Essay

Revisiting *Business Roundtable* and Section 19(c) in the Wake of the Sarbanes-Oxley Act

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Although section 19(c) of the Exchange Act authorizes the SEC to modify stock exchange rules "in furtherance of the purpose" of the Exchange Act, federalism has frustrated the SEC's attempt to use that power to effect corporate governance reform. In *Business Roundtable v. SEC*, the D.C. Circuit vacated the SEC's "one share, one vote" rule, on grounds that Congress did not intend for the SEC to intrude into corporate governance, which traditionally has been considered the domain of state law. However, the Sarbanes-Oxley Act has changed the federalism calculus of section 19(c). Because Sarbanes-Oxley's amendments to the Exchange Act established a new federal policy of fighting fraud through corporate governance reform, federalism has lost much of its vitality as a constraint on SEC authority. Accordingly, the SEC should now have the power to use section 19(c) to promulgate corporate governance standards in furtherance of the purpose of Sarbanes-Oxley, particularly its audit committee provisions.

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Introduction

Ever since the Supreme Court's landmark decision in *Santa Fe Industries, Inc. v. Green,* the specter of federalism has haunted the Securities and Exchange Commission's (SEC) efforts to regulate corporate governance. Under *Santa Fe* and its progeny, disclosure rules came to be viewed as the primary mechanism of federal securities regulation. Corporate governance matters, including the composition of the board of directors and executive compensation, were thought to be the domain of state law, beyond the reach of SEC authority. In an influential 1990 case, *Business Roundtable v. SEC,* the D.C. Circuit applied *Santa Fe*'s federalist reasoning to the rulemaking context. The decision highlighted federalism's constraint on SEC authority. Section 19(c) of the Exchange Act grants the SEC authority to make rules "in furtherance of the purpose" of the Act. The SEC invoked this authority in promulgating Rule 19c-4, the "one share, one vote" rule, which prohibited dual-class capitalization structures for issuers listed on national securities markets. In *Business Roundtable,* the court invalidated the rule as ultra vires, deeming it to be beyond the "purpose" of the Exchange Act, and thus not authorized by section 19(c). Although the SEC was able to circumvent its defeat in court by persuading the New York Stock Exchange (NYSE) and NASDAQ to "voluntarily" adopt listing standards that were substantially identical to Rule 19c-4, *Business Roundtable* has stood as a stark reminder of the limits of SEC authority in our federal system.

The enactment of Sarbanes-Oxley in 2002, however, has upset the uneasy balance between federal securities law and state corporate law. Sarbanes-Oxley amended the Securities Exchange Act to add new statutory restrictions on board structure and executive compensation—corporate governance issues that have never before been specifically addressed by federal securities law. At the level of general policy, it is now clearly incorrect to claim a neat functional division between federal and state law along the lines of disclosure versus corporate governance. An important doctrinal question, then, is whether Sarbanes-Oxley has indirectly overruled the federalist reasoning of cases such as *Santa Fe* and *Business Roundtable.* Such an inquiry is necessarily addressed to specific statutory provisions, cases, and rules.

This Essay analyzes the implications of Sarbanes-Oxley for the interpretation of section 19(c). I argue that *Business Roundtable* has lost much

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of its vitality under Congress’s new policy of combating fraud through corporate governance reform. After a series of corporate scandals in the late 1990s and the early 2000s, Congress identified weak corporate governance as an important enabling factor of securities fraud. Conflicts of interest had vitiated checks on management power, permitted managers to dominate outside auditors and capture boards of directors, and thereby made it easier to present false financial information by circumventing internal corporate controls. Sarbanes-Oxley focused on cleansing corporate governance of these conflicts through strict requirements for director and auditor independence. With corporate governance regulation now itself an essential component of the Exchange Act’s anti-fraud regime, it is no longer tenable to take the position, as Business Roundtable did, that corporate governance regulation is beyond the purview of the Exchange Act. However, this does not mean that the SEC has unfettered authority to regulate corporate governance. Because Sarbanes-Oxley’s corporate governance provisions are aimed primarily at ensuring audit committee independence, any corporate governance standard the SEC promulgates under section 19(c) must serve that same goal to survive judicial scrutiny.

The question of Business Roundtable’s vitality has significance beyond the immediate confines of the “one share, one vote” controversy. Shaken by scandal and eager to restore investor confidence, the NYSE and NASDAQ have in recent years adopted corporate governance standards that go beyond the explicit requirements of Sarbanes-Oxley. In the future, if political pressure recedes and competition for listings heats up, these self-regulatory organizations (SROs) might retreat from the new corporate governance standards, much as the NYSE did in the “one share, one vote” controversy. Such a development is plausible, given the rapidly changing and intensely competitive structure of the securities markets. At some point, the SEC might need to step in to stop a race to the bottom among SROs by imposing uniform corporate governance listing standards under section 19(c). Business Roundtable said the SEC had no authority to do so. This paper argues instead that Sarbanes-Oxley has implicitly expanded the SEC’s rulemaking power under section 19(c). Significantly, the SEC should enjoy Chevron deference in its exercise of that rulemaking authority. So long as the corporate governance standard at issue bears a reasonable relationship to the corporate governance provisions of the Exchange Act, the SEC may use section 19(c) as a vehicle for corporate governance reform.

