UCLA LAW REVIEW

Reassessing the Distinction Between Corporate and Securities Law

James J. Park

ABSTRACT

Public companies in the United States must comply with both federal securities law and state corporate law. This division of labor is premised on the assumption that there is a meaningful distinction between securities and corporate law. The most common view is that securities law is characterized by its use of disclosure, while corporate law sets forth substantive requirements. Critics respond that securities law is really just a federal version of corporate law. They argue that the federal policy of investor protection justifies preempting state corporate law to address corporate mismanagement.

While investor protection concerns have been invoked as a reason for unifying corporate and securities law, this Article contends that corporate and securities law can be distinguished based on the type of protection they provide to investors. Both corporate and securities law serve to protect investors, but they do so at two different phases of the investment process. First, when purchasing or selling a stock, a trading investor is vulnerable to transacting at an unfair price. Second, during the period when an investor owns a stock, he is vulnerable to new corporate misconduct that reduces the value of the company. Simply put, securities law protects investors as traders while corporate law protects investors as owners.

Distinguishing between trading and ownership protection provides a strong basis for regulating securities and corporate law in different ways. Securities law is uniform and mandatory because investors have a common interest in fair valuation when trading. Corporate law is diverse and enabling because the ownership interests of investors are more difficult to reconcile.

AUTHOR

Professor of Law, UCLA School of Law. Thank you to Stephen Bainbridge, Joel Feuer, Sung Hui Kim, and participants at the Corporate and Securities Litigation Workshop, UC Irvine School of Law Business Law Colloquium, and UCLA School of Law Summer Works-in-Progress Workshop for their helpful comments. Thank you to Matthew Brodsky for excellent research assistance.

64 UCLA L. Rev. 116 (2017)

TABLE OF CONTENTS

Introduction 118
I. Securities Law as Federal Corporate Law 122
A. Investor Protection and Federal Corporate Law 123
B. Two Periods of Federal Corporate Law 125
1. Rule 10b-5 and the First Wave of Federal Corporate Law 126
2. The Second Wave of Federal Corporate Law 128
II. Two Ways of Distinguishing Between Corporate and Securities Law 131
A. Internal Affairs 131
B. Disclosure 134
III. Investor Protection and the Distinction Between Trading and Ownership 137
A. The *Birnbaum* Doctrine 137
B. Two Types of Investor Harm 141
C. Trading Protection and Ownership Protection 143
1. Securities Law as Trading Protection 143
a. Public Offering Regulation 143
b. Periodic Disclosure and Fraud on the Market 144
c. Regulation of Markets and Intermediaries 147
2. Corporate Law as Ownership Protection 148
a. Corporate Governance and Firm Value 148
b. Fiduciary Duties 149
c. Corporate Law Disclosure 151
d. Mergers and Acquisitions 153
e. Bondholders and Corporate Law 154
IV. Identifying Federal Corporate Law 155
A. Proxy Regulation 155
1. The Proxy Statement 157
2. Shareholder Proposals 158
B. Takeover Regulation 159
C. Mandatory Disclosure Requirements 163
1. Disclosure and Corporate Governance 163
2. Internal Controls 164
D. Board Regulation Through Exchange Listing Requirements 166
V. Foundation for a Two-Tiered Regulatory System 169
A. Uniform Protection of Trading Investors 169
1. Fair Valuation 169
2. Federal Securities Laws 170
B. Diverse Protection of Owners 172
1. The Divergence of Ownership Interests 172
2. Diversity and State Corporate Law 175
VI. Making Federal Corporate Law 179
Conclusion 182

INTRODUCTION

For some time, there has been a rough separation between corporate and securities law in the United States. According to the conventional account, securities law requires public companies to make disclosures to investors while corporate law sets forth substantive norms regulating the internal affairs of the corporation. This distinction provides the foundation for a dual regulatory system of federal securities law and state corporate law.[1]

The relationship between corporate and securities law has always been a close one,[2] and scholars over the years have debated whether this traditional divide should be maintained. One group claims that securities law is just a federal version of corporate law that can and should be expanded.[3] Another group argues that the federal securities laws are distinguished by their utilization of disclosure as a regulatory mechanism, and should not range into substantive regulation.[4] One commentator has described this exchange as "one of the longstanding and most contentious issues in the history of American securities regulation."[5] This Article reassesses the distinction between corporate and securities law, and offers a framework for defining the boundary between the two subjects.

1. Such dual regulation has been described as: "The Genius of American Corporate Law." *See generally* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).
2. *See, e.g.*, STUART BANNER, ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1680–1860, at 245 (1998) (noting that early securities litigation cases were considered to be part of corporate law); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 751 (2006) ("[T]he distinction between corporate law, whose goal is to reduce corporate agency costs, and securities regulation, the goal of which is to facilitate a competitive market for analysts, is not so clear.").
3. *See* Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons From History*, 106 COLUM. L. REV. 1793, 1813 (2006).
4. *See, e.g.*, Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 618–19 (1991) ("[T]he New Deal Congresses' rejection of a federal corporation law was probably the result of its satisfaction with the balance created by the securities laws. Federal law was to impose disclosure obligations, along with procedural and anti-fraud rules designed to make the disclosure requirements more effective. In contrast, corporate governance standards were left to the states.").
5. Donald C. Langevoort, *Seeking Sunlight in* Santa Fe*'s Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 450 (2001); *see also* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1110 (1995) ("Is securities regulation more properly part of corporate law (as it was for a long time in England) or a separate discipline?").

The traditional disclosure approach does not provide an adequate test for differentiating between corporate and securities law. Disclosure is not exclusive to securities law. Corporate law has long used disclosure obligations to regulate interested transactions and dealings with minority shareholders. Moreover, federal disclosure provisions often range into areas of corporate governance. For example, the securities law disclosure requirements regulating the solicitation of corporate proxies in connection with shareholder votes touch on what is surely a central corporate law issue. More recently, Congress has extended federal disclosure laws to regulate corporate law issues such as executive compensation.

The movement to unify corporate and securities law has largely been motivated by investor protection concerns. Because a primary goal of the federal securities laws is investor protection, there is a longstanding argument that such laws should preempt state corporate law to protect investors from corporate managers.[6] Just one year after the passage of the Securities Act of 1933, William Douglas, then a corporate law professor, argued in an article called *Protecting the Investor* that the Act should do more to regulate corporate misconduct.[7] Decades later, Professor William Cary argued that federal law should be expanded to protect "the real investors," the shareholders, from the manager-friendly regulation of Delaware corporate law.[8] In more recent years, the two federal statutes that have done the most to regulate corporate law, the Sarbanes Oxley Act (Sarbanes-Oxley) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),[9] have cited investor protection in expanding the federal securities laws over territory traditionally thought to be covered by state corporate law.

While investor protection has thus been cited as a reason to unify corporate and securities law, this Article contends that corporate and securities law can be distinguished based on the type of protection they provide to investors. The proponents of investor protection are correct in that both corporate and securities law protect investors, but the argument as currently formulated fails to differentiate between the ways in which investors need protection. A more

6. For an example of this argument, see Lucian Bebchuk, *The Disney Verdict and the Protection of Investors*, FIN. TIMES (Aug. 12, 2005); *see also* Luigi Zingales, *The Future of Securities Regulation*, 47 J. ACCT. RES. 391 (2009) (arguing that securities laws should shift to protecting investors from managers).

7. *See* William O. Douglas, *Protecting the Investor*, 23 YALE L. REV. 522 (1934).

8. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 699 (1974).

9. Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

nuanced conception of investor protection would distinguish between two phases of the typical investment decision. The first relates to the purchase (or sale) of the security, where the trading investor is primarily concerned about paying (or receiving) a fair price. The second relates to the period when the investor owns the security and is vulnerable to new corporate misconduct that reduces the value of the security.

Simply put, securities law protects the investor while he is a trader, and corporate law protects the investor while he is an owner. Disaggregating investor protection into trading protection and ownership protection, I will argue, is a better way of framing the difference between securities and corporate law than the traditional disclosure approach. The goal of the securities laws is not to protect investors in all aspects of their decisionmaking, but mainly with respect to their trading decisions. Two initial examples more concretely illustrate this approach.

Consider a private company selling securities to the public for the first time. Investors will certainly be concerned about the company's governance in valuing the company. However, at this point, corporate law does not give investors a direct legal method for requiring the founding management of the company to adopt strong corporate governance measures. Because the public does not yet own shares, a poor governance structure will not harm the value of their investment if it is properly disclosed prior to their purchase. With truthful disclosure, investors will buy the stock at a valuation that reflects the risks associated with the investment, including that of weak corporate governance. Securities law in regulating such offerings thus exclusively protects the interests of investors as traders.

After investors become owners of a company, they are vulnerable to subsequent value-reducing decisions by managers. The stock may be correctly priced at the time of purchase, but later on, managerial conduct may change in ways unanticipated by the market. Consider the case of a manager who is honest at the time when an investor buys stock, but then has an unexpected midlife crisis several years after the investor's transaction. He decides to secretly divert corporate funds to an entity he personally controls. Because the market did not anticipate this misconduct, the stock price did not reflect this risk at the time the investor purchased the stock. That investor now owns an investment that is worth less because of the misconduct. Securities law does not provide a remedy to the investor for losses caused by such midstream conduct. Instead, shareholder-owners have the exclusive right to bring a corporate law derivative suit on behalf of the corporation to recover those funds.

Corporate law thus provides continuing protection to owners not provided by the securities laws.

The idea that securities law can be distinguished by its focus on trading is consistent with a once prominent judicial rule, the *Birnbaum* doctrine. In *Birnbaum v. Newport Steel Corp.*,[10] the Second Circuit ruled that only purchasers and sellers of securities can bring suit under Rule 10b-5,[11] the primary antifraud provision of the securities laws. In Rule 10b-5's early years, courts often used the *Birnbaum* rule to thwart attempts to extend Rule 10b-5 to recover for damages arising out of poor corporate governance mainly affecting shareholder-owners. The U.S. Supreme Court adopted the *Birnbaum* doctrine in *Blue Chip Stamps v. Manor Drug Stores*,[12] but it did not fully appreciate the doctrine's implications for the boundary between corporate and securities law.

One immediate payoff of this Article's analysis is that it offers a way of distinguishing between corporate law and securities law disclosure. While securities law disclosure serves to ensure that trading valuations are fair, corporate law disclosure largely facilitates the ability of shareholder-owners to exercise control over corporate governance in order to ensure the company is managed to maximize their wealth. Thus, some disclosure provisions contained in the securities laws are better thought of as federal corporate law because they relate to the exercise of ownership rights.

Differentiating between the trading and ownership phases of an investment provides a basis for distinguishing between the regulatory objectives of corporate and securities law. Securities law is primarily concerned with facilitating fair valuation. By protecting investors when trading, securities law encourages the formation of robust trading markets. In contrast, it is more difficult to identify a single policy goal for corporate law. The interests of investors as owners exhibit less uniformity than when they are traders. For example, short-term owners may want corporate law to provide avenues for pressuring managers to achieve immediate results, while long-term owners may prefer corporate law to shield managers from such pressure.

This Article's reframing of the distinction between corporate and securities law thus provides a justification for our two-tiered system for regulating public corporations. Securities law relies upon mandatory, uniform rules because of the unified interests of trading investors in fair valuation. Corporate law is characterized by greater flexibility and diversity because of the

10. 193 F.2d 461 (2d Cir. 1952).
11. 17 C.F.R. § 240.10b-5 (2015).
12. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975).

competing interests of shareholder-owners. Federal regulation of securities has been successful because it has facilitated the creation of a market that generates fair prices. The most significant creator of state corporate law, Delaware, has been successful in part because of its investment in judges who can ably balance the interests of long-term and short-term owners.

Drawing upon this analysis, the Article concludes by proposing a test for assessing the regulation of corporate law through federal law. Federal corporate law is only appropriate when: (1) there is strong evidence that uniform regulation will benefit shareholder-owners; and (2) the law in question does not disproportionately benefit one group of owners over others.

This Article is divided into six parts. Part I describes arguments for expanding securities law to protect investors from corporate mismanagement. Part II discusses the limitations of the current approaches to differentiating between corporate and securities law. Part III argues that investor protection should distinguish between the trading and ownership phases of an investment, and that securities law protects traders while corporate law protects owners. Part IV uses this framework to identify which elements of the securities laws are federal corporate law. Part V contends that the relative uniformity of investor trading interests and diversity of investor ownership interests explain why securities and corporate law have been regulated in different ways. Part VI offers a new approach to assessing federal corporate law.

I. SECURITIES LAW AS FEDERAL CORPORATE LAW

Congress named the two statutes it passed in 1933 and 1934 securities laws,[13] but they have often been called federal corporate law.[14] If the securities laws are essentially corporate law, there is a stronger argument for expanding federal statutes to regulate other corporate law issues. Such preemption is often justified on investor protection grounds. If the federal securities laws are about protecting investors, perhaps they should protect investors from corporate mismanagement. Part I.A shows how a broad conception of investor protection has been used to argue that there is no meaningful distinction

13. Professors Pritchard and Thompson classify other federal statutes passed in this time period such as the Public Utility Holding Company Act of 1935 as part of the securities laws. *See* A.C. Pritchard & Robert B. Thompson, *Securities Law and the New Deal Justices*, 95 VA. L. REV. 841, 844–45 (2009). However, the 1933 and 1934 Acts are the primary securities laws regulating public corporations and contain the core of what is understood to be securities regulation today.

14. *See* Bebchuck & Hamdani, *supra* note 3.

between corporate and securities law. Part I.B describes two major periods in which the argument for federal corporate law gained traction.

A. Investor Protection and Federal Corporate Law

The primary goal of the federal securities laws is to protect investors. For example, Section 10(b) of the Securities Exchange Act of 1934 permits the Securities and Exchange Commission (SEC) to pass antifraud rules "in connection with the purchase or sale of any security" that are "necessary or appropriate . . . for the protection of investors."[15] The phrase "investor protection" is a central part of securities regulation, but it is a phrase that is often used without much precision.[16]

Critics of state corporate law have long used a broad reading of investor protection to justify expanding the federal securities laws to fix corporate law that may favor managers.[17] As noted earlier, Professor William Douglas argued that the Securities Act of 1933 did not adequately fulfill its investor protection goal.[18] Rather than solely protecting investors in the context of securities sales, he argued that securities laws should also govern "the relation of investors to . . . management."[19] Douglas thus proposed various reforms including "federal incorporation" to build "such solid bases for protection of

---

15. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2012). Many other sections of the securities laws explicitly refer to investor protection. *See* Securities Act of 1933 § 7, 15 U.S.C. § 77g (2012); Securities Exchange Act of 1934 § 12(b), 15 U.S.C. § 78l(b) (2012); National Securities Markets Improvement Act of 1996 § 106, 15 U.S.C. § 77b (2012); *see also* Michael D. Guttentag, *Protection From What? Investor Protection and the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 207, 212 (2013) (noting that the securities laws mention the phrase investor protection over two hundred times).
16. *See, e.g.*, Yoon-Ho Alex Lee, *The Efficiency Criterion for Securities Regulation: Investor Welfare or Total Surplus?*, 57 ARIZ. L. REV. 85, 104 (2015) (observing that "investor protection is not itself a well-defined concept"). Some modern scholars have defined the investor protection goals of the securities laws broadly. *See, e.g.*, Guttentag, *supra* note 15, at 210 (stating that securities regulation includes protection of investors from "the extraction of private benefits from the firm by firm insiders"). Others have defined it narrowly. *See, e.g.*, REINEIR KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 275 (2d ed. 2009) (defining investor protection as "legal support for investors in the public trading markets").
17. *See, e.g.*, David S. Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations—Standing to Sue Under Rule 10b-5*, 26 BUS. LAW. 1289, 1290 (1971) ("The suggestion that federal law should protect corporate shareholders runs counter to current trends in state corporate rule making, since recent changes in the Delaware Corporation Law allow management to make fundamental corporate decisions without minority shareholder interference.").
18. Douglas, *supra* note 7.
19. *Id.* at 533.

investors as to make the [Securities Act] wholly insignificant."[20] For the future SEC Chairman and Supreme Court Justice, the precedent of a statute protecting investors with respect to securities sales could be extended to protect investors from a broader range of corporate misconduct.

Over the years, other scholars have argued that investor protection justifies collapsing the boundary between corporate and securities law. In his well-known critique of Delaware corporate law, another law professor who served as SEC Chairman, Professor William Cary, argued that federal law should be expanded to "protect the real investors, those who own the stock of corporations."[21] Professor Ralph Winter accepted this framework in responding to Cary, arguing that "it is not in the interest of management to seek out a corporate legal system which fails to protect investors . . . ."[22] Other commentators have more recently noted that the primary role of corporate law is to mediate the relationship between managers and investors.[23]

In modern times, financial economists have emphasized the concept of investor protection as the major policy goal of corporate law. For example, one article, *Investor Protection and Corporate Governance*, asserts that "[c]orporate governance is, to a large extent, a set of mechanisms through which outside investors protect themselves against expropriation by the insiders."[24] Another article studying whether countries with strong investor protection laws have higher growth rates relied on a similarly broad definition. It classified "[c]ompany laws . . . concerned with . . . the legal relations between corporate insiders . . . and the corporation itself" as law "pertaining to investor protection."[25] The increasing influence of financial economics on corporate

---

20. *Id.*
21. Cary, *supra* note 8.
22. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 276 (1977).
23. *See, e.g.*, Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 547 (1990) (defining corporate law as "laws . . . that primarily govern the relationship between a company's managers and investors"); Chris Brummer, *Corporate Law Preemption in an Age of Global Capital Markets*, 81 S. CAL. L. REV. 1067, 1074 (2008) (noting that both corporate and securities law "ultimately concern core matters of investor protection").
24. Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 4 (2000); *see also* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 737 (1997) (noting that "[c]orporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment").
25. *See* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1120 (1998); *see also* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 526 (2001) ("Investor protection in U.S. firms varies according to the firm's state of incorporation.").

and securities law scholarship could contribute to the tendency of legal scholars to de-emphasize traditional legal categories in favor of the view that the two subjects are functionally the same.

Skepticism about whether there is a meaningful distinction between corporate and securities law is not limited to those who favor strong federal regulation. Professor Roberta Romano agrees with the proponents of federal corporate law that securities and corporate law are substantially the same, but argues that it is securities law that should be changed to look more like corporate law.[26] If state competition for corporate charters leads to a "race to the top," and securities law is really just another type of corporate law, state regulation of securities law might unleash a similar dynamic.[27] The essential question is whether the mandatory disclosure and fraud prohibition policies that are at the heart of the federal securities laws differ in material ways from corporate law. For Professor Romano, there is no substantial difference in that disclosure is like "an officer's or director's judgment concerning a corporate transaction, such as payment of a dividend or undertaking a merger . . . ."[28] Both skeptics and supporters of corporate law federalism have thus concluded that corporate law and securities regulation are essentially the same.

