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Paternalistic Regulation of Public Company Management: Lessons from Bank Management

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PATERNALISTIC REGULATION OF PUBLIC COMPANY MANAGEMENT: LESSONS FROM BANK REGULATION

James Fanto * **

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I. INTRODUCTION

By all accounts, the Sarbanes-Oxley Act of 2002¹ (Sarbanes-Oxley) represented a significant intrusion by the federal government into the substantive regulation of corporate governance of U.S. public companies, an area long considered to be the province of state corporate law. Among other things, Sarbanes-Oxley and the accompanying rules of the Securities and Exchange Commission (SEC) and self-regulatory organizations (SROs) like the New York Stock Exchange (NYSE) instructed boards of directors how to monitor senior executives of their companies and imposed new duties and restrictions upon those executives. This kind of substantive, even paternalistic, regulation of a public firm's corporate governance brings to mind the federal banking agencies' regulation of national and state banks and bank and financial holding companies. Bank regulators screen proposed executives and directors of a new bank and may not allow the bank to begin operations if they disapprove of some or all of these individuals. They set standards of conduct for bank officers and directors and continue, through regular examinations, to monitor them and their performances. Moreover, bank regulators have considerable informal and formal enforcement powers; they can even remove executives and directors, temporarily or permanently, from a financial institution or from the entire banking industry. Indeed, in Sarbanes-Oxley Congress borrowed part of its regulation of public company management from banking law.²

In this Article, I contend that Sarbanes-Oxley represents a significant step in the ongoing development of a paternalistic federal regulation of public firm management that is in certain respects comparable to the regulation of bank and bank holding company management by federal banking agencies. However, I argue that the regulation of public firm management, as it has occurred, is too oriented towards the punishment of directors and officers. Federal regulation of bank management is all-encompassing, covering bank officers and directors from the time a bank begins its operations onward. The pervasive regulatory guidance and constant interaction, both informal and formal, between bank managers and regulators give the managers notice of the regulators' expectations for their behavior and an early warning of regulators' concerns and problems with it. The prescreening and ongoing monitoring thus justify the serious penalties that can be assessed against a bank officer or director by a bank regulator, whether through administrative proceedings or the courts, or by

1. 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.) [hereinafter Sarbanes-Oxley].

2. See *infra* notes 65, 165-66 and accompanying text.

a U.S. attorney in a criminal prosecution.

By contrast, neither the SEC nor any SRO screens officers or directors of public companies. At the direction of Congress, the SEC and the SROs increasingly specify standards of conduct for these officers and directors. However, they do not monitor officers' and directors' compliance with the standards, inspect the firms or interact with them formally (or even informally) outside of enforcement and prosecutions. Despite this approach, which reflects the SEC's jurisdictional limitation to the regulation of company disclosure, the SEC's disciplinary powers over public firm management have grown, as has criminal liability for officers and directors. Those powers more and more parallel the powers of bank regulators over (and the criminal liability of) bank officers and directors. Officers and directors of public firms can be punished harshly even though they do not have the kind of ongoing, close relationship with the SEC and the SROs that their bank counterparts have with bank regulators.

This state of affairs leads to a quandary. As a theoretical and practical matter, the SEC and the SROs cannot replicate the prescreening, setting of standards and oversight of management provided by bank regulators. Public companies are in diverse industries and, in many cases, are exceedingly complex organizations. Thus, it would be difficult to find regulators and examiners who could competently prescreen public company officers and directors, set appropriate behavior standards for them, and then evaluate their performances. Indeed, bank regulators acknowledge the difficulty of standard-setting and monitoring for the management of the largest banking organizations; as a result, they are relying more on organizations' self-regulation and even advocating the use of a disclosed, market-based monitoring of these organizations, especially as they become financial and even commercial conglomerates.³ Moreover, the all-encompassing bank regulation has itself not always deterred bank management scandals, and arguments can be made that the costs of this regulation do not justify its benefits.⁴

Yet current corporate governance in public companies—i.e., the supervision and monitoring of executives by boards of directors⁵—is unsatisfactory. Despite improvements to the boards' abilities to govern over the last decades, including those derived from Sarbanes-Oxley, and despite the activism of institutional shareholders,⁶ directors often do a poor job of monitoring executives. Current corporate governance has been

3. See *infra* notes 75-77 and accompanying text.

4. For a summary of these arguments, see JONATHAN R. MACEY ET AL., *BANKING LAW AND REGULATION* 639-44 (3d ed. 2001).

5. See STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 192-93 (2002).

6. See *generally* MICHAEL USEEM, *INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA* (1996).

particularly ineffective in countering the excessively self-interested behavior of executives, as shown by the corporate scandals of the early 2000s.⁷ Boards of public firms often failed in their monitoring, although not because the directors' motivations to perform well were inadequate or because there were technical, but easily resolvable, problems in governance arrangements. Rather, the failure often was due to the formation in public firms of a destructively cohesive group of senior executives, corporate advisors such as bankers, accountants and lawyers, and even some board members, led by the CEO. Influenced by a group mentality, an "inner circle" operated a firm for its own benefit. Social psychologists explain why these groups form and identify their typical failings, in particular their resistance and hostility to anything and anyone contradicting their views and behavior.⁸

Social psychologists suggest that one way to prevent the formation of these perverse groups, or to break apart existing ones, is to involve in the monitoring of the groups an outsider who is loyal to an organization other than the groups and who, as a result, can resist the attraction of the groups' circles.⁹ For public companies, this person would have to be someone not from the public company, nor from a professional firm providing services to it. One logical outsider is an employee or a representative of a government regulator like the SEC that is already involved in the regulation of public companies. This leads back to the issue of the substantive oversight of public company management, with the problem that the SEC is ill-suited to offer a complete paternalistic regulation.

The bank regulatory model could offer a solution to the problem of public company management regulation, even if the entirety of this model is not practical or desirable. One possibility is that the SEC could appoint a corporate governance monitor for certain public firms who would have a role like that of an examiner of a large bank or financial holding

7. I refer here to the self-interested behavior of people like (to name just a few) Enron's CFO Andrew Fastow, see WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 209-37 (2002); WorldCom's CEO Bernie Ebbers, see RICHARD C. BREEDON, RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF, THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI 767-68, 787-91 (2003); and Tyco International's CEO Dennis Kozlowski, see Mark Maremount & Laurie P. Cohen, *Executive Privilege: How Tyco's CEO Enriched Himself—Mr. Kozlowski, Ex-Chief, Got Secret Loans, Spent Firm's Cash as His Own—A \$6,000 Shower Curtain*, WALL ST. J., Aug. 7, 2002, at A1.

8. See *infra* Part IV.B. See generally James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 OR. L. REV. 435, 460-72 (2004).

9. See *infra* note 217 and accompanying text; see also, e.g., Roger J. Volkema & Ronald H. Gorman, *The Influence of Cognitive-Based Group Composition on Decision-Making Process and Outcome*, 35 J. MGMT. STUD. 105, 117-18 (1998).

company.¹⁰ The SEC would hire, train, and oversee the performance of these monitors, who would be supervised by that part of the SEC's Division of Corporation Finance responsible for their firms and industry. Among other things, a monitor would promote the development of professional standards in a board, assist the board in reviewing any conflicts of interest, look for "red flags" of serious management problems, and convey to directors and executives, on an ongoing and informal basis, any SEC concerns about their conduct. Interaction with the monitor would give executives and directors an opportunity to address any problems in their behavior before the SEC instituted formal enforcement proceedings or the Department of Justice began criminal action. The presence of the monitors "on the ground" in public companies would also enable the SEC to receive valuable information about companies and industries, which could improve overall company disclosure as the SEC becomes aware of, and demands corrections to, inadequacies in current disclosure.

This significant extension of SEC paternalistic regulation of public company management would be controversial and could be seen as a throwback to governance procedures in state-owned firms.¹¹ The backlash against Sarbanes-Oxley is in full swing, and it is unrealistic to believe that any reform intrusive upon public company management would succeed in the present political climate.¹² All aspects of the proposal should be debated and variations on it are imaginable, such as requiring only certain public firms to have monitors or allowing most firms to opt out of a monitor requirement. Even if the immediate success of the proposal is unlikely, it is important that proposals on public company governance be put forward, and kept alive if they are deserving, particularly since it can be argued that recent governance reforms, rather than going too far, did not go far enough in controlling public company management. The reform will have the added advantage of bringing into the open the paternalistic

10. See *infra* Part V.C.

11. For example, in French private companies that were state-owned, the French state had the right to place representatives on the board, to have its agents inspect the company, and to place its agents as monitors within the company. See generally JEAN KERNINON, *LES CADRES JURIDIQUES DE L'ÉCONOMIE MIXTE* 78-89 (1992). Professor Larry Ribstein has criticized the approach of this Article on his "blog." See Larry E. Ribstein, *Business Corporations as Banks: The Next Step in Governance Reform*, IDEOBLOG, Jan. 21, 2006, http://busmovie.typepad.com/ideoblog/2006/01/business_corpor.html (with additional commentary and criticisms from participants).

12. Signs of this backlash are the resistance of the business community to SEC regulatory initiatives, see, e.g., *Chamber of Commerce v. SEC*, No. 04-1300 (D.C. Cir. June 21, 2005) (discussing the Chamber's challenge to SEC corporate governance initiatives with respect to investment companies); see also *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006) (holding, among other things, that the SEC had violated rule-making procedures in promulgating its governance rule for investment companies), and the appointment of Christopher Cox (a person with a deregulatory orientation) to be Chairman of the SEC. See Deborah Solomon et al., *Cox's Nomination to Run SEC Signals a Regulatory Shift*, WALL ST. J., June 3, 2005, at A1.

regulation that already is occurring through the SEC's enhanced enforcement powers over public firm management and the increasing criminalization of management's behavior, and of balancing this enforcement with guidance so that SEC regulation does not just punish firm executives without offering them any accompanying benefits.¹³

This Article proceeds as follows. Part II offers a broad but brief overview of the history and current regulation of bank management under federal banking laws. It explains how all-encompassing it is: Bank regulators screen officers and directors, set standards of conduct for management, and monitor managers on an ongoing basis and exercise considerable informal and formal powers over them, including the power to ban an officer or director from the banking industry for life. Again from a broad perspective, Part III contrasts this comprehensive bank regulation of management with the limited regulation of public firm management authorized to the SEC by the federal securities laws. The SEC does little gatekeeping of public company officers and directors and sets few standards for their conduct. Since the late 1990s, however, as a result of waves of corporate scandals, there has been major growth in SEC and SRO regulation of public firm management. The SEC and SROs, along with federal prosecutors, have received significant powers to discipline and punish officers and directors. This Part also emphasizes how Sarbanes-Oxley, the SEC's implementing regulations, and SRO rules pursuant to these regulations continue this process, and it discusses the reasons for the focus on enforcement. Part IV first argues that an SEC regulation that emphasizes enforcement with little gatekeeping, standard-setting, or ongoing relationships with firm management, is inappropriate and unfair. It then discusses the theoretical and practical reasons why the SEC cannot take on a complete regulatory role toward public firm officers and directors comparable to that of bank regulators to bank management. The next Part describes, from a social psychological perspective, the problem of the formation of inner circles in public firm management and the possible solution of an outside monitor. It sets forth a proposal (as well as possible modifications to it) that there be established corporate governance monitors in certain public companies, using the model of bank examiners

13. An additional justification for this proposal is that ordinary people in the U.S. increasingly invest in the stock market, as opposed to bank deposits, whether directly or indirectly through mutual and pension funds. For example, the number of individuals owning stock either directly or indirectly increased from 52.3 million in 1989 to 84 million in 1998. See NYSE FACT BOOK, *The Investing Public*, <http://www.nyse.com> (now titled NYSE Facts and Figures). Under the proposal, federal regulation of management would follow this movement of savings, for it would extend the substantive regulation of management from financial intermediaries to the major capital raisers, albeit in a modified form, as discussed below. See *infra* note 14.

in large complex banking organizations, and presents a few examples of existing monitors. Part V concludes the discussion.

II. AN OVERVIEW OF BANK REGULATORY SUPERVISION OF BANK MANAGEMENT

The purpose of this Part is to give the reader a panorama of the comprehensiveness of the substantive regulation of bank management. This regulation falls into three parts. First, there is “gatekeeping” where bank regulators¹⁴ screen and preapprove the selection of officers and directors of a new bank. Second, bank regulators set detailed standards of conduct for bank officers and directors. Third, the bank regulators monitor, on an ongoing basis, compliance with the standards and, together with federal prosecutors, enforce this compliance informally and formally. To use a metaphor, bank regulators stay with bank directors and officers from cradle to grave.

A. *Banking Regulators’ Gatekeeping*

Bank regulators review the qualifications and background of individuals proposed by a group seeking to start a bank (known as an “organizing group”¹⁵) to be its directors and officers, and they allow into the banking industry only those who receive their approval. Regulators can, in effect, prevent the appointment and election of all or some of the proposed officers and directors. To succeed in an application to obtain a bank charter, an organizing group must have qualified and experienced bank directors and executives to supervise and operate the institution. The regulatory gatekeeping also includes a probationary period. During the two years after a bank receives a charter, regulators can remove officers and directors.¹⁶

The justification for this gatekeeping has always been the quasi-governmental status of banks. Early American business corporations, which were often formed to perform important tasks like transportation, had this status,¹⁷ which banks never quite lost. Historically (and even

14. The focus of the following discussion will be only on the regulator of nationally chartered banks, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC), which has certain power over the banks to which it provides insurance for customers’ deposits up to statutory limits. *See generally* LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES: CASES AND MATERIALS 197-98 (2004); MICHAEL P. MALLOY, PRINCIPLES OF BANK REGULATION 27-36 (2d. ed. 2003). The FDIC’s power over state-chartered banks is particularly significant, for it is their primary regulator where a state bank is not a member of the Federal Reserve System.

15. *See* 12 C.F.R. § 5.20(d)(6) (2005).

16. *See id.* § 5.20(g)(2).

17. *See generally* JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT

today), a bank's public importance came from its being the primary financial intermediary in a local economy, providing capital, investments, and payment services for local inhabitants and businesses.¹⁸ A bank fell within the public, and thus the government's, interest, for without its effective functioning there would be no complex economic life, and thus no developed social life, in a town, city, or region. Given the bank's role, it is not at all surprising that its directors and officers were viewed almost as public servants and their appointments required government approval. That a bank generally held cash and other liquid assets that could easily be stolen reinforced the need for competent and trustworthy management.¹⁹

A statement from the current *FDIC Risk Management Manual of Examination Policies* demonstrates how, even today, bank regulators consider bank management to be a public service:

Being selected to serve as a bank director is generally regarded as an honor, for it often denotes an individual's reputation as being successful in business or professional endeavors, public spirited, and entitled to public trust and confidence. It is this latter attribute and the public accountability implicit therein that distinguishes the office of bank director from directorships in most other corporate enterprises. Bank directors are not only responsible to the stockholders who elected them, but must also be concerned with the safety of depositors' funds and the influence the bank exercises on the community it serves.²⁰

The public service mission of banks, and by extension their officers and directors, remains, even as banks and their role in the economy have changed. Banks remain critical financial intermediaries in local

HISTORY OF A REVOLUTIONARY IDEA 43-45 (2003); Franklin A. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, March 30, 2004, <http://ssrn.com/abstract=546296> (last visited June 17, 2006) (providing an overview of governance by representation and noting that medieval towns operated as corporate entities.)

18. See generally JAMES L. PIERCE, *THE FUTURE OF BANKING* 17-87 (1991) (describing the reasons for government regulation of banking and the history of banking regulation in the United States).

19. As any student of corporations knows, many early cases on directors' fiduciary duties deal with bank directors' failure to supervise employees who embezzled funds from customer accounts. See, e.g., *Litwin v. Allen*, 25 N.Y.S.2d 667, 677-79 (N.Y. Sup. Ct. 1940).

20. See FDIC, *DSC RISK MANAGEMENT MANUAL OF EXAMINATION POLICIES* 4.1-1 (Dec. 2004), available at <http://www.fdic.gov/regulations/safety/manual/index.html>. The fiduciary nature of a national bank director is emphasized by the statutory requirement that the director take an oath before a notary public to the effect that he or she will "diligently and honestly administer the affairs of such association, and will not knowingly violate or willingly permit to be violated any of the provisions of [banking laws] . . ." See 12 U.S.C. § 73 (2000).

economies, albeit ones connected to a more sophisticated national and international economy. This status continues their quasi-governmental role, even if their regulation has become exceedingly complex. This role is underscored by federal deposit insurance. Since 1933, the federal government, through the FDIC, insures bank deposits (up to set limits) to safeguard the basic savings of ordinary people and thus to prevent bank panics in times of economic stress.²¹

The following discussion explains, from a broad perspective, the kind of screening of officers and directors that bank regulators undertake, although the regulatory focus has shifted from requiring them to be well-regarded, solvent local individuals to demanding that they have financial and banking expertise. The discussion is limited to regulatory gatekeeping of national bank directors and officers.²² There are specific, although somewhat archaic, requirements for national bank directors ensuring that the directors are familiar with and sensitive to the local economy and that they make a financial commitment to the bank: They must be U.S. citizens, live near the bank (i.e., within 100 miles of its main office for a year preceding their election), and own \$1,000 of the bank's stock.²³ Financial commitment remains important in the gatekeeping regulations. The initial directors (or some of them) should have the financial resources to keep the bank afloat, if necessary.²⁴ The OCC explains that "[p]ersonal wealth is not a prerequisite to becoming an organizer or director of a national bank."²⁵ However, it plainly wants each director to make some financial commitment (keyed to an individual's resources), as well as other

21. See COMPTROLLER OF THE CURRENCY, *THE DIRECTOR'S BOOK: THE ROLE OF A NATIONAL BANK DIRECTOR 2* (1997), available at <http://www.occ.treas.gov/director.pdf> (explaining bank regulation partly as a result of the provision of deposit insurance).

22. State bank regulators similarly screen state bank managers, as does the FDIC. See, e.g., STATE OF N. Y. BANKING DEP'T, *INFORMATION AND PROCEDURE FOR THE ORGANIZATION OF A COMMERCIAL BANK UNDER NEW YORK BANKING LAW 1-2, 7-8*, available at <http://www.banking.state.ny.us> (emphasizing the importance of directors and chief executives in application).

23. See 12 U.S.C. § 72 (2000) (listing requirements). The OCC has the power to waive the first requirement for a minority of directors of an institution and the second requirement for all directors. See generally COMPTROLLER'S LICENSING MANUAL, *DIRECTOR WAIVERS 1-4* (June 2002), available at <http://www.occ.treas.gov/corpbook/group3/public/pdf/dirwaiv.pdf> (describing the requirements, the policies regarding waivers, and the procedures for obtaining the waivers); see also PATRICIA A. MCCOY, *BANKING LAW MANUAL* § 14.02 (2004).

24. See 12 C.F.R. § 5.20(g)(3) (2005) (explaining that directors should have a financial commitment to the bank); see also DOUGLAS V. AUSTIN ET AL., *HOW TO CHARTER A COMMERCIAL BANK 702* (1999) ("If the plan is to raise the money for the bank charter primarily from a small group of individuals, then the incorporators should be affluent.").

25. See COMPTROLLER'S LICENSING MANUAL, *CHARTERS 13* (Jan. 2005), available at <http://www.occ.treas.gov/corpbook/group4/public/pdf/charters.pdf>.

contributions within his or her area of expertise, to the bank.²⁶ To qualify as a bank director means having the ability and willingness to give something back to the community.

Today, regulators pre-screen management to see if the proposed directors and officers are competent in banking, rather than just local notables. In its chartering regulations, the OCC requires that an applicant have competent executives and a board of directors²⁷ capable of executing the bank's business plan.²⁸ Members of the bank's organizing group generally serve as its initial directors,²⁹ and the OCC stipulates that the group be composed of competent, experienced, financially astute, and diverse individuals.³⁰ The OCC also prefers that at least one-fourth of the bank's outside directors have previous experience as directors or executives of a financial institution.³¹ If the experience of the board is not satisfactory to it, the OCC may accept a plan of director education as a way for the organizing group to meet the OCC's requirements.³²

The board's major responsibility is to select management that has "integrity, technical competence, character, and experience in the financial services industry."³³ The CEO, who must have banking experience, must be named in the application and attend the preliminary meetings between the OCC and the organizing group.³⁴ The OCC will not approve a charter on the condition that a suitable CEO be named in the future.³⁵ The OCC states that bank senior executives should be "strong," which means "[h]igh-caliber senior executive officers that have the relevant experience necessary to implement the proposed business plan and to exercise corrective action in response to changing internal and external factors."³⁶

26. *See id.* at 12-13.

