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LEGITIMACY AND CORPORATE LAW: THE CASE FOR REGULATORY REDUNDANCY

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ABSTRACT

This Article provides a democratic assessment of the corporate lawmaking structure in the United States. It draws upon the basic democratic principle that those affected by legal rules should have a voice in determining the substance of those rules. Although other commentators have noted certain undemocratic aspects of corporate law, this Article aims to present a more comprehensive assessment of the corporate regulatory regime. It departs from prior accounts by looking past the states' role to consider the ways that federal regulation shores up the legitimacy of the overarching structure.

This focus on the federal role provides some comfort on a democratic account, but also counsels caution with respect to continuing efforts to limit the scope of the federal role within the corporate governance structure. At the federal level, Congress has chosen to regulate corporate matters by setting broad policy objectives and delegating administrative tasks to the Securities and Exchange Commission (SEC). The democratic legitimacy of the corporate regulatory regime thus requires proper respect for the discretion that Congress has vested in the agency.

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This Article therefore urges skepticism toward efforts to constrain the SEC's regulatory role through judicial challenges to its rulemaking authority. It argues that the agency's ability to respond deftly to market crises and scandals has been hampered unnecessarily by a tradition of aggressive judicial review of agency rulemaking. While rooted in concerns for preserving democratic accountability, this tradition has undermined the very values it seeks to protect. Because the procedures for SEC rulemaking comport well with democratic principles, the agency deserves more deference than courts have been willing to allow.

The analysis has implications for current proposals to reform regulation of the national financial markets. Calls to reduce or weaken the SEC's role in financial regulation should give pause to those concerned with the democratic integrity of our regulatory processes. It is the SEC's political independence that bolsters its ability to navigate the rough terrain of regulating the powerful industries within its jurisdiction. Enhancing rather than diminishing the agency's independence should be a central element of proposals to reform our financial regulatory system.

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INTRODUCTION

The impact of corporate law on citizens is often understated. We rely on corporate law to mediate the ever-present tension between authority and accountability which in turn determines whether those with the power to control a corporation's decisions will act with diligence or indifference when overseeing decisions that affect the interests of shareholders, creditors, employees, and the larger society. Corporate law rules often dictate whether the victim of an accident will receive compensation for an injury, or if workers lose their livelihoods when a plant is closed or jobs transferred overseas.

It therefore seems appropriate that citizens throughout the country have the ability to influence the substance of corporate law rules, just as we expect input on criminal and environmental laws. Our system of government, after all, rests on the principle that citizens should have a voice in shaping the substance of the rules that affect their lives. It is this guiding principle that confers legitimacy to the laws that govern our society.

Unfortunately, our system for crafting corporate law rules does not always comport with this democratic ideal. A significant portion of

substantive law is set at the state level—and one small state, Delaware, dominates this process. Further, the task of drafting Delaware's corporate law is delegated to a small group of private lawyers, most of whom represent large corporate interests in their professional capacities.[1] Although many scholars have decried the democratic shortcomings of this arrangement, to date the analysis remains incomplete.[2] To fully assess the democratic legitimacy of our corporate regulatory regime, we must also factor in the role of federal regulation which introduces important democratic safeguards to the system.

This Article is intended to fill a gap in the literature by broadening and sharpening the democratic assessment of American corporate law. It applies basic principles of contemporary democratic theory to an analysis of the structure of the corporate regulatory apparatus. It departs from prior analysis by looking beyond the state role to consider how regulation at the federal level shores up the legitimacy of the overarching structure. This focus on the federal role provides comfort on a democratic account, but also counsels caution with respect to current trends in the corporate regulatory landscape.

Although the base level of corporate law is crafted by states through statutes and common law decision making, the federal government provides a crucial regulatory overlay through federal securities laws administered by the Securities and Exchange Commission (SEC) and the various self-regulatory organizations (SROs) within its purview.[3] This regulatory redundancy, through which multiple regulators exercise authority over similar conduct, is a much maligned feature of our corporate governance regime. Yet, on a democratic analysis, such

1. *See, e.g.*, Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885 (1990); Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749 (2006); Comment, *Law for Sale*: *A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 863–65 (1969).

2. Concerns with the undemocratic underpinnings of corporate law animate the race to the bottom school of corporate scholarship. *See generally* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); Comment, *supra* note 1. Recently scholars have more directly addressed the democratic weaknesses in the corporate law structure by recommending abandonment of the internal affairs doctrine as a choice of law rule. *See* Kent Greenfield, *Democracy and the Dominance of Delaware in Corporate Law*, 67 L. & CONTEMP. PROBS. 135, 136–38 (2004); Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 YALE L. & POL'Y REV. 381, 383 (2005).

3. The most significant self-regulatory organizations are the New York Stock Exchange (NYSE), Nasdaq and the Financial Industry Regulatory Authority (FINRA), which was formed by the 2007 merger of the National Association of Securities Dealers (NASD) and the regulatory arm of the NYSE. Congress also weighs in on corporate governance matters through criminal, tax and other statutory provisions which aim to influence corporate conduct. *See, e.g.*, Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 WASH. & LEE L. REV. 1159, 1160–61 (2004).

redundancy is properly seen as a critical element in a rulemaking system that allows certain centers of authority to function in secrecy, sheltered from public demands for accountability.

Because federal regulation helps compensate for the democratic deficiencies of state corporate law, the soundness of the entire regime depends upon the durability of each of its component parts. Attempts to dismantle or disable a component of the structure therefore threaten to strip the entire system of its integrity. Thus, to the extent that broad SEC authority helps to confer legitimacy to the corporate regulatory structure, judicial constraints on the SEC's administrative discretion risk undermining the legitimacy of the entire regime.

This Article therefore questions efforts to limit the SEC's regulatory power through judicial challenges to its rulemaking authority. It argues that the SEC's ability to respond deftly to market crises and scandals has been hampered unnecessarily by a longstanding tradition of aggressive judicial review of agency decision making. This tradition, while rooted in concerns for preserving accountability, has undermined the very values it seeks to protect. Because the procedures for agency rulemaking comport well with democratic values, agencies deserve more deference than the courts have been willing to allow.

This pattern of intrusive judicial review drives agencies to rely more heavily on less formal modes of regulation that are free from the deliberative requirements Congress has wisely imposed on agencies. The lack of transparency for these more informal policies makes it harder for regulated parties to comply with the "rules" the agency prescribes. Greater judicial deference to SEC decision making would help restore the balance of authority that Congress has sought to maintain since the advent of the modern system of securities regulation.

This analysis has implications for current proposals to reform regulation of the national financial markets.[4] Although beyond the scope of this Article, proposals to diminish the SEC's role in financial regulation or to curtail the SEC's enforcement powers[5] should give pause. It is the

4. *See, e.g.*, A.C. Pritchard, *The SEC at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073, 1092–93 (2005) (advocating transferring the SEC's responsibilities to the Treasury Department and the Justice Department); DEP'T OF TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008). Former Treasury Secretary Henry Paulson released the Blueprint in March of 2008 in the midst of the market upheavals caused by the collapse of Bear Stearns and the related subprime mortgage crisis. Although released amid the turmoil these crises wrought, the plan itself had been under development for more than a year. *Id.* at 1.

5. DEP'T OF TREASURY, *supra* note 4, at 11, 21 (proposing a merger of the SEC and the Commodities and Futures Exchange Commission and transferring enforcement authority to SROs).

SEC's political independence that bolsters its ability to navigate the rough terrain of regulating the powerful industries within its jurisdiction. Incremental adjustment to the regulatory structure rather than a major overhaul seems a superior approach to achieving necessary improvements to the corporate regulatory system.

This Article proceeds in four parts. Part I lays the theoretical groundwork by proposing a set of ideals for a corporate lawmaking process that fairly reflects broadly accepted democratic values. Drawing on deliberative democracy theory, it identifies reasoned debate, broad public participation, transparency, and accountability as values that should be respected in an ideal corporate lawmaking process. Part II assesses the state lawmaking processes in Delaware and other states against these ideals and concludes that such procedures fall short. Part III examines the federal regulatory overlay by assessing corporate oversight mechanisms employed by Congress and the SEC. It concludes that Congress's traditional deference to state authority in corporate governance garners legitimacy only by reason of its concomitant broad delegation of power to the SEC. Part III also examines the SEC's rulemaking procedures and concludes that, in principle, such practices comport better with democratic values than state lawmaking traditions. Part IV argues that in light of the SEC's role in supporting the legitimacy of our corporate governance system, efforts to constrain SEC rulemaking through judicial challenges are misguided. It shows that such efforts and the judicial decisions that support them unwisely disregard the SEC's importance in shoring up the democratic legitimacy of our corporate regulatory regime.

I. THE DEMANDS OF DEMOCRACY

When applied to corporate law, democratic principles would require that the methods for devising the rules that govern the relationship of corporations and their officials to shareholders, creditors, employees, and society should allow for the participation of all those with an interest in the substance of those rules.[6] Democratic accountability would also require mechanisms that allow citizens to provide feedback to their representatives and that facilitate continued debate on important policy issues, so policy adjustments can be made from time to time.[7] Because so much of U.S. corporate law derives from the state of Delaware, we immediately

6. *See, e.g.*, Greenfield, *supra* note 2, at 136–38; Daniel J.H. Greenwood, *Markets and Democracy: The Illegitimacy of Corporate Law*, 74 UMKC L. REV. 41, 45–46 (2005).

7. AMY GUTMANN & DENNIS THOMPSON, DEMOCRACY AND DISAGREEMENT 147 (1996).

confront a democratic dilemma.[8] Most U.S. citizens are unrepresented in Delaware, thus our corporate governance system seems to fail the democratic test.

Probing this apparent dilemma first requires some groundwork as to the principles we are seeking to uphold. This Article invokes deliberative democracy, an influential contemporary theory, as a guidepost for analyzing existing mechanisms for developing corporate law rules.[9] Deliberative democracy emphasizes the values of reasoned public debate and broad citizen participation. As such, the theory can help instruct us on what to look for when assessing the democratic nature of our corporate policymaking process.

A. The Deliberative Model

To stake a claim to legitimacy, American corporate law must be seen as democratic.[10] For it is democracy that provides "legitimacy" for collective decisions by which all citizens are bound.[11] According to most views, such legitimacy depends on some form of participation that allows citizens to have a voice in shaping the substance of laws they must obey. Political theorists (and ordinary citizens) vary greatly in their views of the purposes, potential, and essential elements of democracy. Theories of democracy range from the most ambitious and aspirational to the most parsimonious and pragmatic, making precision difficult when discussing democracy writ large.

The deliberative model stakes out a sensible middle ground between the utopian and the cynical, by combining high aspirations with realistic pragmatism. The theory rests on the principle that because "[p]olitical

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8. *See* Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 638 (2004); Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1576–77 (2005) (discussing Delaware's legitimacy deficit).

9. Deliberative democracy has as its intellectual antecedents discourse theory advanced by Jurgen Habermas and civic republicanism, as advanced by legal scholars such as Frank Michelman and Cass Sunstein. *See, e.g.*, JURGEN HABERMAS, *Discourse Ethics*, *in* MORAL CONSCIOUSNESS AND COMMUNICATIVE ACTION 43 (Christian Lenhardt & Shierry Weber Nicholsen trans., 2nd prtg. 1991); CASS R. SUNSTEIN, THE PARTIAL CONSTITUTION 23–24 (1993); Cass R. Sunstein, *Beyond the Republican Revival*, 97 YALE L.J. 1539 (1988); Frank Michelman, *Law's Republic*, 97 YALE L.J. 1493, 1503–04, 1524–28 (1988).

10. *Introduction* to PHILOSOPHY AND DEMOCRACY 3, 3 (Thomas Christiano ed., 2003) ("Democracy provides a solution to the problem of who may legitimately participate in decision making about issues of great importance to a political community . . . .").

11. Joshua Cohen, *Procedure and Substance in Deliberative Democracy*, *in* PHILOSOPHY AND DEMOCRACY, *supra* note 10, at 17, 17 ("The fundamental idea of democratic legitimacy is that the authorization to exercise state power must arise from the collective decisions of the members of a society who are governed by that power.").

decisions are collectively binding . . . they should therefore be justifiable, as far as possible, to everyone bound by them."[12] Its advocates promote deliberation as a mode of decision making (as opposed to interest group bargaining or majority rule) because, they claim, decisions made after reasoned deliberation have more legitimacy and thus are more likely to be accepted, even when citizens continue to disagree.[13]

Deliberative democracy emphasizes the importance of public participation and reasoned political discourse. Its proponents assert that "[w]hen citizens morally disagree about public policy . . . . [t]hey should deliberate with one another, seeking moral agreement when they can, and maintaining mutual respect when they cannot."[14] They promote deliberation as an ideal mechanism for dealing with (and living with) moral disagreement on divisive issues such as abortion, surrogacy, organ donation and the distribution of scarce resources such as health care.

Although it is infrequently acknowledged, our system of corporate regulation must engage a number of thorny moral problems. Corporate law policy must resolve such moral quandaries as whether individuals should be inured from responsibility for harms that result from the actions that they authorize and whether those who stand to benefit from corporate activities bear responsibility for the harms their firms impose on others.[15] At root, most corporate law questions concern whom among the various participants in a business enterprise will bear losses, compensate others, or reap rewards from business decisions and activities. Resolving these questions requires policymakers to grapple constantly with concerns for fairness, efficiency and justice.[16]

The fallout from the current financial crisis highlights the moral dimension of corporate law. Americans and their leaders are now engaged

12. GUTMANN & THOMPSON, *supra* note 7, at 13.

13. *Id.* at 41–42 ("Even with regard to political decisions with which they disagree, citizens are likely to take a different attitude toward those that are adopted after careful consideration of the relevant conflicting moral claims and those that are adopted only after calculation of the relative strength of the competing political interests.").

14. *Id.* at 346.

15. Disputes over the allocation of losses cased by poor decisions, accidents or insolvency form the core of most corporate law cases. Corporate "veil piercing" cases are one example of such controversies. *See, e.g.*, Walkovszky v. Carlton, 223 N.E.2d 6 (N.Y. 1966) (assessing the culpability of the owner of several taxicab corporations for the injuries caused by a taxi from its fleet). *See generally* David Millon, *Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability*, 56 EMORY L.J. 1305, 1314–25, 1381 (2007) ("Limited liability is best understood as a subsidy designed to encourage business investment."); Timothy P. Glynn, *Beyond "Unlimiting" Shareholder Liability: Vicarious Tort Liability for Corporate Officers*, 57 VAND. L. REV. 329 (2004).

16. In more philosophical terms corporate law regularly embraces questions concerning official immunity, collective agency, collective responsibility and distributive justice.

in a lively debate over who should bear the brunt of the unsound business practices that led to the economic collapse: taxpayers, consumers, shareholders or business executives.[17] The government's role in propping up failing financial institutions has provoked intense criticism.[18] At the same time, government officials and commentators deride business leaders who reward those whose decisions contributed to their company's woes with large bonuses and other perquisites, despite record losses and unprecedented taxpayer support for their institutions.[19] Given the wide range of views on how government should relate to business (and vice-versa), a deliberative framework can help devise a workable decision making structure for managing these controversies.

Deliberative democracy has been embraced as an analytical framework by legal scholars working in a range of fields.[20] Although developed in part as an effort to help society better grapple with the most controversial moral issues confronting the nation, the model interestingly focuses on the very features of an ideal political structure that seem lacking in our current system for corporate lawmaking.[21] By advancing a political conception of

17. *See* David M. Herszenhorn, *Talks on Bailout Plan Advance, Despite Anger and Skeptics in Congress*, N.Y. TIMES, Sept. 23, 2008, at A1; Stephen Labaton & Edmund L. Andrews, *Geithner is said to have Prevailed on the Bailout*, N.Y. TIMES, Feb. 10, 2009, at A1; Carol J. Loomis, *AIG: The Company that Came to Dinner*, FORTUNE, Jan. 19, 2009, at 70; Adam Nagourney, *Bracing for a Bailout Backlash*, N.Y. TIMES, Mar. 16, 2009, at A1; Robert O'Harrow Jr. and Brady Dennis, *This Beautiful Machine*, WASH. POST, Dec. 29, 2008, at A1; James Surowiecki, *Hazardous Materials?*, NEW YORKER, Feb. 9, 2009, at 40.

18. *See* John Cassidy, *Subprime Suspect*, NEW YORKER, Mar. 31, 2008, at 18; Loomis, *supra* note 17; John D. McKinnon, Deborah Solomon & Greg Hitt, *Detroit Gets Access To Bailout Funds*, Wall St. J., Dec. 13, 2008, at A1; Nagourney, *supra* note 17; Sudeep Reddy, *Bear Stearns: A Year Later: Was Rescue the Right Call or Slippery Slope?*, WALL St. J., Mar. 16, 2009, at 23.

19. *See* Cassidy, *supra* note 18; Liam Pleven, Serena Ng & Sudeep Reddy, *AIG Faces Growing Wrath Over Payouts*, WALL. ST. J., Mar. 16, 2009, at A1; Edmund L. Andrews & Peter Baker, *AIG Planning Huge Bonuses After $170 Billion Bailout*, NEW YORKER, Mar. 15, 2009, at A1; David Kiley, *Auto Bailout: Seeking Signs of Sacrifice*, BUS. WK. ONLINE, Nov. 20, 2008, http://bwdaily/dnflash/content/nov2008/db20081119_54139.htm; Heather Landy, *Wall Street Bonuses Draw Scrutiny in Bailout's Wake*, WASH. POST, Jan. 24, 2009; James Surowiecki, *Performance-Pay Perplexes*, NEW YORKER, Nov. 12, 2007, at 34.

20. *See, e.g.*, Glen Staszweski, *Reason-Giving and Accountability*, 93 MINN. L. REV. 1253 (2009); Richard J. Lazurus, *Congressional Descent: Tbe* [sic] *Demise of Deliberative Democracy in Environmental Law*, 94 GEO. L.J. 619 (2006); Ethan J. Leib, *Towards a Practice of Deliberative Democracy: A Proposal for a Popular Branch*, 33 RUTGERS L.J. 359 (2002); Linda C. McClain, *Deliberative Democracy, Overlapping Consensus, and Same-Sex Marriage*, 66 FORDHAM L. REV. 1241 (1998); Mark Seidenfeld, *A Civic Republican Justification for the Bureaucratic State*, 105 HARV. L. REV. 1511 (1992).

21. Corporate scholars have long expressed concerns about a number of structural aspects of the corporate regulatory apparatus, including Delaware's dominance in the corporate landscape, inadequate constraints on managerial discretion, lack of representation for stakeholders within the corporate structure, and the failure of traditional corporate law doctrines to address the problems of externalities. *See generally* PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995).

corporate law, the deliberative framework invites more citizens to participate in corporate law debates and promotes discussion of corporate law in moral terms rather than as a simple problem of private allocation of risks and rewards among voluntary participants in an enterprise.[22]

Adopting the lens of deliberative democracy broadens the view of who has legitimate interests in crafting corporate law, and extends the scope of policy discussions beyond the traditional shareholder/manager dichotomy.[23] This perspective can also help to dismantle the obfuscatory federal/state dichotomy that has long dominated corporate law commentary.[24] By helping to identify key weaknesses (and sources of friction) within our current system, the model can also guide us as we implement regulatory reforms.