B. Two Periods of Federal Corporate Law

Since the passage of the federal securities laws, there have been two major efforts to expand federal regulation of corporate law. In the first, plaintiffs used a federal securities rule, Rule 10b-5, to challenge a broad range of corporate misconduct. This phase came mostly to an end with the Supreme Court's decision in *Santa Fe Industries, Inc. v. Green*.[29] The second began with the wave of corporate frauds that resulted in the passage of Sarbanes-Oxley.

---

26. *See* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2404–05 (1998).
27. Professor David Skeel makes a similar argument with respect to bankruptcy law. He claims that the "artificial separation of state corporate law and federal corporate bankruptcy has undermined both areas of law," and that states should regulate most aspects of bankruptcy law. David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 474 (1994).
28. Romano, *supra* note 26, at 2404.
29. 430 U.S. 462 (1977).

1. Rule 10b-5 and the First Wave of Federal Corporate Law

During the early years of federal securities litigation, plaintiffs contested the boundary between corporate and securities law by arguing for a broad reading of Section 10(b) of the Securities Exchange Act of 1934 and its implementing rule, Rule 10b-5.[30] These laws mainly target misrepresentations that induce investors to purchase securities at inflated prices. The concept of fraud, though, is a broad one and could conceivably reach misconduct that does not involve an explicit falsehood. An expansive argument can be made that corporate wrongdoing harms investors, reduces the value of securities, and thus should be considered to be securities fraud. By proceeding federally, plaintiffs could avoid state corporate law protecting corporate managers such as the business judgment rule and the requirement of making a demand on the board prior to filing suit.

Some courts and scholars accepted this argument, citing investor protection to conclude that Rule 10b-5 covers many forms of corporate misconduct.[31] One circuit court declared in 1961 that the Securities Exchange Act "deals with the protection of investors" and that "[s]ection 10(b) imposes broad fiduciary duties on management vis-à-vis the corporation and its individual stockholders."[32] Defending these developments, a 1965 *Harvard Law Review* article referred to these cases as a "Federal Corporation Law."[33] The article contended

30. *See* 15 U.S.C. § 78j(b) (2012); 17 C.F.R. § 240.10b-5 (2015).
31. *See, e.g.*, Lewis D. Lowenfels, *The Demise of the* Birnbaum *Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268, 277 (1968) (arguing that expansion of Rule 10b-5 to cover corporate law "will help . . . effectuate the central purpose underlying securities regulation—the protection of the investing public").
32. McClure v. Borne Chem. Co., 292 F.2d 824, 834 (3d Cir. 1961); *see also* Popkin v. Bishop, 464 F.2d 714, 718 (2d Cir. 1972) ("[T]his court has recognized that Rule 10b-5 reaches beyond traditional stock transactions and into the board rooms of corporations."); Richard W. Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991, 1021 (1976) ("Rule 10b-5 and Section 14(a) now provide effective legal controls for the correction of internal corporate mismanagement which directly injures the corporation, whether or not by means of a securities transaction.").
33. Arthur Fleischer, Jr., *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146, 1148 (1965) ("It is the thesis of this article that the growth of federal law in the corporate area is sound and consistent with the scope and purposes of the securities laws and that the critics' attacks are misdirected."); *see also In re* Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961) ("[T]he securities acts may be said to have generated a wholly new and far-reaching body of Federal corporation law."). Judge Henry Friendly acknowledged these developments in a famous article but expressed a more skeptical view. *See* Henry J. Friendly, *In Praise of* Erie—*And of the New Federal Common Law*, 39 N.Y.U. L. REV. 383, 413 (1964) ("Although there are serious problems as to the desirability and scope of such a statute and I should not expect one to be enacted tomorrow, significant steps towards the development of a federal common law of

that Rule 10b-5 was not the only example of federal corporate law, but that it "has always existed—since the passage of the Securities Act of 1933."[34] The phrase "federal corporate law" became a common part of the academic literature on Rule 10b-5.[35] Many scholars were supportive, with one author declaring in a 1971 article that "the new Federal Law of Corporate Fiduciary Relations is being created by the federal judiciary, not by Congress."[36]

This use of Rule 10b-5 suits to remedy breaches of fiduciary duties was significantly set back by the Supreme Court's 1977 decision in *Santa Fe Industries, Inc. v. Green*.[37] In that case, shareholders with a minority stake in a subsidiary corporation challenged a short-form merger where the parent corporation was permitted under Delaware law to purchase the minority's shares without their consent.[38] While state law provided an appraisal remedy for shareholders who believed they did not receive fair value, the plaintiffs instead brought federal claims under Rule 10b-5 arguing that the parent's purchase of their shares was motivated by an improper purpose and the price they received was inadequate. The parties agreed that there was no "omission" or "misstatement" accompanying the notice of the merger. The plaintiffs thus based their claim solely on an alleged breach of fiduciary duty.[39] Consistent with the view of some scholars,[40] the lower appellate court found that the rule covered "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure."[41]

corporate responsibility have already been taken by implying causes of action from and filling interstices in laws administered by the SEC.").

34. Fleischer, *supra* note 33, at 1179.

35. *See, e.g.*, Stanley A. Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433, 476–77 (1968) ("[T]here has been an extraordinarily rapid burgeoning of so-called 'federal common law of corporations,' based upon implied civil liability under section 10(b) of the Securities Exchange Act of 1934; this law is pervading, and all but absorbing, a large portion of internal fiduciary obligations."); Lowenfels, *supra* note 31, at 268 (observing that since creation of a private right of action under Rule 10b-5, "a vast body of federal corporate common law has mushroomed under [Section 10(b) and Rule 10b-5]"); Donald E. Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L.J. 71, 81 (1972) ("Mainly as an interpretation of the SEC's rule 10b-5, courts have created a federal common law of corporations to advance shareholder rights.").

36. Ruder, *supra* note 17, at 1292.

37. 430 U.S. 462 (1977).

38. *Id.* at 465.

39. *Id.* at 473–74.

40. *See, e.g.*, Thomas J. Sherrard, *Fiduciaries and Fairness Under Rule 10b-5*, 29 VAND. L. REV. 1385, 1402 (1976) (arguing that "proof of deception" should not be a requirement in Rule 10b-5 cases against a controlling shareholder).

41. *Green*, 430 U.S. at 470 (quoting Green v. Santa Fe Indus., 533 F.2d 1283, 1287 (1976)).

The Supreme Court reversed on the ground that a "breach of fiduciary duty" does not violate Rule 10b-5 without "any deception, misrepresentation, or nondisclosure . . . ."[42] In doing so, it set forth what is now the standard approach to distinguishing between securities law and corporate law. According to the Court, securities law is based on a "philosophy of full disclosure,"[43] while corporate law is about the "internal affairs of the corporation."[44] The Court observed that there were policy reasons for maintaining the line between securities and corporate law. The states had "traditionally" regulated a "wide variety of corporate conduct,"[45] and the "extension of the federal securities laws" might "interfere with state corporate law."[46]

The Court's decision in *Santa Fe Industries* has been widely recognized as the primary case setting the boundary between securities and corporate law. At least one Delaware judge believes that *Santa Fe Industries* enabled Delaware to cement its reputation as a leading source of corporate law.[47] For critics of *Santa Fe Industries*, the case is a tool used by courts that want a "world of weak federal corporate law."[48] After *Santa Fe Industries*, plaintiffs were limited in their ability to challenge corporate misconduct through federal Rule 10b-5.

2. The Second Wave of Federal Corporate Law

The idea that securities law is federal corporate law continued to have its proponents after *Santa Fe Industries*,[49] but it was not until the early 2000s that there was another attempt to significantly expand federal corporate law.

Over the years, the SEC has often promoted good corporate governance in the name of investor protection.[50] During the 1980s, the SEC campaigned

42. *Id.* at 476.
43. *Id.* at 477 (quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972)).
44. *Id.* at 479 (quoting Cort v. Ash, 422 U.S. 66, 84 (1975)).
45. *Id.* at 478.
46. *Id.* at 479.
47. Jack B. Jacobs, *"Patient Capital": Can Delaware Corporate Law Help Revive It?*, 68 WASH. & LEE L. REV. 1645, 1648 (2011) ("Not until 1977 was this creeping federalization of corporate law abruptly reversed by the U.S. Supreme Court's decision in *Santa Fe Industries, Inc. v. Green*.").
48. Langevoort, *supra* note 5, at 475.
49. *See, e.g.*, Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1485 (1989) ("[C]orporation law taken as a whole—that is, taken to include state law and federal law, and the rules of the New York Stock Exchange as a de facto legislator . . . contains a significant number of core mandatory rules that govern the divergencies of interest between top managers and shareholders.").
50. In the words of a skeptical former Securities and Exchange Commission (SEC) Commissioner, the SEC has always "aspired to regulate corporate governance." Roberta S.

against various state corporate law statutes governing takeovers on the ground that such statutes harmed investors.[51] The SEC also justified an effort to prohibit companies listed on an exchange from creating dual classes of stock on investor protection grounds.[52]

Beginning in the mid-1990s, some scholars reemphasized the link between federal securities fraud litigation and corporate governance. Unlike earlier times when Rule 10b-5 was seen as ranging over many areas of corporate law, the new proponents of federal corporate litigation focused specifically on the corporate law duty of care as the main area of overlap. Because poor corporate governance is often accompanied by a failure to disclose acts of mismanagement, securities fraud claims will often target corporate misconduct.

This argument emerged in part as a response to persistent concerns about what some saw as frivolous securities litigation. Defenders of the often-criticized federal securities class action argued that such actions can serve to check corporate misconduct. Writing a few years before the passage of the Private Securities Litigation Reform Act in 1995, which imposed procedural limits on securities class actions, Professor Joel Seligman referred to a "New Corporate Law" created by federal securities litigation.[53] In an article written a decade later, Professors Robert Thompson and Hillary Sale reported that "federal securities laws and enforcement via securities fraud class actions today have become the most visible means of regulating corporate governance."[54]

The investor protection argument for federal corporate law reemerged with great force after the scandals of Enron and WorldCom, which helped prompt the passage of Sarbanes-Oxley.[55] The preamble to Sarbanes-Oxley describes the Act as a law "[t]o protect investors by improving the accuracy

Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 80 (2005).

51. *See, e.g.*, Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862, 1919 (1989) ("In the name of 'investor protection,' the SEC . . . [is] now engaged in a campaign on behalf of hostile takeover activity and . . . on behalf of a decisive federal role in displacing state law on the most divisive corporation law and policy issue in recent memory.").
52. *See* Bainbridge, *supra* note 4, at 595–97.
53. Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 60 (1993) ("[S]ecurities fraud claims, in fact, are often based on conduct that is the equivalent to a state law fiduciary duty violation regardless of the formal pleading requirements of a federal securities law cause of action.").
54. Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 860 (2003).
55. Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002).

and reliability of corporate disclosures . . . ."[56] In describing provisions "aimed at corporate management," the Committee on Banking, Housing, and Urban Affairs noted that Sarbanes-Oxley would "improve investor protection in connection with the operation of public companies."[57]

Soon after, Professors Lucian Bebchuk and Assaf Hamdani described the passage of Sarbanes-Oxley and earlier securities laws as "Federal Corporate Law."[58] They argued that the federal securities laws set a precedent for "mandatory rules" with respect to a "subset" of corporate law issues and "the debate has been about whether this subset of issues should be expanded or contracted."[59] Professor Mark Roe also downplayed the idea of a dual regulatory system by characterizing state corporate law as operating under the shadow of federal law. Because federal authorities could easily preempt state corporate law, states cannot stray too far from federal norms of investor protection. Professor Roe thus refers to "vast parts of the securities laws" as "functionally part of America's corporate law."[60] Just as Professor Cary argued that federal law should replace state regulation of corporate law, a new generation of scholars contended there is little reason to maintain a distinction between corporate and securities law.

In the decade or so after the passage of Sarbanes-Oxley, the investor protection argument has had staying power. The Dodd-Frank Act, which Congress passed after the financial turmoil following the collapse of the housing market, added a number of corporate governance provisions to the securities laws. Tellingly, many of these new requirements are contained in a section called "Investor Protections and Improvements to the Regulation of Securities."[61]

56. *Id.* One prominent scholar has noted that the Act is "about investor protection and should be evaluated as such." Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1828 (2007).

57. REPORT OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, S. REP. NO. 107-205, at 23 (2002).

58. Bebchuk & Hamdani, *supra* note 3, at 1813 ("Federal regulation of corporate affairs has been most salient in the area of mandatory disclosure by public companies.").

59. Lucian Ayre Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553, 608 (2002); *see also* Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1606 (2005) ("[C]orporate law rules adopted through the federal securities laws are enforced publicly, either on an exclusive basis or concurrent with private enforcement.").

60. Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2498 (2005).

61. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1381, 1899 (2010); *see also* The Monitor, *Bank Regulation*, 29 BANKING & FIN. SERV. POL'Y REP. 22 (2010) (noting that Dodd-Frank requires banks to "institute numerous investor protections, including . . . shareholder 'say on pay'").

After times of significant investor losses, it should not be surprising that investor protection arguments for abandoning the distinction between corporate and securities law have gained momentum. While *Santa Fe Industries* temporarily slowed the push for federal corporate law, Sarbanes-Oxley ushered in a new era of federal intervention.

II. Two Ways of Distinguishing Between Corporate and Securities Law

As did the Supreme Court in *Santa Fe Industries*, courts and commentators have marked the boundary between corporate and securities law in two ways. The first is the internal affairs doctrine. Corporate law is said to govern the internal affairs of the corporation while securities law is concerned with external affairs. The second is disclosure. Securities law consists of disclosure requirements while corporate law deals with substantive regulation. This Part reviews these two approaches and discusses their limitations. It concludes that neither approach offers a compelling response to the investor protection argument to unify corporate and securities law.

A. Internal Affairs

It has long been settled in the United States that the internal affairs of a corporation are regulated by the state where it is incorporated. This doctrine allows a corporation to choose one set of corporate law rules rather than being subject to the law of any state or country where it may operate.[62] While it is well established, the line distinguishing internal and external affairs is difficult to precisely define, leaving it as a porous boundary between corporate and securities law.

The internal affairs doctrine serves a compelling purpose in the context of interstate choice-of-law. Corporate law would be unworkable if the law of each of the fifty states defined a corporation's governance rules. For example, if one state requires majority voting on an issue while another state requires

62. One version of the internal affairs doctrine is set forth in the Model Business Corporation Act:

> A foreign corporation shall not be denied a certificate of authority by reason of the fact that the laws of the state or country under which such corporation is organized governing its organization and internal affairs differs from the laws of this State, and nothing in this Act contained shall be construed to authorize this State to regulate the organization of the internal affairs of such corporation.

Model Bus. Corp. Act § 15.06 (2010).

super-majority voting, a corporation with contacts in both states needs a way to resolve which rule applies. Designating the state of incorporation as providing the governing rule provides a clear answer to the choice-of-law issue.[63]

The rough division between internal and external affairs has served as a potential limit to the reach of the federal securities laws. As the Supreme Court noted in 1971, "[w]e agree that Congress by § 10 (b) did not seek to regulate transactions . . . [that are] no more than internal corporate mismanagement."[64] The Court reemphasized this point in *Santa Fe Industries*, declaring that "except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."[65] In recent years, scholars have cited the doctrine as a means of differentiating state corporate law and federal securities law. As Professors William Bratton and Joseph McCahery note, "under the prevailing norm, national regulation covers the securities markets and mandates transparency respecting firms with publicly traded securities, while internal corporate affairs are left to the states."[66] Professor Roe observes that "[t]he line dividing internal and external is surely not bright, but the distinction has been important in defining the national and state spheres of corporate lawmaking."[67]

While it serves as a rhetorical boundary, the internal affairs doctrine is too vaguely defined to separate corporate and securities law. The most common formulation broadly asks whether the issue relates to "the relationships among or between the corporation and its officers, directors, and shareholders."[68] Defined in this way, the doctrine straddles both corporate

63. The internal affairs doctrine is not routinely contested between states, especially with respect to public corporations, but there are cases where states with strong regulatory preferences try to impose their corporate law on corporations formed in other states. *See, e.g.*, Vantagepoint Venture Partners v. Examen, Inc., 871 A.2d 1108 (Del. 2005) (finding that a Delaware corporation was not required to apply a California voting rights rule); *see also* Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 45 (2006) (tracing origins of internal affairs doctrine to assertions of state sovereignty over foreign corporations).

64. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

65. Santa Fe Indus. v. Green, 430 U.S. 462, 479 (1977) (quoting Cort v. Ash, 422 U.S. 66, 84 (1975)).

66. William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 620 (2006).

67. Roe, *supra* note 60, at 2538.

68. Vantagepoint, 871 A.2d at 1113; *see also* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 313 (AM. LAW INST. 1971) ("[A] corporation's internal affairs are involved whenever the issue concerns the relations inter se of the corporation, its shareholders, directors, officers or agents . . . ."); ROMANO, *supra* note 1, at 1 ("[C]orporate law, which concerns the relation between a firm's shareholders and managers, is largely a matter for the states."); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 460 (2004)

and securities law. The relationship between the corporation and its shareholders could conceivably encompass securities law issues such as the sale of securities and the regulation of periodic disclosure.[69] If securities law is meant to protect investors, it might be said that it touches on the relationship between shareholders and management.

More importantly, the doctrine fails to provide a compelling reason for limiting federal regulation of internal affairs. Other than the need for clarity when equal sovereigns attempt to regulate the same corporation, the internal affairs doctrine does not provide a principle that would justify its application. This lack of guidance becomes problematic when the federal government invokes an important policy reason such as investor protection to justify intervention. Moreover, the goal of providing a clear answer to corporate law choice-of-law questions could be as easily achieved by adopting a uniform federal standard.

Because of its vagueness, the internal affairs doctrine is an ineffective barrier to federalization of state corporate law. The internal affairs doctrine may have been adequate to prevent states from regulating the governance of corporations chartered elsewhere, but it has proven too weak to resist the federal government when it seeks to protect investors. Without a robust theory for distinguishing between corporate and securities law, the internal affairs doctrine is largely impotent in the wake of pressures to create a federal corporate law.