27. *See* 12 C.F.R. § 5.20(f)(2)(B) (2005) (explaining the OCC considers whether the applicant "[h]as competent management, including a board of directors, with ability and experience relevant to the types of services to be provided"); *see also* COMPTROLLER'S LICENSING MANUAL, CHARTERS, *supra* note 25, at 7-11 (emphasizing the importance of experienced and competent bank directors and executives for receiving the charter); AUSTIN, *supra* note 24, at 701-02.

28. *See* COMPTROLLER'S LICENSING MANUAL, CHARTERS, *supra* note 25, at 8.

29. *See id.* at 3. The organizing group must be made up of at least five natural persons. *See* 12 U.S.C. § 21 (2000). A national bank must have at least five, and no more than twenty-five, directors. *See id.* § 71a.

30. *See* 12 C.F.R. § 5.20(g)(1) (2005) ("Strong organizing groups generally include diverse business and financial interests and community involvement."); *see also* COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK, *supra* note 21, at 5 (discussing the requirements for a director).

31. *See* COMPTROLLER'S LICENSING MANUAL, CHARTERS, *supra* note 25, at 9.

32. *See id.*

33. *See id.* at 8.

34. *See id.* at 10. The OCC characterizes the CEO's selection as the most important decision of the organizing group. *See id.* at 9.

35. *See id.* at 10.

36. *See id.* at 8.

The OCC preapproves all senior executives in addition to the CEO, and no executive can be employed over the OCC's objection.³⁷

All proposed officers, directors, controlling shareholders, and organizing group members must file a biographical and financial report with bank regulators.³⁸ The form requires, among other things, information on the background, work experience, business and banking affiliations of the person, history of legal or administrative sanctions of the person and organizations that the applicant has been associated with, and a detailed personal financial report of his or her assets and liabilities.³⁹ The OCC then conducts a background check on the person on the basis of the filing, using government and public records, as well as having the FBI check its records for the person's fingerprints.⁴⁰ The OCC explains that the background investigation is designed "to determine if those proposed have the experience, competence, integrity, character, financial ability, and willingness to direct and/or lead a bank's affairs in a safe, sound, and legal manner."⁴¹

The OCC's gatekeeping also involves an onsite review of directors and officers. Under the required chartering procedure, OCC officials first generally hold a preliminary meeting with members of the organizing

37. See *id.* at 11; see also 12 C.F.R. § 5.20(h)(3) (2005); AUSTIN, *supra* note 24, at 701-02 ("Since FIRREA and FDICIA, the regulatory agencies have a much stronger voice in the determination of appropriate directors and management, and they can eliminate directors and officers without even an administrative hearing."). Again, the OCC can remove any officer or director for two years following the date the bank begins business. See 12 C.F.R. § 5.20(g)(2) (2005).

38. See COMPTROLLER'S LICENSING MANUAL, BACKGROUND INVESTIGATIONS 1-2 (June 2002), available at <http://www.occ.treas.gov/corpbook/group1/public/pdf/backgrnd.pdf>. This report is pursuant to a form jointly adopted by financial regulators. See INTERAGENCY BIOGRAPHICAL AND FINANCIAL REPORT (expiry date Oct. 31, 2007), <http://www.occ.treas.gov/efiles/disk1/BankForms/bio.pdf> (consisting of an approximately sixteen-page model form). The form allows an applicant to use another format as long as all information demanded by the form is present and the applicant certifies its accuracy. See *id.*

39. See COMPTROLLER'S LICENSING MANUAL, BACKGROUND INVESTIGATIONS, *supra* note 38; see also 12 U.S.C. § 1829(a)(1) (2000) (prohibiting those convicted of crimes involving dishonesty, breach of trust, or money laundering from serving as officers or directors of any FDIC insured financial institution).

40. See COMPTROLLER'S LICENSING MANUAL, BACKGROUND INVESTIGATIONS, *supra* note 38, at 2-3.

41. *Id.* at 1. A false filing in a report by any person may result in the denial of the charter and sanctions, including criminal penalties, against the filer. See *id.* at 2; see also 18 U.S.C. § 1001(a)(2) (2000) (criminalizing false statements). The OCC may waive a background check if a proposed director or officer is already affiliated with another financial institution. See COMPTROLLER'S LICENSING MANUAL, BACKGROUND INVESTIGATIONS, *supra* note 38, at 5; AUSTIN, *supra* note 24, at 1002 (discussing the importance of full disclosure regarding the background of officer or director).

group.⁴² After the charter application is filed, the OCC conducts a field investigation of the proposed bank and, if it is satisfied, it grants preliminary approval, which enables bank capital-raising and organization to commence.⁴³ The OCC's step-by-step checklist of the organizational process places considerable emphasis upon continuous regulatory review of management.⁴⁴ During the organizational phase, moreover, the spokesperson for the organizing group must alert the OCC to any significant changes in the application, which would include any change in directors, the CEO, or other officers (as well as any new or updated background information about them).⁴⁵ Bank directors and officers are also warned that the OCC will monitor them after the chartering.⁴⁶

It is important not to overemphasize bank regulatory gatekeeping of management, for chartering itself is a small part of the OCC's activities. The OCC spent only 3.2% of its resources on chartering in its 2005 fiscal year.⁴⁷ During 2005, the OCC approved three charter applications and conditionally approved seventeen (conditional approval is the most

42. See COMPTROLLER'S LICENSING MANUAL, CHARTERS, *supra* note 25, at 24-25.

43. See *id.* at 31-32. This is the "organizational phase" before the bank opens for business. See *id.*

44. See *id.* at 66-68 (discussing the investigation of proposed management officials, as well as regulatory process to invite the proposed officer or director to rebut negative information about himself or herself, including through interviews). The OCC also examines the proposed compensation of the organizers, directors and officers and determines whether it is reasonable. See *id.* at 13. It considers excessive compensation to be an unsafe or unsound practice and will disapprove a charter application for inappropriate compensation. See *id.* at 15.

45. See *id.* at 37-38.

46. See *id.* at 89-94; see also 12 U.S.C. § 1831(I) (2000) (dictating that bank regulators must receive notice of, and pre-approve, any change of a director or officer of an inadequately capitalized or troubled institution); *id.* § 5.51(d) (requiring notice and approval be no later than ninety days prior to the person's assuming the position). The OCC explains that it can disapprove of an officer or director proposed in this situation if the appointment or election would be against the best interests of the institution. See *id.* § 5.51(e)(4) (authorizing disapproval for issues of "competence, experience, character, or integrity"); see also COMPTROLLER'S LICENSING MANUAL, CHANGES IN DIRECTORS AND SENIOR EXECUTIVE OFFICERS 2 (Jan. 2003), available at <http://www.occ.treas.gov/corpbok/group3/public/pdf/ChangesinDirectorSEO.pdf> (noting that it "will scrutinize more closely a person with previous banking experience in a failed or troubled financial institution").

47. See COMPTROLLER OF THE CURRENCY, ANNUAL REPORT: FISCAL YEAR 2005, ENSURING A SAFE AND SOUND NATIONAL BANKING SYSTEM FOR ALL AMERICANS 34 (Oct. 2005), available at <http://www.occ.treas.gov/annrpt/annual.htm> (costing \$15 million); see also COMPTROLLER OF THE CURRENCY, ANNUAL REPORT: FISCAL YEAR 2004, THE NATIONAL BANKING SYSTEM: BACKBONE OF A STRONG U.S. ECONOMY 25 (Oct. 2004), available at <http://www.occ.treas.gov/annrpt/annual.htm> (noting that it spent only 4% of its resources on chartering in that fiscal year for a cost of \$16.4 million); COMPTROLLER OF THE CURRENCY, ANNUAL REPORT: FISCAL YEAR 2003, THE VALUE OF A NATIONAL BANK CHARTER 11 (Nov. 2003), available at <http://www.occ.treas.gov/annrpt/annual.htm> (noting costs of \$11.6 million and \$11.3 million, respectively, in 2003 and 2002).

common outcome).⁴⁸ Its charter denials, which are infrequent,⁴⁹ occasionally are based upon its screening of management, when it determines that the organizing group, directors, or officers (or all three) are incompetent or not the proper persons to operate a national bank.⁵⁰ In its denial of a charter application in 2003, for example, the OCC concluded that the proposed senior executives, who had banking and executive experience, did not have sufficient experience in their designated executive positions in the proposed bank.⁵¹ Even when it conditionally approves a

48. See COMPTROLLER OF THE CURRENCY, ANNUAL REPORT: FISCAL YEAR 2005, *supra* note 47, at 35; see also COMPTROLLER OF THE CURRENCY, ANNUAL REPORT: FISCAL YEAR 2004, *supra* note 47, at 26 (approving nine charter applications and conditionally approving twenty-seven). During 2003, it received twenty-nine applications for a charter (the same as in 2002), approved one, and conditionally approved thirteen. See COMPTROLLER OF THE CURRENCY, ANNUAL REPORT: FISCAL YEAR 2003, *supra* note 47, at 22. It appears that fourteen applications were withdrawn, and some of these withdrawals are no doubt due to regulators' problems with proposed bank management. See *id.*

49. Published OCC decisions show that there was no denial of an application in calendar years 1998, 1999, 2000, 2002 and 2005, one denial each in 2001 and 2003, and two each in 1997 and 2004. See Comptroller of the Currency, <http://www.occ.treas.gov/interp/monthly.htm> (last visited May 13, 2006).

50. Because confidential information is often extracted, it is not always easy to determine why an application was denied from the published decisions of the OCC. See Comptroller of the Currency: Corporate Applications, <http://www.occ.treas.gov/interp/monthly.htm> (last visited June 26, 2006). Yet it is sometimes possible from these edited decisions to conclude that the OCC denied a particular application because of its concerns over management. For example, as the OCC stated in Signature Bank of California, OCC Corporate Decision 2004-4, 2004 WL 370732 (O.C.C.) at 1 (Jan. 15, 2004):

In evaluating an application to charter a national bank, the OCC considers, in part, whether the proposed bank has competent management, including a board of directors, with ability and experience relevant to the types of services to be provided by the bank. [deleted material] This also results in our finding that the senior executive officers are unable to compensate for the limited banking experience of the proposed board of directors.

Id. See also OCC Corporate Decision 2001-9, Security National Bank (Apr. 18, 2001), available at 2001 OCC Ltr. LEXIS 20 (observing that "[t]he organizing group failed to select and/or identify management skills needed to successfully offer the proposed line of bank products and services"); OCC Corporate Decision 1997-64, First Value Bank, National Ass'n (July 14, 1997) (denying this application and discussing how the organizers, including the proposed bank chief executives, were unfamiliar with the proposed operating plan).

51. See OCC Corporate Decision 2003-8, Re: Rock Asia Capital Bank, 2-4 (June 18, 2003). In that decision, the OCC explained:

Generally, strong charter proposals include executive officers that have served in a similar position in another bank, which was operated in a safe and sound manner. If the officer candidate has not served in the same or a similar position, we expect the candidate to possess comparable experience or skills relevant to the

charter application, the OCC may impose conditions mandating changes to bank management that an organizing group must meet to receive the charter.⁵²

position. If the officer lacks relevant experience, the OCC assesses the strength of the officer by considering the extent of the proposed candidate's experience, his or her skill set for the position, and the complexity of the bank's business plan. After considering the qualifications of the proposed officers, the OCC determined that the overall management team was not strong.

While all of the three officer candidates—for chief executive officer (CEO), chief credit officer (CCO) and chief financial officer (CFO)—have banking experience, none have served in their particular role before. As the candidates are currently employed elsewhere, their names are not noted here.

The proposed CEO is a senior executive vice president of a large California bank with 20 years of prior banking experience. He has not been the CEO of a bank before, although he has extensive experience in management of the bank's branching network, and presently is head of the bank's commercial lending division. If a candidate for CEO has not served as a CEO before, the OCC, as here, evaluates other factors to determine if the overall management team is strong to compensate for any limited experience by a proposed officer.

The proposed CCO has prior banking experience. However, he has not been employed by a bank since 1994, and has not originated a loan since that time, so he lacks recent relevant direct experience. He has never served as the CCO of a bank before. In our interview with the proposed CCO, he stated that he will not directly supervise any of the lending staff and that he will not originate any loans himself. Given this employment record, and as a result of information obtained during our interview of the candidate, we do not believe that the proposed CCO could function in that role without support from others.

The proposed CFO has extensive experience as a bank cashier and controller. However, she has never served as a bank's CFO. For the last four years she has worked as the CFO of a non-bank investment company. She has limited experience in bank asset/liability management and has never managed a bank investment portfolio. We do not believe the proposed CFO could function in that role without support from others.

Id. See generally OCC Corporate Decision 1997-59, Re: Application to Charter Banco de Prestamos National Bank (July 7, 1997) (expressing similar concerns about applicant's management).

52. See, e.g., OCC Conditional Approval 633, Re: Charter Application, T Bank National Ass'n, 2-3 (Apr. 16, 2004) ("T Bank shall, if required by the Assistant Deputy Comptroller, Dallas North Field Office, establish a single Chief Financial Officer (CFO) position and hire an individual satisfactory to the OCC to fill the position."). It is beyond the scope of this Article to examine the chartering decisions of state banking regulators. However, an organizing group seeking a state bank charter would generally need to apply as well to the FDIC to obtain deposit insurance, unless it was uninterested in accepting retail deposits. Like the OCC, the FDIC may reject an application for insurance because of its concerns over the ability, experience, or character of the chartering bank's management, and its rejection essentially amounts to a denial of a charter. The FDIC web site provides access to its decisions. See FDIC Enforcement Decisions and Orders, <http://www.fdic.gov/bank/individual/enforcement/index.html> (last visited May 20, 2006). In a few of the decisions that deal with a rejection of an application for insurance, the rejection was premised

My point in this overview of bank regulatory gatekeeping is simple. Those who are named as officers and directors in a charter application become acquainted with bank regulators during the chartering and are aware that they will be subject to regulatory scrutiny—not just during the application process but so long as they remain in their positions with the bank. The officers and directors also learn that, because banks are informed with the public interest, there are governmentally-established standards of conduct for them and bank regulators will monitor their compliance with these standards.

B. Banking Regulators' Standard Setting, Monitoring of Management, and Enforcement of Managerial Standards

Bank regulators' oversight of bank directors and officers does not end once a bank is chartered. It continues so long as the individuals are in their respective positions. Regulators establish detailed standards of conduct for directors and officers and monitor individual compliance with them. If directors and officers fail to meet the standards, regulators can take disciplinary action against them, which can include suspension and removal from the financial institution and even a lifelong ban from the industry. They can also refer the matter to federal prosecutors. The following subsections give a broad overview of the standards and discuss the bank regulatory monitoring of compliance with, and enforcement of, those standards.

1. Standards of Conduct for Bank Directors and Officers

Historically, the standards of conduct for bank officers and directors were straightforward because they reflected the relative simplicity of a banking business that consisted primarily of taking deposits and making commercial loans. Bank directors and officers were to supervise and manage these activities and not benefit personally from their positions.⁵³ As time has passed, however, the business of banking has changed significantly because banks and their affiliates increasingly have been allowed to engage in other kinds of financial, and even commercial,

upon the shortcomings of proposed management. *See, e.g., In re Application for Federal Deposit Insurance, Bank of Michigan, Denial of Petition for Reconsideration*, FDIC 94-162aa (Oct. 18, 1994) (denying application for insurance because individual who would be chairman, CEO, and controlling shareholder of applicant had previously been disciplined in his employment with a national bank for commingling personal and banking assets). The lack of denials, as in the case of OCC chartering decisions, may reflect elimination of organizing groups with questionable proposed management early in the state chartering process, which means that the FDIC rarely has to take this drastic action.

53. *See* Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 *FORDHAM L. REV.* 501, 521 (1989).

activities.⁵⁴ As a result of this change, bank regulators take two approaches to the standards of conduct. First, partly in response to management scandals, they have added more detailed standards.⁵⁵ Second, they have left some management behavior, as well as the institution's activity, to self-regulation by the bank.⁵⁶

The standards of conduct for bank directors are those expected of a director of any business, though they are adjusted for banks' traditional lending and deposit-taking, and are familiar to a student of corporate law.⁵⁷ They include the basics of the duty of care: to know and keep informed about the bank's business environment, which includes its peculiar legal environment; to hire and supervise competent management; to adopt an appropriate committee structure, including committees either required or customary for a bank's business; to engage in ongoing monitoring of management and the bank through the use of internal and external control systems; to oversee business performance; and to serve community credit needs.⁵⁸ In effect, banking regulators tell directors to supervise their bank's business and then to explain to them what the business is.⁵⁹ The regulators emphasize that a director must comply with the other "classic" director's duty: to place the institution's interests above the director's own, that is, to avoid conflicts of interest.⁶⁰ In this regard, bank regulators enumerate

54. The culmination of this process was in the Gramm-Leach-Bliley Financial Modernization Act, which allowed banks and their holding companies to enter a broad range of financial activities through a special bank subsidiary or the affiliates of what is now called a financial holding company. See Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12, 15, 16, 18 U.S.C.).

55. See Garten, *supra* note 53, at 546.

56. See *id.* at 549-50 (questioning whether, as bank activities become broader, bank regulators can keep up with monitoring); MCCOY, *supra* note 23, at § 1.04.

57. Federal banking authorities provide directors with publications that set forth the basic standards of behavior expected of them. See, e.g., COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK, *supra* note 21; FDIC, POCKET GUIDE FOR DIRECTORS (reprinted Feb. 2003), available at <http://www.fdic.gov/regulations/resources/directors/index.html> [hereinafter FDIC, POCKET GUIDE]; see also DOUGLAS V. AUSTIN, FINANCIAL INSTITUTION DIRECTOR'S HANDBOOK (1999).

58. See COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK, *supra* note 21, at 19, 23, 25, 31, 36, 43; FDIC, POCKET GUIDE, *supra* note 57, at "Keep Informed"; see also AUSTIN, *supra* note 57, at 22-24, 30, 33-38; COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK, *supra* note 21, at 70-73 (telling a bank director that he or she should attend meetings, review materials beforehand, ask questions and investigate, understand audits or any communication from a regulator, and exercise independent judgment).

59. For example, the OCC explains at length that banking is about managing risks and then describes the kinds of risks that face a bank. See COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK, *supra* note 21, at 10-15, 49-64 (identifying the main policies in the banking business).

60. See *id.* at 73-76, 79; AUSTIN, *supra* note 57, at 47.

the insider abuses that a bank director should avoid.⁶¹ Since, moreover, an important duty of bank directors is to comply with banking law, bank regulators explain to directors the laws that apply to a bank's traditional businesses.⁶²

As the business of banking evolves and becomes more complex, bank regulators establish more standards and policies for directors and officers with respect to a bank's expanded activities. However, they have often done so belatedly, and only after the activities have led to bank failures or to other serious banking problems.⁶³ A notable example in this regard is the requirement of an internal control system that permits bank managers to monitor the bank's activities and their compliance with the law. A bank must have a system of internal controls, the effectiveness of which is certified in a report by the CEO and the CFO of the bank, who also attest to their responsibility for preparing financial statements and to the bank's compliance with laws assuring its safety and soundness.⁶⁴ The same law calls for banks to have a board audit committee composed of outside, independent directors who review bank management's reports, an independent accounting firm's evaluation of those reports, and that firm's audits of the bank.⁶⁵

61. See COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK, *supra* note 21, at 64-67; FDIC, POCKET GUIDE, *supra* note 57, at "Avoid Preferential Transactions."

