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The (Un)Changing Face of Corporate Governance Regulation in the United States: the Evolving Roles of the Federal and State Governments

My talk today is titled, The (Un)Changing Face of Corporate Governance Regulation in the United States: the Evolving Roles of the Federal and State Governments. In this talk, I plan to cover three topics:

1. First, the basic division of the authority to regulate corporate governance between the U.S. federal government, on the one hand, and the individual states, on the other;
2. Second, how that division of authority has evolved over time; and
3. Third, the future of the current U.S. regulatory structure.

The Meaning of Corporate Governance

Let me start by briefly describing what I mean by corporate governance regulation. With this term, I am referring to those laws and regulations that control the internal governance of the corporation. These laws and regulations control how power and authority is allocated and exercised within the corporation, and cover such matters as: What powers various stakeholders in the corporation have to make or participate in corporate decision-making? How, as a practical matter, the groups to whom authority is allocated exercise that power? And the constraints that exist within the corporation to ensure that the power and authority granted to particular groups is not misused.

1. The Basic Division of Regulatory Authority under current US Law

a. The Role of the States

Let me start with the existing division of regulatory authority between the federal government, on the one hand, and the individual states, on the other. I will talk first about the states. In the summary that follows, I am going to emphasize 4 features of state regulation: (1) the ability of businesses to choose where, within the United States, they would like to incorporate and therefore, to a certain extent, select their

regulator; (2) the basic allocation under state law of authority between managers and shareholders; (3) the devices that state law provides to constrain management from misusing its authority; and (4) the on-going debate over the effectiveness of these devices.

i. Choice of State of Incorporation

First, the choice of state of incorporation. As some of you may be aware, in the United States almost all corporations are created by the individual U.S. states, not by the federal government. Therefore, if you have a business that you would like to incorporate, you typically turn to one of the 50 states in order to obtain your corporate charter. Under a conflicts-of-law principle known as the “internal affairs doctrine,” the law of the state in which you choose to incorporate will control the internal affairs of the corporation – that is, the relationship among the various corporate constituencies, especially the shareholders, the directors and the officers. And this internal affairs rule applies *regardless of the location within the United States of the firm’s business or physical assets*. Therefore, for example, a business with all its assets in California, and none in Delaware, could still choose Delaware as its jurisdiction of incorporation with the result that Delaware law, not California law, would set the rules for the internal governance of the firm.

Indeed, for larger public corporations, Delaware is far and away the most popular jurisdiction in the United States for corporations. There are several reasons for Delaware’s popularity: (1) The substance of Delaware’s corporate law. First, there is the substance of Delaware’s corporate law, which appeals to corporate managers by, among other things, giving managers extensive control over the corporation’s affairs, providing powerful protections against shareholder lawsuits, and providing generous indemnification and insurance to those managers who are unlucky enough to be sued. (2) The Delaware Court of Chancery. Second, there is Delaware’s noted Court of Chancery that is staffed by expert judges who resolve corporate cases extremely quickly and with great consistency. (3) Stability. Third, there are the special provisions in Delaware’s state constitution, which promote the stability of Delaware’s corporate law by requiring a special super-majority in both houses of the legislature in order to amend Delaware’s General Corporation Law. But these three explanations, by themselves, don’t seem sufficient to explain Delaware’s advantage because other states could simply copy these features and steal some of Delaware’s lucrative incorporation business. Yet that hasn’t happened, which suggests that something else must be at work to explain Delaware’s dominance – something unique to Delaware that isn’t susceptible to copying. This special feature may be Delaware’s small size and population, which make it particularly dependent on the revenue it earns from its incorporation business. This unique dependence on corporate fees and franchise taxes to fund the state’s operations may mean that Delaware can be uniquely trusted not to alter its corporate laws in ways that public corporations dislike, because any detrimental change to Delaware’s corporate law could lead corporations to leave the jurisdiction, thereby depriving the state of its principal source of revenue. Indeed, another U.S. state— New Jersey, which was the first U.S. state to adopt a general incorporation law in the latter portion of the 19th century and the early leader in U.S. incorporations – saw its advantage disappear when, in the early 20th century, a tough New Jersey antitrust law led corporations to flee that jurisdiction and never return. Delaware’s unique dependence on corporate fees may be why other states that have tried to capture some of Delaware’s incorporation business by simply copying its law have, for the most part, failed to make inroads into Delaware’s dominant position.

ii. Rules favoring Management

Now let me return to the role of the states and talk a little about the allocation of power between managers and shareholders. When it comes to the basic allocation of power between managers and shareholders, state law rules – particularly in Delaware -- plainly favor management over the shareholders. These state laws typically provide that the corporation will be managed by or under the direction of a board of directors, and that the day-to-day operations of the corporation will be carried on by officers appointed by the directors, and employees selected by the officers. Shareholder powers, on the other hand, are generally limited to certain discrete matters, such as: (1) electing the directors at the corporation’s annual meeting; (2) adopting or amending corporate bylaws; and (3) voting to approve fundamental corporate changes, like mergers, sales of all or substantially all the corporation’s assets and dissolutions. In general, state laws provide shareholders with no role in corporate business decisions and state courts generally invalidate contracts that attempt to enhance the role of the shareholders, unless the terms of those contracts are included in the corporation’s organizational documents.

In most cases – though not all, the state law governance rules for corporate operation function as default rules that can be altered in the company’s articles of incorporation or in its bylaws. These alterations can cover almost all aspects of corporate governance, and can include provisions increasing or decreasing the powers of the shareholders to participate in corporate governance. For instance, the number of shares that must be represented at a shareholders meeting for business to be conducted, or the number of shares that must be voted in favor of a resolution for the resolution to pass, can typically be altered through properly approved amendments to the corporation’s charter or its bylaws. In practice, limitations on shareholder powers are far more common than expansions. For example, many public corporations in the United States take steps to limit the ability of shareholders to control the timing of corporate action by restricting the power of shareholders to call meetings and by eliminating the power of shareholders to act by written consent without a meeting. Further, even in the case of shareholder meetings convened by the directors, public corporations frequently require shareholders to give advance notice of any business they plan to bring before the meeting, thereby ensuring that management will be well prepared to respond to any resolutions shareholders may make.¹

iii. Constraints on Managerial Authority

We can now go on to the third point regarding the role of the states, which relates to devices to constrain managerial authority. Because of the vast allocation of authority to management under state law, much of state corporate law, particularly judge-made common law, concerns itself with devices designed to keep corporate directors and officers from misusing their powers. There are a number of these devices built into each state’s corporation law, but I will limit myself to discussing three of the most basic:

(1) *Right to Vote*. First, the right to vote. The right of shareholders to meet at least once every year to elect and remove directors is undoubtedly the most important shareholder right, and the courts generally treat it as fundamental and non-waivable. Come what may, shareholders of U.S. corporations, particularly in Delaware, get *at least* one opportunity per year to meet and exercise their right to replace the old directors with new ones. And if the directors fail to convene such an annual meeting within the statutory period, the courts will summarily order the meeting to be held upon the request of any shareholder.