("The term 'corporate governance' is widely used to refer to the balance of power between officers, directors, and shareholders."). Another formulation has been whether the law governs "those intimately involved with the management of the corporation." McDermott Inc. v. Lewis, 531 A.2d 206, 218 (Del. 1987). Other attempts have avoided the articulation of a unifying test and simply list issues that might fall within the category of internal affairs. RESTATEMENT (SECOND) OF CONFLICT OF LAWS, *supra*, § 302 cmt. a.

69. *See, e.g.*, Winter, *supra* note 22, at 252 (describing the "relationship of the shareholders to management" as subject to "federal securities law"). Commentators differ with respect to whether the sale of securities would be considered an internal affair. *Compare id.* at 253 (noting that transfer of shares is not an internal affair), *with* Jack B. Jacobs, *The Reach of State Corporate Law Beyond State Borders: Reflections Upon Federalism*, 84 N.Y.U. L. REV. 1149, 1150 (2009) ("By 'corporate law,' I mean state statutes and judicial decisions that regulate matters such as forming a corporation, the powers and duties of (and relationships among) officers and directors, the rights of stockholders, the corporate decisionmaking process, raising capital by issuing stock and other securities, corporate elections, corporate mergers, sales of assets, and the like.").

B. Disclosure

While corporate law has been defined by the internal affairs doctrine, federal securities law has been distinguished by its reliance on disclosure as its primary regulatory mechanism.[70] According to the conventional account, rather than judging the merit of investments, modern securities law is characterized by the requirement that public companies provide investors with sufficient information to make an informed decision. Corporate law, in contrast, sets forth substantive rules such as duties of care and loyalty.[71] More and more, however, disclosure obligations are being expanded in a way to implement corporate law reforms, blurring the line between corporate and securities law.[72]

Initially, the disclosure element of the federal securities laws was emphasized to distinguish their regulatory approach from the merit regulation practiced by many states beginning in the early years of the twentieth century.[73] The typical approach of state securities law (often referred to as Blue Sky Law) was to

70. Karmel, *supra* note 50, at 80 ("The federal securities laws generally have been considered full disclosure statutes, as opposed to merit regulation statutes or laws governing the internal affairs of corporations."); William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 973 (2003) ("[T]he division between the two governmental authorities has given primary responsibility for fair disclosure and securities market regulation to the federal government, principally through the SEC. State law has retained the substantive regulation of corporate transactions and board conduct."); *see also* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963) (noting that federal securities laws "substitute a philosophy of full disclosure for the philosophy of *caveat emptor*"); Amanda Acquisition Corp. v. Universal Food Corp., 877 F.2d 496, 503 (7th Cir. 1989) ("Federal securities laws frequently regulate process while state corporate law regulates substance."); Troy A. Paredes, Commissioner, U.S. Securities and Exchange Commission, Speech by SEC Commissioner: Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Director Nominations ("Proxy Access") (Aug. 25, 2010), http://www.sec.gov/news/speech/2010/spch082510tap.htm [https://perma.cc/DZ43-9Q5T] (describing disclosure as a principle limiting securities laws so "that the government will not engage in more direct substantive regulation of corporate affairs but instead will defer to shareholders to evaluate the substance of how companies are organized and run").

71. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005) ("The federal regime had until [Sarbanes-Oxley] consisted primarily of disclosure requirements rather than substantive corporate governance mandates, which were traditionally left to state corporate law.").

72. *See, e.g.*, Daniel M. Gallagher, Commissioner, Remarks at the 26th Annual Corporate Law Institute, Tulane University Law School: Federal Preemption of State Corporate Governance (Mar. 27, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370541315952#.U7TueE1Ovjo [https://perma.cc/AK7L-RWCD] (claiming that some Dodd-Frank provisions "masquerade as disclosure, but are in reality attempts to affect substantive behavior through disclosure regulation").

73. *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 393 (1991) (contrasting disclosure approach with merit-based regulation).

assess whether certain securities were worthy of investment before they were offered to the public. Such "merit regulation differs from disclosure regulation in its direct regulation of the internal structure of a securities issuer, of the relations among insiders and outsiders, and of the terms of the offering."[74]

The courts have consistently highlighted disclosure as a way of distinguishing securities law from corporate law. As noted earlier, in *Santa Fe Industries*,[75] the Supreme Court found that Rule 10b-5 did not apply when the plaintiffs conceded that they received full disclosure of the challenged transaction.[76] Without a disclosure violation, the matter was a fiduciary duty claim governed by state corporate law. In the 1990 case *Business Roundtable v. SEC*,[77] the U.S. Court of Appeals for the D.C. Circuit struck down an SEC regulation prohibiting public companies from issuing a new class of stock with superior voting rights.[78] In doing so, it relied upon the fact that the regulation went "so far beyond matters of disclosure" to regulate an area "that is concededly a part of corporate governance traditionally left to the states."[79]

Corporate and securities law experts have generally accepted the distinction between disclosure and substantive regulation. Professor Romano notes in criticizing Sarbanes-Oxley that its federal corporate law provisions would not have intruded on the traditional role of the states had they "been formulated as disclosure mandates."[80] The leading *Loss, Seligman, and Paredes* treatise observes that the "substantive provisions" of proxy and tender offer regulation "amount to federal corporation law."[81]

74. The Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 829 (1986).
75. Santa Fe Indus. v. Green, 430 U.S. 462 (1977).
76. *Santa Fe Industries* left unclear whether certain types of nondisclosure would trigger Rule 10b-5. The failure to disclose a breach of fiduciary duty could be characterized as fraudulent. *See, e.g.*, Langevoort, *supra* note 5, at 451 ("There are not many instances of governance abuse that are disclosed with compete candor. Hidden breaches of fiduciary obligation can almost always be characterized in terms of fraud or misrepresentation."). However, a conclusory allegation that defendants failed to disclose they were breaching their fiduciary duties is insufficient. *See* Biesenbach v. Guenther, 588 F.2d 400, 402 (3d Cir. 1978). On the other hand, if the nondisclosure prevents minority shareholders from asserting a state remedy for a breach of fiduciary duty, they may have a claim under Rule 10b-5. *See* Goldberg v. Meridor, 567 F.2d 209, 220–21 (2d Cir. 1977).
77. 905 F.2d 406 (D.C. Cir. 1990).
78. *Id.* at 408.
79. *Id.*
80. Romano, *supra* note 71, at 1527.
81. LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, 2 FUNDAMENTALS OF SECURITIES REGULATION 849 (6th ed. 2011).

But disclosure is a problematic way of defining the essence of securities law. Securities regulation often goes beyond disclosure. The Securities Exchange Act of 1934 deploys substantive law in regulating public markets.[82] Stock exchanges are required to ensure that their members adhere to "just and equitable principles of trade."[83] Market participants are governed by anti-manipulation rules that impose substantive restrictions such as the prohibition of wash trades.[84] The securities laws prohibit the securities industry from charging fixed commissions to customers.[85] Finally, as noted earlier, state securities law used substantive merit regulation in policing the sale of securities.

Moreover, not all federal disclosure requirements are easily viewed as securities law. Federal proxy rules have long required disclosure relating to corporate voting, a key mechanism of corporate governance. More recently, disclosure is increasingly used as a method for influencing corporate affairs.[86] For example, Dodd-Frank seeks to regulate corporate governance by requiring public companies to disclose whether or not they split the offices of Chairman and Chief Executive Officer (CEO),[87] and by requiring such companies to describe the relationship between the compensation they pay their executives and firm performance.[88]

Disclosure as a regulatory tool is not unique to the securities laws. State corporate law often sets forth significant disclosure requirements. Delaware courts have held that corporate fiduciary law imposes a duty to disclose on boards.[89] There are disclosure requirements that govern interested transactions between executives and the corporation.[90] Disclosure obligations

82. *See, e.g.*, Steve Thel, *The Original Conception of Section 10(b) of the Exchange Act*, 42 STAN. L. REV. 385, 390 (1990) ("Most of the [Exchange] Act concerns market regulation and has little to do with disclosure.").
83. Securities Exchange Act § 6(b)(5), 15 U.S.C. § 78(f) (2012).
84. Securities Exchange Act § 9, 15 U.S.C. § 78(i).
85. Securities Exchange Act § 6(e), 15 U.S.C. § 78(f).
86. *See, e.g.*, Chandler and Strine, *supra* note 70, at 974 ("This division of responsibility has never been marked by bright borders. To the contrary, many federal disclosure requirements have had the natural and (presumably) intended consequence of influencing boardroom practices. Similarly, the state law of fiduciary duties has been an important tool in evolving better disclosure practices, particularly in the context of mergers and acquisitions requiring a stockholder vote or tendering decision.").
87. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 972, 124 Stat. 1376, 1915 (2010).
88. *Id.* § 953(a).
89. *See, e.g.*, Arnold v. Soc'y for Sav. Bancorp, 678 A.2d 533, 537 (Del. 1996) ("The duty of disclosure is a judicially imposed fiduciary duty which applies as a corollary to the statutory requirements."). *But see* Thompson & Sale, *supra* note 54, at 867 (noting that corporate law imposes few disclosure obligations).
90. DEL. CODE ANN. tit. 8, § 144 (2010).

regulate freeze-out transactions where a majority shareholder purchases the interests of minority shareholders.[91]

Because the federal securities laws initially focused on disclosure rather than merit regulation, it was natural to use disclosure as a way of identifying securities law. Disclosure has an appeal in that it is a less intrusive form of regulation than a substantive mandate. It is thus understandable that critics of federal intervention in corporate law seek to limit such interventions to disclosure. On the other hand, as disclosure requirements become increasingly used to regulate areas traditionally governed by corporate law, it will be difficult to argue that disclosure is what defines the boundary between securities and corporate law. A more promising approach to distinguishing between corporate and securities law must focus on understanding and defining the respective regulatory objectives of these two areas of law.

III. INVESTOR PROTECTION AND THE DISTINCTION BETWEEN TRADING AND OWNERSHIP

This Part develops a new framework for distinguishing between securities and corporate law. The argument that there is no meaningful difference between these two areas of law because they both protect investors reaches too broadly. Securities and corporate law provide protection at different stages of an investment. Securities law protects investors when they are purchasing or selling a security—when they are trading. Corporate law protects investors during the period when they hold a stock—when they are essentially owners.

This distinction between trading and ownership is rooted in both an underappreciated line of cases and modern corporate governance theory. Part III.A describes the *Birnbaum* doctrine, which distinguishes between trading and ownership in Rule 10b-5 cases. Part III.B argues that the distinction reflects two types of investor harm recognized by modern corporate governance theory. Part III.C shows how the distinction between trading and ownership is pervasive in corporate and securities law.

A. The *Birnbaum* Doctrine

Despite its reliance on the problematic concepts of disclosure and internal affairs, *Santa Fe Industries* has been widely recognized as the primary

91. *See* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

Supreme Court decision defining the line between corporate and securities law. This Part discusses a once-prominent line of cases that utilizes a more promising approach, the distinction between trading and ownership.

Prior to *Santa Fe Industries*, which prohibited Rule 10b-5 claims that fail to allege any deception, the courts had already attempted to limit the reach of Rule 10b-5 through the *Birnbaum* doctrine. In 1952, the U.S. Court of Appeals for the Second Circuit decided a case in which a controlling shareholder rejected a profitable merger in favor of selling his control stake for approximately "twice the then market value of the stock."[92] The minority shareholders, who would have benefitted from the merger, brought a Rule 10b-5 suit against the controlling shareholder. In addition to breach of fiduciary duty claims, they alleged that there had been various misrepresentations concerning the sale.[93]

The district court dismissed the case on the ground that Rule 10b-5 only applies to "a fraud perpetrated upon the purchaser or seller" of securities and not "to breaches of fiduciary duty by corporate insiders resulting in fraud upon those who were not purchasers or sellers."[94] Put another way, the court distinguished between those who are trading in securities and those who already own those securities. The minority shareholders could not point to a transaction where they traded. Instead, they were allegedly harmed while they were owners of the company's shares and would have to look to state corporate law for a remedy. In a short opinion by Judge Augustus Hand, the Second Circuit affirmed,[95] establishing the *Birnbaum* doctrine.

In arguing they had a claim under Rule 10b-5, the plaintiffs made a similar investor protection argument as those described earlier. They asserted that the Securities Exchange Act has the "broad purpose . . . to protect investors 'from exploitation by corporate insiders.'"[96] The Second Circuit rejected this argument and in doing so noted that the protection of ownership interests is not the primary purpose of the securities laws. It indicated that when "Congress intended to protect the stockholders of a corporation against a breach of fiduciary duty by corporate insiders, it left no doubt as to its meaning."[97] Section 10(b) of the Securities Exchange Act did not evidence such intent and so did not provide such protection to investors as owners.

92. Birnbaum v. Newport Steel Corp., 193 F.2d 461, 462 (2d Cir. 1952).
93. *Id.* at 462–63.
94. *Id.* at 463.
95. *Id.* at 464.
96. *Id.* at 463 (quoting *Hearings Before S. Comm. on Banking and Currency on S. Res. 84, 56 and 97*, 73rd Cong. 6456 (1933)).
97. *Id.* at 464.

For proponents of investor protection, the *Birnbaum* rule was seen as inadequate because it did not protect shareholder-owners from losses resulting from corporate mismanagement. One article criticized the decision on the ground that "a federal interest exists in assuring that public investors are provided with continuing federal protection beyond the initial purchase of securities."[98] Given the rule's potential to set a boundary between corporate and securities law, the SEC filed amicus briefs in a number of Rule 10b-5 cases arguing against the application of the *Birnbaum* doctrine.[99] Some courts rejected the doctrine,[100] and many courts created exceptions to it.[101] One commentator highlighted the way that *Birnbaum* sets forth a distinction between different types of investor harm in an article entitled *Demise of the Birnbaum Doctrine*. He predicted that the erosion of *Birnbaum* would usher in a new period of investor protection through federal corporate law, where "[n]onselling shareholders who see their shares diminish in value as the result of a fraudulent tender offer or merger . . . [and] stockholders who find their shares decreasing in value as a result of manipulations by insiders—all may receive substantial new federal rights and benefits."[102]

In 1975, the Supreme Court adopted the *Birnbaum* rule in *Blue Chip Stamps v. Manor Drug Stores*.[103] In that case, the Court found that shareholder-owners who could not point to a trading transaction during the period of a fraud do not have standing to bring suit under Rule 10b-5. Decided shortly before *Santa Fe Industries*, *Blue Chip Stamps* is not commonly understood as an important case with respect to the difference between corporate and securities

98. Sherrard, *supra* note 40, at 1428.
99. *See, e.g.*, Vine v. Beneficial Fin. Co., 374 F.2d 627, 636 (2d Cir. 1967).
100. The U.S. Court of Appeals for the Seventh Circuit rejected the *Birnbaum* doctrine on the ground that Rule 10b-5 protected "persons who, in their capacity as investors, suffer significant injury as a direct consequence of fraud in connection with a securities transaction, even though their participation in the transaction did not involve either the purchase or the sale of a security." Eason v. Gen. Motors Acceptance Corp., 490 F.2d 654, 659 (7th Cir. 1973).
101. For example, the rule does not apply to cases solely asserting injunctive relief. *See, e.g.*, Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 547 (2d Cir. 1967). The U.S. Supreme Court also suggested that the requirement was not a rigid one. In discussing the requirement that a fraud be "in connection with" a purchase or sale of security, the Court noted that there only needs to be some nexus between the fraud and the transaction. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12–13 (1971).
102. *See* Lowenfels, *supra* note 31, at 276–77; *see also* Ruder, *supra* note 17, at 1290 (arguing that *Birnbaum* should be interpreted broadly to permit application of Rule 10b-5 to corporate governance issues).
103. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

law.[104] The Court in deciding *Blue Chip Stamps* did not delve into the rationale for distinguishing between trading and ownership.[105] Largely tracking the arguments made in the briefing by the parties,[106] the opinion relied on a superficial combination of precedential support and the policy concern of checking excessive litigation in coming to its conclusion that Rule 10b-5 should be limited to purchases and sales.[107] The Court cited *Blue Chip Stamps* in *Santa Fe Industries*, but for the limited policy argument that an expansive view of Rule 10b-5 could lead to excessive litigation.[108] Given scholarly skepticism of the *Birnbaum* rule and the failure of the courts to further elaborate on the rationale for the distinction, it is unsurprising that the Court did not fully appreciate the importance of the doctrine in defining the boundary between corporate and securities law.

Law professors have largely forgotten the distinction between trading and ownership.[109] Professors Thompson and Sale observe that the *Birnbaum*

104. At least one scholar understood the potential significance of *Blue Chip Stamps*, noting that it "severely limited what had been described as the creation of a general federal law of fiduciary responsibility." Gordon G. Young, *Federal Corporate Law, Federalism, and the Federal Courts*, 41 LAW & CONTEMP. PROBS. 146, 166 (1977).

105. In contrast, an earlier Second Circuit decision that came to the same result as *Santa Fe Industries* cited *Birnbaum* in noting that Rule 10b-5 primarily covers the purchase and sale of securities. *See* O'Neill v. Maytag, Jr., 339 F.2d 764, 768 (2d Cir. 1964).

106. *See* Brief for the Petitioners, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (No. 74-124); Brief for the Respondent, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (No. 74-124).

107. *See, e.g.*, *Blue Chip Stamps*, 421 U.S. at 749 ("[W]e conclude that what may be called considerations of policy . . . [t]aken together with the precedential support for the *Birnbaum* rule over a period of more than 20 years, and the consistency of that rule with what we can glean from the intent of Congress . . . lead us to conclude that it is a sound rule and should be followed.").

108. Santa Fe Indus. v. Green, 430 U.S. 462, 478–79 (1977). In later years, the Supreme Court has primarily cited *Blue Chip Stamps* on this policy concern of reducing litigation costs. *See, e.g.*, Virginia Bankshares v. Sandberg, 501 U.S. 1083, 1091 (1991) (finding that *Blue Chip Stamps* illustrates "a line between what is and is not manageable in the litigation of facts"). On the other hand, some lower courts have applied *Blue Chip Stamps* in limiting the reach of Rule 10b-5. *See, e.g.*, Isquith v. Caremark Int'l, Inc., 136 F.3d 531, 534 (7th Cir. 1998) (Posner, J.) (dismissing 10b-5 claim challenging spinoff of subsidiary because the transaction did not involve a sale of securities).