62. See COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK, *supra* note 21, at 83-93.

63. For example, in 1991 Congress mandated that federal banking regulators develop standards to maintain the "safety and soundness" of their regulated institutions. See 12 U.S.C. § 1831p-1 (2000) (as added by Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, Pub. L. No. 102-242, 105 Stat. 2267). These safety and soundness standards were promulgated by financial regulators in 1995 and are found at 12 C.F.R. § 364 (2005).

64. See 12 U.S.C. § 1831m(b) (2000); 12 C.F.R. § 363.2(b), app. A (2005); see also *id.* § 363, app. A (2005). See also 12 U.S.C. § 1831m(c) (2000) (requiring independent public accountants to report on management's certification on internal controls); 12 C.F.R. § 363.3(b) (2005). This certification requirement, too, was added in 1991 by FDICIA in response to scandals in financial institutions where bank management was found not to be monitoring expanded activities in the institution. It presaged the management certification obligations that would be imposed on public firm CEOs and CFOs a decade later by Sarbanes-Oxley. See MCCOY, *supra* note 23, at § 14.04[c][1]; *infra* notes 164-65 and accompanying text.

65. See 12 U.S.C. § 1831m(g) (2000); 12 C.F.R. § 363.5(a), app. A (2005). In addition, a large depository institution (having assets over \$3 billion) must have an audit committee, composed of outside, independent directors, with at least two members with banking and financial management expertise, with its own outside counsel, and this committee cannot include representatives of bank customers. See 12 U.S.C. § 1831m(g)(1)(c) (2000); 12 C.F.R. § 363.5(b), app. A (2005). In 1996, Congress amended the statute to allow the FDIC to promulgate rules allowing the composition of an audit committee of large institutions to be made up of only a majority of outside independent directors. See Economic Growth and Regulatory Paperwork Reduction Act of 1996, Pub. L. No. 104-208, 110 Stat. 3009-419. Yet the FDIC declined to exercise its authority on this subject, because it failed to find a problem with the committee composition. See FDIC Independent Audits and Reporting Requirements, 62 Fed. Reg. 63,256,

Bank regulators give bank directors simplified guidelines about internal controls and the typical problems those controls may reveal. In one guidebook, the OCC explains the fundamentals of internal controls and provides a basic questionnaire that will help directors understand whether their institution's controls are adequate.⁶⁶ In a more recent guidebook, the OCC warns directors about the changing nature of banking and the enhanced need for them to monitor their institutions for significant risks.⁶⁷ It then reviews measures of banking financial performance and warns directors about specific problems (red flags) that the measures can reveal.⁶⁸ The red flags identified by the OCC are sometimes amusing. For example, bank regulators ask directors to investigate whenever key employees decline to take a vacation!⁶⁹

Indeed, the bank regulatory guidelines for officers and directors are comprehensive in their coverage of each aspect of a bank's business and are constantly updated to deal with new activities approved for banks. The OCC provides a handbook that is primarily designed to guide bank examiners in their reviews of banks, though it also provides recommendations to bank management to help guide their business decisions and legal compliance.⁷⁰ The handbook covers every kind of bank business, from liabilities to capital and assets.⁷¹ From time to time, moreover, bank regulators provide special advice on bank activities that pose particular problems.⁷²

63,256 (Nov. 28, 1997); MCCOY, *supra* note 23, at § 14.04 n.247.

66. See COMPTROLLER OF THE CURRENCY, INTERNAL CONTROLS: A GUIDE FOR DIRECTORS 3-4, 7 (2000), available at <http://www.occ.treas.gov/IntCtrl.pdf> (questioning directors about their internal control system and their access to information about compliance or noncompliance with an institution's policies and procedures).

67. See COMPTROLLER OF THE CURRENCY, DETECTING RED FLAGS IN BOARD REPORTS: A GUIDE FOR DIRECTORS 1 (Oct. 2003), available at http://www.occ.treas.gov/rf_book.pdf.

68. See *id.* at 7 (identifying possible problems with capital ratios), 9-10 (noting red flags about loan portfolio), 13 (discussing problems in asset growth, including growth through products for which the institution has little expertise), 22-23 (explaining warnings about interest rate risks and problems involving the bank's investment portfolio), 26-27 (identifying problems in banks' increasing use of off-balance sheet activities and derivatives), 29-30 (discussing potential warning signs of derivatives, including use of complex or illiquid derivative contracts), 32 (noting red flags concerning asset securitization deals).

69. See *id.* at 37 (noting red flag of employees in key positions not going on vacation or not being absent for two consecutive weeks during the year). The implication here is that, if employees are reluctant to go on vacation, they may be engaged in fraud, for they would fear that someone might discover their improper dealings while they were on vacation.

70. See COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: INTRODUCTION 4 (July 1994), available at <http://www.occ.treas.gov/handbook/intro.pdf>.

71. These are mainly found under the sections of the Comptroller's Handbook dealing with safety and soundness. See generally COMPTROLLER'S HANDBOOK: SAFETY & SOUNDNESS (July 1994), available at <http://www.occ.treas.gov/handbook/SS.htm>.

72. See, e.g., Interagency Statement on Sound Practices Concerning Complex Structured

Bank regulators, however, have acknowledged their own supervisory limitations, particularly with respect to large banking organizations engaged in an ever-growing number of financial activities.⁷³ They generally allow these institutions to develop their own systems of self-supervision, subject to the regulators' oversight.⁷⁴ Given the increasingly complex financial activities of the large banking organizations and the difficulties that bank regulators have keeping up with the activities and rapidly changing market practices, regulators encourage the organizations to produce their own risk assessments and supervisory guidelines.⁷⁵ They hope that practices and guidelines that prove particularly effective in one large banking organization then can be used as supervisory models for others.⁷⁶ This self-supervision does not relieve bank officers and directors of responsibility, but may in fact increase it. They are expected to understand their organization's supervisory policies and to have concluded that they are adequate for their institution.⁷⁷

2. Monitoring and Enforcement of Compliance with the Standards

The final form of regulatory oversight of bank management involves (i) monitoring and examination and (ii) discipline and enforcement. Again, the point here is only to suggest how extensive each category is, not to discuss each exhaustively. Monitoring basically occurs through bank examinations. Under the law, these on-site examinations must take place each year, although smaller institutions may be examined during an eighteen-month cycle.⁷⁸ Examinations, in turn, can lead to enforcement because problems that surface during the examination, including problems

Finance Activities, 69 Fed. Reg. 28,980 (May 19, 2004) (providing guidance on structured finance).

73. See GAO, FINANCIAL REGULATION: INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE, GAO-05-61, at 46-51 (Oct. 2004), available at <http://www.gao.gov/new.items/d0561.pdf>.

74. *Id.* at 90-91.

75. See COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: LARGE BANK SUPERVISION 5 (May 2001), available at <http://www.occ.treas.gov/handbook/lbs.pdf>.

76. See, e.g., Lisa M. DeFerrari & David E. Palmer, *Supervision of Large Complex Banking Organizations*, 87 FED. RES. BUL. 47, 47 (Feb. 2001).

77. See Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 454-75 (criticizing this regulatory approach to the supervision of large complex banking organizations).

78. See 12 U.S.C. § 1820(d) (2000); see also COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: EXAMINATION PLANNING AND CONTROL 1, 4 (July 1997), available at <http://www.occ.treas.gov/handbook/epc.pdf> (discussing how examinations of large banks may be ongoing throughout the 12-month cycle, while smaller banks may be examined either on a 12- or 18-month cycle, depending upon their asset base (less than \$250 million in asset base and lack of supervisory problems qualifies for the 18-month cycle)).

with bank management, can result in penalties to the bank and discipline of individual officers and directors.⁷⁹

Bank examinations underscore the close relationships between bank management and bank regulators, who through the examiners are literally looking over management's shoulder. A central part of the examination involves an evaluation and rating of the quality of bank officers and directors and their decision-making.⁸⁰ The examiner evaluates, for example, the executives' formulation of policies, with board approval, for the bank,⁸¹ their supervision of personnel,⁸² the development of internal control systems, including auditing and compliance with bank policies,⁸³ and the use and quality of management information systems for both financial and nonfinancial information.⁸⁴ The examiner rates management's decision-making and, if necessary, makes recommendations for informal or formal action.⁸⁵

The *Comptroller's Handbook* specifies how an examiner should assess a bank's directors.⁸⁶ It explains the expectations with respect to the conduct of directors⁸⁷ and alerts an examiner to the negligence and abuses for which to look. The examiner, who must rate the board's behavior, evaluates the adequacy of board decision-making by looking at the information the board receives and the extent of its deliberation about issues placed before it (or the absence of important issues placed before it).⁸⁸ The examiner looks at such mundane, but indicative, factors as attendance of a director at board meetings and domination of meetings by a particular director or group of directors.⁸⁹ He or she also looks at how the board sets executive compensation, whether it has an adequate committee structure, whether the board fulfills all statutory requirements with respect to it and its members, whether it has complied with any prior

79. In 2005 the OCC spent 83.4% of its resources, or \$420.3 million, on bank supervision. See COMPTROLLER OF THE CURRENCY, ANNUAL REPORT: FISCAL YEAR 2005, *supra* note 47, at 13.

80. See COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: MANAGEMENT AND BOARD PROCESSES 1 (Mar. 1990), available at <http://www.occ.treas.gov/handbook/Management1.pdf>.

81. See *id.* at 5-6.

82. See *id.* at 6.

83. See *id.* at 7-9.

84. See *id.* at 10-11.

85. See *id.* at 25-26.

86. See COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: DUTIES AND RESPONSIBILITIES OF DIRECTORS 7-8 (Mar. 1990), available at <http://www.occ.treas.gov/handbook/directors1.pdf>. There is no comparable section for management, but management is involved in all aspects of a bank's operations, and all parts of the Handbook thus ultimately guide the examiner's evaluation of it.

87. See *id.* at 2-5 (describing the duties).

88. See *id.* at 9-12.

89. See *id.* at 12.

administrative directives, and whether it has a proper relationship with its shareholders.⁹⁰

The bank examination is, in fact, the first step in enforcement. Before the examination begins, the examiner generally meets with the CEO, other senior executives, and board members to discuss the examination and its objectives.⁹¹ After the examination, the examiner conducts a meeting with top bank executives⁹² and then prepares a report for the board in which he or she recommends any necessary supervisory action, which can be either informal or formal.⁹³ A senior official of the banking agency's supervisory office then meets with the board to discuss the report and any recommendations or requirements for the bank to take corrective action.⁹⁴ The close relationship between monitoring and enforcement is even more pronounced in large complex banking institutions.⁹⁵ Under current policy, these institutions have a full-time examiner who often has an office within the bank; in essence, the monitoring and discipline of the bank never end.⁹⁶

Bank regulators have considerable disciplinary powers available if they

90. *See id.* at 12-21.

91. *See* COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: EXAMINATION PLANNING AND CONTROL, *supra* note 78, at 10.

92. *See id.* at 12.

93. *See id.* This report includes the overall rating of the institution, and the component ratings in the "CAMEL" system, as well as a risk assessment of the institution and its components. COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: BANK SUPERVISION PROCESS 26 (Apr. 1996), available at <http://www.occ.treas.gov/handbook/banksup.pdf>. Under the "CAMEL" examination rating system, one aspect of the examination (the "M") produces a rating of management. *Id.* at 2-3. The nature of the regulatory action depends upon the seriousness of the problem. For a deficiency in the bank's operation that is not serious, informal discussions with and commitments from bank management to take care of a problem may suffice, and the problem will not even be mentioned in an examination report. *See id.* at 38.

94. *See* COMPTROLLER'S HANDBOOK: EXAMINATION PLANNING AND CONTROL, *supra* note 78, at 14. In a small bank, only the examiner and a field officer of that office attend the board meeting. The respective roles of examiner-in-charge (EIC), portfolio manager (who oversees other banks), and the supervisory office are discussed in COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: BANK SUPERVISION PROCESS. *See supra* note 93, at 10, 40-42. Essentially, the EIC manages the examination (with the help of other examiners) and, if necessary, makes conclusions about a supervisory strategy. The supervisory plan is then approved by the OCC's supervisory office. Any such action is based upon the assessment of risks of the institutions and their likely decrease or increase. *See id.* at 22 (noting that there are different risk assessments for larger banks). The board members understand that they are responsible for implementing the corrective plan. *See id.* at 34. The bank can appeal to an OCC ombudsmen if it disagrees with the examination findings. *See id.* at 44; *see also* AUSTIN, *supra* note 57, at 131-32 (recommending the following to banks in responding to examinations: "The reality is—if you fight, you lose. If you cooperate, you will live to work another day. You can gain more ground from extended cooperation than through confrontation.").

95. *See* COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: LARGE BANK SUPERVISION, *supra* note 75, at 1.

96. *Id.*

are dissatisfied with management's conduct.⁹⁷ Congress greatly increased this power, both as a result of banking scandals in the 1980s and as a necessary counterweight to the expansion of banking powers and activities at that time.⁹⁸ The scandals demonstrated that bank directors and executives took advantage of the regulators' reluctance to pursue formal enforcement actions in court—the main discipline then available to regulators—if they were unlikely to be quickly resolved.⁹⁹ Accordingly, the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)¹⁰⁰ and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)¹⁰¹ expanded the administrative enforcement powers of bank regulators, particularly with respect to bank officers and directors.¹⁰²

The heart of these powers lies in 12 U.S.C. § 1818.¹⁰³ This section, which both FIRREA and FDICIA enhanced, empowers bank regulators to seek “cease-and-desist” orders against officers and directors (among others) for any “unsafe or unsound practice in conducting the business of . . . [a] depository institution” or for a violation of “a law, rule, or regulation, or any condition imposed in writing by the agency.”¹⁰⁴ These

97. See, e.g., MACEY ET AL., *supra* note 4, at 661-722 (giving examples of regulator's enforcement power).

98. See AUSTIN, *supra* note 57, at 119-23; MCCOY, *supra* note 23, at § 6.02[1] (discussing safety and soundness guidelines). As Professor McCoy discusses, the enhanced prudential supervision was accompanied by other forms of bank regulation, including regulation through capital requirements and through transactions with affiliates and lending limits. See MCCOY, *supra* note 23, at § 6.02 (discussing capital), at § 6.04 (discussing lending limits), and at § 6.05 (explaining transactions with affiliates).

99. See MCCOY, *supra* note 23, at § 13.01 (noting how formal regulation resulted in severe penalties for individuals), § 13.02 (noting that private parties manipulated the informal agreement process to their benefit); see also AUSTIN, *supra* note 57, at 121 (“Although there are still some elements of discretionary management, regulators are allowed far less freedom and leeway than before 1989 and 1991.”).

100. Pub. L. No. 101-173, 103 Stat. 183 (1989) (codified in various sections of 12, 15, and 18 U.S.C.).

101. See *supra* note 63.

102. *But see* Garten, *supra* note 53, at 549-50 (questioning whether bank regulators with their new disciplinary powers can adequately keep up with bank managers with their expanded bank powers).

103. See 12 U.S.C. § 1818 (2000).

104. See 12 U.S.C. § 1818(b) (2000). This subsection was added in 1966 by Pub. L. 89-695, title II, sec. 202, 204, Oct. 16, 1966, 80 Stat. 1046, 1054. It was expanded by FIRREA to reach beyond officers and directors to “institution affiliated parties” (which would include outside professionals working for the bank). See MCCOY, *supra* note 23, § 13.03[1][a]. On the definition of “unsafe and unsound practices,” see Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175, 196-211 (1995) (discussing the formulation and application of the standards). FDICIA mandated that bank regulators adopt standards for safety and soundness, see 12 U.S.C. § 1831p-1

orders are issued in an administrative proceeding before an administrative law judge.¹⁰⁵ Contrary to its name, the order can also require an institution or person to take affirmative action (as opposed to refraining from action), such as requiring a bank to employ “qualified officers or employees.”¹⁰⁶ Because obtaining a cease-and-desist order can take time, with a notice of charges followed by a hearing, § 1818 empowers bank regulators to issue a temporary cease-and-desist order if the institution is threatened.¹⁰⁷

Among the most significant powers of bank regulators is the authority to suspend, remove and permanently ban officers and directors. The power to remove officers and directors has been available to regulators since 1933,¹⁰⁸ although FIRREA and FDICIA have considerably enhanced it. If a bank regulator determines (i) that an officer or director has violated the law, engaged in an unsafe or unsound practice, or violated his or her fiduciary duty, (ii) that the act or omission has injured the institution or its depositors, and (iii) that it involves personal dishonesty or willful or continuing disregard for the safety and soundness of the institution, the regulator may seek an order to remove the officer or director.¹⁰⁹ As in a cease-and-desist order, the law of removal provides for a hearing before an administrative judge¹¹⁰ and also for a temporary suspension whereby an agency can remove an officer or director pending the hearing.¹¹¹ Moreover, if an officer or director (or bank employee) is indicted for a felony involving dishonesty or a breach of trust, the banking regulator summarily

(2000), including standards defining excessive executive compensation, § 1831p-1(c)(1)(a), which they collectively did in 1995. *See supra* note 63. Under § 1818(b)(8), an unsatisfactory rating as to management in a bank examination counts as an unsafe and unsound practice, if the problem remains uncorrected. 12 U.S.C. § 1818(b)(8) (2000).

105. *See id.* § 1818(e)(4).

106. *See id.* § 1818(b)(6)(E).

107. *See* 12 U.S.C. § 1818(c) (2004). Under the cease-and-desist procedure, a hearing is held before an administrative law judge no sooner than thirty days after the filing of the charges. *Id.* § 1818(b)(1). The decision is issued no later than ninety days after final submission of the matter to the agency involved. *Id.* § 1818(h)(1). A subject of an order may appeal it to the Court of Appeals for the D.C. Circuit. *Id.* § 1818(h)(2). For expedited relief, upon filing of a notice of the cease-and-desist charge, the agency can issue a temporary order, directing negative or affirmative action on the part of the target, which becomes final (pending completion of the cease-and-desist proceeding) unless appealed to a federal district court within ten days; if it stands, it continues until conclusion of the cease-and-desist proceeding. *See id.* § 1818(c)(1).

108. *See* MCCOY, *supra* note 23, § 13.03[6]; Schooner, *supra* note 104, at 188 (noting that, in 1933, banking law authorized removal of directors for unsafe or unsound banking practices and citing the Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162, 193-94).

109. 12 U.S.C.S. § 1818(e) (2006).

110. Section 1818(e)(4) establishes the procedure, which is similar to the cease-and-desist proceeding, except that it allows the subject to request an earlier hearing, and the order goes into force thirty days after its issuance (unless it is appealed). *Id.* § 1818(e)(4).

111. *See id.* § 1818(e)(3). The suspension order may be appealed within ten days of its issuance. *See id.* § 1818(f).

may suspend or remove the person if necessary to maintain public confidence in the bank, and this action becomes final if the person is convicted or pleads guilty to a related offense.¹¹²

FIRREA's additions to this removal power were significant.¹¹³ It empowered a bank regulator to ban an individual who has been suspended or removed from a bank from participating in the affairs of any other financial institution or financial agency; in effect, the regulator could impose an industry-wide bar on the individual.¹¹⁴ In a related vein, FDICIA gave bank regulators the power to take "prompt corrective action[s]" with respect to undercapitalized institutions.¹¹⁵ In the case of "significantly undercapitalized institutions" or "undercapitalized institutions" that were failing to improve their capital position, these actions included the power to dismiss officers or directors, to require an election of a new board and the appointment of specified officers,¹¹⁶ and to restrict senior executives' compensation.¹¹⁷ FIRREA also enhanced civil money penalties that could be levied against officers and directors, among others,¹¹⁸ and empowered the FDIC to pursue officers and directors for claims assumed from a failed bank.¹¹⁹

112. *Id.* § 1818(g). Congress added this provision in 1966. *See* Garten, *supra* note 53, at 538. The targeted officer or director can challenge the suspension or removal before the bank regulator and appeal any final action to the Court of Appeals for the D.C. Circuit. 12 U.S.C. §§ 1818(g)(3), (h)(2) (2000).

