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The Federalization of Corporate Governance—An Evolving Process

Marc I. Steinberg*

This Article focuses on the timely subject of the federalization of corporate governance in the United States from both contemporary and historical perspectives. Although the states traditionally have overseen the sphere of corporate governance, federal law today affects the governance of publicly held corporations to a greater extent than ever before in our nation's history. This Article, drawn from the author's recently published Oxford University Press book (The Federalization of Corporate Governance), addresses this timely subject from the commencement of the 20th century to the present. Through the decades, the federalization of corporate governance has gone through periods of activism, gradual transition, and stagnation. While the Sarbanes-Oxley and Dodd-Frank Acts intensified this federalization process, it is an overstatement to conclude that these Acts comprise its foundational components. Rather, these Acts significantly enhanced the strong presence of federal corporate governance that already prevailed.

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INTRODUCTION

In my recent book, *The Federalization of Corporate Governance*, published by Oxford University Press,¹ I explore the process of

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federalization in the United States, commencing in 1903. During that decade (1903–1914), over twenty bills were introduced in Congress seeking to mandate federal chartering and/or the promulgation of federal minimum substantive standards.² Indeed, both Presidents Roosevelt and Taft supported the institution of federal chartering.³ In the following two decades, seven additional bills were introduced that sought to achieve similar objectives.⁴ It was not until fifty years thereafter that another legislative effort was launched—Senator Howard Metzenbaum’s “Protection of Shareholders’ Rights Act of 1980”⁵—that prescribed federal minimum standards largely directed at codifying the duties of care and loyalty of corporate fiduciaries as well as empowering shareholders to bring suit to enforce the Act’s provisions.⁶ Nearly four decades thereafter, we now have our most recent salvo—Senator Elizabeth Warren’s “Accountable Capitalism Act,”⁷ which returns to concepts of yesteryear: mandating federal chartering of relatively large publicly held enterprises as well as regulating director composition, conduct, stock trading practices, and specified other matters.⁸

1. MARC I. STEINBERG, *THE FEDERALIZATION OF CORPORATE GOVERNANCE* (2018).

2. *Id.* at 28–70 (describing the bills). See Melvin I. Urofsky, *Proposed Federal Incorporation in the Progressive Era*, 26 AM. J. LEGAL HIST. 160 (1982). In 1903, the Bureau of Corporations was established within the Department of Labor. See *id.* at 169. The Bureau had little enforcement authority and was subsequently replaced by the Federal Trade Commission with the enactment of the Federal Trade Commission Act of 1914. See Arthur M. Johnson, *Theodore Roosevelt and the Bureau of Corporations*, 45 MISS. VALLEY HIST. REV. 571, 575, 589 n.74 (1959).

3. See FED. TRADE COMM’N, *UTILITY CORPORATIONS*, S. DOC. NO. 92, pt. 69-A, at 18 (1934); sources set forth in STEINBERG, *supra* note 1, at 28–29.

4. STEINBERG, *supra* note 1, at 71–77.

5. S. 2567, 96th Cong. (1980) (“A Bill [t]o establish Federal minimum standards relating to composition of corporate boards, duties of corporate directors, audit and nominating committees, shareholders’ rights, and for other purposes. . .”).

6. *Id.* at 4. Although the bill was not enacted, a hearing was held. See *Protection of Shareholders’ Rights Act of 1980: Hearing on S. 2567 Before the Subcomm. on Sec. of the Comm. on Banking, Hous., & Urban Affairs*, 96th Cong. (1980).

7. S. 3348, 115th Cong. (2018).

8. Senator Warren’s bill requires US corporations that have greater than \$1 billion in annual revenues to:

[O]btain a federal charter from a newly formed Office of United States Corporations at the Department of Commerce [which would obligate] company directors to consider the interests of all corporate stakeholders—including employees, customers, shareholders, and the communities in which the company operates. . . [;] [e]mpower[] workers at United States corporations to elect at least 40% of Board members . . . [;] [r]estrict[] the sale of company shares by the directors and officers of United States corporations [by] prohibit[ing][such] directors and officers . . . from selling company shares within five years of receiving them or within three years of a company stock buyback. . . [;] [p]rohibit United States corporations from making any political expenditures without the approval of 75% of its directors and shareholders. . . ; and [p]ermit the federal government to revoke the charter of a United States corporation if the company has

All of these bills shared an identical fate: None were enacted.⁹ That does not signify, however, that they were futile gestures. Rather, a number of the provisions in these bills impacted subsequent developments. Examples include prohibiting corporate insiders from serving as officers or directors at competing corporations,¹⁰ requiring independent auditor certification of a subject company's financial statements as a condition of issuing a federal charter,¹¹ and the presence of federal regulatory mandates impacting executive officer remuneration.¹² The current state of federal corporate governance is due, at least in part, to the dialogue that was generated by these bills from decades past. Indeed, to some degree, the Dodd-Frank Act's¹³ shareholder say-on-pay advisory vote may trace its origins to a bill introduced in the midst of the Great Depression that required federal regulatory approval of officer compensation.¹⁴

Hence, the federalization of corporate governance is an evolutionary process that commenced well over a century ago. As such, it is a simplification to assert that the Sarbanes-Oxley Act of 2002¹⁵ and the

engaged in repeated and egregious illegal conduct.

Press Release, Elizabeth Warren, Warren Introduces Accountable Capitalism Act (Aug. 15, 2018), <https://www.warren.senate.gov/newsroom/press-releases/warren-introduces-accountable-capitalism-act>. Over 1300 of the New York Stock Exchange's approximate 2800 listed companies would be subject to the bill's provisions. See *NYSE Companies*, NASDAQ, <https://www.nasdaq.com/screening/companies-by-industry.aspx?exchange=NYSE®ion=North+America&pagesize=200> (last visited Apr. 1, 2019). Not surprisingly, the bill's provisions have been criticized. See, e.g., Tory Newmyer, *The Finance 202: Elizabeth Warren Takes on Corporate Giants as She Lays 2020 Marker*, WASH. POST (Aug. 16, 2018), https://www.washingtonpost.com/news/powerpost/paloma/the-finance-202/2018/08/16/the-finance-202-elizabeth-warren-takes-on-corporate-giants-as-she-lays-2020-marker/5b746bc91b326b7234392946/?noredirect=on&utm_term=.ac28b35be8ec.

9. See discussion in STEINBERG, *supra* note 1, at 28–79.

10. With specified exceptions, this prohibition was codified in the Clayton Act of 1914. 15 U.S.C. § 19 (2012).

11. Today, audited financial statements of publicly held companies are required to be contained in a number of SEC filings, including in the annual Form 10-K report. See, e.g., SEC Form 10-K, 17 C.F.R. § 249.310 (2018).

12. Today, extensive disclosure is required of executive officer remuneration. See Regulation S-K, Item 402, 17 C.F.R. § 229.402 (2018). In addition, pursuant to the Dodd-Frank Act, shareholders have a non-binding say-on-pay vote with respect to executive compensation. See § 14A of the Securities Exchange Act, 15 U.S.C. § 78n-1(a)(1) (2012).

13. Dodd-Frank Wall Street Reform and Consumer Protection Act § 951 (adding § 14A to the Securities Exchange Act, 15 U.S.C. § 78n-1(a)(1) (2012)). See *Shareholder Approval of Executive Compensation and Golden Parachute Compensation*, Securities Act Release No. 9178, Exchange Act Release No. 63,768, 100 SEC Docket 868 (Jan. 25, 2011).

14. See S. 2847, 71st Cong. § 3 (1930) (requiring that the Federal Trade Commission approve managing officers' salaries of subject enterprises).

15. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended at 15 U.S.C. §§ 7201–66 (2012)).