In the pages that follow, Part I will describe the history of the “one share, one vote” controversy and Business Roundtable. Part II analyzes Sarbanes-Oxley and its impact on the vitality of Business Roundtable, making the case that the D.C. Circuit’s opinion is no longer tenable in the new statutory environment. Part III briefly discusses the implications of expanded SEC rulemaking power under section 19(c), with reference to corporate governance standards that have recently been adopted by the SROs. Part IV concludes.
I. Federalism and *Business Roundtable*

The boundary between federal securities law and state corporate law has been contested since the earliest days of federal securities legislation. William O. Douglas, a major proponent of federal securities legislation and later SEC chairman in the Roosevelt Administration, believed that mandatory disclosure was insufficient to protect investors. He argued for direct federal regulation of corporations.  

William Cary, a student of Douglas and SEC chairman in the Kennedy Administration, likewise viewed federal corporate law as a necessary remedy for ineffective and failing state law regimes. Nonetheless, other than specific industries designated by statute—electric power providers under the Public Utilities Holding Company Act and mutual funds under the Investment Company Act—the SEC never had explicit authority to regulate corporate governance prior to Sarbanes-Oxley. In the 1970s, the agency embarked on an aggressive program to extend its power to regulate corporate governance. In 1977 the SEC held hearings on corporate governance reform. Foreshadowing post-Enron reform proposals, Chairman Harold Williams warned that “a board’s nominating, compensation and audit committees should be composed of independent directors.”  

Lacking statutory authority for direct action, the SEC in 1977 persuaded the NYSE to adopt a listing standard that required issuers to form audit committees comprised of independent directors.

While the SEC was taking more interest in regulating corporate governance, the Supreme Court was moving in the opposite direction. In *Santa Fe*, which involved a short-form merger initiated by the controlling shareholder and challenged by minority shareholders, the Court held that mere breach of fiduciary duty, in the absence of actual deception, was not actionable under section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. The Court rested its decision not just on the text of section 10(b), which prohibited only “deceptive and manipulative devices,” but also on federalism principles. Fiduciary relationships were traditionally defined and regulated by state law—extending section 10(b) into the realm of fiduciary duty “would overlap and quite possibly interfere with state corporate law.” The Court explained that “[c]orporations are creatures of state law, and . . . except where federal law expressly requires certain responsibilities of directors with respect to shareholders, state law will govern the internal affairs of the corporation.”
other words, mere 'internal corporate mismanagement' was not a concern of federal securities law.\textsuperscript{14}

The contradiction between the SEC's drive to regulate corporate governance and the federal judiciary's insistence on preserving federalism came to a head in the "one share, one vote" controversy of the 1980s. The NYSE had a longstanding listing standard, dating from 1926, which prohibited listed companies from issuing shares that lacked full voting rights.\textsuperscript{15} The rule was initially adopted in response to public criticism of the NYSE's decision to list the non-voting stock of Dodge Brothers, Inc., which concentrated 100\% of the voting power in holders of less than 2\% of the company's equity.\textsuperscript{16} Although the NYSE banned such capital structures among its issuers, a small number of companies listed on other exchanges continued to adopt multi-class share plans, primarily to help founders retain control. In 1976, for example, Wang Laboratories moved its share listing from the NYSE to the American Stock Exchange so that it could adopt a dual-class share plan that vested voting power in the company's founding family.\textsuperscript{17}

In the 1980s, however, the motivation behind multi-class recapitalization changed. Rather than being used by founding entrepreneurs to retain control, the device came to be used by corporate managers to fend off hostile takeovers. As Stephen Bainbridge explained, "voting control remains the surest takeover defense. An incumbent who cannot be outvoted, after all, cannot be ousted."\textsuperscript{18} The typical plan allowed management to gain control of the company without putting up additional equity investment.\textsuperscript{19} Thirty-seven public companies adopted multi-class recapitalization plans between 1980 and 1984.\textsuperscript{20} While the NYSE prohibited multi-class share issues, its competitors, particularly NASDAQ, did not. If the NYSE insisted on maintaining its ban on non-voting stock, it faced loss of business as issuers took their listings elsewhere. In 1984, General Motors announced plans to adopt a dual-class structure.\textsuperscript{21} Rather than forcing the industrial icon to delist and lose trading volume, the NYSE proposed abandoning its long-standing ban on multi-class shares.

