2005

# Realizing the Dream of William O. Douglas: The Securities and Exchange Commission Takes Charge of Corporate Governance

Roberta S. Karmel
*Brooklyn Law School*, roberta.karmel@brooklaw.edu



Recommended Citation
30 Del. J. Corp. L. 79 (2005)

# REALIZING THE DREAM OF WILLIAM O.DOUGLAS— THE SECURITIES AND EXCHANGE COMMISSION TAKES CHARGE OF CORPORATE GOVERNANCE

BY ROBERTA S. KARMEL*

ABSTRACT

*The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) has markedly changed the boundary between the federal securities laws and state corporation law with regard to corporate governance. This change has not been some accident of hasty congressional action in the wake of the Enron, Worldcom and related scandals. The added grants of authority given to the SEC in Sarbanes-Oxley are with respect to matters of board composition and structure that the SEC has been angling to regulate for some time. Furthermore, in utilizing the self-regulatory organizations to implement the new governance ideas of Sabanes-Oxley, the SEC has exercised its powers under the 1975 amendments to the Securities Exchange Act of 1934 in a manner long considered questionable. The SEC's new activism with respect to corporate governance can thus be analyzed as the latest maneuver in a long running battle between federal and state authorities over the regulation of public corporations.*

*Whether Sarbanes-Oxley will result in better corporate governance and greater sensitivity by corporate officers and directors to investor interests remains to be seen. Despite the laudatory goals of the statute, adverse consequences are possible. The provisions of Sarbanes-Oxley are proscriptive in an area where flexibility has long been valued. Furthermore, it is premised to some extent on an adversarial model of corporate governance in contrast to a consensus model which has been the prevailing norm in boardrooms. In changing the orientation of directors, Sarbanes-Oxley and its implementation by the SEC may result in diminished entrepreneurial activity, corporate profitability and competitiveness. The new emphasis on investor protection may detract attention from long-term business interests. This shift from state to federal law concerning internal corporate affairs may also cause state law either to become unduly restrictive of directorial discretion in an effort to*

---

*Centennial Professor, Chairman of the Steering Committee, and Co-Director of the Center for the Study of International Business Law at Brooklyn Law School. She is a former Commissioner of the Securities and Exchange Commission. The author thanks Dean Joan Wexler for a research grant from Brooklyn Law School for the preparation of this article and Professor Claire Kelly for her helpful comments. The author also thanks Brooklyn Law School student John Ivascu for his research assistance.

*compete with rigorous SEC enforcement cases, or at the other extreme, to atrophy.*

TABLE OF CONTENTS



## I. INTRODUCTION

The federal securities laws generally have been considered full disclosure statutes, as opposed to merit regulation statutes or laws governing the internal affairs of corporations. The Securities and Exchange Commission (SEC), nevertheless, has aspired to regulate corporate governance since its inception and, from time to time, has exploited scandals in the public securities markets to achieve this purpose. Congress has similarly reacted to scandals by giving the SEC greater power, often to prosecute wrongdoing the SEC failed to foresee or prevent. Even when Congress has been operating in a deregulatory mode, federal law still preempted state law and therefore laid the foundation for further regulation

by the SEC over time. Where statutory mandates were ambiguous, however, the courts frequently halted the SEC's reach for jurisdiction to regulate corporate governance, even though the judicially-constructed demarcation between federal and state law was little more than a line in the sand.

The Sarbanes-Oxley Act of 2002[1] (Sarbanes-Oxley) markedly changed the boundary between the federal securities laws and state corporation laws with regard to corporate governance. This was not an accident of hasty congressional action in the wake of the Enron, Worldcom, and related scandals. Rather, the added grants of authority given to the SEC in Sarbanes-Oxley are with respect to matters of board composition and structure that the SEC has been angling to regulate for some time. Furthermore, in utilizing the self-regulatory organizations to implement the new governance ideas of Sabanes-Oxley, the SEC has exercised its powers under the 1975 amendments to the Securities Exchange Act of 1934 (Exchange Act)[2] in a manner long considered questionable. The SEC's new activism with respect to corporate governance can thus be analyzed as the latest maneuver in a long running battle between federal and state authorities over the regulation of public corporations.

Whether Sarbanes-Oxley will result in better corporate governance and greater sensitivity by corporate officers and directors to investor interests remains to be seen. Despite the laudatory goals of the statute, adverse consequences are possible. The corporate governance provisions of Sarbanes-Oxley are proscriptive in an area where flexibility has long been valued. Furthermore, it is premised to some extent on an adversarial model of corporate governance in contrast to a consensus model which has been the prevailing norm in boardrooms. In changing the orientation of directors, Sarbanes-Oxley and its implementation by the SEC may result in diminished entrepreneurial activity, corporate profitability and competitiveness. The new emphasis on investor protection may detract from long-term business interests. Further, this shift from state to federal law concerning internal corporate affairs may cause state law either to become unduly restrictive of directorial discretion in an effort to compete with rigorous SEC enforcement cases, or at the other extreme, to atrophy.

Parts I and II set forth the historical tripartite arrangement for regulation of corporate governance by state corporation and blue sky laws, the SEC, and the self-regulatory organizations. Part III discusses changes to those arrangements. In Part IV, the article analyzes some of the

---

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

[2]15 U.S.C. §§ 78a-78mm (2001).

implications of shifting the regulation of corporate governance from state to federal authorities and inquires whether the shareholder primacy model upon which Sarbanes-Oxley is based is appropriate.

## II. THE TRADITIONAL SPHERES OF FEDERAL AND STATE AUTHORITY OVER CORPORATE GOVERNANCE

### A. *A Full Disclosure Mandate*

The tension between federal and state control of corporate governance pits the virtues of uniformity and national economic growth against a policy of experimentation and decentralized power. State corporation law is based on principles of free incorporation, the absence of substantive regulation, and enforcement of fiduciary duty law to protect shareholders. Federal securities law, however, has relied primarily on disclosure as a regulatory device to influence the conduct of corporate managements and boards. When the first of the federal securities laws, the Securities Act of 1933 (Securities Act),[3] was passed there was a debate between advocates of controlling the sale of securities by issuers that were dishonest or in unsound condition[4] and advocates of disclosure as a means to prevent the sale of poorly capitalized companies.[5] State blue sky laws, which preceded the federal securities laws, generally prevented a corporation from making a public offering unless it was fair, just and equitable, as determined by a state official.[6] The Securities Act permitted any corporation to go public if it made full disclosure of its business and affairs to investors.[7]

---

[3]15 U.S.C. § 77a-z (2000).

[4]An early draft of the Securities Act would have allowed a government agency to determine whether issuers were of unsound condition or insolvent. DONALD A. RITCHIE, JAMES M. LANDIS, DEAN OF THE REGULATORS 45 (1980). Such authority would have been similar to the ability of state blue sky merit regulators to prevent a public offering of securities if an issuer's capital structure is substantively unfair or presents excessive risks to investors. *See* Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 787 (1986) [hereinafter ABA Blue Sky Report].

[5]Full disclosure regulation is based on the often quoted theory that "[p]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914).

[6]ABA Blue Sky Report, *supra* note 4, at 805.

[7]A specified list of disclosure items, including the provision of a profit and loss statement and balance sheet, was attached to the Securities Act as Schedule A to avoid congressional tinkering although this list was the "guts of the bill" according to one of its drafters. *See* RICHIE, *supra* note 4, at 47.

Shortly after the Securities Act was passed, William O. Douglas (Douglas), who was to exert considerable influence on the SEC as an early Chairman, criticized the full disclosure philosophy of the statute. In his view, the Act was a failure because it "presupposes that the glaring light of publicity will give the investors needed protection," but investors "either lack the training or intelligence to assimilate . . . and find . . . useful [the balance sheets, contracts or other data in the registration statement] or are so concerned with a speculative profit as to consider them irrelevant."[8] Douglas espoused a regulatory theory that was an integral part of a whole program of industrial regulation and organization. In his view, administrative control over access to the market must be "lodged not only in the hands of the new self-disciplined business groups but also in the hands of governmental agencies whose function would be to articulate the public interest with the profit motive."[9] Regulation of corporate governance by the SEC was injected into statutes passed after the Securities Act and intended to curb abuses by specific industries,[10] but the SEC was not given authority to regulate the structure of corporate boards generally, even when major amendments to the Exchange Act in 1964 gave the SEC power to direct a continuous disclosure system for all public companies.[11] Even the proxy provisions of the Exchange Act[12] generally have been regarded primarily as disclosure, rather than regulatory provisions.[13] Similarly, the SEC's regulatory authority over tender offers[14] has been

---

[8]William O. Douglas, *Protecting the Investor*, 23 YALE REV. 521, 523-24 (1934).

[9]*Id.* at 531.

[10]The Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79-79z-6 (2001), imposed various substantive controls upon the capital structure of public utility companies. The Investment Company Act of 1940 (Investment Company Act), 15 U.S.C. §§ 80a-1 to 80a-64 (2001 & Supp. 2003), created a corporate governance structure for mutual funds and, in particular, a requirement for control by independent directors. 15 U.S.C. § 80a-10(a) (2001 & Supp. 2003). The Exchange Act required the registration of stock exchanges and broker-dealers but did not give the SEC any control over their governance. Similarly, when the Maloney Act authorized the creation and regulation of national securities associations, 15 U.S.C. § 78o-3 (2001), the SEC was not authorized to regulate the corporate governance of the National Association of Securities Dealers (NASD). A limited power to effect the board structure of these self-regulatory organizations (SROs) was contained in amendments to the Exchange Act passed in 1975. Exchange Act, §§ 78f(b)(3), 78o-3(b)(4) (2001).

[11]Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565; *see* Exchange Act Release No. 7425, 29 Fed. Reg. 13,455 (Sept. 30, 1964). The SEC previously only had authority to direct continuous disclosure of exchange listed companies.