Dodd-Frank Act of 2010¹⁶ are the foundational components in this process. Rather, these Acts further reinforced federal corporate governance as a strong presence. These Acts also serve as a poignant reminder to the states—the principal overseers of corporate governance—that laxity toward fiduciary conduct may induce the passage of federal legislation in an effort to remediate state shortcomings, particularly during times of crisis.¹⁷

To illustrate this point, the next Section of the Article explores several developments at the federal level where corporate governance practices were embraced in the *pre*-Sarbanes-Oxley era, thereby decreasing state oversight. Thereafter, examples will be provided that this federalism, at times, has sought to enhance capital formation and to limit fiduciary liability while adversely impacting the investing public. Last, the Article will examine a number of SEC enforcement practices post-Lehman that merit reexamination.

I. AN EVOLVING PROCESS: THE FEDERALIZATION OF CORPORATE GOVERNANCE

With the enactment of the federal securities acts in 1933 and 1934,¹⁸ the federal government became the premier overseer of the multifaceted aspects of securities regulation. Through the years, the passage of additional federal legislation as well as the adoption of SEC regulatory measures have impacted the federalization of corporate governance. This Section provides several examples of this federalization process.

The first example focuses on the federalization of insider trading. Congress took a key step in this federalization process with the enactment of Section 16 of the Securities Exchange Act of 1934.¹⁹ Going beyond disclosure, this statute precludes corporate officers and directors from engaging in short sales of their company's securities²⁰ and mandates that such insiders (as well as those beneficial shareholders who own more than ten percent of a subject equity security) to disgorge their profits when they purchase and sell (or sell and purchase) such equity security

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

17. Marc I. Steinberg, *The Federalization of Corporate Governance*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 21, 2018), <https://corpgov.law.harvard.edu/2018/06/21/the-federalization-of-corporate-governance/>.

18. 15 U.S.C. §§ 77a–77aa (2012); 15 U.S.C. §§ 78a–78qq (2012).

19. 15 U.S.C. § 78p.

20. *Id.* § 16(c), 15 U.S.C. § 78p(c). Generally, short-selling is “the sale of a security that the seller does not own or that the seller owns but does not deliver.” Ralph S. Janvey, *Short Selling*, 20 SEC. REG. L.J. 270, 271 (1992).

within a six-month period.²¹

Subsequently, frustrated with state court reluctance to address suspect insider trading in the secondary trading markets under traditional fiduciary duty of loyalty concepts,²² the SEC (Commission) in 1961 handed down its monumental decision in *Cady, Roberts & Co.*²³ There, the Commission embraced the “access” rationale—namely, that those persons who, through their profession or other status, have unequal access to material and nonpublic information must either disclose that information to the investing public or must abstain from tipping and trading until such disclosure is made.²⁴ With the Second Circuit’s seminal *SEC v. Texas Gulf Sulphur* decision seven years thereafter,²⁵ adhering to a broad prohibition against insider trading,²⁶ the substantive law of

21. § 16(b), 15 U.S.C. § 78p(b) (stating in part that the statute’s purpose is “preventing the unfair use of information which may have been obtained by such [subject] beneficial owner, director, or officer by reason of his relationship to the issuer”). Suit may be brought by the subject corporation or an eligible shareholder as specified in the statute. Strict liability applies. *See, e.g., Whiting v. Dow Chem. Co.*, 523 F.2d 680, 687 (2d Cir. 1975). Section 16(a) generally requires persons subject to the statute to report to the Commission and the applicable securities exchange their holdings in equity securities and their transactions in these securities. 15 U.S.C. § 78p(a).

22. A key item on the SEC Chairman’s agenda was to fill the state law void with respect to open-market insider trading. Chairman Cary believed that it was “shocking for business executives to personally profit from their inside information about the corporations they managed [and] that those actions were likely to reduce public confidence . . . in the markets.” *Fair to All People: The SEC and the Regulation of Insider Trading, In the Matter of Cady, Roberts & Company*, SEC HIST. SOC’Y (Nov. 1, 2006), http://www.sechistorical.org/museum/galleries/it/takeCommand_b.php. *See* Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1320 (1999) (observing that Chairman Cary’s “speeches and writings during and after his chairmanship at the SEC leave little doubt that he believed that state corporate law was moribund, perhaps even corrupt”). In this regard, *see* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

23. *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

24. *Id.* at 910. The Commission was well aware of the significance of the proceeding, stating: “This is a case of first impression and one of signal importance in our administration of the Federal securities acts.” *Id.* at 907. In that proceeding, the SEC viewed its authority as expansive, asserting that “the securities acts may be said to have generated a wholly new and far-reaching body of Federal corporation law.” *Id.* at 910.

25. *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969). In celebration of the 50th anniversary of this seminal decision, the SMU Law Review has published a Symposium Issue. *See Texas Gulf Sulphur 50th Anniversary Symposium Issue*, 71 SMU L. REV. 625 (2018).

26. The Second Circuit in *Texas Gulf Sulphur* enunciated both a parity of information rule and an access rule. With respect to the parity of information rationale, the court stated that

anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed.

401 F.2d at 848. Focusing on the access approach, the court opined that Section 10(b) sought to ensure that “all investors trading on impersonal exchanges have relatively equal access to material information” *Id.* Note that many countries with developed securities markets have adopted

insider trading became federalized.²⁷ Although US Supreme Court decisions subsequently limited the parameters of the insider trading proscription,²⁸ these high court decisions reinforced the principle that the practice of insider trading principally is a matter within the purview of federal, rather than state, law.²⁹

Another early example of the federalization of corporate governance is the SEC's adoption in 1942 of the shareholder proposal rule.³⁰ Clearly, the conducting of shareholder meetings and items placed on the agenda for such meetings traditionally have been regulated by state law.³¹ This principle remains vibrant today.³² Nonetheless, since 1942, eligible shareholders have been entitled under the federal regime to include their precatory proposals in the subject company's proxy materials in an effort to advance social, political, and economic causes.³³ Since its adoption,

either the parity or access approach. *See, e.g.*, Directive 2014/57/EU, of the European Parliament and of the Council of 16 April 2014 on Criminal Sanctions for Market Abuse, 2014 O.J. (L 173) Art. III.; *Corporations Act 2001* (Cth) s 1043A (Austl.); Ontario Securities Act, R.S.O. 1990, c S-5 s 76(5) (Can.); discussion in STEINBERG, *supra* note 1, at 273.

27. *See* STEINBERG, *supra* note 1, at 123.

28. In *Chiarella v. United States*, 445 U.S. 222 (1980), the Supreme Court rejected the parity of information and access approaches. Rather, such a duty arises where a fiduciary duty or a relationship of trust and confidence exists. *Id.* at 230. *See* *United States v. O'Hagan*, 521 U.S. 642 (1997) (adopting the misappropriation theory premised on a breach of fiduciary duty or relationship of trust and confidence to the source of the information). In the tipper-tippee context, unlawful tipping likewise occurs when the tipper conveys the material nonpublic information in breach of his or her fiduciary duty—normally shown through the knowing receipt by the tipper of a pecuniary benefit or the knowing conveyance of a gift to the tippee-recipient of the subject information. *See* *Salman v. United States*, 137 S. Ct. 420 (2016); *Dirks v. SEC*, 463 U.S. 646 (1983). Notably, the parity of information rule survives in one context under US insider trading law—namely, in the tender offer setting where SEC Rule 14e-3 adheres to this approach. 17 C.F.R. § 240.14e-3 (2018). In addition, SEC Regulation FD, with certain exceptions, precludes selective disclosure by company insiders and intermediaries of material nonpublic information. 17 C.F.R. §§ 243.100–.103. *See generally* WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* (Oxford Univ. Press 3d ed. 2010).

29. *See* STEINBERG, *supra* note 1, at 124–25 (asserting that, “although the Supreme Court has narrowed the scope of the insider trading prohibition, the legacy of *Cady*, *Roberts* and *Texas Gulf Sulphur* comprises the foundation for the federalization of this important component of corporate governance”); Roberta S. Karmel, *Prosecution of Tippees Affirmed in Salman v. United States*, 45 SEC. REG. L.J. 195, 199 (2017) (noting it was “important” that the Supreme Court in *Salman* “unanimously approved insider trading prosecutions pursuant to Section 10(b) of the Exchange Act and Rule 10b-5 against remote tippees”).