(2) *Derivative Suits*. A second important constraint on the power of directors is the ability of shareholders to cause the corporation, through the device of the derivative suit, to sue directors and officers who have allegedly injured the corporation by breaching their legal duties to act as fiduciaries for the shareholders. State corporation statutes are generally explicit as to the existence of the shareholder’s right to employ a derivative suit to seek redress, on the corporation’s behalf, for injuries to the corporation, including injuries inflicted by management itself. But the statutes say very little about the circumstances under which management will be held liable, leaving that important question to the courts. Therefore, at least in theory, corporate managers are constrained by the fear that their actions, if not consistent with the best interests of the shareholders, could result in personal liability.

(3) *Right to Sell*. The third significant constraint on the directors’ exercise of authority is the ability of shareholders to sell their shares. This right functions as a constraint on managerial conduct because the right can be employed by shareholders to sell control of the corporation to a hostile bidder who can use the shares and votes so acquired to remove poorly performing managers. Therefore, managers concerned with maintaining their positions in the firm have an incentive to try to keep hostile bidders at bay

¹ But while alterations designed to limit shareholder powers are more common, there are also examples of changes designed to expand shareholder powers. Most notable in this regard are recent provisions giving shareholders in public corporations greater powers to reject management-proposed candidates to the board of directors by requiring board nominees to receive a majority, rather than a mere plurality, of the votes cast. In addition, public corporations are often required by stock exchange rules to provide shareholders with powers permitted, but not required, by state corporation law, such as right to vote on transactions that may result in excessive issuances of new shares, thereby diluting the stake of existing shareholders. But these modifications seldom, if ever, change the basic state law allocation of authority in the corporation, which gives management the near exclusive authority to manage the business with little or no formal input, or even approval, from shareholders.

by keeping share prices high. The power to sell shares is also an important constraint on managerial action because excessive sales of shares will drive stock prices down, thereby decreasing any managerial compensation that is tied, directly or indirectly, to stock price.

iv. The Debate over the Effectiveness of Constraints

Now let me go on to the fourth point regarding the role of the states, and that is the effectiveness of these three basic devices. Much of the debate over the effectiveness of state corporate governance rules in the United States turns on an analysis of how effective these three devices are in constraining the exercise by managers of their powers to control the corporation. Some critics of state corporate governance rules point to limitations on these devices, which they say prevent them from functioning as effective checks on managers. But others contend that these limitations are relatively minor and are necessary to keep the costs of these devices from exceeding the benefits. I certainly don't have the time today to go over this debate in detail, but I will try to give you at least a small taste of it (without advocating a position myself), taking each of three basic constraints on director action that I have mentioned in turn:

1. State Law Voting Rights. Let me start with state law voting rights. State law voting rights are limited in their usefulness as constraints on managerial conduct for a variety of reasons. First and foremost, in the case of a public corporation with thousands upon thousands of geographically dispersed shareholders, it is extremely expensive for shareholders to communicate with one another. Second, even if shareholders can overcome these costs of communication, shareholders with a limited stake in the firm face credibility issues that make it difficult for them to convince other shareholders to vote with them (rather than with management). Third, most ordinary shareholders will be largely apathetic about shareholder voting, since the financial consequences of any vote for any individual shareholder will generally be small and, as a result, the typical shareholder will ignore communications from his fellow shareholders and adopt the simple strategy of either voting as management recommends or not at all, except in the most extreme instances. Finally, as I already mentioned, many corporate charters include limitations that make it difficult for shareholders to convene meetings, or to otherwise act without management consent, and provide management with advance notice of potential shareholder action so management has time to plan and react. As a result, shareholder voting may, in fact, function as a check on managerial misconduct, but only in the most extreme instances.

There are, of course, responses to this critique of shareholder voting. The first is that a check on extreme conduct may, itself, be enough. A second response focuses on the fact that, in many firms, particularly larger ones, institutional investors – like insurance companies, pension funds, mutual funds, and hedge funds -- own a large percentage of the stock (often greater than 50%). This means that attracting an influential block of shares to a dissident shareholder's position may not be as difficult as it first appears. For example, in 2004 dissident shareholders in Disney Corporation were able to convince shareholders owning 45% of the corporation's stock to withhold support for the re-election of Michael Eisner to the Disney board and thereby ultimately force his resignation as Disney Chairman and CEO. However, it certainly remains true that outright victories by dissident shareholders and even indirect victories, as in Disney, are extremely rare.

2. Shareholder Derivative Suit. The ability of shareholders to use the device of the derivative suit to cause the corporation to sue directors or officers who have performed poorly is limited by both statutory and judicial doctrines, which make it very difficult not only for shareholders to prevail in such cases, but also to commence such cases in the first place. The shareholders derivative suit effectively permits a single shareholder (no matter how small his or her ownership interest) to take control of the corporation's right to litigate, a fairly dramatic step. Accordingly, state corporation laws include a variety of constraints designed to prevent the misuse of this power, particularly by shareholders who may have only a limited stake in the firm. These constraints include doctrines that limit the shareholder's ability to commence and continue a derivative suit (known as standing requirements), as well as substantive legal doctrines that provide special defenses to managers who are charged with misconduct. Key among these requirements and defenses are the demand requirement and the business judgment rule. (1) The demand requirement is a rule that requires that the shareholder first present the proposed litigation to the corporation so that the corporation, rather than the shareholder, can handle the lawsuit. But making demand generally means that litigation will never be commenced, because boards of directors, when asked, almost always determine that litigation is not in the best interests of the corporation and courts almost always defer to the board's

judgment. Therefore, in order to get a derivative case to court, the shareholder commencing the suit must convince the court either that demand should be excused or that the board's response to the demand should be ignored. Courts will do these things, but only when convinced that the board responding to the demand lacks a disinterested majority or when the court is presented with particularized facts establishing the existence of an actionable claim against the alleged wrongdoers, assuming those facts can be established at trial. This showing is very difficult to make both because facts are difficult to come by and because state law provides corporate managers with formidable defenses, one of which I will turn to next.

(2) In Delaware, as well as under the law of all U.S. states, directors and officers sued by the shareholders in a derivative suit can avail themselves of a defense known as the business judgment rule. This defense essentially bars judicial second-guessing of managerial business decisions, except in extraordinary cases. In general, the courts will only entertain challenges to managerial conduct, if the shareholder challenging the conduct can provide specific facts showing that a majority of the directors who made the challenged decision had a conflict of interest or that the particularized facts alleged show an extreme decision that no reasonable person could have reached under the circumstances. As a result of these rules, few shareholder complaints survive the defendants' preliminary dismissal motions under the demand requirement, and of those that do survive, very few result in any meaningful recovery by the corporation, because of the difficulties of prevailing at a trial.