[12]Exchange Act, § 14(a); 15 U.S.C. § 78n (2001).

[13]*See infra* notes 266-67 and accompanying text.

[14]Exchange Act, §§ 13(d)-(e), 14(d)-(f); 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2001).

interpreted as giving the SEC little authority to determine the outcome of contests for corporate control.[15]

Douglas's vision of an administrative agency that would protect investors by controlling business was acted upon by the SEC from time to time, but any ambitious corporate governance program was curbed by decisions of the courts and the Commission itself. One of the agency's first corporate governance cases, *In re Franchard Corp.*, involved a stop order suspending the effectiveness of registration statements that the SEC deemed materially deficient because of the failure to disclose the use of company funds for the personal benefit of the issuer's CEO.[16] In a statement that became a keystone of future SEC programs, the SEC found that this improper diversion of funds was "germane to an evaluation of the integrity of his management" and that "[t]his quality is always a material factor."[17] Nevertheless, although the SEC staff urged that this case be used to define the duties of corporate directors, the Commission declined to do so, stating: "The [Securities] Act does not purport . . . to define Federal standards of directors' responsibility in the ordinary operations of business enterprises and nowhere empowers us to formulate administratively such regulatory standards."[18] When implied rights of action were recognized under section 10(b)[19] and section 14(a)[20] of the Exchange Act, federal courts were similarly tempted to consider cases involving not only misrepresentation, but also equitable fraud or breaches of fiduciary duty under state law by corporate managers.[21] This led one commentator to declare that the federal securities laws had given rise to a federal corporation law.[22] The observation proved premature, and in *Schoenbaum v. Firstbrook*[23] the Second Circuit declined to interpret section 10(b) of the Exchange Act to permit an action for breach of a fiduciary duty by

---

[15]*See infra* notes 29-31.

[16]42 S.E.C. 163 (1964).

[17]*Id.* at 172.

[18]*Id.* at 176.

[19]*See* Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). Such a right was not specifically approved by the Supreme Court until 1971 in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

[20]These rights were recognized by the Supreme Court in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964). The Court has subsequently noted a stricter approach to finding implied causes of action in the Exchange Act. Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979).

[21]*See, e.g.*, Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970); Ruckle v. Roto Am. Corp., 339 F.2d 24 (2d Cir. 1964).

[22]"[A] federal law of corporations now exists. But it has always existed—since the passage of the Securities Act of 1933." Arthur Fleischer, *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146, 1179 (1965).

[23]405 F.2d 215 (2d Cir. 1968).

corporate directors in a shareholder derivative action alleging the sale of treasury shares to a related corporation at a deflated price.

The Supreme Court, in a non-securities law case, later stated: "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."[24] This doctrine was applied in *Santa Fe Industries, Inc. v. Green*[25] to quash the development of a judicially-constructed federal law of corporate fiduciary duty under section 10(b) of the Exchange Act. In *Santa Fe*, the minority shareholders in a squeeze out merger contested the appraisal value of their shares by alleging unfairness and overreaching, as sanctioned by Delaware statutory law. The Second Circuit took the view that Rule 10b-5 reached "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure."[26] The Supreme Court reversed, holding that section 10(b) cases require deception, manipulation, or nondisclosure.[27] In so doing, the Court rejected the notion that the securities laws "federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[28]

In *Schreiber v. Burlington Northern, Inc.*, the Supreme Court indicated that *Santa Fe* would not be confined to its facts, but rather was a general holding concerning fiduciary duty.[29] *Schreiber* raised the issue of whether the withdrawal of a hostile tender offer bid and the substitution of a partial bid, following negotiations with the target company's management, constituted a "manipulative" act under section 14(e) of the Exchange Act. The Court held that the term "manipulative" in sections 10(b) and 14(e) should be similarly interpreted and that manipulative acts require misrepresentation or nondisclosure.[30] The Court reiterated its reluctance to displace state corporation law regulating contests for corporate control in *CTS Corp. v. Dynamics Corp. of America*, when the Court refused to

---

[24]Cort v. Ash, 422 U.S. 66, 84 (1975).

[25]430 U.S. 462 (1977).

[26]Green v. Santa Fe Indus., Inc., 533 F.2d 1283, 1287 (2d Cir. 1976).

[27]*Santa Fe Indus.*, 430 U.S. at 476.

[28]*Id.* at 479. After the *Santa Fe* case, some courts took the view that material non-disclosure of a breach of fiduciary duty denying minority shareholders an opportunity to seek relief in a state court stated a section 10(b) and Rule 10b-5 claim. *See, e.g.*, Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977); Wright v. Heizer Corp., 560 F.2d 236 (7th Cir. 1977).

[29]472 U.S. 1 (1985).

[30]*Id.* at 7-8.

declare a state law making tender offers more difficult preempted by the securities laws or invalid as a burden on interstate commerce.[31]

In a case arising under the Investment Company Act, which specifies some corporate governance regulation for mutual funds and codifies the common law duties and obligations of corporate directors generally,[32] the Supreme Court noted that Congress did not intend for the Investment Company Act to supplant the "entire corpus of state corporation law."[33] The case concerned the ability of investment company directors to terminate a shareholder derivative suit. The Court reversed a decision that directors have no power to terminate and stated that federal courts "should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the Investment Company Act and the Investment Advisers Act."[34]

### B. *SEC Efforts to Regulate Corporate Governance*

Despite the SEC's lack of authority to regulate corporate internal affairs, the SEC embarked on an activist corporate governance reform program in the 1970s. This program, in the context of a post-Watergate hysteria, was an effort to blame business for a prevailing climate of corruption, a stagflation economy and a long bear market. In 1973, the Watergate special prosecutor charged several corporations and executive officers with using corporate funds to make illegal political contributions.[35] The SEC first published a statement that nondisclosure of these matters might involve violations of the federal securities laws,[36] then brought enforcement actions against corporations that made illegal political

---

[31]481 U.S. 69, 94 (1987).

[32]Investment Company Act, 15 U.S.C. § 80a-1(b) (2001 & Supp. 2003). *See* Aldred Inv. Trust v. SEC, 151 F.2d 254, 260 (1st Cir. 1945).

[33]Burks v. Lasker, 441 U.S. 471, 478 (1979).

[34]*Id.* at 475, 486. Sarbanes-Oxley provides for a federal derivative action in section 306(a)(2) (codified at 15 U.S.C. § 7244(a)(2) (2002)) when corporate insiders trade during certain pension black-out periods. Whether this will lead to a new federal law with regard to demand refusal is an interesting question. *See* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, , at 8 n.12 (N.Y. Univ. Center for Law & Business, Working Paper #CLB 03-01, Feb. 26, 2002, *at* http://papers.ssrn.com/abstract=367720).

[35]*See* SEC. & EXCH. COMM'N REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, 94th Cong., REPORT OF THE SEC & EXCH. COMM'N ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES (Comm. Print 1976) [hereinafter SEC REPORT ON QUESTIONABLE PAYMENTS].

[36]*Id.* at 2.

contributions.[37] These investigations, in turn, led to the "questionable foreign payments" cases, which involved various payments to foreign government officials to obtain or keep business abroad. In some cases, the SEC obtained consent injunctions that resulted in the restructuring of particular corporate boards.[38]

As a result of the SEC's sensitive payments program, Congress amended the federal securities laws in 1977 with the enactment of the Foreign Corrupt Practices Act.[39] This law made bribery of foreign government officials, candidates or political parties by SEC regulated issuers and certain other domestic concerns a crime.[40] It also required companies registered with the SEC to maintain accurate books and records and develop a system of internal accounting controls.[41] The object of the SEC's sensitive payments program was not to outlaw the bribery of foreign officials by U.S. companies, but rather to obtain more power to regulate the internal affairs of public companies. The SEC achieved this objective by persuading Congress to enact section 13(b) of the Exchange Act requiring issuers to make and keep books, records and accounts that accurately and fairly reflect the transactions and dispositions of the assets of the issuer. The newly-enacted law also required companies to devise and maintain an adequate system of internal accounting controls to provide reasonable assurance to auditors with respect to specified transactions.

At this time there was a clamor for a federal chartering law for large corporations by consumer activist Ralph Nader, former SEC Chairman William Cary and others.[42] Although these authors espoused different views, many were generally sympathetic to the Nader argument that giant multinational corporations had become private governments, exercising a detrimental influence on quality of life for which they were not being held accountable. Federal chartering, therefore, was needed to restructure the

---

[37]*See, e.g.*, SEC v. ITT Corp., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,948 (D.D.C. Aug. 8, 1979); SEC v. Lockheed, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95, 509 (D.D.C. Apr. 3, 1976).

[38]*See* SEC REPORT ON QUESTIONABLE PAYMENTS, *supra* note 35, at 3-5.

[39]Exchange Act, §§ 13(b)(2), 30A, 32; 15 U.S.C. §§ 78m(b)(2), 78dd-1-2, 78ff, added by Public L. No. 95-213, 91 Stat. 1494 (Dec. 19, 1977).

[40]15 U.S.C. § 78dd-1-2 (2001).

[41]*Id.* § 78m(b)(2).