113. *See generally* Michael P. Malloy, *Nothing to Fear but FIRREA Itself: Revising and Reshaping the Enforcement Process of Federal Bank Regulation*, 50 OHIO ST. L. J. 1117, 1146-52 (1989) (discussing the "enhancement of administrative powers under FIRREA").

114. *See* 12 U.S.C.S. § 1818(e)(6),(7) (2006); *see also* McCoy, *supra* note 23, § 13.03[6][a]. Admittedly, the agency issuing the order could later consent to the removal of this prohibition. *See* 12 U.S.C. § 1818(e)(7)(B) (2000) (demanding the written consent of the financial regulator overseeing the institution that the disciplined party would like to join as an institution-affiliated party).

115. *See* 12 U.S.C. § 1831(o).

116. *See id.* § 1831(o)(f)(2)(F).

117. *See id.* § 1831(o)(f)(4). For a critically undercapitalized institution, a regulator can restrict the payment of excessive executive compensation and bonuses. *Id.* § 1831(i)(2)(F).

118. *See id.* § 1818(i)(2) (setting forth system of three tiers of civil money penalties). For liabilities of directors of national banks for money damages, and for the three-tiers of penalties associated with them, *see id.* § 93; for liabilities of directors and officers of state banks that are members of the Federal Reserve System, *see id.* §§ 503-504. *See also* McCoy, *supra* note 23, §§ 13.03[7], 13.04.

119. *See* 12 U.S.C. § 1821(k) (2000). Criminal violations for bank fraud were also substantially increased beginning in 1984. *See generally* Michael A. Green, *After the Fall: The Criminal Law Enforcement Response to the S&L Crisis*, 59 FORDHAM L. REV. (ANNUAL SURVEY ISSUE) S155 (1991) (outlining increased penalties for, and prosecutions of banking crimes following the S&L crisis of the 1980's).

Available data show that bank regulators use these enforcement powers against bank officers and directors.¹²⁰ In 2005, of the OCC's thirty-two consensual removal orders, twelve involved senior bank officers (at the level of president or CEO) or directors; the rest concerned lower-level officers and bank employees, such as tellers.¹²¹ For 2005, of the ten cease-and-desist orders targeting individuals rather than institutions, three addressed senior bank officers (again, at the presidential level) and directors.¹²² For 2004 and 2003, the data was roughly similar.¹²³ The FDIC similarly disciplined officers and directors of state-chartered banks.¹²⁴

120. The OCC website provides some records of enforcement actions against officers and directors of national banks. See *Legal & Regulatory, Enforcement Actions*, <http://www.occ.treas.gov/EnforcementActions/> (last visited July 7, 2006) (providing a search engine for enforcement actions). Moreover, the OCC highlights its enforcement actions against top bank officers and directors. See, e.g., *COMPTROLLER OF THE CURRENCY, ANNUAL REPORT: FISCAL YEAR 2004*, *supra* note 48, at 16-17.

121. To identify removals or suspensions, it is necessary to select Prohibition Orders from the "IAP Actions" menu. See <http://www.occ.treas.gov/EnforcementActions/>. Non-consensual removal orders are issued pursuant to 12 U.S.C. § 1829 (2000) for conviction of a crime involving dishonesty. See *COMPTROLLER OF THE CURRENCY, ANNUAL REPORT: FISCAL YEAR 2005*, *supra* note 47, at 21 (listing 410 such removals in 2005). The OCC website lists these removals, but does not provide the details, so that there is no way to determine from this site whether a removal involves a director or senior officer. See <http://www.occ.treas.gov/EnforcementActions/>.

122. See <http://www.occ.treas.gov/EnforcementActions/> (follow "Personal Cease and Desist Orders" hyperlink under the "IAP Actions" menu; then follow "2005" hyperlink under the "Year" menu; then follow "Search" hyperlink). The cease-and-desist order often demands affirmative action from the disciplined party, such as avoiding the misbehavior in the future and disclosing the past discipline to a financial institution if the person is ever asked to serve again as an institution affiliated party. See, e.g., *In re David A. Barrett, Former Chairman of the Board, Guaranty National Bank*, OCC No. 2005-66 (June 24, 2005) (requiring him not to provide legal services to financial institutions in the future and, if he becomes an institution-affiliated party, to comply with laws and institutional guidelines, and imposing \$27,500 penalty).

123. In 2004, of the OCC's thirty-seven consensual removal orders, five involved senior bank officers or directors. See *supra* note 47 and accompanying text. In 2003, eleven of the thirty-nine consensual removals involved top officers or directors. See *supra* note 47 and accompanying text. For 2004, six of the fifteen cease-and-desist orders targeting individuals, rather than institutions, addressed senior bank officers and directors. See *supra* note 47 and accompanying text. In 2003, six of the twenty-one personal cease-and-desist orders reached bank officers and directors. See *supra* note 47 and accompanying text.

124. The problem is that the available data for state-chartered banks does not always clearly identify the position of the individual being disciplined in consensual removal or cease-and-desist actions. Enforcement actions against state insured banks that are not members of the Federal Reserve System are accessible through the website of the FDIC. See *FDIC Enforcement Decisions and Orders*, <http://www.fdic.gov/bank/individual/enforcement/index.html> (last visited May 20, 2006). That search engine leads to details on the position of the disciplined individual only when the action is contested and subject to an FDIC judgment. See, e.g., *In re Roque De La Fuente II, First International Bank*, Docket No. FDIC-97-31e (Feb. 17, 2004) (imposing removal and industry ban on officer and director after lengthy proceedings), available at <http://www.fdic.gov/bank/individual/enforcement/5278.html>. Indeed, the FDIC's proceedings relating to De La Fuente

Although criminal actions against bank officers and directors are handled by the Department of Justice and U.S. attorneys instead of by bank regulators, and although this is a complex area of the law, it is important to mention these actions in reference to the enforcement of standards of conduct for bank management. Just as civil enforcement powers increased for bank regulators as a result of the failures of banks and other financial institutions in the 1980s, federal prosecutors increasingly prosecuted bank officers and directors. The FBI activated a Financial Institutions Fraud Unit, which, at the beginning, concentrated on fraud by bank insiders.¹²⁵ Moreover, FIRREA increased the maximum penalty for numerous bank-related crimes from a five-year imprisonment and fines ranging from \$1,000 to \$10,000 to a twenty-year imprisonment

exemplify the circumstances when regulators seek a lifelong ban of an individual from the financial services industry. A director of a bank, De La Fuente essentially used it to make numerous loans to firms controlled by him, in violation of restrictions on insider loans. *See* *Roque De La Fuente II v. FDIC*, 332 F.3d 1208 (9th Cir. 2003) (holding that FDIC properly found that De La Fuente had violated Regulation O (restricting insider loans), but remanding case to FDIC regarding propriety of Section 23A violation (affiliate loans) and proper aspect of lifetime ban). In the FDIC proceeding of February 2004, the FDIC concluded that the lifetime ban was proper solely in light of the Regulation O violations and in order to protect the public and to punish De La Fuente. *See In re Rogue De La Fuente II*, First International Bank, Docket No. FDIC-97-31e (Feb. 17, 2004) (imposing removal and an industry ban on the officer and director following a lengthy proceeding), available at <http://www.fdic.gov/bank/individual/enforcement/5278.html>. By contrast, the Board of Governors of the Federal Reserve System's web site provides enforcement action information with respect to state-chartered banks that are members of the Federal Reserve System, bank holding companies and branches and agencies of foreign banking organizations and their parent banks, among others. *See* List of Enforcement Actions, <http://www.federalreserve.gov/boarddocs/enforcement/search.cfm> (last visited May 20, 2006). There were only two of twelve removal actions involving a top executive or director in 2005. *See id.* In 2004, there were two removal actions addressing exclusively a top executive or director. *See id.* In 2003, there was a notice of charges seeking a prohibition order against Jean Peyrelevede, former Chairman and CEO of *Crédit Lyonnais*, a defunct French bank, for a complex proceeding involving that foreign bank's disguising its acquisition of a U.S. insurance company. *See In re Jean Peyrelevede*, Federal Reserve Docket Nos. 03-041-CMP-I, 03-041-B-I, 03-041-E-I (Dec. 18, 2003) available at <http://www.federalreserve.gov/BOARDDOCS/PRESS/Enforcement/2003/20031218/attachment3.pdf>. Federal Reserve Board enforcement actions also sometimes seek to improve the performance of particular officers and directors of an institution, as well as to improve the performance of the institution's entire management. *See, e.g.*, Written Agreement between Ridgedale State Bank and Federal Reserve Bank of Minneapolis, Federal Reserve Docket No. 03-024-WA/RB-SM (July 29, 2003) (requiring the board, among other things, to conduct an outside review of its management and, on the basis of that review, to take action to improve that management), available at <http://www.federalreserve.gov/boarddocs/press/enforcement/2003/20030902/attachment1.pdf>.

125. KEITH SLOTTER, FIN. INST. CRIME UNIT, CHECK FRAUD: A SOPHISTICATED CRIMINAL ENTERPRISE (1996), <http://www.fbi.gov/publications/leb/1996/aug961.txt>. *See* <http://www.fbi.gov/hq/cid/fc/fifu/fifu.htm>. The unit explains that insider abuse has declined, to be replaced by financial fraud coming from outside the institution. *See id.*

and a \$1,000,000 fine.¹²⁶ The 1990 Crime Control Act¹²⁷ increased the maximum penalties even further, to a thirty-year imprisonment.¹²⁸ These acts, among other things, directed the U.S. Sentencing Commission to establish guidelines that would increase the sentences for these crimes,¹²⁹ authorized forfeiture of the proceeds of banking crimes,¹³⁰ and created new banking crimes particularly aimed at insiders.¹³¹

Certainly, the power of bank regulators to monitor and discipline bank management is extensive and, in some cases, draconian. No officer or director can wish to be banned for life from the banking industry (unless the alternative is prison). Yet this discipline is part of the nature of the bank officer and director position and the regulatory oversight of it. Upon becoming an officer or director, an individual has been alerted that he or she will occupy a position subject to considerable government oversight.¹³² Monitoring by bank regulators, particularly through bank examinations, reinforces this message, as well as constantly alerts him or her to bank regulatory expectations about behavior and to specific concerns about his or her performance of duties. If, then, the applicable bank regulator disciplines the officer or director or refers the matter to a federal prosecutor, generally the targeted party would have little ground for asserting that he or she was never warned about the importance of the position and the penalties for breaching its duties.

126. See Brian T. Fitzpatrick, *Congressional Re-election Through Symbolic Politics: The Enhanced Banking Crime Penalties*, 32 AM. CRIM. L. REV. 1, 3, 13 n.80 (1994). Fitzpatrick discusses how FIRREA raised the maximum penalties for the ten primary financial institution offenses and statutes from two-to-five to twenty years, criminalized a financial institution insider's obstruction of justice, extended criminal liability to "institution-affiliated" parties who violate agency prohibition or removal orders, made bank fraud a predicate offense under the Racketeer Influenced and Corrupt Organizations Act (RICO), and extended the statute of limitations for the principal banking crimes from five to ten years. See *id.* at 13-14. He refers to increased penalties for bank bribery, see 18 U.S.C. § 215 (2000), misapplication of funds, see *id.* §§ 656, 657, false entries, see *id.* §§ 1005, 1006, the submission of false documents to the FDIC, see *id.* § 1007, the making of false statements in connection with a loan or credit application, see *id.* § 1014, and bank fraud, see *id.* § 1344. See Fitzpatrick, *supra*, at 13 n.80.

127. Crime Control Act of 1990, Pub. L. No. 101-647, § 2504(b), 104 Stat. 4789 (1990).

128. See Fitzpatrick, *supra* note 126, at 14-15.

129. See 28 U.S.C.A. § 994 (2003).

130. See 18 U.S.C.A. § 982(a)(2) (2002).

131. See 18 U.S.C. § 1510(b) (2000) (criminalizing a bank officer or director's revealing the receipt of a subpoena or its contents to a bank customer, by way of FIRREA); 18 U.S.C.A. § 1032 (2002) (criminalizing knowing concealment of assets from a bank receiver or conservator, by way of the Crime Control Act); 18 U.S.C. § 1517 (2000) (criminalizing obstructing a bank examiner, by way of the Crime Control Act); *id.* § 225 (criminalizing operating a continuing financial crimes enterprise through the Crime Control Act).

132. See *supra* Part II.A.

III. PATERNALISTIC REGULATION OF PUBLIC COMPANY MANAGEMENT

The picture of regulation of bank management that emerges from the preceding Part is one of all-encompassing oversight. Bank directors and officers are screened and preapproved by bank regulators who set standards for their conduct and monitor them on an ongoing basis. Bank regulators (and federal prosecutors) have considerable power to enforce compliance with these standards.

By contrast, the SEC's regulation of management of public companies is quite different. This Part first provides a brief overview of the regulation. Historically the SEC's regulation of management through the federal securities laws was indirect because it was based on disclosure: The SEC required companies to disclose information about their officers and directors, which indirectly affected the background of these persons and their behavior. The Part next argues that Sarbanes-Oxley brought into the open a different kind of SEC regulation of public company management that has been growing over the past twenty years and is more akin to bank regulation. But the development of this regulation has been one-sided. The SEC has gained considerable enforcement powers over officers and directors in public companies, but has no comparable power to screen them, and only a limited role in setting their standards of conduct. The Part concludes by explaining the reasons for this outcome, which is due mainly to Congress's and the SEC's reactions to corporate scandals and to the SEC's institutional limitations.

A. *The One-Sided Growth of SEC Paternalistic Regulation*

Historically, in stark contrast to bank management, officers and directors of a typical public company were subject to little substantive regulatory oversight. Shareholders have the power to elect board members, who in turn appoint the senior officers.¹³³ There are no qualifications under corporate law for public company officers and directors other than that they be natural persons.¹³⁴ The selection of and standards for officers and directors are essentially industry and market issues designed to identify the

133. The Model Business Corporation Act reflects the development of corporate law jurisprudence and is often a model for the corporate law in many States. See MODEL BUS. CORP. ACT §§ 8.03(c), 8.40(b) (2004) [hereinafter MBCA]. See also FRANKLIN A. GEVURTZ, CORP. LAW 179 (2000).

134. See MBCA § 8.02 & commentary, § 8.03(a), § 8.40(b). Historically, there were qualifications for directors, but even they generally required only that directors be shareholders. See GEVURTZ, *supra* note 133, at 186. Under the internal affairs doctrine, under which the governance of a corporation is dictated by state corporate law, any such standards are part of this law. See GEVURTZ, *supra* note 133, at 35-39.

individuals with the necessary industry and professional management training and competence.¹³⁵ Standards of conduct for directors and officers have also been primarily a market issue. State law provides general guidelines for behavior of officers through agency law¹³⁶ and for directors through fiduciary duty standards of care and loyalty (which also have agency law origins) under corporate law.¹³⁷ Since the early days when obtaining a corporate charter required a special grant from a legislature,¹³⁸ outside of a regulated industry, no governmental body or agency (like bank regulators) screens the entry of individuals into the positions of public officer and director or monitors their performance.

The federal securities laws in no way empower the SEC, unlike bank regulators, to preapprove officers and directors for service in public companies. Rather, they only indirectly affect the composition of public company officers and directors by requiring a firm to disclose information about its management when it enters, and remains in, the public markets.¹³⁹ This information is extensive and could uncover embarrassing information about the officer or director.¹⁴⁰ Disclosure of this information, like all SEC-based disclosure, is supposed to have a “sunshine” effect; in this case, it should discourage inappropriate people from assuming officer and director positions because, the reasoning goes, investors will be unwilling

135. Historically, the main question for company management, and particularly company executives, was whether the executives had the training and expertise to operate the large national firms (such as the railroads) that became publicly held. *See generally* ALFRED D. CHANDLER, JR., *THE VISIBLE HAND* 130-33 (1977).

136. *See* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 *BUS. LAW.* 439 (2005) (emphasizing the agency law foundation of standards of conduct for officers).

137. *See* MBCA § 8.30 & Official Comment.

138. *See* GEVURTZ, *supra* note 133, at 20-21.

139. *See infra* notes 140, 142 and accompanying text.

140. Historically, the disclosure about officers and directors dealt with their identity, their securities holdings, their compensation and their transactions with the company. *See* 15 U.S.C. § 77aa, Schedule A(4), (7), (14), (22) and (24) (2000). It has grown considerably over the years. *See* 17 C.F.R. § 229.401(a)-(d) (2005) (requiring an identification of all directors and executives officers, including their positions and ages, as well as any arrangement or contract pursuant to which he or she was selected, and any family relationships with other officers and directors). The company must describe the business experience of the officer or director for the past five years, and any other director positions held in another public company or registered investment company. *See* 17 C.F.R. § 229.401(e) (2005); *see also* 17 C.F.R. § 229.401(f) (2005) (requiring disclosure of the involvement of a named officer or director in any of specified kinds of legal proceedings). This means that officers and directors must answer detailed questionnaires about themselves for the company at the time of its becoming public, and on a regular basis thereafter. When a company is going public, this kind of information is included in the registration statement on Form S-1. Once a company is public, this kind of disclosure is included in annual filings under the Exchange Act, *see* Form 10-K, Items 10-13, which are incorporated by reference in the company’s registration statements for future offerings on Form S-3.

to invest in a company directed and managed by them.¹⁴¹

The federal securities laws and SEC regulations do impose a few standards of conduct on officers and directors of public companies, as well as sanctions for the failure to follow them. As is well known, the standards primarily focus on ensuring the material accuracy of the company's disclosure and the officer's and director's trading in the company's securities. Officers and directors must ensure that their company, when it raises capital from the public and while it remains a public firm, complies with the disclosure requirements of the federal securities laws concerning the company's business and financial results, as well as other information deemed by Congress and the SEC to be material to investors.¹⁴² The officers and directors also have to follow standards restricting their short-term trading and insider trading in their company's securities.¹⁴³

Over the years, the standards of conduct imposed upon a public company director and officer by the federal securities laws and SEC rules have increased, yet these standards generally have been disclosure-based as well. Under the Foreign Corrupt Practices Act that amended the Exchange Act, for example, a public company has to establish internal accounting controls that would allow it to prepare accurate financial statements, and this is management's responsibility.¹⁴⁴ Additional

141. In reality, if the SEC is concerned about the quality of the executives and directors of a company doing a public offering, it has statutory powers pursuant to which it can delay or impede an offering, such as a refusal order and a stop order. *See* 15 U.S.C. § 77h (2000).

142. When a company goes public, it must file a registration statement that contains the prospectus or main selling document. The senior officers and all directors are liable for any material omission or misrepresentation of a material fact in the registration statement. *See* 15 U.S.C. § 77k(a) (2000) (reaching all directors and those who sign the registration statement, who must be the principal executive officer or officers, the principal financial officer, the controller or principal accounting officer and of a majority of the board of directors). Once public, a company must file periodic disclosure reports with the SEC, the main one of which (the Form 10-K) must be signed by the principal executive and financial officers and the majority of the board. Liability attaches to such persons for material misrepresentations or omissions in the reports. *See id.* § 78r(a). There is also potential liability under Section 10(b) of the Exchange Act, *see id.* § 78j(b), and Rule 10b-5, *see* 17 C.F.R. § 240.10b-5 (2005), for these misrepresentations and omissions.

143. To summarize baldly a complex legal area, the federal securities laws regulate trading in the company's equity securities by company officers and directors in two ways: (i) through the disclosure and short-swing penalties of Section 16 of the Securities Exchange Act, *see* 15 U.S.C.A. § 78p (2002), and (ii) through the prohibition on insider trading under Section 10(b), 15 U.S.C. § 78j (2000), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (2005).