Again, an example from the Disney Corporation illustrates the point. In 1996, Disney dismissed its president, Michael Ovitz, after only 13 months on the job. Disney paid Michael Ovitz a severance package worth approximately \$140 million for those 13 months of service. Yet even with this extraordinary amount of severance pay, shareholders who commenced a derivative suit on the corporation's behalf had a very difficult time obtaining a trial on their claim that Disney's directors had breached their duty to the corporation in approving Ovitz's employment contract. When the Delaware Chancery Court first heard the case in the latter part of the 1990s (well before the Enron/WorldCom debacle), it concluded that the challenged actions were protected by the business judgment rule, because it could not conclude that no reasonable person would have agreed to a contract with such a high level of severance pay. While the plaintiffs did ultimately obtain a trial on the merits after the Delaware Supreme Court gave the plaintiffs a second chance to plead their case with additional facts, in the end the trial judge ruled against the plaintiffs on all counts, finding, among other things, that the challenged decisions were protected against judicial second-guessing because a reasonable person could have concluded that Michael Ovitz's reputation in the industry, and the lucrative position he surrendered to accept the Disney presidency, warranted an extraordinary severance.

Of course, some argue that the derivative suit must be limited to prevent abuse of the derivative remedy by attorneys or shareholders with limited stakes in the corporation. Here one hears frequent mention of the fear of so-called strike suits where an attorney may bring an action, with little factual basis and little chance of success but alleging large potential damages, in the hope of extracting a quick settlement from defendants who would rather pay a modest amount to settle the claim than be bothered with the litigation, particularly when that amount is covered by indemnification or insurance. Along the same lines, if it were too easy to sue corporate managers whenever a decision turned out badly, perhaps due to bad luck rather than bad judgment, managers might be dissuaded from taking the kinds of business risks that shareholders in business corporations often prefer them to take.

3. Market for Corporate Control. Finally, the ability of shareholders to sell their shares to hostile bidders who might displace poorly performing managers is impaired by the powers of directors to unilaterally erect obstacles – so called “poison pills”-- which make takeovers by bidders, who have not received prior approval from incumbent management, practically impossible. Courts that have scrutinized these antitakeover measures, particularly in Delaware, have consistently upheld them. And, in many instances, state legislatures have amended their corporate statutes to make clear that directors are, in fact, authorized to act unilaterally (without explicit shareholder approval) to adopt devices that make hostile takeovers more difficult.

Again, there are responses from those who would defend state corporate law. Let me just mention two briefly: (1) First, these antitakeover measures may not be as insurmountable as they at first appear; in fact, while the directors of public corporations have had the clear authority to implement poison pill takeover defenses for more than two decades, hostile takeovers still occur even if somewhat less frequently than in the past. In many of those successful takeovers, incumbent managers voluntarily dismantle the defenses when market and shareholder pressures to yield to the bid become too great; and (2) Second, it

may be necessary to limit the threat of hostile takeovers by making them a bit more difficult because managers who fear they might be easily removed from office when the stock price declines might be led to pursue short term strategies that keep stock prices high, at least in the short term, rather than taking a longer-term perspective that could work out better for shareholders in the end.

To this point in my talk, I've focused on the role of the states in regulating corporate governance. Now, I'd like to shift to a discussion of the role of the U.S. Federal Government.

b. The Role of the Federal Government

In the late 19th century and the early part of the 20th century, as the corporate form was becoming increasingly popular in the United States, the federal government played no real role in regulating the internal governance of U.S. corporations, not even of larger firms. Instead, the federal role was largely limited to controlling the outward conduct of corporations through such devices as monopoly and price-fixing regulation. However, this state of affairs began to change as part of the government's response to the 1929 Stock Market Crash and the Great Depression, in particular with the adoption of the Securities Act of 1933, the Securities Exchange Act of 1934 and the creation, under the latter statute, of the United States Securities and Exchange Commission (the SEC). In the next part of my talk, I'll briefly describe each of these statutes and the federal role in corporate governance for the SEC that these statutes have created.

i. The Securities Act of 1933

First, the Securities Act of 1933. One of the first statutory responses to the 1929 Stock Market Crash, the Securities Act of 1933 had both a limited focus and a limited impact on corporate governance. Without going into detail, the Securities Act of 1933 was designed primarily to prevent the recurrence of the speculative frenzy in stock purchases that had marked the 1920s. The idea underlying the Securities Act of 1933 was not to change the state law rules that governed the management of corporations, but instead to ensure that the investors who purchased securities did so only after receiving full information about the company's management, its business, its properties, and its finances – that is, only after learning the “truth” about the securities. Consequently, instead of tinkering with the internal governance of corporations, or limiting the types of securities that could be offered or sold to the public, the 1933 Act focused its attention, almost single-mindedly, on disclosure. Under the 1933 Act, corporations would be permitted to continue to issue securities to the public whenever they wished, and on terms of their own choosing, but only if they provided full and fair disclosure to prospective investors before the investment decision was made. Toward that end, the 1933 Act did three things: (1) first, it required issuers of securities to prepare and file with federal securities regulators a detailed registration statement with extensive disclosures about the company, its business, its management, its properties and its financial affairs; (2) second, it mandated that the prospectus prepared as part of that registration statement be distributed to all investors to whom securities were offered or sold; and (3) third, it limited the use of non-statutory sales materials, barring all sales efforts – written or oral – until a registration statement had been filed and also barred the use of written materials, other than the statutory prospectus, thereafter. In addition, to ensure the accuracy of the registration statement and statutory prospectus, the law subjected all those connected with the offering – the company itself, its directors and principal officers, and the underwriters, securities dealers and accountants associated with the offering -- to legal liability if information in the registration statement and prospectus proved to be materially inaccurate or incomplete. The purpose of this regime was to ensure that all investors who were offered securities made their investment decision based solely on the sober, complete information prepared in compliance with the federal securities laws, rather than based on the unsupported (and often unsupported) hype of unaccountable corporate promoters.

The statute and related rules are, of course, far more complicated than this, but for my purposes, the key point is that the Securities Act of 1933 did not give the federal authorities any substantial power to set standards of corporate governance; that power remained, as it always had been, with the states. Therefore, the federal government's response to the 1929 Stock Market Crash and the Great Depression, at least in the Securities Act of 1933, was not to directly change the way corporations were governed, but to ensure that all relevant facts about the corporation, including information necessary to assess the quality of its governance, were made available to potential investors. This is not to say, however, that the 1933 Act had no impact on corporate governance. It almost certainly did, but that impact was indirect. Because of the disclosure obligations imposed on management under the Act, management undoubtedly had an incentive to avoid governance arrangements that might appear questionable to shareholders when disclosed.