109. The distinction between trading and ownership has been mentioned in passing over the years, but scholars have not developed the distinction as a way of analyzing the propriety of federal corporate law. During the 1980s, Professor Harold Bloomenthal alluded to the distinction when he stated that "the Securities Acts generally are designed to protect investors in making investment decisions in the purchase or sale of securities, rather than to protect them as shareholders." Harold S. Bloomenthal, *Shareholder Derivative Actions Under the Securities Laws—Phoenix or Endangered Specie?*, 26 ARIZ. L. REV. 767, 767 (1984). Professor Edmund Kitch also mentioned the distinction in 1984, writing: "The drafters of the securities acts of 1933 and 1934 would have had no difficulty with the proposition that these statutes governed an area of law—the sale and trading of securities—very different from the

rule is now considered to be trivial. They explain: "Securities fraud law is ostensibly directed at buyers and sellers of securities, but in the context of class actions, this purchaser-seller connection acts more like the minimalist jurisdictional hook of the interstate commerce requirement than a real constraint on the use of securities law to regulate corporate governance."[110]

The *Birnbaum* doctrine arose in the context of a particular aspect of securities regulation, the reach of Rule 10b-5, but it sets forth an approach that can be applied to a much broader range of legal provisions. The rest of this Article builds upon the *Birnbaum* distinction in developing a new way of differentiating between securities and corporate law.

B. Two Types of Investor Harm

The *Birnbaum* doctrine faded from view because courts and scholars did not understand it to provide a general basis for limiting securities law to trading investors. *Birnbaum* thus could be dismissed as merely reflecting the language of Rule 10b-5, which refers to purchasers and sellers of securities. But *Birnbaum*'s separation of securities and corporate law is more rational than previously acknowledged. In distinguishing between trading and ownership protection, *Birnbaum* recognizes that investors suffer different types of harm. Securities law targets a particular kind of investor injury that is triggered by the purchase or sale of securities at a distorted price.

Investors are vulnerable to two types of losses—they can either purchase or sell securities at an unfair price or the value of a security they already own can go down. Consider a simple example. An investor buys a stock for $50 only to find that the company's financial statements were fraudulent. A fair price for the stock is actually $25, so the investor has paid $25 too much for the stock. While the investor is holding the stock, the managers of the company divert some of its assets for themselves, leaving enough assets to support a stock price of $10 a share. The investor thus suffers another loss of $15 a share. The $25 loss is a trading loss while the $15 loss is an ownership loss.

---

law of the governance of corporations." Edmund W. Kitch, *A Federal Vision of the Securities Laws*, 70 VA. L. REV. 857, 858 (1984); *see also* Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 11 (1998) ("[T]he law governing the purchase and sale of securities has developed along a very different evolutionary path than did corporate law."); Russell B. Stevenson, Jr., *The SEC and the New Disclosure*, 62 CORNELL L. REV. 50, 86 (1976) ("The SEC was established principally to administer laws regulating trading in securities, not to supplant state law governing the structures of publicly held corporations.").

110. Thompson & Sale, *supra* note 54, at 860–61.

These two types of losses are related but distinct. If an investor purchases the stock at a price that perfectly reflects the risk of managerial misconduct, it will be less likely that the investor will suffer unexpected losses as an owner. However, unless markets perfectly predict future events, there will be a risk that unforeseen corporate wrongdoing results in value destruction. Investors thus need protection from both types of harm.

The distinction between these two forms of investor harm is recognized by the modern corporate governance literature. Consider the debate about the fundamental nature of corporate law, whether it is essentially a set of contracts that can be freely altered rather than a set of mandatory rules. The issue raised by this literature is whether investors need the protection of mandatory corporate law from undesirable governance arrangements. Investors need the least protection when a governance provision is contained in the initial corporate charter.[111] Investors have not committed to investing in the company, and their decision to purchase the shares is like consenting to the terms of a contract. Purchasers can protect themselves by adjusting the price they are willing to pay for the shares if the charter has undesirable provisions.[112]

Investors are more vulnerable when corporate governance rules are changed after they buy shares.[113] Once they become owners, investors can suffer losses related to midstream governance changes. If management pushes through an undesirable governance provision despite objections by shareholder-owners, it is more difficult to characterize the provision as reflecting contractual consent. Because the shareholder is already committed to the investment, he will suffer a loss if the change reduces the value of the firm.[114]

These two situations roughly track the distinction between trading and ownership.[115] In the first situation, investors as traders are protected by the

111. *See, e.g.*, Lucian Ayre Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1828 (1989) (distinguishing between phase before investment when an investor can price corporate governance provision and phase after investment when an investor is vulnerable to changes that reduce value).

112. *See, e.g.*, Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1332 (2013) ("The securities market is expected to price governance arrangements provided for in a firm's charter, just as it prices the quality of a firm's business model . . . .").

113. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1442–43 (1989) (observing that initial pricing does not capture midstream changes in corporate governance).

114. *See, e.g.*, *id.* at 1443 (noting that after midstream governance change, owners "can sell, but they can't avoid the loss").

115. Some investors recognize there is a distinction between trading and ownership interests. *See, e.g.*, Anne Simpson, *In the Wake of the Financial Crisis: Rethinking Responsible Investment*, 26

securities laws, which facilitate accurate valuation of the provisions contained in the corporate charter. In the second situation, any protection of investors as owners would come from corporate law, which might protect them through the shareholder's right to vote on amendments to the corporate charter.

Thus, the *Birnbaum* doctrine sets forth a boundary that has significance beyond the reference in the text of Rule 10b-5 to purchasers and sellers. *Birnbaum* reflects a focus by the securities laws on a particular type of investor harm. Corporate and securities law are best distinguished by recognizing that investors are vulnerable in different ways when trading and owning stock.

C. Trading Protection and Ownership Protection

This Part shows how the preponderance of corporate and securities law can be classified based on the distinction between trading and ownership. Federal securities law facilitates the process of valuation, which is the primary concern of trading investors. State corporate law seeks to prevent corporate misconduct that diminishes the value of a shareholder-owner's investment.

1. Securities Law as Trading Protection

As some commentators have noted over the years, the securities laws are fundamentally concerned with protecting investors when trading.[116] They do so by facilitating a fair pricing mechanism for securities. This Subpart briefly provides an overview of these provisions.

a. Public Offering Regulation

As noted in the Introduction, in its earliest form, federal securities regulation exclusively protected investors when purchasing securities of newly public companies. When an issuer is selling securities to investors for the first time, the asymmetry of information between issuer and purchaser is at its

NOTRE DAME J.L. ETHICS & PUB. POL'Y, 73, 78–79 (2012) (distinguishing between "owners, traders, and raiders").

116. *See, e.g.*, ADVISORY COMM. ON CORP. DISCLOSURE, 95TH CONG., REP. TO THE SECURITIES AND EXCHANGE COMMISSION 573 (Comm. Print 1977) ("The Exchange Act . . . had as its dominant purpose the regulation of securities trading markets . . . ."); Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 757 (1989) (noting that the SEC has focused "on the needs of transacting investors").

greatest. This situation places the issuer, who will want to sell at a high price, at an advantage relative to the purchaser, who will want to buy at a low price.

The Securities Act of 1933 levels the playing field between issuer and trading investors by requiring that the issuer file a registration statement for such offerings.[117] The truth of the registration statement is governed by a powerful antifraud provision, Section 11.[118] Because of the particular vulnerability of purchasers with respect to offerings by new public companies, Section 11 provides for liability for any material misrepresentation in the registration statement, even those made without fraudulent intent.[119] This liability provision covers not only the issuer, but gatekeepers such as underwriters and auditors,[120] who play an essential role in protecting purchasers by verifying the truth of the registration statement.

It is notable that the securities laws are one-sided in protecting the trading interests of investors who purchase. The issuer, who is selling shares, is faced with stringent obligations while the purchaser receives substantial protections. This asymmetry of protection reflects the exclusive focus of the Securities Act of 1933 on a particular subset of trading investors, the purchasing investor. However, by facilitating fair valuation, the Act benefits not only those investors who can purchase with confidence, but also issuers who are able to sell shares because purchasers trust the integrity of the market.

At least for an initial public offering (IPO), it is difficult to say that the securities laws protect ownership interests. Prior to purchasing shares in the IPO, public investors are not yet owners of the company and thus do not receive protection from corporate law. The managers of the company are not yet the agents of these public investors and owe them no duties. While the requirement of disclosure creates incentives for newly public firms to implement good governance procedures, state corporate law does not require such firms to have strong corporate governance. At the public offering stage, the gap between corporate and securities law is perhaps at its greatest.

b. Periodic Disclosure and Fraud on the Market

After a security has been distributed to the public, it trades in a secondary market. Such transactions involve trading between investors rather than a sale from the issuer to an investor. At this point, unlike the example of an initial

117. *See* Securities Act of 1933 § 5, 15 U.S.C. § 77e (2012).
118. *See id.* § 11, 15 U.S.C. § 77k.
119. *Id.* § 11(a).
120. *Id.*

public offering, there are public shareholder-owners of the corporation whose interests can be affected by trading markets. There is thus a closer relationship between securities and corporate law with respect to regulation of secondary market transactions than for offerings by the issuer.

As with public offerings, the securities laws require the issuer to provide mandatory disclosure for its stock to continue trading in secondary markets.[121] Such disclosure periodically provides updated information to the markets that helps determine the price of a company's stock. With such disclosure, investors have greater confidence that they are likely to receive or pay a fair price for a security. Periodic disclosure is thus directed at facilitating trading transactions.

At the same time, such disclosure benefits a wide range of parties, including the owners of the corporation. Some of the information released pursuant to the securities laws can be useful in monitoring the agents of the shareholders.[122] To the extent that managers are shirking, such conduct may be reflected in the disclosures reporting the economic performance of the corporation. In discussing the relationship between the securities laws and the corporate law goal of reducing agency costs, Professor Paul Mahoney has argued that "the Exchange Act created federal law at the very core of corporate governance."[123] Much of the argument that securities law and corporate law are indistinguishable reflects the reality that periodic disclosure serves the interests of a wide range of parties.

121. *See* Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m (2012).

122. *See, e.g.*, Elvin R. Latty, *Why Are Business Corporation Laws Largely "Enabling"?*, 50 CORNELL L.Q. 599, 618 (1965) ("In part as a result of disclosure requirements of the various federal laws previously mentioned, management in publicly-held corporations virtually lives in a glass house."); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1085 (1995) ("One might view financial reporting as principally a form of monitoring for the benefit of shareholders, creditors, and other interested parties."); Seligman, *supra* note 53, at 3 ("[T]he emphasis of federal securities law reporting requirements is to prevent corporate dysfunction from occurring by requiring compliance with detailed disclosure standards *ex ante*."); Thompson & Sale, *supra* note 54, at 905 ("In addition to assisting shareholders, disclosure aids directors in their monitoring function and can be an important support for accountants as they undertake the monitoring role that is a key component of corporate governance.").

123. Mahoney, *supra* note 122, at 1110. A number of scholars have noted that the disclosure requirements of the Exchange Act affected the organization of the public corporation. *See, e.g.*, Kitch, *supra* note 109, at 859 ("Although the purpose of the 1934 Act was to improve the operation of the securities markets by regulating manipulative practices and improving the quality of information available to the market, one could anticipate that regulation of the use and disclosure of information would shift allocations of power within the corporate structure."); Thel, *supra* note 82, at 456 (noting that opponents of the Exchange Act argued that disclosure would bureaucratize public corporations).

There is an important difference, however, between trading investors and owners with respect to periodic disclosure. Only investors who trade can recover under the securities laws for damages caused by fraudulent disclosures. As noted earlier, the antifraud provisions set forth in Section 10(b) of the Securities Exchange Act and Rule 10b-5 only apply to securities fraud occurring "in connection with the purchase or sale of any security."[124] Under the *Birnbaum* doctrine, "[Rule 10b-5] was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement . . . ."[125] Thus, when damages are calculated in Rule 10b-5 cases, owners of the shares during the period of the fraud are excluded from the calculation.[126]

At best, owners benefit indirectly from such securities fraud suits. Successful Rule 10b-5 claims by trading investors can increase the expected cost of committing such fraud, producing some deterrent effect.[127] However, the only legal remedy shareholder-owners might directly assert for securities fraud is a derivative suit that comes from state corporate law.

Moreover, periodic disclosure does not always further the interests of shareholder-owners. An investor who holds shares for years might prefer less periodic disclosure than trading investors. Periodic disclosure is costly, and the shareholder-owner may not benefit from short-term fluctuations in the price.[128] In contrast, purchasing and selling investors seek constant updates about developments that will affect stock prices when they transact and have a stronger interest in periodic disclosure.

Finally, the fact that periodic disclosure affects third parties does not mean it sets forth law with respect to those third parties. Disclosure benefits not only shareholder-owners, but also other stakeholders of the corporation,

124. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2012).
125. Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952).
126. *See, e.g.*, Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491, 496–97 (1996) (describing the two trader model, which distinguishes between traders and owners of shares).
127. *See, e.g.*, *In re* Franchard Corp., 42 SEC 163, 176 n.36 (1964) ("The deterrent effect of disclosures required by the Securities Act and other provisions of the Federal securities laws do, of course, have an impact on standards of conduct for directors.").
128. For example, the securities laws require companies to disclose bad news that will cause the stock price to decline. *See, e.g.*, Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044, 1048 (2005) ("[D]isclosure of a possible risk harms a firm's *current* investors," while "failure to disclose the risk . . . may harm the firm's *future* investors."); *see also* Ian Ayres, *Back to* Basics*: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 989–90 (1991) (noting that owners can have different incentives than traders to encourage managers to disclose good news).

such as employees and even competitors of the corporation. Even if employees can utilize the company's financial information to bargain with managers, we do not consider periodic disclosure to be labor law. A company's rivals can use disclosures to compete with a public corporation, but such periodic disclosure is not considered to be antitrust law. Similarly, the fact that shareholder-owners can use periodic disclosure to monitor management does not make it corporate law.

c. Regulation of Markets and Intermediaries

In addition to periodic disclosure and the prohibition of fraud, the Securities Exchange Act protects investors when purchasing and selling securities by regulating the major institutions that facilitate such trading.

A significant task of the securities laws is to regulate the securities exchanges where public trading occurs. The Securities Exchange Act of 1934 defines an exchange as "a market place or facilities for bringing together purchasers and sellers of securities . . . ."[129] Among other requirements, exchanges must have rules that "prevent fraudulent and manipulative acts and practices . . . promote just and equitable principles of trade . . . and . . . protect investors and the public interest . . . ."[130] Exchange regulation thus protects trading by policing securities markets for fairness.

Because many investors act through brokers in purchasing and selling securities, the securities laws have long regulated such brokers. The Securities Exchange Act defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others,"[131] and requires registration with the SEC.[132] Again, the statute emphasizes transactions in defining who is a broker. As with exchange regulation, broker regulation is often substantive in nature. For example, brokers are subject to duties such as fair dealing with respect to investors.[133] The securities laws thus protect investors who rely on intermediaries to trade.

129. Securities Exchange Act of 1934 § 3(a)(1), 15 U.S.C. § 78c(a)(1) (2012).
130. *Id.* § 6(b)(5), 15 U.S.C. § 78f(b)(5) (2012).
131. *Id.* § 3(a)(4)(A), 15 U.S.C. § 78c(a)(4)(A) (2012).
132. *Id.* § 15(a)-(b), 15 U.S.C. § 78o(a)-(b) (2012).
133. *See, e.g.*, FINRA Rule 2121 (2014), http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=11539 [https://perma.cc/D83H-ZNYH] (requiring brokers to charge fair prices for transactions).

2. Corporate Law as Ownership Protection

The primary purpose of corporate law is to protect investors, in particular shareholders, while they own a company's stock.[134] Under state corporate law, shareholder-owners have the right to elect the directors of the corporation and are protected by fiduciary duties they can enforce through derivative suits. This Subpart briefly covers some of the major elements of corporate law and its protection of investors while they are owners.

a. Corporate Governance and Firm Value

Before turning to particular provisions of corporate law, it is telling that scholars influenced by a financial economics approach typically assess such laws in terms of whether they are associated with greater firm value.[135] If a particular set of corporate law rules is successful at efficiently protecting shareholders from corporate mismanagement, firms governed by those rules should be on average more valuable than firms governed by less efficient corporate law regimes. The corporate law of Delaware, in particular, has been shown at times to be associated with higher market valuations.[136] Regardless of whether the results of these studies are conclusive, the terms of the debate

---

134. *See, e.g.*, Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) (noting that directors have "the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners"); *see also* Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II: Empirical Studies of Corporate Law*, 4 AM. L. & ECON. REV. 380, 381 (2002) ("The objective of U.S. corporate law is furthering the interest of the owners of the firm . . . .").

Some scholars have questioned whether shareholders are the owners of the corporation. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 278 (1999) ("Our argument suggests that it is misleading to view a public corporation as merely a bundle of assets under common ownership."). This Article need not address whether shareholders truly "own" the corporation. Shareholders at the very least own their shares. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 564–65 (2003) (distinguishing between ownership of residual claim and ownership of firm).

135. *See generally* Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803 (2008) (summarizing empirical studies of corporate governance and firm performance).

136. *See* Daines, *supra* note 25, at 555 (finding "that firms subject to Delaware corporate law are worth significantly more than firms incorporated elsewhere"). *But see* Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 33 (2004) (finding that the advantage of Delaware firms disappeared by the late 1990s).

are whether corporate law increases the worth of a firm,[137] resulting in returns that would be captured by investors as owners.

Consider a decision about whether a firm should change its corporate governance in a way that increases shareholder value. Perhaps it might reincorporate in a state with better corporate law. If such a decision were to increase firm value, such value would primarily benefit the shareholders who already own shares of the corporation. Subsequent purchasers would not see gains, because they would have to pay a price for the shares that reflects the improvement in corporate governance.

In contrast to corporate law, securities law is not judged in terms of whether it increases the value of a particular firm. The securities laws might indirectly increase the worth of all public firms by increasing the liquidity of investments,[138] but scholars do not generally contend that certain securities law provisions would improve individual firm performance. Indeed, defenders of the need for mandatory disclosure primarily rely on evidence that such disclosure reduced volatility in stock prices rather than arguing that such disclosure increased returns for investors.[139] In contrast, corporate governance reforms are motivated by the idea that if a firm adopts particular governance provisions, its value will increase, benefiting shareholder-owners.

b. Fiduciary Duties

Perhaps the primary way corporate law protects owners is through fiduciary duties governing the directors of the corporation. Officers and directors owe duties of care and loyalty to the owners of the corporation's stock.[140] In providing for such duties, corporate law protects shareholder-owners from

---

137. ROMANO, *supra* note 1, at 15 ("In both the Cary and the Winter positions, the goal of maximizing revenues functions as an invisible hand guiding the decentralized system of state corporation laws to codify the arrangements that firms desire.").