[42]RALPH L. NADER ET AL., TAMING THE GIANT CORPORATION (1976); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663 (1974); Thomas Hazen, *Corporate Chartering and the Securities Markets: Shareholder Suffrage, Corporate Responsibility and Managerial Accountability*, 1978 WIS. L. REV. 391; Joel F. Henning, *Federal Corporate Chartering for Big Business: An Idea Whose Time Has Come?*, 21 DE PAUL L. REV. 915 (1972); Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976).

board of directors, to redefine its relations with managers, employees, shareholders, and the community and to regulate corporate disclosure and conduct in areas of social concern.[43] Former Chairman Cary expressed more concern about shareholder rights and advocated federal chartering as an antidote to the failure of state corporation law to discipline corporate officers and directors.[44] Other reform advocates focused upon the poor economic performance of American business and perceived abuses of trust by corporate managers and urged that state corporation law be changed to strengthen corporate boards.[45]

In this atmosphere of criticism of business leaders, the corporate governance debate turned to questions of board composition and director independence and the SEC embarked on a program to influence board structure. In April of 1977, the SEC announced that it would hold public hearings concerning shareholder communications, shareholder participation in the corporate electoral process, and corporate governance in general.[46] After these hearings, the SEC proposed rules to encourage boards to become independent of management. At the very least, in the view of Harold Williams, then SEC Chairman, a board's nominating, compensation and audit committees should be composed of independent directors.[47] Williams also viewed management remuneration and corporate perquisites as playing an important, though subtle, role in corporate accountability.[48] At this time, however, the only mechanism the SEC could use to implement boardroom reform was disclosure regulation. Accordingly, the SEC proposed to require all corporations subject to the SEC's proxy rules to label their directors as "independent" or "affiliated."[49] These rules aroused a storm of protest,[50] and the SEC's final rules required only a brief description of "significant economic and personal relationships . . . between

---

[43]NADER, *supra* note 42, at 63-64, 75-179.

[44]Cary, *supra* note 42, at 670-84.

[45]E.g., MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 137-70 (1976).

[46]Re-examination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process, and Corporate Governance Generally, 42 Fed. Reg. 23,901 (May 11, 1977).

[47]*See* Harold M. Williams, Chairman SEC, Corporate Accountability—One Year Later, Address at the Sixth Annual Securities Regulation Institute, San Diego, Calif. (Jan. 18, 1979) (transcript available in the Loyola University Law Library).

[48]*Id.*

[49]Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 14,970, 43 Fed. Reg. 31,945, 31,947 (July 24, 1978).

[50]Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 15,384, 43 Fed. Reg. 58,522, 58,523 (Dec. 14, 1978).

the director and the issuer."[51] In addition, the SEC adopted rules designed to make disclosure of management remuneration more meaningful and to eliminate undisclosed management perquisites.[52]

The SEC also tried to exert more control in the 1970s over the public accounting profession. When the Financial Accounting Standards Board (FASB) was formed, the SEC's oversight over the formulation of accounting principles was clarified.[53] The SEC exercised its power to oversee the development of generally accepted accounting principles by working together with the FASB to develop more effective methods of oil and gas accounting for the purpose of disclosure.[54] The SEC also addressed the issue of management consulting by accounting firms, but was politically unable to eliminate such consulting.[55] The SEC was similarly frustrated in its efforts to achieve clear authority to formulate auditing standards and discipline accountants. Although auditing standards for accountants who certify financial statements filed with the SEC were indirectly regulated

---

[51] *Id.* at 58,524.

[52] Uniform and Integrated Reporting Requirements: Management Remuneration, Proposed Amendments to Item 4 of Regulation S-K, Securities Act Release No. 6210, 45 Fed. Reg. 31,733 (May 14, 1980) (to be codified at 17 C.F.R. pts. 229, 240); Uniform and Integrated Reporting Requirements: Management Remuneration, Securities Act Release No. 6003, 43 Fed. Reg. 58,181 (Dec. 13, 1978). *See also* Disclosure of Management Remuneration, Securities Act Release No. 6166, 44 Fed. Reg. 74,808 (Dec. 18, 1979) (clarifying management remuneration disclosure requirements).

[53] Financial statements filed with the SEC must be certified by an independent certified accountant, and the SEC has the power to prescribe the detail and content of such financial statements. *See* Securities Act, Schedule A, Items 25-27, 15 U.S.C. §§ 77aa(25)-(27) (2001). In addition, the SEC was empowered to define "accounting, technical and trade terms" and prescribe the form in which required information should be presented, the items to be shown in the balance sheet and earnings statement, and the methods to be followed in the preparation of accounts. Securities Act, § 19(a), 15 U.S.C. § 77s(a) (2000). The SEC then assigned considerable responsibility for formulating accounting principles to private sector organizations like the FASB. *See* Accounting Series Release No. 150, 39 Fed. Reg. 1260 (Jan. 7, 1974), 3 S.E.C. Docket 275 (1973-74). *See generally* James F. Strother, *The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards*, 28 VAND. L. REV. 201 (1975) (discussing the development and regulation of accounting and auditing standards).

[54] *See* Financial Reporting by Oil & Gas Producers, Securities Act Release No. 6294, 46 Fed. Reg. 15,496 (Mar. 6, 1981) (codified at 17 C.F.R. pt. 211).

[55] The SEC is empowered to define the term "independent" and thereby may prevent auditors from engaging in non-audit services. The Commission considered doing so in 1979, but then pulled back and mandated disclosure of such services instead. *See* Scope of Services by Independent Accountants, Accounting Services Release No. 264, Securities Act Release No. 6078, 44 Fed. Reg. 15,920 (June 14, 1979). Even this limited regulation of non-audit services was subsequently repealed. *See* Relationships Between Registrants and Independent Accountants, Securities Act Release No. 6379, 47 Fed. Reg. 5404 (Feb. 5, 1982). Almost twenty years later, the SEC once again attempted to prohibit accountants from engaging in non-audit services. *See* Revision of the Commission's Auditor Independence Requirements, Securities Act Release No. 7919, [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,406, at 83,989 (Nov. 21, 2000).

through enforcement proceedings, the SEC's authority to bring such proceedings was continually questioned,[56] since accountants were licensed and disciplined under state law. The SEC's dissatisfaction with the performance of the large accounting firms continued, but the SEC was unable to achieve the reforms it thought necessary.[57]

In the 1970s, the SEC had an aggressive enforcement program against securities attorneys, under its Rule 2(e) of its Rules of Practice,[58] bringing numerous disciplinary cases before the agency. This program was seriously questioned and then halted, in part because of doubts over the SEC's authority to regulate lawyers. Instead, the SEC adopted a policy of instituting actions against attorneys in court injunctive actions.[59] The SEC staff chafed at its inability to bring administrative cases against lawyers under Rule 2(e) and sometimes resorted to other administrative remedies.[60]

The SEC's ambition to pursue an activist corporate governance agenda in the 1970s was thwarted by its lack of authority. Nevertheless, during this time the SEC laid the foundation for increasing its power to regulate public corporations and their accountants and attorneys as it would later have the power to do pursuant to the provisions of Sarbanes-Oxley. In the 1980s and 1990s, the politics of regulation underwent a significant change and deregulation became the order of the day. The SEC then

---

[56]This authority was upheld in *Touche Ross & Co. v. SEC*, 609 F.2d 570 (2d Cir. 1979), but the nature of such a disciplinary proceeding and the type of proof needed remained controversial. *See* Checkosky v. SEC, 139 F.3d 221 (D.C. Cir. 1998). *See also* Dissenting Statement of Commissioner Norman S. Johnson, Amendment to Rule 102(e) of the Commission's Rules of Practice, Securities Act Release No. 7593, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,052, at 80,852 (Oct. 19, 1998) (criticizing the amendments to Rule 102(e) clarifying the Commission's standard for determining "improper professional conduct" as outside the Commission's authority).

[57]*See* ARTHUR LEVITT & PAULA DWYER, TAKE ON THE STREET WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW, WHAT YOU CAN DO TO FIGHT BACK 105-43 (2002); REPORT OF THE NATIONAL COMMISSION ON FRADULENT FINANCIAL REPORTING 63-78 (Oct. 1987).

[58]This is now Rule 102(e), 17 C.F.R. § 201.102(e) (2004).

[59]*See generally* Simon M. Lorne & W. Hardy Callcott, *Administrative Actions Against Lawyers Before the SEC,* 50 BUS. LAW. 1293 (1995) (discussing SEC Rule 2(e) and the trade-off between the administrative need to deter or remedy a lawyer's violation of securities laws and the professional responsibility of an attorney to provide effective legal advice). *See also* Robert W. Emerson, *Rule 2(e) Revisited: SEC Disciplining of Attorney Since* In re Carter, 29 AM. BUS. L.J. 155 (1991) (reviewing the Rule 2(e) debate and concluding that a disciplinary formula that moves away from adjudication while maintaining procedures to remove or rehabilitate malfeasant or incompetent attorneys is a workable compromise).

[60]*See In re* Jeffrey L. Feldman, Admin. Proc. No. 3-8063, Securities Act Release No. 7001, 54 SEC Docket 330 (May 27, 1993). The use of alternative remedies was not always effective. *See, e.g., In re* George C. Kern, Jr., Exchange Act Release No. 29,356, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991).

looked to the market for corporate control to discipline underperforming managers and tried to become a power in regulating that market. This effort failed, however, because of court decisions adverse to the SEC.[61] Furthermore, the SEC was not able to fully assert itself in the one share, one vote controversy. This failure requires an explanation of the role of stock exchange listing rules in corporate governance.

In the 1990s, the SEC was the beneficiary of federal statutes preempting state securities law. The National Securities Markets Improvements Act of 1996 (NSMIA)[62] preempted state securities law in three areas. First, it preempted blue-sky securities registration, merit review and prospectus disclosure requirements for SEC registered investment companies and stock exchange and Nasdaq listed securities.[63] It also preempted blue-sky law in most private placements.[64] Second, NSMIA preempted state regulation of broker-dealers with respect to capital, custody, margin, financial responsibility, records, bonding, and reporting requirements to the extent state regulation was inconsistent with federal law.[65] Third, the SEC was given exclusive regulatory authority over investment advisers to SEC registered investment companies and advisers with $25 million or more in assets under management.[66] In addition, the Securities Litigation Uniform Standards Act of 1998 (SLUSA)[67] curbed state law securities class action suits, providing that no class action based on state law alleging fraud in connection with the purchase or sale of a "covered security" may be maintained in state or federal court and any such action shall be removable to a federal district court and dismissed.[68] While such preemption did not give the SEC specific authority to regulate corporate governance, it did provide a precedent for supplanting other areas of state law relating to public companies.