30. Rule 14a-8, 17 C.F.R. § 240.14a-8. *See* General Rules and Regulations, Solicitation of Proxies Under the Act, Exchange Act Release No. 3347, 7 Fed. Reg. 10,637, 10,655–56 (Dec. 22, 1942) (explaining the impact of the shareholder proposal rule).

31. *See, e.g.*, MODEL BUS. CORP. ACT §§ 7.01, 7.02, 7.05, 7.08, 7.25 (AM. BAR ASS'N 2016); Delaware General Corporation Law, DEL. CODE ANN. tit. 8, §§ 216, 222 (2018).

32. *See, e.g.*, *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971); *Superwire.com, Inc. v. Hampton*, 805 A.2d 904 (Del. Ch. 2002); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

33. *See, e.g.*, *Trinity Wall St. v. Wal-Mart Stores, Inc.*, 792 F.3d 323 (3d Cir. 2015) (submission

the shareholder proposal rule periodically has been revised.³⁴ As anticipated, the rule has both ardent supporters³⁵ and fierce critics who advocate for its repeal.³⁶ Having endured for longer than three quarters of a century, the rule is not easily dissolved. In this context, the SEC's shareholder proposal rule is a vivid example that the federalization of corporate governance is an evolving process dating back to the early years of federal securities regulation.

Through the decades, the Commission has sought to impact normative fiduciary conduct through the guise of disclosure.³⁷ Implementing the philosophy that revelation of management self-dealing, related party transactions, and remuneration practices may induce enhanced substantive standards, the SEC has promulgated disclosure standards under Regulation S-K.³⁸ To address defective disclosure in this context, the Commission has brought enforcement actions against subject fiduciaries. For example, in a 1964 proceeding, the Commission found that lack of disclosure relating to fiduciary self-dealing in a company's registration statement was material to investors, as this information was

of shareholder proposal regarding company's policy of selling firearms equipped with high-capacity magazines); *Med. Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970) (submission of shareholder proposal requesting company to cease its manufacturing of napalm used in Vietnam War), *vacated as moot*, 404 U.S. 403 (1972); *Laborers' Local v. Intersil*, 868 F. Supp. 2d 838 (N.D. Cal. 2012) (holding shareholder say-on-pay vote does not rebut application of business judgment rule).

34. See SEC Staff Legal Bulletin No. 14 (July 13, 2001), available at <https://www.sec.gov/interps/legal/cfs14.htm> (setting forth the substantive grounds for the exclusion of shareholder proposals pursuant to Rule 14a-8); Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 40,018, 67 SEC Docket 373 (May 1, 1998); SEC Requests Comments on Proxy Rule Revision, Fed. Sec. L. Rep. (CCH) No. 2836, at 5 (2018) (seeking comments on whether the SEC's proxy rules should be revised).

35. See discussion in Virginia J. Harnisch, *Rule 14a-8 After Reagan: Does It Protect Social Responsibility Shareholder Proposals?*, 6 J.L. & POL. 415 (1990); Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97 (1988); Donald E. Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 419 (1971).

36. See discussion in Stephen M. Bainbridge, *Revitalizing SEC Rule 14a-8's Ordinary Business Exclusion: Preventing Shareholder Micromanagement by Proposal*, 85 FORDHAM L. REV. 705 (2016); Susan W. Liebler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425 (1984); Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 879 (1994). Nonetheless, it may be asserted that, in practical effect, the shareholder proposal rule "is well entrenched as an accepted facilitator of shareholder activism and of dialogue between management and institutional shareholders . . . [and] should be recognized as a vintage asset—a Rule that has symbolized for 75 years that vibrant federal corporate governance at times is an appropriate vehicle for ameliorating state law shortcomings." STEINBERG, *supra* note 1, at 190.

37. See Ralph C. Ferrara, Richard M. Starr & Marc I. Steinberg, *Disclosure of Information Bearing on Management Integrity and Competency*, 76 NW. U.L. REV. 555 (1981).

38. See, e.g., Items 401, 402, 404 of Regulation S-K, 17 C.F.R. §§ 229.401, .402, .404 (2018).

“germane to an evaluation of the integrity of . . . management.”³⁹

Similarly, in the aftermath of the Supreme Court’s 1977 decision in *Santa Fe Industries v. Green*,⁴⁰ holding that Section 10(b) of the Securities Exchange Act⁴¹ encompasses only deceptive and manipulative conduct and not “mere” breaches of fiduciary duty,⁴² the SEC promulgated Rule 13e-3.⁴³ Through the mechanism of disclosure, that rule and its implementing provisions seek to impact fiduciary substantive conduct in the going-private setting⁴⁴ by mandating that the subject person disclose whether it reasonably believes that the going-private transaction is fair or unfair to unaffiliated security holders and the bases for such belief.⁴⁵ Defective disclosure in this context may give rise to both government and private lawsuits.⁴⁶

On occasion, the SEC has nullified state law. One such example is the SEC’s adoption of the all-holders rule mandating that tender offers by publicly held enterprises must be open to all shareholders.⁴⁷ The Commission’s action was in response to the Delaware Supreme Court’s

39. *Franchard Corp.*, 42 S.E.C. 163, 172 (1964) (also opining that the “quality” of executive officers to investors is of “cardinal importance”). See *Maldonado v. Flynn*, 597 F.2d 789, 796 (2d Cir. 1979) (stating that “shareholders are entitled to truthful presentation of factual information ‘impugning the honesty, loyalty or competency of directors’ in their dealings with the corporation to which they owe a fiduciary duty.” (quoting *Cohen v. Ayers*, 449 F. Supp. 298, 317 (N.D. Ill. 1978), *aff’d*, 596 F.2d 733 (7th Cir. 1979))).

40. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

41. 15 U.S.C. § 78j(b) (2012).

42. 430 U.S. at 477–79. The Court reversed the Second Circuit’s expansive decision that recognized a Section 10(b) claim without requiring deficiency of disclosure. In that decision, the Second Circuit opined: “If there is no valid corporate purpose for the merger, then even the most brazen disclosure of that fact to the minority shareholders in no way mitigates the fraudulent conduct.” *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1292 (2d Cir. 1976), *rev’d*, 430 U.S. 462 (1977). See generally Ralph C. Ferrara & Marc I. Steinberg, *A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980).

43. 17 C.F.R. § 240.13e-3. See *Going Private Transactions by Public Companies or their Affiliates*, Securities Act Release No. 6100, Exchange Act Release No. 16,075, 44 Fed. Reg. 46,736 (Aug. 8, 1979).

44. See Harold N. Iselin, Note, *Regulating Going Private Transactions: SEC Rule 13e-3*, 80 COLUM. L. REV. 782, 787 (1980) (asserting that “rule 13e-3 does in effect regulate substantive fairness through item 8’s requirement that the issuer state its reasonable belief that the transaction is fair or unfair”). A going-private transaction

[r]efers to a transaction or series of transactions in a publicly held company whereby the controlling (or other) group substantially reduces or eliminates entirely the number of shares held by the public by inducing shareholders to exchange their stock for cash, thereby causing the company to attain privately held status.

MARC I. STEINBERG, *UNDERSTANDING SECURITIES LAW* 486 (7th ed. 2018).

45. See Rule 13e-3(e), 17 C.F.R. § 240.13e-3(e); Schedule 13E-3, item 8, 17 C.F.R. § 13e-100; Regulation M-A, item 1014, 17 C.F.R. § 229.1014.

46. See, e.g., *Howing Co. v. Nationwide Corp.*, 826 F.2d 1470 (6th Cir. 1987); *FSC Corp.*, Exchange Act Release No. 17,892, 22 SEC Docket 1374 (June 25, 1981).