Also, because the 1933 Act required underwriters and accountants to certify the information in the registration statement, dishonest or less competent managers faced higher hurdles in selling securities to the public than they had in the past.

I should note that this statutory scheme established in 1933 largely remains in place today, albeit with considerable modifications and alterations designed to streamline the registration process and diminish regulatory burdens, particularly on larger, more closely followed corporations.

ii. The Securities Exchange Act of 1934

Now let me move on to the second major federal securities statute, the Securities Exchange Act of 1934. Unlike the 1933 Act, which dealt almost exclusively with initial distributions of securities to the public, the Securities Exchange Act of 1934 focused on secondary trading in public securities markets. But while the focus of the two statutes was different, the two statutes had similar goals – and took similar, though not identical steps – to achieve those goals. To ensure that investors in public markets could have confidence in the markets themselves, and in the prices generated by those markets, the 1934 Act – like the 1933 Act – relied, at least in part, on disclosure. Companies whose securities were listed for trading on a national securities exchange would have to register those securities with the SEC, and comply with certain SEC rules. Central among these rules was the requirement that all public companies file detailed information with the SEC on a quarterly and annual basis. The annual report, known now as a 10-K, includes the same type of detailed information about a company, its business, its management and its finances as is included in a registration statement for a public offering prepared under the 1933 Act; quarterly reports, known now as 10-Qs, update this annual information, though these quarterly reports are far less extensive than the required annual reports and need not be audited by independent accountants. To ensure the accuracy of these reports, the statute permits lawsuits against any person, including the company’s outside accountant, who makes a materially false or misleading statement in a filed document.

Unlike the 1933 Act, however, the 1934 Act did not rely exclusively on disclosure regulation to solve the problems that plagued U.S. corporations, and U.S. Securities Markets, in the 1930s. Instead, the statute went beyond the periodic disclosure requirements I briefly described and included, among other things, requirements that securities professionals and securities markets themselves register with the SEC and abide by SEC rules. Most importantly for purposes of my discussion today, the 1934 Act also took steps, in particular the authorization Federal Proxy Rules, to respond to academic critics of corporate governance – most prominently Columbia and Harvard Professors, Adolph Berle and Gardiner Means, whose 1932 book, *The Modern Corporation and Private Property*, had revolutionized thinking about corporate America.

Berle and Means argued that, at least part of the problem with American corporations in the 1930s could be traced to their control by corporate managers who were not themselves constrained to act as owners would act. Managers of modern corporations could not be expected to act as owners themselves would act because the managers lacked a significant ownership interest in the firm, while the actual owners -- the shareholders -- could not be expected to actively monitor the firm’s managers because of the small size of their individual ownership stakes, their geographic dispersal, and their limited access to information about the corporation and the performance of management. As a result, Berle and Means concluded that the American Corporation of the 1930s was marked by a separation of ownership by shareholders from control by managers that could result in corporations being run in the private interests of the firm’s managers, rather than in the interest of the owners. In Berle and Means view, owner-run firms could be trusted to act in the public interest because, at least in the ideal world, the owners would be guided by Adam Smith’s invisible hand to use the vast resources held in the corporate form to society’s advantage. But management controlled firms operated with no such constraint, leading to the danger that managers with control over vast corporate assets would use them, not in society’s interests, but in the managers’ own personal interests. In effect, Berle and Means saw the rise of the modern public corporation, and the related separation of ownership and control, as disrupting the basic market forces that previously guided the use of private property in the public interest.

Influenced by the work of Berle and Means, the drafters of the Securities Exchange Act of 1934 took the first steps, at the federal level, to change the ways in which public corporations were governed, and in the process introduced the two-tiered state-federal system of corporate governance regulation that the United States still has today. These first federal steps into corporate governance regulation were limited largely to a single subsection in the 1934 Act designed to improve shareholder voting – section 14(a) of the statute, which made it “unlawful for any person, . . . in contravention of such rules as [the

SEC] may prescribe . . . , *to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security registered [under the 1934 Act.]*” With this single subsection, Congress granted the SEC the authority to control the methods and processes by which public corporations communicated with their shareholders. This power over the proxy solicitation process by no means authorized the SEC to displace the states as the primary setters of corporate governance standards, but it did give the SEC a foot in the door.

The SEC made quick use of its new power, adopting its first proxy rules in 1935. These initial proxy rules, like many subsequent modifications over the last seventy-five years, attempted to address the Berle and Means critique by increasing the likelihood that shareholders would vote their shares in an intelligent and informed fashion, rather than simply granting management general discretionary authority to vote shares as management saw fit on whatever issues might come before the shareholders’ meeting. The 1935 rules took just a small step towards this goal, requiring only that shareholders be given basic information identifying the various matters that management intended to present or consider at the meeting and specifying the actions management intended to take with respect to those matters. Subsequent revisions of the proxy rules, beginning as early as 1938, strengthened the federal proxy rules in a variety of ways that are still with us today: these revisions required (1) greater information about the identity of the person seeking the authority to act as a proxy, including any private interest of that person in the subject matter of the vote; (2) detailed information about the matters to be voted on at the meeting; and (3) the opportunity for shareholders to actually direct, in the proxy, exactly how their shares should be voted.² The idea underlying this scheme was to make corporate managers more responsive to the interests of the firm’s owners, that is, the shareholders, to address the separation of ownership from control that Berle and Means had identified. Accordingly, even though the federal proxy rules did not formally change state law governance rules concerning the power and authority of directors and shareholders, the federal proxy rules nonetheless shifted the state law balance of corporate power in the shareholders’ direction.

As with the 1933 Act, this basic regulatory scheme established by the 1934 Act largely remains in place today, although with some significant modifications, including a vast expansion in the number of firms covered by the SEC’s rules in 1964.³ As a result of these changes, there are now approximately 15,000 U.S. corporations that are subject to this dual structure of governance regulation I’ve described, with (1) state law – particularly that of Delaware -- providing the basic rules of corporate governance, and (2) federal law largely controlling corporate disclosure and the proxy solicitation process.

I should emphasize, once again, that, while the federal securities laws – both the 1933 Act and the 1934 Act – primarily focus on disclosures that public corporations are required to make, these disclosure regulations can have the indirect effect of regulating corporate governance practices. The best examples of this phenomenon are disclosure regulations that I refer to as “shaming” regulations. These are regulations where the SEC requires disclosure of certain information, not because that information is useful to help value securities, but because of the hope that public corporations will change their practices in order to avoid making the required disclosures. I’ll give two brief examples from current law to illustrate the point, but there are many others beyond these two. First, the SEC has long required public corporations to disclose whether directors or executive officers have been convicted of any crimes or whether the corporation has engaged in material transactions with its own directors and officers. These disclosures are required, not so much because the SEC feels this type of information is economically significant in valuing the corporation, but because the SEC seeks to discourage public companies from selecting those convicted of crimes to act as fiduciaries for shareholders and the SEC believes that self dealing by directors and

² Therefore, instead of having general proxies that gave management the power to vote shares as they determined in their sole discretion, shareholders would now, at least in theory, direct how their shares would be voted based on a review of detailed information provided by management.

