANY MANUAL, *supra* note 41, § 103.00 Non-U.S. Companies.

73. This regime was criticized in James A. Fanto, *The Absence of Cross-Cultural Communications: SEC Mandatory Disclosures and Foreign Corporate Governance*, 17 Nw. J. INT'L L. & BUS. 119 (1996).

74. Self-Regulatory Organizations, Order Approving Proposed Rule Changes by the American Stock Exchange, Inc. and New York Stock Exchange, Inc. to Amend the Exchanges' Listing Standards for Foreign Companies, Exchange Act Release No. 24,634, 52 Fed. Reg. 24,230 (June 23, 1987) [hereinafter Foreign Issuer Rule Changes]. Prior to 1987, the NASD did not have any corporate governance or shareholder reporting requirements. *Id.* at 3. In 1987, under a new rule change, securities traded on the Nasdaq are considered as part of the National Market System and are subject to the Commission's reporting requirements as well as corporate governance requirements similar to the NYSE and AMEX. Self Regulatory Organizations; Transaction Reporting Plan; Order Approving Amendments to the Transaction Reporting Plan with Respect to NASDAQ/NMS Securities, Exchange Act Release No. 24,633, 1, 52 Fed. Reg. 24,234 (June 23, 1987). In 1997, these requirements were extended to Nasdaq SmallCap issuers as well. *Id.*

75. Foreign Issuer Rule Changes, *supra* note 74.

76. *Id.* at 2.

listing standards stemmed from a recognition that many differences exist between the corporate governance practices of foreign companies and U.S. companies in the areas of voting and independent directors, quorum requirements, and financial reporting. For example, the AMEX asserted that "many foreign issuers are incorporated in nations which lack a history of providing shareholders with the same degree of participation in the choice of management, and in voting of stock issuances, as is the norm in this country" and that "[o]ther means of corporate accountability and discipline are favored over shareholder voting as a check on management."⁷⁷

However, the real impetus for change was global competition among exchanges. A critic of the foreign issuer listing standards has argued that the rule change was an SEC response "to the need[s] of its constituencies, the U.S. stock exchanges and their investment banking members to develop a U.S. market for foreign securities."⁷⁸ Differences among the corporate governance practices of foreign issues would unduly inhibit those companies from listing on American exchanges unless foreign issuers were afforded special treatment.⁷⁹

The SEC concluded that the foreign issuer listing rule would not have a "detrimental competitive impact on domestic companies."⁸⁰ The SEC stated that it was "appropriate to permit differentiations from the requirements imposed on domestic companies in order to permit the exchanges to be more competitive on an international basis and to provide access to U.S. investors to investment opportunities in a large number of foreign securities."⁸¹ Nevertheless, there is some concern that domestic issuers will eventually campaign for a reduction in listings requirements under the same justifications cited for foreign issuers, an argument for equal treatment of all issuers.⁸²

Because the reporting and disclosure requirements for listed companies are much more onerous than those required by a foreign issuer's home country, it is very common for foreign issuers to seek waivers. Waivers are routinely granted as long as the practices of the issuer do not

77. Self-Regulatory Organizations, Proposed Rule Change by American Stock Exchange Amending Section 110 of the Amex Company Guide to Modify Foreign Listing Guidelines, Exchange Act Release No. 23,064, 1, 51 Fed. Reg. 11,125 (Apr. 1, 1986). Instead, one commentator has argued for a new set of disclosure rules for foreign issuers which more adequately reflects the company's structure and disclosures more meaningful information to investors. Fanto, *supra* note 73.

78. *Id.* at 177.

79. Self-Regulatory Organizations, Order Approving Proposed Rule Changes by the American Stock Exchange, Inc. and New York Stock Exchange, Inc. to Amend the Exchanges' Listing Standards for Foreign Companies, Exchange Act Release No. 24,634, 1, 52 Fed. Reg. 24,230 (June 23, 1987). Supporting the exchanges' proposals, the SIA International Committee, in a comment letter to the SEC, noted that the "NASDAQ's current lack of corporate governance standards may have been a factor in the decisions by these companies to choose NASDAQ." *Id.* at 4; *see also* Fanto, *supra* note 73.

80. Foreign Issuer Rules changes, *supra* note 74, at 3.

81. Foreign Issuer Rule Changes, *supra* note 74, at 6.

82. *Id.*

violate the law of the issuer's home country. The NYSE has stated that it does not intend to limit waivers or exemptions to situations where it would be impossible for a company to comply with a specific corporate governance requirement and also comply with home country law,⁸³ but abuse of the rule will not be allowed. In an SEC release, the NYSE stated the following: "If, for example, a waiver were available any time compliance with SRO rule requirements imposed any additional burdens on foreign companies beyond those imposed by law or custom by the country of domicile, the proposals would be tantamount to eliminating all listing standards in this area from foreign companies."⁸⁴

Despite the adoption of several corporate governance listing standards for U.S. issuers, the exchanges' policies toward foreign issuers have remained accommodating. In 1991, the SEC approved exchange rules which mandate that issuers have at least two independent directors and an audit committee composed of a majority of independent directors. However, these requirements do not apply to foreign issuers as long as the U.S. practice is inconsistent with the custom or practice of a foreign issuer's home country.⁸⁵ Advancing its position, the NYSE stated that its policies are consistent with the SEC's foreign issuer guidelines.⁸⁶

Similarly, foreign issuers are exempt from changes to the NYSE, AMEX, and NASD's rules governing the voting rights of common shareholders adopted in 1994.⁸⁷ The exchange rules exempt issuances or actions by foreign issuers from these voting rights rules as long as the company's voting structure is not prohibited by the issuer's home country's laws.⁸⁸ Accordingly, foreign issuers could meet exchange listing standards regarding voting rights if it either complied with the requirements of Rule 19c-4 (discussed in Part III(C) below) or was in compliance with the issuer's home country laws.⁸⁹

In 1989, the SEC approved another NYSE rule change liberalizing the

83. *Id.*

84. *Id.*

85. Self-Regulatory Organizations, the American Stock Exchange, Order Approving Proposed Rule Change and Notice and Order Granting Accelerated Approval to Amendment No. 1 Relating to Independent Directors and Audit Committees, Exchange Act Release No. 29796, 56 Fed. Reg. 51,953 (Oct. 8, 1991).

86. "The fact that its proposed audit committee requirements will not apply to foreign issuers if the requirement is inconsistent with the custom and/or practice in the company's country of domicile is consistent with the Exchange's foreign issuer guidelines." *Id.* at 4.

87. Self-Regulatory Organizations, American Stock Exchange, Inc., National Association of Securities Dealers, Inc. and New York Stock Exchange, Inc., Order Granting Approval to Rule Changes Relating to the Exchanges' and Association's Rules Regarding Shareholder Voting Rights, Exchange Act Release No. 35,121, 1, 59 Fed. Reg. 66,570 (Dec. 19, 1994).

88. *Id.* at 3.

89. Self-Regulatory Organizations, New York Stock Exchange, Inc., Order Partially Approving Proposed Rule Change Relating to Amendments to the Exchange's Voting Rights Listing Standards and Listing Standards for Non-U.S. Companies as set forth in Sections 313.00 and 103.00 of the Exchange's Listed Company Manual, Exchange Act Release No. 27,554, 2, 54 Fed. Reg. 53,227 (Dec. 20, 1989).

procedures for foreign issuers listing on a U.S. exchange.⁹⁰ The rule allows the exchange to consider any “nonconforming practice” of a foreign issuer which is not prohibited by the laws of the issuer’s home country rather than limiting the exchanges’ consideration to those “nonconforming practices” which are consistent with the practice of the issuer’s home country.⁹¹ The purpose of the rule was to reduce administrative burdens on foreign issuers; the exchanges claimed that obtaining certification that nonconforming practice is not prohibited under the law is easier than showing that the practice is consistent with the custom of a particular country.⁹²

Excusing foreign issuers from listing standards can be justified on the ground that corporate governance is generally a matter of home state regulation, but it can also be viewed as a means to attract foreign issuer listings in a competitive global market. Thus, the competition for listings can result in races to the top or races to the bottom, depending upon how an exchange perceives its competitive edge with regard to particular listing standards.⁹³

B. THE SEC’S AUTHORITY OVER CORPORATE GOVERNANCE

Corporate governance is primarily a matter of state corporation law. This was expressed by the United States Supreme Court in a non-securities law case as follows:

Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.⁹⁴

Thereafter, in *Santa Fe Indus., Inc. v. Green*,⁹⁵ the Court applied this principle in a case arising under the federal securities laws involving a

90. *Id.* In 1991, the SEC approved a similar rule change by the AMEX. Self-Regulatory Organizations, American Stock Exchange, Inc., Order Approving Proposed Rule Change Relating to Foreign Issuers and Rights Offerings, Exchange Act Release No. 28,832, 1, 56 Fed. Reg. 4658 (Jan. 29, 1991) [hereinafter Amex Foreign Issuers].