The SEC responded by promulgating Rule 19c-4, which imposed a uniform "one share, one vote" listing standard on all SROs. The rule prohibited SROs from listing the securities of an issuer if it issues "any class of security . . . with the effect of nullifying, restricting, or disparately reducing the per share

\textsuperscript{14} 430 U.S. at 479 (quoting Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 (1971)).
\textsuperscript{16} \textit{Id.} at 700.
\textsuperscript{17} \textit{Id.} at 704.
\textsuperscript{18} Bainbridge, \textit{supra} note 5, at 565-66.
\textsuperscript{19} \textit{Id.} at 572.
\textsuperscript{20} \textit{Id.} at 570.
voting rights of holders of an outstanding class” of common stock. The rule was adopted pursuant to section 19(c) of the Exchange Act, which authorizes the SEC to “abrogate, add to, and delete from . . . the rules of a self-regulatory organization as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to the requirements of [the Exchange Act] . . . or otherwise in furtherance of the purposes of [the Exchange Act] . . . .” The SEC justified Rule 19c-4 under the last, “purpose” prong of section 19(c). According to the agency, 19c-4 furthered the purpose of Exchange Act provisions for proxy regulation (section 14),23 for SRO protection of the “public interest” (sections 6(b)(5) and 15A(b)(6)),24 and for fair competition among SROs (section 11A(a)(1)(C)(ii)).25

Upon a challenge by The Business Roundtable, an association of corporate chief executives, the D.C. Circuit held that the SEC had exceeded its authority. The court’s opinion drew heavily on the federalist principles of Santa Fe and its progeny. Following Santa Fe’s teaching that corporate governance remained the province of state law, the court reasoned that section 19(c)’s seemingly broad mandate must be read in a way that would prevent a general SEC intrusion into corporate governance. The court accomplished this by identifying the means of federal policy as the demarcation line between federal and state law: “[U]nless the legislative purpose is defined by reference to the means Congress selected, it can be framed at any level of generality—to improve the operation of capital markets, for instance.”26 The court determined that the policy means provided in the Exchange Act was disclosure. A rule promulgated under section 19(c) would likely survive only if it furthered the Act’s underlying disclosure objectives.

Accordingly, the court rejected the SEC’s contention that Rule 19c-4 furthered section 14(a)’s goal of promoting fair corporate suffrage. Section 14(a) is a broad grant of authority for the SEC to promulgate proxy rules “as necessary or appropriate in the public interest or for the protection of investors.”27 The SEC relied on legislative history to argue that fair corporate

26 905 F.2d at 410.
27 Section 14(a) provides:
It shall be unlawful for any person, by the use of the mails or by any means or instrumentalities of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect if any security or authorization in respect of any security (other than an exempted security) registered pursuant to section 12 of this title.
suffrage was the goal served by this provision. But the court disagreed. While references to fair corporate suffrage were indeed made in the legislative history of section 14(a), disclosure was the means that Congress chose to accomplish that goal. Section 14(a) was designed to ensure that investors receive the information they need to make informed decisions, and not to prejudge the substantive outcome of the proxy process. Rule 19c-4, which prohibited even those dual-class capitalization plans approved by shareholders, had stepped beyond proxy procedure regulation into the realm of substantive corporate regulation. The court pointed out that the legislative history of the 1934 Act showed that Congress did not contemplate federal regulation of corporate governance. The Senate committee report on the bill disclaimed any power for the SEC to "interfere in the management of corporations." The court further explained, "[i]f the Commission's one share/one vote rule is to survive, then, some kind of firebreak is needed to separate it from corporate governance as a whole." However, under the SEC's theory that it could promulgate any rule to promote "fair corporate suffrage," there was no firewall preventing the SEC from establishing a general federal law of corporate governance. Granting the SEC such authority would "overturn or at least impinge severely on the tradition of state regulation of corporate law."

Next, the court held that Rule 19-c could not be justified by the SEC's mandate under sections 6(b)(5) and 15A(b)(6) to ensure that SRO rules protect "the public interest." A broad and vague term such as "public interest" must be interpreted with regard to congressional purpose—and the purpose of the sections was to regulate SRO member firms, not non-member corporate issuers. In a chastising tone, the court stated: "[T]he SEC's assertion of authority directly invades the 'firmly established' state jurisdiction over corporate governance and shareholder voting rights . . . . Upholding the Commission's advance into an area not contemplated by Congress would circumvent the legislative process that is virtually the sole protection for state interests."

Lastly, the court found the SEC's reliance on section 11A(1)(C)(ii) to be unavailing. The agency claimed that section 11A(1)(C)(ii)'s preambular directive to "assure . . . fair competition" among markets permitted it to stop a race to the bottom by imposing uniform listing standards. The court countered that section 11A was intended to facilitate the establishment of a national market system by empowering the SEC to regulate matters such as trading hours and communication systems—but not corporate governance. The court observed that "nothing in the statute and legislative history" suggested

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28 905 F.2d at 411.
29 Id. at 413.
30 Id. at 412.
31 Id. at 413.
authorization for the SEC to "federalize corporate law for all companies wishing access to the national capital markets." 32

Nor could the SEC save 19c-4 by invoking the Chevron 33 doctrine. Under Chevron, if statutory text and congressional intent are silent or ambiguous, a court must defer to an agency's construction of the statute it is charged with administering and uphold the agency's position so long as it is reasonable. 34 For deference to apply, the SEC had to show that the Exchange Act was ambiguous as to the SEC's authority to promulgate corporate governance regulation. The D.C. Circuit declined to accord the SEC Chevron deference; 35 as discussed above, for each section of the Exchange Act the purpose of which the SEC claimed to further with Rule 19c-4, the court found clear congressional intent to keep the SEC out of corporate governance.