138. For a study finding evidence that disclosure can improve liquidity, see Allen Ferrell, *Mandated Disclosure and Stock Returns: Evidence From the Over-the-Counter Market*, 36 J. LEGAL STUD. 213 (2007).

139. *See, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 735 (1984) (noting that studies agree "that price dispersion declined after passage of the Securities Act of 1933"); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1379 (1999) (noting that studies show "that imposition of the current system of mandatory disclosure did increase price accuracy and the amount of meaningful information in the market"); *see also* Ferrell, *supra* note 138 (finding that extension of mandatory disclosure to over-the-counter stocks significantly reduced their volatility).

140. *See, e.g.*, Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) (discussing duties of care and loyalty).

the effect of agency costs that can result in misconduct that reduces company value. In contrast, investors considering a purchase do not need protection through fiduciary duties because they are not yet vulnerable to value destruction by managers.

Any breach of a corporate fiduciary duty will primarily affect investors as owners. Consider a few examples. A board that fails to inform itself about an important matter can make a poor decision that negatively affects the value of the firm's shares. Managers who steal from the company are diverting resources belonging to the owners of company shares.[141] If a controlling shareholder attempts to effectuate a merger that is unfair to minority shareholder interests, the decision affects the ownership interests of those shareholders.[142] When directors fail to monitor the company for substantial risks and a company fails because of reckless decisionmaking, it is the owners of the corporation who will see the value of their investment collapse. In contrast, investors who have not committed to the stock will have the opportunity to purchase the company's stock for a substantial discount after any of these forms of misconduct is revealed.

The primary legal remedy for such misconduct, the derivative suit, is tailored to protect ownership interests. Only a current shareholder is permitted to bring a derivative suit[143] and must remain a shareholder through the end of the litigation.[144] In other words, former or potential shareholders (that is, trading investors) have no remedy for breaches of fiduciary duties. Any monetary recovery from a derivative suit goes to the corporation, not to the investors who

141. Another possibility is that they sell all of the company's assets, a process that is regulated by what one court referred to as "shareholder-protection statutes." U.S. Bank Nat'l Ass'n v. Angeion Corp., 615 N.W.2d 425, 432 (Minn. 2000).

142. In Delaware, the remedy for such a situation would come from *Weinberger v. UOP, Inc.*, 493 A.2d 701, 703 (Del. 1983), which has been described as protecting minority shareholders. *See, e.g.*, Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 848 (Del. 1987) (observing that "[t]he thrust of *Weinberger* is to protect those rights of minority shareholders which have been tainted by an element of unfairness"). Another remedy would come from appraisal statutes, which have been described as serving to "protect minority shareholders from unfair treatment." Casey v. Brennan, 801 A.2d 245, 246 (N.J. 2002); *see also* McMinn v. MBF Operating Acquisition Corp., 164 P.3d 41, 45 (N.M. 2007).

143. *See, e.g.*, DEL. CODE ANN. tit. 8 § 327 ("In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law.").

144. *See, e.g.*, Kramer v. W. Pac. Indus., 546 A.2d 348, 354 (Del. 1988) ("To have standing to maintain a shareholder derivative suit, a plaintiff must be a shareholder at the time of the filing of the suit and must remain a shareholder throughout the litigation.").

brought the suit.[145] Thus, the remedy for a breach of fiduciary duty benefits all of the owners of the corporation. Moreover, the board has the power to terminate derivative suits it concludes do not benefit shareholder-owners.[146] To the extent that frivolous suits by disgruntled shareholders reduce corporate value, the board has the power to protect other owners from the costs of those suits.

c. Corporate Law Disclosure

As noted earlier, both corporate and securities law require disclosure in various circumstances. The difference between these two areas of law is not that one utilizes disclosure while the other does not. The distinction is that when corporate law requires disclosure, it does so primarily to benefit shareholder-owners by providing them with information they need to make governance decisions.

For example, one concern addressed by corporate law disclosure is exploitation of shareholder-owners by managers and majority shareholders. When an officer seeks approval to enter into an interested transaction with the corporation, corporate law generally requires that "material facts" be "disclosed" or "known" either by the board or shareholders.[147] This requirement protects owners from managers who seek to siphon off shareholder value for themselves. Another area of concern arises when a majority shareholder that controls the board seeks to remove minority shareholder-owners through a merger. In Delaware, there is a corporate law duty to disclose facts to the minority shareholder relating to the fairness of the price they are to receive.[148] Moreover, the courts will scrutinize such transactions for "fraud" or "misrepresentation."[149]

145. *See, e.g.*, Joy v. North, 692 F.2d 880, 887 (2d Cir. 1982) ("Since any judgment runs to the corporation, shareholder plaintiffs at best realize an appreciation in the value of their shares.").
146. *Id.* (discussing demand requirement).
147. DEL. CODE ANN. tit. 8, § 144; *see also* MODEL BUS. CORP. ACT § 8.60 (mandating "required disclosure" of conflicts of interest).
148. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 703 (1983) (finding that failure to disclose material information "necessary to acquaint" minority shareholders with the majority's bargaining position was breach of fiduciary duty); *see also* Glassman v. Unocal Expl. Corp., 777 A.2d 242, 248 (Del. 2001) (extending duty to disclose to short-form mergers).
149. *Weinberger*, 457 A.2d at 714; *see also* Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1104 (Del. 1985) (noting that under *Weinberger*, "a cash-out merger must be free of fraud or misrepresentation").

Another major function of corporate law disclosure is to provide information relevant to shareholder-owners voting on major corporate transactions. In Delaware, directors "are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action."[150] As one court noted, the failure to fulfill this duty would "violate the fiduciary duties that protect shareholders."[151] The materiality of corporate disclosure is determined in terms of whether "there is a substantial likelihood that a reasonable stockholder would consider it important in deciding how to vote."[152] Though shareholder votes will sometimes require consideration of a company's valuation, the exercise of the right to vote can be distinguished from the decision to purchase or sell a stock. In voting, the shareholder is not selling his particular shares of stock but is participating in a collective decision that could result in the sale of a company.

It is telling that Delaware, the leader in developing corporate law disclosure,[153] has been careful to develop regulation that is distinct from what is required by federal securities law disclosure. Two procedural elements of Delaware corporate disclosure speak to its focus on ownership rights. First, claims for breach of the fiduciary duty of disclosure can be brought by holders of securities who did not purchase or sell securities during the period of the alleged wrongdoing.[154] Delaware has thus distinguished its remedy for fraudulent disclosure from Rule 10b-5, which under the *Birnbaum* rule, requires a plaintiff to be a trading investor. Second, Delaware's regulation of fraud relating to secondary market trading is deliberately minimal. Unlike the securities laws, which presume that traders can bring class actions under Rule 10b-5 when fraud distorts

150. Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992); *see also* Smith v. Van Gorkom, 488 A.2d 858, 890 (Del. 1985) (noting that there is "a fiduciary duty to disclose all facts germane to the transaction at issue in an atmosphere of complete candor").

151. *In re* InfoUSA, Inc. S'holders Litig., 953 A.2d 963, 990 (Del. Ch. 2007).

152. Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 143 (Del. 1997).

153. Professor Robert Thompson has observed that Delaware could carve out a distinct role relative to the federal government by further developing corporate disclosure rights. *See* Robert B. Thompson, *Delaware's Disclosure: Moving the Line of Federal-State Corporate Regulation*, 2009 U. ILL. L. REV. 167 (2009). One study shows that a substantial number of derivative suits allege violations of duties to disclose. Jessica M. Erickson, *Overlitigating Corporate Fraud: An Empirical Examination*, 97 IOWA L. REV. 49, 70 (2011) (finding that 90 percent of derivative cases in sample involved disclosure violations). Professors Fisch, Griffith, and Solomon argue that federal securities law is better suited to regulating merger-related disclosure than Delaware law. Jill E. Fisch et al., *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 TEX. L. REV. 557, 602–04 (2015).

154. *See* Malone v. Brincat, 722 A.2d 5, 13 (Del. 1998) ("[T]he claim appears to be made by those who did not sell and, therefore, would not implicate federal securities laws which relate to the purchase or sale of securities.").

market prices,[155] Delaware does not provide a procedural mechanism allowing traders to bring a class action for secondary market fraud.[156] Thus, corporate law disclosure litigation is less likely to involve frauds that relate to trading interests than federal securities litigation.

d. Mergers and Acquisitions

Corporate law is arguably most influential when a company is sold or merged into another company. Fiduciary duties protect shareholder-owners to help ensure they receive a fair price for their shares. In this context, an argument could be made that investors are essentially trading in that they are selling their shares to a third party.[157] However, given the reality that corporate law delegates the power to sell a company to corporate managers, the law governing the sale of a company is better classified as protecting ownership interests.

In a public corporation, investors do not directly choose whether or not to accept an offer to buy the company. The board of directors has the power to manage the corporation and therefore acts on behalf of shareholders in assessing the adequacy of a bid for the company.[158] It is difficult to conclude that a merger involves a pure decision by an investor to sell its shares because the board must initially approve the transaction. As with other major decisions, the board has fiduciary duties to protect the interests of shareholder-owners when it evaluates a merger.[159] An investor cannot directly accept an offer for the company but instead must exercise ownership rights such as the right to elect the board and the right to bring a derivative suit if the board arbitrarily declines to accept a generous offer.

155. The fraud-on-the-market presumption allows plaintiffs to satisfy the reliance element of a securities fraud claim by alleging that they relied on the integrity of the market price rather than a particular misrepresentation. *See* Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2419 (2014).

156. *See, e.g.*, Gaffin v. Teledyne, Inc., 611 A.2d 467, 474–75 (Del. 1992).

157. *See, e.g.*, Vine v. Beneficial Fin. Co., 372 F.2d 627, 633–34 (2d Cir. 1967) (concluding that minority shareholder challenging freeze-out is a forced seller).

158. Delaware law, for example, provides that the power to manage the corporation is centered in the board. *See* DEL. CODE ANN. tit. 8, § 141 (2016). On the delegation of the power to sell the company to the board, see generally Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791 (2002).

159. Delaware has been the leader in developing law in this area. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

An offer to purchase the company made to the board should be distinguished from a tender offer made directly to shareholders.[160] Such a direct appeal requires each investor to decide whether or not to accept the tender offer. When the investor individually makes the decision to accept such an offer, it is selling its shares. As will be discussed later, federal law regulates such tender offers, and it makes sense to think of such law as securities rather than corporate law.[161]

With the acceptance by Delaware of takeover defenses such as the poison pill,[162] the use of the tender offer to directly purchase shares has largely been replaced by negotiated transactions with the board. Many scholars have been critical of this development because it impedes a vibrant market for corporate control.[163] The states have used corporate law to shift the market for control from trading investors to boards representing the interests of shareholder-owners. The question, which a later Part of this Article will discuss,[164] is whether the regulation of takeover defenses sufficiently relates to trading interests so there is a case that federal securities law should preempt state corporate law on this issue.

e. Bondholders and Corporate Law

The focus of corporate law on ownership interests is highlighted by its exclusive protection of shareholders.[165] Other stakeholders such as bondholders do not typically receive protection under corporate law. Bondholders are also investors in securities, but unlike shareholders, bondholders are creditors of the corporation rather than owners. Thus, absent limited circumstances, they cannot bring a corporate law derivative suit to challenge misconduct that reduces the value of their investment.[166] Corporate law thus focuses on the protection of shareholder-owners rather than the general protection of all investors.

---

160. *See, e.g.*, Frandsen v. Jensen-Sundquist Agency, Inc., 802 F.2d 941, 944 (7th Cir. 1986) (describing "distinction between a sale of shares and a merger" as "a familiar one").
161. *See infra* Part IV.B.
162. For an analysis of Delaware law's permissive approach to the poison pill, see Lucian A. Bebchuk & Robert J. Jackson, Jr., *Toward a Constitutional Review of the Poison Pill*, 114 COLUM. L. REV. 1549 (2014).
163. *See, e.g.*, *id.*
164. *See infra* Part IV.B.
165. *See, e.g.*, Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) (noting that directors have "the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners").
166. *See* N. Am. Catholic Educ. Programming Found., Inc., v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) ("When a corporation is *solvent*, those [fiduciary] duties may be enforced by its

In contrast, securities law allows bondholders to bring suit under various antifraud provisions.[167] The securities laws protect all investors when trading in stocks, bonds, or any other security. Such trading investors all have an interest in purchasing and selling securities at a fair price. Just like a purchaser of stock, a purchaser of a bond can seek recovery if it suffered a loss because it bought a security at a price inflated by fraud.

Bondholders can bring a securities lawsuit under Rule 10b-5 for trading losses but are not permitted to bring a corporate derivative suit for ownership losses. The differing treatment of bondholders is another example of how the ownership interests covered by corporate law are distinct from the trading interests covered by securities law.

IV. IDENTIFYING FEDERAL CORPORATE LAW

Although the federal securities laws mostly protect trading interests, some elements of federal law, even those that are disclosure requirements, are best understood as corporate law protecting owners.[168] The distinction between trading and ownership offers a better way than the disclosure test of identifying the parts of federal securities law that are corporate law. Some aspects of federal securities law are difficult to classify because they affect both trading and ownership interests, but many aspects predominately protect one of those interests. Application of this Article's framework shows that some provisions that are thought to be securities law are actually federal corporate law, while other provisions thought to be federal corporate law are arguably securities law.

A. Proxy Regulation

The rules governing the solicitation of proxies from shareholders who do not vote in person at the company's annual meeting are perhaps the oldest example of

shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value.").

167. It is common for bondholders to receive part of a securities class action settlement. *See* James J. Park, *Bondholders and Securities Class Actions*, 99 MINN. L. REV. 585 (2014).

168. There are also provisions that may not qualify as either. For example, disclosure mandates relating to conflict minerals seek to protect interests that are "quite different from the economic or investor protection benefits that our rules ordinarily strive to achieve." Conflict Minerals, 77 Fed. Reg. 56,274, 56,335 (Sept. 12, 2012) (to be codified at 17 C.F.R. pts. 240, 249 and 249b).

federal disclosure concerned with the protection of ownership interests.[169] Even though proxy regulation has characteristics of securities law, because it relates to the main mechanism by which owners assert control rights in the corporation, it is best classified as corporate law.

This is not an obvious conclusion. If judged in terms of disclosure, most proxy regulation would be securities law. The proxy rules primarily rely upon disclosure in helping ensure that shareholder votes are informed.[170] In describing proxy regulation as a type of securities regulation, the D.C. Circuit emphasized that "although § 14(a) [of the Securities Exchange Act] broadly bars use of the mails (and other means) 'to solicit . . . any proxy' in contravention of Commission rules and regulations, it is not seriously disputed that Congress's central concern was with disclosure."[171] As noted earlier, a leading treatise singled out the "substantive" but not the disclosure provisions of proxy regulation as "federal corporation law."[172] Proxy regulation would also be securities law under a broad reading of investor protection. Indeed, Section 14(a) explicitly references "the protection of investors" in describing the types of rules that can be passed pursuant to that section.[173]

Proxy regulation consists of two major sets of rules relating to the proxy statement and shareholder proposals. Each of these areas primarily relates to ownership rather than trading interests.

169. Section 14(a) of the Securities Exchange Act authorizes the SEC to promulgate rules governing proxies for public companies. Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a) (2012).

170. *See* SEC Rule 14a-3(a), 17 C.F.R. § 240.14a-3(a) (2015).

171. Bus. Roundtable v. SEC, 905 F.2d 406, 410 (D.C. Cir. 1990); *see also* MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 111–12 (1976) ("[T]he Proxy Rules do not preempt the field of proxy regulation to the exclusion of state law, but merely set minimum conditions of fair disclosure and fair conduct; beyond these minimum conditions, questions concerning the allocation of powers between management and shareholders . . . must be answered by state law."); Bainbridge, *supra* note 4, at 609–13 (arguing that proxy regulation was originally a minimal intrusion limited to disclosure); Karmel, *supra* note 50, at 83 ("Even the proxy provisions of the Exchange Act generally have been regarded primarily as disclosure rather than regulatory provisions." (citations omitted)).

172. LOSS, SELIGMAN & PAREDES, *supra* note 81.

173. 15 U.S.C. § 78n(a)(1) (2012). The Supreme Court has also observed: "While [§ 14(a)] makes no specific reference to a private right of action, among its chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result." J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

1. The Proxy Statement

The main requirement of the proxy rules is that anyone who solicits proxies must circulate a disclosure statement to the company's shareholders that they can use to inform themselves before voting at annual or special meetings.[174] Section 14(a) was meant to encourage "the free exercise of the voting rights of stockholders."[175] In most cases, shareholder voting relates to governance matters mainly of concern to the owners monitoring their investment.[176] A typical annual proxy statement will contain information on the election of directors and other issues of corporate administration.[177]

The truth of this voting information is governed by SEC Rule 14a-9, which prohibits material misstatements or omissions in the proxy statement.[178] A federal suit for proxy fraud has characteristics that resemble a state corporate law derivative suit. The courts have implied a private cause of action to enforce Rule 14a-9 that can be brought by a current owner of the company's stock.[179] In such a suit, shareholder-owners can recover not only for direct harm they suffer from a proxy misstatement but also for "damage done [to] the corporation."[180] Only misstatements affecting ownership rights, that "a reasonable shareholder would consider . . . important in deciding how to vote," meet the requisite materiality to trigger liability under Rule 14a-9.[181]

While much proxy regulation is directed at the interests of owners, there will be some settings where proxy disclosure touches on trading interests. For example, when the board makes a decision to sell the company, shareholders typically will vote on the transaction. In doing so, the acquired company's

---

174. *See* SEC Rule 14a-3(b), 17 C.F.R. § 240.14a-3(b) (2015).
175. *Borak*, 377 U.S. at 431 (quoting H.R. REP NO. 73-1383, at 14 (1934)).
176. *See, e.g.*, Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1237 (1999) ("[T]he legislative history of section 14(a) demonstrates that Congress's purpose in enacting section 14(a) was to require issuers to provide their shareholders with information about how public companies were being managed, so that shareholders could exercise their voting rights with adequate information."); *see also* SEC v. Transamerica Corp., 163 F.2d 511, 517 (3d Cir. 1947) (noting that proxy rules help ensure the "corporation is run for the benefit of its stockholders and not for that of its managers").
177. SEC Rule 14a-4(b), 17 C.F.R. § 240.14a-4(b) (2015).
178. SEC Rule 14a-9, 17 C.F.R. § 240.14a-9 (2015).
179. Piper v. Chris-Craft Indus., 430 U.S. 1, 38 (1977) (noting that a purchase or sale of securities is not required to bring suit under Section 14(e)).
180. *Borak*, 377 U.S. at 432.
181. TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) (citing Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 (1970)).

shareholders are essentially voting with respect to selling their shares.[182] Proxy disclosure provides shareholders with information they need to assess the fairness of the price. Such valuation information could be characterized as information relevant to a trading decision.[183] On the other hand, as noted earlier, the board of directors arguably makes the decision to sell, and shareholder-owners essentially just ratify the decision. Thus, even when a company is being sold, proxy regulation can be described as corporate law.