47. See SEC Rules 13e-4, 14d-10, 17 C.F.R. §§ 240.13e-4, .14d-10.

decision in *Unocal v. Mesa Petroleum Co.*⁴⁸ There, the court held that a target company's selective tender offer that excluded the hostile bidder from participating in the offer was an appropriate response by the board of directors.⁴⁹ By its promulgation of the all-holders rule, the Commission, in practical effect, "reversed" the Delaware Supreme Court's decision with respect to publicly held companies. In doing so, the SEC nullified a significant holding by this nation's preeminent state court in corporate law matters. The rule thus provides a clear example in the pre-Sarbanes-Oxley era of the SEC acting proactively to federalize this area of corporate governance.⁵⁰

From a historical perspective, for decades, SEC enforcement actions have impacted corporate governance.⁵¹ In several enforcement proceedings, the Commission successfully has procured far-reaching orders of ancillary relief mandating that the subject corporation undertake such fundamental measures as the appointment of independent directors,⁵² the retention of independent legal counsel who is tasked with investigating and reporting regarding specified aspects of the company's affairs,⁵³ and the appointment of independent consultants.⁵⁴ To a significant degree, the SEC's use of Undertakings in its enforcement

48. *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

49. *Id.* at 958 (opining that "there was directorial power to oppose the Mesa tender offer, and to undertake a selective stock exchange made in good faith and upon a reasonable investigation pursuant to a clear duty to protect the corporate enterprise").

50. In the adopting release, the Commission reasoned:

[M]any commentators have asserted that the Commission's authority under this provision is limited to regulating disclosure. It is clear, however, that in adopting the Williams Act, Congress granted to the Commission broad rulemaking authority in Section 13(e) to determine the most appropriate regulatory scheme for issuer tender offers . . . [including the] adoption of substantive regulations.

Amendments to Tender Offer Rules—All-Holders and Best-Price, Securities Act Release No. 6653, Exchange Act Release No. 23,421, 1986 WL 703866, at *6 (July 11, 1986). *See* discussion in STEINBERG, *supra* note 1, at 140–42.

51. The Commission's enforcement actions ordinarily are through the consent negotiation process whereby the subject party agrees to the sanctions levied without admitting or denying the SEC's allegations. *See* William R. McLucas et al., "Neither Admit Nor Deny" Settlements from the Stanley Sporkin Era: Wise Policy or Outdated Enforcement Notion?, 43 SEC. REG. L.J. 29 (2015).

52. *See, e.g.*, SEC v. Mattel, Inc., [1974–1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,807 (D.D.C. Oct. 1, 1974). A recent example is Tesla's undertaking to appoint two new independent directors to its board of directors pursuant to the settlement of an SEC enforcement action. *See* Press Release, SEC, Elon Musk Settles SEC Fraud Charges; Tesla Charged with and Resolves Securities Law Charge (Sept. 29, 2018), <https://www.sec.gov/news/press-release/2018-226> [hereinafter Musk Press Release].

53. *See, e.g.*, SEC v. Lockheed Aircraft Corp., [1975–1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,509 (D.D.C. Apr. 13, 1976).

54. *See, e.g.*, Occidental Petroleum Corp., Exchange Act Release No. 16,950, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,622 (SEC July 2, 1980).

actions continues today.⁵⁵

A vivid historical example of the Commission's "intrusion" in the corporate governance area through the use of Undertakings is its 1980 proceeding against Occidental Petroleum Corporation (Oxy).⁵⁶ In a settlement whereby the company did not admit wrongdoing,⁵⁷ the SEC alleged that Oxy failed to disclose several material facts relating to such matters as

Oxy's discharge of chemical or toxic wastes . . . into the environment; . . . the status of Oxy's negotiations with Libya concerning the financial arrangement pursuant to which Oxy operated in Libya; and . . . signed, undated letters of resignation which were submitted by certain nominees to Oxy's Board of Directors at the request of Dr. Armand Hammer, the Chairman of the [Oxy] Board.⁵⁸

Pursuant to the settlement, Oxy agreed to undertake several significant corporate governance enhancements, including, for example, designating a director deemed "satisfactory" by the Commission who was tasked with the responsibility for: the preparation of an environmental report recommending procedures to the board of directors to ensure the timely and accurate disclosure of all mandated information relating to the company's environmental matters; reasonably determining the potential costs which the company would incur within the subsequent three years in order to make its facilities compliant with applicable government environmental requirements; and ascertaining the maximum monetary penalties as well as monetary damages that may be incurred by the company for such environmental noncompliance.⁵⁹ The settlement

55. For example, the appointment of independent consultants and monitors occurs today with some frequency. *See, e.g.*, Port Auth. of N.Y. & N.J., [2016–2017 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,573 (SEC Jan. 10, 2017) (appointment of independent consultant); SEC v. Avon Prods., Inc., Civil Action No. 14-CV-9956 (KPF) (S.D.N.Y.), Litigation Release No. 23,159, 110 SEC Docket 2714 (Dec. 17, 2014) (appointment of independent monitor); John J. Huber et al., *The Brave New World of SEC Monitorships*, 43 Sec. Reg. & L. Rep. (BNA) 1480 (2011) (asserting that "the SEC may increasingly require appointment of a monitor as part of a settlement of an enforcement action").

56. *Occidental Petroleum Corp.*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,622. In view of its prominence, all seven editions of my *Securities Regulation* textbook contain this proceeding. *See, e.g.*, MARC I. STEINBERG, *SECURITIES REGULATION* 1182–90 (7th ed. 2017).

57. *Occidental Petroleum Corp.*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 83,347.

58. *Id.* at 83,348.

59. *Id.* at 83,356. Disclosure as to environmental matters, including the costs of compliance, remains a focus of the SEC disclosure mandates. With respect to climate change, see Commission Guidance Regarding Disclosure Related to Climate Change, Securities Act Release No. 9106, Exchange Act Release 61,469, 97 SEC Docket 2414, 2415 (Feb. 2, 2010) ("This release outlines our views with respect to our existing disclosure requirements as they apply to climate change . . . [and] is intended to assist companies in satisfying their disclosure obligations under the federal securities laws and regulations.").

provided that the SEC could consult with the subject director and was entitled to access the materials that were generated in the preparation of the environmental report.⁶⁰ The director also was tasked with utilizing the company's newly appointed senior environmental official as well as an independent consulting firm, each of whom was required to be deemed acceptable to the Commission, to assist in the preparation of the report.⁶¹ Regarding the signed, undated letters of resignation from the subject directors, Oxy was ordered to make requisite disclosure of the change in its policy.⁶² Reflecting on this meaningful settlement, I opined in my recent book:

That a New York Stock Exchange Company in the late 1970s had its nominees sign undated letters of resignation is surprising and perhaps shocking. By invoking its authority enforcing the securities laws' adequacy-of-disclosure mandate, the SEC in *Oxy* attained a meaningful measure of remediation with respect to the company's environmental practices as well as corporate governance practices. This proceeding as well as others instituted by the Commission over four decades ago exemplify the SEC's impact on enhancing compliance with the law in areas outside of the securities laws as well as inducing improved standards of corporate governance.⁶³

A last example focuses on the SEC's authority to bar subject persons from serving as an officer or director of any publicly held company. The Commission's power to levy this sanction is based on both congressional legislation and its entitlement to procure ancillary relief in its enforcement actions.⁶⁴ The SEC has obtained bar orders in settlements as well as in litigated proceedings.⁶⁵ In this context, violation of the securities acts' antifraud provisions coupled with a finding of "unfitness"

60. *Occidental Petroleum Corp.*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 83,357.

61. *Id.*

62. *Id.* (providing that Occidental "will make appropriate disclosure of a change in its policy that neither Oxy nor any officer, director or employee of the company will request or receive any written or oral agreement, assurance or promise of any kind from any nominee to, or member of, Oxy's Board of Directors as it now is or may in the future be constituted").

63. STEINBERG, *supra* note 1, at 145.

64. The SEC received statutory authority to procure officer and director bar orders pursuant to The Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990). The Commission obtained this relief in a litigated case as early as 1974. *See SEC v. Techni-Culture, Inc.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,501 (D. Ariz. Apr. 2, 1974).