Business Roundtable left SEC authority over SRO listing standards in a state of uncertainty. All SRO rules are subject to SEC review under section 19(b) and amendment under section 19(c). But if the SEC lacks the power to promulgate corporate governance listing standards for SROs under section 19(c), on what authority does the agency review corporate governance listing standards under section 19(b)? The SROs have a long tradition of regulating corporate governance. As discussed above, the NYSE's own "one share, one vote" rule was originally adopted in 1926, before the advent of federal securities legislation. After the 1975 amendments to the Exchange Act gave the SEC authority to review SRO rules, the SEC began a consistent practice of reviewing and approving corporate governance listing standards. The NYSE's 1977 standard requiring issuers to establish independent audit committees, for example, was submitted to the SEC for consideration and approval. 36

In reviewing SRO rules, the SEC believed it had a broad "mandate to 'protect investors and the public interest,'" and did not necessarily have to reference the purpose of any specific section of the Exchange Act. 37 In dicta, the Business Roundtable court declared this approach an impermissible intrusion into state corporate law. It noted, "[i]f Rule 19c-4 were validated on such broad grounds, the Commission would be able to establish a federal corporate law by using access to national capital markets as its enforcement mechanism." 38 Citing Santa Fe, the court explained that such a move "would . . . overturn or at least impinge severely on the tradition of state regulation of

32 Id. at 415.
34 "If the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." Id. at 843. If Congress delegated authority to the agency to fill in the gaps of a statute by rulemaking, the resulting regulations "are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." Id. at 843-44.
35 905 F.2d at 408.
36 Karmel, supra note 7, at 92.
37 905 F.2d at 412.
38 Id.
corporate law.” Accordingly, while acknowledging section 19(b)’s clear grant of authority for the SEC to review all SRO rules, the court opined that the SEC’s authority “will be quite limited” when the SRO rule concerns corporate governance rather than stock trading or SRO administration. But the precise extent of the SEC’s “limited” authority remained unelaborated.

Academic commentary on the “one share, one vote” controversy was divided, with most writers approving the D.C. Circuit’s analysis. Stephen Bainbridge, for example, agreed that the statutory text and legislative history of both the 1934 Act and the 1975 amendments showed no congressional intent to delegate broad authority over corporate governance to the SEC; the agency should not assume such authority through SRO regulation. Even Joel Seligman, who argued that 19c-4 probably was justifiable to serve the purposes of proxy regulation and restraining unfair competition, conceded that federalism precluded section 19(c) regulation over such matters as “the number of directors or how many shall be outsiders.”

A thornier issue was the propriety of SRO regulation over corporate governance in general—especially the extent of the SEC’s 19(b) power to review SRO corporate governance rules. Douglas Michael advanced the theory that SROs themselves had no authority to regulate corporate governance through listing standards, even if they adopted the rules voluntarily. He contended that the Exchange Act established a system of supervised self-regulation that empowered the SROs to use rules to facilitate efficient trading markets. Corporate governance listing standards venture beyond self-regulation of SRO members to substantive regulation of issuers, an area beyond the purpose of the Exchange Act. If the SEC had no authority to regulate corporate governance, neither did the SROs.

Nonetheless, the SEC continued to use SRO listing standards as a vehicle of corporate governance regulation. Shortly after the invalidation of Rule 19c-4, the SEC used its influence to persuade the NYSE and the NASD to adopt listing standards that were nearly identical to the vacated rule.

II. Sarbanes-Oxley and Its Implications

Roughly a decade after Business Roundtable, a wave of corporate scandals swept the markets. After financial irregularities at Sunbeam, Xerox, and Cendant, a full-blown political crisis erupted with the collapse of Enron Corporation in 2001. Enron had been the seventh largest American corporation

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39 Id.
40 Bainbridge, supra note 5, at 604-18.
41 Seligman, supra note 15, at 715.
43 Bainbridge, supra note 5, at 625.
by market capitalization. Its sudden fall called into question the integrity of the nation’s financial regulatory system as a whole. Another bombshell dropped in April 2002, when WorldCom disclosed the biggest financial fraud in U.S. history. The telecommunications giant had overstated its income by nearly $4 billion. The political reaction was swift and furious. In the summer of 2002, President Bush signed into law the Sarbanes-Oxley Act, probably the most significant change to the structure of federal securities regulation since the Exchange Act’s enactment in 1934.

Sarbanes-Oxley marked an unprecedented federal intrusion into matters traditionally governed by state law. Most importantly, Sarbanes-Oxley changed the means by which federal securities laws combat fraud. Rather than limiting its means to disclosure, the amended Exchange Act now expressly addresses board composition and executive compensation.

A. Sarbanes-Oxley’s Corporate Governance Provisions

Sarbanes-Oxley received much attention for establishing a new regulatory regime for accountants and stiffening criminal penalties for securities law violations, but just as significant were its corporate governance provisions. First, Title III of the Act, entitled “Corporate Responsibility,” directly mandates the implementation of federal corporate governance rules through SRO listing standards—precisely the type of “back door” regulation rejected in Business Roundtable. Section 301 of Sarbanes-Oxley, which adds section 10A(m) to the Exchange Act, directs the SEC to promulgate rules requiring SROs to “prohibit the listing of any security of an issuer that is not in compliance” with Sarbanes-Oxley’s audit committee provisions. Each public corporation is required to have an audit committee composed solely of independent directors, with direct responsibility for the “appointment, compensation, and oversight” of outside auditors. All issuers are strongly encouraged to appoint at least one “financial expert” to the audit committee. If no expert is appointed, the issuer must explain why not in a public disclosure statement. The audit committee must also have procedures for receiving tips from whistleblowers, as well as independent authority to engage its own advisers, such as legal counsel or accountants. Each issuer is directed to ensure adequate funding for the audit committee.