B. Critical Elements

Although a comprehensive account of deliberative democracy is beyond the scope of this Article, it is useful to identify its key elements. The discussion that follows will therefore focus on the democratic criteria of reasoned debate, citizen participation, transparency, and accountability.[25]

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22. This view of corporate law as a "contract" among the various corporate participants has dominated corporate law commentary for decades. The "contractarian model" has been advanced by legal scholars such as Frank Easterbrook and Daniel Fischel. *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) (developing the nexus of contracts model of the corporation). The perspective is also championed by scholars such as Stephen Bainbridge, Roberta Romano, Henry Butler and Larry Ribstein. *See, e.g.*, STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE (2008); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); HENRY N. BUTLER & LARRY E. RIBSTEIN, THE CORPORATION AND THE CONSTITUTION (1995).

23. *See, e.g.*, Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001) (asserting the ascendancy of the shareholder primacy model for corporate governance). For critiques of the shareholder primacy model see Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189, 1189–90 (2003) (arguing that corporate law discussion focuses myopically on the interests of only three of the significant corporate constituents: shareholders, managers and directors).

24. *See* Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879, 880–81 (2006).

25. This discussion draws on the conception of deliberative democracy presented by Professors Dennis Thompson and Amy Gutmann in DEMOCRACY AND DISAGREEMENT, *supra* note 7. Gutmann and Thompson use the terms reciprocity, publicity and accountability to describe roughly the same concepts outlined here. *Id.* at 12. I discuss their foundational concepts within a framework more conducive to an evaluation of the corporate lawmaking process.

Deliberative democracy is not without its critics, both within and outside of the legal academy. For a sampling of critical responses to the Thompson and Gutmann account, see DELIBERATIVE POLITICS: ESSAYS ON DEMOCRACY AND DISAGREEMENT (Stephen Macedo ed., 1999) and Christopher

1. Reasoned Debate

The deliberative democracy model hews closely to the contours of modern liberal democracy, but demands more of decisionmakers and citizens than traditional models of representative democracy. Its theorists assert that a workable model of democracy must squarely address "the fact of reasonable pluralism" within our society.[26] Thus a model of democracy must include a framework for decision making that allows citizens to continue living together despite persistent moral disagreement.

Deliberative democrats advance a requirement for reasoned public debate, in which citizens express their preferences by giving reasons in terms that fellow citizens can understand, and decisionmakers provide citizens with reasons for their policies.[27] Such reciprocal reason-giving promotes mutual respect and is more likely to lead to policies that citizens can accept. Democratic deliberation is favored over other methods of conflict resolution because "[w]hen citizens deliberate in democratic politics, they express and respect their status as political equals even as they continue to disagree about important matters of public policy."[28]

By asking "citizens and officials to justify public policy by giving reasons that can be accepted by those who are bound by it,"[29] deliberative democracy stands in contrast to the more strategic pluralist model. The pluralist model assumes that interest groups will compete to achieve their policy goals, and that competing interests will balance each other to achieve a workable, if not entirely just, outcome most of the time.[30] The traditional interest group model and its theoretical justifications favor more powerful interests such as business groups. Therefore, its acceptance as a model for political decision making confers unmerited legitimacy to the political status quo. When policies are based on reasons, not merely

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H. Schroeder, *Deliberative Democracy's Attempt to Turn Politics into Law*, 65 L. & CONTEMP. PROBS. 95.

26. Cohen, *supra* note 11, at 18. Cohen defines reasonable pluralism as "the fact that there are distinct, incompatible understandings of value, each one reasonable, to which people are drawn under favorable conditions for the exercise of their practical reason." *Id*. Reasonable pluralism is evidenced by persistent disagreement among citizens about "the values of choice and self-determination, happiness and welfare and self-actualization." *Id*.

27. Gutmann and Thompson maintain that reciprocity in public deliberation requires that citizens "appeal to reasons or principles that can be shared by fellow citizens who are similarly motivated." GUTMANN & THOMPSON, *supra* note 7, at 55. This reflects the concept of "public reason" as outlined by John Rawls. *See* JOHN RAWLS, POLITICAL LIBERALISM 48–54 (1993).

28. GUTMANN & THOMPSON, *supra* note 7, at 18.

29. *Id.* at 52.

30. *See, e.g.*, ROBERT A. DAHL, A PREFACE TO DEMOCRATIC THEORY 132–51 (1956); *see also* DAVID HELD, MODELS OF DEMOCRACY 186–93 (1987).

political power, we should expect different policy outcomes in those arenas in which large power disparities exist among competing interest groups.

2. Participation

Citizen participation in politics forms a central element in the deliberative democratic model. The deliberative model (and its reason-giving requirement) is aimed not only toward judicial and legislative decisionmakers, but is also urged upon ordinary citizens, policy advocates, and public activists, within the arena its proponents label "middle democracy."[31] Although its proponents readily concede that most political decisions should be made by elected representatives and other public officials, they also favor broader popular participation in political life.[32] As Gutmann and Thompson explain, "[w]hat makes deliberative democracy democratic is an expansive definition of who is included in the process of deliberation—an inclusive answer to the questions of who has the right (and effective opportunity) to deliberate or choose the deliberators, and to whom do the deliberators owe their justifications."[33]

On this view, public officials "are expected not only to deliberate among themselves, but also to listen to and communicate with their constituents."[34] Deliberation within an array of public fora can help to bring previously excluded forces into politics and to draw out legitimate moral dissatisfactions that might otherwise be suppressed.[35] Further, "citizens and their representatives are more likely to take a broader view of issues, and to consider the claims of more of their fellow citizens, in a process in which moral arguments are taken more seriously than in a process in which assertions of political power prevail."[36]

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31. GUTMANN & THOMPSON, *supra* note 7, at 40–41.

32. A deliberative analysis can be equally useful when considering questions regarding the appropriate internal corporate governance structure for corporations; including the role of shareholders in corporate decision making and questions of accountability of corporate officials to shareholders, employees, and society. These questions are set aside in this Article, which focuses on the process of determining what external constraints society might impose on corporate conduct. For a discussion of what deliberative democracy can teach about improving internal corporate governance questions, see DENNIS F. THOMPSON, *Restoring Distrust*, *in* RESTORING RESPONSIBILITY: ETHICS IN GOVERNMENT, BUSINESS, AND HEALTHCARE 245, 245–65 (2005).

33. AMY GUTMANN & DENNIS THOMPSON, WHY DELIBERATIVE DEMOCRACY? 9 (2004).

34. *Id.* at 30.

35. GUTMANN & THOMPSON, *supra* note 7, at 42. Public fora for democratic deliberation include legislative sessions, court proceedings and administrative hearings, as well as grass roots organizations, professional associations and shareholders' meetings.

36. *Id.*

3. Transparency

Another key component of deliberative democracy theory is a requirement of transparency. Its advocates assert that officials should publicly state their reasons for their policy decisions.[37] Transparency in policymaking is essential, both to accommodate public participation and to assure political accountability. Secrecy and obscurity within the policymaking process frustrate the objectives of public deliberation because citizens cannot contribute to any deliberations that occur.[38] The lack of an adequate basis for assessing the performance of public officials also undermines the objective of accountability. Without transparency, citizens cannot assess the reasonableness of public policies, and are therefore disabled from providing the (explicit or implicit) consent that underlies democratic legitimacy.

4. Accountability

Democracy also requires that decisionmakers be held accountable for their decisions.[39] In most views of democracy, representatives are accountable to voters, who can remove them from office if dissatisfied with their performance. Deliberative democrats embrace a broader view of democratic accountability. They argue that representatives must justify their decisions in moral terms not only to their own constituents, but to *all* citizens who may be affected by them.[40]

Deliberative democracy thus broadens the scope of accountability beyond that embraced by pure proceduralists. Not only are representatives accountable to all citizens, but citizens are accountable to each other, and to their representatives, when they deliberate in public forums. In addition, on the deliberative view, accountability is an ongoing process, as officials present proposals, citizens respond, officials revise and so on.[41]

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37. *Id.* at 95.

38. *Id.* at 101. The authors recognize the occasional need for secrecy. *Id.*

39. *Id.* at 128.

40. *Id.* at 129.

41. *Id.* at 131 ("Deliberative democracy does not specify a single form of representation. It searches for modes of representation that support the give-and-take of serious and sustained moral argument within legislative bodies, between legislators and the citizens, and among citizens themselves."). *Id.*

C. Broadening Perspectives on Corporate Law

Deliberative democracy's well-reasoned call for a policymaking process marked by reasoned debate, broad participation, transparency, and accountability provides a useful framework for assessing the American corporate governance regime. Its specific prescriptions provide a benchmark against which to evaluate the common complaint that the current policymaking process is undemocratic.[42] By adopting a vision of broad citizen participation in policy debates and an expansive concept of political accountability, the model encourages a more capacious perspective on the parameters of that debate, one that acknowledges the impact corporate law policies have on a broader range of citizens.[43] In short, deliberative democracy helps instruct us on what to look for when assessing the democratic nature of a policymaking process. It also urges us to take a comprehensive perspective on what counts as corporate policymaking when we engage in such assessments.

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42. *See, e.g.*, Greenwood, *supra* note 6, at 41–42; Greenwood, *supra* note 2, at 384–86; Greenfield, *supra* note 2, at 137. Professors Greenfield and Greenwood both advocate abandonment or modification of the internal affairs doctrine as a corrective to the undemocratic nature of American corporate law. *Compare* Greenwood, *supra* note 6, at 41–42, *and* Greenwood, *supra* note 2, at 384–86. Modification of the internal affairs doctrine could increase the ability of states to promote or protect the interests of their citizens in ways that the current structure of corporate law makes impossible. This reform could allow states to calibrate some of the morally complex corporate law rules (veil piercing, recapitalizations, and takeover law come readily to mind) in a way that achieves a different balance among the interests of managers, investors, consumers, tort victims, and creditors, than the Delaware-dominated system has produced.

Preserving state power, while dispersing power away from Delaware, could help to achieve a more democratically justifiable system. Yet, significant democratic deficiencies would remain. The conduct of most corporations (aside from the smallest enterprises) affects citizens throughout the country. Therefore, a decision making structure must produce policies that are justifiable (as far as possible) to all who are affected by them. Even in the absence of a choice of law rule that embraces a broadly construed internal affairs doctrine, a system of regulatory redundancy would remain as an essential component of a democratic corporate regulatory structure. For further discussion on this point, see *infra* Part II.C.

43. A number of corporate scholars have supported expanding the dominant conception of the objectives of corporate regulation. *See, e.g.*, Mitchell, *supra* note 23, at 1189–90; Thomas W. Joo, Comment, *Corporate Governance and the "D-Word*," 63 WASH. & LEE L. REV. 1579, 1582–85 (2006) (discussing a societal purpose for corporate disclosure policies). Professor Donald Langevoort recently articulated a possible understanding of Sarbanes-Oxley as a sign that Congress is embracing the trust conception of the corporation more firmly than it has in the recent past. *See* Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1828–33 (2007). Professor Roberta Karmel has made a similar argument, but she is more critical than Professor Langevoort of this development. *See* 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, 93–94 (2005).

II. THE PRIVATIZATION OF STATE CORPORATE LAW

This Part analyzes the process for crafting corporate law at the state level. It focuses on Delaware, the dominant state, and briefly reviews the process for crafting the Model Business Corporation Act (MBCA), which governs in twenty-nine states.[44] It concludes that the mechanisms for crafting state law fail the democratic test. The state lawmaking process is dominated by lawyers who in their professional capacities represent corporate interests. Furthermore, the procedures followed in states can be fairly described as closed, secretive, and exclusionary, the very antithesis of democratic deliberation.

A. Delaware

Concerns about the undemocratic character of Delaware's dominance in corporate law underlie many commentators' longstanding disaffection with Delaware's role in setting national corporate law policy. Many critics have charged that state corporate law is "manufactured" in an undemocratic process from which most Americans who are affected by the policies are excluded.[45] A significant proportion of corporate regulation is handled at the state level, with tiny Delaware being the dominant state in setting corporate law rules.[46] Because the rights and interests of shareholders and others who reside throughout the nation are determined by the laws of Delaware, where most citizens have no representation, the system *prima facie* seems undemocratic.

The lack of representation for citizens throughout the country is the most salient aspect of the undemocratic nature of Delaware's dominance in corporate law. However, even putting aside the problem of representation, Delaware's lawmaking process violates most other

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44. MOD. BUS. CORP. ACT, *Introduction* xix (2005).

45. *See* Cary, *supra* note 2, at 701 (describing Delaware as a "pygmy" among the fifty states); Comment, *supra* note 1, at 870–72.

46. Delaware is the second smallest state in geographic area and the sixth smallest in population. U.S. Census Bureau Annual Population Estimates 2000 to 2008, http://www.census.gov.popest/states/NST-ann-est.html (last visited Feb. 19, 2009). Yet more than fifty percent of all U.S. publicly-traded corporations, and sixty-three percent of all Fortune 500 companies are incorporated in Delaware. Delaware Division of Corporations, http://www.corp.delaware.gov (last visited Feb. 19, 2009). Furthermore, because of the large number of corporate decisions that emanate from Delaware, courts in other states look to Delaware as a leader in corporate law, and follow Delaware law as persuasive authority in many decisions under their own statutes and common law. *See, e.g.*, Swope v. Siegel-Robert, Inc., 243 F.3d 486, 496 (8th Cir. 2001); Shoen v. Amerco, 885 F. Supp. 1332, 1341 n.20 (D. Nev. 1994); Westar Energy, Inc. v. Lake, 493 F. Supp. 2d 1126, 1139 (D. Kan. 2007); Burcham v. Unison Bancorp, Inc., 77 P.3d 130, 143 (Kan. 2003).

principles of deliberative democracy. Corporate policymaking in Delaware is managed primarily by three institutions: the Delaware Bar Association, the state legislature, and the judiciary. These three groups work cooperatively to fashion a body of law that preserves Delaware's dominant position in chartering large corporations.[47] A complete understanding of the process for crafting corporate law in Delaware thus requires consideration of the roles of the each of these key players.

1. The Delaware Bar Association

The Delaware General Corporation Law and amendments thereto are crafted by an exclusive, self-perpetuating council of the Corporation Law Section of the Delaware Bar Association.[48] The council consists of twenty-one members and is dominated by attorneys who in their professional capacities represent the corporations and managers whose rights, duties and obligations are governed by corporate law.[49] Other corporate constituencies (shareholders and creditors, for example) are underrepresented on the council.[50]

The council meets only in private sessions and does not publicly discuss its deliberations until a formal proposal is presented.[51] Only clients of council members enjoy easy access to the council, which enables them

47. Race to the top and race to the bottom advocates agree that Delaware's legal system is geared toward preserving the state's lead in the corporate law race. They disagree principally about whether the race leads to desirable or undesirable corporate law policy. *See* Jones, *supra* note 8, at 629–31.

48. The nominating committee of the council, made up of sitting council members, nominates new members to the council. Nomination is tantamount to election. Alva, *supra* note 1, at 899. The information for this account of the activities of the council is drawn principally from two sources: The first is a 2006 description of the functioning of the council by the reporter for the council, Lawrence Hamermesh, a professor at Widener University in Delaware. Hamermesh, *supra* note 1. The second is a 1990 account of the council's activities by Curtis Alva. Alva, *supra* note 1. Additional first-hand and near-first-hand accounts of the practices and activities of the council can be found in Comment, *supra* note 1, and Ernest L. Folk, *Some Reflections of a Corporate Law Draftsman*, 42 CONN. B.J. 409 (1968).

49. Hamermesh, *supra* note 1, at 1755. Hamermesh, the reporter for the council, states that seven large commercial firms in Delaware each nominate two members to the council. *Id*. The other seven members work in smaller corporate law firms, except for Hamermesh, who is a law professor at Widener Law School in Wilmington. *Id*.

50. *Id.* at 1755–56. The council membership is evenly split between litigators and transactional lawyers, and includes very few lawyers (Hamermesh does not specify how many) who represent shareholder plaintiffs as a significant part of their practice. *Id*. One council member is from a firm that represents a number of public institutional investors. *Id*. The Council includes no in-house lawyers, no non-Delaware lawyers and only one attorney from a firm that is not based principally in Delaware. *Id.*

51. *Id*. at 1756 ("There is a strongly held tradition that preliminary or potential legislative proposals are not to be discussed with or disseminated to persons outside the firms represented on the Council.").

to press their interests in promoting their desired reforms.[52] The council sometimes circulates proposals privately to practitioners and other parties with an interest in the legislation, but does not have a practice of publishing its proposals to the general public.[53] Because the council's proposals are crafted in private and presented as a fait accompli, it is impossible for council members to hear or respond to criticisms or concerns of any citizens (of Delaware or otherwise) except those select few who have access to the process.[54]

The council's proposed statutory amendments are subject to the approval of the full Corporation Law Section and the Executive Committee of the Delaware Bar Association. This formal review process allows other Delaware lawyers to weigh in on the relative merits of the council's proposals.[55] Thus, lawyers who represent clients whose interests are not represented on the council can comment or object to specific proposed amendments.[56] Upon approval of the Corporation Law Section and the Executive Committee, proposed statutory amendments are submitted to the Delaware General Assembly for adoption.

2. The Delaware General Assembly

The selectivity and the secrecy of the council's work would be of less concern if its proposals were properly vetted in the state legislature. Remarkably, however, the Delaware legislature adopts almost all of the committee's proposals wholesale, without so much as a committee hearing or floor debate.[57] In fact, neither chamber of the Delaware General Assembly has a committee that focuses primarily on corporate matters.[58] Instead, proposals to amend the Delaware General Corporation Law are

52. Alva, *supra* note 1, at 901 (listing the types of people who can influence the work of the council). Hamermesh, *supra* note 1, at 1756 ("Council members not uncommonly receive suggestions for change from clients or co-counsel outside of Delaware. . . .").

53. Alva, *supra* note 1, at 910; Hamermesh, *supra* note 1, at 1757.

54. Hamermesh, *supra* note 1, at 1757 ("Council members consider it important that further deliberation on the proposal proceed without further input from or influence by persons outside of their own law firms.").

55. According to Hamermesh, this review process is almost always perfunctory. *Id*. at 1758 ("These approvals usually follow Council approval in a fairly routine way, but not always.").

56. *Id*. (describing Corporate Counsel Section's objections to proposed amendments to Delaware General Corporation Law § 220).

57. Alva, *supra* note 1, at 915–16. Notable exceptions include the 1987 Amendments that adopted a new anti-takeover provision, and the 1986 amendments providing exculpation and indemnification for corporate directors and officers. *Id*. at 910–12, 915–16.

58. *Id*. at 897.

handled by the Judiciary Committees of the House and the Senate.[59] Although the preceding sentence implies that these committees meet and review the substance of proposed amendments, such an understanding is highly misleading.[60] Instead, published accounts of the legislative process report that (at least some) committee members never see the bills containing amendments to the Delaware General Corporation Law before voting in favor of them.[61]

In sum, Delaware citizens who may be shareholders, employees or other stakeholders in corporations have little or no opportunity to learn about, comment on, or criticize any proposals made by the Delaware Bar Association's Corporation Law Section, which are routinely rubber-stamped by the Delaware General Assembly. In fact, the entire legislative process has been almost completely privatized; the regulated entities through their officials and paid representatives maintain nearly complete control over the content of the statutes that govern their conduct.