91. Amex Foreign Issuers, *supra* note 90, at n.3.

92. *Id.* at 2. In 1994, the SEC also approved NYSE rule changes permitting foreign issuers to distribute summary annual reports in the place of full annual reports only if it is the practice in the issuer’s home country and on the condition that certain procedural safeguards are met. Self-Regulatory Organizations, New York Stock Exchange, Inc., Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to Proposed Rule Change Relating to Listing Standard for Non-U.S. Companies, Exchange Act Release No. 33,661, 1, 59 Fed. Reg. 10,028 (Feb. 23, 1994). On July 1, 1994, a similar AMEX rule was approved. Self-Regulatory Organizations, American Stock Exchange, Inc., Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to Proposed Rule Change Relating to Listing Standards for Non-U.S. Companies, Exchange Act Release No. 34,300, 59 Fed. Reg. 35,156 (July 1, 1994).

93. Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2419-22 (1998).

94. *Cort v. Ash*, 422 U.S. 66, 84 (1975).

95. 430 U.S. 462 (1977).

short form merger. Under Delaware law owners of at least ninety percent of a subsidiary's stock may merge with that subsidiary without requesting the consent of minority shareholders—who, in turn, must receive fair value for their shares. The plaintiff, the minority shareholders in *Santa Fe*, did not allege any material misrepresentation or omission. Rather, they argued that the antifraud provisions of the federal securities laws were applicable to a breach of corporate fiduciary duty, in that the majority shareholders were not pursuing a legitimate corporate purpose. The Court, however, refused to apply Rule 10b-5 to allegations of internal corporate mismanagement. It stated: "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."⁹⁶

In *Schreiber v. Burlington N., Inc.*,⁹⁷ the Supreme Court indicated that *Santa Fe* would not be confined to its facts, but rather was a general holding concerning fiduciary duty. *Schreiber* raised the issue of whether the withdrawal of a hostile tender offer bid and the substitution of a partial bid, following negotiations with the target company's management, constituted a manipulative act under the Williams Act.⁹⁸ The Court held that the term "manipulation" in sections 10(b) and 14(c) of the Exchange Act⁹⁹ should be similarly interpreted and that manipulative acts require misrepresentation or nondisclosure.

Nevertheless, the SEC has long claimed authority and expertise with respect to corporate governance and made its views felt through disclosure and other regulation. William O. Douglas, an early SEC Chairman and then Supreme Court Justice wrote:

Both prior to and during my SEC days I had promoted the idea of having 'public' directors of our large corporations . . . The reason was that, by and large, directors tend to become subservient to the management, courteously serving its interests, which are not necessarily consistent with the interest of stockholders or compatible with the public reputation of the company . . . at least some of the directors of our large corporations must not be subservient to management. This was a policy which the SEC had power to enforce.¹⁰⁰

The views of Justice Douglas remain controversial. The more common view is that the Securities Act is a full disclosure, rather than a merit, statute and the SEC does not have the power to regulate corporate governance. Even in the case generally cited as the first to focus on management integrity and corporate governance issues, *In re Franchard*,¹⁰¹ the

96. *Id.* at 479.

97. 472 U.S. 1 (1985).

98. The Williams Act, which regulates tender offers, is contained in §§ 13(d)-(e) and 14(d)-(f) of the Exchange Act, 15 U.S.C. §§ 78m(d)-(e) and 78n(d)-(f) and the regulations thereunder, 17 C.F.R. §§ 240.13d-1 to 13e-101, 240.14a-1 to 14f-1.

99. 15 U.S.C. §§ 78j(b), n(e).

100. WILLIAM O. DOUGLAS, *GO EAST YOUNG MAN* 272 (1974).

101. 42 S.E.C. 163 (1964).

SEC backed off from sanctioning directors neglect of duty in failing to deal with a CEO who was making unauthorized loans to himself. In this stop order proceeding, the staff had argued that prospectuses were deficient in not disclosing that the directors, in overseeing the operations of the company, failed to exercise the degree of diligence required. The Commission viewed this as an "issue raising fundamental considerations as to the functions of the disclosure requirements of the Securities Act."¹⁰² In deciding this issue, the Commission held that the Securities Act did not

define Federal standards of directors' responsibility in the ordinary operations of business enterprises and nowhere empowers us to formulate administratively such regulatory standards. The diligence required of registrant's directors in overseeing its affairs is to be evaluated in the light of the standards established by State statutory and common law.¹⁰³

In this case, the Commission thus anticipated the holding of the Court in *Santa Fe*.

Nevertheless, the SEC has had a tendency to use disclosure requirements for their prophylactic effect of regulating corporate conduct. In addition, various provisions of the Exchange Act can and have been used by the SEC to effect corporate conduct. These include regulatory authority over proxy solicitations¹⁰⁴ and regulatory authority over tender offers.¹⁰⁵ Further a catch-all antifraud provision¹⁰⁶ and broad rulemaking authority¹⁰⁷ gave the SEC the ability to utilize enforcement cases and disclosure rules to impose its notions about corporate governance on public companies. In a wide variety of management fraud cases¹⁰⁸ and disclosure rules concerning management remuneration¹⁰⁹ the SEC succeeded in regulating corporate governance. Another weapon which the SEC was given that might have been used to federalize corporate governance was its power to define "qualified securities" in a national market system.¹¹⁰ But, as will be discussed in connection with the one-share, one-vote controversy, the potential for using this power to achieve corporate governance objectives by way of SEC changes to stock exchange listing rules has thus far not been realized.

When the SEC tested the limits of its authority in dictating corporate governance standards for stock exchange listing requirements, it succeeded with respect to requirements for audit committees, but failed with respect to the one-share, one-vote controversy. As a result, stock ex-

102. *Id.* at 172.

103. *Id.*

104. 15 U.S.C. § 78n.

105. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f).

106. 15 U.S.C. § 78j(b).

107. *See, e.g.*, 15 U.S.C. § 78w(a).

108. *See* Exchange Act Release No. 13,901, 42 Fed. Reg. 44,860 (Aug. 29, 1977); Exchange Act Release No. 13,482, 42 Fed. Reg. 23,901 (Apr. 28, 1977).

109. *See* Item 402, Regulation S-K, 17 C.F.R. § 229.402.

110. 15 U.S.C. § 78k1(a)(2). This provision was added to the Exchange Act in 1975.

change listing standards operate as a bridge between state and federal law with respect to corporate governance, but their legal status is uncertain.