Second, Sarbanes-Oxley delves into issues of executive compensation, which the Exchange Act had never done. Section 402 of Sarbanes-Oxley,

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45 See HAROLD S. BLOOMENTHAL, THE SARBANES-OXLEY ACT IN PERSPECTIVE 1-22 (2002), for an overview of the events leading up to the statute’s enactment.
46 905 F.2d at 413.
which adds section 13(k) to the Exchange Act, entitled “enhanced conflict of interest provisions,” directly prohibits issuers from extending personal loans to executives. 49

Third, in a departure from the Exchange Act’s traditional emphasis on regulating communications between the issuer and the public, Sarbanes-Oxley prescribes codes of conduct on how corporations manage their internal affairs. To ensure the independence and integrity of audits, the SEC is authorized to promulgate rules prohibiting the exercise of “improper influence”—defined as manipulation, coercion, fraudulent influence, or misrepresentation—on an issuer’s outside auditors by its officers and directors. 50 To assure the truth of corporate financial disclosures, Sarbanes-Oxley not only requires CEOs and CFOs to certify financial reports, but also prescribes the ways in which they must do so. The signing officers must review financial reports, establish and maintain internal controls designed to ensure their accuracy, evaluate those controls, and discuss the report with the audit committee. 51 To create incentives for compliance, the statute requires the disgorgement of any incentive- or equity-based compensation received by corporate executives in the event of an earnings restatement by the issuer. 52 And to deter self-dealing and discourage conflicts of interest, the SEC is directed to promulgate rules that require each issuer to disclose whether it has a code of ethics, and if not, to explain why not. 53 While these are stand-alone provisions rather than amendments to the Exchange Act, they nonetheless express a new federal policy of using corporate governance reform to combat fraud.

As has been widely acknowledged in academic commentary, 54 Sarbanes-Oxley ventures into areas of corporate conduct traditionally regulated by state law. For example, the audit committee provisions mark a significant departure from Delaware corporate law. 55 Sarbanes-Oxley’s definition of director independence is stricter than that of Delaware. Its designation of an audit committee with specific duties contravenes the board’s wide discretion, under Delaware law, to designate committees and delegate authority. Whereas state law generally allows personal loans to chief executives so long as the loans do

49 Sarbanes-Oxley Act § 402; Exchange Act § 13(k); 15 U.S.C. § 78m(k).
55 Jones, supra note 54, at 642.
not violate the duty of loyalty.\textsuperscript{56} Sarbanes-Oxley bans them outright. As for the officer certification procedures for financial reports, commentators have pointed out that "this provision directly imposes a duty of care on company managers. It not only makes them agree to a particular disclosure, but also tells them what they must do before signing the disclosure statement."\textsuperscript{57}

The question, then, is whether Sarbanes-Oxley has revised the policy and purpose of the Exchange Act such that the section 19(c) power the SEC was denied in \textit{Business Roundtable} has become a viable vehicle for federal corporate governance regulation.

\textbf{B. Business Roundtable Revisited}

\textit{Business Roundtable} described the divide between federal securities law and state corporate law as an "intelligible conceptual line excluding the [SEC] from corporate governance."\textsuperscript{58} In light of Sarbanes-Oxley's deep intrusion into traditional state law territory, the distinction is no longer so intelligible. As a first step of analysis, a court interpreting section 19(c) should no longer presume, on federalism grounds, that an SEC rule on corporate governance falls outside the scope of its authority. Although eliminating fraud remains the fundamental purpose of the Exchange Act, Sarbanes-Oxley altered the mix of policy means available to the SEC under the Exchange Act.

The policy and purpose of Sarbanes-Oxley can be discerned from its legislative history. The audit committee provisions, now section 10A(m) of the Exchange Act, stand for a policy of promoting powerful and independent audit committees within corporate boards. Bainbridge and Johnson characterize the statute's policy paradigm as "anti-managerialism" and "a substantial effort to shift the balance of power from management to the independent directors."\textsuperscript{59} An early draft of the bill presented in the House committee report did not contain the audit committee requirements, but merely called for the SEC to undertake a study to assess whether current corporate governance practices "serve the best interests of investors."\textsuperscript{60} Among other objectives, the SEC was directed to evaluate "whether rules, practices, and standards relating to determining whether independent directors are in fact independent are adequate,"\textsuperscript{61} and specifically to see if current practices on audit committee independence were "uniformly applied and adequate to protect investor interests."\textsuperscript{62} The SEC was to report its findings to Congress, presumably to