65. *See, e.g., SEC v. Posner*, 16 F.3d 520 (2d Cir. 1994). Recently, pursuant to the settlement of an SEC enforcement action, Elon Musk agreed to step down as Tesla's Chairman for at least a three-year period. *See Musk Press Release, supra* note 52; Tim Higgins et al., *Tesla Braces for Uncertainty Amid Shift in Elon Musk's Role*, WALL ST. J. (Sept. 30, 2018, 8:02 PM), <https://www.wsj.com/articles/tesla-braces-for-uncertainty-amid-shift-in-musks-role-1538352138>.

are the requisite components for the imposition of a bar order.⁶⁶ For the last several decades (since 1974), the Commission has utilized this enforcement measure to prevent allegedly miscreant fiduciaries from serving as officers and directors of publicly held companies.⁶⁷ In this way, with Congress's authorization, the officer and director bar sanction has preempted state corporate governance in a very traditional area—namely, the appointment and election of directors in a duly incorporated enterprise pursuant to applicable state governing principles.⁶⁸

It also bears emphasis that the national stock exchanges have played an important role in this federalization process. Over forty years ago, with the SEC's "persuasion," the New York Stock Exchange adopted a rule mandating that the composition of a listed corporation's audit committee must consist solely of independent directors.⁶⁹ Today, a number of provisions of the Sarbanes-Oxley and Dodd-Frank Acts condition the eligibility of a subject enterprise to list its shares on a national stock exchange by mandating that such enterprise comply with the Acts' requirements.⁷⁰ Through this process of government directives and SEC persuasion, the national stock exchanges have advanced the

66. See § 305 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (amending §§ 8A, 20(e) of the Securities Act and §§ 21(d)(2), 21C of the Securities Exchange Act). Prior to the enactment of the Sarbanes-Oxley Act, the standard was "substantial unfitness" as enacted pursuant to the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (codified at 15 U.S.C. § 77a et seq.).

67. See, e.g., SEC v. Bankosky, 716 F.3d 45 (2d Cir. 2013); SEC v. Jasper, 678 F.3d 1116 (9th Cir. 2012); SEC v. Patel, 61 F.3d 137 (2d Cir. 1995); SEC v. Techni-Culture, Inc., [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,501 (D. Ariz. Apr. 2, 1974); sources cited in MARC I. STEINBERG & RALPH C. FERRARA, SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT § 6:18 (2d ed. 2001 & 2018-2019 supp.).

68. See STEINBERG, *supra* note 1, at 146-47.

69. See New York Stock Exchange, Inc.: Order Approving Proposed Rules Change, Exchange Act Release No. 13,346, 1977 WL 173602 (Mar. 9, 1977) (approving NYSE audit committee rule). In that release, the SEC stated that it "has urged strengthening the independence and vitality of corporate boards of directors and has suggested that, at least initially, those principles could be implemented by amending the listing requirements of the NYSE and other self-regulatory organizations, rather than by direct Commission action." *Id.* at *1; see discussion in STEINBERG, *supra* note 1, at 241.

70. See, e.g., § 301 of the Sarbanes-Oxley Act of 2002; SEC Rule 10A-3, 17 C.F.R. § 240.10A-3 (2018) (stating that "[t]he rules of each national securities exchange registered pursuant to section 6 of the [Securities Exchange] Act must, in accordance with the provisions of this rule, prohibit the initial or continued listing of any security of an issuer that is not in compliance with the requirements of . . . this rule [addressing audit committee requirements]"); § 952 of the Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, 1900 (2010) (adding § 10C to the Securities Exchange Act) (mandating that the SEC, by rule, is to direct the national securities exchanges to prohibit the listing of any equity security of a subject issuer that does not comply with the statute's requirements regarding an independent compensation committee).

federalization of corporate governance.⁷¹

When considered from this perspective, the Sarbanes-Oxley and Dodd-Frank Acts are a continuation of this federalization journey.⁷² Focusing on such matters as the presence of independent directors, the composition, functions, and roles of board committees (including the audit and compensation committees), the prohibition of company loans to officers and directors, the shareholder advisory say-on-pay vote, and the promulgation of corporate codes of conduct,⁷³ these Acts significantly impact normative fiduciary conduct. These Acts thus reinforce the strong presence of federal corporate governance. They also are a poignant reminder to the states that the lax oversight of corporate fiduciary conduct may portend the enactment of vibrant federal legislation, particularly during times of crisis.⁷⁴

II. THE FEDERALIZATION PROCESS ADVERSELY IMPACTING INVESTORS

The federalization of corporate governance typically associates the enactment of federal legislation and the presence of vibrant SEC regulation with greater investor protection. The discussion in the preceding Section of this Article serves to illustrate this principle.⁷⁵ Nonetheless, during the past few decades, actions taken by Congress, the US Supreme Court, and the SEC to federalize certain aspects of corporate governance have been antithetical to investor interests. This Section provides a number of examples where federalization has adversely impacted investors.

Commencing in 1980 with the adoption of Rule 506 of Regulation D,⁷⁶ the SEC slighted US Supreme Court precedent set forth in *SEC v. Ralston*

71. See discussion in STEINBERG, *supra* note 1, at 191–262.

72. See *supra* notes 1–3.

73. See STEINBERG, *supra* note 1, at 191–224; Symposium, 39 LOY. U. CHI. L.J. 469 (2008); Symposium, 105 MICH. L. REV. 1597 (2007); Robert B. Ahdieh, *From “Federalization” to “Mixed Governance” in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFF. L. REV. 721 (2005); Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79 (2005); Charles W. Murdock, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Prevent Future Crises?*, 64 SMU L. REV. 1243 (2011); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

74. See Steinberg, *supra* note 17; Marc I. Steinberg, *Curtailing Investor Protection Under the Securities Laws: Good for the Economy?*, 55 SMU L. REV. 347 (2002).

75. See *supra* notes 19–74 and accompanying text.

76. See Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11,243, 11,251 (Mar. 16, 1982). Rule 506 is an issuer exemption from Securities Act registration of the subject securities.

*Purina Co.*⁷⁷ by equating an individual's personal wealth with financial sophistication and access to registration-type information.⁷⁸ Seeking to enhance capital formation, the Commission determined that an individual's net worth of \$1 million creates an irrebuttable presumption of accredited investor status, signifying that such person has the requisite financial sophistication and has access to registration-type information.⁷⁹ As a consequence, no information is required to be provided to the accredited investor under SEC rules—although some disclosure is made pursuant to the negotiation process and to comply with the antifraud provisions.⁸⁰ Although inflation through the years effectively has diluted this \$1 million level, the SEC has refused to adjust this monetary amount.⁸¹ Indeed, it was not until the Dodd-Frank Act of 2010 where Congress took some action, mandating that the \$1 million net worth level must be exclusive of the value of one's primary residence.⁸²

Although a majority of the states in the interpretation of their respective securities laws generally acquiesced in the SEC's approach,⁸³ a number of states adhered to greater investor safeguards.⁸⁴ As a result,

77. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). For an example of a lower court decision after *Ralston Purina* supporting the proposition that one's financial wealth does not equate to financial sophistication, see *Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1977).

78. See SEC Rules 501(a), 502(b), 506(b), (c), 17 C.F.R. §§ 230.501(a), .502(b), .506(b), (c).

79. See Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11,243, 11,251 (Mar. 16, 1982). See Marc I. Steinberg, *The Securities and Exchange Commission's Administrative, Enforcement, and Legislative Programs and Policies—Their Influence on Corporate Internal Affairs*, 58 NOTRE DAME L. REV. 173, 209–14 (1982) (criticizing the SEC's promulgation of Rule 506).

80. See STEINBERG, *supra* note 56, at 121–38.

81. See Marc I. Steinberg, *The "Accredited" Individual Purchaser Under SEC Regulation D: Time to Up the Ante*, 29 SEC. REG. L.J. 93 (2001) (urging the Commission to raise the \$1 million level and pointing out that the \$1 million net worth level in 1982 adjusted for inflation represented a net worth of less than \$600,000 in September 2000).