---

[61] *See, e.g.*, CTS Corp. v. Dynamics Corp., 481 U.S. 69, 83 (1987); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 (Del. 1985).

[62] National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

[63] 15 U.S.C. § 77r (2001).

[64] *Id.*

[65] *Id.* § 78o(h)(1).

[66] Investment Adviser Act of 1940, 15 U.S.C. § 80b-3a(b)(1)(A) (2001).

[67] Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.).

[68] 15 U.S.C. § 77p(b)-(c) (2001).

### C. *The Role of Stock Exchange Listing Requirements*

Stock exchange listing requirements preceded both the federal securities laws and state blue sky laws. Written agreements between issuers and stock exchanges were initially enforceable only as a matter of contract law. As early as 1900, New York Stock Exchange, Inc. (NYSE) listing agreements included a provision requiring companies to distribute annual reports to stockholders.[69] In 1909, the NYSE added the requirement that stockholders hold an annual meeting.[70] Congress closely tracked NYSE listing requirements in drafting the disclosure provisions of the Exchange Act.[71] Even after the Act was passed, the NYSE remained concerned with the corporate governance practices of listed companies, adding such requirements as the need to obtain shareholder approval for any acquisition of assets from an insider resulting in a twenty percent dilution of outstanding shares and the need to have two outside directors on corporate boards.[72] In 1977, at the insistence of the SEC, the NYSE adopted a listing standard requiring all domestic companies to establish and maintain "an audit committee comprised solely of directors independent of management and free from any relationship that . . . would interfere with the exercise of independent judgment as a committee member."[73]

Although the Exchange Act as passed in 1934 granted the SEC authority to abrogate and amend self-regulatory organization (SRO) rules, including listing standards, the SEC never used this authority during the period from 1934 to 1975.[74] Then, in 1975, amendments to the Exchange Act gave the SEC significantly more power over SROs, including the power to approve or disapprove SRO rule changes and to unilaterally change SRO rules.[75] Not much attention was paid, in 1934 or in 1975, to the question of whether this power transformed listing requirements from state contract law provisions into federal regulations. The failure of the

---

[69]Special Study Group, *Special Study on Market Structure, Listing Standards and Corporate Governance,* 57 BUS. LAW. 1487, 1498 (2002) [hereinafter Special Study].

[70]*Id.*

[71]A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers,* 85 VA. L. REV. 925, 1008 (1999).

[72]Special Study, *supra* note 69, at 1500. For a summary of current corporate governance standards of the NYSE and the NASD, see *id.* at 1510-13.

[73]*See* New York Stock Exchange, Inc., Order Approving Proposed Rule Change, Exchange Act Release No. 13,346, 42 Fed. Reg.14,793, 14,794 (Mar. 16, 1977).

[74]*See* Special Study, *supra* note 69, at 1517.

[75]Exchange Act, § 19(b)-(c), 15 U.S.C. § 78s(b)-(c) (2001).

NYSE, however, to enforce its one share, one vote listing requirement[76] in the mid 1980s led to litigation concerning this question.

In response to the takeover boom of the mid and late 1980s many companies effected dual class recapitalizations in order to defend against unwelcome tender offers. At this time, the American Stock Exchange (Amex) permitted listed companies to have disparate voting rights for their common shares while the Nasdaq market had no rules on voting rights; this competitive threat motivated the NYSE to abandon its one share, one vote listing requirement.[77] In response, after failing to persuade the exchanges to voluntarily adopt a uniform voting rights rule, the SEC adopted its own rule to the Exchange Act, requiring the exchanges to bar the listing of a domestic corporations's securities if that company acted disparately to reduce the per share voting rights of existing stockholders.[78] The validity of this rule was tested in *Business Roundtable v. SEC*,[79] on the ground that the rule directly controlled the substantive allocation of powers among classes of shareholders and therefore exceeded the SEC's authority under section 19 of the Exchange Act.[80] The court found that the SEC regulation was a "rule" under sections 19(b) and (c) of the Exchange Act, but that it was not "in furtherance of the purposes of the Exchange Act."[81] The court's rationale was that there was no indication that Congress intended to permit such broad federal preemption over corporate governance and shareholder rights—matters traditionally left to state law.[82] This decision establishes the SEC's inability to create a comprehensive federal corporate law through listing standards. Instead, SEC authority over corporate governance listing standards must be reviewed on a case-by-case basis with respect to a specific Exchange Act purpose.[83]

---

[76]NYSE Listed Company Manual § 313.00(A) & (C) (repealed 1994); *NYSE'S Proposed Rule Changes on Disparate Voting Rights*, 18 Sec. Reg. & L. Rep. (BNA) 1389 (Sept. 19, 1986). Beginning in 1926 the NYSE refused to list any company with nonvoting common stock or any company with more than one class of common stock having disparate voting rights. Then in 1984 General Motors and other companies violated this policy and were not delisted and in 1986 the NYSE modified its rule. *See* Voting Rights Listing Standards; Disenfranchisement Rule, Exchange Act Release No. 25,891, 53 Fed. Reg. 26,376 (July 12, 1988) [hereinafter Disenfranchisement Rule].

[77]*Id. See* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 688, 707 (1986).

[78]Disenfranchisement Rule, *supra* note 76.

[79]905 F.2d 406 (D.C. Cir. 1990).

[80]*Id.* at 407.

[81]*Id.* at 409-17.

[82]*Id.* at 408.

[83]Special Study, *supra* note 69, at 1525.

Because Sarbanes-Oxley greatly enlarged the scope of the Exchange Act as to specific matters of corporate governance, the SEC acquired greater freedom to utilize SRO listing standards to accomplish corporate governance reform. In implementing Sarbanes-Oxley the SEC has made ample use of this new authority, raising the interesting question of how the line in the sand between federal and state regulation of a corporation's internal affairs should now be drawn. This question may be addressed in the context of SEC rulemaking to mandate that shareholder nominations for directors be included in management's proxy solicitation under certain circumstances.[84]

### D. *Preemption of State Blue Sky Laws*

When the Securities Act and the Exchange Act were passed, Congress did not exempt state law. To the contrary, "savings clauses" were inserted in both statutes.[85] As a result, state blue sky laws, which imposed a variety of corporate governance restrictions on companies making public offerings of their securities continued to co-exist with the federal securities and state corporation laws. These blue sky laws included such provisions as restrictions on the offering price relative to book value or some other metric, anti-dilution regulations, and restrictions on promoters' and underwriters' compensation.[86] Listed issuers were generally exempt from these requirements, however, because most state securities laws provided an exemption from their securities registration requirements for such issuers.[87] Although the SEC never had authority or attempted to impose such merit standards on IPO offerings, the NASD did so through its regulation of underwriters.[88]

The federal securities laws and state blue sky laws co-existed until 1996 when Congress passed NSMIA, and preempted most blue sky securities registration and merit review.[89] The congressional justification for such preemption was that the system of dual federal and state securities

---

[84]*See infra* text accompanying notes 266-74.

[85]*See* Russell A. Smith, *State "Blue Sky" Laws and the Federal Securities Acts*, 34 MICH. L. REV. 1135, 1160 (1936).

[86]*See* Roberta S. Karmel, *Blue Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOK. L. REV. 105, 117 n.51, 126 tbl. I (1987).

[87]*See Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 792-93 (1986).

[88]Conduct Rule 2710-2730, N.A.S.D. Manual (2003).

[89]*Supra* notes 62-66.

regulation was unnecessarily redundant, costly, and ineffective.[90] While NSMIA did not give the SEC powers akin to those of a merit regulator, by preempting state merit regulation the statute put the SEC in a position to impact underwriting practices and compensation, either directly or though NASD rulemaking. Current investigations and rulemaking regarding underwriting abuses exceed the scope of this article, but some of the problems being addressed have corporate governance implications.[91] Further, there is a serious power struggle in progress between state and federal authorities in this area.[92]

### E. *Delaware Case Law*

Much has been written on the regulatory competition between the states for corporate charters[93] while less attention has been given to competition between the SEC and state legislators and judges.[94] With

---

[90]H.R. CONF. REP. NO. 104-864, at 39 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3920.

[91]For example, one practice which has led to some prosecutions involves "spinning" whereby favored customers buy initial public offerings, the price immediately rises, and these favored customers sell at a substantial profit. When the favored customers are officers and directors of underwriting clients there is a question as to whether these officers have breached state fiduciary duties as well as federal and state securities laws. *See* Therese H. Maynard, *Spinning in a Hot IPO—Breach of Fiduciary Duty or Business as Usual?*, 43 WM. & MARY L. REV. 2023 (2002); NYSE/NASD IPO ADVISORY COMMITTEE, REPORT AND RECOMMENDATIONS 10 (May 2003).

[92]*See* Charles Gasparino, *Cleaning Up Wall Street: Morgan Stanley Goes to Washington*, WALL ST. J., June 21, 2002, at C1; Richard Hill, *Panel Postpones Action on Bill Panned by States for Stripping Power*, 35 Sec. Reg. & L. Rep. (BNA) 1243 (July 28, 2003); Tim Lauricella et al., *Morgan Stanley Case Illustrates States' Strategy*, WALL ST. J., July 15, 2003, at B1. *See also* Stephen M. Cutler, Remarks at the F. Hodge O'Neal Corporate and Securities Law Symposium (Feb. 21, 2003), *at* http://www.sec.gov/news/speech/spch022103smc.htm (discussing the competing role of federal and state securities regulation).