144. *See* Pub. L. No. 95-213, title I, § 102, 91 Stat. 1494 (Dec. 19, 1977) (codified at 15 U.S.C. § 78m(b)(2) & (3)). Another celebrated example involved disclosure about executive compensation. In 1992, the SEC tried to rein in the amount of this compensation, but it could do so only indirectly by requiring a company to disclose, among other things, the relationship of the compensation to a company's financial performance. *See* Executive Compensation Disclosure, Securities Act Release No. 6940, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,003 (proposing provisions that would require a report by the Board Compensation Committee on the

standards also came from stock exchange rules.¹⁴⁵ At about the same time as the passage of the Foreign Corrupt Practices Act, for instance, the NYSE required its listed companies to have an audit committee composed only of independent directors, which indirectly affected the composition of public company boards.¹⁴⁶

SEC regulation of public company officers and directors has grown exponentially on the “back end” of enforcement, but without any SEC monitoring of the officers and directors. As the standard securities law treatise remarks, the SEC’s enforcement powers are “awesome.”¹⁴⁷ In 1989, as a reaction to an earlier wave of scandals in public companies, the SEC sought to increase its enforcement powers against officers and directors of public companies. The culmination of this effort was the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Remedies Act),¹⁴⁸ which gave the SEC the power (similar to that of bank regulators) to seek from a court a temporary suspension or permanent bar against an officer or director of a public company from serving in a similar capacity in the future if the person’s conduct “demonstrate[s] substantial unfitness to serve as an officer or director” of any issuer.¹⁴⁹

The Remedies Act also gave to the SEC several powers that are in the arsenal of bank regulators. Under the power to issue cease-and-desist orders through administrative proceedings, which is in addition to the longstanding SEC enforcement power to seek a court injunction to

bases for its compensation decisions with respect to the Chief Executive Officer and the other named executive officers, and the relationship of such compensation to company performance) (June 23, 1992); No. 6962, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,056 (Oct. 16, 1992). See generally 17 C.F.R. § 229.402 (2004) (covering standards of executive compensation disclosure). Disclosure about executive compensation is currently the subject of SEC rule-making. See Executive Compensation and Related Party Disclosure, 71 Fed. Reg. 6542 (proposed Feb. 8, 2006).

145. Under federal securities law, these internal accounting controls must be pre-approved by the SEC. See 15 U.S.C. § 78s(b) (2000).

146. See Exchange Act. Release No. 13,346, 11 SEC Docket 1945 (1977).

147. See LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1420 (2001) (“The SEC’s enforcement arsenal is now awesome.”).

148. Pub. L. No. 101-429, title II, § 201 (Oct. 15, 1990), 104 Stat. 935.

149. See 15 U.S.C.A. § 77t(e) (2002); 15 U.S.C.A. § 78u(d)(2)(2002). See Ralph C. Ferrara et al., *Hardball! The SEC’s New Arsenal of Enforcement Weapons*, 47 BUS. LAW. 33, 33-41 (1991) (describing at length the new enforcement powers, including the power to bring cease-and-desist proceedings before an administrative law judge, rather than seek an injunction before a court, against any party, and this power was modeled on the banking agencies). See generally Jayne W. Barnard, *SEC Debarment of Officers and Directors After Sarbanes-Oxley*, 59 BUS. LAW. 391 (2004) (noting that the SEC debarment power came about as a result of the Remedies Act following upon a recommendation of the Treadway Commission in 1987). Courts interpreted this provision to require egregious misbehavior on the officer or director’s part and a likelihood of future misconduct. See *id.* at 396-401; see also, e.g., SEC v. Patel, 61 F.3d 137, 141-42 (2d Cir. 1995).

discipline, among others, officers and directors of public companies,¹⁵⁰ the SEC is empowered to compel a party both to refrain from taking an action and to take a specified action.¹⁵¹ The Remedies Act also empowered the SEC to have a court impose three tiers of civil money penalties—again like those in the banking law statutes—and allowed them to be used for, among other things, violations of a cease-and-desist order.¹⁵²

B. *The Advance of Paternalistic Regulation in Sarbanes-Oxley*

It is not surprising that Sarbanes-Oxley significantly advanced SEC paternalistic regulation of public company officers and directors, for it was an acute congressional reaction to a perception of widespread scandals involving those executives.¹⁵³ Sarbanes-Oxley contributed to three types of this regulation: gatekeeping, setting standards of conduct, and monitoring and enforcement. Although it did not empower the SEC to screen public firm officers and directors, Sarbanes-Oxley mandated eligibility criteria for some public company directors.¹⁵⁴ More importantly, it significantly intruded upon state corporate law by setting certain standards of conduct for officers and directors.¹⁵⁵ In further empowering the SEC and federal prosecutors to enforce adherence to the standards, Sarbanes-Oxley clearly took a page from the bank regulatory book.

The gatekeeping aspect of Sarbanes-Oxley is indirect insofar as it imposes qualifications applicable to only some directors of a public

150. See 15 U.S.C.A. § 77t(b) (2002) (power to seek injunctions in federal court in Securities Act); *id.* § 78u(d)(1) (power to seek injunctions in federal court in Exchange Act); *id.* § 78o(c)(4) (giving SEC administrative power to compel a person to correct a report not in compliance with the law and SEC rules).

151. See *id.* § 77h-1(a); *id.* § 78u-3(a). As in the case of the similar power held by bank regulators, the SEC may also seek a temporary cease-and-desist order, although only against securities professionals, not public company officers and directors. See *id.* § 77h-1(c)(2).

152. See *id.* § 77t(d); *id.* § 78u(d)(3). The money penalties range, for a natural person, from \$5,000, \$50,000 to \$100,000, or, in each case, the gross amount of the pecuniary gain, if it is greater. See *id.* § 78u(d)(3)(B). The SEC can impose money penalties administratively only on regulated persons, such as brokers. See *id.* § 77h-1(c)(2). It must ask a court to impose them against an officer or director of a public company. See *id.*

153. The perception reflected reality. Existing evidence suggests that in the late 1990s and early 2000s a significant number of companies engaged in questionable accounting practices that were known or designed by senior management. See GENERAL ACCOUNTING OFFICE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES, GAO-03-138, at 4-9 (2002) (summarizing data on the increase in financial restatements in period 1997-2001). See generally GENERAL ACCOUNTING OFFICE, FINANCIAL STATEMENT RESTATEMENT DATABASE, GAO-03-395R (2003) (providing data about restatements from individual companies).

154. See Sarbanes-Oxley, Pub. L. No. 107-204, §§ 301, 403, 116 Stat. 745, 775-77, 787-90.

155. See *id.* §§ 403, 406-07.

company.¹⁵⁶ Since in the corporate scandals misleading financial statements disguised the real financial condition of the companies and the self-interested transactions by their executives, the basic thrust of Sarbanes-Oxley was to improve financial disclosure. As is well known, it enhanced the role of the board audit committee, which is responsible for overseeing a firm's preparation of financial statements and its financial disclosure. One reform with a gatekeeping import is the requirement that all members of a board audit committee be independent, with independence defined to ensure that a board member will have no financial or other connection to the company.¹⁵⁷ This reform was not new, because an independent audit committee had been a NYSE listing requirement for years and was a recommended and accepted best practice for public firms.¹⁵⁸ However, the new statutory requirement had a ripple regulatory effect by emphasizing the importance of and criteria for independence of a board member in other contexts.¹⁵⁹ Moreover, both the NYSE and the

156. *See id.*

157. Sarbanes-Oxley does this by prohibiting stock exchanges from listing the security of any company that does not have an audit committee formed and functioning in accordance with its standards. *See* Sarbanes-Oxley § 301, 15 U.S.C.A. § 78j-1(m) (2002). The SEC implemented § 301 by its rule-making, which shaped the stock exchange rules. *See* Standards Related to Listed Company Audit Committees, Securities Act Release No. 8220, 68 Fed. Reg. 18,788 (Apr. 16, 2003) (setting forward final Rule, 17 C.F.R. § 240.10A-3); Securities Act Release No. 8173, 68 Fed. Reg. 2638 (Jan. 17, 2003) (proposed rule). Prior to Sarbanes-Oxley, the SEC attempted to enhance the quality of audit committees by, among other things, imposing independence requirements upon the audit committee and requiring it to have a charter and its members to be financially literate. *See* Audit Committee Disclosure, Exchange Act Rel. No. 42,266, 64 Fed. Reg. 73,389 (Dec. 30, 1999); *see also, e.g.*, Self-Regulatory Organizations; Order Approving Proposed Rule Change by the NYSE, Inc., Amending the Exchange's Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto, Exchange Act Rel. No. 42,233, 64 Fed. Reg. 71,529 (Dec. 21, 1999). 15 U.S.C.A. § 78j-1(m)(3) (2002) sets forward the statutory standards of independence. The NYSE requires that a listed company have an audit committee that satisfies these statutory standards, *see* NYSE, Inc., Listed Company Manual [hereinafter NYSE] § 303.A06 (2005), *available at* <http://www.nyse.com/listed/1022221393251.html>, and its rules then explain that the standards demand that audit committee members be independent, in accordance with the general NYSE definition of independence. *See* NYSE, § 303.A07(b). The NASD follows a similar approach for the Nasdaq Stock Market. *See* NASD, Inc., Marketplace Rules [hereinafter NASD] § 4350(d)(2) (2005), *available at* <http://nasd.complinet.com/nasd/display/index.html> (adding that a committee member must not have participated in the preparation of the financial statements of the company or any current subsidiary at any time during the past three years).

158. *See, e.g., In re* New York Stock Exchange, Exchange Act Release No. 13,346, 11 SEC Docket 1945 (Mar. 9, 1977) (illustrating that the NYSE had in fact recommended that a company have a board audit committee since 1940).

159. The NYSE extended the independence requirement to the two other major board committees, the nominating/corporate governance committee (which nominates individuals for board membership and oversees a firm's corporate governance), *see* NYSE, § 303A.04(a), and the compensation committee (which sets executive compensation), *see* NYSE, § 303A.05(a). Under

NASD amended their listing rules to require that the board of a listed company have a majority of independent directors, and defined independence more strictly than before.¹⁶⁰ Even more relevant from the indirect gatekeeping perspective, Sarbanes-Oxley required a public company to have a director who is a “financial expert” on its board audit committee (in essence, someone qualified to detect financial machinations by executives) or to disclose the reason for the absence of this expert, and the SEC and the stock exchanges reinforced this requirement through their regulations.¹⁶¹

That Sarbanes-Oxley established standards of conduct for public company officers and directors is more significant, and controversial, than its indirect gatekeeping effect.¹⁶² A detailed review of those standards is beyond the scope of this Article, but a few examples make the point. For senior executives, the standards actually have punitive, enforcement-oriented importance. One of the best known Sarbanes-Oxley reforms is its requirement that a CEO and a CFO, or respective equivalents, certify the material accuracy of the firm’s public disclosure and financial statements in a firm’s quarterly and annual reports.¹⁶³ The requirement is intended to

NASD, § 4350(c)(4)(A), board nominations generally can be done by a majority of the independent directors on the board or a nominating committee of independent board members. On the independence of the compensation committee, see NASD, § 4350(c)(3) (allowing, but not requiring, a compensation committee composed of independent directors, to determine executive compensation; this committee’s tasks can be performed by a majority of the independent directors). The SEC indirectly compels companies to have a nominating/corporate governance committee through its disclosure rules by requiring disclosure of whether a company has such a committee, the identification of its members, the number of its meetings, and its functions. *See* 17 C.F.R. § 240.14a-101 Item 7(d)(1) (2005); *see also* Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Exchange Act Release No. 48,825, 68 Fed. Reg. 66,992 (Nov. 28, 2003).

160. *See* NYSE, § 303A.01; NASD, § 4350(c)(1).

161. *See* Sarbanes-Oxley § 407, 15 U.S.C.A. § 7265 (2002). The SEC implemented the statute by rule, under which a company must disclose in its annual report the identity of the financial expert (or why the audit committee has no such expert), who has certain attributes related to the statutory factors. *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177, 68 Fed. Reg. 5110, 5111 (Jan. 31, 2003) (final rule); Securities Act Release No. 8138, 67 Fed. Reg. 66,208 (Oct 30, 2002) (proposed rule); 17 C.F.R. § 229.401(h)(2) (2005). For the stock exchange requirements, see NYSE, § 303.A07(a); NASD, § 4350(d)(2)(A). The exchanges went further in this regard by mandating that all audit committee members be (or become) financially literate. *See* NYSE, § 303.A07(a) & Commentary; NASD, § 4350(d)(2)(A).

162. *See, e.g.,* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521, 1568-85 (2005) (arguing that the provisions dealing with standards of conduct were added irresponsibly by Congress under pressure from corporate governance entrepreneurs with no cost/benefit analysis).

163. *See* Sarbanes-Oxley § 302, 15 U.S.C.A. § 7241 (2002) (setting out certification responsibilities); Sarbanes-Oxley § 906, 18 U.S.C.A. § 1350 (2002) (subjecting executives to

prevent executives from ordering their subordinates to prepare misleading disclosures and statements and then laying the blame on these subordinates. The requirement also imposes minimum standards of officer behavior with respect to establishing and monitoring a firm's system of controls for recording transactions and representing the firm's performance.¹⁶⁴ Another example is the restriction on executives borrowing money from their firms to prevent them from taking excessive loans from their companies, as happened in WorldCom.¹⁶⁵

Sarbanes-Oxley's imposition of standards of conduct on public company directors was designed less to be punitive and more to enhance the board's monitoring of executives. These standards made inroads into firm corporate governance, although in an expected way since for the most part they codified existing market practice. An example suffices. Sarbanes-Oxley articulated the minimum responsibilities of a board audit committee, specifying that it, and not senior executives, is responsible for appointing and supervising the independent accounting firm, for receiving complaints about financial matters (including anonymous ones from employees), and for selecting its own advisors.¹⁶⁶ The stock exchanges,

criminal penalties for false certifications). The SEC promulgated Exchange Act Rules 13a-14 (17 C.F.R. § 240.13a-14 (2005) and 15d-14 (17 C.F.R. § 240.15d-14 (2005)) for companies to follow in making the certification. *See* Certification of Disclosure in Companies' Quarterly and Annual Results, Securities Act Release 8124, 67 Fed. Reg. 57,276 (Sept. 9, 2002) (final rule); Exchange Act Release No. 46,300, 67 Fed. Reg. 51,508 (Aug. 8, 2002) (revising proposed rule); Exchange Act Release No. 46,079, 67 Fed. Reg. 41,877 (June 14, 2002) (proposed rule offered before passage of Sarbanes-Oxley, made because investors were losing confidence that executives are paying attention to company disclosure); *see also* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Filings, Securities Act Release No. 8238, 68 Fed. Reg. 36,636 (June 5, 2003) (final rule under which managers of a public company must report on and certify internal control systems in their company).

164. This subject refers to internal controls for financial information and controls dealing with non-financial information in the firm, ensuring accurate disclosure to the securities markets. On internal controls, see 15 U.S.C.A. § 78m(b)(2) (2002) (addition made by the Foreign Corrupt Practices Act). There is a parallel requirement of management responsibility for internal controls in the banking statutes. *See supra* note 64.

165. *See* Enhanced Conflict of Interest Provisions, Sarbanes-Oxley § 402, 15 U.S.C.A. § 78m(k) (2002). WorldCom's Ebbers seems to have been the source of this prohibition. *See* DENNIS R. BEVESFORD, REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLD COM, INC. (Mar. 31, 2003), available at <http://files.findlaw.com/news.findlaw.com/hdocs/docs/worldcom/bdspcomm60903rpt.pdf> at 323-27. In effect, WorldCom assumed loans of \$5 billion made to Ebbers by various financial institutions. *Id.* There is no SEC rule-making on this subject. *Id.* The restriction exactly parallels the kind of restriction under banking laws on bank loans to bank officers. *See* COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK, *supra* note 21, at 85-87.

166. *See* 15 U.S.C. § 78j-1(m) (2004); *see also* 17 C.F.R. § 240.10A-3(b)(2), (3), (4) & (5) (2005). Again, the comparison with banking regulation is striking because banking law reforms in the 1990s also enhanced the standards of conduct for bank audit committees. *See supra* note 65.

with SEC approval, added other tasks for this committee, including the review of the adequacy of internal controls and the review of a firm's risk management policies.¹⁶⁷

The most significant contribution of Sarbanes-Oxley to the regulation of public company management is in its enforcement of standards of conduct for officers and directors, which is particularly punitive and akin to the enforcement powers of bank regulators and federal prosecutors as to bank management. Criminal and civil penalties are specifically tied to some of the new officer and director duties. Misleading certification by a CEO or a CFO can result in a fine ranging from one to five million dollars or imprisonment of ten to twenty years, depending upon whether the violation is knowing or willful.¹⁶⁸ Sarbanes-Oxley requires that a board audit committee have a reporting channel for whistleblowers and an officer or director who retaliates against a whistleblower may be subject both to civil and criminal action.¹⁶⁹ Other provisions punish specific officer and director misbehavior exhibited in the scandals: A CEO or a CFO must return any bonus, equity-based compensation, or profits received on his or her sale of securities during the twelve-month period following any accounting restatement, due to failure of the company to comply with financial reporting requirements.¹⁷⁰ In a similar vein, the SEC is empowered to seek a temporary order freezing an "extraordinary payment" from a public company to an officer or director.¹⁷¹

Sarbanes-Oxley's addition of the officer and director bar to SEC enforcement powers is directly comparable to the power of bank regulators. As noted above, this sanction was in existence prior to Sarbanes-Oxley, but only a court could impose it and only then upon finding the officer or director substantially unfit for service in a public

167. See NYSE, § 303A.07(c); NASD, § 4350(d)(3).

168. See Sarbanes-Oxley § 906, 18 U.S.C.A. § 1350(c) (2002).

169. See Sarbanes-Oxley § 1107, 18 U.S.C.A. § 1513(e) (2002) (providing for criminal imprisonment of up to 10 years); Sarbanes-Oxley § 806, 18 U.S.C.A. § 1514A (2002) (giving whistleblower employees a cause of action for reinstatement or damages and costs as a result of demotion, firing, and harassment due to whistleblowing). For other behavior criminalized by Sarbanes-Oxley, see 18 U.S.C.A. § 1519 (2002) (knowingly to destroy, alter or cover up documents to impede a federal investigation); 18 U.S.C.A. § 1512(c) (2002) (amending a federal obstruction of justice statute so that it reaches corrupt destruction or alteration of documents to be used in an official proceeding); 18 U.S.C.A. § 1348 (2002) (new crime of securities fraud); 18 U.S.C.A. § 1349 (2002) (new crime of attempt and conspiracy to commit securities fraud).

170. See Sarbanes-Oxley § 304, 15 U.S.C.A. § 7243 (2002).

171. See Sarbanes-Oxley § 1103, 15 U.S.C.A. 78u-3(c)(3)(A)(i) (2002); see also SEC v. Gemstar TV Guide Int'l, Inc., 367 F.3d 1087, 1094 (9th Cir.) (holding that the provision requires the SEC to show what is an ordinary payment so as to determine that a particular payment is extraordinary), *vacated en banc*, 384 F.3d 1090, 1090 (9th Cir. 2004), *rev'd*, 401 F.3d 1031, 1046-47 (9th Cir. 2005) (holding that no SEC showing of what constitutes ordinary payment is required).

company.¹⁷² Sarbanes-Oxley made two important changes to the bar power. First, it amended the standard for a court's imposition of a suspension or bar against a director or officer from "substantial unfitness" to simply "unfitness."¹⁷³ Second, and even more significantly, Sarbanes-Oxley added the power to seek the officer and director bar in administrative proceedings, rather than only in judicial proceedings, to the SEC's arsenal, applying the same "unfitness" standard.¹⁷⁴ Thus, like bank regulators, the SEC can now impose a lifetime, industry bar on an officer and director of a public company through an administrative proceeding, a penalty likely to receive considerable deference from a court.¹⁷⁵

C. *Psychological Explanations for the Increased Paternalism of SEC Regulation of Management*

What explains the SEC's increasingly paternalistic and enforcement oriented regulation of public company directors and officers? The enforcement focus of SEC regulation arises from basic human psychological tendencies or predilections. Studies indicate that individuals have a major tendency to attribute effects in complex organizations and social settings to the actions and personalities of a few key individuals, who are perceived to represent the entire organization.¹⁷⁶ Human beings are predisposed to believe that the decisions and actions of other individuals are responsible for most social outcomes, such as the failure

172. See *supra* note 148 and accompanying text.

173. See Sarbanes-Oxley § 305 (amending 15 U.S.C.A. §§ 78u(d)(2), 77t(e)(2002)); Barnard, *SEC Debarment*, *supra* note 149, at 409-19 (noting that the question is left open as to whether cease-and-desist bans require a lower showing of potential future misconduct by the SEC (requiring only a "risk," rather than a reasonable likelihood of future violations)).