82. See § 413(a) of the Dodd-Frank Act, 15 U.S.C. § 77b (2012); Net Worth Standard for Accredited Investors, Securities Act Release No. 9287, 76 Fed. Reg. 81,787, 81,793 (Dec. 21, 2011). The \$1 million net worth level is to be reviewed periodically by the Commission to ascertain whether this level should be adjusted. See § 413(a) of the Dodd-Frank Act. To date, the SEC has not raised this \$1 million net worth level.

83. See Uniform Limited Offering Exemption (North American Securities Administrators Association (NASAA), NASAA Rep. (CCH) ¶ 6201 (1983); SEC. EXCH. COMM'N, REPORT ON THE UNIFORMITY OF STATE REGULATORY REQUIREMENTS FOR OFFERINGS OF SECURITIES THAT ARE NOT "COVERED SECURITIES" (1997), available at <https://www.sec.gov/news/studies/uniform.htm> (citing Mark A. Sargent and Hugh H. Makens, *ULOE: New Hope, New Challenge*, 45 BUS. LAW. 1319, 1320 n.9 (1990)) (stating that approximately thirty states had adopted ULOE).

84. See SEC. EXCH. COMM'N, *supra* note 83; STEINBERG, *supra* note 44, at 99 (discussing the position of the Maryland Securities Division in a letter sent by its Commissioner Ellyn L. Brown to the SEC in May 1988).

this lack of uniformity was perceived as impairing capital formation.⁸⁵ Congress responded by enacting the National Securities Markets Improvement Act of 1996.⁸⁶ Among other provisions, this Act preempted the states from regulating offerings that are effected in compliance with Rule 506 of Regulation D.⁸⁷ The result of this federal preemption is that Rule 506 serves as the key issuer exemption from Securities Act registration and has been largely successful in its mission to enhance capital formation.⁸⁸ This success is tempered by the fact that unsophisticated individuals, who have \$1 million in net worth (exclusive of primary residence), are subject to substantially greater risk of incurring financial loss.⁸⁹

Another example focuses on the aftermath of Congress's enactment of the Private Securities Litigation Reform Act of 1995 (PSLRA),⁹⁰ as well as restrictive US Supreme Court decisions. In 1994, in *Central Bank of Denver v. First Interstate Bank of Denver*,⁹¹ the Court, slighting the overwhelming view held by the federal appellate courts,⁹² held that (in private actions) Section 10(b) of the Securities Exchange Act⁹³ does not provide for aider and abettor liability.⁹⁴ In ascertaining the parameters of

85. See SEC. EXCH. COMM'N, *supra* note 83, at Summary of Findings (stating that "there is still more to be done to accomplish true uniformity among the states in their regulation of offerings of securities that are not 'covered securities'"); Therese H. Maynard, *The Uniform Limited Offering Exemption: How 'Uniform' Is 'Uniform?'*—An Evaluation and Critique of the ULOE, 36 EMORY L.J. 357 (1987).

86. Pub. L. No. 104-290, 110 Stat. 3416 (1996). See generally Robert G. Bagnall & Kimble Cannon, *The National Securities Markets Improvement Act of 1996: Summary and Discussion*, 25 SEC. REG. L.J. 3 (1997).

87. See § 18(b)(4)(F), 15 U.S.C. § 77r(b)(4)(F) (2012). Recently, in promulgating an exemption pursuant to Tier 2 of Regulation A, the states now are preempted from regulating these offerings. See SEC Rules 251–263, 17 C.F.R. 230.251–.263 (2018); Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Securities Act Release No. 9741, Exchange Act Release No. 74,578, 111 SEC Docket 455 (Mar. 25, 2015). The effort by a number of states to declare this regulation invalid was unsuccessful. See *Lindeen v. SEC*, 825 F.3d 646 (D.C. Cir. 2016) (upholding validity of Tier 2 of Regulation A).

88. See Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11,243, 11,251 (Mar. 10, 1988); Regulation D Revisions, Securities Act Release No. 6758, 40 SEC Docket 449 (Mar. 3, 1988); Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 106 SEC Docket 3343 (July 10, 2013).

89. See sources cited *supra* notes 79, 81.

90. Pub. L. No. 104-67, 109 Stat. 737 (1995).

91. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

92. *Id.* at 192 (Stevens, J., dissenting) ("In hundreds of judicial and administrative proceedings in every Circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under § 10(b) and Rule 10b-5.")

93. 15 U.S.C. § 78j(b) (2012).

94. See *Cent. Bank of Denver*, 511 U.S. at 173–75 (determining the issue principally based on

Section 10(b) primary liability, the Supreme Court's subsequent decisions have further confined the scope of private liability.⁹⁵ With the passage of the PSLRA, Congress, *inter alia*, enhanced a subject plaintiff's pleading requirements,⁹⁶ provided an expansive safe harbor for publicly held companies with respect to their forward-looking statements,⁹⁷ and authorized the levying of significant sanctions.⁹⁸

With the "double-whammy" of the PSLRA and confining US Supreme Court decisions, plaintiffs in class actions involving publicly held enterprises increasingly resorted to the state courts.⁹⁹ Displeased with this development, Congress responded by enacting the Securities Litigation Uniform Standards Act of 1998 (SLUSA).¹⁰⁰ With certain exceptions,¹⁰¹ SLUSA requires that class actions under the Securities Exchange Act¹⁰² involving nationally traded securities must be brought in federal court with only federal law applying.¹⁰³ State securities as well as common law

the language of § 10(b)). For an analysis of *Central Bank of Denver*, see Marc I. Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 NOTRE DAME L. REV. 489 (1995).

95. See *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135 (2011) (holding that under Rule 10b-5(b), primary liability based on material misrepresentation or half-truth may be imposed only upon those persons who have ultimate authority over the statement's content and how it is communicated); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 522 U.S. 148 (2008) (rejecting flexible "scheme" liability framework in private actions under § 10(b)). *But see* *Lorenzo v. SEC*, 139 S. Ct. 1094 (2019) (holding that persons who knowingly disseminate materially false statements subject to liability under Rule 10b-5(a) and (c)).

96. See § 21D(b) of the Securities Exchange Act; *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007) (interpreting fraud pleading requirements of the PSLRA); Symposium, *Strategies for Investigating and Pleading Securities Fraud Claims*, 45 LOY. U. CHI. L.J. 525 (2014).

97. See § 27A of the Securities Act, 15 U.S.C. § 77z-2 (2012); § 21E of the Securities Exchange Act; *Slayton v. Am. Express Co.*, 604 F.3d 758 (2d Cir. 2010) (interpreting parameters of the PSLRA safe harbor for forward-looking statements).

98. See § 27(c) of the Securities Act; § 21D of the Securities Exchange Act; *City of Livonia Emps.' Ret. Sys. v. Boeing Co.*, 306 F.R.D. 175 (N.D. Ill. 2014); discussion in MARC I. STEINBERG, WENDY GERWICK COUTURE, MICHAEL J. KAUFMAN & DANIEL J. MORRISSEY, *SECURITIES LITIGATION—LAW, POLICY, AND PRACTICE* 582–83 (2016).

99. See H.R. REP. NO. 105-803, at 14 (1998); STEINBERG, COUTURE, KAUFMAN & MORRISSEY, *supra* note 98, at 494 ("After the PSLRA's enactment, in order to avoid the rigors of federal law, plaintiffs sought to bring class actions in state courts.").

100. Pub. L. No. 105-353, 112 Stat. 3227 (1998).

101. The key exceptions are individual actions, derivative suits, and class actions in the merger and acquisition context (such as going-private transactions, mergers, tender offers, and invocation of appraisal rights). See § 16(f)(2) of the Securities Act; § 28(f)(3) of the Securities Exchange Act.

102. See *Cyan, Inc. v. Beaver Cty. Emps. Ret. Fund*, 138 S. Ct. 1061 (2018) (holding that class actions alleging solely violations of the Securities Act may be brought in state court and are not subject to removal pursuant to SLUSA).