Some may wonder why Delaware's citizens tolerate this undemocratic outsourcing of corporate law to the Delaware Bar Association. The apparent answer is that Delaware citizens are aware of the Faustian bargain their state has struck in providing favorable corporate law rules to corporations in exchange for a significant subsidy by these corporations of their state's coffers.[62] They therefore willingly tolerate their exclusion from the policy process as a reasonable price to pay for the financial advantages the state and its citizens gain through this arrangement.[63]

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59. *Id.* at 898.

60. Hamermesh reports that the members of the Delaware General Assembly play no significant role in initiating or drafting changes to the Delaware General Corporation Law, and that amendments are not the product of legislative staff or of any lobbyists engaged by individual businesses. Hamermesh, *supra* note 1, at 1754.

61. Alva, *supra* note 1, at 898 ("The Committee member explained that if a corporate law bill has the support of the Delaware Bar Association and the Secretary of State's office, then it is passed without amendment or debate.").

62. Delaware generates $600 million in annual tax revenue from its corporate chartering business. *See* Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553, 556 & n.13 (2002). This amounts to almost 20% of the state budget and the equivalent of $3,000 per four-person household in Delaware. *See id.* at 556.

63. *See* William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 635 (2006) ("So far as . . . concerns the people of Delaware, any corporate law policy that suits the chartering customers also suits them."); Bebchuk & Hamdani, *supra* note 62, at 553 (noting that Delaware and its citizens earn substantial profits from its chartering business); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 687–99 (2002) (outlining the advantages states gain from attracting out-of-state incorporations).

3. The Delaware Judiciary

It could be argued that, with a few notable exceptions, legislative changes to Delaware's corporation law are relatively inconsequential.[64] The statute itself contains so few mandatory rules that the legislative amendments advanced by the Delaware Bar Association and enacted by the legislature amount merely to tinkering around the edges. For example, Delaware General Corporation law has no provisions relating to the fiduciary duties of corporate officials, a foundational concept in corporate law.[65] Instead, fiduciary duty doctrine is entirely judge-made and is subject to modification and interpretation on a case-by-case basis. Delaware's corporate statute is also largely silent (and practically irrelevant) on the legality of takeover practices of corporate raiders and the defenses targets erect in seeking to retain control.[66] The courts, rather than the legislature, play the leading role in determining the legality of actions taken in the midst of takeover contests or other battles for corporate control.[67]

If it is correct that legislative changes advanced by the Delaware Bar Association rarely significantly alter the relative rights and duties of major corporate parties, the fact that the process excludes most interested parties should be of less concern. The claim that legislative changes matter little still invites the question of which Delaware officials *are* responsible for setting significant corporate law rules, and whether such officials are appropriately constrained by mechanisms that promote democratic accountability. Addressing this question requires scrutiny of the policymaking role of Delaware's judiciary.

The unique role of Delaware's judiciary in setting national corporate law policy has been thoughtfully pondered in the corporate law literature. The standard description is that of an expert, experienced, and efficient judiciary, uniquely qualified to mediate the disputes of the corporate titans

64. Bernard S. Black, *Is Corporate Law Trivial*?*: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544–46 (1990); Kahan & Rock, *supra* note 8, at 1600–02.

65. *See* 18b AM. JUR. 2D *Corporations* § 1460–64 (2008); 19 C.J.S. *Corporations* § 562 (2008); *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 298–309 (1999).

66. Like many other states, Delaware has adopted a "second generation" anti-takeover statute of the type validated by the Supreme Court in CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987). DEL. CODE ANN. tit. 8, § 203 (2001). By the time of its adoption, Delaware courts had already approved of more potent anti-takeover devices such as the poison pill. *See* Moran v. Household Int'l, Inc. 500 A.2d 1346 (Del. 1985).

67. *See, e.g.*, Unitrin Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995); Paramount Commc'ns Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Unocal Corp. v. Mesa Petroleum Corp. 493 A.2d 946 (De1. 1985).

that appear before them.[68] An alternative and less widely-embraced view is that of self-serving apologists, committed to protecting corporate profligacy, Delaware's coffers, and their own sphere of influence.[69] The truth most likely lies somewhere between these two extremes.

What seems beyond dispute is that Delaware's judges cannot be seen merely as impartial arbiters of business conflicts. Indeed, they play a pivotal role in protecting Delaware's corporate chartering machinery. Without their continued commitment to a *laissez-faire* approach to corporate regulation, Delaware would lose its appeal to the corporate managers who control incorporation decisions. It should be not be surprising then that Delaware's jurists have an openly acknowledged bias toward maintaining the status quo, reflected in a stated preference for incrementalism.[70] The Delaware judiciary also demonstrates a bent toward open-ended, case-specific decisions, which make it difficult for even well-informed observers to state with confidence a legal rule or to reliably impart meaning to particular decisions.[71]

Delaware judges also engage in active political advocacy for their self-preserving approach to corporate jurisprudence, and in defense of their state's supremacy in setting national corporate policy. They eagerly court academic favor, appearing regularly at academic conferences, teaching courses at elite law schools, and publishing numerous articles that defend their jurisprudence and their unique policymaking role.[72] It is difficult to assess the impact of these policy speeches and academic-style articles. They seem geared to countering or forestalling academic criticism. They may also be seen as an attempt to engage support for the Delaware judiciary's carefully crafted image as thoughtful, intelligent, and sincere experts in regulating corporate affairs.[73]

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68. *See* Hamermesh, *supra* note 1, at 1760; Bratton & McCahery, *supra* note 63, at 682–85 (providing a positive assessment of the quality of judging in Delaware).

69. *See, e.g.*, Cary, *supra* note 2, at 688; Mitchell, *supra* note 23, at 1189 (describing Delaware as a "brothel of corporate law"); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 502–03 (1987) (suggesting that Delaware judges prefer legal rules that support keeping corporate litigation within Delaware); Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265, 279 (1990).

70. Hamermesh, *supra* note 1, at 1761.

71. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work*?, 44 UCLA L. REV. 1009, 1105 (1997); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998); Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85, 92–101 (1990).

72. *See* Hamermesh, *supra* note 1, at 1759–60 & App. A (cataloguing judges' extra-judicial writings); Kahan & Rock, *supra* note 8, at 1603–04 (same).

73. *See* LAWRENCE BAUM, JUDGES AND THEIR AUDIENCES 4 (2006) ("[J]udges care about the

Generally speaking, the role of the judiciary presents a theoretical conundrum for advocates of deliberative democracy. To perform their roles effectively, judges must be viewed as independent, and thus must be somewhat insulated from everyday political struggles. Although central to our constitutional structure, judicial independence conflicts squarely with the democratic value of accountability.[74] Deliberative democrats resolve this tension by favoring an unelected, independent judiciary, while insisting that judges provide reasoned justifications for their decisions and engage in an ongoing dialogue with the public on questions of justice and moral responsibility.[75]

The role of Delaware's judiciary seems most at odds with the principle of accountability—even a conception that accords proper respect for judicial independence. Although appointed through a state-based political process, Delaware judges act like and are treated as national policymakers. They are thus in the politically awkward position of being selected by and accountable to Delaware politicians and citizens, yet exercising power over large corporate entities and all citizens whose rights and interests are affected by their corporate law decisions.

Delaware judges seem to intuitively sense a need to account more broadly for their judicial rulings, which may explain their national campaign to shore up their legitimacy.[76] This feint at accountability is insufficient. Instead of providing reasoned justifications for their decisions and general approach to rulemaking, these judges seek sustained insulation from political accountability by seeking to forestall federal efforts to influence or set national corporate governance standards.[77] In criticizing federal regulation, Delaware judges seek to preserve the accountability gap

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regard of salient audiences because they like that regard in itself, not just as a means to other ends.").

74. *See* George D. Brown, *Political Judges and Popular Justice: A Conservative Victory or a Conservative Dilemma?*, 49 WM. & MARY L. REV. 1543 (2008) (describing the democratic tensions inherent in maintaining an elected judiciary).

75. *See, e.g.*, Dennis F. Thompson, *Judicial Responsibility*, *in* RESTORING RESPONSIBILITY: ETHICS IN GOVERNMENT, BUSINESS, AND HEALTHCARE 71, 71–98 (2005).

76. *See* Kahan & Rock, *supra* note 8, at 1614 ("The extra-cameral activities . . . market Delaware law to the legal community . . . .").

77. *See, e.g.*, Myron J. Steele, *Sarbanes-Oxley: The Delaware Perspective*, 52 N.Y.L. SCH. L. REV. 503, 506 (2007) (criticizing Sarbanes-Oxley and federal intervention in corporate governance); Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1079–81 (2008) (defending Delaware's "enabling" approach to corporate regulation); Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1 (2005) (extolling the flexibility inherent in Delaware's indeterminate style of corporate jurisprudence); William 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, 976–79 (2003) (defending Delaware corporate law and criticizing Sarbanes-Oxley and related reforms).

by declining to acknowledge such interventions as a legitimate political response to public dissatisfaction with their *laissez-faire* approach to corporate law.

B. A Note on The Model Business Corporation Act

Although Delaware is the leader among states in fashioning the law and settling disputes on significant corporate matters, the Model Business Corporation Act (MBCA) also has a significant influence on the development of corporate law standards throughout the country. A majority of states have adopted some version of the MBCA.[78] Therefore, the workings of the American Bar Association's (ABA) Corporate Law Committee (the "Committee"), which drafts the MBCA, deserve close scrutiny.

The ABA Committee drafts and proposes amendments to the MBCA. The Committee is comprised of a chair and twenty-five members, all of whom are lawyers.[79] The chair of the ABA's Section of Business Law appoints the Committee's chair who helps select the remaining committee members.[80] Committee members serve for staggered six-year terms, and by tradition, members are not reappointed for consecutive terms.[81] What is most striking is the Committee's unique and privileged status among ABA committees and councils. Its member selection process and the breadth of its authority and autonomy is unparalleled within the ABA. On both these counts the Committee avoids several of the accountability checks that constrain the policy-making latitude of other ABA committees.

Until recently, the Committee was chaired by E. Norman Veasey, a former Chief Justice of the Delaware Supreme Court, now a partner in a major corporate law firm.[82] Veasey is a vocal advocate for the supremacy of state corporate law. Like other Delaware jurists, he has been a critic of Sarbanes-Oxley and the recent trend toward expanded federal involvement

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78. MODEL BUS. CORP. ACT, *Introduction* xix. Twenty-nine states have adopted all or substantially all of the MBCA. Four other states have statutes based on the 1969 version of the Model Act. *Id.*

79. *Id.* at xx.

80. *Id.*

81. *Id.*

82. Veasey is a partner in the Delaware office of Weil, Gotshal & Manges. Veasey, E. Norman—People—Weil, Gotshal & Manges, http://www.weil.com/enormanveasey (last visited Feb. 20, 2009). The current chair of the Committee is Herbert Wander, a lawyer at Katten Munchin Rosenman in Chicago. Katten Muchin Rosenman LLP—Professionals—Wander, Herbert S., http://www.kattenlaw.com/Herbert-s-wander (last visited Feb. 20, 2009).

in U.S. corporate governance.[83] The Committee's membership includes a mix of partners from law firms, academics, in-house counsel, and judges or former judges. Although its members hail from twelve different states, a disproportionate number are from Delaware.[84]

On the whole, the ABA's drafting procedures are more transparent than Delaware's. The Committee meets quarterly, generally for two days at a time. These meetings are open to ABA members and the public. However, in practice, attendance is generally limited to Committee members. Much of the Committee's substantive work is performed by task forces that review and propose revisions to various sections of the MBCA.[85]

The Committee publishes its proposals in the *Business Lawyer*, a publication of the Business Law Section of the ABA which is widely-read by lawyers and other governance activists. It also posts its proposals on its Web site. Upon publishing its proposals and preliminary drafts, the Committee invites comments from the public and publishes the comment letters on the ABA's web site. The notice and comment procedure provides opportunities for deliberation, and is analogous to the notice and comment process followed by federal agencies.[86] The process is far from ideal, however, as it is dominated by lawyers and thus excludes perspectives that may be offered by the general public.

After moving through the notice and comment procedures, the revisions are adopted by the Committee and become part of the Model Act. The Committee's work is not subject to approval or review by any other body of the ABA, including the Business Law Section (under the auspices of which it functions),[87] making the Committee unique among ABA bodies.[88]

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83. *See, e.g.*, E. Norman Veasey, *The Stockholder Franchise is Not a Myth*, 93 VA. L. REV. 811 (2007); E. Norman Veasey & Christine T. DiGuglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399 (2005) (extolling Delaware judiciary's jurisprudential excellence); E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441 (2003).

84. 2004–2005 Committee members resided or practiced in the following states: Virginia (2); Delaware (5), Florida, Massachusetts (2), Connecticut, California (3), Iowa, Washington (2), Pennsylvania, Minnesota, Michigan, Ohio, Maine, New York and Illinois. MODEL BUS. CORP. ACT, *Introduction* xx, xxxix. The fact that there were more committee members from Delaware (including, until recently, the chair) than any other state is notable considering that Delaware is not an MBCA state.

85. MODEL BUS. CORP. ACT, *Introduction* xx.

86. *See infra* notes 179–81 and accompanying text.

87. MODEL BUS. CORP. ACT, *Introduction* xxi.

88. Most policies of the ABA are subject to review by its Board of Governors, and the ABA House of Delegates. *See* American Bar Association, Constitution and Bylaws (2007–2008), http://www.abanet.org/policy/cpo304.pdf. Generally, the House of Delegates formulates policy for the

The Committee lacks power to directly effect changes to any state's corporation statute. Instead, state bar associations tend to take the lead in prodding their state legislatures to incorporate ABA-prescribed provisions into law. The sporadic, scattershot history of state-by-state adoption suggests that in most states the amendment process is less automatic than Delaware's.[89]

The state of Massachusetts's recent experience in "modernizing" its business corporation statute illustrates the effort involved in moving Model Act revisions through a state legislature. In 2003, Massachusetts replaced its antiquated business corporation law with an MBCA-based statute. Unlike the assembly line process in place in Delaware, the effort to draft and persuade the Massachusetts legislature to adopt the new statute spanned more than fifteen years.[90] This process suggests that states other than Delaware engage in a greater degree of deliberation when handling substantive questions of corporate law.[91]

C. Limits on States' Claims as Corporate Regulators

A strong theme in contemporary legal theory counsels devolution to local authorities as an elixir for promoting more democratic governance.[92] Local governance advocates might therefore assert that the proper fix to Delaware's dominance in corporate law is to augment the authority of other states in this arena. Shifting power from Delaware to more populous states like California and New York could better reflect interests of a wider range of constituencies, as recent judicial skirmishes over the

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ABA. *Id.* at 13. However the Board of Governors may perform the policy making functions of the House in between the body's meetings. *Id.*

89. MODEL BUS. CORP. ACT, *Introduction* ix.

90. Massachusetts lawyers formed a task force in 1989 to seriously consider proposals to overhaul the state's corporation statute. The task force studied the existing law, considered complaints from practitioners regarding its inadequacies, and weighed the option of piecemeal reform against calls for a fresh start. The committee also looked at the MBCA model, carefully considered its strengths and weaknesses, and rejected a number of its provisions in favor of preserving extant Massachusetts law. *See* Stanley Keller & Robert L. Nutt, Progress Report, *Task Force on the Revision of the Massachusetts Business Corporation Law*, BOSTON B.J., Nov./Dec. 1990, 5; Case & Statute Comments, *The New Massachusetts Business Corporation Act, Chapter 127, Acts of 2003*, 88 MASS. L. REV. 213 (2004).

91. A stark counter-example to this deliberative process is provided by Massachusetts's rushed adoption of anti-takeover legislation to protect Norton Corporation from an unwanted hostile takeover bid in 1990. *See* Kathleen Pierce, *Dukakis Signs Norton Bill but BTR Vows New Law Won't Derail its Bid*, WORCESTER TELEGRAM & GAZETTE, Apr. 18, 1990, at C1 (reporting on a new law adopted in one day to require that all Massachusetts corporations have staggered boards).

92. *See, e.g.*, David J. Barron, *A Localist Critique of the New Federalism*, 51 DUKE L.J. 377 (2001).

application of California's pseudo-foreign corporation law reveal.[93] Yet, the localization of corporate governance lawmaking would not resolve many of the problems identified above.

A singular reliance on states to craft corporate law policies would not satisfy the requirements of deliberative democracy without the added reassurance that a federal overlay provides. The impact of corporate governance policies (including securities regulation) continuously traverse state boundaries and cannot be handled exclusively on a state by state basis, as any state's policies inevitably impact citizens living in other parts of the country. The federal overlay provides citizens the chance to object to, and to change, those rules that seem unjustified. Whether the rules are set in New York, New Jersey, Delaware, or California, it is the possibility of federal intervention and supplementation that helps to preserve the legitimacy of a state-centered regime.

III. THE FEDERAL OVERLAY

Critics of the state-based corporate governance regime often advocate shifting the center of gravity on corporate law issues from Delaware to Washington, D.C.[94] Shifting corporate law making from the states to Congress would address some of the deliberative inadequacies of the lawmaking process at the state level. Still, a number of political constraints hamper Congress's ability to effectively regulate corporate conduct. This helps explain why Congress defers to states on most corporate law issues and delegates the task of implementing federal corporate governance standards to the SEC. Congress has also imparted significant power to the SRO's, subject to SEC oversight and supervision.[95]

This Part assesses some of the deliberative advantages of federal-level corporate regulation, while noting the political realities that thwart achievement of a deliberative ideal. It argues that Congress has adopted a pragmatic approach to grappling with such constraints by utilizing the securities laws to set broad policy objectives and relying on the SEC, an

93. *See* Timothy P. Glynn, *Delaware's Vantage Point: The Empire Strikes Back in the Post-Post-Enron Era*, 102 NW. U. L. REV. 91, 93–97 (2008); Matt Stevens, Note, *Internal Affairs Doctrine: California Versus Delaware in a Fight for the Right to Regulate Foreign Corporations*, 48 B.C. L. REV. 1047 (2007).

94. *See, e.g.*, RALPH NADER ET AL., TAMING THE GIANT CORPORATION 51–76 (1976); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 971–74 (1990).

95. Securities Exchange Act § 19, 15 U.S.C. § 78s (2000).

independent administrative agency, to further articulate and enforce a broad Congressional mandate. Certain institutional characteristics equip the SEC to facilitate democratic deliberation over appropriate corporate law policy, providing a critical supplement to Congress's efforts to regulate corporate conduct.