\begin{footnotesize}
\begin{thebibliography}{99}
\item 56 \textit{Id.}
\item 57 Thompson & Sale, supra note 54, at 875.
\item 58 905 F.2d at 413.
\item 61 \textit{Id.}
\item 62 \textit{Id.}
\end{thebibliography}
\end{footnotesize}
recommend further legislation. This approach was criticized as inadequate by the House minority, which called for an explicit requirement of audit committee independence and a strict definition of director independence.\textsuperscript{63} The House minority's position prevailed in the final enactment, which was largely based on the Senate bill. The Senate committee report openly took the position that management capture of boards undermines the financial reporting process. It found that "the auditing process may be compromised when auditors view their main responsibility as serving the company's management rather than its full board of directors or its audit committee."\textsuperscript{64} Further problems arise if the audit committee is itself captured by management. Indeed, "[m]any recent failures have been attributed to close ties between audit committee members and management."\textsuperscript{65} The report spoke of "the need for strong, competent audit committees with real authority."\textsuperscript{66}

Another policy objective of Sarbanes-Oxley is to reduce incentives for fraud created by executive compensation. Initially, the bill reported out of the Senate committee called for immediate disclosure of loans to corporate officers, but it did not ban them outright. A floor amendment by Senator Charles Schumer added the ban in what is now Exchange Act section 13(k). He explained that personal loans were unfair and "just wrong."\textsuperscript{67} Based on Schumer's floor statement, section 13(k) appears to reflect populist concern over excessive executive compensation. However, in light of the statutory context, the purpose of the loan provision can also be understood to be the elimination of management incentives to conduct fraud. Former WorldCom CEO Bernard Ebbers had accumulated huge personal debts, backed by his holding of company stock. The debt burden may have created incentives for him to manipulate financial statements.\textsuperscript{68} The ban on loans helps to mitigate such incentives. Looking beyond the amendments to the Exchange Act, this

\begin{footnotesize}
\begin{itemize}
\item[63] \textit{Id.} at 47.
\item[64] S. REP. NO. 107-205, at 23 (2002).
\item[65] \textit{Id.} at 24.
\item[66] \textit{Id.} at 23.
\item[67] BLOOMENTHAL, \textit{supra} note 45, at 89. Senator Schumer explained:
\begin{quote}
My amendment is very simple: it makes it unlawful for any publicly traded company to make loans to its executive officers.
\end{quote}

The question is: Why can't these super rich corporate executives go to the corner bank, the Suntrust's or Bank of America's, like everyone else to take loans?
In the case of WorldCom, Ebbers had funded his personal stock market activities by borrowing on margin. When the value of those investments plunged, Ebbers had to pay up. How did he do it? He borrowed money from his board of directors to pay for the stock he had bought that was now being called in.
This is just wrong, and it must be stopped.
\end{quote}
\textit{Id.}
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\end{footnotesize}
policy is also reflected in Sarbanes-Oxley’s standalone provisions. 15 U.S.C. § 7243 requires corporate executives to forfeit options and bonuses in the event of earnings restatements. It has the unmistakable effect of reducing the expected value of fraud and thereby cutting management’s incentives to release false financial information. This policy is consistent with the general anti-fraud goal of Sarbanes-Oxley, which was after all enacted not to curb excessive executive compensation but to fight fraud.⁶⁹

Read in light of their policy objectives, the corporate governance provisions of Sarbanes-Oxley have an expansive effect on the SEC’s section 19(c) rulemaking power. An SEC corporate governance standard promulgated under section 19(c) should stand if it advances the Exchange Act’s fundamental anti-fraud purpose through the new policy means provided by Sarbanes-Oxley. Significantly, the SEC should enjoy Chevron deference in its application of its section 19 authority. On the surface, section 19(c) grants the SEC broad authority to set SRO rules to “in furtherance of the purpose” of the Exchange Act. Such an expansive delegation of rulemaking authority should ordinarily imply, under the Chevron doctrine, broad interpretive discretion for the SEC.⁷⁰

_Business Roundtable_ declined to accord the SEC Chevron deference on federalism grounds. In so holding, _Business Roundtable_ relied not just on manifestations of congressional intent in legislative history, but also on the background federalist principles of _Santa Fe_. However, in Sarbanes-Oxley, Congress explicitly directed the SEC to implement new audit committee rules via SRO regulation—precisely the kind of “back door” regulation that _Business Roundtable_ rejected. The collapse of the dichotomy between disclosure and corporate governance renders the scope of section 19(c) more ambiguous than it was at the time _Business Roundtable_ was decided. Without federalism as the boundary-setting mechanism, the limits of SEC authority under section 19(c) are now much less clear. As the agency to which the rulemaking authority to implement an ambiguous statute is delegated, the SEC is probably entitled to Chevron deference, with the power to promulgate any rule that reasonably furthers the purpose of Sarbanes-Oxley’s amendments to the Exchange Act—particularly the audit committee provisions.

What does this mean for the result reached in _Business Roundtable_? The “one share, one vote” rule would probably survive if it had been adopted after Sarbanes-Oxley’s enactment. In its rulemaking release for 19c-4, the SEC had focused on collective action problems among shareholders as justification for using the “one share, one vote” rule to safeguard shareholders’ proxy rights

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⁶⁹ See BLOOMENTHAL, supra note 45, at 1-22.