2. Shareholder Proposals

The other major aspect of proxy regulation relates to shareholder proposals. A shareholder who has "continuously held" a minimum amount of the company's voting stock "for at least one year" can submit a proposal that will be included in the company's proxy statement.[184] The SEC passed the rule allowing such proposals based on the idea that "stockholders are owners of their corporations and the stockholders' meetings are their meetings, and not the management's meetings."[185] The shareholder proposal is thus a corporate law mechanism by which shareholder-owners can raise concerns about the governance of the corporation.

The so-called say-on-pay provisions of Dodd-Frank are a recent expansion of the shareholder proposal mechanism.[186] These rules require periodic advisory votes by shareholders with respect to the executive compensation

182. In one of its earliest Rule 10b-5 cases, the U.S. Supreme Court held that shareholders of a company acquired through a merger "purchased" shares of the acquirer "by exchanging them for their old stock." SEC v. Nat'l Sec., Inc., 393 U.S. 453, 467 (1969).
183. Misrepresentations relating to such transactional disclosure can give rise to liability under Rule 14a-9. The ability to bring suit for the "fairness" of a merger price under Rule 14a-9 is in tension with *Santa Fe Industries*'s prohibition of a Rule 10b-5 suit challenging the fairness of a transaction involving minority shareholders. The Supreme Court has acknowledged that tension, but said that such proxy suits can proceed. *See* Virginia Bankshares v. Sandberg, 501 U.S. 1083, 1093 n.6 (1991).
184. *See* SEC Rule 14a-8(b)(1), 17 C.F.R. § 240.14a-8(b)(1) (2015).
185. Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 63 WASH. & LEE L. REV. 1503, 1551 (2006) (quoting *Securities and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 Before the H. Comm. on Interstate and Foreign Commerce*, 78th Cong. 183 (1943) (statement of Ganson Purcell, Chairman, Securities and Exchange Commission)). One SEC Commissioner voted against the rule on the ground that it was "beyond the remedy of disclosure and thus beyond the scope of the SEC's authority." *Id.* at 1552. The SEC acknowledged that the rule went beyond disclosure yet made efforts to "confine[] itself to the disclosure principle . . . ." 78th Cong. 238 (statement of Baldwin B. Bane, Director, Corporation Finance Division, Securities and Exchange Commission).
186. *See* Securities Exchange Act § 14A, 15 U.S.C. § 78n (2012).

packages of managers.[187] Rather than representing a totally novel application of federal law to govern corporate affairs, say-on-pay can be understood as a form of the shareholder proposal. Like shareholder proposals, say-on-pay gives shareholders a voice with respect to how their funds are used in compensating executives.[188] The results of such a vote do not require the board to change its compensation policies.[189] On the other hand, unlike a shareholder proposal, say-on-pay votes do not arise from the initiative of shareholders, but are mandated by law. The legislation is therefore a more aggressive form of federal corporate law than the traditional shareholder proposal.

B. Takeover Regulation

Like proxy regulation, the Williams Act,[190] which amends the Securities Exchange Act to add provisions governing tender offers, operates through disclosure and is said to be an investor protection statute. Unlike proxy regulation, the Williams Act contains provisions that primarily concern investors as traders rather than as owners. Some commentators have argued that the Williams Act is federal corporate law meant to displace state regulation of takeover defenses, but the better argument is that the Williams Act is securities regulation that should not widely displace state corporate law.

The Williams Act regulates takeovers in two ways. First, it requires disclosure: when an investor (a) accumulates a position of 5 percent or more of a company's shares[191] or (b) makes a tender offer that if consummated would result in ownership of 5 percent or more of a company's shares.[192] Such transactions often precede an effort to gain control of the targeted corporation. Second, it "establish[es] procedural rules to govern tender offers."[193] Such rules generally seek to prevent coercive tender offers where shareholders feel compelled to accept the offer for fear that waiting will result in a less generous offer after the acquirer gains control.

---

187. *See id.*
188. The motivation for this law was the belief that "shareholders needed a greater voice in corporate governance . . . ." S. REP. NO. 111-176, at 35 (2010).
189. Securities Exchange Act § 14A(c)(1), 15 U.S.C. § 78n-1(c)(1) (2012) (noting that say-on-pay votes will not overrule any decision by the board).
190. Williams Act, Pub. L. No. 90-439, 82 Stat. 455 (1968).
191. *See* Securities Exchange Act 1934 § 13(d), 15 U.S.C. § 78m (2012).
192. *Id.* § 14(d), 15 U.S.C. § 78n.
193. CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 79 (1987).

Both the courts and Congress have characterized the Williams Act as concerned with investor protection.[194] But what sort of investor interests does it protect? At least with respect to tender offers, there is a strong case that trading interests are the focus. As the Supreme Court has noted, "[t]ender offers contemplate transfers of stock by stockholders to a third party and do not themselves implicate the internal affairs of the target company."[195] Absent interference by managers, investors can decide for themselves whether or not to accept the tender offer, and disclosure provides them with the information to decide whether the offer is fair.[196] Moreover, the various procedural rules governing tender offers have the same goal in mind, ensuring that investors will not be coerced into tendering at an unfair price. As one court has noted, "the distinguishing characteristic of the activity the Williams Act seeks to regulate

194. The U.S. Supreme Court has stated: "The legislative history thus shows that the sole purpose of the Williams Act was the protection of investors who are confronted with a tender offer." Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 35 (1977); *see also* Edgar v. Mite Corp., 457 U.S. 624, 633 (1982) (concluding "[t]here is no question that in" passing the Williams Act, "Congress intended to protect investors").

195. *Edgar*, 457 U.S. at 645; *see also* Richard A. Booth, *The Problem With Federal Tender Offer Law*, 77 CAL. L. REV. 707, 753 (1989) ("[T]ender offers more closely resemble a form of trading than do the proxy contests on which their regulation under the Williams Act is based."); Johnson & Millon, *supra* note 51, at 1880 ("It is possible to regard tender offers as straightforward securities transactions, that is, to characterize their central feature as involving nothing more than the decision by individual shareholders to sell or refuse to sell their stock to a prospective purchaser."). Corporate law distinguishes between tender offers where shareholders decide whether to sell, and mergers, where the board has been delegated the authority to make the decision. Thus, in the context of freeze-out transactions, where a controlling shareholder seeks to purchase the shares of the minority, the standard differs depending on whether a tender offer is made. When the transaction occurs through a merger, minority shareholders are protected by an entire fairness standard, which recognizes that the board has a conflict of interest that might make it difficult to represent the interests of the minority shareholders. *See* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. Supr. 1983); *see also* Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1357 (1978) ("Freezeouts, by definition, are coercive: minority stockholders are bound by majority rule to accept cash or debt in exchange for their common shares, even though the price they receive may be less than the value they assign to those shares."); James Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1202 (1964) (noting that under freeze-out, "those in control rather than the stockholder himself would decide when he shall sell his stock"). In contrast, when the controlling shareholder makes a tender offer, the minority shareholders do not receive entire fairness protection, because they make the decision to accept the offer themselves. *See* Solomon v. Pathe Comm., 672 A.2d 35, 39 (Del. 1996).

196. *See, e.g.*, BNS Inc. v. Koppers Co., 683 F. Supp. 458, 468 (D. Del. 1988) ("The point of requiring [Williams Act] disclosure . . . is to give stockholders sufficient, balanced information upon which to choose whether to tender their shares.").

is the exertion of pressure on the shareholders to make a hasty, ill-considered decision to *sell their shares*."[197]

The disclosure required when an investor accumulates 5 percent of a company's stock is more difficult to characterize as purely affecting trading interests.[198] On the one hand, such disclosure provides useful information to the market in that the accumulation of a significant stake in a company can signal that the company's stock is undervalued. On the other hand, such a disclosure requirement also puts the company's managers on alert that a takeover bid could be imminent, allowing them to formulate a defensive response. This early warning function of the Williams Act thus arguably affects corporate governance by helping to entrench managers of the company.

Because it touches on the balance of power between managers and certain shareholder interests, there is a question whether the Williams Act broadly regulates the important corporate law area of takeover defenses. In *Edgar v. Mite*,[199] three justices would have held that the Williams Act preempted an Illinois state statute, partly on the ground that managers could utilize it to indefinitely delay accepting a tender offer. These justices argued that the Williams Act sets forth a policy of neutrality between managers and the takeover bidder, and that allowing managers to indefinitely block a tender offer would disrupt that balance.[200] The Illinois law in question would have run afoul of this principle, because it allowed management to essentially stop a takeover by invoking a provision that would require the Secretary of State to hold a hearing on the substantive fairness of a tender offer.[201] Citing this concurrence, some lower courts subsequently read the Williams Act as requiring takeover defenses to give tender offers a "meaningful opportunity for success."[202] A number of academics have cited this principle in arguing that the Williams Act preempts state antitakeover statutes and defenses.[203]

---

197. Panter v. Marshall Field & Co., 646 F.2d 271, 286 (7th Cir. 1981) (emphasis added); *see also* Schreiber v. Burlington N., Inc., 472 U.S. 1, 8 (1985).
198. *See, e.g.*, Winter, *supra* note 22, at 287 ("Takeover statutes, however, although they involve trading in shares, regulate the market for management control and it may well be that they can serve as a vehicle for monopolization even at the state level.").
199. 457 U.S. 624 (1982).
200. *Id.* at 633–34.
201. *Id.* at 637.
202. Bebchuk & Jackson, *supra* note 162, at 1564.
203. *Id.* at 1552 (arguing that Delaware law permitting indefinite use of poison pill to prevent acceptance of a tender offer fails meaningful opportunity for success standard). *See generally* Guhan Subramanian et al., *Is Delaware's Antitakeover Statute Unconstitutional? Evidence From 1988–2008*, 65 BUS. LAW. 685 (2010) (arguing that Delaware antitakeover statute does not give bidders a meaningful opportunity for success).

As with other attempts to make federal corporate law, this broad reading of the Williams Act is rooted in the Court's description of the Act as representing a "federal policy of investor protection."[204] The minority reading of the Williams Act essentially argues that the Act's policy of neutrality evidences a concern with protecting investors from managers who want to indefinitely thwart a takeover bid. Such a reading would make the Williams Act federal corporate law.

Under this Article's approach, the case for broad Williams Act preemption of state antitakeover policy is a weak one. With respect to the Williams Act, investor protection is best defined as encompassing the narrow goal of protecting trading investors, rather than broadly protecting the right of shareholder-owners to accept a tender offer. This point was made by a concurrence in *Edgar v. Mite* by Justice Stevens, who took issue with the minority reading that the Williams Act policy of neutrality requires preemption of state antitakeover law.[205] While the Act's provisions on their own terms were meant to be neutral, the Act does not require state law to be neutral with respect to the relationship between managers and shareholders. Nothing in the Act precludes states from providing managers with more or less authority with respect to tender offers.[206] It thus does not affect state corporate law that would govern the extent of protection shareholder-owners receive from entrenched managers.[207] Justice Powell expanded upon this argument in the Court's opinion in a later Williams Act case, *CTS Corp. v. Dynamics Corp.*,[208] where he noted that the minority reading of the Williams Act is unworkable because it would preempt a wide range of state corporate law provisions that affect the relationship between shareholders and managers.[209] Without clear evidence that the Williams Act intended to create so much federal corporate law, it should be considered securities law that does not preempt state antitakeover law.

204. CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 83 (1987).
205. Edgar v. Mite Corp., 457 U.S. 624, 647–48 (1982) (Stevens, J., concurring in part and concurring in the judgment).
206. *See id.*
207. *See, e.g.*, Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 853 (1993) (noting that the type of statute at issue in *CTS Corp* "regulate[s] a corporation's internal affairs (i.e., matters of corporate governance), which are the province of the incorporation state").
208. 481 U.S. 69 (1987).
209. *CTS Corp.*, 481 U.S. at 85–87.

C. Mandatory Disclosure Requirements

As noted earlier, disclosure requirements are common in the context of state corporate law. Such mandates typically protect owners from misconduct by managers or majority shareholders. The federal securities laws increasingly require disclosure that primarily protects ownership rather than trading interests. Such disclosure is best described as federal corporate law.

1. Disclosure and Corporate Governance

The securities laws give the SEC a broad mandate to require disclosure concerning any information "necessary or appropriate in the public interest or for the protection of investors."[210] The SEC has thus often been encouraged to use disclosure mandates to reform corporate governance. At times, the SEC has resisted such efforts, stating that while "disclosure requirements may have some indirect effect on corporate conduct, the Commission may not require disclosure solely for this purpose."[211]

More recently, Congress has increasingly imposed disclosure requirements with the main goal of protecting shareholder-owners. Such corporate governance regulation has been justified by a broad conception of investor protection. For example, consider Dodd-Frank and its disclosure provisions relating to executive compensation. Such compensation has been the subject of disclosure for years,[212] but Dodd-Frank seeks to more aggressively influence the nature of such compensation. The statute requires new disclosures relating to the relationship between a company's executive compensation and its performance,[213] as well as the disclosure of the ratio between the median compensation of all employees and the CEO's compensation.[214]

Though these new provisions are couched in terms of disclosure and are contained in the federal securities laws, they were meant to be corporate law

---

210. *See* Securities Act of 1933 § 7, 15 U.S.C. § 77g (2012); Securities Exchange Act of 1934 § 12(b), 15 U.S.C. § 78l (2012).
211. Commission Conclusions and Rulemaking Proposals, Securities Release No. 5627, 8 SEC Docket 73, 1975 WL 160503, at *8 (Oct. 14, 1975); *see also* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 534 (3d ed. 2003) (noting that the "SEC's response to the corporate governance debate . . . was strikingly limited").
212. *See, e.g.*, Executive Compensation Disclosure, Release No. 6962, 52 SEC Docket 1961, 1992 WL 301259 (Oct. 16, 1992) (describing amendments to executive compensation disclosure requirements).
213. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 953(a), 124 Stat. 1376, 1903 (2010).
214. *Id.* § 953(b).

aimed at protecting owners. The legislative history refers to these provisions as "designed to address shareholder rights and executive compensation practices."[215] The SEC rules implementing these provisions were primarily justified as informing the voting decisions of shareholder-owners.[216] A U.S. Senate report described these reforms in terms of the "investor protection" ground of preventing "excessive risk taking" by corporate managers.[217] The leading academic proponents of enhanced disclosure of executive compensation note that the "main aim" of such policies "is not to enable accurate pricing of the firm's securities," but "to provide some check on arrangements that are too favorable to executives."[218]

These efforts could be the start of a significant change in the nature of federal disclosure. Some elements of disclosure have always affected ownership interests. What is different about this new disclosure regulation is that it more aggressively appeals to the protection of owners as a reason for creating disclosure obligations. To the extent that this trend continues, federal mandatory disclosure will look more like federal corporate law.

2. Internal Controls

The provisions of the federal securities laws requiring public companies to establish and assess the reliability of a system of internal controls have been controversial. Some commentators have implied that such controls are an example of corporate governance regulation. Because they arguably impose substantive requirements, under the disclosure test, internal controls seem like corporate law.[219] A close look at these provisions reveals that it is not so clear that internal controls regulation is purely federal corporate law. Such controls seek to prevent diversion of corporate assets, but they also serve

215. H.R. REP. NO. 111-517, at 872 (2010) (Conf. Rep.).
216. Pay Ratio Disclosure, Release Nos. 33-9877, 34-75610, 60 Fed. Reg. 50,104, 50,149 (Aug. 18, 2015) ("[T]he primary benefit that Congress intended with pay ratio disclosure is to provide shareholders with a company-specific metric that they can use to inform their voting decisions regarding executive compensation . . . .").
217. S. REP. NO. 111-176, at 35–36 (2010).
218. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 192 (2004); *see also* Edward M. Iacobucci, *The Effects of Disclosure on Executive Compensation*, 48 U. TORONTO L.J. 489, 497 (1998) ("The purpose of increased disclosure is invariably stated to be the improved governance of the establishment of executive compensation and improved governance of the corporation generally . . . .").
219. *See, e.g.*, Peter V. Letsou, *The Changing Face of Corporate Governance Regulation in the United States: The Evolving Roles of the Federal and State Governments*, 46 WILLAMETTE L. REV. 149, 187 (2009) (describing internal controls requirements as "substantive corporate governance regulations").

to ensure that public companies produce accurate valuation information. The former concern relates to ownership while the latter concern relates to trading. Internal controls requirements thus have elements of both corporate and securities law.

As described by Section 13(b) of the Securities Exchange Act, internal controls have two aspects.[220] The first relates to whether "financial statements" are prepared in accordance with proper accounting standards.[221] This formulation relates to the accuracy of periodic disclosures, a traditional concern of the securities laws. The second relates to "accountability" and "access to" the company's assets.[222] This provision is targeted at the misuse of corporate assets, a concern more closely associated with corporate law.