A. The Role of Congress

On balance, the federal legislative process for corporate regulatory matters comports better with our specified democratic criteria than the procedures followed in states. Most clearly, concerns about the lack of political representation in the state lawmaking process fade at the federal level, where all adult citizens enjoy political representation. The interests of the federal legislature are also less parochial than those of the states, which in the classic "race" paradigm are concerned more with enhancing a revenue stream of franchise taxes and filing fees than with adopting appropriate substantive standards.[96] As raising revenue is achieved primarily through the tax code, Congress is less likely to focus on increasing revenues when considering corporate law issues. Federal legislators must also balance the interests of competing constituencies in ways that legislators in Delaware and other states can avoid.[97]

Although subject to significant limitations discussed below, Congress does far better than states in satisfying deliberative democracy's criteria of reasoned debate, public participation, transparency, and accountability. In the classic paradigm, members of Congress engage in a bipartisan decision making process that is buffeted by a number of institutional checks. Before becoming law, legislation must move through respective committees in the House and Senate, be considered on the floor of both chambers, reconciled in conference committee and signed by the President.[98] These multiple checkpoints within the normal legislative process seem well-designed to inculcate discussion, debate, and compromise by national policymakers.

Although this textbook process does not always rule the day, the model still prevails often enough in practice.[99] When considering significant

96. *See* Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2495 (2005).

97. *See id.* at 2503–04.

98. For an overview of the legislative process, see ROBERT B. DOVE, ENACTMENT OF A LAW (1997), *available at* http://thomas.loc.gov/home/enactment/enactlaw.pdf.

99. Frequently, major legislation bypasses the conventional committee process. *See* BARBARA SINCLAIR, UNORTHODOX LAWMAKING: NEW LEGISLATIVE PROCESSES IN THE U.S. CONGRESS 3–7 (1997) (describing the increase in unorthodox legislative practices since the 1970s). Major legislation

legislation, Congress often hears testimony from experts, concerned citizens, and advocacy groups and considers multiple perspectives on an issue.[100] The committee process provides for give and take among legislators as they seek to craft legislation that can attract majority support. Members of Congress also engage in debate on the House and Senate floors, with members giving reasons for supporting or opposing legislation.[101]

The legislative process is also more inclusive than state corporate lawmaking. In theory, at least, the halls of Congress are open to all constituents and advocates for shareholders, workers, consumers, and the environment enjoy freer access to the national policy process.[102] Unlike the state paradigm of corporate law as a contest between shareholder and management interests, at the federal level the concerns of other constituents are more likely to hold sway.[103] As one example, a concern for constituents other than managers or shareholders is evident in several provisions of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)[104] that are aimed squarely at protecting workers rights.[105]

When dealing with corporate law issues, Congress also conducts its business in a more open and transparent manner than the states. In contrast to the states, where bar committees operate behind closed doors, Congress conducts much of its business in the public eye. Committee hearings and floor sessions are open to the public and broadcast on C-Span. Policy proposals are formalized as bills and are made available for public

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may be assigned to multiple committees in each chamber or may be assigned to a task force selected by party leadership, one that may even exclude members of the minority party. *Id*.

100. *See* Jones, *supra* note 8, at 636–37 & n.68 (describing testimony in Sarbanes-Oxley hearings).

101. *See, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1551–55 (2005) (summarizing floor debates on Sarbanes-Oxley).

102. Roe, *supra* note 96, at 2522.

103. *Id*. at 2496 (national ideologies and policy goals weigh more heavily in Washington than in Delaware); Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 WASH. U. L. REV. 1591, 1595–96 (2006).

104. Pub L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C. (2006)) [hereinafter Sarbanes-Oxley].

105. Section 306 of Sarbanes-Oxley imposes a blackout on executives' transactions in company stock received as compensation during any period in which rank and file employees are prohibited from trading in such stock in their employee benefit plans. Sarbanes-Oxley § 306 (codified at 15 U.S.C. § 7244). Sections 806 and 1107 protect corporate whistleblowers who report evidence of corporate wrongdoing to their supervisors or to government officials. *Id*. §§ 806, 1107 (codified at 18 U.S.C. §§ 1514A and 1513(e)); *see also* Roe, *supra* note 96, at 2522; Langevoort, *supra* note 43, at 1828–89 (noting broader societal themes permeating the Enron and WorldCom sagas).

inspection as they move through the legislative process.[106] Public scrutiny of Congressional action is facilitated by the many journalists, lobbyists, interest groups, and policy advocates that keep a close eye on Congressional action with respect to issues of public concern.[107]

Finally, members of Congress are accountable to the public and risk replacement if they fail to adequately address citizen's concerns. Less directly, but more consistently, our representatives are required to constantly justify their decisions on issues that are salient to the public. Between election cycles politicians are expected, and often compelled, to comment and act on issues of public concern. The media, constituents, policy advocates, and analysts all contribute to sustaining these accountability mechanisms.

B. The Example of Sarbanes-Oxley

An examination of the history surrounding the enactment of Sarbanes-Oxley demonstrates that Congress follows a more transparent, inclusive, and deliberative process when enacting major corporate legislation than what commonly occurs in Delaware or other states. Congress engaged in significant deliberation throughout the process of fashioning a legislative response to the Enron and WorldCom scandals.[108] After the exposure of Enron's frauds, the House and Senate committees began to hold hearings to inquire into what went wrong.[109] Principals in the scandal were called to testify before Congress.[110] Coverage of the hearings was available on C-Span, with the most dramatic scenes replayed on the nightly news. As the

106. There are, of course, significant departures from this norm. SINCLAIR, *supra* note 99, at 3–8 (1997) (describing the increase in unorthodox legislative practices since the 1970s); *see also* GLEN S. KRUTZ, HITCHING A RIDE: OMNIBUS LEGISLATING IN THE U.S. CONGRESS (2001) (discussing the increase of omnibus legislation in Congress); JOHN B. GILMOUR, STRATEGIC DISAGREEMENT: STALEMATE IN AMERICAN POLITICS (1995) (arguing that politicians will often reject compromise because maintaining disagreements can lead to political advantages).

107. *See* BENJAMIN I. PAGE, WHO DELIBERATES? 5–11 (1996) (discussing the role of the media in facilitating democratic deliberation).

108. Although some commentators lament the brevity of the Sarbanes-Oxley floor debates, such an emphasis minimizes the importance of the extensive committee hearings and public discussion that preceded the legislation's introduction. *See* Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 GEO. L.J. 1843, 1852 (2007) ("[F]loor debate is not where real deliberation takes place in the U.S. Congress.").

109. J. MICHAEL ANDERSON, CONGRESSIONAL RESEARCH SERVICE, ENRON: A SELECT CHRONOLOGY OF CONGRESSIONAL, CORPORATE, AND GOVERNMENT ACTIVITIES (2002), *available at* http://www.fpc.state.gov/documents/organization/9659.pdf. During 2001 and 2002 Congress held thirty-seven hearings related to the Enron scandal. *Id.*

110. Those testifying included Enron executives Kenneth Lay, Jeffrey Skilling, and Sherron Watkins. *Id.* at 12–13, 23.

government inquiries proceeded, the media also engaged in extensive investigation and reporting, transmitting emerging details to the public on an ongoing basis.

Congress's initial response to Enron was to do little or nothing. President Bush pressed for SEC reforms and more responsible self-regulation. Although Democratic Senator Paul Sarbanes proposed comprehensive reform, including greater accounting oversight, Republican Representative Michael Oxley introduced more modest legislation that was approved by the House in April 2002.[111] Meanwhile, Senator Sarbanes's more sweeping bill stalled in the Senate until the WorldCom scandal broke.[112] The public outrage and media firestorm that followed WorldCom's demise led Congress to rush through legislation in advance of looming mid-term elections.[113]

In addition to the Congressional testimony and debates, continuous media reporting primed informal public deliberation on the proper legislative response to the corporate scandals.[114] Special committees convened by courts and corporations published reports of their findings.[115] The SEC and NYSE embarked on reforms that inspired further public discussion of governance policies. Even during the final march toward enactment, public deliberation continued in Congress among party leaders and in floor debates, during which some Senators introduced amendments from the Senate floor. After the legislation passed both houses of Congress, a conference committee ironed out a compromise to reconcile the two bills, which retained most of the provisions from the Senate version. Finally, President Bush signed the legislation in a public ceremony, publicly stating his reasons for supporting the new law.[116]

The preceding discussion should not be taken to imply that the legislative process surrounding the adoption of Sarbanes-Oxley was a paragon of ideal public deliberation. Professors Romano, Ribstein, Butler and others have accurately identified numerous shortcomings in the

111. Romano, *supra* note 101, at 1550–53.

112. *Id.* at 1557–58.

113. *Id*. at 1558; Richard A. Oppel Jr., *Negotiators Agree on Broad Changes in Business Laws*, N.Y. TIMES, July 25, 2002, at A1.

114. Romano, *supra* note 101, at 1559. Accounting and governance scandals also occurred at other well-known companies such as Qwest, Global Crossing, Adelphia and Tyco, further fueling the public's sense of outrage. *See* Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 137 (2006).

115. *See, e.g.*, SPECIAL INVESTIGATIVE COMM. OF THE BD. OF DIRS. OF ENRON CORP., REPORT OF INVESTIGATION (2002).

116. Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1.

deliberative process.[117] These critics have questioned the quality of information considered by Congress, arguing that many of the legislation's central proposals lacked empirical support.[118] They also express dismay that several key substantive provisions, such as the controversial ban on executive loans, and the attorney conduct provisions were adopted as floor amendments without adequate public justification or debate.[119] More generally, critics have condemned the entire legislative process surrounding the Act as a "rush to judgment"; insisting that the near unanimity of Congressional support indicated a shameful abandonment of principles by republican legislators, rather than a laudable sign of political unity.[120]

Although these criticisms of Sarbanes-Oxley are overstated, they do expose several drawbacks to according Congress a leading role in managing corporate regulation. Only a few significant items can make it to the top of the legislative agenda at any given time, which means that Congress cannot sustain consistent attention to corporate regulatory matters. These limitations often cause Congress to respond reflexively to external shocks, rather than working to maintain an even keel.[121] Furthermore, the partisanship and ideological rigidity that characterizes Congress in recent decades also creates obstacles to meaningful substantive debates. These factors limit Congress's ability to act decisively on corporate issues except in times of crisis. In such circumstances, it is almost inevitable that the perceived exigencies would detract from the thoughtfulness, deliberation, and reciprocity that represent the hallmarks of an ideal deliberative process.[122]

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117. Romano, *supra* note 101, at 1564–68; HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT 14–16 (2006).

118. Romano, *supra* note 101, at 1526–29. *But see* Prentice & Spence, *supra* note 108 (disputing Romano's analysis).

119. Romano, *supra* note 101, at 1562–63; Stephen M. Bainbridge, *Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure*, 2 CORP. GOVERNANCE L. REV. 69, 70–71 (2006).

120. Romano, *supra* note 101, at 1564–68 ("Why Did the Republicans Support the Democrats' Bill?"); BUTLER & RIBSTEIN, *supra* note 117, at 14–16.

121. The recent political maneuverings that surrounded the enactment of the 2008 federal financial bailout package demonstrate once again the potential peril of Congress's reactive stance on corporate issues. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765. What was initially a three page proposal penned by Secretary of the Treasury Henry Paulson, quickly grew to 169 pages after two weeks of intense negotiations between Congress and the Executive Branch. *See* David M. Herszenhorn, *Talks on Bailout Plan Advance, Despite Anger and Skeptics in Congress*, N.Y. TIMES, Sept. 28, 2008, at A1; Mark Landler & Edmund L. Andrews, *Bailout Plan Wins Approval; Democrats Vow Tighter Rules*, N.Y. TIMES, Oct. 4, 2008, at A1. *See* discussion *infra* at notes 140–45.

122. Prentice & Spence, *supra* note 108, at 1907 ("SOX [Sarbanes-Oxley] *was* passed in a frenzy."); Bratton & McCahery, *supra* note 63, at 665 ("So rapidly was the package cobbled together

C. Constraints on Congress as a Corporate Regulator

From a democratic perspective, Congress is the superior policymaking institution for corporate law when compared to states. Yet, significant structural and political constraints hamper its ability to attend consistently to important corporate regulatory matters.[123] These intractable problems stem from the relationship between business and government and are exacerbated by increasing levels of dysfunction in the national political process.

1. Theoretical Difficulties

Political observers have long expressed concern about Congress's capability to competently regulate business affairs.[124] Theorists have identified a number of constraints that seem to limit Congress's effectiveness in this realm. An early account by Charles Lindblom posited that these constraints emanate from the very structure of our political economy.[125] Because private business interests play a dominant role in sustaining the economic prosperity of the nation, Congress and other regulators must always take account of industry concerns when setting public policy.[126]

As Lindblom explains, in a private enterprise system it is business executives who control such economically significant decisions as the "nation's industrial technology, the pattern of work organization, location of industry, market structure, resource allocation, and, of course, executive compensation and status."[127] Thus, "in any private enterprise system, a large category of major decisions is turned over to businessmen."[128] Lindblom reasons that because of their authority over these central

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that little of its contents received much in the way of considered attention.").

123. There are no meaningful constitutional constraints on Congress's ability to regulate corporations. Arguments for Congressional restraint on federalism grounds typically are based on concepts of prudence rather than concerns regarding constitutional authority. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 596–98 (2003).

124. *See* ROBERT A. DAHL, A PREFACE TO ECONOMIC DEMOCRACY (1985); CHARLES E. LINDBLOM, POLITICS AND MARKETS 172–88 (1977).

125. LINDBLOM, *supra* note 124, at 172–88.

126. *Id*. at 171–74; *see also* Charles E. Lindblom, *The Market as Prison*, *in* PHILOSOPHY AND DEMOCRACY 275, 276–79 (Thomas Christiano ed., 2003); Prentice & Spence, *supra* note 108, at 1846–48.

127. LINDBLOM, *supra* note 124, at 171.

128. *Id*. at 172.

functions, "jobs, prices, production, growth, the standard of living, and the economic security of everyone" rest in the hands of businessmen.[129]

It ineluctably follows that government officials cannot afford to be indifferent as to how business performs. Instead such officials must "take action to secure the profitability and prosperity of the private sector: they are dependent upon the process of capital accumulation which they have for their own sake to maintain."[130]

In Lindblom's view, "a major function of government, therefore, is to see to it that businessmen perform their tasks."[131] Business leaders are therefore accorded "a privileged position in government."[132] As Lindblom states, "businessmen do not appear simply as representatives of a special interest" when they approach their government.[133] Instead, "[t]hey appear as functionaries performing functions that government officials regard as indispensable."[134]

Some commentators view Lindblom's description of the role of business in government as simplistic.[135] Political scientist Mark Smith questions the premises of Lindblom's account–in particular the assumption that when business unites on a policy issue it usually prevails in obtaining its desired outcome.[136] He argues instead that when the business community does unify on a public policy issue, it will prevail *only if* the public's preferences coincide with those of business.[137] As Smith explains, "unifying issues are highly ideological and fit cleanly into the liberal-conservative dimension of political struggles."[138] He argues that the ideological nature of these issues spurs politicians to assess and respond to public opinion when determining their policy positions. In Smith's view, therefore, businesses' success in promoting their preferred policy can be best attributed to broad public support for their objectives.[139]

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129. *Id*.
130. HELD, *supra* note 30, at 206.
131. LINDBLOM, *supra* note 124, at 173.
132. *Id*. at 175.
133. *Id.*
134. *Id*.
135. *See* MARK A. SMITH, AMERICAN BUSINESS AND POLITICAL POWER 143–66 (2000); Bratton & McCahery, *supra* note 63, at 655.
136. SMITH, *supra* note 135, at 4.
137. *Id*. at 8.
138. *Id*. at 21.
139. *Id*. at 10. Smith assesses the extent to which policy decisions favorable to business coincide with periods of economic prosperity or malaise—the assumption being that Congress will be more indulgent of business demands during downturns, as the imperative to foster economic recovery becomes acute. *Id.* at 149. Smith concludes, however, that "[t]he historical record of lawmaking from 1953 to 1996 provides little support for the strong or mild versions of the structuralist implications for

Despite the appearance of a core disagreement between Lindblom and Smith on the extent and impact of business's influence in politics, both appear to accept the existence of a strong identity of business interests with the public's interest in steady economic growth. It is this political reality that helps explain why business groups maintain so strong an influence over national policy. Business influence over corporate law policies is further amplified by general public apathy and the low political salience of corporate legal issues during times of relative economic prosperity.[140]

Corporate law scholars seem to have settled on a descriptive account of the relationship between business and government that reflects Lindblom's structural perspective, but is qualified by insights offered by contemporary scholars such as Smith, John Kingdon and Stuart Banner. These scholars concur that business interests, represented by such groups as the American Institute of Certified Public Accountants, the Investment Company Institute, the U.S. Chamber of Commerce, and the Business Roundtable enjoy a fair amount of political success in Congress during prosperous times (as denoted by rising stock markets). However, according to the received account, these interests can be shut out and neutralized during times of economic malaise when public attention to corporate issues intensifies.[141]

Professors William Bratton and Roberta Romano both invoke John Kingdon's "window" metaphor to help explain when conditions are ripe for major corporate reform legislation.[142] Kingdon's description of agendas and policy windows finds support in the history of U.S. corporate regulation. Professor Stuart Banner has documented a consistent pattern in

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representation." *Id.* at 160. Instead, he found that "[r]esponsiveness by members of Congress and presidents to public opinion does not happen only when prosperity allows it; responsiveness is a continuing process, persisting through good and bad economic times." *Id*. at 159.

140. Bratton & McCahery, *supra* note 63, at 674, 676; SMITH, *supra* note 135, at 27–28 (salience creates incentives for elected officials to respond to voter preferences).

141. Romano, *supra* note 101, at 1591–94; Bratton & McCahery, *supra* note 63, at 661–69; Roe, *supra* note 96, at 2529; Prentice & Spence, *supra* note 108, at 1846–51; *see also* ANNE M. KHADEMIAN, THE SEC AND CAPITAL MARKET REGULATION: THE POLITICS OF EXPERTISE 26–27 (1992) (describing business interests' political weakness after the Great Depression, which facilitated the enactment of the Securities Act of 1933).

142. Romano, *supra* note 101, at 1523–26; Bratton & McCahery, *supra* note 63, at 667. According to Kingdon, a policy window opens for new policy initiatives only sporadically. JOHN W. KINGDON, AGENDAS, ALTERNATIVES, AND PUBLIC POLICIES 166 (2d ed. 1995). Windows open because of a change in the political stream (a change in administration, a shift in national mood) or because a new problem emerges, often upon the occurrence of a dramatic external event. *Id*. at 166–70. When a policy window opens, policy entrepreneurs seize the opportunity to put forward their favored solutions to the perceived problem. *Id*. at 179–82. These solutions are often policies that have been floating around for a while, waiting for a problem to arise to latch onto. *Id*. at 183.

which securities reform legislation follows serious financial downturns.[143] This history suggests that the policy window opens for the favored reform initiatives of corporate governance "entrepreneurs" only upon the rare confluence of an economic downturn, falling stock markets, and corporate or political scandal.[144] Only in such political-economic conditions do corporate law issues attain the salience that spurs public demand for Congressional action. Although corporate commentators strongly dispute the substantive merits of the resulting legislation, they seem to agree about the strength of the influence of business leaders over the national regulatory process during times of relative prosperity and the conditions necessary to bring about the neutralization of such power.[145]

2. Congressional Dysfunction

Federal policymakers rely heavily on business leaders to oversee and manage our country's economic health. Government cannot compel, but must instead cajole, businesses to adopt desirable policies with respect to such basic economic fundamentals as investment, employment, production, and prices. Considering the key role business leaders play in fostering economic growth, politicians must be highly sensitive to their demands and concerns.[146]

This political bind may be more acute than Lindblom suspected given recent evidence of the extent to which corruption has infected the national political process.[147] In the era of modern political campaigns, national

143. Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 850 (1997) ("[M]ost of the major instances of new securities regulation . . . have come right after [stock market] crashes.").