III. THE SEC'S AUTHORITY OVER STOCK EXCHANGE RULEMAKING

A. STATUTORY PROVISIONS

Until 1975, exchange listing standards were clearly the subject of private or contract law between an exchange and its listed companies. However, in 1975, Congress laid the foundation for the establishment of a national market system in amendments to the Exchange Act. Without mandating specific components of the national market system or even defining the term, Congress vested the SEC with broad flexible authority to design, implement, and regulate the trading markets. Further, important new powers over stock exchanges and the NASD were given to the SEC. Sections 19(b) and (c) of the Exchange Act gave the SEC a new power to approve, disapprove, abrogate, add to, or delete from rules adopted by exchanges.¹¹¹ Any amendments to any exchange rules mandated by the SEC remain rules of the exchange and do not become SEC rules.¹¹² Nevertheless, the SEC's authority under section 19(c) is limited to actions in "furtherance of the purposes" of the Exchange Act.¹¹³

In addition to the generalized power over exchange rulemaking contained in section 19, the SEC has authority to establish criteria for "qualified securities." Although this authority is not facially limited by the statute, it is limited implicitly by the objectives of the national market system because of section 19(c). One of these principles is that the securities qualified to be included in the national market system should depend primarily on their trading characteristics, rather than where they happen to be traded. The Senate Report accompanying the 1975 amendments, for example, noted that "many securities do not have the characteristics—e.g., trading volume, price, and number of stockholders—which would justify auction-type trading."¹¹⁴ Also, the Exchange Act was amended in 1975 to provide that it is in the "public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . fair competition . . . among exchange markets, and between exchange markets and markets other than exchange markets." Thus, in giving the SEC authority to define "qualified securities" it would appear that Congress intended the SEC to equalize listing standards of competing marketplaces, if this were necessary to achieve the statutory purposes of the Exchange Act.

111. 15 U.S.C. §§ 78s(b)-(c).

112. 15 U.S.C. § 78a(c)(4)(C).

113. 15 U.S.C. § 78s(c).

114. S. REP. NO. 75, 94th Cong., 1st Sess. 3, at 16 (1975).

B. AUDIT COMMITTEE REQUIREMENTS

As early as 1940, the SEC recommended that corporations form audit committees composed of independent directors.¹¹⁵ The SEC did not have an opportunity to force such a requirement on public companies, however, until the 1970s. In connection with widespread scandals concerning questionable or illegal payments by many public corporations to domestic and foreign government officials, the SEC discovered inadequate or improper corporate books and records that concealed the existence of these payments. This was very disturbing since the integrity of corporate books and records is essential to the entire reporting system administered by the SEC.¹¹⁶ Among other things, the SEC pointed to the importance of audit committees in uncovering falsification of corporate records and the use of "slush" funds and endorsed audit committees as appropriate models of corporate conduct.¹¹⁷ Following its investigation into the sensitive payments scandal, the SEC urged strengthening the independence and vitality of corporate boards of directors, and suggested, in a letter from SEC Chairman Roderick Hills to William M. Batten, then Chairman of the NYSE, that the NYSE "could take the lead in this area by appropriately revising its listing requirements, thus providing a practical means effecting . . . important objectives without increasing direct governmental regulation."¹¹⁸

The NYSE thereafter developed such a proposal. On March 9, 1977, the SEC then approved the NYSE rule requiring all listed domestic companies to establish by June 30, 1978, and maintain thereafter, an audit committee comprised solely of directors independent of management and free from any relationship that "would interfere with the exercise of independent judgement as a committee member."¹¹⁹ Further, a majority of the audit committee was required to be composed of directors who were not formerly officers of the company or one of its subsidiaries.¹²⁰ Thereafter, the AMEX and Nasdaq imposed similar requirements on their listed companies, but required only that a majority of the audit committee members be independent.¹²¹

The voluntariness of the NYSE's adoption of this rule was debatable. So was the extent of the SEC's power to compel the NYSE to change its

115. In re McKesson & Robins, Inc., Accounting Series Release No. 19, Exchange Act Release No. 2707, [1940 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 72,020 (Dec. 5, 1940).

116. Report of the Commission on Questionable and Illegal Corporate Payments and Practices, to the Senate Comm. on Banking, Housing and Urban Affairs, 95th Cong., 1st Sess. (1976), at 48-49.

117. See *id.* at 55-56.

118. Letter from Roderick M. Hills to William M. Batten, May 11, 1976.

119. In the Matter of New York Stock Exchange, Inc., Exchange Act Release No. 13346, 11 S.E.C. 1945 (Mar. 9, 1977).

120. NYSE LISTED COMPANY MANUAL, *supra* note 41, § 303.00 Audit Committee (1983).

121. THE AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, § 3.05, cmt. a (1992) [hereinafter ALI PRINCIPLES].

listing requirements.¹²² Although the SEC might have invoked its power to modify exchange listing requirements, since it is questionable that the SEC could compel issuers to form audit committees, it could have been argued that the SEC's power to mandate listing requirements to this effect was not in furtherance of the purposes of the Exchange Act. Such an analysis would have been in keeping with the Court's demarcation between federal and state power in *Santa Fe*. On the other hand, the SEC has fairly broad powers to define auditor independence.¹²³ Further, the SEC has the power to mandate disclosure about corporate governance matters, and about this same time it exercised its authority by requiring a description of the structure of certain board committees, including the audit committee.¹²⁴

Over the next two decades, the mantra that a board of directors should be composed of persons independent of management was spread around the world by regulators and institutional investors. A steady stream of reports and recommendations by blue ribbon committees¹²⁵ and distinguished business and legal bodies¹²⁶ praised the value of independent directors in giving capitalism credibility.¹²⁷ In 1998, in response to an expressed concern by the SEC about the adequacy of the oversight of the audit process by independent directors, the heads of the NYSE and the NASD appointed a Blue Ribbon Committee that issued a report on this

122. See Proceedings, the Airlie House Symposium, An In-Depth Analysis of the Federal and State Roles Regulating Corporate Management, June 13-14, 1975, Airlie House, Warrenton, Virginia, reprinted in 31 BUS. LAW. 863, 1096 (1976).

123. See Revision of the Commission's Auditor Independence Requirements, Securities Act Release No. 7919, 65 Fed. Reg. 76,008 (Nov. 21, 2000) [hereinafter Auditor Independence Requirements]; Revision of the Commission's Auditor Independence Requirements, Securities Act Release No. 7870, 65 Fed. Reg. 43,148, at n.14 (June 30, 2000).

124. Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 15,384, 43 Fed. Reg. 58,522 (Dec. 14, 1978). The SEC initially proposed much broader rulemaking that would have classified directors as "independent" or "not independent." See Proposed Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 14970, 43 Fed. Reg. 31,945 (July 24, 1978). The author dissented from the issuance of this proposal.

125. See, e.g., REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES, reprinted in 54 BUS. LAW. 1067 (1999) [hereinafter REPORT ON AUDIT COMMITTEES]; A REPORT TO THE OECD BY THE BUSINESS SECTOR ADVISORY GROUP ON CORPORATE GOVERNANCE, CORPORATE GOVERNANCE: IMPROVING COMPETITIVENESS AND ACCESS TO CAPITAL IN GLOBAL MARKETS (Apr. 1998); REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR PROFESSIONALISM (1996).

126. BUSINESS ROUNDTABLE STATEMENT ON CORPORATE GOVERNANCE (1997); ABA Section of Business Law, *Corporate Director's Guidebook—1994 Ed.*, 49 BUS. LAW 1243 (1994); ALI PRINCIPLES, *supra* note 121.

127. Only a few hardy academics have questioned whether independent directors improve business performance. See Sanjat Bhagat & Bernard Black, *Board Composition and Firm Performance: The Uneasy Case for Majority-Independent Boards*, 1053 PLI/CORP. 95 (1998); Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 616-22, 642-59 (1982); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898 (1996).

subject a year later.¹²⁸ The Committee recommended a more stringent definition of "independence" for audit committee members than exchange rules contained, that listed companies with a market capitalization above \$200 million have an audit committee composed solely of independent directors, and that audit committee members be financially literate.¹²⁹ Following these recommendations, the NYSE, NASD, AMEX, and SEC came out with rules to implement the Blue Ribbon Report.¹³⁰

The NYSE listing standards therefore now provide that each listed company must have a qualified audit committee that meets certain standards. The audit committee must have a formal written charter specifying the scope of the committee's responsibilities and how they are implemented, including the accountability of the outside auditor to the board and audit committee and that the committee satisfies itself that the outside auditor is independent. In addition, the audit committee must have at least three directors who have no relationship to the company that may interfere with their independence, and each member must be financially literate; one member must have accounting or related financial management expertise.¹³¹ The new AMEX and NASD rules are essentially the same, but have slightly different definitions of "independence" and financial literacy.¹³²

128. REPORT ON AUDIT COMMITTEES, *supra* note 125.

129. *Id.* at 3-4.