174. See Sarbanes-Oxley § 1105 (amending 15 U.S.C.A. §§ 78u-3, 77h-1 (2002)).

175. See Jayne W. Barnard, *The SEC's Suspension and Bar Powers in Perspective*, 76 TUL. L. REV. 1253, 1268 (2002) (discussing why the SEC wanted to add suspension and bar powers to its existing cease-and-desist powers); see also Barnard, *SEC Debarment*, *supra* note 149, at 405-07 (arguing that the SEC wanted unfettered discretion to impose a lifetime bar on directors and officers (even if this power interferes with state corporate law)).

176. This is a case of what psychologists call the bias of the "fundamental attribution error." See generally ROGER BROWN, *SOCIAL PSYCHOLOGY* 169-94 (2nd ed. 1986) (explaining how observers incorrectly attribute internal change to the actors involved). The assumption in this discussion is that, despite their efforts to act rationally, individuals suffer cognitive limitations because their decision-making is adversely affected by unconscious biases and employs decision models inappropriate for complex reasoning tasks. The literature on these limitations, which call into question the model of individuals as rational decision-makers, is voluminous. See generally CASS SUNSTEIN, ED., *BEHAVIORAL LAW AND ECONOMICS* (2000) (collection of essays applying insights of behavioral studies to the analysis of law and policy); Symposium, *The Legal Implications of Psychology: Human Behavior, Behavioral Economics, and the Law*, 51 VAND. L. REV. 1497 (1998) (expounding on the weakness of the application of the rational choice model to economic theory).

of a company or the declaration of a war.¹⁷⁷ Another well-documented psychological phenomenon is the tendency of individuals to become overly concerned about a problem that is presented vividly to them and is constantly brought to their attention (in psychological terms, it is “salient” or “available”). This phenomenon occurs even if, as a statistical matter, the problem is not significant in comparison to other perceived risks and dangers.¹⁷⁸ For example, people commonly experience a fear of flying after a well-publicized airplane crash, often resulting in a decision to drive to their destinations instead, even though automobile travel is statistically more dangerous than airplane travel.¹⁷⁹ This way of thinking generally exposes a failure to rationally weigh the benefits of recognizing the “vivid” problem (which might be small) with the costs of the reaction or regulation (which might be large).

Taken together, these psychological tendencies may explain both the congressional and SEC focus on punishing public company directors and officers. Once a corporate scandal is revealed, it seems that the firm is not as it appeared to be. As the firm loses business and goes bankrupt, the market for its stock plummets, with a great loss of value to shareholders, creditors, and eventually, to employees. The business media highlight the loss and attribute it to senior executives in the firm, parroting the tendency of editors and reporters to look for the responsible individuals. In turn, viewers, listeners, and readers find this assessment convincing. The publicity, in turn, generates public outrage and leads people to believe that the scandal and others like it reveal a significant general problem in firms that needs to be immediately addressed in order to prevent more losses. In response to media and public pressure, companies jettison the targeted executives, who are now ironically painted as villains, despite being celebrated as business heroes a few months before. This same psychologically-oriented focus on the individual in the immediate wake of the scandals leads Congress, the SEC, and federal prosecutors to take action by punishing executives and directors, often by congressional proceeding, agency enforcement action, or criminal prosecution. Officials may also take action through punitive prospective measures with respect to public company management, incorporating legislation, regulations, and task forces. The measures include additional enforcement powers for the SEC, new categories of crimes specifically aimed at directors and officers, and the imposition of strict, almost punitive, standards of conduct on them.

177. See SCOTT PLOUS, *THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING* 180-85 (1993).

178. This is referred to as the availability heuristic. See generally JONATHAN BARON, *THINKING AND DECIDING* 210-13 (1st ed. 1988).

179. See Stan Finger, *Yes, Storms Kill . . . but so can your Tub*, WICHITA EAGLE, Jan. 19, 2005, at 1A.

This psychological theory certainly explains Sarbanes-Oxley as a reaction to the scandals in Enron and WorldCom,¹⁸⁰ and to preceding enforcement-oriented securities legislation.

This psychological explanation of increased paternalism in public company management complements other accounts of the growth of enforcement regulation generally based on a model of *rational* human behavior. For example, Professor Roberta Romano opines that members of Congress legislated Sarbanes-Oxley in reaction to public concerns about corporate scandals, fearing they would be voted out of office if they did nothing.¹⁸¹ In her view, the interest groups and political entrepreneurs favoring increased government regulation of business and corporate management took advantage of the political climate to lobby Congress to pass laws implementing regulation in line with their views.¹⁸² From a related perspective, the addition to the U.S. criminal code of new crimes targeting public company directors and executives can be viewed as symbolic action by Congress. Thus, Congress does something in reaction to the scandals, even if the newly-created crimes will have little effect since they merely duplicate existing crimes, such as mail and wire fraud.¹⁸³ In light of these revisions, business and corporate interests acted rationally in not opposing the increase in criminal liability, because they could see that additional crimes did little to change the legal risks for directors and officers. A psychological explanation would add to these accounts the view that the psychological tendencies drive, or at least add their force to, the political and self-interested motivations of the actors involved. Members of Congress, regulators, and prosecutors are not simply calculating machines, manipulating situations only to serve themselves; they, too, see corporate scandals as vivid events, caused primarily by individuals and in great need of regulation.

180. See Makoto Toda & William McCarty, *Corporate Governance Changes in the Two Largest Economies: What's Happening in the U.S. and Japan?*, 32 SYRACUSE J. INT'L L. & COM. 189, 190 (2005).

181. See Romano, *supra* note 162, at 1551.

182. See *id.* at 1523-26. The legal literature that attempts to find a rational explanation for corporate scandals and legal reforms is also voluminous. See, e.g., *infra* note 211.

183. See Romano, *supra* note 162, at 1585. On the symbolic import of new crimes that essentially criminalize behavior that is already criminal, see William J. Stuntz, *The Pathological Politics of Criminal Law*, 100 MICH. L. REV. 505, 531-34 (2001) (arguing that, by adding crimes, legislators make it easier for prosecutors to charge multiple crimes and obtain convictions or pleas, and prosecutors like their discretionary power to charge crimes as they see fit). See also *id.* at 543-44 (arguing that federal prosecutors often prosecute crimes, like white-collar crimes, that are more interesting and professionally beneficial to them, and they seek laws to help them in this prosecution); Vikramaditya Khanna, *Corporate Crime Legislation: A Political Economy Analysis*, 82 WASH. U. L.Q. 95, 117-24 (2004) (explaining that corporate criminal liability takes away attention from the liability of individual directors and officers).

This psychological account also explains the similarities in the growth of enforcement powers in the regulation of both bank and public company management. The scandals in savings and loans in the 1980s produced considerable public outrage over the alleged misbehavior of financial institution directors and officers, even though the causes of the scandals were complex and potentially inappropriately placed at management's door.¹⁸⁴ The outrage and the resulting focus on blaming bank executives and directors led Congress to give bank regulators new enforcement powers aimed at financial institution management in FIRREA (of 1989) and FDICIA (of 1991), and, in FIRREA and the Crimes Control Act of 1990, new crimes for federal prosecutors to use.¹⁸⁵ In a similar way, corporate scandals in public firms in the late 1980s and the late 1990s resulted in enhanced SEC enforcement powers and new federal crimes, respectively, in the Remedies Act (of 1990) and in Sarbanes-Oxley (of 2002).¹⁸⁶ Amid the popular outrage about management, particularly in complex business and financial areas, Congress is willing to grant more administrative, even informal, enforcement powers to the regulator, enabling it to be better able to respond rapidly to misbehavior by firm management and to prevent additional losses, and to add more crimes to the arsenals of federal prosecutors.¹⁸⁷

Yet even if the developments in both bank and SEC regulation and the federal prosecution of management as a result of scandals resemble each other in their psychological origins, the effects of these developments have been very different. More enforcement powers for bank regulators and more enumerated federal crimes add to the preexisting, all-encompassing regulation of bank management by completing the circle of both informal and formal oversight of bank directors and officers, from their entrance at

184. See PIERCE, *supra* note 18, at 75-79 (offering a concise description of the problems with savings and loans); FDIC, AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S, in HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE vol.1, § 1 at 43 (1997), available at <http://www.fdic.gov/bank/historical/history/index.html> [hereinafter FDIC, HISTORY OF THE EIGHTIES].

185. See *supra* notes 97-119, 125-31 and accompanying text; see also Fitzpatrick, *supra* note 126, at 29-31 (arguing that the new crimes in FIRREA and the CCA of 1990 were simply symbolic action to respond to fears of ordinary Americans about threats to the banking system).

186. See Barnard, *SEC Debarment*, *supra* note 149, at 394-96 (noting that the origin of the SEC's enforcement power in the Remedies Act came at the end of the 1980s after another decade of financial exuberance and investor losses from financial fraud).

187. This approach also responds to the tendency of regulators, borne of their authority over and expertise in a particular area of business or finance, to wish to conduct their regulatory mission without interference from outsiders (including the courts). See Barnard, *SEC Debarment*, *supra* note 149, at 405-11 (discussing the Sarbanes-Oxley extension to the SEC of the power to impose an industry bar on public company directors and officers, observing that it was done with little Congressional consideration and little expression of dissatisfaction with courts' imposition of the bar).

the bank's chartering to their exit (often at the bank's demise). By contrast, the result for public company management is out of proportion, with a growth of enforcement powers for the SEC and new federal crimes, but little to balance them on the gatekeeping, standards-setting, or monitoring sides.

IV. BALANCING SEC PATERNALISM

This Part makes three arguments. First, it emphasizes that the back-ended enforcement of SEC regulation and federal prosecution of public company directors and officers is inappropriately one-sided, and thus unfairly penalizes those officers. This Part also highlights the practical factors that make it difficult, if not impossible, for the SEC to apply the same extensive oversight of management exercised by bank regulators to public companies. Second, this Part uses social psychology to explain the inability of public company boards and corporate service professionals to effectively monitor senior executives, particularly on "self-dealing."¹⁸⁸ It also discusses why the model of bank regulation management involving an outside monitor could still be effectively implemented in public firms. Third, the Part offers a proposal that would draw from this bank regulatory model to correct the monitoring problem in public companies and, in turn, add balance to the SEC's current enforcement emphasis. Under the proposal, a specified group of public firms would have an SEC examiner monitor the corporate governance of the firm, acting as a link or mediator between the board and senior executives on the one hand, and the SEC on the other.

A. *Equitable and Practical Problems with SEC Regulation of Management*

The comparison between the regulation of banks and the SEC's regulation of public company management shows that SEC regulation is inappropriately concentrated on the back end of enforcement. The harshness of the penalties that can be placed on public firm management, coupled with the discretionary nature of enforcement by the SEC and federal prosecutors, is not accompanied by any close, ongoing relationship between the directors and officers and the SEC. This disparity has both equitable and practical consequences. The close relationship between the bank regulator and the bank management justifies the regulator's enforcement powers and proves beneficial to bank officers and directors. Bank directors and officers receive approval, even conditional approval,

188. Company executives and directors are under an obligation to act in the best interests of the corporation and not for their own interest. Self-dealing means that, when making a corporate decision or taking a corporate action, they act for themselves. See generally 1 A.L.I., *Principles of Corporate Governance* § 501, Reporter's Note 205-08 (1994).

from regulators at chartering. They are then given extensive guidance, both initial and ongoing, on proper conduct as regulators advise them on their weaknesses and become familiar with their strengths through regular interactions and examinations. Although regulators can always abuse their discretionary enforcement powers, the exercise of these *ex post* powers is fair since it accompanies, and lends support to, the *ex ante* gatekeeping, standard setting, and monitoring.

The SEC's discretionary approach to administrative enforcement powers starkly contrasts with its distant and formal relationship to public firm management that is primarily based upon a company's disclosure. That is not to say that indirect contacts do not occur between a public company's executives and SEC staff. For example, when a company is going public or when it later, as a "seasoned" issuer, does an innovative capital-raising campaign or a complicated transaction falling under the SEC's jurisdiction, executives may respond to SEC staff concerns. However, these responses are generally disclosure-related and dealt with by the company's securities lawyers and legal counsel.¹⁸⁹ The SEC and its staff may discuss issues with, receive feedback from, and be lobbied by, company executives during SEC rule-making, although again, this communication is likely to be handled primarily by lawyers or bar committees. Once it becomes public, a company's relationship with the SEC is also mediated through the stock exchange(s) listing the company's securities since the SEC supervises SROs like the exchanges.¹⁹⁰ Yet even the emphasis under stock exchange rules is also on the company's disclosure, and not on the conduct of its directors and officers (unless the conduct is disclosure-related).¹⁹¹

These episodic contacts related to disclosure do not begin to approximate the extensive relationship between bank management and bank regulators. Apart from a company's disclosure, the SEC has little opportunity to evaluate the quality of its directors and officers and to advise them on improving their individual performance.¹⁹² The SEC does not send members of its staff to spend months examining or inspecting

189. See LOSS & SELIGMAN, *supra* note 147, at 1383-84.

190. See generally 15 U.S.C. § 78s (2000) (detailing oversight of public companies).

191. *Id.*

192. Out of concern that the SEC was ignoring the disclosure of established public companies, in Section 408 of Sarbanes-Oxley Congress mandated that the SEC review a company's filings at least once every three years. See Sarbanes-Oxley § 408, 15 U.S.C.A. § 7266 (2002). The SEC had its Division of Corporation Finance staff conduct a review of the annual reports of Fortune 500 companies and summarized their disclosure problems. See generally Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies, <http://www.sec.gov/divisions/corpfm/fortune500rep.htm> (last visited May 20, 2006) (reporting on the SEC's 2002 Monitoring of Fortune 500 companies).

public companies.¹⁹³ When a problem develops with a company, or with a director or officer of that company, the SEC mobilizes its enforcement powers and refers the matter to the Department of Justice, enabling possible application of a full range of administrative sanctions.¹⁹⁴ An individual director or officer's first direct contact with the SEC is thus likely to be with the SEC's Division of Enforcement.

Although, as discussed earlier, the SEC increased its role in gatekeeping and setting standards for management conduct in Sarbanes-Oxley, it can go only so far in this direction. Unlike bank regulation, the basic jurisdiction of the SEC is company disclosure, not governance.¹⁹⁵ Congress could change the law and extend the SEC's jurisdiction to include this governance, but for federalist reasons it has done this only intermittently, with most of the SEC's gatekeeping and standard-setting being indirect because it is disclosure-based.¹⁹⁶ Moreover, even if it was possible for this jurisdictional obstacle to SEC regulation of substantive management behavior to be set aside, there would still be practical limitations to the SEC's ability to regulate in this way. Public companies pervade many different industries, in contrast to banks, which until recently basically focused on deposit taking and commercial lending. The SEC does not have staff with the competence to set detailed standards of conduct for directors and officers in so many industries nor does it have the resources to hire such staff (if such could even be found).¹⁹⁷ The SEC concentrates its limited resources on enforcement of disclosure violations in public companies; it cannot possibly apply a bank regulatory approach to the regulation of public company management without an extraordinary growth in staff resources and competence that is practically impossible and conceptually difficult to imagine.

For the same reasons, the SEC cannot define and enforce "entrance" criteria for public company directors and officers, other than indirectly

193. This is why the SEC requires the following legend on every prospectus filed under the Securities Act, indicating that SEC review is not a merit review of the company: "A legend that indicates that neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of the securities or passed upon the accuracy or adequacy of the disclosures in the prospectus and that any contrary representation is a criminal offense." 17 C.F.R. § 229.501(b)(7) (2005).

194. See generally *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.sec.gov/about/whatwedo.shtml> (discussing SEC functions, including those of the Division of Enforcement).

195. See *LOSS & SELIGMAN*, *supra* note 147, at 31; see also *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479-80 (1977).

196. See *supra* note 140.

197. Indeed, its main competence lies in setting standards of conduct for those financial intermediaries, like broker-dealers and investment advisors and companies, over which it has jurisdiction. See generally 15 U.S.C.A. § 78o (2002) (detailing the regulation of broker-dealers); *id.* §§ 80a-1 to -64 (noting regulations for investment companies and advisors).

through its disclosure requirements.¹⁹⁸ Even if it had the jurisdiction, the SEC staff would be hard pressed to do for public companies what bank regulators now do in bank chartering: to evaluate whether a public company has experienced directors and officers who are competent to administer the firm's business plan. The number of industries of the companies whose management suitability the SEC would have to review would overwhelm the SEC's resources and sorely test its staff's competence.¹⁹⁹ Moreover, the SEC would be put in an awkward position if it were to screen company directors and officers at the public offering stage, which is when its primary jurisdiction over them arises.²⁰⁰ Unlike an organizing group that is seeking a bank charter, which is a business in formation, an incipient public company is, at least historically,²⁰¹ one with a good enough track record in its business that underwriters are willing to take the risk of selling the firm's equity securities on the public markets. Firms going public are generally not start-up companies.²⁰²

Indeed, bank regulators are already experiencing the kind of practical problems that would be faced by the SEC if it had the power to act as a gatekeeper, and a standard setter of conduct, for public company management. The powers of banks and banking organizations have expanded from traditional banking to include all financial activities.²⁰³ As discussed earlier, in their regulation of the large, complex banking organizations that engage in these activities, bank regulators have acknowledged their supervisory limitations by adding a market-based and self-regulatory approach to their traditional paternalism.²⁰⁴ Yet the analogy is imperfect, for at least the financial activities are in many cases

198. See *supra* notes 140-41 and accompanying text.

199. The SEC staff was expanded to deal with the new burdens imposed on the agency by Sarbanes-Oxley. See Pub. L. No. 107-204, § 601, 2002 U.S.C.A.N. (116 Stat.) 745, 793-94 (to be codified at 17 U.S.C. § 78kk).

200. The SEC regulates all securities offerings. However, it has historically exempted most private capital raising (known as private placements) from much regulatory oversight. See, e.g., Regulation D, 17 C.F.R. §§ 230.501-230.508 (2005). Conceivably, it could screen management at this earlier stage. But this would make the SEC the regulator of all businesses in formation in the United States, a problematic mandate from both a jurisprudential and practical perspective.

201. I make this qualification because, during the technology boom of the late 1990s, many companies went public after a shorter period of existence (five years) than the historical norm (seven years). See Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795, 1801 (2002).

202. *Id.* (noting the general age of firms going public).

203. See Gram-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12, 15, 16, 18 U.S.C.).

204. See *supra* notes 73-77 and accompanying text. See generally BANK FOR INTERNATIONAL SETTLEMENTS, CONSULTATIVE DOCUMENT: THE NEW BASEL CAPITAL ACCORD (Apr. 2003) (discussing the orientation of international bank regulation as capital regulation, self assessment of risks and market discipline).

functionally similar to traditional banking,²⁰⁵ which justified the legislation permitting banks to engage in them in the first place. Moreover, the other financial activities have generally been the subject of paternalistic regulation by other agencies on which bank regulators can now piggyback.²⁰⁶

Consequently, the present SEC enforcement-oriented, regulatory approach is unsatisfactory and may even get worse for public company officers and directors. Despite resurgent business opposition to increased government regulation, additional scandals will surely bring new or enhanced SEC enforcement powers and new federal crimes aimed at public company management. Similarly, now that federal inroads have been made into the setting of standards of conduct for public company directors and officers, there is reason to believe that additional standards will be promulgated, even if disclosure-based.²⁰⁷ But, short of a financial cataclysm akin to the Great Depression, the psychological and political forces necessary to persuade Congress to direct the SEC to develop an all-encompassing paternalistic regulation of public company management will likely not emerge.²⁰⁸ Public company directors and officers will nevertheless bear the brunt of ever-increasing, and at times informal, SEC enforcement powers with little useful *ex ante* SEC guidance and monitoring.