144. A counter-cycle seems to exist in which the policy window for deregulatory corporate measures opens during times of sustained economic prosperity and bull markets (i.e., bubbles). *See* Bratton & McCahery, *supra* note 63, at 671–73 (discussing business's legislative success during the 1990s bull market, including enactment of the Private Securities Litigation Reform Act, the National Securities Market Improvement Act and the Securities Litigation Uniform Standards Act); Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 113–14 (2005) (describing the retrenchment trend in securities enforcement).

145. Bratton & McCahery, *supra* note 63, at 666–68; Romano, *supra* note 101, at 1591–94; Prentice & Spence, *supra* note 108, at 1847–49, 1908; Kahan & Rock, *supra* note 8, at 1588–89 ("High-profile scandals can shift the balance of power both in Congress and, derivatively, at the SEC, by triggering a deep, populist theme in American politics and energizing broad, loosely organized constituencies.").

146. The recent financial bailout legislation is yet another a stark example of this political co-dependency. In October 2008, Congress adopted emergency legislation to authorize up to $700 billion in spending to rescue major U.S. financial institutions threatened with collapse. *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

147. The Jack Abramoff saga is emblematic of the extent to which corruption can distort the democratic process. *See* THOMAS E. MANN & NORMAN J. ORNSTEIN, THE BROKEN BRANCH: HOW

politicians must raise enormous sums of money to win elections and stay in office.[148] The need to constantly replenish campaign coffers makes national politicians highly sensitive to the interests of business leaders, a key source of these contributions.[149] Corporations also use their vast resources to influence public opinion, shaping perceptions of business even before salient political issues emerge.[150]

Legislators' dependence on the largesse of corporate officials impedes their ability to objectively assess policy proposals that affect the interests of their benefactors. Furthermore, lobbyists have come to command a greater degree of control over legislation than the idealized deliberative account admits.[151] The influence of lobbyists and major contributors in Congress has created an environment that can make the type of reasoned

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CONGRESS IS FAILING AMERICA AND HOW TO GET IT BACK ON TRACK 179–91 (2006) (describing the role of lobbyists in Washington and the K Street project).

148. As examples, the most expensive Senate race in 2006, run by former Senator Hillary Clinton of New York, cost nearly $47 million. The most expensive race for the House cost $11 million. Center for Responsive Politics, Most Expensive Races, http://www.opensecrets.org/bigpicture/topraces.php?cycle=2006&display=allcands (last visited Feb. 21, 2009). The average cost of a successful Senate campaign in 2006 was $9,635,370, while the average successful House campaign cost $1,253,031. Center for Responsive Politics, Election Stats, http://www.opensecrets.org/bigpicture/elec_stats.php?cycle=2006 (last visited Feb. 21, 2009). Similarly, the costs of a Presidential campaign have soared. President Barack Obama spent almost $730 million in his presidential campaign, compared to $333 million spent by Senator John McCain. Center for Responsive Politics, Banking on Becoming President, http://www.opensecrets.corg/pres08/index.php (last visited Feb. 21, 2009). Although President Obama's fundraising prowess was unprecedented, it differed in some respects from traditional fundraising for national campaigns because he commanded a large base of small contributors. The Obama campaign reported receiving donations from more than three million individual contributors with an average contribution of less than $100. *See* Michael Luo, *Obama's September Success Recasts the Fund-Raising Landscape*, N.Y. TIMES, Oct. 20, 2008, at A21.

149. Interest groups spent $2.8 billion to lobby federal government officials in 2007. Center for Responsive Politics, Lobbying Top Spenders, http://www.opensecrets.org/lobby/top.php (last visited Feb. 21, 2009). Campaign contributions and lobbying were also a contributing factor in the savings and loan crisis and the Enron scandal. For detailed reports on the influence of political contributions and corporate lobbying on Congress and other government officials, see Michael Waldman, *The S&L Collapse: The Cost of a Congress for Sale*, 2 STAN. L. & POL'Y REV. 47, 55 (1990) ("[T]he S&L debacle . . . is a crisis of the way politics and business interact in the late twentieth century."); Albert R. Hunt, *Enron's One Good Return: Political Investments*, WALL ST. J., Jan. 31, 2002, at A19; Jill E. Fisch, *How do Corporations Play Politics?: The FedEx Story*, 58 VAND. L. REV. 1495 (2005) (describing how FedEx Corporation used its political influence to effect desired deregulation in the transportation industry).

150. SMITH, *supra* note 135, at 32 (describing the role of conservative think tanks in shaping public opinion of the role of business in government).

151. SINCLAIR, *supra* note 99, at 115. During the legislative push for the Contract with America in 1995, "Republicans gave [business] groups unusually intimate access to the legislative process at the pre-floor stage, even allowing lobbyists to draft provisions of the legislation." *Id.* As Sinclair reports it, "[e]very Thursday morning Rep. John A. Boehner of Ohio, chair of the Republican Conference, met with a large group of lobbyists, including representatives of Project Relief and of the Alliance for Reasonable Regulation, another similar coalition. The purpose of the meetings was to coordinate the groups' lobbying and grass-roots campaigns for the Contract [with America]." *Id.* at 116.

substantive debate that deliberative democrats favor unduly idealistic.[152] When we factor in further political realities, such as divided government and heightened partisanship, it becomes increasingly challenging for legislators to work together to craft the kind of legislation that reflects deliberative democratic values.[153]

D. Congress's Pragmatic Posture—Delegation to the SEC

As the preceding analysis demonstrates, Congress's ability to regulate corporations and markets is hampered by inherent structural limitations and more base political realities. Congress manages these constraints by deferring broadly to state authority, intervening in corporate matters only when compelled by a financial crisis or populist rancor brought on by corporate scandal.[154] Congress's tradition of deference to state regulation can thus be viewed as a conditional grant of authority.[155] When corporate governance problems arise that threaten the national economy, Congress stands ready to intervene, adopting a more assertive regulatory approach than that favored by the states.[156] Between these episodic crises, Congress relies on a dual strategy of delegation and deference. During tranquil periods, the SEC (and SROs) are charged with responding to the more modest disruptions in the markets related to corporate governance.

Congressional delegation to agency authority solves a number of political dilemmas.[157] Members of Congress lack the time, inclination, and

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152. *See id*. at 227–30 (discussing the negative impact of "unorthodox lawmaking" on the quality of deliberation in Congress).

153. *See* Richard J. Lazarus, *Congressional Descent: The Demise of Deliberative Democracy in Environmental Law*, 94 GEO. L.J. 619, 620–22 (2006). Lazarus asserts that Congress's increased reliance on the appropriations process to pursue policy initiatives has led to a much less transparent approach to environmental legislation, which has given more influence to special interests and resulted in ad hoc, balkanized policies. *See also* Gerald B.H. Solomon & Donald R. Wolfensberger, *The Decline of Deliberative Democracy in the House and Proposals for Reform*, 31 HARV. J. ON LEGIS. 321, 322, 369 (1994). Another problematic trend is the practice of attaching riders and amendments to popular legislation without proper vetting by the substantive committees. *See* Edward R. Becker, *Of Laws and Sausages*, 87 JUDICATURE 7, 7–9 (2003) (giving examples of how the procedural rules of the House of Representatives are frequently ignored in practice). This practice allows new policies to be enshrined into federal law without so much as an explanation, hearing, or debate. *Id.*

154. Bratton & McCahery, *supra* note 63, at 661 (describing Congress's occasional regulatory forays, including FCPA and Sarbanes-Oxley, as a "fire patrol.").

155. *See* Roe, *supra* note 96, at 2530–35 (analogizing Delaware to a federal agency subject to Congressional oversight); Bratton & McCahery, *supra* note 63, at 693 (same).

156. *See, e.g.*, Jones, *supra* note 8, at 628–29; Roe, *supra* note 123, at 600–07.

157. KENNETH F. WARREN, ADMINISTRATIVE LAW IN THE POLITICAL SYSTEM 16, 56 (4th ed. 2004) (describing the political considerations compelling the creation of independent administrative agencies); Jerry L. Mashaw, *Prodelegation: Why Administrators Should Make Political Decisions*, 1 J.L. ECON. & ORG. 81, 99 (1985) ("Administrators at least operate within a set of legal rules

expertise to oversee the increasingly complex financial markets that overwhelmingly influence the health of our economy. Congress prudentially delegates administrative authority to agencies, while retaining the power and responsibility to set broad policy parameters and monitor their implementation through the exercise of oversight.

1. The Rationale for Delegation

Agencies are widely viewed to be better suited to administrative tasks than the legislature due to institutional qualities such as professionalism, administrative expertise, subject-matter expertise, and experience.[158] At least until recently, the SEC has been consistently rated as one of the best performing administrative agencies.[159] Its staff enjoyed a reputation as committed public servants who strived to remain above politics and sought to base decisions on the law and conventions of legal reasoning.[160] The

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(administrative law) that keep them within their jurisdiction, require them to operate with a modicum of explanation and participation of the affected interests, police them for consistency, and protect them from the importuning of congressmen and others who would like to carry logrolling into the administrative process.").

158. Mashaw, *supra* note 157, at 99; Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549, 579 (2002) ("The agency's career staff provide an ongoing repository not only of substantive knowledge but also of decision making experience so that agencies . . . need not reinvent the wheel every four or eight years."); *see also* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET xix (3d ed. 2003).

159. KHADEMIAN, *supra* note 141, at 9. *See* BILLY RAY HALL, JR., A LEGAL SOLUTION TO GOVERNMENT GRIDLOCK: THE ENFORCEMENT STRATEGY OF THE SECURITIES EXCHANGE COMMISSION 5–6 (1998).

The SEC's reputation has suffered badly as a result of the financial crisis and other major scandals. Former SEC Chairman Christopher Cox has been singled out for criticism. Kara Scannell & Susanne Craig, *SEC Chief Under Fire as Fed Seeks Bigger Wall Street Role—Cox Draws Criticism for Low-Key Leadership During Bear Crisis*, WALL ST. J., June 23, 2008, at A1. According to his critics, there has been a let up in enforcement vigor during Cox's term. *Id*. In addition, the SEC has been seen as adopting more pro-management positions, and has proposed policies that would erode U.S. accounting standards. *Id*. Cox has also been criticized for his passivity in the face of the emerging Wall Street debacle. *Former SEC Chair Levitt Says Lax Oversight Helped Create Financial Crisis*, 40 SEC. REG. & L. REPT. 1682, Oct. 20, 2008. For a more extensive discussion of the SEC's regulatory failures, see Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. (forthcoming 2009) (*available at* http://ssrn.com/abstract=1392284).

Many of SEC's recent problems have been attributed to leadership failure. Cox exhibited hostility to the agency's mission often siding with industry over investors in securities law disputes, and implementing new policies that hampered enforcement efforts and undermined staff morale. *See* U.S. Government Accountability Office, Securities & Exchange Commission, Greater Attention Needed to Enhance Communication and Utilization Resources in the Division of Enforcement, March 2009, at 7–8 (describing the enforcement division attorney's frustration with the SEC's new penalty policies). Although these observations detract from the case for enhancing SEC independence, from a broader perspective, greater independence over the long-term could have equipped the SEC to adopt policies that would better withstand efforts of a hostile administration to weaken its effectiveness.

160. KHADEMIAN, *supra* note 141, at 89–93; BREYER ET AL., ADMINISTRATIVE LAW AND

agency's adherence to a consistent mission and mode of regulation helped contribute to its perceived legitimacy among investors and the parties that it regulates.[161]

This agency expertise is a compelling rationale for deference, yet it is insufficient to justify Congress's long-standing practice of broad delegation of authority to agencies.[162] If competence and expertise are the main objectives, Congress could conceivably retain such expertise within its own domain. The justification for agency authority must therefore rest on firmer ground; the value of democratic deliberation provides a stronger rationale for this tradition of delegation.

Delegation to agencies enhances the quality of democratic deliberation in the policymaking process.[163] Rulemaking procedures prescribed for administrative agencies, including the SEC, square well with the democratic values.[164] The Administrative Procedure Act (APA)[165] and other constraints on agencies instill deliberation, participation, transparency, and accountability into the rulemaking process. These requirements help to ensure that agency rulemaking is subject to public scrutiny and careful review from the executive branch, Congress, and affected parties.

2. The SEC as Rulemaker

Several factors contribute to the SEC's ability to satisfy many of the demands of deliberative democracy. First, the SEC benefits from a degree of political independence that helps insulate it from the raw political pressures that limit Congress's ability to actively manage corporate law policy.[166] By law, the SEC's five commissioners are appointed by the President, with the advice and consent of the Senate, to serve for staggered five-year terms.[167] No more than three of the five commissioners can be from the same political party.[168] This mandated political balance helps

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REGULATORY POLICY 62 (6th ed. 2006); HALL, *supra* note 148, at 11–13.

161. KHADEMIAN, *supra* note 141, at 84–88; SELIGMAN, *supra* note 158, at 619–21.

162. *See* THEODORE J. LOWI, THE END OF LIBERALISM: THE SECOND REPUBLIC OF THE UNITED STATES 92–126 (2d ed. 1979).

163. *See* Seidenfeld, *supra* note 20, at 1515–16 ("[T]he civic republican conception [provides] an essential justification for the modern bureaucratic state."); Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 802 (2006).

164. Seidenfeld, *supra* note 20, at 1559–60.

165. 5 U.S.C. §§ 551–59 (2000).

166. *See* discussion *supra* Part III.C; WARREN, *supra* note 157, at 16.

167. Securities Exchange Act of 1934 § 4, 15 U.S.C. § 78d(a) (2000).

168. *Id.*

support deliberative decision making and serves as an antidote to the phenomenon of "groupthink" that can hinder group decision making processes.[169]

The SEC flexes its administrative muscle principally through its rulemaking power.[170] It exercises authority under six federal securities statutes including the Securities Act of 1933 (the "Securities Act")[171] and the Securities and Exchange Act of 1934 (the "Exchange Act").[172] Under these statutes, the SEC enjoys broad discretion to adopt regulations to fulfill its Congressional mandate.[173] Additional corporate oversight is provided by the SROs, which by statute operate under SEC supervision.[174]

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169. *See* Jones, *supra* note 114, at 140–41; James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 91–99 (1985) (discussing how powerful ingroup bias is created in the boardroom) (1985); *see also* Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1257–93 (2003) (providing a case study of how the Enron Board may have been affected by "groupthink").

170. The SEC also relies heavily on enforcement as an administrative tool. *See The State of the Securities Market: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (statement of Christopher Cox, Chairman, U.S. Securities and Exchange Commission), *available at* http://banking.senate.gov/public/_files/ACF1CA4.pdf (discussing the recent activities of the SEC Enforcement Division). It sometimes uses enforcement actions to establish new policies, but more frequently does so to ensure compliance with existing policies. *See generally* ROBERTA KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION V. CORPORATE AMERICA (1982). The SEC's practice of policymaking through enforcement has garnered criticism from observers. *See generally id*.; Jonathan Macey, *Executive Branch Usurpation of Power: Corporations and Capital Markets*, 115 YALE L.J. 2416, 2440 (2006).

171. 15 U.S.C. §§ 77a–z, 77aa (2000).

172. 15 U.S.C. §§ 78a–78mm (2000). The SEC also exercises jurisdiction over the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa–77bbbb (2000); the Investment Company Act of 1940, 15 U.S.C. §§ 80a–1 to 80a–64 (2000); the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b–1 to 80b–21 (2000); and the Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.). The SEC was responsible for administering the Public Utility Holding Company Act of 1935 until that Act was repealed in 2005. 15 U.S.C. §§ 79–79z, 79z–1 to 79z–6 (repealed by Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594).

173. *See* 17 C.F.R. § 200.2 (2008) (providing an overview of the SEC's statutory functions).

174. New York Stock Exchange and Nasdaq listing standards provide more in the way of substantive governance requirements than state corporate law. *Compare* NYSE, Rules 496–501A, Listing and Delisting, *available at* http://rules.nyse.com/nyse/nyse_rules (follow "Listing and Delisting" hyperlink) (last visited Feb. 21, 2009), *and* NASDAQ, LISTING STANDARDS & FEES 21–24 (Dec. 2008), *available at* http://www.nasdaq.com/about/nasdaq_listing_req_fees.pdf (last visited Feb. 21, 2009) *with* 8 DEL. CODE ANN. tit. 8, ch. § 141(a)–(k). Listing standards address such central governance issues as shareholder voting rights, board composition, board committee requirements and shareholder voice in mergers. *See* NYSE, Rules 496–501A, *supra*; NASDAQ, LISTING STANDARDS & FEES, *supra*, at 21–24. The SROs also play an important role in disciplining members, issuers, brokers, and dealers through rulemaking, investigations and disciplinary procedures. *See, e.g.*, New York Stock Exchange, Disciplinary Rules (475–77), *available at* http://rules.nyse.com/nyse/nyse_rules (last visited May 12, 2009) (follow "Disciplinary Rules" hyperlink); NASDAQ, Investigations and Sanctions (8000–8300), *available at* http://wallstreet.cch.com/NASDAQ/Main/. In 2007, the NASD merged with the regulatory arm of the NYSE to form a new SRO, the Financial Industry Regulatory Authority, also known as FINRA. New York Stock Exchange, Disciplinary Rules (475–77), *available at*

Although the SROs have the freedom to craft their own rules, such rules are subject to SEC approval, after notice and comment, before becoming effective.[175]

Each securities statute confers upon the SEC the power to adopt rules that carry the force of law.[176] Such rulemaking power is generally referred to as legislative rulemaking, as a rule adopted under this authority can be enforced in the same manner as a statute adopted by Congress.[177]

Minimum standards for rulemaking by federal agencies are set forth in the APA.[178] Legislative rules are adopted under the "notice and comment" rulemaking rubric, which requires the agency to give general notice of the proposed regulation including the legal basis for the rule, a description of the rule, and an explanation of the issues involved, in the Federal Register.[179] The agency must afford interested parties the opportunity for public comment through "submission of written data, views, or arguments with or without opportunity for oral presentation."[180] After giving consideration to the views and evidence presented, the agency reviews the

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http://rules.nyse.com/nyse/nyse_rules (last visited May 12, 2009) (follow "Disciplinary Rules" hyperlink).

175. Securities Exchange Act § 19; 15 U.S.C. § 78s (2000). The importance of these deliberative protections makes current proposals to streamline—or short-circuit—the SEC's role in approving SRO rules unappealing from a democratic perspective. *See* DEP'T OF TREASURY, *supra* note 4, at 111–15 (proposing to expedite the SRO rules approval system and to make more SRO rules effective upon filing).