[93]The seminal article on the subject was Cary, *supra* note 42, arguing that the competition for corporate charters led to a race to the bottom respecting legal standards and therefore a minimum federal standard in corporate law was necessary. In response to Professor Cary, others argued that such competition led to a race to the top. *See* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). *See also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1-40 (1991) (explaining that states with the best laws attract the most corporate investment); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 1-2 (1993) (discussing state competition to attract corporations). This debate continues. *See, e.g.*, Lucian Ayre Bebchuk & Allen Ferrell, *On Takeover Law and Regulatory Competition*, 57 BUS. LAW. 1047 (2002); Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961 (2001); Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103 (2002).

[94]Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003); Jonathan R. Macey, *Displacing Delaware: Can the Feds Do a Better Job Than the States in Regulating Takeovers?*, 57 BUS. LAW. 1025 (2002).

respect to control contests, state legislators frequently have put anti-takeover statutes in place, whereas the policy of the SEC has been at least neutral as between bidders and targets, if not tilted toward bidders.[95] In the end, the Supreme Court upheld the state statutes even though the SEC believed they should have been preempted.[96] In another chapter of the story, when the Delaware Supreme Court held that an issuer could defend against a hostile bid by instituting an issuer self-tender addressed to all shareholders but the bidder,[97] the SEC responded by adopting the all-holders rule prohibiting such conduct.[98]

A substantial number of listed companies are incorporated in Delaware.[99] As the preeminent authority on state corporate law, the Delaware courts have frequently reacted to federal securities law developments by changing interpretations of Delaware law. The SEC on the other hand often reacts to Delaware case law developments through rulemaking to overcome or clarify doctrines that the SEC believes do not provide investors adequate protection, as it did by adopting the all-holders rule. A good example of this dialogue between the Delaware courts and the SEC occurred after the U.S. Supreme Court decided *Santa Fe*.[100] After the Court rejected the plaintiff's claims that breaches of fiduciary duty could be a federal action and that a freezeout merger without a corporate business purpose was fraudulent under Rule 10b-5,[101] the Delaware courts were challenged to express greater concern for minority shareholder interests in going-private transactions. The Delaware Supreme Court, in response, held that a long-form merger made for the sole purpose of freezing out minority shareholders was an abuse of the corporate process and a breach of duty.[102] Then, in 1979, the SEC passed Rule 13e-3, which requires the issuer in a going-private transaction to disclose the true purpose of the transaction and alternative ways of achieving that purpose, the probable detriments and benefits to the issuer and minority shareholders, and whether the issuer

---

[95]*See* Edgar v. MITE Corp., 457 U.S. 624, 627-33 (1982).

[96]CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 83 (1987).

[97]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 (Del. 1985).

[98]Rules 13e-4(f), 14d-10, 17 C.F.R. § 240.13e-4(f), 14d-10 (2004).

[99]*See* Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. SUPP. 317, 339 (1998).

[100]Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), *rev'g* 533 F.2d 1283 (2d Cir. 1976).

[101]*Id.* at 478-80.

[102]Singer v. Magnavox Co., 380 A.2d 969, 980 (Del. 1977). In *Tanzer v. Int'l Gen. Indus., Inc.*, 379 A.2d 1121, 1124 (Del. 1977), the court similarly held a cashout merger was proper so long as it was for a *bona fide* purpose and entirely fair to the minority.

believes the transaction is fair to unaffiliated holders.[103] A few years later, in *Weinberger v. UOP, Inc.*,[104] the Delaware Supreme Court held that a parent tender offer for shares of a 50.5% owned subsidiary had to be entirely fair to the minority; this meant fair dealing and fair price.[105] In view of this holding and an expanded appraisal remedy, however, the court abandoned the *Singer* business purpose test.[106]

Although the SEC has generally managed to utilize disclosure requirements as a prophylactic device to achieve some modification of corporate conduct, the agency has chafed at being unable to directly regulate corporate behavior. Furthermore, the SEC has viewed the absence of any regulation of corporate board structure negatively.[107] In this connection it should be noted that state corporate law does not have regulatory requirements dictating particular board structures, including whether or not any independent directors are required on boards or particular committees such as the audit committee.[108] Legislators have instead remained silent on this issue so that corporations could deal with it flexibly and good corporate practices could develop over time.[109] Delaware courts have dealt with issues of board structure and independent directors in cases enforcing fiduciary duties[110] or in certain specific contexts such as whether demand needs to be made in a derivative case.[111] Very generally, the courts have encouraged boards to have independent directors by

---

[103] 17 C.F.R. § 240.13e-3 (2004). The SEC initially hoped to go much further than a disclosure rule, mandating substantive fairness in going-private transactions, but could not find the authority for such a rule. Dale Arthur Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 246 (1988).

[104] 457 A.2d 701 (Del. 1983).

[105] *Id.* at 710-11.

[106] *Id.* at 712. In *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001), the Delaware Supreme Court limited Weinberger to long-form mergers. *Id.* at 248.

[107] *See supra* text accompanying notes 46-52.

[108] *See generally* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS, § 5.5 (2002) (discussing the myriad of proposals designed to fill in the perceived deficiency in state corporate codes that do little either to define the composition or function of the board).

[109] *See generally* EASTERBROOK & FISCHEL, *supra* note 93 (describing state corporate codes as "enabling statutes" that allow economics and experience to shape corporate structure).

[110] *See* McMullin v. Beran, 765 A.2d 910, 923 (Del. 2000); Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997); Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 44 (Del. 1994); Cooke v. Oolie, 2000 Del. Ch. LEXIS 89 (Del. Ch. May 24, 2000), *reprinted in* 26 DEL. J. CORP. L. 609 (2001).

[111] *See, e.g.*, Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988); Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984); Marx v. Akers, 666 N.E.2d 1034, 1037-40 (N.Y. 1996).

scrutinizing the actions of non-independent directors with greater skepticism.[112]

## III. CHANGES EFFECTED BY SARBANES-OXLEY

Sarbanes-Oxley was passed in response to the bursting of the stock market bubble of the late 1990s, and the uncovering of widespread financial fraud at large public companies that had been high fliers during the boom in technology stocks.[113] The demise of Enron, Adelphia Communications, Qwest, Global Crossing, WorldCom, and other companies resulted in enormous losses to shareholders and employees of the companies affected, not only of their jobs, but also of their pensions.[114] Without inquiring too deeply into the reasons for the bubble and its collapse, or why accounting irregularities at public companies had become so pervasive, Congress passed Sarbanes-Oxley to restore investor confidence. The statute was based primarily on recommendations from the SEC, and in the process the SEC acquired the power to regulate corporate governance at large public companies and to exercise much more regulation of auditors and attorneys.

A stock market bubble is primarily psychological and perhaps there was little anyone could have done to prick this bubble more promptly.[115] Politicians, however, are even more loathe than others to announce that the emperor is wearing no clothes. After Alan Greenspan observed that the stock market was suffering from "irrational exuberance," the Federal

---

[112]*See, e.g.*, Kahn v. Lynch Communications Sys., 638 A.2d 1110, 1120-21 (Del. 1994); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378, 379-80 (N.Y. 1918).

[113]About 1,000 companies had to restate earnings in the five years prior to the enactment of Sarbanes-Oxley. *See* Jeff Madrick, *Economic Scene—Bush is Talking Tough on Corporate Ethics, but Where is the Regulatory Bite?*, N.Y. TIMES, July 11, 2002, at C2. According to a Report of the General Accounting Office approximately ten percent of publicly traded companies restated their financials between 1997 and 2001. United States General Accounting Office, Report to the Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges, at 15 (Comm. Print 2002).

[114]*See* JOHN T. BOSTELMAN, THE SARBANES-OXLEY DESKBOOK §§ 2:1.2-2.3, 2:4.2-2:6 (2003). *See also* Susan J. Stabile, *Enron, Global Crossing, and Beyond: Implications for Workers*, 76 St. John's L. Rev. 815, 819-24 (2002) (discussing the disproportionate impact of stock failure on workers compared to executives).

[115]*See* Donald C. Langevoort, *Taming the Animal Spirits in the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 143-47 (2002); Symposium, *Enron; What Went Wrong?*, 8 FORDHAM J. CORP. & FIN. L. S1, S5-S6 (2002).

Reserve Board did nothing to dampen such optimism.[116] The financial shenanigans at Enron probably were discernable from Enron's SEC filings,[117] but the SEC did not review any of Enron's filings perhaps because, throughout the 1990s, Congress was extremely niggardly with funding for the agency.[118] Although the SEC was collecting huge fees from registrants during the 1990s, the SEC budget requests were repeatedly denied.[119] Assuming that any politician would want to end a feel good bull market economy, Congress was so corrupted by campaign contributions that it could not have blown the whistle on Enron.[120] Moreover, to the extent that misaligned compensation incentives were one cause of the stock market bubble,[121] Congress actually contributed to the problem by

---

[116]*See* Chairman Alan Greenspan, Remarks at the Annual Dinner and Francis Boyer Lecture of the American Enterprise Institute for Public Policy Research, *available at* http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm (Dec. 5, 1996). It has been argued that the Fed played a "key role in nurturing the equity bubble of the late 1990s by holding down interest rates." *See Breaking the Deflationary Spell—World Economy*, THE ECONOMIST, June 28, 2003, at 23, 25. The Fed could also have increased the fifty percent securities margin requirement, a level it declined to increase in June 1995 or thereafter. *See* Justin Fox, *Fed Would Ax Some Reg T Restrictions, but Maintain 50% Margin Requirement*, 160 AM. BANKER, June 29, 1995, at 11. Although this might not have been very effective in view of the growth of derivatives, it might have put a brake on the speculation by individual investors in margin accounts.

[117]*See* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TULANE L. REV. 1275, 1299-332 (2002); Anthony H. Catanach, Jr. & Shelley Rhoades-Catanach, *Enron: A Financial Reporting Failure?*, 48 VILL. L. REV. 1057, 1074 (2003).