130. Auditor Independence Requirements, *supra* note 123; Self-Regulatory Organizations, Order Approving Proposed Rule Change by the American Stock Exchange LLC Amending the Exchange's Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and 2 Thereto, Exchange Act Release No. 42,232, 64 Fed. Reg. 71,518 (Dec. 14, 1999) [hereinafter AMEX Audit Committee Rules]; Self-Regulatory Organizations, Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. Amending its Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and 2 Thereto, Exchange Act Release No. 42,231, 64 Fed. Reg. 71,523 (Dec. 14, 1999) [hereinafter NASD Audit Committee Rules]; Self-Regulatory Organizations, Order Approving Proposed Rule Change by the New York Stock Exchange, Inc. Amending the Exchange's Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and 2 Thereto, Exchange Act Release No. 42,233, 64 Fed. Reg. 71,529 (Dec. 14, 1999) [hereinafter NYSE Audit Committee Rules].

131. New SEC disclosure rules complement these requirements. *See* Audit Committee Disclosure, Exchange Act Release No. 42,266, 64 Fed. Reg. 73,389 (Dec. 22, 1999).

132. Under the NYSE Rule, the independence and financial literacy of audit committee members is interpreted by the company's board in its business judgment. Therefore, directors who have some kind of business relationship to the company "may serve on the audit committee only if the company's board determines in its business judgment that the relationship does not interfere with the director's exercise of independent judgment." It is clear, however, that directors who are principals of companies with a material business interest with the issuer would not usually be considered independent. NYSE Audit Committee Rules, *supra* note 130, at 71,533. In contrast, the NASD's and AMEX's definitions do not rely on the opinion of the company's board and prohibit certain persons from obtaining independence status and require audit committee members to display certain skills. Audit committee members must be able to "read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement." NASD Audit Committee Rules, *supra* note 130, at 71,525; AMEX Audit Committee Rules, *supra* note 130, at 71,519.

In this more recent round of rulemaking on audit committees there were almost no voices raised questioning the SEC's authority to pressure exchanges into revising their listing requirements, even though the D.C. Circuit Court had in the interim between 1977 and 1999 struck down the SEC's efforts to impose a one-share, one-vote standard on exchanges, as will be explained below. Whether this was because of general agreement on the advisability of the tightened standard, or the exchange's seeming voluntary initiatives with regard to improving its audit committee requirements, is unclear. As a practical matter, the SEC has enormous leverage over exchanges and so they are unlikely to resist SEC "suggestions" that are not controversial or perceived by an exchange to be contrary to its interests.

C. THE ONE-SHARE, ONE-VOTE LISTING REQUIREMENT

An important shareholder protection listing standard that was in effect at the NYSE from 1926 until the late 1980s was the principle that all shares of common stock of a listed company should have one vote. During the hostile takeover boom of the 1980s, however, some companies engaged in defensive recapitalizations whereby company insiders obtained shares with greater voting rights than public shareholders. Some well known AMEX listed companies, for example Wang, had a weighted capitalization of ten to one in favor of insiders and, as explained in Part II above, such unequal voting shares were permitted by the AMEX and Nasdaq.¹³³ The NYSE proved unable to resist this competition, especially after General Motors Corporation ("GM") issued a class of lesser-weighted voting shares in connection with its acquisition of Electronic Data Systems, Inc. ("EDS").¹³⁴ Further, although the SEC attempted to impose a voting rights standard on all exchanges, its authority to do so was negated by the D.C. Circuit Court.

During the 1920s, dual class issuances were motivated by the desire to raise additional equity capital and simultaneously retain control in the hands of a founding family or entrepreneurial group.¹³⁵ These shares were ordinarily called "bankers' shares" and resulted in a phenomenon called "bankers' control," where voting rights were held exclusively by one class of stock.¹³⁶ Professor William Z. Ripley, heralded public outcry against these dual class structures, stating that "they form one of the major problems which lie on the border line between corporation law and financial practice."¹³⁷

133. See *Study Predicts NYSE Will Permit Dual Classes of Stock With Unequal Voting Rights*, Daily Rep. Exec. (BNA) No. 21, at A-2 (Jan. 31, 1986).

134. See David A. Vise, *GM Runs Afoul of NYSE Rule Created New Class of Stock to Pay for Hughes Deal*, WASH. POST, June 7, 1985, at B1.

135. Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 570 (1991).

136. *Non-Voting Stock and Bankers' Control*, 39 HARV. L. REV. 673, 674 (1926).

137. *Id.* (citing Address of William Z. Ripley before American Academy of Political Science, reported, NEW YORK TIMES, Oct. 29, 1925, at 27, *republished as More Power to the Bankers*, 121 NATION 618 (Dec. 2, 1925)).

Again in the 1980s, dual class capital structures became popular. However, this resurgence was not due to the same motivators as in the 1920s. Dual class voting structures of the 1980s were developed in response to management's fear of hostile takeovers to ensure that voting control remained with management and corporate insiders. By creating dual classes of common stock, management and corporate insiders could maintain a controlling interest in the firm without having to contribute substantial amounts of equity. Although an effective defense to corporate takeovers, the separation of ownership and voting control were seen as adverse to the interests of common stockholders and therefore, the issue of voting rights became very controversial.¹³⁸ As explained in Part II, among the most influential stock exchanges, the NYSE set the most restrictive standards regarding voting rights, with an absolute restriction on any infringement on shareholder voting rights,¹³⁹ while the NASD placed no restrictions on the creation of dual classes of common stock and the AMEX had limited restrictions.

As early as the 1920s, the NYSE was skeptical of listing nonvoting common stock. Disparate voting rights were seen as adverse to notions of investor protection because those who had contributed the most capital generally were given the least amount of voting rights. The roots of the NYSE's policy were planted in a 1926 announcement regarding the listing of Dodge Brothers, Inc., which had held a disproportionate amount of non-voting common stock in relation to its voting common stock.¹⁴⁰ There was much public outcry and the NYSE responded by stating: "Without at this time attempting to formulate a definite policy, attention should be drawn to the fact that in the future the committee, in considering applications for the listing of securities, will give careful thought to the matter of voting control."¹⁴¹

The NYSE enforced its rule for more than a half a century thereafter. But in 1984, when GM acquired EDS, it refused to comply with the NYSE rule and threatened to list with competitor exchanges AMEX or Nasdaq. Because of the importance of GM as a listed company, the NYSE ignored its rule and did not delist GM. Two motivating factors for the NYSE were: to counter threatened competition from other exchanges, and to provide corporate managers with a new takeover defense, which issuers wanted during the 1980s.¹⁴² With the continued listing of GM, the path was now clear for other companies with similar

138. During the 1980s, dual class voting structures were established to ensure that voting control remained with management and corporate insiders. Bainbridge, *supra* note 135 ("Voting rights do matter in one critical context - contests for corporate control.").