The Foreign Corrupt Practices Act,[223] which initially implemented these provisions in 1977, was primarily driven by concerns relating to the diversion of assets by corporate managers who paid bribes to foreign officials. In justifying this amendment to the securities laws, the SEC again used the broad conception of investor protection. It described such regulation as "oriented toward the basic interests of investors" because "the managements of corporations are stewards acting on behalf of the shareholders, who are entitled to honest use of, and accounting for, the funds entrusted to the corporation . . . ."[224] This justification for internal controls speaks to the interests of shareholder-owners, the primary concern of corporate law.[225]

In contrast, Sarbanes-Oxley, which requires controversial enhancements to the internal controls mandate,[226] was mostly directed at the protection of trading investors. The Senate Report situates the Sarbanes-Oxley reforms within the traditional concern of securities law when it described their goal as "enhanc[ing] the quality of reporting and increas[ing] investor confidence. . . ."[227] The prevention of fraud resulting from poor internal controls is more closely related to

220. Securities Exchange Act § 13(b), 15 U.S.C. § 78m(b) (2012).
221. *Id.* § 13(b)(2)(B)(ii), § 78m(b)(2)(B)(ii).
222. *Id.* § 13(b)(2)(B)(ii) & (iii), § 78m(b)(2)(B)(ii) & (iii).
223. Foreign Corrupt Practices Act, Pub. L. No. 95-213, 91 Stat. 1494 (1977).
224. SECURITIES AND EXCHANGE COMMISSION, 94TH CONG., REP. ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES 19–20 (Comm. Print 1976).
225. Delaware has approached the issue by establishing a basic duty of the board to monitor the corporation for wrongdoing. *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006).
226. Managers are now required to assess the effectiveness of the company's internal controls, and auditors must attest to this assessment. *See* Sarbanes-Oxley § 404, Foreign Corrupt Practices Act, Pub. L. No. 107-204, 116 Stat. 745 (2002).
227. S. REP. NO. 107-205, at 31 (2002); *see also* John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 929 (2015) (observing that the main purpose of Sarbanes-Oxley was to "reduce fraud").

the core concern of securities regulation than the prevention of foreign bribe payments.[228]

At the same time, Sarbanes-Oxley was largely prompted by the significant losses suffered by the shareholder-owners of fraudulent companies such as Enron and WorldCom.[229] Congress passed the law to address "[d]efects in procedures for monitoring financial results and controls" that were "blamed for recent corporate failures."[230] Stronger internal controls might have helped prevent such destruction of value.[231] Thus, such controls also can be understood as protecting owners from widespread illegality by managers, a concern that has traditionally been one of corporate law.[232]

In requiring measures to help ensure the accuracy of public company disclosures, provisions regulating internal controls sit at the boundary between corporate and securities law. These provisions have benefits (and costs) for both trading and ownership.

D. Board Regulation Through Exchange Listing Requirements

Both Sarbanes-Oxley and Dodd-Frank have significantly shaped the boards of public corporations. These reforms have been implemented through federal securities law amendments requiring stock exchanges to implement certain listing requirements. On the one hand, board reform is primarily meant to protect shareholder-owners from managerial overreaching. On the other hand, because listing requirements govern which companies can

228. The SEC rules defining the scope of internal controls appear to focus on information relating to trading interests. SEC Rule 13a-15 refers to two types of internal controls: (1) disclosure controls and procedures; and (2) internal control over financial reporting. *See* 17 C.F.R. 240.13a-15 (2015).

229. *See, e.g.*, Small v. Fritz Cos., 65 P.3d 1255 (Cal. 2003) (observing that holders of Enron securities suffered substantial losses). For a time, such owners of securities could bring class actions under state law, but Congress preempted such actions. *See* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71 (2006). For an argument that ownership-claims differ from trading-claims, see Amanda M. Rose, *Life After SLUSA: What Is the Fate of Holding Claims?*, 69 DEF. COUNS. J. 455, 461 (2002) ("Holding claims, by contrast, involve no transactional element. Rather, they concern the static relationship between shareholder and corporation, a substantive relationship defined consistently throughout American history by state law.").

230. S. REP. NO. 107-205, at 23 (2002).

231. Though as Professor Donald Langevoort notes, when internal controls are implemented, the costs are mostly borne by shareholder-owners, who may not see the costs as justified. *See* Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting* Corporate Law*'s "Duty of Care as Responsibility for Systems"*, 31 J. CORP. L. 949, 961 (2006).

232. *See, e.g.*, Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006) (confirming that the board has a duty to monitor that can be satisfied by setting up a system of internal controls).

trade on the most liquid public markets, these provisions are arguably also directed at trading interests.

After the last two financial crises, Congress passed statutes mandating the independence of certain board committees. Sarbanes-Oxley requires stock exchanges to pass rules specifying that all exchange-traded companies have audit committees consisting solely of independent directors.[233] Building on that precedent, Dodd-Frank requires all directors on compensation committees of listed companies to be independent.[234] Dodd-Frank also seeks to encourage board independence by requiring justification of the company's policy on whether the CEO can also be the Chairman of the Board.[235]

The appeal of an independent board is that it can protect shareholders from selfish managers, a goal that is squarely part of corporate law. Increasing the number of independent directors has long been seen as improving the ability of the board to monitor managers of the company on behalf of shareholders.[236] As with other areas of federal corporate law, reformers such as William Douglas have invoked a broad reading of investor protection to encourage federal regulation of boards.[237] The SEC has long seen board independence as important to investor protection.[238]

Though board reform gets to the heart of corporate law, the fact that these reforms were passed as exchange listing requirements makes it difficult to conclude that they are completely unrelated to trading.[239] Exchanges facilitate investor trading by making orderly markets in securities. Only companies that satisfy certain listing requirements associated with quality issuers

233. *See* Sarbanes-Oxley Act § 301, Pub. L. No. 107-204, 116 Stat. 745 (2002); 17 C.F.R. § 240.10A-3 (2015).

234. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900 (2010); *see also* 17 C.F.R. § 240.10C-1(b)(1) (2015).

235. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 972, 124 Stat. 1376, 1915 (2010).

236. *See* EISENBERG, *supra* note 171, at 162–68; *see also* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1541 (2007) (noting that more informative stock prices enable independent directors to monitor the corporation).

237. *See* William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1332–34 (1934); *see also* Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1301–02 (2009) (arguing that "independent directors who serve on the board or on certain key committees could enhance investor protection").

238. *See, e.g.*, Karmel, *supra* note 50 (summarizing history of such efforts); *see also* SEC v. Mattel, Fed. Sec. L. Rep. (CCH) ¶ 94, 807 (Oct. 1, 1974) (requiring company to appoint two independent directors as remedy for securities fraud).

239. The SEC has long had power to regulate stock exchanges such as the New York Stock Exchange. *See* Securities Exchange Act of 1934 § 6(a), 15 U.S.C. § 78f(a) (2012).

are permitted to trade on an exchange.[240] Listing requirements protect investors by screening out those companies that are not worthy to be traded.[241]

At least some board-related listing requirements can rightly be seen as screening public companies for quality. The New York Stock Exchange declares that "every listed company is expected to follow certain practices aimed at maintaining appropriate standards of corporate responsibility, integrity and accountability to shareholders."[242] On the other hand, such listing requirements could serve to regulate virtually all matters of corporate governance.[243] If trivial or cosmetic governance requirements are routinely implemented through listing regulation, securities law could eventually subsume state corporate law.

In determining whether a listing requirement that sets forth a corporate governance requirement is securities law or corporate law, the question should be whether the governance requirement materially improves the quality of the security. Though it is beyond the scope of this Article to fully develop such a test, a discussion of the major Sarbanes-Oxley and Dodd-Frank board reforms is illustrative. The independent audit committee provisions of Sarbanes-Oxley arguably help ensure the quality of a security's valuation. By reducing the ability of managers to influence audits, such committees might improve the objectivity of the audit. In contrast, Dodd-Frank's requirement of independent executive compensation committees is more difficult to categorize as essential to ensuring the quality of a security. It is unclear that the amount at stake with respect to executive compensation will significantly affect the valuation of a company. Thus, while some board reforms are arguably securities law, other board reforms look more like corporate law.

---

240. For example, at the time of listing, public companies must have a minimum market value to trade on the New York Stock Exchange. NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 102.01B (last amended Oct. 18, 2012); § 802.01B (last amended Dec. 9, 2013), http://nysemanual.nyse.com/LCM/Sections [https://perma.cc/6Y28-JD48].

241. According to the New York Stock Exchange, a listing "is internationally recognized as signifying that a publicly owned corporation has achieved maturity and front-rank status in its industry . . . ." *Id.* § 101.00; *see also* Van Gemert v. Boeing Co., 520 F.2d 1373, 1381 (2d Cir. 1975) ("[A] company must meet certain qualifications of financial stability, prestige, and fair disclosure, in order to be accepted for that listing, which is in turn so helpful to the sale of the company's securities."); KRAAKMAN ET AL., *supra* note 16, at 289 (noting that listing requirements protect investors by screening the quality of traded companies).

242. NEW YORK STOCK EXCHANGE, *supra* note 240, § 301.00.

243. *See, e.g.*, Comment, *Stock Exchange Listing Agreements as a Vehicle for Corporate Governance*, 129 U. PA. L. REV. 1427, 1429 (1981) ("By requiring the listing corporation to follow various provisions and reservations in the agreement, stock exchanges can effectively govern aspects of the corporation's internal affairs.").

V. FOUNDATION FOR A TWO-TIERED REGULATORY SYSTEM

As the investor protection argument has gained momentum, the longstanding dual system of federal securities law and state corporate law is moving towards unified federal regulation.[244] By differentiating between the types of investor concerns addressed by corporate and securities law, this Article provides a foundation for maintaining two sources of regulation for public corporations.[245] Part V.A argues that securities law is uniform and mandatory because it focuses on a clear policy goal—facilitating valuation for trading investors. Part V.B claims that corporate law consists of diverse, enabling rules because the differing time horizons of owners make it more difficult to identify policies that will not favor one set of owners over others.

A. Uniform Protection of Trading Investors

In protecting investors when trading, securities law facilitates fair valuation. The securities laws are mandatory and uniform because there is consensus that traders benefit when markets are fair and valuation is facilitated by national regulation.

1. Fair Valuation

In order for a market to function, investors must be confident that they are transacting at fair prices. As a purchaser, the investor wants to know that he is paying a price for a security that reasonably reflects the prospects of the firm. As a seller, an investor will need some assurance that he is receiving a fair price for a security. Though it is an elusive concept, the integrity of security prices is a concern that unites investors when they trade.

That is not to say that a trading investor at a particular point in time will not prefer markets to be inflated or deflated to his advantage. Purchasers and sellers inherently have conflicting interests. When buying stock, the purchaser

244. *See, e.g.*, Eric L. Talley, *Corporate Inversions and the Unbundling of Regulatory Competition*, 101 VA. L. REV. 1649, 1693 (2015) ("Although the separation of corporate and securities law was never entirely air-tight, the acoustic separation between them began disintegrating substantially after the bursting of the dot-com bubble, as securities law began increasingly and progressively to colonize corporate governance, preempting and displacing the mandates of state corporate law.").

245. Though state regulation of corporate law is typically justified in terms of federalism, the concept of federalism arguably offers little clarification about the policy goals of corporate and securities law. *See generally* Alison Grey Anderson, *The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934*, 70 VA. L. REV. 813 (1984).

wants the lowest price possible, while a seller will want the highest price possible. Many investors will arguably want prices that are distorted in a direction that favors them. However, if prices are systematically distorted in one direction, the disadvantaged side will no longer trade.[246] In order for there to be frequent transactions, trading investors must believe that valuations are reasonable. Both purchasers and sellers thus have an interest in the creation of markets with fair valuations where investors are willing to transact.[247]

Fair valuation is thus a neutral policy goal that unites investors when they are trading. Such a goal is achieved when markets reliably reflect fundamental information about public companies. There is consensus that U.S. stock markets exhibit some form of such market efficiency that is partly the result of legal policies that facilitate valuation.[248]

2. Federal Securities Laws

Because trading investors have a common interest in fair valuation, securities law is appropriately implemented by the national regulation provided by federal law. When basic policy goals are clear, a single set of rules can be effective in establishing a baseline of regulation. A mandatory system helps ensure that the rules are implemented consistently. Rather than leave disclosure, antifraud, and market regulation to states that might implement diverse policies, federal securities laws provide certainty to trading investors seeking fair markets.

Uniformity has particular benefits for a body of law that seeks to encourage fair valuation. The process of valuing securities is facilitated when trading investors can easily compare different companies. If public companies were not governed by a single set of mandatory securities laws, investors would

246. *See, e.g.*, Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 357 (1979) (describing Congress's belief that unfair informational advantages will discourage public investors from entering the market).

247. It is important to acknowledge that investors will differ in their willingness to take on the risk of buying a security for a price that exceeds its true value. *See generally* Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611 (1995) (describing diverse investor expectations). A long-term investor may be less sensitive to the exact price because he expects to hold the security for a long period. A chartist might even purchase in the belief that past patterns predict that the price will soon go up. *See, e.g.*, Alfred Rappaport, *The Economics of Short-Term Performance Obsession*, 61 FIN. ANALYSTS J. 65, 67–68 (2005) (describing technical analysis investing strategy). Other investors may place significant weight on noneconomic considerations, such as social responsibility, in choosing investments. Nonetheless, most investors benefit when securities trade at roughly fair prices.

248. *See, e.g.*, Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2410 (2014).

have to constantly adjust for different legal regimes. Investors can more easily assess companies that are all providing similar types of information. Federal securities regulation contains a basic template for disclosure that enables such comparison. More recent efforts such as Sarbanes-Oxley standardize the production of public company information so it is reliable enough to facilitate valuation.[249] The federal prohibition of fraud creates incentives for all issuers to comply with mandatory disclosure rules.

Over the decades, many statutes have been passed with the goal of furthering uniformity with respect to securities regulation. The 1964 Amendments to the Securities Exchange Act applied mandatory disclosure rules that had previously been limited to stocks trading on exchanges to stocks trading in over-the-counter markets.[250] The 1975 Amendments to the securities laws sought to create a "national market system" for securities trading.[251] The 1995 Private Securities Litigation Reform Act sets forth uniform standards governing federal securities class actions.[252] The 1996 National Securities Market Improvement Act preempts state blue sky regulation for securities trading on national markets.[253] The 1998 Securities Litigation Uniform Standards Act sought to establish "national standards for securities class action lawsuits involving nationally traded securities . . . ."[254] These laws evidence consensus over time about the need for uniform regulation with respect to the rules governing trading markets.

Some prominent commentators have argued that securities regulation would benefit from greater diversity. Certain disclosure requirements might be too burdensome, thus it may be desirable to offer issuers a choice with respect to which securities laws govern their disclosure.[255] Just as an issuer can choose which jurisdiction's corporate law governs its internal affairs, an issuer could choose which jurisdiction governs its securities regulation obligations. A jurisdiction would have incentive to provide an optimal set of securities

249. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 745, 789.
250. Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964).
251. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975).
252. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).
253. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 102, 110 Stat. 3416 (1996).
254. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, § 2(5), 112 Stat. 3227, 3227 (1998).
255. *See, e.g.*, Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 917 (1998) (arguing that issuers will sort themselves by choosing different regulatory regimes); Romano, *supra* note 26, at 2391 (predicting that Delaware would offer regulation that minimizes costs to issuers if states regulated securities law).

laws to persuade issuers to choose its law. As jurisdictions compete for issuers, the result might be a regulatory race-to-the-top with most issuers choosing the jurisdiction with the most efficient securities laws.

These proposals highlight a tension between trading investors, who want securities regulation to facilitate valuation, and the issuers who must comply with such regulation. Public companies must pay for disclosure, and these costs are ultimately borne by shareholder-owners. It is beyond the scope of this Article to resolve this tension, but it is worth noting that this Article offers a modest way of narrowing the scope of disclosure requirements. A significant source of increasing disclosure costs is the effort to add corporate governance requirements to the federal securities laws. By more precisely defining the distinction between corporate and securities law, this Article provides a justification for resisting federal corporate law. A mandatory disclosure regime that focuses on the interests of trading investors would reduce some of the burdens that regulatory competition proposals seek to address.

B. Diverse Protection of Owners

Because it seeks to further the diverse interests of shareholder-owners, there is less agreement with respect to the goals of corporate law. Shareholder-owners can have very different interests depending on the timeframe of their investment. Corporate law that is flexible and diverse allows for balancing of the interests of long-term and short-term shareholders.

1. The Divergence of Ownership Interests

There is greater variation in the preferences of investors at the ownership stage of an investment. While trading involves discrete decisions to buy or sell at particular times, ownership occurs across a continuous spectrum. Shareholders differ significantly in the length of time they seek to own an investment. Depending on their timeframe, owners can have very different preferences with respect to corporate governance.[256]

256. It has been common to describe this conflict as one between shareholders and managers. As Professor Edward Rock has observed, "incorporation in Delaware benefits shareholders because its law and courts do better than any alternative jurisdiction in striking the balance between shareholders and managers . . . ." Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1983–84 (2013); *see also* Marx v. Akers, 666 N.E.2d 1034, 1037 (N.Y. 1996) (noting that demand requirement for derivative suits balances manager and shareholder interests).

Professors Stephen Bainbridge and Iman Anabtawi have each made this point, noting that shareholder time horizons differ, making it difficult to identify uniform shareholder interests.[257] It is unrealistic to precisely catalog the holding preferences of shareholders, but some rough generalities are possible. Retail investors saving for retirement and institutions that invest passively on behalf of such investors are most likely to hold stock for significant periods of time. Hedge funds seeking fast gains from the market will have short-term time horizons. There is some evidence that average holding periods have declined in recent years,[258] but there will always be a substantial number of investors who own an investment for a significant time.

The primary goal of corporate law is often said to be shareholder wealth maximization, but because shareholders have different time horizons, wealth maximization does not completely unify their interests.[259] The goals of short-term and long-term owners often conflict.[260] Short-term owners rationally prefer companies to seek a higher stock price within a quick timeframe. They are less likely to defer to the strategy of the current managers of the corporation. Long-term owners are not as concerned about immediate results and want to maximize returns over many years. As a result, they may want to give managers more deference than short-term owners, or at least more time to implement their strategy. Many commentators argue that there is a trade-off between short-term and long-term interests in that an excessive focus on the short-term will compromise the long-term strategy of a corporation.[261] Unlike securities regulation, which uses fair valuation to mediate

257. *See, e.g.*, Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579 (2006) ("Heterogeneity among shareholders with respect to their expected holding periods can lead to differences in shareholder preferences over corporate decisionmaking."); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1745 (2006) ("Shareholder investment time horizons are likely to vary from short-term speculation to long-term buy-and-hold strategies, which is likely to result in disagreements about corporate strategy."); *see also* K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67, 110–11 (2016) (summarizing finance literature on shareholder disagreement).

258. *See, e.g.*, Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977 (2013) (summarizing evidence).

259. If markets were always fundamentally efficient, there would not be a conflict between short-term and long-term shareholders. This argument thus depends on the belief that markets are not always fundamentally efficient.

260. *See, e.g.*, Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N.C. L. REV. 137, 140 (1991) ("Although short-term and long-term interests do not invariably diverge, they are in conflict most of the time.").

261. *See, e.g.*, Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554, 1615 (2015) ("[E]ach type of shareholder will want managers to maximize the payout

the interests of purchasers and sellers, there is no single principle that resolves the tension between short-term and long-term owners.