³ Probably the single most important of these changes relates to the companies that are now required to register securities under the 1934 Act and comply with the SEC’s rules under that Act. Initially, the periodic disclosure and proxy rules under the 1934 Act applied only to those corporations whose shares were listed for trading on a national securities exchange, such as the New York Stock Exchange. But in 1964 Congress extended the registration and compliance requirements under the 1934 Act to all corporations with at least 500 shareholders of record and assets in excess of an amount set by the SEC (now \$10 million).

executives officers is a poor corporate governance practice. Therefore, the SEC attempts to dissuade corporations from engaging in these types of conduct by threatening to “shame” those who do. A more modern example of this phenomenon is the post-Enron requirement that public corporations disclose “any material weakness in the [corporation’s] internal control over financial reporting.” This disclosure requirement is designed primarily to encourage public companies to improve their internal accounting controls, rather than to provide information that might make investors nervous. As a result of these and other similar disclosure regulations, including with respect to compensation, the SEC often accomplishes indirectly through disclosure regulation that which it lacks the power to do directly – that is, regulating corporate governance.

2. The Evolution of the Federal-State Division of Authority over Public Corporations

Now that I’ve described the division of regulatory authority between the SEC, on the one hand, and the States (and particularly Delaware), on the other, I would like to talk a bit about how this division of authority has evolved over the last seventy-five years, particularly in response to corporate crises and scandals. Periodically, over the last several decades, commentators have criticized the dominant role that the small state of Delaware has played in setting corporate governance standards for the majority of U.S. public corporations – in part because of questions about the effectiveness of Delaware law that I discussed earlier. These commentators have called on the SEC, the federal courts, and the U.S. Congress to do more. As I will describe, each of these bodies has taken steps, at times, in response to these calls for an increased federal role in corporate governance regulation, but for the most part these steps have been relatively modest. More ambitious proposals – those that would cause a fundamental shift of corporate governance regulation from the states to the federal government – have been uniformly rejected. Let me turn then to a discussion of three sub-topics: (1) first, the classic critique of state corporate law, (2) second, some of the modest steps that have been taken at the federal level to more greatly control the substance of corporate governance, and (3) third, some of the more dramatic steps that have been proposed – but not taken -- at various times over the last century.

a. The Classic Critique

The classic critique of permitting the states, particularly Delaware, to act as the primary setters of corporate governance standards is that of Professor William Cary in his well known 1974 article from the Yale Law Journal, *Federalism and Corporate Law: Reflections Upon Delaware*. A former Chairman of the SEC, Professor Cary argued that competition among the states for corporate charters had led to a “race for the bottom” in corporate law. In effect, states competed with one another to set lower and lower corporate governance standards so that corporate managers would be enticed to incorporate within their jurisdictions. Delaware won this competition by adopting the most lax governance standards of all. To support his position, Professor Cary cited examples of Delaware statutory provisions and judicial decisions he viewed as unjustifiably favorable to management. These included statutory provisions such as those permitting corporations to substitute written consents for actual shareholder meetings as well as judicial decisions setting low standards for the directors’ duty of care. Cary contrasted these Delaware statutes and court decisions with federal cases brought under the federal securities laws, including during his tenure as SEC Chairman, where the federal courts had demonstrated a much greater willingness than the Delaware courts to set rigorous standards with respect to such matters as deceptive proxy statements and duties of disclosure, not because the federal courts were necessarily better than state courts, but because federal courts did not need to compete for business – as the states did. Professor Cary used his critique as a basis to call for uniform federal standards of corporate responsibility that would apply to all public corporations, regardless of their state of incorporation.

b. SEC/Congressional Forays Into Corporate Governance: Successes

Now let me move onto the incremental steps of the SEC and Congress to exert greater control over corporate governance. Responding to critiques like those of Professor Cary, the SEC and the Congress have taken steps, over the years, at the federal level that encourage or mandate changes in corporate governance practices of public corporations. These steps, however, tend to be more modest ones, rather than wholesale displacements of state corporate law. The SEC’s actions, of course, must be modest because of statutory limitations on the SEC’s authority; in general, the SEC is authorized to set disclosure standards for public corporations and to adopt proxy rules, but not to prescribe corporate governance standards more generally. Congress, of course, can do whatever it pleases, but like the SEC, it too has only

taken small incremental steps into the corporate governance area, even in response to dramatic crises like the accounting scandals of the first years of this decade and the more recent financial crisis. To illustrate the types of incremental steps the SEC and Congress have taken over the years, let me provide a few examples.

1. *The Shareholder Proposal Rule.* Very early on in its history, the SEC adopted a rule, which has come to be known as the “Shareholder Proposal Rule.” Adopted in 1942, this rule now enables a qualifying shareholder to have a proposal for shareholder action included in the proxy materials prepared by the corporation in connection with corporation’s annual meeting. The qualifying shareholder also gets to include a supporting statement for the proposal and the corporation’s proxy card must provide a space where shareholders can indicate whether their shares should be voted for or against the shareholder’s proposal. Absent something like the shareholder proposal rule, it would be practically impossible for an ordinary shareholder to present a resolution to his fellow shareholders because of the cost and expense of preparing and circulating his own proxy materials to thousands and thousands of shareholders scattered across the nation and the world. Although the shareholder proposal rule substantively alters the balance of power between management and shareholders, the SEC justified the rule on disclosure – not corporate governance -- grounds, contending that management had a duty to inform shareholders of proposals that management knew would be presented at an upcoming meeting. Consequently, as we will see again, with the shareholder proposal rule the SEC used a disclosure-oriented rule to, in effect, alter the substantive balance of power within the corporation.⁴

2. *Insider Trading Restrictions.* A second example of SEC efforts to influence the governance of public corporations relates to insider trading restrictions. Prior to 1961, state law determined the question of whether corporate insiders could trade in the U.S. while in possession non-public material information about the company or its prospects. The states did not uniformly bar insider trading, with many taking the view that insider trading would only constitute a violation when special circumstances were present, such as when the corporate insider traded in a face-to-face transaction with the shareholder, rather than over an anonymous securities exchange. In 1961, however, the SEC used its power to police fraudulent disclosures in securities markets to bar trading by corporate insiders based on non-public information. The SEC reasoned that those who had a special relationship that gave them access to confidential information intended to be available only for a corporate purpose and not for the personal benefit of anyone committed a fraud on the other party to a securities transaction when they traded on that information without first disclosing it. Because the SEC construed insider trading as a failure of disclosure, the SEC was able to use its unquestioned power to police fraud to bar a practice that the SEC felt might undermine the proper management of a corporation, as well as the efficiency of securities markets.⁵

⁴ But while the rule certainly strengthens shareholder activists, it’s impact is limited: first, there are many limitations included in the rule, itself, on when and how the rule could be used; and, second, shareholder activists still face more practical barriers, including the tendency of ordinary shareholders to side with management.