[118]Press Release, Senate Comm. on Homeland Security & Governmental Affairs, Report Reveals "Systematic and Catastrophic Failure" of Financial Oversight in Enron Case (Oct. 7, 2002), *available at* http://govt-aff.senate.gov/100702press02.htm.

[119]*See* David Rogers, *House Approves $37.7 Billion Spending Measure*, WALL ST. J., Aug. 6, 1999, at A2; Michael Schroeder & Greg Ip, *Imperfect Guardian: SEC Faces Hurdles Beyond Low Budget in Stopping Fraud Legal Limits, Entrenched Ways Will Affect How Well It Meets New Expectations*, WALL ST. J., July 19, 2002, at A1. *See also* Office of the Executive Director of the SEC, *Self Funding Study, Submitted in Response to the Request of the Securities Subcomm. of the Senate Comm. on Banking, Housing and Urban Affairs* (Jan. 1989), *in SEC Study on Self-Funding: Hearing Before the House Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 100th Cong. 91 (Dec. 20, 1988) (discussing the Commission's lack of sufficient resources).

[120]Of the 248 Senators and House representatives serving on the 11 congressional committees that investigated Enron after it collapsed, 212 received campaign contributions from Enron or Anderson. Don Van Natta Jr., *Enron or Andersen Made Donations to Almost All Their Congressional Investigators*, N.Y. TIMES, Jan. 25, 2002, at C4.

[121]*See* John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990's*, 89 CORNELL L. REV. 269, 275 (2004).

interfering in the attempt by the FASB to treat stock options as corporate expenses.[122]

The purpose of this litany of governmental actors who might be blamed for investor losses that preceded the adoption of Sarbanes-Oxley is to suggest that the hearings preceding the statute were, at least in part, an effort by Congress to blame business instead of government for the nation's economic woes, and that the statute was, at least in part, an effort by the SEC to obtain more power over public companies and to facilitate prosecutions of business for derelictions that were already illegal. It is probably appropriate for the SEC to have greater power over the accounting profession; this is an issue that was studied and debated for years. Perhaps making high-ranking corporate officers individually responsible for a corporation's financial statements will lead to more accurate and more meaningful financial disclosure. Probably executive greed has become so completely out of control that substantive regulation of executive compensation is the only way to curb management remuneration. Perhaps investor protection requires some regulation of the legal profession by the SEC. But the implications of federalizing all of this regulation was not considered or debated in Congress before Sarbanes-Oxley was passed. The newspapers were full of corporate scandals and the SEC, Congress, and the White House felt they had to act to satisfy angry constituents.[123] Sarbanes-Oxley was thus enacted amidst much laudatory self-congratulation,[124] the Congress directed the SEC to implement its provisions, in many cases

---

[122]*See* LEVITT & DWYER, *supra* note 57, at 241-43. Despite the many efforts to bolster independence on the part of those who set accounting standards, Congress is once again interfering with decision making at the FASB on stock options. *See Moving the Market: House Panel Set to Rein in FASB on Options Rule*, WALL ST. J., June 16, 2004, at C3.

[123]*See* Meg Richards, *Corporate Reform*, THE CINCINNATI POST, July 28, 2003, at B7. Ironically, SEC Chairman Harvey Pitt, who was one of the masterminds behind Sarbanes-Oxley was driven out of office because of criticism from both the left and the right. *See* Abigail Rayner, *WorldCom Checks Its Accounts for "Further Irregularities,"* THE TIMES OF LONDON, July 2, 2002, at 27; On the same day in October 2002 the *Wall Street Journal* and the *New York Times* called for the resignation of Harvey Pitt as SEC Chairman. *Cleaning Up Dodge*, WALL ST. J., Oct. 10, 2002, at A14; *Revenge of the Accountants*, N.Y. TIMES, Oct. 10, 2002, at A38.

[124]President George W. Bush called Sarbanes-Oxley "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt." Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1. SEC Commissioner Harvey J. Goldschmid called Sarbanes-Oxley the "most sweeping reform since the New Deal." Shanon D. Murray, *Is SEC Ready for Its Own Sweeping Changes?*, N.Y.L.J., Aug. 29, 2002, at 6.

within a very short time period,[125] and the country turned to the 2002 congressional elections.[126]

Because Sarbanes-Oxley and its implementing regulations are exceedingly complex and prolix, this article will not attempt to discuss every provision of the statute, but will only highlight those provisions that particularly impact upon the federalization of corporate governance and the federalization of the regulation of accountants and attorneys for public companies.

### A. *Certifications*

Sarbanes-Oxley requires the SEC to adopt rules requiring the principal executive and financial officers of SEC registered issuers to certify annual and quarterly reports filed with the SEC.[127] The signing officers must certify that: he or she has reviewed the report, it does not contain untrue or misleading statements, it fairly presents in all material respects the financial condition and results of operations of the issuer, and the signing officers are responsible for establishing and maintaining internal controls, have designed such controls to ensure that material information is made known to such officers and others and have evaluated such controls.[128] Further, there are criminal penalties provided for false certifications.[129]

A related mandated disclosure is that companies include in their annual reports an assessment of their internal controls.[130] Under the SEC's final rules, an issuer's annual report must include: a statement of the management's responsibility over internal controls and reporting; a statement on the framework used to evaluate those controls over the past year; management's assessments of the effectiveness of these controls over the past year, with an identification of any material weaknesses; and a

---

[125]*See Wishy-Washy—New Governance Rules from the SEC*, ECONOMIST, Feb. 1, 2003, at 60.

[126]Although the Democrats tried to make corporate wrongdoing a campaign issue, this ploy was unsuccessful. The Republicans took control of both houses of Congress in November 2002. *See* Deborah McGregor, *Bush Knows War May Not Win Vote*, FINANCIAL TIMES, Sept. 24, 2002, at 11; *Congress: Point My Finger*, AM. POLITICAL NETWORK—THE HOTLINE, July 19, 2002, at 5; Adam Nagourney, *Republicans Point Corporate Abuse Finger at Democrats*, N.Y. TIMES, July 18, 2002, at A16.

[127]Sarbanes-Oxley, § 302(a), 15 U.S.C. § 7241(a) (2002).

[128]*Id.* These provisions have been implemented by rules 13a-14, 13a-15, 17 C.F.R. §§ 240.13a-14, 13a-15 (2004). *See* Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Act Release No. 8124, 67 Fed. Reg. 57,276 (Sept. 9, 2002).

[129]Sarbanes-Oxley, § 906(c), 18 U.S.C. § 1350(c) (2002).

[130]This disclosure is required by Sarbanes-Oxley, § 404(a), 15 U.S.C. § 7262(a) (2002).

statement that the issuer's auditors have attested to the management's assessment of internal controls.[131]

Prior to the enactment of Sarbanes-Oxley, the SEC proposed a rule requiring the certification of financial statements by executive officers.[132] After WorldCom's restatement announcement, the SEC even ordered the principal executive officers and principal financial officers of 947 named public companies to file a one-time certification about the accuracy of those companies' SEC filings, claiming authority for this order under an investigative section of the statute never previously utilized for such a purpose.[133] Although the SEC's authority for such an order was questionable,[134] Sarbanes-Oxley made such questions moot.

The filing of false or misleading financial statements with the SEC has long been subject to a variety of sanctions in SEC proceedings, criminal cases, and private litigation. Whether a CEO or CFO could be held liable for such statements generally depended on an analysis of the particular facts of a case.[135] The new certification requirement probably will make it easier to prosecute top executive officers in such situations, but will not prevent the filing of fraudulent financial statements.[136] The legal requirement that corporations have adequate systems of internal controls dates back to the 1977 amendments to the Exchange Act discussed above.[137] This need for directors to be concerned about internal control systems in fulfilling their duty of care responsibilities has been referred to in Delaware case law.[138] Sarbanes-Oxley adds another layer of legal obligation to this standard by imposing direct responsibility on executive

---

[131]*See* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 47,986, 68 Fed. Reg. 36,636 (June 8, 2003).

[132]Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 46,079, 67 Fed. Reg. 41,877, 41,879 (June 20, 2002).

[133]Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, File No. 4-460, *at* www.sec.gov/rules/other/4-460.htm (June 27, 2002).

[134]In the past, the author questioned the SEC's use of Section 21(a) for enforcement purposes. *See In re* Spartek, Inc., Securities Exchange Act Release No. 15,567, 16 SEC Docket 1094-1 (Feb. 14, 1979) (Karmel, Comm'r, dissenting).

[135]Liability could have been predicated on the theory that the officer or director was a direct participant in an accounting fraud, an aider and abettor or a control person. *See, e.g., In re* Par Pharmaceutical, Inc. Sec. Litig., 733 F. Supp. 668 (S.D.N.Y. 1990); General Elec. Co. v. Rowe, No. 89-7644, 1992 U.S. Dist. LEXIS 15036 (E.D. Pa. Sept. 30, 1992).

[136]*See* SEC Charges HealthSouth Corp., CEO Richard Scrushy With $1.4 Billion Accounting Fraud, Litigation Release 18,044 (Mar. 20, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18044.htm.

[137]*See supra* text accompanying notes 39-41.

[138]*See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967-70 (Del. Ch. 1996).

officers for the establishment and maintenance of internal control systems. There is no question that internal control systems are extremely important and are the predicate for accurate and reliable financial reporting in today's complex business environment. But do the new certification requirements really ensure the reliability of financial statements by adding layers of bureaucratic review that is costly and time consuming?[139]

The certification provision is of note because it gives the SEC direct regulatory authority over corporate officers of all public companies. The SEC was also given the power to bar executives from serving as corporate officers in administrative proceedings without the need to go to court.[140] This may seem like a negligible addition to the SEC's existing authority since corporations were already required to file accurate financial statements with the SEC and to have adequate systems of internal controls, but the SEC could well use this new authority to regulate corporate officers in ways not contemplated by the Congress that passed Sarbanes-Oxley.