205. Gramm-Leach-Bliley authorized a bank to be affiliated with insurance companies and investment banks in a financial holding company, and it allowed certain large, well-capitalized banks to set up a financial subsidiary to engage in similar, but not identical, activities (e.g., a bank financial subsidiary could not engage in insurance underwriting). See 12 U.S.C. §§ 24a, 1843(k) (2000). The financial activities of banks, insurance companies and investment banks are increasingly blurring together.

206. See 12 U.S.C. § 1844(c) (specifying functional regulation in the financial holding company). Functional regulation means that each separate financial intermediary in the holding company is regulated by the government authority or agency most competent to do so, i.e., the SEC regulates the investment bank affiliate, the state insurance department regulates the insurance company, and bank regulators regulate the bank(s).

207. See, e.g., Romano, *supra* note 162, at 1591-94.

208. Even the cataclysm of the Depression did not result in a paternalistic regulation of U.S. businesses, although it did with respect to banking. Given that today the ordinary American has more of his or her assets invested in the stock market than did the ordinary American of the 1920s, it is conceivable that a massive financial disaster could result in a changed regulation of business. See generally STEVE FRASER, EVERY MAN A SPECULATOR 573-615 (2005) (suggesting that because of the number of Americans investing in the stock market, a market crisis would lead to political upheaval and possibly increased regulation).

B. *The Social Psychological Need for Regulatory Oversight of Management*

At this point, the argument could go in one of at least two possible directions. The enforcement nature of the SEC's regulation of public company management and the impracticality of the SEC's engaging in a comprehensive management regulation could suggest that the SEC should lessen its enforcement emphasis or ask Congress for new powers to increase its monitoring of management. This Section argues, however, for a different direction because a modified, but still limited, SEC paternalistic regulation of management could bring a valuable service to public companies. This regulation provides a unique kind of check on management, particularly with respect to its self-dealing. This check was, in fact, the primary historical reason for the regulation, especially where, as in banks and other financial institutions, directors and officers could easily remove a company's liquid assets. This kind of regulation would also provide more support for directors and officers to live up to their governance and ethical standards. As discussed below, social psychological research, evidence from the corporate scandals, and the experience of directors in public firms indicate that existing kinds of regulation, such as self-regulation and the use of gatekeepers, are not as effective as this paternalistic regulation.

Research in the field of social psychology points to the phenomenon of (and explains the creation of) close-knit groups, in business firms as well as in other social settings, which come to ignore their organization's mission and function exclusively for the well-being of the group and its members. These groups, in effect, take to a pathological extreme the normal social behavior of human beings, chiefly their self-identification²⁰⁹ and cohesion with their groups. While under the influence of a group mentality and group identity,²¹⁰ group members may not even see the impropriety of their actions, if the admission would conflict with the group consensus. The group is also likely to stifle any serious dissent within

209. For a discussion of an individual's "social" identification with a group, see Michael A. Hogg, *A Social Identity Theory of Leadership*, 5 PERSONALITY & SOC. PSYCHOL. REV. 184-200 (2001). Individuals also join groups to help reduce the uncertainty in their lives. See Michael A. Hogg & Barbara A. Mullin, *Joining Groups to Reduce Uncertainty: Subjective Uncertainty Reduction and Group Identification*, in SOCIAL IDENTITY AND SOCIAL COGNITION 249, 255 (Dominic Abrams & Michael A. Hogg, eds. 1999).

210. This social phenomenon is commonly referred to as "groupthink." See IRVING L. JANIS, *GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES* 174-77 (2d ed. 1982) (classic account of "groupthink"). See generally James K. Esser, *Alive and Well After 25 Years: A Review of Groupthink Research*, 73 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 116 (Feb.-Mar. 1998) (summarizing empirical research on groupthink theory).

itself. For example, it may make some dissent a formal, but meaningless, part of group discussions. Group members may thus engage in behavior, such as blatant self-dealing or criminal activity, that, from other perspectives and identities within the individual personalities, they would find completely objectionable and know to be improper.²¹¹

There is more than adequate evidence that dysfunctional groups with this pathological behavior existed in the top management of public firms involved in the corporate scandals.²¹² As the numerous investigations, criminal trials, and civil suits with respect to senior executives and board members in Enron, WorldCom, Tyco International, Adelphia, HealthSouth, and the New York Stock Exchange (to name just the most notorious) have shown, groups formed, generally around a CEO, and took improper advantage of their position to plunder their firms. The misconduct of these executives and board members, in fact, exemplifies the kind of group self-dealing and reckless mismanagement that paternalistic bank regulation of management was designed to counter in banks. Placed on trial or named as defendants in civil suits, but no longer within their pathological group's identity, the participants are left to blame one another and cannot adequately articulate the compelling power of the group perspective that led to their ruin.²¹³

Social psychologists point out that this pathological behavior can be countered in several ways. A group can embrace serious self-criticism and self-examination as part of its own self-identity.²¹⁴ Yet this is difficult to achieve and may be rare in reality because it requires that the group leader, who epitomizes the identity and attributes of the group, espouse the norm

211. This acceptance of improper behavior may be gradual, as group members accept a somewhat innocuous impropriety that leads in turn to larger improprieties. See Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with the Law*, 2002 COLUM. BUS. L. REV. 71, 89-90. This process refers to the socialization of individuals into organizational evil. See John M. Darley, *How Organizations Socialize Individuals into Evildoing*, in CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS 13, 13-14 (David M. Messick & Ann E. Tenbrunsel eds. 1996).

212. See Fanto, *supra* note 8, at 444-60 (discussing the evidence of the group nature of the scandals). For a symposium in which prominent social psychologists and organizational theorists explained social behavior that led to recent corporate scandals, see *Corporate Misbehavior by Elite Decision-Makers Symposium: Perspectives from Law and Social Psychology*, 70 BROOK. L. REV. 1165 (2005) (including essays by social psychologists John Darley, Michael Hogg, Tom Tyler, and organizational scholars Rakesh Khurana and Linda Trevino).

213. For example, in the trial of former WorldCom CEO Bernie Ebbers, his guilt revolved around a dispute about whether he or the CFO Scott Sullivan was the architect of the fraud. See Shawn Young et al., *Executives on Trial: Cooperation Pays: Sullivan Gets Five Years*, WALL ST. J., Aug. 12, 2005, at C1.

214. See Daniel P. Forbes & Francis J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 494-95 (1999).

of self-criticism, which can threaten his or her own position.²¹⁵ Another promising strategy to counter the overly cohesive group is to introduce into the group a powerful outsider, who is not otherwise dependent upon the group, and to give him or her authority over it.²¹⁶ The outsider can monitor the group, offer it criticism, and even lend support to the following of ethical standards and the expression of different members' viewpoints.

In public firms, there are really no such outsiders. As monitors, corporate board members are supposed to offer CEOs and other senior executives this outsider perspective, but directors, usually existing or former CEOs or CFOs, are drawn from the same background as executives and are bound together with them by numerous social and financial relationships.²¹⁷ Moreover, students of board behavior, and directors themselves, explain that it is difficult for board members, both practically and psychologically, to resist the pressure to conform to existing board norms, which generally favor consensus and deference to the CEO.²¹⁸ As seen by the corporate scandals, the considerable time and effort that had been spent before Sarbanes-Oxley to improve board performance in public companies from the inside have not really borne fruit,²¹⁹ and limitations on the board may prevent it from ever truly accomplishing a monitoring role.²²⁰ It has been similarly argued, and hoped, by many that corporate service professionals, such as accountants, lawyers, bankers, and rating agencies, would fulfill this outsider role and be the "gatekeepers" who

215. See JANIS, *supra* note 210, at 262-63.

216. See generally Jennifer S. Lerner & Philip E. Tetlock, *Accounting for the Effects of Accountability*, 125 PSYCHOL. BULL. 255, 259 (1999) (discussing how certain outsiders to whom groups are accountable can improve certain decision-making of the groups).

217. See generally JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 17-35, 174-75, 188-89 (1989); JACKIE COOK, CORPORATE AND DIRECTOR INTERLOCKS IN THE USA: 2003 14-17 (2003).

218. Professor Jay Lorsch points out, in an anecdotal way, the sheer power of board members to bind each other to the group. See COLIN B. CARTER & JAY W. LORSCH, BACK TO THE DRAWING BOARD: DESIGNING CORPORATE BOARDS FOR A COMPLEX WORLD 174 (2004).

219. See Fanto, *supra* note 8, at 476.

220. For a work questioning the board's limitations and the problems inherent in the monitoring role as such, see Lawrence E. Mitchell, *The Trouble with Boards 2* (George Wash. Univ. Law Sch. Pub. Law & Legal Theory, Working Paper No. 159, 2005), available at <http://ssrn.com/abstract=801308>. It may be possible to enhance boards' performance by increasing directors' adherence to high professional and ethical standards. See generally Tom Tyler, *Promoting Employee Policy Adherence and Rule Following in Work Settings: The Value of Self-Regulatory Approaches*, 70 BROOK. L. REV. 1287 (2005) (proposing a self-regulatory model that emphasizes the role that employees' ethical values play in monitoring); Tom R. Tyler & Steven L. Blader, *Can Businesses Effectively Regulate Employee Conduct? The Antecedents of Rule Following in Work Settings*, 48 ACAD. MGT. J. 1143 (2005) (presenting evidence on the effectiveness of internal, rather than external, motivations in employee conduct).

would weed out bad management and bad companies from the public markets.²²¹ Indeed, new “gatekeepers” are periodically suggested by proponents of private solutions to corporate governance.²²² As the corporate scandals showed, however, these professionals have a self-interest and psychological need to be a group or team member, even if it is only as a member at the periphery of the group. Accordingly, they are generally drawn within the sphere of influence of management groups and lose any outsider status.²²³ From the social psychological perspective, a critical question in public firms becomes who can assume the outsider status that will both check, and inspire ethical behavior by, management groups.

C. *The Public Company Monitor*

It is desirable, and even necessary, to obtain the outsider and inspirational benefits of paternalistic regulation of public company management while at the same time balancing the enforcement emphasis of SEC regulation and recognizing SEC limitations in this area. The contention in this Section is that bank regulation may prove to be a model for SEC regulation, even if it is impractical and not theoretically desirable to expect the SEC to adopt the all-encompassing oversight of management comparable to what bank regulators exercise with respect to bank officers and directors. Bank regulation, in fact, provides several regulatory models. A pertinent one for SEC regulation is that of the bank examiner who, for large banking organizations, spends considerable time at a firm and thus monitors bank management on an ongoing basis.²²⁴

From the social-psychological perspective, the examiner of a large bank provides the valuable role of a powerful outsider to bank executives and directors. His or her main professional social identity is created by the regulatory agency, with its own goals and norms, to which he or she

221. For a discussion by a longtime proponent of the value of gatekeepers concerning the failings of gatekeepers in the corporate scandals, see John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 *BUS. LAW.* 1403, 1412-13 (2002) (explaining in a perceptive way why it made sense for “gatekeepers” of our financial markets, the accountants, investment bankers, and analysts, to go along with the scandals).

222. See, e.g., Sean J. Griffith, UNLEASHING A GATEKEEPER: WHY THE SEC SHOULD MANDATE DISCLOSURE OF DETAILS CONCERNING DIRECTORS' AND OFFICERS' LIABILITY INSURANCE POLICIES 1 (Univ. Of Pa. Law Sch. Inst. For Law & Econ., Working Paper No. 05-15, 2005), available at <http://ssrn.com/abstract=728442> (proposing that directors' and officers' insurance companies act as gatekeepers for public companies).

223. See, e.g., M.H. Bazerman et al., *Why Good Accountants Do Bad Audits*, *HARV. BUS. REV.*, Nov. 2002, at 96, 97. One can certainly try to give new life to these gatekeepers by imposing upon them stricter legal responsibilities to their corporate clients, and that has been the point of many reforms addressed to them. See Fanto, *supra* note 8, at 525-29.

224. See *supra* notes 80-85 and accompanying text.

reports, not the institutions that he or she is regulating.²²⁵ Examiners have no social identity need to become part of the group; it would be contrary to their role within the agency for them to do so.²²⁶ Bank executives and board members cannot therefore use social sanctions to isolate or dismiss the examiner or to bring him or her into line. As outsiders with power over banks and with a mission to ensure safe and sound banking practices, moreover, examiners can inquire into any questionable activity, such as any suggestion of self-dealing, and even into business decisions where there are risks of abuse, such as executive compensation, which bank executives and board members with their group vision cannot see as problematic or are reluctant individually to challenge.²²⁷ Examiners affect bank directors' and executives' thinking even when they are absent. In their strategies and decisions, bank managers must anticipate the examiner's viewpoint, for the managers understand that they have to justify their actions to him or her.²²⁸ In this regulatory model, there is a kind of regulator's "superego" within the executives' group mentality, which may itself change their behavior. The examiner may thus embolden those executives or board members who have reservations about particular actions to speak up and dissent since they know that they will likely have the support of the examiner.

This kind of regulation offers another benefit that contributes to addressing group pathologies. The examiner reinforces high standards of director and officer conduct and service as part of their roles within the institution. Social psychologists and organizational theorists emphasize that a group's ideology of acceptable goals and purposes, in short its ethics, can significantly affect the behavior of its members.²²⁹ Unfortunately, self-interest has become enshrined as an acceptable

225. Admittedly, there is always the possibility that regulators could be captured by the industries that they regulate. See generally FRED S. MCCHESENEY, *MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION* 7-19 (1997) (discussing the basics of this capture model).

226. See AUSTIN, *supra* note 57, at 130-33 (discussing the distant and sometimes abrasive demeanor of banking examiners).

227. See *supra* Part II.B.2. Of course, some question the effectiveness of examiners at deterring fraud and self-interest, especially in light of the banking scandals in the 1980s and early 1990s. See MACEY ET AL., *supra* note 4, at 640. The regulatory failings that led to bank failures during this period, however, did not appear to focus on problems with examiners, but on larger regulatory issues (e.g., allowing new charters in a highly competitive environment). See FDIC, *HISTORY OF THE EIGHTIES*, *supra* note 184, at 11-13.

228. See AUSTIN, *supra* note 57, at 121-23 (discussing how bank directors and officers must anticipate dealing with criticisms from bank regulators).

229. This is Professor Tyler's point, i.e., that creating internal norms (ethics and professionalism) of positive group behavior and self-sacrifice can be much more effective (and less costly) than outside monitoring to ensure this behavior. See Tom R. Tyler, *Trust and Law Abidingness: A Proactive Model of Social Regulation*, 81 B.U. L. REV. 361, 403-06 (2001).

perspective in business (and even law) schools and in the business milieu, and thus among directors, top executives, and the professionals who serve them and their firms.²³⁰ From a social psychological perspective, the relentless emphasis upon and celebration of the pursuit of unbridled self-interest contributed to the scandals because it reinforced group pathologies; groups could pursue their collective (and their members' individual) self-interest while its members convinced themselves that they were doing what was acceptable and even desirable. Bank regulation presents the positions of bank director and officer as ones partaking of a public service, given the significance of bank financing in the economic well-being of communities, and it thus reinforces standards of conduct that look beyond self-interest.²³¹ The examiner demands that directors and officers individually live up to the public service standards of their positions and thereby reinforces their public service roles. In this regard, he or she asks not whether the institution is supporting them, but how they are supporting or assisting the institution.

The daunting task is to imagine how to institute a position like the bank examiner in public firms with the theoretical and jurisprudential limitations and practical difficulties discussed earlier. The proposal here is a program of corporate monitors in public firms. "Monitor" rather than "examiner" is used since the position does not involve the constant assessment of the firm's business operations and strategy that a traditional bank examiner would undertake. Rather, the monitor would resemble more the kind of bank examiner who today oversees large complex banking organizations.²³² This examiner evaluates the adequacy of a firm's control and risk assessment systems and its supervisory and governance policies and keeps an eye out for "red flag" transactions that raise conflict of interest issues, particularly compensation schemes for officers and directors.²³³ Business strategies and decisions would be left to the

230. See generally Sumantra Ghoshal, *Bad Management Theories Are Destroying Good Management Practices*, 4 ACAD. MGT. LEARNING & EDUC. 75 (2005) (discussing the prevalence of a self-interested approach in business schools).

231. See *supra* note 20 and accompanying text. Admittedly, in a financial world where self-interest reigns, the original bank model of management behavior is under considerable pressure.

232. See *supra* notes 76-78; see also GAO, FINANCIAL REGULATION: INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE, GAO-05-61, at 10 (Oct. 2004), available at <http://www.gao.gov/new.items/d0561.pdf> (suggesting that this regulatory model might be used for all large financial institutions, other than banking organizations). One justification for the monitor in a large financial institution is that the demise of the institution might jeopardize the entire financial system, since these institutions are interconnected and the failure of one could bring down many others (this is systemic risk). The failure of a large public firm has similar and pernicious, if not as sudden, effects: As in the case of Enron, it undermines the confidence of investors and ordinary people in the economic system and its fairness.

233. See COMPTROLLER OF THE CURRENCY, *supra* note 75, at 8-14.

organization's officers and directors; the monitor is not there to stifle or inhibit risk-taking by business executives, which is the basic purpose of the business firm.²³⁴ A monitor, of course, could act generally as a devil's advocate to management, questioning a strategy when it appears that it has been adopted without any real substantive debate by board members.²³⁵

There have, in fact, been recent examples of corporate monitors. Some firms involved in corporate scandals have had court-appointed outsiders put in place to suggest changes to, and to monitor compliance with, their corporate governance and internal control arrangements as a way of addressing the behavior that brought on the scandals and of improving the firm. Installing a monitor is, in fact, often a condition imposed by the Department of Justice under a deferred prosecution agreement, whereby prosecution of the firm (which could be its death sentence) is indefinitely postponed if the firm remedies its behavior in accordance with the agreement, with the monitor ensuring that the firm is complying with the agreement.²³⁶ The most well-known example is Richard Breedon, a former SEC chairman, who was appointed corporate monitor over the defunct WorldCom (now MCI). In this post, he reviewed the problems of the firm so as to help establish the responsibility for the scandal.²³⁷ More importantly, he recommended the institution of policies and procedures that were intended to prevent a recurrence of its corporate governance problems.²³⁸ As monitor, he regularly dealt with senior executives and board members, and was empowered to veto many firm decisions, particularly those involving executives' compensation.²³⁹ Monitors have

234. Indeed, the presence of a monitor might help discourage lawsuits against executives and directors for their risk-taking.

235. An outsider like the proposed monitor may face a dilemma: He or she must get inside the organization in order to understand it adequately; but being an insider makes him or her susceptible to the group's attraction. One can only hope that the monitor's professional and government identity will be strong enough to resist that attraction.

236. See Steven R. Peiken, *Deferred Prosecution Agreements: Standard for Corporate Probes*, 231 N.Y. L.J. 52, Jan. 31, 2005; see, e.g., U.S. v. American Online, Inc., Deferred Prosecution Agreement 6-7, Exhibit 99.2 to Form 8-K (Dec. 14, 2004), available at http://www.sec.gov/Archives/edgar/data/1105705/000110570504000051/f04-12_158kex993.txt.

237. For his report on WorldCom's problems, see RICHARD C. BREEDON, RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF, THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC. 20-24 (Aug. 2003), available at http://www.nysd.uscourts.gov/rulings/02cv4963_082603.pdf.

238. See generally *id.* (recommending "a large number of corrective steps that will strengthen the governance practices at the Company in the future to safeguard and protect the interests of investors, and the larger public interest in the functioning of one of the country's largest corporations").

239. See Joann S. Lublin & Shawn Young, *Even as MCI Makes Strides, Monitor Stays*, WALL ST. J., Apr. 20, 2004, at B1.

had similar, although less-publicized, roles with other firms.²⁴⁰

It is important not to wait for a scandal to appoint a corporate monitor, for the goal of the monitor is to prevent the scandal and its costs, including the costs associated with an all-powerful monitor like Breedon, from occurring in the first place. The monitor envisioned here is not intended to have extensive powers over and to intrude upon business decision-making, as might occur when a monitor is appointed following a scandal. Yet, despite this clarification, hard questions about the proposal remain: Should a monitor be appointed in all public firms, or only in a subgroup of them?²⁴¹ If the former, would that not be as costly and administratively complex as would the implementation of a bank-like examination program? If a lesser program is adopted, which firms should have monitors or when in a firm's life should it be required to have one? Should the monitor be made a default requirement that firms could opt out of?²⁴² Could the task be delegated to a non-governmental organization?²⁴³ Who would select, train and pay the monitors? What statutory changes would the proposal entail?