⁵ *Going Private Regulation.* A third example of an SEC effort to influence corporate governance relates to so-called “going private transactions.” With relatively low stock prices in the early 1970s, it became popular for the management of public corporations in the United State to take those corporations private – that is, for the company itself, or its affiliates, to purchase stock from the public shareholders in a transaction or series of transactions that would generally result in the complete or near complete elimination of public ownership, with the result that the corporation’s shares would be delisted from trading on securities exchanges and the company’s obligation to file periodic reports and provide other information to the SEC under the federal securities laws would be terminated. The SEC and other shareholder advocates became concerned about these transactions not only because those few public shareholders who might remain after a going private transaction would no longer have access to a liquid securities market or information filed under the federal securities laws, but also because “going private” transactions presented management with a conflict of interest that could call into question the fairness of the terms offered to the public shareholders. Shareholder advocates called on the SEC to require that going private transactions satisfy a federal fairness standard, but the SEC ultimately declined to directly regulate the substance of

3. Audit Committee Reports. My next example of an SEC attempt to improve corporate governance is more recent -- from the late 1990s. Even before the Enron WorldCom crises of 2001 and 2002, the SEC had made efforts to encourage public companies to increase the effectiveness of the audit committees of their boards of directors to help ensure the accuracy and completeness of the company's audited financial statements. Through new rules adopted in 1999, the SEC attempted to increase the likelihood that audit committees did their jobs and did them well. These rules worked through the SEC's traditional "shaming" approach, rather than through direct regulation of the conduct of audit committees. Accordingly, the 1999 rules required that each annual proxy statement include a report from the audit committee, which in effect required the audit committee to state *whether* (not *that*) it had done its job in connection with that year's audit.⁶ The rules also required that the proxy statement disclose whether the board of directors had adopted a written charter for its audit committee and whether the audit committee members were "independent" of the corporation. Again, these rules were written in classic SEC style. So as not to directly tread on ground reserved for the states, the SEC wrote rules that did not actually *require* that corporations or audit committees do anything -- that is, to change any of their behavior. Instead, the rules simply required that corporations disclose certain details about how their audit committees had performed their duties, with the hope that corporations and their audit committees would be shamed into doing the "right thing" as the SEC defined it.⁷

In 2006, similar disclosure standards were established with respect to: (a) compensation committees of board's of directors; and (b) nominating committees of boards of directors. Like the audit committee rules, these rules mandated disclosures only, requiring the company to state such things as: (a) whether the committees exist; (b) whether the members of the committees are independent; and (c) whether the committees have written charters guiding their operations.

4. Sarbanes-Oxley. I've left the most famous example of federal intervention in corporate governance for last -- and that's Sarbanes-Oxley. Adopted in June of 2002, Sarbanes-Oxley was the principal piece of U.S. Federal legislation that resulted from the combined effects of the Enron and WorldCom accounting scandals of 2001 and 2002. Sarbanes-Oxley covered much ground in addition to the corporate governance reforms that are my focus, but those aspects of Sarbanes Oxley will have to be left for another day.⁸ I'll focus on only those Sarbanes-Oxley provisions that relate to corporate governance, in particular four provisions that go well beyond the Federal Government's traditional "shaming" approach to corporate governance regulation.

going private transactions, and instead limited itself to its more traditional disclosure-focused role. Therefore, in 1979 the SEC adopted its going-private rule requiring special disclosures in "going private transactions." The core of the SEC's new rule was a requirement that management state whether or not it believed the transaction to be fair under state law, and provide supporting reasons for that assessment. Therefore, as with some of the SEC's other forays into corporate governance regulation, the SEC did not directly alter the state law rules governing going-private transactions, but once again sought -- through its disclosure rules -- to shift the balance in favor of the shareholders, this time by helping shareholders to gather the information necessary to challenge going private transactions under state law.

⁶ [Specifically, these rules required the audit report to state (a) whether the audit committee reviewed and discussed the audited financial statements with management; (b) whether the audit committee had discussed certain important matters, such as the selection of significant accounting policies, with the independent auditors, and (c) whether the auditor committee had received disclosures from the auditors regarding the auditor's independence.]

⁷ In general, these corporate governance disclosures must also discuss various ways in which these committees operate. The rules governing disclosures with respect to audit committees, nominating committees and compensation committees are now grouped together in a single rule referring to corporate governance disclosures. (Rule 407)]

⁸ Among other things, it created the Public Company Accounting Oversight Board to regulate public accounting firms that audit public companies, it adopted new standards of auditor independence, and it mandated the implementation of new rules designed to minimize conflicts of interest for securities analysts.

a. Audit Committees. As the Enron-WorldCom fiascos were chiefly accounting failures, it probably isn't surprising that Sarbanes-Oxley provided the SEC with enhanced authority to govern the substance of the operations of audit committees of public companies. Specifically, the SEC received the authority to require securities exchanges to adopt listing standards that *required* public companies to have strengthened audit committees. Under the statute, exchange listing standards must mandate: 1) that the audit committee – not the firm's management -- be directly responsible for the appointment, compensation, and oversight of the work of the independent accountant employed by the company; 2) that, in general, each member of the audit committee be independent; and 3) that audit committees have the authority to engage independent counsel and other advisers.

b. Enhanced CEO/CFO responsibilities. The statute also imposes enhanced responsibilities on CEOs and CFOs, requiring them to review the company's annual and quarterly financial reports, attest to the accuracy and completeness of those reports, evaluate the company's internal accounting controls, and report any deficiencies identified to the company's auditors and to the audit committee.

c. Officer/Director misconduct and prohibition on personal loans. Along the same lines, Sarbanes-Oxley makes it unlawful for any officer or director to fraudulently influence, coerce or mislead the company's independent auditors and also bars public companies from extending, or arranging an extension of, credit for any officer or director.

Each of these four provisions plainly goes beyond the federal government's traditional shaming approach to corporate governance regulation and, to at least a limited extent, infringes on the traditional powers of the states to control corporate governance.⁹ Therefore, at least in the area of audits of public companies and certain other practices thought to be at the heart of the accounting scandals in the early years of this decade, federal standards have encroached, to a limited extent, on traditional state turf and, at least in the case of loan restrictions, have displaced conflicting – and more permissive – state laws.