103. See § 16 of the Securities Act; § 28(f) of the Securities Exchange Act. Nationally traded securities are those that trade on a national securities exchange. See *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006).

claims cannot be brought due to SLUSA preemption.¹⁰⁴ The consequence is that aggrieved investors cannot invoke such attractive claims as those based on negligence and aider liability.¹⁰⁵

This preemption has been particularly problematic with respect to collateral actors. Prior to the Supreme Court's decision in *Central Bank of Denver*, attorneys, investment bankers, and consultants were brought within the private-liability umbrella by means of aider and abettor claims.¹⁰⁶ With the elimination of aider and abettor liability along with confining decisions construing the scope of primary liability,¹⁰⁷ the consequence is that collateral actors all too frequently avoid private liability under the federal securities laws.¹⁰⁸ This dilemma is exacerbated by the enactment of SLUSA which precludes the bringing of meritorious state claims premised on negligence and aider liability.¹⁰⁹ The consequence is that for ordinary investors, who cannot afford to opt out of subject class actions, recompense from these allegedly miscreant collateral actors will not be forthcoming. SLUSA preemption thereby has been antithetical to the investor protection objectives of the federal securities laws.¹¹⁰

III. THE NEED FOR ENHANCED FEDERALIZATION

As set forth in my recent book, three areas merit enhanced federalization: the undue deference by federal courts to state law,¹¹¹ the need for congressional enactment of a comprehensive statutory framework prohibiting unlawful insider trading,¹¹² and the application of

104. *See Dabit*, 547 U.S. at 87.

105. *Id.* *See also* *Chadbourne & Parke LLP v. Troice*, 571 U.S. 377 (2014) (holding that to have SLUSA preemption, purchase or sale must be of a "covered" security).

106. *See, e.g.*, *SEC v. Wash. Cty. Util. Dist.*, 676 F.2d 218 (6th Cir. 1982); *IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980); *Stern v. Am. Bankshares Corp.*, 429 F. Supp. 818 (E.D. Wis. 1977).

107. *See* cases cited *supra* notes 91, 95.

108. *See, e.g.*, *Regents of Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007); *Ziembra v. Cascade Int'l, Inc.*, 256 F.3d 1194 (11th Cir. 2001); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996); cases cited *supra* note 95.

109. *See* discussion *supra* notes 100–05 and accompanying text.

110. *See* Lisa L. Casey, *Shutting the Doors to State Court: The Securities Litigation Uniform Standards Act of 1998*, 27 SEC. REG. L.J. 141 (1999); Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1 (1998).

111. *See* STEINBERG, *supra* note 1, at 265 (stating that "the Supreme Court's reliance on state law standards to interpret federal law, given the federalization of corporate governance that has occurred, is misplaced").

112. *Id.* at 274 (asserting that Congress should "follow the path traversed by other developed securities markets and enact an insider trading law premised on either the parity of information or equal access to information approach").

federal law to substantive tender offer tactics.¹¹³ This Section focuses on this last subject—the federalization of substantive tender offer maneuvers.

The legality of offensive and defensive maneuvers undertaken by bidder and target companies today, for the most part, is assessed pursuant to state law fiduciary standards.¹¹⁴ Federal law generally focuses on the process that applies to tender offers¹¹⁵ and, on occasion, forbids the undertaking of a particular defensive tactic.¹¹⁶ Nonetheless, the application of the internal affairs doctrine¹¹⁷ signifies that Delaware, being the state where most major publicly held enterprises elect to incorporate,¹¹⁸ is the primary determiner in evaluating the legality of substantive maneuvers in the tender offer setting.¹¹⁹ The consequence is that Delaware, a state having wonderful beaches and a population of less than one million residents,¹²⁰ serves as adjudicator in determining whether billion-dollar global tender offers will be consummated.¹²¹

In a 1985 decision rejecting federal fiduciary standards, the US Supreme Court held that Section 14(e) of the Securities Exchange Act,¹²² the Exchange Act's antifraud provision in the tender offer context, is concerned with adequacy of disclosure rather than substantive fairness.¹²³ The Court's ruling thus signified that the propriety of takeover maneuvers largely is within state law purview. For the state of

113. *Id.* at 265–69.

114. *See, e.g.*, *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586 (Del. 2010); *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003); *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

115. *See, e.g.*, SEC Rules 14d-6, 14d-8, 14d-9, 14d-10, 14d-11, 17 C.F.R. §§ 240.14d-6, .14d-8, .14d-9, .14d-10, .14d-11 (2018); discussion in STEINBERG, *supra* note 44, at 443–44.

116. *See, e.g.*, SEC Rules 13e-4, 14d-10, 17 C.F.R. §§ 240.13e-4, .14d-10 (requiring tender offers to be open to all shareholders and that the best price paid to any such tendering shareholder must be paid to any other tendering shareholder); discussion *supra* notes 47–50 and accompanying text.

117. The internal affairs doctrine generally signifies that the law where the subject company is incorporated governs the relations among such company, its directors and officers, and its stockholders. *See CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 91 (1987).

118. *See Cary, supra* note 22, at 671; Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061 (2000); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

119. *See, e.g.*, cases cited *supra* note 114; STEINBERG, *supra* note 1, at 266.

120. *See* Karl Baker, *Delaware Population to Approach 1 Million in 2020*, DEL. ONLINE (July 5, 2016, 4:08 PM), <http://www.delawareonline.com/story/news/2016/07/05/delaware-population-approach-1-million-2020/86708466/>.

121. *See, e.g.*, cases cited *supra* note 114.

122. 15 U.S.C. § 78n(e) (2012).

123. *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 8 (1985) (“All three species of misconduct [listed in Section 14(e)], *i.e.*, ‘fraudulent, deceptive, or manipulative’ . . . are directed at failures to disclose.”).

Delaware (or any state) to determine matters of national policy under the guise of the internal affairs doctrine is an abdication of the federal government's appropriate sphere of authority. To correct this situation, substantive maneuvers that are undertaken in mergers and acquisitions (including tender offers) that involve enterprises traded on a national stock exchange should come within the province of federal law. Congress should enact legislation to ensure that the federal government, not states whose economic welfare depends in part on revenues generated from fees received from enterprises incorporated within their borders, determines the legitimacy of substantive maneuvers in M&A deals having national and global magnitude.¹²⁴

IV. REACTING TO THE FINANCIAL CRISIS—THE SEC'S NEGLECT TO INVOKE CONTROL PERSON LIABILITY

In the aftermath of the financial scandals that precipitated the passage of the Sarbanes-Oxley Act of 2002 and the financial crisis that prompted Congress to enact the Dodd-Frank Act of 2010, the Commission instituted numerous enforcement actions, imposing hundreds of millions, and even billions, of dollars of money penalties against subject enterprises.¹²⁵ Many of these companies are publicly traded, signifying that innocent shareholders incurred the brunt of these fines.¹²⁶ Yet, only on rare occasions did the Commission sue an individual officer or director of these enterprises.¹²⁷

What is remarkable is that an express statutory provision exists which the SEC easily could have utilized and deliberately declined to do

124. See STEINBERG, *supra* note 1, at 265–69. For one of the earlier articles that advocated for federal regulation of substantive maneuvers in tender offers, see Gary G. Lynch & Marc I. Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 CORNELL L. REV. 901 (1979). See also Marc I. Steinberg, *Tender Offer Regulation: The Need for Reform*, 23 WAKE FOREST L. REV. 1 (1988).

125. See, e.g., Citigroup Alt. Invs. LLC & Citigroup Global Markets LLC, Securities Act Release No. 9893, Exchange Act Release No. 75,710, 2015 SEC LEXIS 3364 (Aug. 17, 2015); Deutsche Bank AG, Exchange Act Release No. 75,040, 2015 SEC LEXIS 2145 (May 26, 2015); JPMorgan Chase Bank, N.A., Securities Act Release No. 9992, Exchange Act Release No. 76,694, 2015 SEC LEXIS 5157 (Dec. 18, 2015); Bank of Am. Corp., Exchange Act Release No. 72,888, 2014 WL 4101590 (Aug. 21, 2014).