### B. *Executive Compensation and Loans*

During the 1990s, executive compensation reached exorbitant levels. In 1980, the ratio of CEO pay to the pay of rank and file employees was 42 to 1; in the early 1990s it surged to 120 to 150 to 1. It then rose to about 475 to 500 to 1 by the end of the decade.[141] It has been argued that this disparity was due in part to the shareholder primacy norm..[142] It can also be argued that shareholders have inadequately constrained executive compensation norms, and that executive compensation is set by the managers with little outside control.[143] Although the setting of executive compensation is a self-dealing transaction, there has been a curious absence of judicial review of CEO pay, and instead a deference to market forces to

---

[139]These requirements have spawned much work for corporate advisors suggesting ways in which officers can comply with the new regulations. *See, e.g.*, BOSTELMAN, *supra* note 114, § 5.3.4-6.

[140]Sarbanes-Oxley § 1105(f),15 U.S.C.§ 78u-3(f) (2002). Previously, the SEC could only obtain such bars by way of a court order.

[141]*See* Susan J. Stabile, *One for A, Two for B, and Four Hundred for C: The Widening Gap in Pay Between Executives and Rank and File Employees*, 36 U. MICH. J.L. REFORM 115, 115-16 (2002).

[142]*Id.* at 117, 134.

[143]*See generally* Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002) (arguing that a "managerial power approach" in which boards deviate from optimal compensation schemes because directors are influenced by or sympathetic to management more accurately explains excessive executive compensation arrangements).

determine appropriate compensation levels.[144] The SEC's traditional approach to executive compensation was through disclosure regulation, with an implicitly strong suggestion that the compensation committee should be composed of independent directors.[145] Although annual compensation paid to the CEO and four other highest paid officers of public companies in excess of $1 million may not be deducted as an ordinary and necessary business expense,[146] this legislative effort to cap executive pay has either been avoided through the structure of contingent compensation schemes or ignored.[147]

The campaign by institutional investors in the 1990s to align management compensation with shareholder interests only made matters worse because this idea placed a portion of CEO compensation at risk according to a performance based formula devised by compensation consultants beholden to management.[148] Stock option grants were a significant component of CEO compensation in part because such options were not treated as a cost for financial reporting purposes.[149] In a rising market these options and other stock based compensation arrangements became very valuable.[150] It can be argued that the widespread use of stock options were a key cause of the 1990s stock market bubble and its collapse. The equity-based compensation formulas that became so popular shifted the focus of corporate executives to stock market prices and away from more traditional metrics of business prosperity and growth, and provided

---

[144]Generally, where there is a self-dealing transaction, the transaction will be voidable unless it is disclosed to and approved by disinterested directors; it is disclosed to and approved by disinterested shareholders; or it is fair to the corporation. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (2001); N.Y. BUS. CORP. L. § 713(a) (2003). State statutes, however, permit directors to fix their own compensation, *see, e.g.*, DEL. CODE ANN. tit. 8, § 141(h) (2001); N.Y. BUS. CORP. L. § 713(e) (2003), and the test for upholding management remuneration is that it only needs to be reasonable, rather than fair. *See, e.g.*, Zupnick v. Goizueta, 698 A.2d 384, 387 (Del. Ch. 1997); Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 892 (Del. Ch. 1999). *See also* AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.05 (1994) (recommending that large publicly held corporations be required to have an independent audit committee). In a particularly egregious recent case, a derivative suit alleging waste survived a motion to dismiss, perhaps a harbinger of a change in judicial deference to directors in setting executive compensation. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003).

[145]*See* Executive Compensation Disclosure, Securities Act Release No. 6962, 57 Fed. Reg. 48,126 (Oct. 21, 1992).

[146]I.R.C. § 162(m)(1), 26 U.S.C. § 162(m)(1) (2003).

[147]*See* Stabile, *supra* note 141, at 159-61.

[148]*See id.* at 133-41; Bebchuk et al., *supra* note 143, at 789-93.

[149]*See* Laura Jereski, *Found Money: Stock-Option Exercise is Bringing Many Firms a Big Break on Taxes They Needn't Spend Money to Get the Deduction; That Stirs Controversy; Hidden Cost: Big Buybacks*, WALL ST. J., May 13, 1997, at A1.

[150]*See* Stabile, *supra* note 141, at 140-41.

strong incentives to manipulate accounting principles and financial statements.[151]

Although Congress did not try to limit executive compensation directly, several provisions of Sarbanes-Oxley, all of which are self-executing, were directed at specific management compensation abuses. First, where an issuer must file an accounting restatement due to misconduct, the CEO and CFO must return any bonus, incentive, or equity-based compensation, or profits from the sale of the issuer's securities during the twelve month period following the publication of the financial statement.[152] Second, to give some teeth to this provision, Congress authorized the SEC to freeze assets to prevent an issuer from paying bonuses to executives in cases involving financial fraud.[153] Third, directors and executive officers of issuers are prohibited from trading in any equity securities of the issuer during any employee fund blackout period .[154] These provisions were in response to well-publicized abuses at Enron and other companies prior to the time Sarbanes-Oxley was enacted,[155] and were relatively noncontroversial. The fourth provision of Sarbanes-Oxley that affected management compensation prohibited companies from extending, maintaining or arranging for the extension of credit to any director or CEO of any public company.[156] This section proved very disruptive of standard arrangements at many corporations. For example, questions concerning indemnification advances, travel advances, personal use of a company car, split dollar life insurance, and cashless option exercises have been so pervasive that twenty-five major law firms released a joint outline describing their views on interpretive issues with respect to the prohibition against loans to CEOs.[157]

Although the foregoing provisions of Sarbanes-Oxley were addressed to specific outrageous abuses, regulation of any aspect of executive compensation is a major step in the federalization of corporate governance. The widespread consensus that executive compensation

---

[151]Coffee, *supra* note 121, at 273-78.

[152]Sarbanes-Oxley, § 304, 15 U.S.C. § 7243 (2002).

[153]Sarbanes-Oxley, § 1103, 15 U.S.C. § 78u-3 (2002).

[154]Sarbanes-Oxley, § 306, 15 U.S.C. § 7244 (2002).

[155]The loans made to executives of Tyco International Ltd., which were exposed shortly before Sarbanes-Oxley was signed, were particularly egregious. *See* Andrew Ross Sorkin & Susan Saulny, *Former Tyco Chief Faces New Charges*, N.Y. TIMES, June 27, 2002, at C1.

[156]Sarbanes-Oxley, § 402(k), 15 U.S.C. § 78m(k) (2002).

[157]*See* BOSTELMAN, *supra* note 114, §§ 13:2.1-2.6.

became out of control during the 1990s[158] could become a populist rallying cry for reform of management remuneration. As a result, the SEC could be pressured to use Sarbanes-Oxley as a means to reign in executive pay possibly through regulation of corporate compensation committees or SRO listing rules.

### C. *Codes of Ethics and Whistleblowers*

Sarbanes-Oxley requires the SEC to issue rules to require issuers to disclose whether they have codes of ethics applicable to senior financial officers.[159] Accordingly, the SEC passed implementing rules requiring issuers to disclose in their annual reports whether a code of ethics has been adopted and to file such a code with the SEC.[160] The way in which the SEC defined the term "code of ethics" is quite broad and was interpreted to mean:

> written standards that are reasonably designed to deter wrongdoing and to promote:
>
> > (1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
> > (2) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;

---

[158] *See generally* THE CONFERENCE BOARD, COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE, FINDINGS AND RECOMMENDATIONS, PT. 1 EXECUTIVE COMPENSATION (Sept. 17, 2002) (noting a widespread perception of lack of fairness with regard to executive compensation). *See also* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1413-19 (2002) (explaining incentive to engage in short-term stock price maximization where executives are compensated with stock options); Tod Perry & Mark Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123 (2000) (expressing little surprise that executive compensation has become a political issue). *Cf.* Marc J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1 (2000) (arguing that majority of current research does not support conclusion that CEOs are overpaid).

[159] Sarbanes-Oxley, § 406, 15 U.S.C. § 7264 (2002).

[160] Item 406 of Regulation S-K, 17 C.F.R. § 229.406 (2004). *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177, 68 Fed. Reg. 5110 (Jan. 31, 2003).

> (3) Compliance with applicable governmental laws, rules and regulations;
> (4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and
> (5) Accountability for adherence to the code.[161]

The SEC rules do not specify the exact details that must be included in a code of ethics or any specific language that must be used. Some of the matters have been included in SRO proposed rules.[162] The open-ended nature of the Sarbanes-Oxley provisions regarding codes of ethics and the SEC rules, however, give considerable scope to the SEC to insert its views concerning corporate governance into the workings of public corporations, either through future enforcement actions or otherwise.

As noted above, one of the matters which must be addressed in a code of ethics is the prompt internal reporting of violations of the code. This fits in with the provisions federalizing state law that protect whistleblowers.[163] The whistleblower protection provisions are contained in three separate sections of Sarbanes-Oxley. First, Sarbanes-Oxley establishes a civil cause of action that protects employees of publicly traded companies who assist in the investigation of conduct that the employee "reasonably believes" is a violation of federal mail, wire, bank, or securities fraud statutes, any rule or regulation of the SEC, or any federal law protecting shareholders from fraud.[164] Another provision establishes criminal liability for whistleblower retaliation.[165] Finally, audit committees of public companies are required to establish procedures for "the receipt, retention, and treatment of complaints" the company receives regarding "accounting, internal accounting controls, or auditing matters," and certain confidential anonymous submissions by employees concerning questionable accounting or auditing.[166]

---

[161]17 C.F.R. § 229.406(b) (2004).