176. Various sections of the securities statutes give rules the force of law. *See, e.g.*, Exchange Act § 23(a)(1), 15 U.S.C. § 78(w) (2000) ("The Commission . . . shall . . . have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter for which they are responsible or for the execution of the functions vested in them by this chapter."); 17 C.F.R. 200.1–220.2 (2008) (describing the statutory functions and authority of the Commission). The SEC can also issue interpretive rules and statements of policy—or non-legislative rules—that are often issued to the public as "SEC Releases." These interpretative rules are exempt from the APA's procedures for notice and comment rulemaking. *See* 5 U.S.C. § 553(b)(3(A) (2000); 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.4[2] (4th ed. 2002). Examples of non-legislative rules include "safe harbor" rules that provide objective criteria that investors can use to determine whether or not they qualify for statutory exemptions. *See, e.g.*, Rule 147, 17 C.F.R. § 230.147 (2008) (safe harbor provision for the intrastate offering exemption); Rule 144, 17 C.F.R. § 230.144 (2008) (safe harbor provision for the definition of "underwriter."); Rule 506, 17 C.F.R. § 230.506 (2008) (safe harbor provision for a private offering exemption). Even more informal methods of policy making include the interpretative releases, staff legal bulletins, and no-action letters. For further discussion of the practice and import of these informal policy pronouncements, see Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 929–33 (1998) (describing in detail the SEC rulemaking and adjudicatory powers).

177. 2 KENNETH CULP DAVIS, ADMINISTRATIVE LAW TREATISE § 7:8 (2d ed. 1979); 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.4[2][A] (4th ed. 2002).

178. 5 U.S.C. §§ 551–59 (2000).

179. *Id.* § 553(b).

180. *Id.* § 553(c).

record *de novo* before publishing its final rule accompanied by a statement of reasons.[181] The APA's mandates are supplemented by the SEC's enabling acts and its own procedural rules.[182] The Exchange Act, for example, requires the SEC to consider whether the rule being promulgated "promote[s] efficiency, competition, and capital formation."[183] These procedural protections help to ensure that the public is well-informed of an agency's policy proposals and has an opportunity to respond with objections, suggestions, and concerns.[184] The process also encourages the SEC to justify its rulemaking by giving reasons for its policies and responding to the concerns of those who are affected by them.

The SEC often goes beyond the letter of these requirements by seeking public participation and dialogue through town-hall meetings and public hearings, and by establishing special committees and advisory groups to study particular issues.[185] SEC Commissioners and staff also regularly

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181. *Id.*; TOM C. CLARK, ATTORNEY GENERAL'S MANUAL ON THE ADMINISTRATIVE PROCEDURE ACT 31–32 (1973).

182. *See* SEC Rules of Practice Rule 192, 17 C.F.R. § 201.192 (2008).

183. Exchange Act § 3(f), 15 U.S.C. § 78c(f) (2000). The Investment Company Act contains an analogous requirement. 15 U.S.C. § 80(a)–2c (2000). Other federal statutes create additional rulemaking burdens. For example, under the Congressional Review Act agencies face reporting requirements which aim to facilitate Congressional review of new federal regulation. Congressional Review Act of 1996, 5 U.S.C. §§ 801–08 (2000) (requiring agencies to submit cost-benefit analysis, regulatory flexibility analysis and analysis pursuant to the Unfunded Mandates Reform Act of 1995). Likewise, the Regulatory Flexibility Act requires agencies to analyze the effects of proposed new rules on small businesses, and to review and re-evaluate regulations. 5 U.S.C. §§ 601–12 (2000). The Paperwork Reduction Act creates further informational and publication burdens on agencies promulgating new rules. 44 U.S.C. §§ 3501 et seq. (2000).

Some scholars have criticized these additional procedural burdens for having a chilling effect on notice and comment rulemaking. *See* Robert A. Anthony, *Interpretive Rules, Policy Statements, Guidances, Manuals, and the Like—Should Federal Agencies Use them to Bind the Public?*, 41 DUKE L.J. 1311, 1379 (1992) (arguing that agencies should adhere to Congressionally prescribed notice and comment rulemaking despite the fact that such procedures "can levy upon limited agency funds, people, and other resources."); Thomas O. McGarity, *Some Thoughts on "Deossifying" the Rulemaking Process*, 41 DUKE L.J. 1385, 1386–95 (1992) (discussing the ossification of informal rulemaking and pointing out that recent evidence suggests "that agencies are beginning to seek out alternative, less participatory regulatory vehicles to circumvent the increasingly stiff and formalized structures of the informal rulemaking process."). These scholars argue that legislatively-imposed procedures are too burdensome for most agencies, causing them to circumvent the deliberative process. *See, e.g.*, Anthony, *supra*, at 1379; McGarity, *supra*, at 1386–95. For a related discussion on the deleterious effects of judicially imposed procedural burdens, *see infra* Part IV.A.2.

184. *See* WARREN, *supra* note 157, at 269 ("Rulemaking is comprehensible, relatively quick, and democratically accountable, especially in the sense that decision making is kept above board and equal access is provided to all.").

185. Recent examples include roundtable discussions and task forces formed to study mutual fund board independence requirements and hedge fund regulation. *See The State of the Securities Market*, *supra* note 170; *Oversight Hearing on Mutual Fund Trading Abuses: Hearing Before the H. Sub. Comm. on Commercial and Administrative Law*, 109th Cong. (2005) (statement of Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange

engage with the public through speeches, articles and "SEC Speaks" seminars at which staff members and commissioners discuss the agency's regulatory agenda.[186]

3. Agency Accountability

Although it enjoys broad regulatory discretion, the SEC remains accountable to the executive, Congress, and the courts.[187] The President exerts control over the direction of SEC policy by nominating new commissioners when vacancies arise and, more importantly, by selecting the chair who in turn selects the senior staff and controls the regulatory agenda.[188] Although the President lacks authority to remove a sitting commissioner without cause, he can designate a new chair at any time.[189]

Like the President, Congress has a myriad of tools available to influence SEC policy.[190] Oversight committees can summon the chair or senior staff to express disapproval of a policy position or a failure to address a perceived problem.[191] Congress also controls the agency's budget, and committee chairs can use this power to press their policy

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Commission); *available at* http://www.investorscoalition.com/judrichardsjune705.pdf; Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Opening Remarks at the SEC Roundtable on the Role of Independent Investment Company Directors (Feb. 23, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch253.htm. The SEC also held roundtable discussions as it considered adopting shareholder access proposals. Agenda for Proxy Process Roundtable, May 7, 2007, Roundtable Discussions Regarding the Proxy Process, http://www.sec.gov/spotlight/proxyprocess/proxyagenda-050707.htm.

186. Prentice, *supra* note 163, at 801–02.

187. KHADEMIAN, *supra* note 141, at 3 (describing the tension between expertise and accountability in administrative bureaucracies).

188. 17 C.F.R. 200.10 (2007); Reorganization Plan No. 10 of 1950, § 3, 64 Stat. 1265 (1950); ERNEST GELLHORN & RONALD M. LEVIN, ADMINISTRATIVE LAW AND PROCESS 49–59 (1997); Macey, *supra* note 170, at 2432–33.

189. *See* Humphrey's Ex'r v. United States, 295 U.S. 602 (1935). The new chair can be another sitting commissioner or a new appointee if a vacancy exists. The administration can also turn to the President's Working Group on Financial Markets ("President's Working Group") to guide agency policy. *See* PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 11–12, 19–20 (2008), *available at* http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf. The President's Working Group acts as an inter-agency coordinator for financial regulation and provides the President an additional source of influence over financial regulation, including regulations provided under the auspices of the SEC. *Id*. For example, in March 2008, the President's Working Group released a policy statement on the origins of the financial market "turmoil" and made several recommendations, including reforming the mortgage origination process and enhancing prudential regulatory policies. *Id*.

190. *See* CORNELIUS M. KERWIN, RULEMAKING: HOW GOVERNMENT AGENCIES WRITE LAW AND MAKE POLICY 213–26 (3d ed. 2003); Mark Seidenfeld, *The Psychology of Accountability and Political Review of Agency Rules*, 51 DUKE L.J. 1059, 1075–78 (2001).

191. Seidenfeld, *supra* note 190, at 1077–78.

preferences or those of their favored constituencies.[192] In addition, Congress can amend statutes or adopt new laws to compel or forbid certain policies.[193]

Finally, the SEC is accountable to courts. Private citizens can sue the agency to challenge final agency orders and rules that run afoul of its statutory mandate or prescribed regulatory procedures.[194] Disgruntled interest groups often initiate such suits when dissatisfied with the outcome of the rulemaking process.[195]

4. The Realities of Rulemaking

Significant SEC rules typically evoke hundreds (sometimes thousands) of comment letters.[196] These comment letters are accepted electronically and posted on the SEC website, enhancing the transparency and accessibility of SEC rulemaking.[197] Due to the specialized nature of the rules, business interests tend to dominate public comments on agency rules.[198] However, a significant number of comment letters received by the SEC are submitted by individual investors and other citizens with an interest in SEC policy.[199] Academics sometimes weigh in with their views

192. *See* Aulana L. Peters, *Independent Agencies: Government's Scourge or Salvation?*, 1988 DUKE L.J. 286, 294–96; ARTHUR LEVITT WITH PAULA DWYER, TAKE ON THE STREET 131–33 (2002); SELIGMAN, *supra* note 158, at 712–28.

193. For example, many Sarbanes-Oxley provisions direct the SEC to adopt statutorily prescribed rules and to conduct studies on various regulatory matters. *See* Sarbanes-Oxley § 307, 15 U.S.C § 7245 (2000); §§ 701–705 15 U.S.C. § 7201 (2000). This form of political accountability can be a double-edged sword as interest groups can bypass the agency's deliberative process to lobby the President or Congress to constrain the SEC from adopting policies they oppose. *See, e.g.*, LEVITT, *supra* note 192, at 10–12 (describing corporate lobbyists' efforts to thwart SEC policy proposals).

194. Securities Exchange Act § 25(b), 15 U.S.C. § 78y(a), (b) (2000); 5 U.S.C. §§ 702, 704, 706 (2000); *see also* discussion *infra* Part IV.A.1.

195. *See infra* text accompanying notes 258–302.

196. Prentice, *supra* note 163, at 802.

197. U.S. Securities and Exchange Commission, How to Submit Comments on SEC Rulemaking, http://www.sec.gov/rules/submitcomments.htm (last visited Feb. 21, 2009). Some question the impact of electronic rulemaking on the extent or quality of public participation in rulemaking. *See* Cary Coglianese, *Citizen Participation in Rulemaking: Past, Present, and Future*, 55 DUKE L.J. 943, 949–52 (2006) (discussing how, prior to e-rulemaking, few comments to agencies came from ordinary citizens).

198. Marissa Marino Golden, *Interest Groups in the Rule-making Process: Who Participates? Whose Voices Get Heard?*, 8 J. PUB. ADMIN. RESEARCH & THEORY 245, 252–53 (1998) (noting that business interests dominate rulemaking).

199. David C. Nixon et al., *With Friends Like These: Rule-making Comment Submissions to the Securities and Exchange Commission*, 12 J. PUB. ADMIN RESEARCH & THEORY 59, 64 (2002) (finding that individuals submitted a large percentage of comments on two significant SEC rules in 1998); *see also* Mariano-Florentino Cuellar, *Rethinking Regulatory Democracy*, 57 ADMIN. L. REV. 411, 414 (2005) (finding that comments from the lay public make up the vast majority of total comments for some regulations).

on various SEC proposals and policies either individually or in groups.[200] In choosing to adopt, defer, or abandon a final rule, the SEC appears to take the views of commenters seriously.[201] Comments are acknowledged and directly addressed in the final rules releases.[202]

The rulemaking record for Regulation FD (Fair Disclosure), which was adopted in 2000, illustrates how public participation in SEC rulemaking can be both broad and substantial.[203] Regulation FD was a priority of then-SEC Chairman, Arthur Levitt, and was adopted to curb the practice of selective disclosure of material financial information to securities analysts and institutional investors. The SEC received 6,000 comment letters on Regulation FD.[204] A majority of the letters were from individual investors who strongly supported the rule. On the other side of the ledger, comments from securities industry groups were decidedly negative.[205] These commenters insisted the rule would chill disclosure and "choke" the flow of information to investors.[206] Despite strong industry opposition, the proposed rule was adopted by the Commission, with modifications that took into account some of the commenters' concerns.[207]

As the preceding example demonstrates, the SEC's rulemaking process often accords well with the ideals of deliberative democracy. Unfortunately, however, the process does not always proceed in such a principled manner. Just as Congress faces real constraints on its regulatory flexibility, a number of worrisome factors constrain the SEC as well.

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200. Recent examples include a letter from law professors encouraging the SEC to adopt a rule regarding professional responsibilities of lawyers practicing before the commission. Letter from Richard Painter, Prof., Univ. of Minn. et al., to Harvey Pitt, Chairperson, Sec. and Exch. Comm'n (Mar. 7, 2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/pitt.pdf. In 2007, a group of law professors submitted a comment letter on the SEC's competing "shareholder access" proposals. Comment Letter of thirty-nine Law Professors in Favor of Placing Shareholder-Proposed Bylaw Amendments on the Corporate Ballot, to Nancy M. Morris, Sec'y, Sec. and Exch. Comm'n (Oct. 2, 2007), *available at* http://www.sec.gov/comments/s7-17-07/s71707-119.pdf.

201. Nixon et al., *supra* note 199, at 65; *see also* Cuellar, *supra* note 199, at 414 (agencies react to the notice and comment process by making changes in their proposed rules); KERWIN, *supra* note 190, at 202 (describing how seriously agencies take public comments).

202. Nixon et al., *supra* note 199, at 65 ("[F]ailure to adequately acknowledge or respond to a comment is grounds for judicial appeal . . . .") (emphasis omitted); KHADEMIAN, *supra* note 141, at 101–06 (describing public participation during the SEC's one share-one vote rulemaking process); *see also* Cuellar, *supra* note 199, at 460 ("[A]gencies respond to the comments they get by making changes in their proposed rule.").

203. Selective Disclosure and Insider Trading, Securities Act Release No. 7,881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599 65 Fed. Reg. 51,738 (Aug. 24, 2000).

204. SELIGMAN, *supra* note 158, at 654.

205. LEVITT, *supra* note 192, at 93.

206. *Id*. at 94–95.

207. *Id*.

Undoubtedly, the SEC and its staff are susceptible to the influence of the well-funded, organized interest groups that are repeat players before the agency.[208] The agency is also influenced by a law-centered culture that tends to favor complex solutions to market problems.[209] The possibility of securing lucrative employment opportunities may also encourage staff members to favor opaque practices and standards that confer professional advantages to former SEC staffers and others with good contacts within the agency.[210]

The apparent influence of private interest groups on SEC policies has led some commentators to conclude that the agency has been "captured" and reduced to the menial task of doling out private rents to lawyers and interest groups, instead of regulating in the public interest.[211] Less cynical observers view the SEC as managing disputes among competing industry groups, rather than consistently serving a monolithic corporate interest.[212] Most academic assessments of the agency's history conclude that the agency has avoided capture.[213] The agency's culture, which has been guided by a consistent regulatory philosophy, provides a better

208. *See* Jonathan R. Macey, *Positive Political Theory and Federal Usurpation of the Regulation of Corporate Governance: The Coming Preemption of the Martin Act*, 80 NOTRE DAME L. REV. 951, 972 (2005) ("[T]he SEC [is] an important vehicle through which interest groups sustain and even extend the political victories they have won in Congress."); *see also* Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 922 (1994) [hereinafter Macey, *Agency Obsolescence*] ("The predictable phenomenon of agency 'capture' by special interest groups has led to subsidies to favored constituencies, particularly securities analysts, institutional investors, market professionals (traders and market makers) and retail brokerage firms.").

209. *See* HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 18–20 (1979). Some observers speculate that lawyers' dominance at the agency may be responsible for its preference for complexity in the law, as complexity increases the value of lawyers' specialized services and expertise in the legal market. *See* Langevoort, *supra* note 103, at 1604–07. The pattern of movement by senior staff between private law firms and the SEC is another factor that some speculate spurs the agency to continue to create newer and more complex rules. *Id*.

210. A recent report from the Inspector General of the SEC found that a common practice exists within the SEC of "giving outside lawyers' clients access to high level SEC Officials." Walt Bogdanich, *Impartiality of SEC is Questioned*, N.Y. TIMES, Oct 7, 2008, at B1; Memorandum from H. David Kotz, Inspector General, Sec. and Exch. Comm'n, to Christopher Cox, Chairman, Sec. and Exch. Comm'n, Re-Investigation of Claims by Gary Aguirre of Improper Preferential Treatment and Retaliatory Termination (Sept. 30, 2008), *available at* http://finance.senate.gov/press/Gpress/2008/prg100708.pdf.

211. Macey, *Agency Obsolescence*, *supra* note 208, at 948 (describing turf-grabbing and capture as the agency's modus operandi); Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 972–78 (2001); Pritchard, *supra* note 4, at 1099–1100 (summarizing the capture account).

212. SELIGMAN, *supra* note 158, at xix–xx; KHADEMIAN, *supra* note 141, at 13–16.

213. SELIGMAN, *supra* note 158, at xix; Prentice, *supra* note 163, at 801.

explanation for the agency's policy approach than a simplistic capture story.

Of larger concern than the risk of capture is the reality that despite the strong legislative mandate for an open and inclusive rulemaking process, there can be no assurance that publicly-oriented concerns will actually influence agency policy.[214] Commissioners can ignore public comments and proceed as they intended all along.[215] Alternatively, the agency might heed the concerns and preferences of a favored group to the detriment of others.[216] Such favoritism can be easily disguised as deliberative reason giving—allowing the SEC to comply with the ritual of the deliberation, while evading its spirit.[217]

E. Relative Advantages of Federal Rulemaking

Despite unavoidable flaws in the SEC's rulemaking procedures, SEC regulation offers a number of advantages over legislation and judicial decision making at the state and federal levels. When practiced in its ideal form, SEC rulemaking is based on reasons, accessible to the public, transparent, and subject to accountability to the executive, Congress, and the courts. The SEC's rulemaking procedure is also flexible and responsive.[218] The agency regularly reviews its rules and can revise problematic rules and reconsider proposals that were tabled in the past due to a failure to achieve consensus.[219]

IV. THE DEMOCRATIC CASE FOR BROAD SEC AUTHORITY

Congress's tradition of broad delegation to the SEC helps protect democratic ideals. Delegation empowers the agency to address promptly

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214. *See* Golden, *supra* note 198, at 259–62 (finding that one of the ten rules studied was changed "a great deal" in response to public comments); KERWIN, *supra* note 190, at 202–07 (reviewing mixed evidence of the influence of public comments on agency rules).

215. *See, e.g.*, Stephanie Stern, *Cognitive Consistency: Theory Maintenance and Administrative Rulemaking*, 63 U. PITT. L. REV. 589, 591 (2002); Golden, *supra* note 198, at 261 ("When there is conflict rather than consensus among the commenters . . . the agency tends to hear most clearly the voices that support the agency's position.").

216. Rachlinski & Farina, *supra* note 158, at 588 ("There is little chance that compulsory exposure to other points of view during the policymaking process will redeem an agency that has sold out to an interest group.").