On the surface, it may appear that the law should always favor long-term interests over short-term interests. It is difficult to argue that corporate law should not seek to maximize the growth of a corporation over many rather than just a few years.[262] It is unclear, however, that seeking immediate results always undermines long-term performance. Indeed, short-term activism may be necessary if an incompetent management group is unresponsive to shareholder interests.[263] The performance of long-term policies can be difficult to assess, and pressure from short-term investors can help ensure that managers are held accountable for competently implementing such policies. There are tensions between short-term and long-term owners, and it is not apparent that the law should always favor one set of shareholders.

Moreover, while there is some consensus that regulation promoting fair valuation increases social welfare, the evidence is more mixed as to whether corporate governance measures increase shareholder wealth. Though studies have found an association between certain governance provisions and firm performance,[264] other studies have not found such a link.[265] It is unclear whether particular governance measures increase value or whether better performing

to her own group, even if those steps may reduce the size of the pie—the value flowing to all shareholders—short-term, long-term, and future—over time."); Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 104 (1979) (describing policy issue of "[w]hether the long-term interests of the nation's corporate system and economy should be jeopardized in order to benefit speculators"); Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1 (2010) (arguing that short-term horizons of institutional investors conflict with long-term goals of their clients).

262. Some case law reflects the view that long-term growth should be the ultimate end of corporate law. *See, e.g.*, *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 37 (Del. Ch. 2013) ("[T]he duty of loyalty therefore mandates that directors maximize the value of the corporation over the long-term for the benefit of the providers of equity capital . . . ."); Katz v. Oak Indus., 508 A.2d 873, 879 (Del. Ch. 1986) ("It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders . . . ."). *But see* SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) ("The speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders.").

263. *See, e.g.*, Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637 (2013) (responding to argument that insulating boards from shareholder input improves long-term value of corporations); *see also* Roe, *supra* note 258 (disputing view that short-term pressure from investors justifies insulating boards).

264. *See, e.g.*, Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003) (finding that during the 1990s, firms with strong shareholder rights earned greater returns than firms with weak shareholder rights).

265. *See, e.g.*, Gordon, *supra* note 236, at 1500 ("Evidence that connects the increased presence of independent directors to shareholder benefit is weak at best.").

corporations are likely to implement such measures.[266] Thus, there is inconclusive evidence that there are uniform corporate governance policies that would clearly benefit shareholder-owners.[267]

2. Diversity and State Corporate Law

In contrast to securities law, corporate law must meet the needs of owners with different, sometimes conflicting, interests. The current structure of corporate law thus utilizes diverse state regulation that is more flexible than the uniform and mandatory regime of federal securities law. This system where states create corporate law allows for experimentation in which states strike different balances between the interests of short-term and long-term owners.

Corporate law is often said to be enabling rather than mandatory. That is, corporate rules are flexible in that corporations have some choice with respect to which rules they adopt. Diversity of shareholder interests increases the complexity of corporate law problems, and uniform rules can be ill-suited to resolving them. Mandatory rules governing owners can be problematic because they might unfairly favor one set of owners over the other. Corporate law should thus allow room for both courts and corporations to balance the varying interests of shareholder-owners.

Much of the flexibility of corporate law comes from the use of broad standards that can be interpreted differently based on the context. Prior literature has puzzled over this indeterminacy of corporate law, noting that uncertainty over meaning increases transaction costs.[268] One prominent explanation for indeterminacy is the influence of interest groups such as courts and lawyers that can capture rents from the need to interpret vague legal standards.[269]

266. *See, e.g.*, Bhagat et al., *supra* note 135, at 1808 (observing that "governance and performance, are plausibly endogenous, meaning that their relationship is bidirectional rather than unidirectional").

267. *See, e.g.*, *id.* at 1809 (arguing that indeterminacy of studies suggests that corporate law should be governed by a "flexible regulatory regime allowing ample variation across firms").

268. *See, e.g.*, William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 71 (claiming that "both litigants and those attempting to order their business affairs" must deal with "jumbled law" in Delaware). *But see* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1017 (1997) (claiming that Delaware adjudication "leads to reasonably precise standards . . . through richly detailed narratives of good and bad behavior").

269. *See, e.g.*, Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1913 (1998) ("[T]he corporate bar, Delaware's judiciary, and the general legal culture have all fostered a judge-oriented corporate law . . . ."). Professor Kamar

Others have argued that indeterminacy is a way that Delaware hides its tendency to favor corporate managers.[270]

Indeterminacy may also be partly explained by the main challenge of corporate law, balancing the interests of owners with different time horizons. Corporate law standards allow judges to balance interests in a way that would be more difficult with inflexible rules.[271] Delaware judges have noted the importance of case-by-case decisionmaking in developing their body of corporate law.[272] A comprehensive discussion of the way corporate law balances ownership interests is best left to another day, so the discussion will highlight a few areas of doctrine to illustrate this point.

Consider the business judgment rule that is a common part of state corporate law. This rule provides directors of the corporation with significant protection from liability for breaches of the duty of care.[273] By giving directors substantial discretion in their decisionmaking, corporate law gives directors the ability to balance long-term and short-term interests. As the Delaware Supreme Court put it in *Paramount Communications, Inc. v. Time, Inc.*,[274] "precepts underlying the business judgment rule militate against a court's engaging in the process of attempting to appraise and evaluate the relative merits of a long-term versus a short-term investment goal for shareholders."[275]

Another example is the law governing takeover defenses in Delaware. In *Unocal Corp. v. Mesa Petroleum Co.*,[276] the court set forth a broad test that assesses the existence of a threat to the corporation and the proportionality of the company's response to that threat in assessing the validity of a takeover

argues that Delaware maintains its competitive advantage in part because it is difficult for other states to interpret indeterminate corporate law in the exact same way. *See id.* at 1923–27.

270. *See* Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553, 603 (2002) (claiming that the uncertainty of Delaware's law favors managers over shareholders).

271. *See, e.g.*, Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1084 (2000) (noting that "[m]uddy rules also enable courts to engage in ex post tailoring" and that corporate law consists of an "essentially unlimited range of structural possibilities," making "ex ante specification difficult").

272. For a discussion of the importance of case-by-case decisionmaking to Delaware law, see Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 939 (Del. 2003) (Veasey, C.J., dissenting) ("The beauty of the Delaware corporation law, and the reason it has worked so well for stockholders, directors and officers, is that the framework is based on an enabling statute with the Court of Chancery and the Supreme Court applying principles of fiduciary duty in a common law mode on a case-by-case basis.").

273. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

274. 571 A.2d 1140 (Del. 1990).

275. *Id.* at 1153.

276. 493 A.2d 946, 955 (Del. 1985).

defense.[277] Such a test gives the board discretion to consider not only the interests of short-term shareholders to maximize the sales price, but also the interests of long-term shareholders and stakeholders.[278] In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[279] Delaware created an exception to this rule when the sale of the corporation becomes inevitable[280]—a test that requires the board to follow a path favoring the desires of short-term investors.[281] In other cases, Delaware has deferred to the long-term plans of directors in executing a strategy.[282] Delaware's balancing approach with respect to takeover regulation is made possible by the indeterminacy of corporate law.[283]

The traditional argument for corporate law federalism is that competition among states for corporate charters will result in corporate law that maximizes shareholder wealth.[284] Under this system, a state should have an incentive to create good corporate law to attract corporations that will pay for the right to incorporate in that state. As states experiment with corporate law, they will innovate in a way that creates law that increases shareholder value.[285] There is some evidence that state regulation has increased shareholder wealth, but it has not been conclusive.[286]

---

277. *See id.* at 955. Many other states use a business judgment rule standard, *see* Carney & Shepard, *supra* note 268, at 35 n.182 (listing states), providing even more discretion to balance interests.
278. Unocal Corp., 493 A.2d at 955 (emphasizing "the element of balance" in setting forth proportionality test for takeover defenses); Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 527–28 (2002) (observing that Delaware law gives companies discretion to consider various interests); Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037, 1040 (2002) (arguing that directors should be able to consider stakeholders and long-term interests of shareholders).
279. 506 A.2d 173 (Del. 1986).
280. *Id.*
281. *See, e.g.*, Hazen, *supra* note 260, at 197 (noting that *Revlon* favors short-term over long-term shareholders).
282. *See, e.g.*, Paramount Commc'ns, Inc., 571 A.2d at 1154 ("Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.").
283. *See, e.g.*, *id.* at 1150 (characterizing "undue emphasis on long-term versus short-term corporate strategy" as "unwise"; and noting that "the question of 'long-term' versus 'short-term' values is largely irrelevant because directors, generally, are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon").
284. *See, e.g.*, Winter, *supra* note 22, at 254 ("[C]ompetitive legal systems should tend toward optimality so far as the shareholder's relationship to the corporation is concerned.").
285. *See, e.g.*, Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. REG. 209 (2006) (documenting diffusion of corporate law across states).
286. *Compare* Daines, *supra* note 25, *with* Subramanian, *supra* note 136.

Other commentators have argued that state regulation of corporate law serves the more modest goal of providing regulatory options for companies with different needs.[287] The diversity of ownership interests suggests that providing a range of corporate law regimes is desirable. Some states may favor managers over shareholders, in essence choosing the long-term over the short-term. Other states may seek to balance rather than favor particular interests. Such diversity offers an additional argument for state regulation of corporate law in the absence of clear evidence that competition between states increases shareholder value. To the extent that there is uncertainty about which policies are best, it makes sense to allow different states to choose diverse policies that reflect the values of their local electorate.

An example of such diversity is the variation in state antitakeover laws.[288] States have differed in adopting statutes that make it difficult for hostile bidders to gain control of a corporation without the board's consent.[289] Takeover bids are a significant area where the interests of long-term and short-term shareholders can conflict. Short-term shareholders arguably prefer weaker takeover regulation so they can easily accept any bid offering a premium to the market price. Long-term shareholders are open to stronger antitakeover protections because they are more willing to defer to management's plans. Some states such as Massachusetts, Ohio, and Pennsylvania have very strong antitakeover statutes.[290] Other states such as California have no antitakeover

287. *See, e.g.*, Barry D. Baysinger & Henry N. Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 456–62 (1985).

288. Other defenses such as the poison pill have reduced the importance of antitakeover statutes in affecting whether a bid is accepted. *See* Subramanian et al., *supra* note 203, at 704–05. However, the effectiveness of the pill may be weakening, making antitakeover statutes more important. *See id.* at 705–08. Moreover, there is significant variation in states with respect to the law governing the ability of managers to indefinitely thwart a takeover bid. *See* Michal Barzuza, *The State of State Antitakeover Law*, 95 VA. L. REV. 1973, 2018 (2009). *But see* Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 136 (2001) ("[I]t is far from clear that the overall protection given to Delaware firms from takeovers is significantly less than that provided by most other states.").

289. *See* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1828 (2002) (listing antitakeover statutes by state). Some of these statutes are directed at protecting long-term stakeholders such as employees of the corporation. There can be substantial overlap between the interests of stakeholders and long-term shareholders. *See, e.g.*, John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1326 (1992) ("This longterm shareholder stage of corporate law harnesses the incentives of shareholders seeking to maximize their longterm wealth while collaterally advancing the longterm interests of nonshareholders and society.").

290. Subramanian, *supra* note 289.

statute.[291] States such as Delaware are said to have antitakeover statutes of intermediate strength.[292]

A diverse array of regulation allows for both companies where shareholders can put more pressure on managers for immediate results and companies that seek to grow slowly over the long-run. Even those who contend that there is no competition for corporate charters should agree that there are different ways that states might balance long-term and short-term interests. By providing such options, state regulation of corporate law reduces the possibility that one set of shareholder-owners is always unfairly favored over other shareholder-owners.

A skeptic might respond that because Delaware dominates the market for corporate charters, there is not true diversity in the production of corporate law.[293] Delaware's approach with respect to balancing short-term and long-term interests will prevail for most large public companies. Moreover, without the possibility of federal intervention, there is little checking Delaware if it favors one set of interests. Ultimately, this objection is not persuasive. A system where Delaware makes most corporate law would still offer more diversity than if corporate law is defined by federal statute. Moreover, even though Delaware is influential, public corporations often choose to stay in their home state,[294] perhaps because they prefer the approach taken by local law.

Preemption of state law through uniform policies would result in the risk that the law systematically favors one set of owners at the expense of others. To the extent that the federal securities laws are extended to regulate corporate law, there is a danger that law that was meant to regulate the uniform interests of traders will be ill-suited to regulate the diverse interests of shareholder-owners.

VI. MAKING FEDERAL CORPORATE LAW

The prior Part argued that securities law and corporate law differ in their regulatory objectives. There is thus good reason to limit federal regulation to securities law while allowing states to regulate corporate law. It is likely, however, that attempts to federalize corporate law will continue. Congress and the courts need guidance when they are called upon to create federal corporate

291. *Id.*
292. *Id.*
293. *See, e.g.*, Bebchuk & Hamdani, *supra* note 59, at 555 ("Delaware's dominant position is far stronger, and thus . . . the competitive threat that it faces is far weaker, than has been previously recognized.").
294. *See* Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383 (2003) (finding significant home-state advantage).

law. This Part builds on the framework developed by this Article to briefly describe a possible way of evaluating proposals for federal regulation of corporate law.

Under this Article's approach, rather than asking whether a provision relates to disclosure, policymakers should first ask whether the regulation is primarily directed at protecting the interests of traders or owners. When federal law is directed at ownership interests, it is federal corporate law, regardless of whether it is couched in terms of disclosure. Because there is a greater risk that the interests of owners with respect to a policy are divergent, such federal regulation should be closely scrutinized. Federal law should not displace state corporate law without good reason.[295]

The presumption against federal regulation of corporate law could be overcome if there is a clear and convincing showing that uniform regulation of a corporate law issue is appropriate. Policymakers should weigh two different criteria. First, is there a strong case that federal intervention would create significant value for shareholder-owners? Second, is the regulation neutral in that it does not significantly favor some shareholder-owners over other shareholder-owners?

The first of these two criteria recognizes that while ownership interests may diverge, there will be some cases where virtually all shareholders will benefit from a federal regulation. Such a case could be made through empirical evidence, a strong theoretical argument, or some combination of the two.

Consider the basic elements of federal proxy regulation. As noted earlier,[296] proxy disclosure and shareholder proposals primarily protect shareholder-owners, so they are federal corporate law. There is a strong case that shareholders benefit from accurate information relating to voting decisions. Informed votes should improve the quality of governance in a corporation, and it is difficult to conclude that shareholders are better off when they are uninformed. An argument might also be made that allowing individual shareholders to submit proposals is in the collective interest of shareholder-owners. By giving shareholders an additional mechanism to voice concerns, federal shareholder proposals could enhance shareholder governance rights. On the other hand, the benefits of good proposals might be offset by the costs of frivolous proposals. While

295. Because the interests of trading investors and owners overlap, there will be situations where it is unclear whether a rule is directed primarily at one or the other. This issue will raise some difficulties in applying the framework, but such difficulties are not insurmountable. In the case of a hybrid rule, where there are benefits to both trading investors and owners, the presumption against federal regulation would be somewhat less than when the regulation is purely meant to protect owners.

296. *See supra* Part IV.A.

there may not be conclusive empirical evidence on the effects of proxy regulation, there is a strong theoretical argument for providing basic levels of disclosure and a somewhat weaker case for permitting shareholder proposals.

The second factor would require closely examining whether federal regulation would favor a group of owners at the expense of another group of owners. Even if there is a case that federal corporate law would be beneficial, this standard would consider whether its benefits would inure to almost all shareholders rather than particular groups. Uniform rules are less likely to be appropriate with respect to issues where shareholder-owners have different interests. In applying this standard, decisionmakers should recognize that there would be some objection to potentially any proposal. Thus, there must be a substantial group of shareholders that would oppose the proposal.

Consider again the federal proxy rules. The basic elements of federal proxy disclosure do not unduly favor one set of shareholder-owners. All owners benefit from full and accurate information relating to a shareholder vote. With respect to shareholder proposals, the legislative history indicates that Congress was careful to not upset the balance between shareholders who defer to management and those shareholders who might more aggressively question management.[297] The basic shareholder proposal rules, which appear to give greater voice to activist owners, have been structured by the SEC so that managers can govern the corporation without undue interference.[298] Moreover, to the extent that proxy disclosure is effective, the ability of particular interest groups to pursue their own agenda would be limited as the other shareholders would be informed about the proposal and vote against it if it does not meet their interests.[299] Thus, while the benefits of shareholder proposals are less clear than the benefits of proxy disclosure, shareholder proposal rules are appropriate as federal corporate law to the extent that they are implemented in a neutral manner.

As this example illustrates, the two criteria set forth by the proposed test would interact in assessing federal corporate law on a case-by-case basis. If

297. LOSS, SELIGMAN & PAREDES, *supra* note 81, at 1643 (noting that "approach of neutrality in proxy contests" is "a position firmly grounded in legislative history").

298. The rule allows the corporation to exclude shareholder proposals in certain circumstances such as if the proposal violates state law or interferes with managerial functions. *See* 17 C.F.R. § 240.14a-8(i); *see also* Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 166 (1988) (describing shareholder proposal rule as having "achieved a kind of studied neutrality").

299. It is important to note that while the basic elements of proxy regulation are neutral, more recent regulation that provides for more aggressive forms of shareholder proposals may not pass the neutrality test.

there is convincing evidence of benefits for all shareholders, federal corporate law might be appropriate even if some shareholders object. If the evidence of benefits is more speculative, a proposal for federal corporate law might be salvaged if there are strong procedural safeguards ensuring the proposal would be implemented in a neutral manner.[300] While it argues for limiting federal corporate law, this Article's approach would offer the possibility that some federal corporate law might be appropriate.

CONCLUSION

This Article sets forth a better way of understanding the boundary between securities and corporate law by refining the broad standard of investor protection that has been cited so often in extending federal law. Put simply, securities law protects the interests of investors when purchasing or selling securities (when they are traders), and corporate law protects investors while they own the investment (when they are owners).

This Article provides a reason for slowing or even reversing the trend to unify federal securities law and state corporate law. There is a simple answer for why securities law is regulated by federal law while corporate law is state law. The interests of trading investors are more uniform than the interests of owners, and the law protecting these interests reflects those differences. Judges and policymakers should be wary of the effects of uniform policies on diverse shareholder-owners.

300. As Professor Romano proposes, another possibility would be to implement the reform through a sunset provision that must be renewed after several years. *See* Romano *supra* note 71, at 1600.