139. See Daniel F. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U CHI. L. REV. 119 (1987).

140. Seligman, *supra* note 24, at 699; Bainbridge, *supra* note 135, at 569.

141. Seligman, *supra* note 24, at 699. The statement generally is cited as the first unofficial announcement of the disapproval of disparate voting rights among holders of stock of public companies. *Id.*

142. *Id.* at 701. The NYSE rationalized this decision on the theory that GM was engaged in a financing transaction concerning its purchase of EDS.

intentions. In June 1984, the NYSE announced a moratorium on delisting based on dual class capitalizations, and by 1988 more than 50 issuers were in violation of the one-share, one-vote rule.¹⁴³

In connection with its 1984 moratorium, the NYSE established a Subcommittee on Shareholder Participation and Qualitative Listing Standards (the "Subcommittee") in order to re-evaluate the exchange's voting policies. Believing that strict adherence to its one-share, one-vote policy would cause the NYSE to lose listings to its competitor exchanges,¹⁴⁴ the Subcommittee explained that the NYSE was obliged to relax its rule because of competition from other exchanges and also in order to prevent a "race to the bottom." Finally, in 1986, the NYSE officially modified its "longstanding rule mandating a one-share, one-vote for all common stocks listed on the NYSE."¹⁴⁵ Several factors influenced the NYSE to reconsider the rule:

the growing competition for listings with the AMEX and NASD, the desire of NYSE-listed companies to adopt disparate voting rights plans as takeover defenses, the belief that corporate issues should have flexibility in raising capital and adopting corporate structures, and the belief that regulatory changes, such as improvements in corporate disclosure, had made the shareholder protection provided by the one-share, one-vote rule less important.¹⁴⁶

The NYSE abandonment of its one-share, one-vote rule illustrates the political organization of the exchanges and the limits of exchange regulation.¹⁴⁷ Competition among the exchanges was the primary cause leading to revision of the rule. The NYSE folded after feeling pressured by listed corporations to abandon its policy. Only if competing exchanges were willing to adopt and enforce such a rule could the NYSE have upheld its policy. During 1985 Congressional Hearings on one-share, one-vote, the Exchange testified that "the national competitive environment may very well preclude the Exchange from unilaterally retaining one share, one vote."¹⁴⁸ Some also state that the NYSE's policy had endured primarily for political reasons, and therefore the NYSE was easily susceptible to outside pressures.¹⁴⁹ Indeed, the NYSE's abandonment of the one-share, one-vote rule has been used as a critique of exchange regulation, raising questions about the exchanges' credibility in enforcing investor

143. See Nathaniel C. Nash, *Big Board Defends Plan on 2 Classes of Shares*, N.Y. TIMES, Dec. 17, 1986, at D1; Voting Rights Standards; Disenfranchisement Rule, Exchange Act Release No. 25,891, 53 Fed. Reg. 26,376, 26,379 (Jul 12, 1999) [hereinafter Disenfranchisement Rule].

144. NYSE Subcommittee on Shareholder Participation and Qualitative Listing Standards, Initial Report—Dual Capitalization (Jan. 3, 1985).

145. Disenfranchisement Rule, *supra* note 143, at 26,376.

146. *Id.* at 26,377.

147. Pritchard, *supra* note 30, at 1001.

148. Self Regulatory Organizations, Proposed Rule Change by New York Stock Exchange, Inc. Relating to Amendments to the Exchange's Voting Rights Listing Standards for Domestic Companies, Exchange Act Release No. 23,724, 51 Fed. Reg. 37,529, 37,530 (Oct. 17, 1986).

149. Seligman, *supra* note 24, at 700.

protections.¹⁵⁰

After attempts to persuade the exchanges to adopt a uniform voting rights rule failed, in 1988 the SEC adopted its own rule to the Exchange Act prohibiting listed companies from changing the voting rights of common stockholders. Recognizing that the abandonment of the NYSE rule would have far reaching consequences, the SEC adopted Rule 19c-4 that required the exchanges to bar the listing of a domestic corporation's securities if that company acted disparately to reduce the per share voting rights of existing stockholders.¹⁵¹ The rule prohibited an issuer from issuing securities, or taking other corporate action, which would either nullify, restrict, or disparately reduce the per share voting rights of common stockholders.¹⁵² Nevertheless, disparate voting rights were permitted if they served a *bona fide* business purpose.¹⁵³ The rule was intended to achieve several contradictory goals: ensure management accountability; limit hostile tender offer situations and adverse changes in corporate control; maintain the rights of public shareholders; limit competition among SROs; and preserve the integrity of U.S. securities markets.¹⁵⁴

However, in 1990, in *Business Roundtable v. SEC*,¹⁵⁵ the D.C. Court of Appeals abrogated Rule 19c-4 on the grounds that the rule directly controlled the substantive allocation of powers among classes of shareholders and therefore was in excess of the SEC's authority under section 19 of the Exchange Act.¹⁵⁶ In the court's view, the rule was not in furtherance of any purpose of the Exchange Act, and could not be justified under the proxy rules, the SEC's plenary power over exchanges, including its power to approve or add to exchange rules, or its powers to facilitate the establishment of a national market system and designate securities qualified for trading in such a system. This is because permitting the SEC to adopt corporate governance standards through the back door by mandating uniform listing standards would disrupt state jurisdiction over corporate governance and shareholder voting rights.¹⁵⁷ Although an exchange could adopt a voting rights listing standard, such a standard was not a rule under the authority of the Exchange Act. This was not viewed as the exercise of governmental power regulating an issuer.¹⁵⁸

The *Business Roundtable* case did not put an end to the voting rights rule story. After much negotiation with the SEC, the NYSE and Nasdaq adopted a uniform rule that was essentially a modified version of former SEC Rule 19c-4. The policy prohibited any restriction or disparate reduc-

150. Pritchard, *supra* note 30, at 1013-14.

151. Disenfranchisement Rule, *supra* note 143, at 26,383; *SEC Approves New Voting Rights Rule, Adopts Rule Streamlining SRO Regulation*, 26 Sec. Reg. & L. Rep. (BNA) Dec. 23, 1994, at 1708 [hereinafter *Streamlining SRO Regulation*].

152. Disenfranchisement Rule, *supra* note 143, at 26,383.

153. *Id.*

154. *Id.* at 26,380.

155. 905 F.2d 406 (D.C. Cir. 1990).

156. *Id.* at 407.

157. *Id.* at 412-13.

158. *Id.* at 414.

tion in the voting rights of the common stock of public shareholders through any corporate action. In view of changes in the marketplace, the NYSE emphasized the "flexibility" of the new policy: "The Exchange's interpretations under the Policy will be flexible, recognizing that both the capital markets and the circumstances and needs of listed companies change over time."¹⁵⁹ The rule was intended to eliminate a race to the bottom in shareholder voting rights.¹⁶⁰ It was the NYSE's stated aim to permit those corporate actions previously permitted under Rule 19c-4. As such, the policy does permit disparate voting rights and the listing of non-voting common stock as long as the stockholders are afforded certain safeguards, which seek to align (as much as possible) the rights of non-voting shareholders with voting shareholders.¹⁶¹ Minimum voting rights are also required for preferred stockholders.

Several commentators have suggested that the primary motivator for the NYSE's decision to maintain a voting rights rule was a "concern with public opinion."¹⁶² However, the NYSE has emphatically stated that its policy is based upon a desire to "encourage high standards of corporate democracy."¹⁶³ It would appear that in the case of the voting rights rule, as in the case of exchange rules concerning audit committees, the SEC accomplished what the D.C. Circuit Court said it could not do—establish a federal voting rights standard through the back door of exchange listing standards. Yet, the legal basis for such initiatives is unclear and the tenuous nature of the SEC's power in the corporate governance area weakens the ability of exchanges to establish and enforce listing standards that issuers find objectionable.

IV. THE CURRENT STATUS AND FUTURE OF LISTING STANDARDS

A. STOCK EXCHANGE DEMUTUALIZATION

When the Exchange Act was passed in 1934 and when it was amended in 1975 to establish a framework for SEC regulation of exchanges, stock exchanges all operated in the form of non-profit mutual or membership organizations under state law. To the extent market power was not curtailed by competition or regulation, mutual governance gave specialist or

159. NYSE LISTED COMPANY MANUAL, *supra* note 41, § 313.00 Voting Rights.

160. *Streamlining SRO Regulation*, *supra* note 151.

161. These safeguards ensure the following: (1) that the rights of non-voting common shareholders are the same as those of voting common shareholders; (2) that non-voting shareholders receive an annual report; and (3) receive all communications, including proxy materials, received by voting shareholders. NYSE LISTED COMPANY MANUAL, *supra* note 41, § 313.00(B)(1)-(3) Voting Rights (1999).