217. *Id.*

218. KERWIN, *supra* note 190, at 30.

219. *Id.* at 28–36. "One of the great advantages of rulemaking by agencies is their ability to respond in a timely manner to unanticipated and changed conditions, and most especially emergencies." *Id.* at 30.

those corporate law problems that arise during extended periods when Congress is politically disabled, due to disinterest or dysfunction, from taking appropriate action.[220] During these prolonged periods of Congressional passivity, it is the SEC that supplies a democratic counterweight to the more insular corporate lawmaking processes embraced by the states. In this way, the SEC's delegated authority mitigates some of the shortcomings of the states' regulatory practices.

Because the SEC performs a critical role in supporting our corporate regulatory structure, it seems essential that its authority and flexibility be respected and protected by its counterparts in government. Judicial respect for a broad conception of SEC authority should be seen as a necessary element in protecting the stability of the corporate governance structure. Although many scholars urge courts to vigilantly constrain the scope of SEC authority, the values of deliberative democracy command the opposite approach.

A. Balancing Independence with Democratic Accountability

There is an unavoidable tension in seeking to protect the independence necessary to buffer the SEC from persistent political pressure, while adequately respecting the democratic principle of accountability.[221] Society has managed this tension by creating political and procedural mechanisms to hold administrative agencies accountable to each of the constitutional branches of government: the legislature, the executive, and the courts. The challenge for society lies in affording the agency sufficient flexibility to overcome the political constraints that sometimes hamper the legislature's effectiveness.

Judicial review of agency rulemaking is a key component of the system of checks and balances that helps ensure that bureaucracies remain accountable to the public. Yet, administrative law scholars have expressed serious concern that courts' excessive involvement in agency rulemaking has contributed to a paralysis in the administrative process.[222] These commentators warn that activist judicial review of agency rulemaking has

220. *See supra* Part III.C.

221. *See generally* JOHN HART ELY, DEMOCRACY AND DISTRUST (1980); KENNETH CULP DAVIS, DISCRETIONARY JUSTICE (1970); LOWI, *supra* note 162.

222. *See, e.g.*, McGarity, *supra* note 183 (arguing for an efficient and effective informal rulemaking process that is unhampered by fears of judicial or political reversal); R. Shep Melnick, *Administrative Law and Bureaucratic Reality*, 44 ADMIN. L. REV. 245, 246 (1992) ("Judicial review has subjected agencies to debilitating delay and uncertainty.").

had a number of adverse effects.[223] They charge that judicial review overburdens the rulemaking process by creating excessive uncertainty, increasing costs, encouraging forum shopping, and otherwise impeding agency effectiveness.[224]

1. General Principles of Judicial Review

The principal securities statutes lay out procedures and standards for judicial review of agency rules.[225] For example, Section 25 of the Exchange Act provides for special statutory review of rules promulgated under certain sections of the act.[226] It instructs courts to set aside rules if the SEC's action is "found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; contrary to constitutional right, power, privilege, or immunity; in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; or without observance of procedure required by law."[227] For SEC rules not specifically covered by Section 25 or other securities law provisions, the APA provides for judicial review under the same "arbitrary and capricious" standard.[228]

Despite the broad discretion implied by the terms "arbitrary" and "capricious", courts are far less deferential to agency decision making than

223. *See* McGarity, *supra* note 183, at 1386 ("The informal rulemaking process of the 1990s is so heavily laden with additional procedures, analytical requirement, and external review mechanisms that its superiority to case-by-case adjudication is not as apparent now . . . ."); Melnick, *supra* note 222, at 247–48.

224. McGarity, *supra* note 183, at 1400; Richard J. Pierce, *Two Problems in Administrative Law: Political Polarity on the District of Columbia Circuit and Judicial Deterrence of Agency Rulemaking*, 1988 DUKE L.J. 300, 301–02.

225. *E.g.*, Exchange Act § 25(b), 15 U.S.C. § 78(y)(b) (2000).

226. Exchange Act § 25(b)(1), 15 U.S.C. s 78y(b)(1) (2000). Section 25 provides for judicial review of rules promulgated under sections 6, 9(b)(2), 11, 11A, 15(c)(5) or (6), 17 or 19 of the Exchange Act. Any person adversely effected by these specified rules can seek direct judicial review in a Federal Court of Appeals within sixty days of the rule's promulgation.

The Exchange Act and other securities statutes also provide special review in the Court of Appeals for final SEC orders. Exchange Act § 25(a), 15 U.S.C. § 78y (2000); Securities Act § 9(a), 15 U.S.C. § 77(i)(a) (2000) (providing for judicial review of final orders in an appeals court); Investment Company Act § 42, U.S.C. § 80a-42(a) (2000) (providing for court review of SEC orders under the Investment Company Act in an appeals court); Investment Advisers Act § 213(a), 15 U.S.C. § 80b-13(a) (2000) (providing review of orders made under the Investment Advisers Act in an appeals court). Courts have undertaken judicial review of SEC rules adopted under these securities statutes pursuant to the provisions cited above.

227. Exchange Act § 25(b)(4), 15 U.S.C. § 78(y)(b)(4) (2000). Facts identified by the SEC as forming the basis for the rule are considered conclusive if supported by substantial evidence. *Id*. The substantial evidence standard requires greater judicial scrutiny than the arbitrary and capricious standard. *See* Nat'l Audubon Soc. v. U.S. Forest Serv., 46 F.3d 1437, 1445 (9th Cir. 1993).

228. 5 U.S.C. § 706(2)(A) (2000).

a literal interpretation would suggest.[229] When agency rulemaking is challenged, reviewing courts take a "hard look" at the agency's decision to determine whether or not it is reasonable.[230] Courts traditionally scrutinize the administrative record and the agency's explanation for the rule to determine "whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment."[231] The purpose of such review is "to determine whether the agency applied the correct analytical methodology, applied the right criteria, considered the relevant factors, chose from among the available range of regulatory options, relied upon appropriate policies, and pointed to adequate support in the record for material empirical conclusions."[232]

The degree of discretion courts afford to agencies is complicated by judicial trends that have developed in light of the Supreme Court's landmark *Chevron* decision. In *Chevron USA v. National Resources Defense Council*,[233] the Court held that when a provision of a statute is ambiguous, courts should defer to an agency's reasonable interpretation of the statutes it administers.[234] Although *Chevron* is widely perceived to compel greater judicial deference to agencies,[235] in reality it has continued

229. *See* Motor Vehicles Mfrs. Ass'n v. State Farm Mutual Automobile Ins. Co., 463 U.S. 29, 43 (1983). However, the arbitrary and capricious standard of review does generally result in the application of a "relatively deferential rational basis test to the agency action under review." ALFRED C. AMAN, JR. & WILLIAM T. MAYTON, ADMINISTRATIVE LAW 463 (2001). Some commentators and courts have noted that the differences between the arbitrary and capricious and substantial evidence standards are, at this point, largely semantic. *See* Pacific Legal Found. v. Dep't of Transp., 593 F.2d 1338, 1343 n.35 (D.C. Cir. 1979), *cert. denied*, 44 U.S. 830 (1979); William F. Pederson Jr., *Formal Records and Informal Rulemaking*, 85 YALE L.J. 38, 48–49 (1975).

230. McGarity, *supra* note 183, at 1410 & n.123.

231. Citizens to Preserve Overton Park v. Volpe, 401 U.S. 402, 416 (1971); *see* BREYER ET AL., *supra* note 160, at 347–404.

232. McGarity, *supra* note 183, at 1410.

233. 467 U.S. 837 (1984).

234. *Id.* at 866. The two-step analysis outlined in *Chevron* has been refined in later cases. In *Christensen v. Harris County*, the Court held that an agency opinion letter did not automatically receive *Chevron* deference since it did not have the force of law, but it was instead afforded to the more intrusive Skidmore deference. 529 U.S. 576, 587 (2000). In *United States v. Mead Corp.*, the Court held that administrative implementation of a statute is entitled to *Chevron* deference only when that agency is exercising its congressionally delegated power to resolve statutory ambiguity. 533 U.S. 218, 218 (2001). Unlike *Chevron*, which takes "ambiguity to signify delegation, *Mead* establishes that the default rule runs against delegation." Adrian Vermeule, *Introduction:* Mead *in the Trenches*, 71 GEO. WASH. L. REV. 347, 348 (2003). ("Unless the reviewing court affirmatively finds that Congress intended to delegate interpretive authority to the particular agency . . . *Chevron* deference is not due . . . ."). These cases restrict the situations in which courts can apply *Chevron* deference, allowing for increased scrutiny of agencies' interpretations of statutes.

235. Cass R. Sunstein, Chevron *Step Zero*, 92 VA. L. REV. 187, 190 (2006) ("*Chevron* has signaled a substantial increase in agency discretion to make policy through statutory interpretation."); Richard J. Pierce, Jr., Chevron *and its Aftermath: Judicial Review of Agency Interpretations of Statutory Provisions*, 41 VAND. L. REV. 301, 313 (1988) ("[I]f courts apply the *Chevron* test

to enmesh judges in the mire of administrative decision making.[236] As applied, *Chevron* has had the effect of converting many controversies over agency rulemaking that would otherwise be governed under the APA's more deferential "arbitrary and capricious" standard into questions of statutory interpretation, for which judges can credibly claim equal, if not superior, expertise to agency administrators.[237] By treating questions of administration as matters of statutory interpretation, courts have remained at least as involved in agency policy as under the oft-maligned "hard look" standard.[238]

2. Ossification Concerns

The problems caused by judicial impediments to agency rulemaking create a phenomenon administrative law scholars have labeled "ossification."[239] As Professor Thomas McGarity describes the problem, "[a]n assortment of analytical requirements have been imposed on the simple rulemaking model, and evolving judicial doctrines have obliged agencies to take greater pains to ensure that the technical bases for rules are capable of withstanding judicial scrutiny."[240] Similarly, Professor Shep Melnick asserts that "[j]udicial review has subjected agencies to debilitating delay and uncertainty. Courts have heaped new tasks on agencies while decreasing their ability to perform any of them."[241]

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universally, judges will have less room to infuse their personal political philosophies in the Nation's policy making process."); Daniel J. Gifford, *The Emerging Outlines of a Revised* Chevron *Doctrine: Congressional Intent, Judicial Judgment, and Administrative Autonomy*, 59 ADMIN. L. REV. 783, 833 (2007) ("[T]his new model restricts the scope of *Chevron*'s application, [but] allows greater freedom to agencies to formulate their own statutory interpretations and to revise them than did the earlier law.").

236. Rates of judicial affirmance of agency decisions have remained relatively stable pre- and post-*Chevron*. *See* Thomas J. Miles & Cass R. Sunstein, *Do Judges Make Regulatory Policy? An Empirical Investigation of* Chevron, 73 U. CHI. L. REV. 823 (2006) (finding that even after *Chevron*, the political convictions of federal judges affects judicial review of agency interpretations of law); Orin S. Kerr, *Shedding Light on* Chevron*: An Empirical Study of the* Chevron *Doctrine in the U.S. Courts of Appeals*, 15 YALE J. ON REG. 1, 30 (1998) (finding a post-*Chevron* affirmance rate of 73% in 1995–96); Peter H. Schuck & E. Donald Elliott, *To the* Chevron *Station: An Empirical Study of Federal Administrative Law*, 1990 DUKE L.J. 984, 1039 (finding an affirmance rate of 70.9% of pre-*Chevron* cases and an affirmance rate of 75.5% post-*Chevron* in 1988).

237. *See* Elizabeth V. Foote, *Statutory Interpretation or Public Administration: How* Chevron *Misconceives the Function of Agencies and Why It Matters*, 59 ADMIN. L. REV. 673, 676–77, 703 (2007).

238. *See id.* at 677.

239. McGarity, *supra* note 183, at 1368.

240. *Id.* at 1385.

241. Melnick, *supra* note 222, at 246.

Professors McGarity, Melnick and others maintain that intense judicial scrutiny of agency rulemaking has created several major problems. The most significant of these are prolonged delays and increased costs.[242] In anticipation of legal challenges and a "hard look" review, agencies respond by preparing lengthy explanations of the rules and engaging in exhaustive analysis. The costs of the requisite studies sometimes run into the millions of dollars and the time for an agency to promulgate a rule can extend for years, sometimes as long as a decade.[243]

The unappealing prospect of devoting the inordinate time and expense required for rulemaking is compounded by uncertainty about whether a proposed rule will be upheld by the courts.[244] Given the particularized, fact-intensive nature of judicial review, agencies cannot possibly anticipate what factors the court will consider significant, and which alternatives among many a judicial panel will conclude were worthy of the agency's consideration. This uncertainty compels agencies to engage in exhaustive analysis, provide elaborate justifications for policies, and respond to all comments no matter how germane.[245]

Not only are agencies stymied in predicting what factors a reviewing court will consider significant, they engage in regulatory roulette when adopting controversial rules, as the ideological composition of the panel that will review the rule cannot be foreseen.[246] Most rulemaking challenges are heard in the D.C. Circuit, which is well known for its sharp ideological divide.[247] A rule that is too stringent is likely to be challenged by industry, and a rule that is too permissive will provoke a lawsuit from a public interest group.[248] Many scholars maintain that the outcome of litigation in these circumstances is influenced less by the substantive merits of the rule or the procedure followed in its promulgation, than by the political ideology of the judges assigned to review the rule.[249]

The litigation risks that accompany rulemaking make agencies more reluctant to engage in this form of policymaking. This reluctance reduces

242. Pierce, *supra* note 224, at 301.
243. McGarity, *supra* note 183, at 1387–91.
244. Pierce, *supra* note 224, at 302.
245. *Id.* at 301; Melnick, *supra* note 222, at 247.
246. Pierce, *supra* note 224, at 300.
247. *Id.* at 302. Challenges to many SEC rules can be brought by an aggrieved person directly to the "Court of Appeals for the circuit in which he resides or has his principal place of business, or for the District of Columbia Circuit . . . . *See* Exchange Act § 25(a)(1), 15 U.S.C. § 78y(a)(1) (2000); *see also supra* text accompanying notes 225–28.
248. *See* Pierce, *supra* note 224, at 302.
249. *See* Miles & Sunstein, *supra* note 236, at 870–71 (2006); Pierce, *supra* note 224, at 302; Melnick, *supra* note 222, at 247.

regulatory flexibility. A rule that has survived the treacherous litigation process is unlikely to be amended as such action reopens a Pandora's box. As a result, agencies stick to their guns and rely on less transparent methods for adjusting their policies. These alternative regulatory methods, which include licensing, adjudication, product recalls, and interpretative statements (and, in the SEC's case, no-action letters) are less transparent but better insulated from judicial review.[250]

The undesirable fallout of aggressive judicial review has led many scholars to urge courts to adopt a more deferential approach when reviewing agency rules.[251] These scholars maintain that by virtue of their expertise, administrators are better positioned than judges to make most policy determinations.[252] Because the executive and legislative branches exercise oversight over agency decisions, judicial review can afford to be significantly relaxed.[253]

B. The Destabilizing Threat of Aggressive Judicial Review

Although administrative law scholars tend to focus on agencies such as the EPA, NHTSA, and OSHA, their concerns apply with equal force to trends in judicial review of SEC rulemaking. Recently, federal courts have shown a marked willingness to reject SEC rules at the behest of organized business interests.[254] In 2005 and 2006, two significant rulemaking projects were derailed in this manner. On a deliberative account such decisions have unnecessarily constrained the SEC's regulatory authority, impeding its ability to fulfill its statutory mandate. These decisions reinforce concerns voiced by "ossification" scholars that judicial activism is unwittingly undermining the deliberative nature of the administrative process.[255]

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250. McGarity, *supra* note 183, at 1440–43; Melnick, *supra* note 222, at 247–48; Pierce, *supra* note 224, at 301, 311 (asserting that the NHTSA retreated from rulemaking and instead implements its policy in an ad hoc manner by issuing recalls for defective products); *see also* Robert A. Anthony, "*Well, You Want the Permit, Don't You?" Agency Efforts to Make Nonlegislative Documents Bind the Public*, 44 ADMIN. L. REV. 31 (1992); Nagy, *supra* note 176, at 933–36.

251. Melnick, *supra* note 222, at 258 ("Judges should remember a key part of the Hippocratic oath: First, do no harm. In administrative law that translates into the command, defer! defer!").

252. Rachlinski & Farina, *supra* note 158, at 577 ("[T]he courts are probably the institution least-well suited to making policy decisions that avoid cognitive traps.").

253. Many commentators are more sympathetic to the need for aggressive judicial review. *See, e.g.*, Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 490–91 (2002); Macey, *supra* note 170, at 2418.

254. *See, e.g.*, Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

255. Melnick, *supra* note 222, at 251 ("[J]udicial review short-circuits real deliberation about what constitutes good policy.").

As previously mentioned, the SEC long enjoyed a reputation as one of the most respected federal agencies.[256] It traditionally commanded strong support from Wall Street and corporations that valued the disclosure regime and the enforcement apparatus that help support public confidence in the markets.[257] For the most part the SEC has sought to work cooperatively with Wall Street, the accounting industry, and other industries within its regulatory purview. At times, however, these cooperative efforts fail. When industry is unable to thwart SEC rulemaking through persuasion or political pressure, it sometimes appeals to courts. Beginning in the late 1980s, industry groups have found success in challenging SEC rules on substantive and procedural grounds. These precedents are troubling, as they embolden regulated entities and the courts to meddle unnecessarily in otherwise sound rulemaking procedures.

These "wing-clipping" decisions also have the deleterious effect of encouraging the SEC to rely more heavily on less formal policy pronouncements such as interpretive releases, no-action letters, and enforcement actions that are spared of the procedural rigors of the APA rulemaking.[258] This increased reliance on these more informal policy mechanisms renders SEC policy less transparent, and therefore less accessible to regulated parties and to the general public.

1. The Classic Case

Business Roundtable v. SEC represents the classic case in which federal courts rejected an SEC rule on the motion of a regulated party.[259] The controversy arose when the SEC adopted Rule 19c-4, a new rule that forbade national stock exchanges from listing shares of common stock that failed to adhere to the governance principle of one vote per share of stock owned by a stockholder.[260] Rule 19c-4 was adopted in response to General Motors' proposal to issue a new class of common stock with one-half vote per share. This plan conflicted with the exchange's longstanding rule that required that all common stock listed on the exchange enjoy one vote per share.[261] Rather than enforce its rule, the NYSE proposed abandoning it.[262]

256. *See supra* notes 158–61 and accompanying text.

257. SELIGMAN, *supra* note 158, at xx; Prentice, *supra* note 163, at 800; KHADEMIAN, *supra* note 141, at 95–99.

258. Nagy, *supra* note 176, at 958–962; *see also* Pierce, *supra* note 224, at 301.

259. 905 F. 2d 406 (D.C. Cir. 1990).

260. *Id*. at 407.

261. *Id*.

262. *Id*.