⁷⁰ As the Supreme Court has noted, “we have recognized a very good indicator of delegation meriting Chevron treatment in express congressional authorizations to engage in the process of rulemaking or adjudication that produces regulations or rulings for which deference is claimed.” United States v. Mead Corp., 533 U.S. 218, 229 (2001); see also United States v. O’Hagan, 521 U.S. 642, 658 (1997) (according Chevron deference to the SEC’s application of its rulemaking authority under section 14(e) of the Exchange Act).
under section 14. Now, the SEC can instead argue that dual-class stock, by vesting potentially all voting power in the hands of management, could undermine the independence of outside directors, including members of the all-important audit committee. Section 10A(m)'s independence requirement does not itself ensure the strong audit committees that Congress sought to create. The audit committee's position and function could be undermined by a variety of factors not specifically contemplated in section 10A(m). Section 19(c) gives the SEC the authority to promulgate additional corporate governance standards to safeguard the integrity of an institution—the audit committee—that is now at the heart of the Exchange Act's anti-fraud program. In the case of dual-class recapitalization, because it would subject director nomination to the absolute control of management, the simple desire for renomination on the part of outside directors can compromise their independence. Vesting nearly all voting power in management would put the whole board, which depends on management for appointment, under management's sway, seriously undermining the audit committee provisions of Exchange Act section 10A(m). It is true that management typically enjoys informal control over board appointments even without a dual-class structure, but establishing more formal control could further undermine the board's oversight capacity. The "one share, one vote" rule would reasonably advance section 10A(m)'s goal of ensuring "strong" audit committees.

One may object that section 10A(m) does not confer such rulemaking authority on the SEC. Because section 10A(m) merely gives the SEC authority to promulgate rules that prohibit the listing of securities that are not in compliance with section 10A(m) itself, it can be argued that Congress did not intend for this narrow grant of authority to expand to other spheres of corporate governance. However, it is not necessary that section 10A(m) directly confer such authority, because section 19(c) does that on its own. As Joel Seligman has pointed out,

[The legislative history of [section 19(c)] underlines Congress’s intent to give the Commission “plenary power over self-regulatory rules.” “The SEC would be granted,” explains the Senate Report, “the power to change the rules of a self-regulatory organization in any respect, not just with respect to certain enumerated areas.” The key restriction emphasized in the legislative history, and implicit in the language of the statute, is that the SEC’s actions must be “consistent with the objectives of the Exchange Act.”]

Thus, section 19(c) gives the SEC the authority to promulgate rules to further the purpose of section 10A(m), even if the latter's own rulemaking provision is relatively narrow. If the scope of section 19(c) authority is read to be identical to the SEC's independent grant of authority under other parts of the Exchange Act, section 19(c) would become superfluous. It is a "cardinal rule of
statutory interpretation that no provision should be construed to be entirely redundant."\(^{74}\) To give force to both section 19(c) and section 10A(m), section 19(c) should be interpreted to grant the SEC authority to further the purpose of 10A(m) through SRO rules, so long as the rule is reasonably related to the purpose of and policy means provided by section 10A(m).

III. New SRO Listing Standards Since Enron

Congress did not have a monopoly on corporate governance reform. Following the Enron and WorldCom debacles, the NYSE and NASDAQ, with SEC encouragement, implemented a series of corporate governance listing standards designed to strengthen board independence and rein in executive compensation. SRO listing standards must be uniform to be effective. When an SRO lacks market power, it may yield to the temptation to lower standards in order to attract listings, as the NYSE did in the “one share, one vote” controversy. In the tense regulatory environment after Enron, the NYSE and NASDAQ have been able to coordinate on substantively similar, although not identical, corporate governance listing standards.\(^{75}\) But as memories of Enron and WorldCom recede and competition between the NYSE and NASDAQ continues, it is possible that the SROs may again join a race to the bottom in listing standards in order to retain business. The ongoing trend toward consolidation in the securities trading market may increase the likelihood of such a development. The NYSE has merged with Archipelago, a leading electronic trading network, and has converted from a membership association to a for-profit public company.\(^{76}\) NASDAQ has also completed a merger of its own—with Instinet, an electronic stock market.\(^{77}\) In the rapidly changing market for securities trading, the NYSE and NASDAQ will continue to compete fiercely for trading volume. If complaints about the cost and burden of post-Enron regulation continue to mount, the profit-driven SROs may not adhere to their recent reforms. The SEC may need to be ready to use its 19(c) power to impose uniformity if signs of a race to the bottom emerge.


Recently adopted NYSE and NASD listing standards go far beyond the corporate governance provisions of Sarbanes-Oxley. Some merely specify in greater detail the conduct, composition, and duties of the audit committee. Others prescribe general board structure and even internal corporate functions. The new standards are too numerous and complicated to be fully explicated here, and below I briefly discuss five requirements: (1) that boards must have a majority of independent directors; (2) that independent directors must hold regular executive sessions without the presence of management; (3) that director nominations must be made by a majority of independent directors or a nominating committee comprised solely of independent directors; (4) that equity compensation plans must be approved by shareholders; and (5) that executive compensation must be approved by a compensation committee comprised solely of independent directors or a majority of independent directors. If an SRO retreats from one of these standards in the future, does the SEC have power under section 19(c) to re-impose it through rulemaking? The answer depends on each rule and its relationship to the audit committee and executive compensation mandates of Sarbanes-Oxley.