162. Seligman, *supra* note 24, at 698.

163. *Id.* at 699. The NYSE has cited the following and similar language from its Listed Company Manual when denying listings: "Consistent with the Exchange's long-standing commitment to encourage high standards of corporate democracy, every listed company is expected to follow certain practices aimed at maintaining appropriate standards of corporate responsibility, integrity and accountability to shareholders." NYSE LISTED COMPANY MANUAL, *supra* note 41, § 301.00 Introduction.

market maker members of an exchange control of the price, quality, and range of services produced by the exchange. Exchange profits were returned to broker and dealer members in the form of lower access fees or trading profits. Further, exchanges have long operated as self-regulatory organizations ("SROs") with members contributing their time to governance and self-regulation to make exchanges more effective and more profitable. Self-regulation gave exchanges more credibility as quasi-public institutions and also protected their monopoly type powers.

Among these monopoly type powers was the trading of securities in issuers that determined to list on the exchange. Although as far back as the *Multiple Trading Case* in 1941,¹⁶⁴ the SEC attempted to prevent exchanges from exercising a monopoly in the trading of an issuer's securities, the NYSE's off-board trading rule, Rules 390¹⁶⁵ and Rule 500¹⁶⁶ effectively prevented serious competition among exchanges in dually listed stocks. The first significant attack on the monopolization of trading in the stock of a listed issuer was Exchange Act Rule 19c-3, which permitted exchange members to trade off-board as agent for customers, except in agency crosses, and abolished off-board trading restrictions as to stocks listed after April 26, 1979.¹⁶⁷ In recent years, competition to exchange trading monopolies has come from electronic communications networks ("ECNs") or alternative trading markets ("ATs").

In addition to having to compete with new markets, the world's exchanges are demutualizing, and this is leading to new challenges. The first exchange to demutualize was the Stockholm Stock Exchange in 1993, followed by the Helsinki Stock Exchange in 1995, the Copenhagen Stock Exchange in 1996, the Amsterdam Stock Exchange and the Borsa Italiana in 1997, and the Australian Stock Exchange in 1998. By the end of 2000, many more exchanges will have joined this group, including the Paris Bourse, the Toronto Stock Exchange, the London Stock Exchange, and Nasdaq.¹⁶⁸ The NYSE had announced plans to demutualize in 1999, but as yet has not taken steps to do so.¹⁶⁹ So far only the Stockholm and Australian Stock Exchanges have gone public and listed on their own

164. 10 S.E.C. 270, 1941 WL 1566 (Oct. 4, 1941).

165. See Self-Regulatory Organizations, New York Stock Exchange, Inc. Order Approving Proposed Rule Change to Rescind Exchange rule 390, Exchange Act Release No. 42,758, 65 Fed. Reg. 30,175 (May 5, 2000).

166. This rule inhibits listed companies from delisting. It has recently been amended but not repealed. Self-Regulatory Organizations, New York Stock Exchange, Inc. Order Approving Proposed Rule Change and Amendment Nos. 1 and 2 Relating to Voluntary Delistings by Listed Companies, Exchange Act Release No. 41,634, 64 Fed. Reg. 40,633 (July 27, 1999).

167. Off-Board Trading Restrictions, Exchange Act Release No. 16,888, 45 Fed. Reg. 41,125 (June 11, 1980); Off-Board Trading Restrictions, Exchange Act Release No. 16,889, 45 Fed. Reg. 41,156 (June 11, 1980).

168. See *Exchange Demutualization Trend Sweeps World Markets*, Int'l Sec. Outlook (CCH), Oct. 18, 1999, at 4.

169. *Stock Markets; NYSE, NASD Agree on Demutualization; Disagree on Self-Regulatory Arm 'Spin Off'*, 31 Sec. Reg. & L. Rep. (BNA) Oct. 1, 1999, at 1283.

boards.¹⁷⁰

When the federal securities laws were passed, stock exchanges were required to register with the SEC.¹⁷¹ The SEC thus obtained oversight authority over stock exchanges, but the stock exchanges continued to have rulemaking and regulatory authority with respect to their members, their trading markets, and their listed companies. Although the efficacy of self-regulation was called into question by stock market abuses reported in the 1963 SEC Special Study,¹⁷² that study concluded that self-regulation should be maintained and strengthened.¹⁷³ Nevertheless, in 1964 the SEC obtained greater direct authority over the continuous disclosures made by public companies.¹⁷⁴ Previously, the SEC was given power to regulate financial disclosure by issuers making initial public offerings,¹⁷⁵ but after 1964 the SEC also was given responsibility for regulating annual and periodic reports.¹⁷⁶

The 1975 Act further strengthened the SEC's oversight role over the stock exchanges and NASD by, among other things, giving the SEC the power to initiate and approve SRO rulemaking,¹⁷⁷ thus expanding the SEC's role in SRO enforcement and discipline¹⁷⁸ by allowing the SEC to play an active role in structuring the market.¹⁷⁹ For the first time, the statute set forth requirements with respect to the composition of exchange and association boards of directors.¹⁸⁰ The 1975 Act sought to preserve and reinforce the concept of industry self-regulation with SEC oversight. However, by directing the SEC to facilitate the creation of a national market system, injecting competition as a statutory goal and giving the SEC greater authority over SRO rulemaking, disciplinary activities and other matters, the SEC became able to exert more leverage over exchange self-regulation and corporate governance than in the past. In addition to the imposition of audit committee and voting rights listing standards described above, a good example of this leverage is the forced reorganization of the NASD in 1996.¹⁸¹

170. See Gwen Robinson, *ASX Shares Likely to Start Above A\$3.50*, FIN. TIMES., Oct. 14, 1998, at 18; Bengt Ryden, *The Privatization of Stock Exchanges: The Case of Stockholm Stock Exchange*, ISE REVIEW, July-Sept. 1997, at 1, 10-11 (1997).

171. Exchange Act, § 6, 15 U.S.C. § 78f.

172. See SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKET, H.R. DOC. NO. 88-95, pt. 4, at 201-12 (1963).

173. *Id.* pt. 5, at 502.

174. See Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964).

175. See Securities Act of 1933, § 5, 15 U.S.C. § 77e (1999).

176. See Exchange Act, §§ 12(g), 14(a), 15 U.S.C. §§ 78l(g), 78n(a).

177. See Exchange Act, § 19(c), 15 U.S.C. § 78s(c) (1994).

178. *Id.*, §§ 19(c), (d), (g).

179. See *id.*, § 11A.

180. See *id.*, §§ 6(a)(3), 15A (b)(4).

181. The NASD was completely reorganized in the aftermath of a Department of Justice and SEC investigation into anti-competitive practices by OTC market makers. See In the Matter of National Association of Securities Dealers, Inc., Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market, Exchange Act Release No. 37,542, 62 S.E.C. 1385 (Aug. 8, 1996). The SEC criticized the NASD for its regulatory deficiencies in failing to uncover these practices or discipline its members, and found that the NASD was unduly influenced by Nasdaq market making

The 1996 NASD reorganization resulted in the creation of a parent holding company and two operating subsidiaries—Nasdaq and NASD Regulation, Inc. (“NASDR”). All three boards are constituency boards that are required to have a majority of non-industry members.¹⁸² NASD governance is again in a state of flux because of a restructuring that will result in the sale of 78% of Nasdaq to issuers and NASD members and will lead to the registration of Nasdaq as a stock exchange with the SEC.¹⁸³

Among the purposes of the demutualization of Nasdaq are to permit the NASD to focus more intently on its original mission: of being a membership-focused organization; to streamline corporate governance; and to create a financially stronger Nasdaq better able to address competitive challenges and invest in new technology.¹⁸⁴ The Nasdaq board will be restructured prior to its registration as an exchange. Currently, all 10 members of the Nasdaq board sit on the NASD board. It is contemplated that the Nasdaq board will be increased by four members who will not serve on the NASD board, two of whom will be industry members and two of whom will be non-industry members.¹⁸⁵

One of the more contentious questions under discussion concerning exchange demutualization is the future of self-regulation. There are several issues that have been raised. First, some have argued that there would be conflicts of interests between shareholders and members in a demutualized exchange environment that would diminish the ability of exchanges to engage in effective self-regulation. A potentially more serious conflict is the regulation of an ATS market by the NYSE or NASD. Second, securities firms are concerned about the costs of multiple SROs, especially if several ATSS become exchanges and begin to engage in self-regulation. Therefore, some industry members are arguing in favor of a single SRO

firms with respect to rulemaking, the disciplinary process and the admission of new members. In a settlement of these matters, the NASD agreed, among other things, to achieve greater diversity of representation on its board and its policy making committees, to provide for the autonomy and independence of its staff with respect to disciplinary and regulatory matters, to create an enhanced audit trail, and to improve its surveillance and examination of order handling and the reliability of trade reporting. *See id.* at 1386-87.