126. See Marc I. Steinberg & Forrest C. Roberts, *Laxity at the Gates: The SEC's Neglect to Enforce Control Person Liability*, 11 VA. L. & BUS. REV. 201 (2017) (stating that “allegedly blameworthy publicly-traded companies have paid huge monetary penalties—a punishment which directly harms their innocent shareholders” (footnote omitted)).

127. See, e.g., SEC v. Mozilo, No. CV 09-3994-JFW (MANx), 2010 WL 3656068 (C.D. Cal. Sept. 16, 2010) (former chief executive officer of Countrywide Financial Corporation); SEC v. Delphi Corp., 508 F. App'x 527 (6th Cir. 2012) (former chief accounting officer of Delphi Corporation); SEC v. DHB Indus., Inc., Nos. 0:11-CV-60431-JIC, -60432-WPD, 2011 WL 700536 (S.D. Fla. Feb. 28, 2011) (claims brought against outside directors of company).

so—namely, the control person provision. Pursuant to Section 20(a) of the Exchange Act, a control person is equally as liable as the person who committed the violation unless he or she shows good faith and noninducement.¹²⁸ Hence, a chief executive officer, chief financial officer, chief operating officer, chair of the board of directors, lead independent director, chair of the audit committee, and/or chair of the compensation committee, depending on the facts and circumstances, may be deemed control persons of the subject enterprise.¹²⁹ Accordingly, a corporation's violations of the federal securities laws would subject these individuals to joint and several liability, with the affirmative defense of good faith and noninducement being available.¹³⁰

The control person provision may be viewed as federalizing a component of a fiduciary's duty of care and loyalty—namely, the duty of disclosure.¹³¹ When a publicly held corporation engages in deficient disclosure, those fiduciaries who are deemed control persons are equally liable unless they establish their affirmative defense under Section 20(a). The control person statute thus functions as a law compliance mechanism¹³²—seeking to effectuate lawful conduct while sanctioning noncompliant fiduciaries who fail to adhere to their disclosure oversight responsibilities.¹³³

With regularity, plaintiffs in class actions plead Section 20(a) control person claims against corporate fiduciaries.¹³⁴ The provision clearly is available to the SEC;¹³⁵ yet, the Commission neglected to invoke this

128. 15 U.S.C. § 78t(a) (2012).

129. *See, e.g.*, *Maverick Fund, L.D.C. v. Converse Tech., Inc.*, 801 F. Supp. 2d 41 (E.D.N.Y. 2011); *In re Tronox, Inc. Sec. Litig.*, 769 F. Supp. 2d 202 (S.D.N.Y. 2011); *Salit v. Stanley Works*, 802 F. Supp. 728 (D. Conn. 1992).

130. Accordingly, once a primary violation of a controlled person adequately is alleged, asserting a Section 20(a) claim is subject to a generally low pleading threshold. *See Steinberg & Roberts, supra* note 126, at 215.

131. *See, e.g.*, *Malone v. Brincat*, 722 A.2d 5, 14 (Del. 1998) (stating that Delaware law “protects shareholders who receive false communications from directors even in the absence of a request for shareholder action”).

132. Depending on the applicable facts and circumstances, gatekeepers may be control persons. *See, e.g.*, *Rospach Sec. Litig.*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,939 (W.D. Mich. July 8, 1992) (attorney and law firm). Gatekeepers generally encompass attorneys and accountants who, in a securities law setting, are well situated to detect improper conduct and who have the ability to withhold their essential services in order to prevent such misconduct from eventuating or continuing. *See Lawson v. FMR LLC*, 571 U.S. 429, 448–51 (2014); Fred Zacharias, *Lawyers as Gatekeepers*, 41 SAN DIEGO L. REV. 1387, 1389 (2004) (“Lawyers are gatekeepers and always have been.”).

133. *See Steinberg & Roberts, supra* note 126, at 207–16.

134. *Id.* at 238 (citing cases and stating that “within the last three years, cases have been filed in every single U.S. circuit alleging Section 20(a) control person liability”).

135. Pursuant to the Dodd-Frank Act of 2010, Congress reaffirmed that the Commission has the authority to invoke Section 20(a) in its enforcement actions. *See* § 929P(c) of the Dodd-Frank

provision in these times of crisis. The Commission has no explanation for this failure. One can only speculate. Even with a democratic administration in power and a former US Attorney (Mary Jo White) as its chair, one may ask: was the SEC overly concerned with the “noise” that would have ensued from corporate America if it had invoked this provision against “upstanding” members of the business community? Unfortunately, no member of Congress has called upon the SEC to explain its reluctance—including Senators Bernie Sanders and Elizabeth Warren.¹³⁶

Very recently, perhaps due to an article that I coauthored on this subject¹³⁷ (at least I can pretend that to be the reason), the SEC resolved an enforcement action against corporate officers in a publicly held company premised on control person liability. In *SEC v. ITT Educational Services, Inc.*,¹³⁸ the former chief executive officer and former chief financial officer of the company entered into a settlement based on their noncompliance with the control person provision of Section 20(a).¹³⁹ Whether this proceeding is an aberration or represents the commencement of the Commission invoking Section 20(a) with vigor is yet to be determined. What is clear, however, is that the SEC abysmally failed in its law enforcement obligations by neglecting to utilize the control person provision to pursue corporate fiduciaries after the financial scandals two decades ago and the financial crisis a decade ago.¹⁴⁰

Act, Pub. L. No. 111-203, 124 Stat. 1376, 1865 (2010) (amending 15 U.S.C. § 78t(a) (2012)). Prior to that legislation, the majority of courts that addressed the issue held that the SEC had the authority to utilize Section 20(a). *See, e.g.*, *SEC v. Hawk*, No. 03:05-CV-00172-LRH-VPC, 2007 U.S. Dist. LEXIS 57414, at *6 (D. Nev. Aug. 3, 2007) (stating that “the majority of courts have concluded that an SEC enforcement action can be brought pursuant to Section 20(a)”).

136. Although these senators at times have been critical of the Commission, apparently they have not focused on the SEC’s failure to invoke the control person provision. *See infra* note 139.

137. *See* Steinberg & Roberts, *supra* note 126.

138. *SEC v. IIT Educ. Servs., Inc.*, SEC Litigation Release No. 24,188, 2018 WL 3344233 (S.D. Ind. July 9, 2018).

139. *Id.* at *1. Pursuant to settlement, the defendants were enjoined, received a five-year bar from serving as an officer or director of a publicly held company, the former CEO paid a \$200,000 money penalty, and the former CFO paid a \$100,000 money penalty. *Id.* In a letter to SEC Chairman Clayton, Senators Blumenthal, Brown, Durbin, and Warren criticized the Commission for the “measly fine amounts” that are “nothing more than a parking ticket . . .” Letter from Senators Blumenthal, Brown, Durbin, & Warren to SEC Chairman Clayton (July 20, 2018), *available at* <https://www.durbin.senate.gov/imo/media/doc/7.20.18%20ITT%20SEC%20letter%20FINAL.pdf>. While the senators’ criticism has merit, what they perhaps did not realize was that this proceeding may have represented the first instance in a prolonged period that the SEC invoked the control person provision against corporate fiduciaries of a publicly traded company.

140. *See* STEINBERG, *supra* note 1, at 283 (“For whatever reason, which the Commission has declined to articulate, it has not utilized [the control person] provision.”); Steinberg & Roberts, *supra* note 126, at 206 (asserting that “it is inexplicable why the SEC declines to focus on this manifestly clear statutory [Section 20(a)] remedy to address the blatant misconduct that transpires

CONCLUSION

The federalization of corporate governance is an evolutionary process that began at the beginning of the twentieth century. Through the decades, this process has gone through periods of gradual transition, activism, and stagnation. Certainly, the Sarbanes-Oxley and Dodd-Frank Acts have intensified this process. Today, to the greatest extent in our nation's history, federal law plays a central role in the governance of publicly held corporations. Undoubtedly, this federalization process will serve as a primary determiner for the continuing stability of the US securities markets and the quest for meaningful investor protection.

[and that this article] will seek to determine why the SEC has neglected to bring enforcement actions based on control person liability against executives of Wall Street's biggest miscreants").