The SEC intervened with Rule 19c-4, which prohibited national stock exchanges from listing any common stock that was the product of a mid-stream, dual-class recapitalization.[263]

The Business Roundtable challenged the rule, arguing that the SEC lacked authority to adopt it.[264] The D.C. Circuit Court agreed.[265] It held that the SEC had crossed a jurisdictional line when it adopted a rule that "directly controls the substantive allocation of powers among classes of shareholders."[266] In adopting the one-share one-vote policy, the SEC relied on Section 19(c) of the Exchange Act, a provision that authorizes the agency to amend the rules of an SRO as it "deems necessary or appropriate . . . in furtherance of the purposes of [the Exchange Act]."[267]

Despite the broad conception of that purpose embraced by Congress, which included such expansive objectives as "protect[ing] investors" and "in the public interest," the court credited a much narrower view, and concluded that the Act's purposes were limited to enhancing corporate disclosure.[268] The court foreswore the notion that Congress envisioned that the SEC would force upon the exchanges rules pertaining to "substance" as opposed to mere "disclosure."[269] The court therefore concluded that "the Exchange Act cannot be understood to include regulation of an issue that is so far beyond matters of disclosure . . . and of the management and practices of self-regulatory organizations, and that is concededly a part of corporate governance traditionally left to the states."[270]

By crediting industry efforts to limit the scope of the SEC's authority in a manner not clearly intended by Congress, *Business Roundtable* represented a shot across the bow, prodding the agency into a more cautious regulatory posture. Post-*Business Roundtable*, a truce of sorts ensued, with the stock exchanges voluntarily adopting the rule the SEC

263. 17 C.F.R. § 240.19c-4 (2007).

264. *Business Roundtable*, 905 F.2d at 407. The Business Roundtable is an organization of chief executives of the nation's largest corporations. Business Roundtable, About Us, http://www.businessroundtable.org/about (last visited Feb. 22, 2009).

265. *Business Roundtable*, 905 F.2d at 407.

266. *Id*.

267. Exchange Act § 19(c), 15 U.S.C. § 78s(c) (2000).

268. *Id*. at 412.

269. *Id*. at 411.

270. 905 F.2d at 408. As I have argued elsewhere, *Business Roundtable*'s constraint on SEC rulemaking is based on an inappropriately narrow conception of the SEC's regulatory mandate: the notion that the federal securities laws are geared exclusively toward disclosure rather than conduct regulation. *See supra* notes 257–69. Although a number of securities law provisions belie this common notion, it nonetheless continues to guide courts as they consider challenges to agency actions. Jones, *supra* note 24, at 886–88; *see also* Jeffrey Y. Wu, *Revisiting* Business Roundtable *and Section 19(c) in the Wake of the Sarbanes-Oxley Act*, 23 YALE J. ON REG. 249 (2006).

had sought to impose.[271] Still, *Business Roundtable* remained a beacon of inspiration for industry groups in their efforts to forestall unwanted regulation, and litigation threats have loomed in the background whenever the SEC proposed to tread on uncharted regulatory terrain.[272]

2. Mutual Funds and Hedge Funds

Just as Congress was compelled to respond to the 2001/2002 accounting scandals with new mandatory corporate governance standards, the SEC faced a number of market-related scandals at the turn of the century. One set of scandals related to conflicts that pervaded the mutual fund industry. At the same time, the SEC struggled to formulate a policy to respond to the growing market influence of a new form of private investment vehicle, commonly referred to as hedge funds.[273]

The mutual fund scandals and market dislocations threatened by unstable hedge funds were serious enough to command regulators' attention, yet they lacked the political salience necessary to spur Congress to action. This regulatory space occupied by the scandals represents a middle ground in which the SEC's role as first responder is critical. The SEC responded to the mutual fund and hedge fund problems with new rulemaking initiatives that worked their way through the normal notice and comment process.[274] Both initiatives garnered significant attention in the business press and among commentators and industry groups. When industry failed to thwart rulemaking through the normal deliberative

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271. *See* Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 625–26 (1991).

272. For example, the U.S. Chamber of Commerce threatened to sue the SEC if it adopted the highly-contested shareholder access proposal. Phil McCarty, *SEC's Proxy Plan Threatened with Suit by Business Chamber*, WALL ST. J., Mar. 11, 2004, at A6; *see also* Letter from Henry A. McKinnell, Chairman, Bus. Roundtable to Jonathan G. Katz, Sec'y, Sec. and Exch. Comm'n (Dec. 22, 2003), *available at* http://www.sec.gov/rules/proposed/s71903/brt12203.htm (asserting that the SEC lacks authority to adopt the proposed shareholder access rule). This threat may have played a role in former-Chairman Donaldson's hesitancy and ultimate unwillingness to support the proposal. *See* Stephen Labaton, *S.E.C. Rebuffs Investors on Board Votes*, N.Y. TIMES, Feb. 8, 2005, at C2. The ABA also lobbied strenuously to discourage the SEC from adopting the "reporting out" requirement, proposed as part of the SEC's new attorney conduct rules adopted under the auspices of the Sarbanes-Oxley Act. *See* Letter from Alfred P. Carlton, Jr., President, Am. Bar Ass'n, to Jonathan G. Katz, Sec'y, U.S. Sec. and Exch. Comm'n (Dec. 18 2002), *available* at http://www.abanet.org/poladv/priorities/initial_comment.pdf.

273. For helpful background on the hedge fund regulation issue see Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975; Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPRENEURIAL BUS. L.J. 1 (2006).

274. Both of these rulemaking initiatives were preceded by prolonged dialogue with industry parties in the form of roundtables and task forces.

channels, it turned to the courts for solace. These groups (or an individual in the case of the hedge fund rule) successfully sued to overturn or delay implementation of the new rules.

a. Mutual Funds

In *Chamber of Commerce v. SEC*, the court twice remanded new SEC rules governing mutual funds for further analysis and consideration.[275] In 2004, the SEC amended its exemptive rules under the Investment Company Act of 1940, which governs mutual funds.[276] These amendments essentially mandated that at least 75% of the directors on a mutual fund board be independent and that an independent chairman preside over each fund (collectively the "Independence Requirements").[277] The Independence Requirements were adopted in response to scandals that were plaguing the mutual fund industry at the time. Investigations by state securities regulators had exposed widespread trading abuses, including late trading and market timing by favored mutual fund customers.[278]

The SEC viewed these abuses as evidence that mutual fund boards were inadequately policing conflicts of interest between mutual funds and their managers, and reasoned that an increased presence of independent directors would lead to a higher quality of monitoring of conflicts by directors and trustees.[279] Mutual fund giants Fidelity and Vanguard vigorously opposed the rule and led a public relations campaign in an effort to defeat it.[280] Despite this opposition, the new rules were adopted by a 3–2 SEC vote, with outgoing SEC-chair William Donaldson casting the deciding vote.

The U.S. Chamber of Commerce challenged the rule in federal court, claiming the SEC lacked the authority to adopt it, and that the rulemaking

275. 412 F.3d 133 (D.C. Cir. 2005) [hereinafter *Chamber I*]; *Chamber of Commerce*, 443 F.3d 890 (D.C. Cir. 2006) [hereinafter *Chamber II*].

276. 15 U.S.C. § 80a-1 et seq. (2000).

277. Investment Company Governance, Investment Company Act Release No. 26520 (Jul. 27, 2004) [hereinafter *Mutual Fund Release*], *available at* http://sec.gov/rules/final/ic-26520.htm.

278. *See* Jones, *supra* note 144, at 119–21.

279. *Mutual Fund Release*, *supra* note 277.

280. In addition to submitting a comment letter opposing the rule, Fidelity commissioned a study that purported to show that mutual funds with independent chairs did not perform better than those without. Letter from Eric D. Roiter, Senior Vice President, Fidelity Mgm't & Research Co., to Jonathan G. Katz, Sec'y, Sec. and Exch. Comm'n, *available at* http://www.sec.gov/rules/proposed/s70304/fidelity031804.htm. Its leaders also published op-ed columns in prominent business journals decrying the new rules. *See* Edward C. Johnson, III, '*Interested'—and Proud of It!*, WALL ST. J., Feb. 17, 2004, at A20 (Op-ed by Fidelity's chairman).

procedure did not comply with the requirements of the APA.[281] Although the court rejected the Chamber's broadest claims, it remanded the rule for further consideration.[282] The court applied exacting scrutiny to the question of whether the agency had "examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including rational connection between the facts found and the choice made."[283] Although it rejected the Chamber's argument that a failure to perform empirical analysis or to consider empirical data prepared by others violated the APA,[284] the court was unsympathetic to the SEC's claim that it was unable to assess the costs of the new requirements. Such difficulties in assessing compliance costs did not excuse the SEC from determining as best it could the rule's economic implications.[285] The court ruled that the SEC's failure to adequately consider the costs of the rules violated its obligations under the Investment Company Act and the APA.[286] Accordingly, the court remanded the rule to the SEC to correct the stated deficiencies in the rulemaking process.[287]

The SEC responded to the ruling by quickly preparing the mandated cost estimates and re-promulgating the identical rule, which was approved again on a 3–2 vote, timed to occur just before Chairman Donaldson's departure from the agency.[288] The Chamber again challenged the rule, and again the court rejected it.[289] The basis of the second ruling was the SEC's consideration of a report that was not part of the public rulemaking record

281. *Chamber I*, 412 F.3d 133, 136 (D.C. Cir. 2005).

282. *Id.* at 140–45. The court rejected the Chamber's claim that the Commission lacked authority to regulate corporate governance, an area traditionally viewed as within the province of the states. Holding *Business Roundtable* inapposite, it concluded that the purposes of the Investment Company Act included tempering conflicts of interests and regulating the governance structure of mutual funds. *Id.* at 139.

283. *Id.* at 140 (quoting Motor Vehicle Mfrs. Ass'n v. State Farm Mutual Auto Ins. Co., 463 U.S. 29, 43 (1983).

284. The court rejected this argument stating that "an agency need not—indeed cannot—base its every action upon empirical data." *Id*. at 142.

285. *Id*. The Investment Company Act requires that the SEC consider a rule's "impact on competitiveness," 15 U.S.C. § 80(a)-2c (2000), which the court interpreted to mandate an assessment of the new rule's costs to mutual funds. *Chamber I*, 412 F.3d at 142, 144.

286. *Id*. at 144. The court also ruled the SEC failed to give adequate consideration to alternatives to the rule in violation of the APA. According to the court, the SEC should have considered the "disclosure alternative" under which funds would be required to disclose whether or not they had an independent chair, leaving investors to make an informed investment choice. *Id.* at 144, 145.

287. *Id*. at 145.

288. The rule was re-promulgated within one week of the court's decision.

289. *Chamber II*, 443 F.3d 890, 894 (D.C. Cir. 2006).

and thus not afforded adequate consideration during the notice and comment period.[290]

Under Chairman Cox, the SEC reopened notice and comment on the Independence Requirements. However, the proposal lay dormant after the comment period expired, as the SEC lacked initiative to move forward on the proposal for a third time. The end result was substantial, yet less than complete, compliance with the Independence Requirements.[291]

b. Hedge Funds

In *Goldstein v. SEC*,[292] the D.C. Circuit invalidated the SEC's hedge fund rule which had required hedge fund advisors to register with the SEC.[293] The new rule revised the agency's interpretation of the term "client" under the Investment Advisers Act (the "Advisers Act") so as to require previously exempt hedge funds to register under the act.[294] The Advisers Act provides an exemption from registration for investment advisers with fewer than fifteen clients.[295] In the past, the SEC had interpreted the term "client" to allow advisers to consider entities such as partnerships and trusts as a single client, and to disregard the investors in such entities for purposes of determining their eligibility for the private adviser's exemption.

The new rule required hedge fund advisers to count as "clients" all of the investors in the partnerships or other entities that they advised; an interpretation that eliminated the private adviser exemption for most hedge funds.[296] Like the mutual fund Independence Requirements, the hedge fund rule was adopted by a divided SEC in a 3–2 vote.[297]

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290. *Id*. at 908.

291. Tatiana Serafin, *Who's In Charge Here?*, FORBES, Sept. 17, 2007, at 162; John Morgan, *Funds Choose More Independent Directors*, MONEY MGT. EXECUTIVE, Nov. 19, 2007, at 1 (citing ICI/IDC survey reporting that by late 2006, 88% of funds met the 75% independent director requirements and 56% had an independent chairman).

292. 451 F.3d. 873 (D.C. Cir. 2006).

293. A hedge fund is generally understood to be a private investment vehicle for wealthy investors that is exempt from the SEC's registration requirements under the Investment Company Act and the Investment Advisers Act.

294. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. IA-2333 (Dec. 10, 2004) [hereinafter *Hedge Fund Rule*], *available at* http://www.sec.gov/rules/final/ia-2333.htm.

295. Advisers Act, § 203(a)(3), 15 U.S.C. § 80b-3(b)(3) (2000).

296. *Goldstein*, 451 F.3d. at 877.

297. *Hedge Fund Rule*, *supra* note 294. The two non-Chair Republican Commissioners, Cynthia Glassman and Paul Atkins, dissented from the rule and described it as "the wrong solution to an undefined problem." *Id*.

Philip Goldstein, a hedge fund manager, sued. He argued the SEC had misinterpreted the Advisers Act's private adviser exemption.[298] The D.C. Circuit Court of Appeals agreed.[299] It concluded the SEC's interpretation came "close to violating the plain language of the statute," and that it was "counterintuitive to characterize the investors in a hedge fund as the 'clients' of the adviser."[300] The court also found that that the SEC had failed to justify the rule, because it had not "adequately explained how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter."[301] The court thus concluded that the rule was arbitrary and vacated it.[302]

C. The Need for Greater Judicial Deference

In *Business Roundtable*, *Chamber of Commerce*, and *Goldstein*, the D.C. Circuit found a basis for rejecting SEC rules on the motion of regulated parties or their representatives. In each case the grounds for the rejection differed, yet the stories behind these failed rulemaking efforts are remarkably similar: (1) a high stakes rule introducing a new regulatory burden or revoking regulatory relief is proposed by the SEC, (2) organized business interests strenuously object to the rule, making their views known to the SEC through comment letters, private lobbying, and public commentary, (3) the rulemaking proceeds despite industry objections, and (4) the disappointed parties then appeal to federal courts where they find a more receptive audience for their concerns.

Courts have little difficulty finding deficiencies in the SEC's reasoning, its procedural practices, or the administrative record.[303] Honing in on the fatal flaw, the court rejects the rule. Whether the court remands or vacates the rule, the litigation has the effect of taking the wind from the agency's sails and the rulemaking project typically falters. Interestingly, however, despite judicial defeat, the agency often finds a way to effect its desired policy. In the one share/one vote controversy, the SEC managed to cajole the stock exchanges to voluntarily adopt the rule it sought to impose.[304] In the *Chamber of Commerce* case, many mutual funds opted to comply

298. *Goldstein*, 451 F.3d at 878.
299. *Id*. at 878–81.
300. *Id*. at 881.
301. *Id*. at 882.
302. *Id.* at 884.
303. Pierce, *supra* note 224, at 310 ("[A]ny issue can be considered so significant that failure to address it 'adequately' and 'objectively' will yield judicial reversal and remand of a rule.").
304. Bainbridge, *supra* note 271, at 625–26.

voluntarily with the independence requirements rather than deal with the uncertainty wrought by drawn out litigation. Similarly, some hedge fund advisers opted to register voluntarily with the SEC rather than await the outcome of the *Goldstein* litigation, and the agency continues to consider alternative methods for regulating hedge funds.[305] The result is that the SEC's desired policy sometimes becomes adopted as a best practice.

As adherents to the "ossification" viewpoint have argued, close judicial scrutiny of agency rulemaking accomplishes little more than exacerbating agency gridlock (although that may be the main point). Because the outcome of any prospective litigation is unpredictable, agencies adopt a defensive posture, spending more time and money to justify their rules prior to final rulemaking. Judicial oversight does little to stem the agency's regulatory (or deregulatory) vigor. And when rulemaking fails, the agency will likely seek alternative methods of effecting its desired policy.

The ultimate effect of intrusive judicial review is to deprive the SEC of its ability to nimbly address new problems and challenges that arise in the financial markets. Such review rarely has the effect of substantively altering the agency's course of conduct. But, by forcing policymaking to a more informal rubric, judicial scrutiny deprives the public of the deliberative advantages of APA rulemaking, undermining the very value of public accountability the courts claim to be protecting. The unfortunate result is less certainty for regulated parties and investors, and less transparency to the public. The cure for this dilemma is greater deference to SEC rulemaking by regulated parties, commentators, and most importantly, the courts.

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305. *See* Todd Zaun, Note, Goldstein v. Securities and Exchange Commission, 1 J. BUS. ENTREPRENEURSHIP & L. 111, 129 (2007). As an interim step, the SEC increased from $1 million to $2.5 million the minimum asset requirement for investors in hedge funds necessary for the funds to maintain exemption from SEC's registration requirements. *See* Hannah Glover, *SEC Adopts More Moderate Stance, Haunted by Ghosts of Meetings Passed*, MONEY MGT. EXECUTIVE, Dec. 18, 2006, at 1. This step was intended to address the problem of "retailization" of hedge funds; the offering of these investment vehicles to less sophisticated investors who lacked the ability to fend for themselves. *Id.*

Hedge fund regulation is back on the agenda as Treasury Secretary Timothy Geithner has indicated such regulation will constitute a significant prong in the administration's proposal to create a new "systemic risk" regulator to oversee financial markets. *See* U. S. Department of the Treasury, Press Release: Treasury Outlines Framework For Regulatory Reform, *available at* http://www.treasury.gov/press/releases/tg72.htm.

CONCLUSION

This Article has assessed the mechanisms for crafting American corporate law rules against a backdrop of core democratic principles. The Article has shown that although the state lawmaking regime fails to comport with democratic values, the legitimacy of the broader structure is more robust. Our corporate regulatory structure consists of layers of authority, and democratic protections at the federal level help to compensate for flaws which are apparent in state lawmaking processes.

The Article identifies regulatory redundancy (represented by legislative rulemaking by the SEC) as a key component of the comprehensive structure that helps bring corporate lawmaking closer in line with our democratic values. It therefore urges courts to accord more deference to the agency's rulemaking authority. By constraining SEC rulemaking, courts detract from the agency's ability to handle adeptly the broad array of tasks that Congress has delegated to it. In so doing, courts risk undermining the legitimacy of our corporate governance system.

Although the Article emphasizes the undesirable impact of aggressive judicial review of SEC rules, its insights have broader implications. The regulatory failure laid bare by the current global financial crisis only reinforces the need for a robust financial regulatory structure. The crisis demonstrates that a lack of effective regulation puts at risk much more than private losses for investors. Indeed, regulatory failure has the potential to destabilize the entire global economy.

A greater appreciation of the SEC's central role in overseeing corporate conduct seems particularly crucial in light of currently circulating proposals for financial regulatory reform.[306] Efforts to weaken the SEC's independence or limit the scope of its authority are misguided, as these are the very institutional characteristics by which the SEC contributes to the legitimacy of corporate regulation. Reform proposals that seek to centralize corporate regulatory authority within the executive branch, or to otherwise restrict opportunities for democratic deliberation, would only serve to further threaten the stability of the corporate law regime.

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306. *See* DEP'T OF TREASURY, *supra* note 4, at 1–14; Pritchard, *supra* note 4 at 1092–93. The Treasury Department has reportedly revived proposals to transfer substantial regulatory authority to other agencies and SROs. *See* Robert Schmidt & Jesse Westbrook, *U.S. May Strip SEC of Powers in Regulatory Overhaul*, Bloomberg.com, May 20, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a96oAfZjGryw.