182. *See* By-Laws of the NASD, art. VII, § 4(a), Nasdaq By-Laws, art. IV, § 4.1, NASDR By-Laws, art. IV, §§ 4.2, 4.3, NASD GUIDE (CCH), 1315, 1503, 1703-3.

183. *See* Nasdaq, *Fact Sheet on the Proposed NASD Restructuring*, available at <http://www.nasdaqnews.com/news/pr2000/fact313.html>. On April 14, 2000, the membership of the NASD voted overwhelmingly to turn Nasdaq into a for-profit company and alter its ownership structure. *See Nasdaq Firms Solidly Favor Sale of Market*, N.Y. TIMES, Apr. 15, 2000, at C3. This transformation will be accomplished in two stages. In the first stage, up to 49% of Nasdaq's common stock was offered in a private placement to NASD members, Nasdaq issuers, institutional investors, and strategic partners. After a further sale of Nasdaq stock in a second phase, either by way of a public offering or private placement, the NASD will own only a minority stake of approximately 22% of Nasdaq. *See* Terzah Ewing, *NASD Members Vote to Sell Nasdaq, Paving the Way for Private Ownership*, WALL ST. J., Apr. 17, 2000, at C21; *see also* NASD, Press Release, *NASD Restructuring Wins in Landslide Vote of the Members*, at http://www.nasdaqnews.com/news/pr2000/ne_section00_091.htm.

184. *See* Nasdaq, *Fact Sheet on the Proposed NASD Restructuring*, *supra* note 183.

185. *See id.*

for exchanges and member firms.¹⁸⁶

Exchanges engage in self-regulation in four areas: listed company governance and disclosure; surveillance and discipline of their markets and specialists, floor brokers and market makers; member firm financial and operational compliance; and fair and equitable treatment of customers. Of particular relevance to the future of listing standards is what conflicts will be encountered if and when Nasdaq or the NYSE become public companies.

In that situation, it would seem anomalous for them to negotiate listing agreements with themselves and then supervise continuing compliance with such agreements. For this reason, when the Stockholm and Australian Stock Exchanges went public, government regulators were assigned the task of overseeing exchange disclosure to shareholders.¹⁸⁷ On the other hand, the NYSE and Nasdaq will continue to have a motivation to market their exchanges as lists of quality issuers. Further, once exchanges demutualize, they can become embroiled in takeover battles.¹⁸⁸ It is precisely in such situations that corporate governance listing standards come into play. If a demutualized exchange becomes a target in a hostile takeover would it be able to enforce listing standards that prevent the erection of defenses to such an unwelcome bid? As Dean Joel Seligman has observed with regard to the effect of competition on the willingness of exchanges to enforce rigorous listing standards:

Given the determined efforts of the New York Stock Exchange in the 1963-1975 period to retain fixed commission rates and to oppose rescission of Exchange rules that limit competition in the trading of securities listed on the Exchange, as well as its recent championing of disparate common stock voting rights, there seems no plausible basis for assuming that the Exchange would be more prepared to enforce disclosure rules opposed by listed corporations than it had been before 1934. However enlightened the intentions of the Exchange's leadership, retention of its membership (or listings) inevitably will require it to reflect members' and listed firms' economic interests.¹⁸⁹

Even without regard to demutualization, because of the legal limbo into which exchange listing requirements were thrust by the *Business Roundtable* case, it has been suggested that stock exchange corporate

186. Securities Indus. Assoc., *Reinventing Self Regulation*, at <http://www.sia.com/demutualization/index.html>; Securities Indus. Assoc., *Recommendations Regarding Self-Regulatory Structure*, at http://www.sia.com/demutualization/html/recommendations_regarding_self.html; Securities Indus. Assoc., *Reinventing Self-Regulation: White Paper for the Securities Industry Association's Ad Hoc Committee on Regulating Implications of Demutualization*, Jan. 5, 2000, at http://www.sia.com/legal_regulatory/pdf/selfreg.pdf.

187. See Roberta S. Karmel, *Stock Exchange Demutualization in Sweden and Australia*, N.Y. L.J., Aug. 19, 1999, at 3. In the United States, however, the SEC already has this authority.

188. James R. Hagerty, *Swedish Bid for Bourse Clouds Deal—London-Frankfurt Tie is Further Complicated by Unexpected Offer*, WALL ST. J., Aug. 28, 2000, at A13; Erik Portanger, *Exchange in London Now in Play—Swedish Concern OM Launches Hostile Bid Valued at \$1.19 Billion*, WALL ST. J., Aug. 30, 2000, at A18.

189. LOSS & SELIGMAN, *supra* note 46, vol. I, 222.

governance standards be dismantled.¹⁹⁰ On the other hand, at least one commentator has argued that the benefits of increased capital mobility would be better realized through regulatory decentralization than greater centralization. Under a decentralized model, exchanges should be the primary writers and enforcers of rules relating to disclosure by listed companies, standards of conduct for member broker-dealers and for market structure.¹⁹¹ Whether this model would work for demutualized exchanges is a good question. By what authority could a for-profit public company regulate other companies?

B. THE NEW SOCIAL PROTESTERS

1. *The Political Protesters*

At times of social protest against business, corporate governance becomes a political issue. The corporate governance debates of the late 1970s were an aftermath of the anti-government, anti-business ferment of the Nixon years. The post-Watergate period at the SEC gave rise to the sensitive payments program and Hearings on Corporate Governance. The SEC threatened to adopt sweeping new disclosure regulations designed to compel corporate boards to select independent directors and otherwise rein in corporate managers.

Although the SEC then backed off from some of its more controversial proposals, and corporate governance reform was not an SEC priority during the Reagan and Bush administrations, institutional investors began to make their views felt with regard to corporate governance issues. Because of the SEC's questionable authority in this area, pressure to reform corporate governance generally was exerted through changes in the proxy rules, Internal Revenue Service regulation of executive compensation,¹⁹² changes in SEC disclosure rules, and changes in stock exchange listing requirements.

Harbingers of a new anti-business activism may be spotted now. An international movement protesting globalization has emerged to question multinational corporate activity and the operations of the World Bank and similar international organizations.¹⁹³ This backlash against globalization does not have a coherent program and is comprised of disparate anti-capitalist radical groups that have a common loathing of the established economic order.¹⁹⁴ Some groups emphasize labor issues, others environmental issues, and others focus on human rights and the alleviation of poverty.¹⁹⁵

190. Michael, *supra* note 3, at 1461.

191. See Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997); Pritchard, *supra* note 30; Romano, *supra* note 93, at 2399.

192. 26 U.S.C. § 162m (1999).

193. See Roger Cohen, *Growing Up and Getting Practical Since Seattle*, N.Y. TIMES, Sept. 24, 2000, at 1.

194. *Anti-Capitalist Protests Angry and Effective*, ECONOMIST, Sept. 23, 2000, at 85.