That said, many other provisions of Sarbanes-Oxley, which I won't discuss today, still fit within the federal government's traditional "shaming" approach to corporate governance regulation.¹⁰ Therefore, in response to what was then the largest public company financial scandal in many years—the Enron/WorldCom crisis -- the U.S. Congress only moved slightly from its traditional approach; it tried to take a greater hand in regulating the corporate governance of public companies and did so directly in a few cases. But for the most part, it continued to leave standards of corporate conduct to the states, while relying on the SEC for disclosure regulation. This shows the durability – even in times of crisis – of the basic state-federal division of regulatory authority over corporate governance.

These limited encroachments of the federal authorities on the states' control of corporate governance standards should be contrasted with the fate over the last century of proposals that would have gone much farther in displacing state law.

⁹ The first requires an active, independent audit committee for listed public companies as a matter of federal law; the second imposes new audit-related responsibilities on CEOs and CFOs; the third makes the improper influence of a public company audit a violation of federal law; and the fourth bars extensions of credit to officers and directors, a practice specifically authorized by many state corporation laws, including Delaware's.

¹⁰ These provisions include:

a. Internal Controls Reports. One of the most discussed provisions of Sarbanes-Oxley, that which required the SEC to adopt rules requiring management to prepare an internal controls report containing an assessment of the effectiveness of the company's internal control structures and procedures of the issuer for financial reporting. Unlike the provisions I just mentioned, this provision does not require a company to have adequate internal controls, but only that the system be assessed and any material deficiencies be identified.

b. Code of Ethics for Senior Financial Officers. Along the same lines, Sarbanes-Oxley instructs the SEC, to require public companies to report *whether* (not *that*) they have adopted a Code of Ethics for the company's senior financial officers.

c. Financial Expert on Audit Committee. And Sarbanes-Oxley instructs the SEC to adopt rules requiring public companies to disclose whether or not their audit committees include at least one member who is a financial expert.

1. Federal chartering or licensing of corporations. On several occasions over the last century, politicians and academics have called for a more extensive federal role in regulating the conduct, rather than merely the disclosures, of U.S. corporations. There were calls for Federal chartering or licensing of corporations as part of the progressive movement in the first years of the 20th century, with no fewer than 13 bills on federal chartering or licensing introduced in the United States Congress between 1905 and 1909. Calls for increased federal regulation of corporations, including federal chartering and licensing proposals, were renewed in several bills introduced in the U.S. Congress during the New Deal era of the 1930s. And more recently, proposals for a greater federal role in regulating at least larger corporations once again took center stage during the 1970s as Congress and the public began to focus on the corporate social responsibility – or the lack thereof -- of large U.S. Corporations, like General Motors.¹¹

Despite the populist appeal of all of these proposals, in each instance the U.S. Congress failed to act, leaving the states in general, and Delaware in particular, free to set corporate governance standards in the United States.¹²

2. Federal Fiduciary Duties under 10b-5. Having failed to get Federal chartering or licensing from the U.S. Congress, shareholder advocates have, at times, turned to the federal courts to provide at least a partial antidote to the limitations of state law. During the 1970s, shareholders who sought a greater federal role in standard setting tried to convince the federal courts to use SEC Rule 10b-5 for that purpose. Adopted by the SEC in 1942, Rule 10b-5 prohibits, as a matter of federal law, fraudulent devices and schemes as well as acts and practices which operate as a fraud or deceit in connection with the purchase or sale of any security. Essentially, Rule 10b-5 federalizes the law of fraud in securities transactions.

Proponents of using 10b-5 as a vehicle for setting federal standards of corporate conduct argued that certain corporate practices constituted frauds under Rule 10b-5, at least when the challenged conduct occurred in connection with the corporation's purchase or sale of securities. Had this argument succeeded, the SEC would have obtained the authority to regulate at least a subset of corporate conduct, including, among other things, corporate conduct related to mergers and other similar corporate transactions. But, like the previous efforts in Congress, this effort also failed when, in 1975, the U.S. Supreme Court held that the SEC's authority in connection with Rule 10b-5 extended only to outlawing conduct that involved some form of deception. Accordingly, conduct that corporate managers engaged in openly, even if plainly contrary to shareholder interests – such as causing the corporation to engage in a securities transaction with its own shareholders on unfair terms or without a valid business purpose – could not constitute a 10b-5 violation. The Supreme Court thereby made absolutely clear its belief that existing legislation did not give the SEC authority to set federal fiduciary duty standards that would undermine the traditional role of the states in corporate law.

3. Business Roundtable v. SEC. The SEC made a final effort to adopt substantive rules directly setting standards of corporate conduct 1987. This time the SEC used its authority under a different section of the 1934 Act, section 19(c) that permits the SEC to amend the rules of a securities exchange, like the New York Stock Exchange “. . . in furtherance of the purposes of this title.” Acting under this grant of authority, the SEC adopted Rule 19c-4 – its so-called one share-one vote rule which prohibited the

¹¹ [During this era, more liberal consumer advocates like Ralph Nader called once again for federal chartering that would completely displace state law, while others, such as Professor William Cary – the former SEC Chairman whom I mentioned earlier – took a more measured approach by calling for uniform federal minimum standards that would supplement, but not displace state chartering.]

¹² [This is not say that these calls for federal chartering or minimum federal standards had no effect. At least during the 1970s, if not in earlier periods, the calls for Federal chartering or licensing caused Delaware to take steps to mute those calls, in some cases tightening up state law standards that policymakers and shareholder advocates had criticized. This tactic is repeating itself in the post-Enron period as both the Delaware legislative and the Delaware courts have taken actions designed, at least in part, to mute calls for federal action that might endanger Delaware's dominance in domestic corporate law. These steps have been sufficient to stave off any serious effort to oust Delaware from its pre-eminent position.]

exchanges from listing a company's stock if the company took any action that nullified, restricted or disparately reduced the voting power of existing stockholders." Essentially, this rule was designed to prohibit an antitakeover device that had become popular in the 1980s – dual class common stock recapitalizations which resulted in management's receipt of high voting stock while public shareholders received low voting stock. This technique was often used to put voting control of the corporation in the hands of management (and other friendly shareholders), even though management owned only a small fraction of the firm's equity.

The SEC contended that its rule was authorized under 19(c) because it furthered the purposes of the 1934 Act, in particular the statutory concern with fair shareholder voting reflected in the 1934 Act's proxy provisions that I mentioned earlier. However, the federal court ultimately rejected the SEC's argument and invalidated the rule, holding that the SEC's powers under the 1934 Act extended only to regulating the proxy *process*, not to regulating the *substantive* voting rights of shareholders. Therefore, the SEC's attempt to extend its own powers to the substance of corporate law suffered the same fate as prior Congressional and judicial efforts to set federal standards of conduct for publicly traded corporations, leaving in place the traditional division of state and federal authority, with Delaware as the *de facto* national regulator.