The first standard, that the majority of the board be composed of independent directors, goes the furthest in federalizing corporate governance. In terms of its effect on board composition, it reaches even deeper than the audit committee requirement in Sarbanes-Oxley. An argument can be made that if Congress intended to impose a majority requirement for independent directors, it would have done so, with the implication that SEC rulemaking is contrary to legislative intent. However, just because Congress did not enact a specific rule does not mean that the SEC is powerless to adopt it through section 19(c) rulemaking. The question is whether the rule bears a reasonable relationship to the purpose of section 10A(m). Generally, the majority-independence rule appears to be consistent with Sarbanes-Oxley’s policy of strengthening the board, and particularly the audit committee, as a check on managerial power. Members of the audit committee are less likely to be beholden to management if their independent peers comprise a majority of the board. Independent directors, including those on the audit committees, may feel

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78 Each company is required to have an internal audit function. CLEARY, GOTTLIEB, STEEN & HAMILTON, supra note 75, at 102-03.
80 N.Y. Stock Exchange, supra note 79, § 303A.03; NASDAQ, Marketplace Rule 4350(c)(2) (2006).
81 N.Y. Stock Exchange, supra note 79, § 303A.04 (requiring a nominating committee of only independent directors); NASDAQ, Marketplace Rule 4350(c)(4) (2006).
less deferential to management when they comprise the majority than if insiders do, and may be less susceptible to “groupthink.”\textsuperscript{84} Moreover, having a majority of independent directors helps to ensure that the audit committee will have adequate support from the rest of the board.

The second standard, that independent directors hold executive sessions without management participation, should pass muster under \textit{Chevron}. Requiring independent directors—particularly those on the audit committee—to meet on their own may strengthen the cohesiveness and esprit de corps of the outside directors as a group, lessening the chance that they would be captured by management. Moreover, in these executive sessions outside directors may feel more comfortable raising questions and discussing issues that might be awkward in the presence of management.

The third standard, requiring independent nominating committees, can probably also be justified. This rule reaches fairly deeply into questions of general board structure, but it bears a direct relationship to Sarbanes-Oxley’s audit committee provision. The audit committee members are already required by statute to be independent. Excluding management from the nomination process—although it will continue to exercise informal influence—will further ensure that audit committee members will owe no favors to management and will be in a position to vigorously perform their roles as accounting watchdogs.

The fourth standard, requiring shareholder approval of equity compensation plans, is more problematic. The three board independence standards discussed above all have tangible connections to the function and effectiveness of the audit committee, which is itself a core component of Sarbanes-Oxley’s corporate governance program. In contrast, requiring shareholder approval does not appear to further the prohibition on personal loans to executives in section 13(k) of the Exchange Act. While audit committee independence might be undermined by multi-class capitalization, personal loans will be just as illegal under section 13(k) regardless of whether executive compensation has been approved by shareholders. Moreover, it is not clear how shareholder approval of equity compensation plans would reduce management incentives to commit fraud. This rule is probably beyond the reach of the SEC’s section 19(c) power.

The fifth standard, requiring independent director approval of executive compensation, is also problematic. The SEC might argue that independent compensation committees are more likely to craft executive compensation packages that align shareholder interests with management interests. The problem, again, is that having an independent compensation committee does not further the purpose of section 13(k) the same way that having an independent nomination committee strengthens section 10A(m)’s audit committee requirement. Section 304 is narrowly tailored. Unlike section

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10A(m), it does not set up a new institution such as the audit committee that must function effectively in order for the statute's purpose to be fulfilled. Section 13(k) merely prohibits a specific form of compensation. Requiring an independent compensation committee may be beyond the SEC's 19(c) authority even after Sarbanes-Oxley.

IV. Conclusion

Sarbanes-Oxley has broken the presumption against federal corporate governance regulation embodied in *Business Roundtable*. At the same time, listing standards have become a favored mechanism for the SEC and the SROs to implement corporate governance standards, making the scope of the SEC's 19(c) rulemaking power an important issue in the post-Enron legal environment. This Essay has shown that the SEC has expanded authority to regulate corporate governance, particularly in matters related to audit committee independence, but its power is not unfettered. In the executive compensation area, since Sarbanes-Oxley's own related provisions are narrowly tailored, the SEC may not have the authority to impose some reforms that the SROs have thus far voluntarily adopted.

This still leaves a puzzling gap, which *Business Roundtable* and Douglas Michael have identified,\(^85\), between the SEC's section 19(b) power to review SRO listing standards and its 19(c) power to impose them. The issue probably would not be addressed in court until an SRO retreats from a listing standard, as the NYSE did during the "one share, one vote" controversy. As SRO listing standards become an increasingly important vehicle for corporate governance regulation, Congress would be well advised to comprehensively examine the wisdom of using SRO regulation for such purposes and enact clarifying legislation.

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\(^85\) See *supra* note 42 and accompanying text.