195. *Id.*

The street protesters at the World Trade Organization, International Monetary Fund, and World Bank conferences have counterparts among legal academic scholars. A comprehensive proposal to reform the SEC's proxy disclosure rules with regard to labor, environmental, and other social and political goals appeared in a recent issue of the *Harvard Law Review*.¹⁹⁶ Other scholars have written about other aspects of this inchoate movement against international business.¹⁹⁷ According to Professor Cynthia Williams, while the SEC was probably correct that broader social disclosure was not material to investors based on the typical 1970s investor, today there is reason to believe a substantial and growing subset of investors consider social disclosure material. Today, both the economic investor as well as the social investor could benefit from increased social disclosure by public companies. "[T]he trend is toward greater investor interest in social investing. And because people in the social investor sector of the market are using socially significant information to make investment decisions, that information is clearly material to them, irrespective of its economic implications."¹⁹⁸ Nevertheless, "social investors withdrawing their capital from certain companies will not raise those companies' cost of capital, and thus will have little short-term financial impact on the companies."¹⁹⁹ While pressure on stock exchanges to reform their listing standards has not occurred, if the SEC is pressured to react to these new protesters, the SEC could turn to the exchanges, as it did with audit committee reform, and request changes in listing standards. When it is recognized that some of the biggest and loudest institutional investors are government pension funds, this type of political reaction to serious corporate criticism is not as far fetched as it might seem.

Further, big corporations have been persuaded to adopt voluntary codes of conduct embodying some of the objectives of today's activists. The business world has recently established the new Global Sullivan Principles—global core labor standards modeled after those made for South Africa during the 1970s. Similar environmental standards have been proposed by the Coalition for Environmentally Responsible Economies ("CERES") called the "Valdez Principles" and some corporations have adopted these standards aimed at preserving the environment. In 1995, President Clinton established his own set of voluntary ethical standards for multinationals known as the "Model Business Principles," which encourage businesses to adopt voluntary codes of corporate conduct.²⁰⁰

196. Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 *HARV. L. REV.* 1197 (1999).

197. Daniel J.H. Greenwood, *Fictional Shareholders: For Whom are Corporate Managers Trustees, Revisited*, 69 *S. CAL. L. REV.* 1021 (1996); Maria O'Brien Hylton, "Socially Responsible" Investing: *Doing Good Versus Doing Well in an Inefficient Market*, 42 *AM. U. L. REV.* 1 (1992).

198. Williams, *supra* note 196, at 1288-89.

199. *Id.* at 1294.

200. For a discussion of the effect of globalization of labor markets, see Henry H. Drummonds, *Transnational Small and Emerging Business in a World of Nikes and*

The Organisation for Economic Cooperation and Development ("OECD") is pushing for the adoption of international corporate governance guidelines. As more corporations become transnational, they may adopt some of the European social welfare philosophies. In Germany, for example, corporations are required by law to operate the company for the common good.²⁰¹ In the United States, union and government employee pension funds that are large institutional investors tend to be particularly interested in social responsibility and corporate governance issues.²⁰²

It is likely that the SEC would channel pressures for corporate reform into shareholder proposals under the proxy rules, rather than trying to mandate new corporate governance structures. This benign solution might not satisfy the activists, however. Further, changing academic scholarship about the theory of the firm could have an impact upon the SEC and stock exchanges.

2. *New Theories of the Firm*

The contractarian model theory of the firm, deriving from law and economics scholarship, has been a dominant model in recent years.²⁰³ Many traditional scholars continue to reject this model²⁰⁴ and some scholars have been fashioning new theories, perhaps best described as a stakeholder model.²⁰⁵

Under contractarian principles, a view of stock exchange listing requirements as matters of private contract law between an exchange and

Microsofts, 4 J. SMALL & EMERGING BUS. L. 249. For a discussion of environmental issues, see Elizabeth G. Gross & Andrew E. Skroback, *Environmental Activism and the Ethical Investor*, 22 J. CORP. L. 465, pt. D (1997). For a discussion of human rights issues, see John Christopher Anderson, *Respecting Human Rights: Multinational Corporations Strike Out*, 2 U. PA. J. LAB. & EMP. L. 463, 482-83 (2000).

201. Symposium, *Corporate Social Responsibility: Paradigm or Paradox*, 84 CORNELL L. REV. 1282, 1291 (1998).

202. See Joseph Evan Calio & Rafael Xavier Zahraiddin, *The Securities and Exchange Commission's 1992 Proxy Amendments: Questions of Accountability*, 14 PACE L. REV. 459, 471-77 (1994); Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 148-49 (1988) (describing increased activity by institutional investors through the use of Rule 14a-8 proposals); Barnaby J. Feder, *Talking Business: Companies Face the Social Issues*, N.Y. TIMES, Apr. 12, 1998, at D2 (interview with Timothy Smith, executive director of Interfaith Center on Corporate Responsibility).

203. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Lucian Arye Bebchuck, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1999).

204. MELVIN EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 111-27 (1976); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract Law*, 85 COLUM. L. REV. 1403 (1985).

205. William Bratton, *The New Economic Theory of the Firm: Critical Perspectives From History*, 41 STAN. L. REV. 1471 (1989); John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495 (1990); Lawrence Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEXAS L. REV. 579 (1992).

an issuer makes sense. Under traditional theories, the SEC's approach to social protest as limited to its statutory mandate of investor and shareholder protection fits comfortably. Further, a view of stock exchange listing standards as investor protection devices under the umbrella of the Exchange Act is not a stretch. But how will stock exchange listing standards fit into a stakeholder model of the firm? Under this model, shareholders are not the only corporate constituencies. Labor, customers, and communities also matter.

Another new theory of the firm undermining the traditional shareholder primacy model is the team production model.²⁰⁶ Under this theory directors act as mediators to determine how profits should be allocated between shareholders and other stakeholders. Under this model, director independence is very important and therefore corporate governance listing standards encouraging director independence are critical. Listing standards encouraging good corporate citizenship or social responsibility could also be important because the political nature of the corporation is recognized by this theory.²⁰⁷

Does this mean an exchange could establish as a listing standard that only corporations adhering to CERES' Valdez principles can list? In the current political climate such a scenario seems unlikely, but times change. If Professor Williams is correct in her assertions, then a blue chip company could become one that is environmentally sensitive, as well as one with a large market capitalization. Such an emphasis on qualitative, rather than quantitative, listing standards would bring the NYSE full circle back to its original 1869 concerns about a listed company's general reputation in the business community.

V. CONCLUSION

The use of listing standards by exchanges to achieve a competitive edge has produced varying results over time. From 1869 until the mid 1980s the NYSE tried to differentiate itself from the AMEX and Nasdaq by having higher listing standards and advertising a blue chip issuer list. Until the mid 1960s the AMEX attracted listings by having virtually no listing standards. In the 1980s the AMEX led the race to undermine the voting rights of shareholders in order to list Wang and other issuers. In order to achieve its goal of a blue chip exemption for its listed companies Nasdaq maintained and improved its listing standards during this same period. Yet, all of the exchanges petitioned the SEC for relaxed listing standards for foreign issuers because they saw strict corporate governance standards for foreign companies as a barrier to obtaining listings.

When the federal securities laws were passed in the early 1930s federal law supplanted many exchange listing standards, but the limits of SEC authority over corporate governance standards was demonstrated in the

206. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

207. *Id.* at 323.

one-share, one-vote controversy. However, in the case of audit committees, the SEC was able to pressure the exchanges to enhance corporate governance listing standards.

In a future marketplace of demutualized for-profit exchanges it is difficult to predict whether listing standards will be used as a differentiating marketing device for selling higher quality trading products, or whether listing standards will be abandoned in a competitive race to list issuers. It is likely that the ability of exchanges to adhere to and enforce listing standards that become unpopular with listed companies will be more difficult for exchanges that are themselves listed companies. Whether the SEC would be able to compel exchanges to maintain and improve such listing standards is entirely a matter of politics. Very little tinkering with section 19(c) of the Exchange Act would be required for Congress to overturn the result of the *Business Roundtable* case. Also, the case could be distinguished or overruled in subsequent cases.

Other private section solutions are also possible. The securities industry has employed self-regulation in a wide variety of ways to avoid direct government regulation. It can be anticipated that even if stock exchanges become unable to effectively raise and police the corporate governance standards of their listed companies, some self-regulatory solutions to resulting problems will be proposed as preferable to direct SEC regulation of corporate governance.

Comments