The point here is to articulate and outline the proposal, not to answer all the questions that it raises. At least with respect to the firms to which the monitor requirement is to apply, it should be made a mandatory, not a default, requirement. Admittedly, the kind of modified paternalistic regulation that distinguishes itself from traditional paternalism by its use of default (rather than mandatory) strategies has considerable appeal, particularly in the legal academy.²⁴⁴ However, the problem of

240. See, e.g., Deferred Prosecution Agreement—KPMG 16-18 (Aug. 26, 2005), available at <http://www.usdoj.gov/usao/nys/Press%20Releases/August%2005/KPMG%20dp%20AGMT.pdf> (discussing appointment of monitor for a minimum three-year term, among other things, to monitor KPMG's compliance with the agreement and its implementation of an ethics program). In addition, as a result of the settlement with New York State Attorney General Eliot Spitzer and other regulators over abuses in their use of analysts, settling investment banks each agreed to appoint an "Independent Monitor" to review compliance with the terms of the settlement. See, e.g., *In re CITIGROUP GLOBAL MARKETS INC., ASSURANCE OF DISCONTINUANCE PURSUANT TO EXECUTIVE LAW § 63(15) Exhibit 2 10-11* (Apr. 28, 2003).

241. Public firms number about 13,000 (as of 2003). See SECURITIES AND EXCHANGE COMM'N, PROTECTING INVESTORS: 2003 ANNUAL REPORT 63.

242. See Romano, *supra* note 162, at 1595-97 (discussing benefits of opt-out default rules).

243. Cf. Hildy Teegen et al., *The Importance of Nongovernmental Organizations (NGOs) in Global Governance and Value Creation: An International Business Research Agenda*, 35 J. INT'L BUS. STUD. 463 (2004) (discussing factors that have increased the role of nongovernmental organizations in global value creation and governance).

244. See generally Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211 (2003) (proposing a paternalism that corrects behavioral errors but is not burdensome for people or organizations acting rationally); Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism is not an Oxymoron*, 70 U. CHI. L. REV. 1159 (2003) (proposing a system of libertarian paternalism for public and private

dysfunctional groups in public firms is significant enough to require a mandatory strategy, and firms should not be allowed to opt out of it. Accommodation can be made to firms, however, in line with a default approach. The appointment of a monitor could be subject to a “sunset” provision: A firm could be free of the monitor requirement after a set period, such as three years, unless the SEC established before a court that the firm still needed a monitor.²⁴⁵ Similarly with respect to another deregulatory or market-based suggestion, at this time the private sector, whether by for-profit or non-profit firms, cannot satisfy the monitoring function. In the wake of Sarbanes-Oxley, corporate governance advisory firms have sprung up, and prominent lawyers and former regulators like Breedon are available for, and are sometimes hired by, public firms.²⁴⁶ But there is no reason to think that these independent firms and individuals will have the authority to break down inner group problems in public firms, particularly at the incipient state of development of this advisory industry. Moreover, no longer having the reinforcement of membership in a government agency, former government officials will likely succumb in time to the social identity of top management groups, particularly if it comes with the typical and excessive rewards bestowed on members in these groups.²⁴⁷ This probable lack of authority of corporate governance advisors seems especially likely when one considers that those in the long-established professions of law, accounting, and banking, were unable to fulfill this role, even with the support of the law and their own well-developed ethical and professional codes.²⁴⁸

institutions that influences behavior while respecting freedom of choice).

245. See Romano, *supra* note 162, at 1600-02 (discussing various sunset strategies, although for legislation). For example, the SEC could be required to establish before a court, by a presentation of relevant evidence (e.g., new accounting restatements, managerial problems), that a company should continue to have a monitor. Of course, a firm could elect to continue the monitor on its own. Sunset provisions do counteract the bias to maintain the status quo. However, since significant legal reforms to corporate governance are rare except in a crisis, when business resistance can be overcome, to place a sunset provision in all legislation can undermine important and valuable legal reforms. Without the crisis and the political opposition to them that it creates, business interests can contend that there is no need for any real reform and proponents would have the difficult burden, outside of a crisis, of renewing the legislation.

246. See, e.g., Joann S. Lublin & Ian MacDonald, *Moving the Market: AIG Hires Levitt, Ex-Chief of SEC, to Advise Board*, WALL ST. J., July 6, 2005, at C3; see also Judith Burns, *Corporate Governance (A Special Report)—The Cop on the Board: Companies are Finding it Pays to Choose a New Kind of Director: The Former Regulator*, WALL ST. J., Oct. 17, 2005, at R8 (pointing out that public companies are increasingly appointing high-level regulators to sit on boards).

247. See, e.g., Jed Horowitz, *Morgan Stanley Welcomes Attorney Lynch with \$13.2 Million*, Dow Jones, Oct. 19, 2005 (explaining compensation package of Gary Lynch, former director of SEC’s Division of Enforcement, as chief legal officer for Morgan Stanley).

248. See Fanto, *supra* note 8, at 527-29. A serious question arises as to whether banking is a profession at all. See generally Rakesh Khurana et al., *Management as a Profession*, in RESTORING

The monitor would not be required in all public firms. One possibility is that the requirement would apply only to public firms that are the main recipients, directly or indirectly, of ordinary investor funds in the U.S. capital markets. These are the “well-known seasoned” public firms with the largest market capitalization, the greatest trading volume, and the largest offerings of their securities in the capital markets: They number around 4,000.²⁴⁹ The firms are in fact replacing banks as the ultimate recipients of most of the investment of ordinary people²⁵⁰ and, as seen in the corporate scandals, their downfall can adversely affect many retail investors, both directly (in investment losses) and indirectly (by making them lose confidence in other public firms). Indeed, although these firms are the most followed by analysts, rating agencies, and other market professionals,²⁵¹ and their stock price is deemed by financial economists to be the most efficient,²⁵² they are not immune to scandals.²⁵³ Moreover, their size and complex operations make it difficult for board members to feel completely competent about their understanding of the firm’s operations.²⁵⁴ They also have market power over professionals, such as bankers, accountants, and lawyers, to whom they give considerable business.²⁵⁵ Thus, in the absence of their exercise of ethical and professional standards, and with an excessive focus on their self-interest, these professionals make poor monitors of such firms.²⁵⁶ If the firms were banks or financial holding companies, they would receive the special

TRUST IN AMERICAN BUSINESS (Jay W. Lorsch et al. eds. 2005) (noting that when compared to traditional professions such as law and medicine, managerial careers could be more aptly described as “occupations” than “bona-fide professions”).

249. See Securities Offering Reform, Exchange Act Release No. 8591, 70 Fed. Reg. 44,722, 44,727-29 (Aug. 3, 2005) (final rule) (noting that they represent 30% of listed issuers, but 95% of equity market capitalization and 96% of debt; such an issuer must have either \$700 million in equity market capitalization or \$1 billion in non-convertible debt).

250. See *id.* at 44,727.

251. See *id.*

252. See *id.* at 44,728.

253. All the companies involved in the major scandals, such as Enron, WorldCom, and Tyco International, would have fit into this category.

254. These firms, of course, present a similar problem to a corporate monitor, but at least he or she would not be impeded by a group-imposed blindness.

255. See PHILIP AUGAR, *THE GREED MERCHANTS: HOW THE INVESTMENT BANKS PLAYED THE FREE MARKET GAME* 153-57 (2005) (discussing market power of largest firms).

256. This is why in Sarbanes-Oxley Congress sought to restrict the services that outside accountants could provide to public firms whose financial statements they were auditing (i.e., to decrease the control a firm could exercise over the auditor by threatening the auditor with a loss of business if it did not go along with a financial presentation favored by the company). See, e.g., Coffee, *supra* note 221, at 1410-12. The way in which these firms undermine professional standards is more subtle than what the self-interest model of behavior portrays. See generally Bazerman, *supra* note 223 (arguing that professionals, almost unconsciously, cannot maintain their standards if they become overly identified with their clients).

supervision that regulators give to large complex banking organizations. In addition, these firms can better bear the expenses of the monitor than can smaller public companies. Because these firms are still numerous, there are ways (in addition to a sunset provision) to minimize the regulatory burden on them, say, by shrinking the number of them to which the requirement applies: For example, the monitor may be imposed upon a firm only if there occurs a triggering event (e.g., an accounting restatement) or, on an initial basis, only upon public firms that have a clear public interest, such as healthcare organizations.

The proposal would be for the SEC to hire public company monitors. The SEC would be as inclusive as possible in the hiring while recognizing that the position demands a business, financial, and legal background. A monitor would be a regular SEC staff member who has no conflicts in taking the position, nor could he or she work for a monitored firm or a related party for a cooling off period following his or her departure from the SEC. These requirements will eliminate from the pool the kinds of people now selected for corporate boards, such as current and former CEOs and CFOs, high-level bankers and lawyers, leaders of nonprofits, and even former government officials, like SEC commissioners. There are without doubt numerous qualified persons both within the SEC and without, who do not have the strategic connections and prestige to be board members, but who do have the requisite business and legal competence. Moreover, since he or she would be in a full-time position, the monitor would be expected to be more active than a typical board member in acquiring and checking information about a company. The SEC would determine monitor compensation, in accordance with guidelines that it would establish, which would be paid from a general assessment on companies subject to the monitor requirement.²⁵⁷

The SEC would train and supervise monitors. A corporate monitor would need to understand the general business and governance issues of the industry and firms that he or she is monitoring and to know how to recognize the red flags of self-dealing and mismanagement in that industry and its firms. In fact, it might make sense for a monitor to be assigned to supervise a number of firms in a specific industry and to be associated with and further instructed by the group within the SEC's Division of

257. There are subtle costs or benefit issues lurking here. A system of corporate monitors could give investors more confidence about investing in public firms than they should have: An investment in a public firm is not free of risk or of low risk, like a bank deposit. This confidence, in turn, may lead investors to demand less of a return than they otherwise would, which would give an implicit subsidy to firms with a monitor (i.e., investors, thinking of firms as being backed by the government, would impose less of a discount than is appropriate on them). It is important for the SEC to continue to communicate that the government is not standing behind public firms, including those with a monitor.

Corporation Finance that reviews disclosure of firms in that industry.²⁵⁸ This assignment and association would help both parties. The monitor would benefit from the developed expertise of the Division's group as to issues in the firm's industry and the firm itself—e.g., the staff would warn the monitor to be on the lookout for specific problems. The Division's staff, in turn, would gain an inside, on-the-ground perspective from the monitor that could help it critically review disclosure of other companies in the firm's industry, particularly new public companies. The monitor would give the SEC the kind of access to and close knowledge about companies and their management. Moreover, associating a monitor with a group within the SEC will help the monitor assimilate SEC values and loyalty, which will be necessary to give the monitor the social identity that will enable him or her to counter the social attractions of the groups in the firms that he or she is monitoring.

The use of monitors would also balance the current enforcement orientation of the SEC's paternalistic regulation of public company management by introducing an ongoing relationship with public company management that would make the exercise of its enforcement powers (and prosecution by U.S. Attorneys) justifiable and equitable.²⁵⁹ A monitor can engage in a constant dialogue with management of the public firm and alert officers and directors at an early stage to problematic transactions and SEC concerns. The monitor would also relay to the SEC staff information about a firm's practices, its management, and its management's views about critical disclosure issues. Accordingly, many management problems would be avoided altogether with this relationship, because they would be resolved informally and early, without the need for the heavy hand of enforcement. If, moreover, the SEC feels that a situation calls for use of its enforcement powers, this exercise will be justifiable for, except in extreme circumstances, it would come after informal accommodation and

258. See U.S. Securities and Exchange Commission, How the SEC PROTECTS INVESTORS, MAINTAINS MARKET INTEGRITY, AND FACILITATES CAPITAL FORMATION, <http://www.sec.gov/about/whatwedo.shtml#org> (last visited May 21, 2006) (containing a discussion regarding the activities of the Division); see also JOHN C. COFFEE, JR. & JOEL SELIGMAN, SECURITIES REGULATION 202 (9th ed. 2003) (containing an excerpt from William W. Barker, *SEC Registration of Public Offerings Under the Securities Act of 1933*, 52 BUS. LAW. 65 (1996) (discussing the splitting of the Division of Corporation Finance into subgroups based on industry)). Firms might be concerned that a monitor would pass along information to competitors in their industry, especially if, as is likely, the monitor also supervises some of these other firms. Yet a similar confidentiality issue exists for bank examiners without any reported problems. In fact, a monitor's involvement in numerous firms in the same industry may help raise industry standards when the monitor points out problems and possible solutions based on his or her experience in monitoring the industry. See AUSTIN, *supra* note 57, at 132-33 (recommending that bank directors and officers take advantage of examiners' industry expertise).

259. See *supra* Part IV.A.

prior warnings have failed. Given these advantages of monitoring, it is possible that public firms not required to have a monitor might opt into the regulation.²⁶⁰

Implementation of even a limited corporate monitor program upon public companies would require a legislative change, for the federal securities laws, being primarily disclosure-based, despite the substantive corporate governance nature of much of Sarbanes-Oxley, are not expansive enough to allow for this reform.²⁶¹ The stock exchanges could impose this monitoring system, but they would also likely be reluctant to do so without a legislative mandate. This in turn raises the question of political will. Sarbanes-Oxley was a significant reform following the revelation of massive corporate scandals. Now there is an ongoing, forceful backlash against many of its reforms from the business community, its spokespersons in law firms and bar associations, and from sympathetic, generally conservative legal academics.²⁶² In the absence of new scandals, politicians will likely not have the will to impose any additional regulatory burden upon even a limited class of public companies.

That this proposal, in any of its possible modifications, will not be implemented in the foreseeable future does not justify declining to make it, or not taking it seriously, especially if the proposal responds to continuing problems in public firm management. During this period of backlash, it is critical that reform proposals be put forward, debated, and kept alive if they have any value, for there will eventually be a need for them. The corporate scandals showed that, despite years of corporate governance reforms in the law and in best practices, many public firms were operated primarily for the benefit of small groups of executives, board members, and outside professionals. This long-standing problem in firms ebbs and flows, but never goes away.²⁶³ Sarbanes-Oxley likely

260. Thus, the ideal design of the monitoring system may be to require a monitor for certain firms (subject to any sunset provisions) and to allow all public firms to opt into it.

261. It may be possible for the SEC to implement the monitoring system on the basis of its jurisdiction over public firms and its mission of ensuring the accuracy of disclosure to public firm investors. But it is questionable whether this implementation could withstand a challenge to its jurisdiction. Requiring public company boards to have public directors would interfere with state corporate law's regulation of corporate governance. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) (observing that the internal governance of companies is a traditional province of state corporate law); *Bus. Roundtable v. SEC*, 905 F.2d 406, 407-08 (D.C. Cir. 1990) (striking down SEC regulation attempting to enforce one share/one vote as a stock exchange listing rule).

262. See *supra* note 12.

263. See generally Ernie Englander & Allen Kaufman, *Managerial Fiduciary Duty and Social Responsibility: The Changing Nature of Corporate Governance in Post-War America 2* (Dep't of Strategic Mgmt. & Pub. Polic, George Wash. Univ. Sch. of Bus. & Pub. Mgmt., SMPP Working Paper No. 03-04, 2003), available at <http://ssrn.com/abstract=472965> (describing the cyclical

improves public firm governance and checks extreme governance problems, especially when, in the immediate wake of the scandals, board members and gatekeeping professionals become energized and vigilant. In time, however, the group mentality of executives and boards will reassert itself—a mentality reinforced by the fact that the circle from which these individuals are drawn is a closed one—because no reform has adequately addressed group pathologies in corporate management.²⁶⁴ And there will be serious scandals again. At that time, during the short window that politics allows for reform, it will be necessary to have ready reform proposals that have survived a critical debate, and the corporate monitor may be one of these.²⁶⁵ The business community may even find that it is in its interest not to oppose the corporate monitor, if it only recognizes that the regulation of public firm management is already a long way down the paternalistic road, but, at least with regards to enforcement, in a way that is not favorable to this management. Executives and board members are now sanctioned harshly for their faults by the SEC and federal prosecutors without having the kind of relationship with a regulator that might make unnecessary the sting of enforcement.

V. CONCLUSION

The comparison of bank regulation of bank management with SEC regulation of public company management offers a new perspective on the latter. This kind of bank regulation is all encompassing: Bank regulators screen bank executives and directors, establish standards of conduct for them and then monitor their compliance with the standards, and enforce them through informal and formal proceedings. By contrast, SEC regulation of management has been for many years primarily disclosure-based. As a result of recurring corporate scandals, it has grown during the last decades in ways often borrowed from bank regulation. The outcome

nature of corporate ethics).

264. See Fanto, *supra* note 8, at 524-37.

265. Another reform, which also has a bank regulatory origin, would be to have a public firm compliance officer who reviews transactions and business relationships for compliance with regulatory guidelines. This officer (with a supporting staff) is common in banks, given the web of regulations that surround them. See MCCOY, *supra* note 23, at § 14.04[3][c][v][c][4]. Because of the growth of regulations affecting the public firm, particularly with respect to disclosure and internal controls, there is increasing need in these firms for this kind of officer to oversee the firm's compliance with the enhanced regulatory requirements. See, e.g., Joseph Weber, *The New Ethics Enforcers*, BUS. WK., Feb. 13, 2006, at 76 (discussing the role of compliance officers in public firms). Yet it is unlikely that the officer can *alone* provide the necessary social psychological counterweight to management, again for both individual and social reasons: Ultimately, he or she becomes part of the firm's hierarchy and has little real authority unless supported by a government outsider.

in SEC regulation, however, is an unsatisfactory imbalance, with the SEC doing little screening of public firm officers and directors, setting only general standards for their conduct and having no ongoing relationship with them, and then (together with the Department of Justice's criminal prosecutions) using bank-like enforcement penalties that include a lifetime bar of an officer or director from public company positions.

Not only is this outcome unfair to public company officers and directors, but it does not produce the best corporate governance outcome. One advantage of the close relationship between bank regulators and bank management is that bank directors and officers receive the advice and oversight of a genuine outsider in the person of a bank examiner. This outsider is well-positioned to resist the inevitable social pressures of management groups and can even help bank executives, board members, and advisors themselves break out of pathological group perspectives. As an outsider with authority, an examiner may help the management group avoid improper self-interested transactions and cases of gross mismanagement. This examiner, moreover, cannot be replicated by any other party in corporate governance, because, as corporate scandals have shown, others, such as corporate service professionals, can be co-opted into firm management groups.

The proposal set forth in this Article is not to transform SEC regulation of public firm management into the all-encompassing paternalistic oversight of bank regulators. The diversity of public firms and the governmental resources that would be required for this oversight make it both theoretically daunting and impracticable. Rather, the proposal is to require only certain public firms, perhaps with the largest capitalization and trading volume, to have a corporate monitor akin to that used in large complex banking organizations. This means that the monitor ensures that the firm has adequate control systems and follows proper standards of management conduct, and, as a general firm devil's advocate, he or she would scrutinize self-interested transactions and question a firm's overall strategy and business plans, with a goal of preventing gross mismanagement and self-dealing. The monitor would be a member of the SEC staff and work closely with the SEC's Division of Corporation Finance, which would also be able to improve company disclosure as a result of the "on the ground" insights of the monitors.

The proposal will not be popular in this period of backlash against corporate governance reforms. However, it may become politically more palatable if public firm officers and directors realize that today they personally are bearing most of the costs and receiving none of the benefits of the SEC's existing paternalistic regulation. Legislation has given the SEC and the Department of Justice considerable enforcement powers over public firm management. Other scandals will surely enhance these powers

and add other punitive measures to the SEC's and federal prosecutors' arsenals. Company executives and directors may in time come to realize that they will be the beneficiaries of a proposal that could make infrequent the exercise of these powers by establishing a relationship between firm management and the SEC that can alert firm officers and directors to SEC concerns.