[It's worth noting, however, that while the SEC may have lost the battle, ultimately it when the war, when it convinced the exchanges, through not so delicate persuasion, to "voluntarily adopt rules very similar to the ones the SEC proposed.]

3. The Future of the Current Regulatory Structure

This brings me to the final portion of my talk today and that is the future of the current regulatory structure. Will the dual roles of the federal government and the states persist or will the weight of the current financial crisis finally result in the expansion of federal regulation so that the federal government, rather than the states, becomes the primary standard setter for corporate governance?

A. Persistence of Current Division of Authority

I think the answer to this question is "Yes." Despite the pressures for change, I expect the current regulatory structure to persist and I say this for three reasons: (1) History, (2) Politics, and (3) Recent Experience.

i. History

Let me start with history. Here I'll simply reiterate some points I've already made. There have been many, many proposals over the last century for the federal government to take a greater role in regulating corporate governance. We saw those proposals in the early part of the 20th century during the progressive era, during the Great Depression of the 1930s, and during the debate over corporate social responsibility during the 1970s. In each of these eras, proposals to federalize corporate law or impose minimum federal standards of conduct failed in the United States Congress. Only in Sarbanes-Oxley, adopted in the aftermath of the Enron-WorldCom debacle, did the U.S. Congress go somewhat beyond the traditional federal role, encroaching to a limited degree on state powers, and even then the steps taken were small ones at best. As a result, even against the backdrop of the present financial crisis, history suggests that a federal takeover of corporate governance standards is highly unlikely.

ii. Politics.

Political considerations also support this conclusion. There are a whole host of entrenched interests that benefit from the current regulatory regime that leaves the states largely in control of corporate governance standards. First and foremost, the small State of Delaware derives much of the revenue needed to finance the operations of the state from franchise taxes and other fees paid by businesses that are incorporated in the state. It is doubtful that Delaware will relinquish its control over this revenue stream without a spirited fight. Indeed, in the past Delaware has taken steps to reduce the pressure for federalization of corporate law by responding to crises in corporate governance with changes to its law designed to relieve the pressure for federalization; that process appears to be under way now, with Delaware recently adopting amendments to its corporate law to give shareholders greater abilities to nominate directors in order to counter SEC proposals to expand shareholder access to the corporate proxy.

In addition to the State itself, there are a number of private interest groups with considerable investments in state control of corporate governance, which could be expected to strongly resist any

substantial change in the current state-federal regulatory structure. These include, first and foremost, the many public corporations that have chosen Delaware as their state of incorporation, because of the many advantages of Delaware incorporation, including a reliable legislature, an expert judiciary, and a highly stable corporate law. Others who benefit from the current structure include many of the country's leading law firms, who have made substantial investments in lawyers and law offices within the state, and the entire corporate servicing industry that has grown up within the Delaware to offer services to corporations that choose Delaware as their jurisdiction of incorporation without having any physical presence in the state.

It 's also at least worth noting that the current United States Vice President, Joe Biden, was a long-time U.S. Senator from the State of Delaware. It seems unlikely that he would support any federal changes that could have the effect of undermining the stature or economy of his home state.

iii. Experience: The SEC's Shareholder Access Proposal

Finally, we have the SEC's recent experience with its now six-year-old proposal to expand the ability of shareholders to access the corporation's annual proxy statement to nominate candidates to the corporation's board of directors.

In October 2003, the SEC, acting in response to the corporate scandals of 2001 and 2002, proposed new rules that would have required companies to include in their proxy materials shareholder nominees for election to positions on the corporation's board of directors. The proposed proxy access rules were relatively modest, and would only have become operative upon the occurrence of certain triggering events indicative of shareholder discontent. Further, only shareholders who owned at least 5% of the corporation's stock would be permitted to nominate directors and, in no event, would the corporation have to include more than three shareholder nominees in its proxy statement..¹³

Hardly a fundamental reallocation of governance power within the corporation, this proposal languished for almost six years without being adopted by the SEC. Only after the onset of the current financial crisis and the election of a new administration in Washington did the SEC renew its efforts to provide shareholders with the ability to include board nominees in the corporation's proxy materials by offering a new proposal in May of this year. The new proposal is broader than the 2003 proposal in the sense that there is no triggering event that must occur before shareholders get to include nominees in the company's proxy materials and the ownership thresholds for shareholder eligibility have been reduced. However, the rule also makes clear that corporations can, in effect, opt out of the shareholder nomination process by eliminating the power of shareholders to nominate directors in the corporation's charter or bylaws, and that shareholder nominees can not comprise more than 25% of the board of directors.

In the current atmosphere, with a new President, a new SEC Chair, and a new democratic majority on the SEC, one might have expected this revised proposal to be approved with ease. But approval still hasn't been obtained.

Business groups in the United States, as well as many leading corporations, have joined in opposing the SEC's proposal, arguing, among other things, that the proposed rule would exceed the SEC's statutory authority by encroaching on the substantive governance area traditionally left to the states. At least in part due to this opposition, the SEC cancelled a meeting that had been scheduled for November 9th (next Monday) and delayed final consideration of the proposal until 2010.

The bitter and continued opposition to this one SEC proposal suggests that the likelihood for any greater expansion of federal authority over corporate governance is small at best.

¹³ The shareholder access rule would have become operative only after the occurrence of one of two triggering events: if (1) at least one of the company's nominees for the board of directors had received "withhold" votes from more than 35% of the votes cast at an annual meeting of shareholders; or (2) a shareholder proposal providing that the company become subject to the shareholder nomination procedure had received more than 50% of the votes cast at a meeting. To be eligible to submit a nomination in accordance with the proposed rule, a shareholder or group of shareholders would, among other things, have been required to beneficially own more than 5% of the company's shares for at least two and even then would be permitted to nominate at most candidates for three board slots.

B. Should We Lament the Inability of the Federal Government to Exert a Greater Role in Corporate Governance?

Let me close today with one final question: should we lament the failure of the federal government to play a greater role in corporate governance regulation? In my view we should not. One of the benefits of the U.S. Federal system is the regulatory experimentation and innovation generated when the individual states compete with one another to develop the best regulatory scheme. It's certainly possible that the competition could, in some instances, lead to a "race for the bottom," as Professor Cary has argued, rather than a "race to the top." But at least in the area of corporate governance regulation, there appear to be adequate checks to prevent the states from getting too far out of line: the federal government can take direct control of certain matters as we saw in Sarbanes-Oxley, and the SEC has ample power to strongly influence corporate governance practices through its ability to adopt "shaming" regulation and through its considerable influence over securities exchanges (as we saw in the aftermath of the court's rejection of Rule 19c-4). Because of these checks, and because of Delaware's strong interest in avoiding the complete federalization of corporate law, I believe we have little to fear, and maybe something to gain, from continuing to allow the states to act as the primary standard setters in the corporate governance area.