[162]*See infra* text accompanying notes 237-42.

[163]*See* Dennis J. Block & Jonathan M. Hoff, *Whistleblower Protection Under the Sarbanes-Oxley Act*, N.Y. L. J., June 26, 2003, at 5.

[164]Sarbanes-Oxely, § 806, 18 U.S.C. § 1514A (2002).

[165]Sarbanes-Oxley, § 1107, 18 U.S.C. § 1513 (2002).

[166]Sarbanes-Oxley, § 301(4), 15 U.S.C. § 78j-l(4) (2002).

### D. *Audit Committees*

The SEC began advocating the value of independent audit committees as early as 1941,[167] but took no action to implement this idea until the mid-1970s. It then brought several enforcement cases in which consent injunctions ordered board restructuring so there would be an audit committee with a majority of unaffiliated or independent directors.[168] In addition, the SEC used its leverage with the NYSE and other SROs to persuade them to require an audit committee with a majority of independent directors as a condition of listing on an exchange.[169] In July 1978, the SEC proposed management affiliation rules to indirectly encourage corporations to replace directors, who were officers or otherwise affiliated with a corporation, with unaffiliated directors. As proposed, these rules would have required all corporations subject to its proxy rules to label their directors as "independent" or "affiliated."[170] Although the final rules did not go this far,[171] the SEC continued to believe in the value of audit committees of independent directors.

In September 1998 the heads of the NYSE and the NASD appointed a Blue Ribbon Committee at the behest of the Chairman of the SEC to inquire into the adequacy of the audit oversight process by independent directors. The Committee issued a report recommending that the NYSE and the NASD require listed companies with a market capitalization above $200 million to have an audit committee composed solely of independent directors.[172] The Committee also recommended a requirement of financial

---

[167]*In re* McKesson & Robbins, Inc., Accounting Series Release No. 19 (Dec. 5, 1940), 11 Fed. Reg. 10,918 (Sept. 27, 1946).

[168]*See, e.g.*, SEC v. Killearn Props., Inc., [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,256 (May 1977); SEC v. Mattel, Inc., [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,807 (Oct. 1, 1974).

[169]*See In re* NYSE, Exchange Act Release No. 13,346, 11 SEC Docket 1945 (Mar. 9, 1977); AM. LAW INST., *supra* note 144, § 3.05, cmt. a.

[170]Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 14,970, 43 Fed. Reg. 31,945 (July 24, 1978). *See also* Securities Exchange Act Release No. 13,901, 42 Fed. Reg. 44,860 (Sept. 7, 1977) (requiring disclosure of any personal or business relationships of any nominee director).

[171]Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 15,384, 43 Fed. Reg. 58,522, at 58,524 (Dec. 14, 1978).

[172]REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES (1999) [hereinafter BLUE RIBBON COMMITTEE REPORT]. The Committee recommended that members of an audit committee should be considered independent only "if they have no relationship to the corporation that may interfere with the exercise of their independence from management." *Id.* at 10. Examples of questionable

literacy for audit committee members.[173] In lieu of rule proposals by the SEC, the SROs filed proposals for amended listing standards.[174] Following the collapse of Enron in February 2002, the SEC asked the SROs to further review their listing requirements with the goal of enhancing the accountability, integrity and transparency of listed companies. In June 2002, a committee of the NYSE issued a report on possible changes to the NYSE listing standards.[175] This report contained a variety of recommendations that went beyond Sarbanes-Oxley, including: requiring listed companies to have a majority of independent directors, with a stringent definition of the term "independent"; provision for regularly scheduled executive sessions of boards chaired by a lead director or independent chairman; requiring listed companies to have nominating and compensation committees composed entirely of independent directors; and requiring shareholder votes on equity-compensation plans.[176] Several of these recommendations were then filed with the SEC as proposed new listing standards. Among the NYSE proposals were listing requirements to the effect that non-management directors must meet at regularly scheduled executive sessions and that nominating and compensation committees be composed entirely of independent directors.[177] Nasdaq filed

---

relationships were: "employ[ment] by the corporation or any of its affiliates for the current year or any of the past five years"; receiving any compensation other than "for board service or benefits under a tax-qualified retirement plan";

> being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer, . . . being a partner in, or controlling shareholder or an executive officer of, any for-profit business organization

with "significant" transactions with the corporation in any of the past five years; employment "as an executive of another company where any of the corporation's executives serves on that company's compensation committee." *Id.* at 10-11. A "significant" transaction is $200,000 over a two year period. *Id.* at 10 (citing AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE § 1.34(a)(4) (1992)).

[173]BLUE RIBBON COMMITTEE REPORT, *supra* note 172, at 25-26.

[174]Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by NYSE, Amending Audit Committee Requirements of Listed Companies, Exchange Act Release No. 41,980, 64 Fed. Reg. 55,514 (Oct. 13, 1999); Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change By Nat'l Ass'n of Securities Dealers, Inc. Amending Nasdaq's Audit Committee Requirements, Exchange Act Release No. 41,982, 64 Fed. Reg. 55,510 (Oct. 13, 1999); Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the American Stock Exchange LLC Amending the Exchange's Audit Committee Requirements, Exchange Act Release No. 41,981, 64 Fed. Reg. 55,505 (Oct. 13, 1999).

[175]REPORT OF THE NEW YORK STOCK EXCHANGE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE (June 6, 2002).

[176]*Id.* at 2-3.

[177]*See* Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance, Exchange Act Release No. 47,672, 68 Fed. Reg. 19,051, 19,054 (Apr. 17, 2003).

similar listing proposals with the SEC.[178] The SEC finally approved the revised listing standards by the NYSE and Nasdaq on November 4, 2003.[179]

Sarbanes-Oxley gave the SEC the authority the agency had long wanted to restructure corporate audit committees, but it did so primarily by authorizing the SEC to direct SROs to change their listing rules to meet certain standards.[180] Sarbanes-Oxley also gave the SEC a mandate to require a public company to disclose whether its audit committee includes at least one "financial expert."[181] The regulation of public company audit committees by SROs and the substantive standards articulated in Sarbanes-Oxley, respectively, pushed listing standards further in the direction of making the audit committee independent. Indeed, the statute took authority for financial reporting away from management and placed it with the audit committee. Moreover, it made the audit committee a potential critic and antagonist of the CEO and CFO. The specific grant of authority to the SEC to regulate the structure and duties of audit committees was a radical departure from previous legal theories regarding the divide between federal and state law.

There are a number of important ways in which Sarbanes-Oxley altered the structure and work of audit committees. Each member of the audit committee of a listed issuer must be "independent," and this term was defined to mean that an audit committee member may not, other than in his or her capacity as a board member, accept any consulting, advisory, or other fee compensation from the issuer, or be an affiliated person, the issuer, or any subsidiary.[182] The audit committee must become directly

---

[178]*See* Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Assoc. of Securities Dealers, Inc. Relating to Proposed Amendments to NASD Rules 4200 and 4350 Regarding Board Independence and Independent Committees, Exchange Act Release No. 47,516, 68 Fed. Reg. 14,451, 14,453-54 (Mar. 25, 2003).

[179]Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes Relating to Corporate Governance, Exchange Act Release No. 48,445, 68 Fed. Reg. 64,154 (Nov. 12, 2003) [hereinafter Listing Rules Approval].

[180]Sarbanes-Oxley, § 301, 15 U.S.C. § 78j-1 (2002).

[181]Sarbanes-Oxley, § 407, 15 U.S.C. § 7265 (2002).

[182]Sarbanes-Oxley, § 301, 15 U.S.C. § 78j-1 (2002). This is more stringent than prior definitions of independence utilized for listed company audit committees. Prior NYSE listing rules required all listed domestic companies to establish and maintain audit committees comprised solely of directors independent of management and free from any relationship that, in the opinion of its board of directors, would interfere with their exercise of independent judgment as a committee member. *See* In re NYSE, Exchange Act Release No. 13,346, 11 SEC DOCKET 1945 (Mar. 9, 1977). Other formulations similarly allowed directors to exercise their business judgement within generally enunciated rules to determine questions of independence. *See, e.g.*, Committee on Corporate Laws, American Bar Association, *Corporate Director's Guidebook—1994 ed.*, 49 BUS. LAW. 1243, 1257-58, 1264 (1994). The concept of an

responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer.[183] Audit committees must establish procedures for receiving, retaining and treating complaints regarding accounting, internal controls or auditing matters and the confidential, anonymous submission of concerns by employees of the issuer regarding questionable accounting or auditing matters.[184] The audit committee must also have the authority to engage independent counsel and other advisers and be adequately funded.[185] Although all of these requirements were to be implemented by SRO rather than SEC rules, the SROs only have authority to go beyond, not derogate from, these minimum standards. The SEC was also directed to adopt rules requiring a public company to disclose whether its audit committee includes at least one person who is a "financial expert."[186] Taken as a whole, these rules undercut the long-standing principle of state law that the entire board of directors is responsible for directing the management and supervising the affairs of a corporation.[187] The audit committee is now required to be set up as a kind of executive committee for certain purposes and the "financial expert" becomes a super committee member. Further, an adversarial model of governance is substituted to a certain extent for the traditional collegial model of board governance. The implications of these changes, in terms of director liability and board practice, will probably take some time to be felt and understood.

The SEC implementation of the Sarbanes-Oxley requirement that companies have a "financial expert" on the board or disclose why not,[188] also thrust the SEC directly into corporate governance. The SEC's proposed rule would have defined a "financial expert" to mean "a person who has, through education and experience as a public accountant or auditor or as a principal financial officer, controller, or principal accounting officer of [an SEC reporting company]" or similar position with certain enumerated attributes: an understanding of GAAP; experience applying GAAP "in connection with the accounting for estimates, accruals, and

---

independent director is a fluid one, however, and is difficult to encapsulate in a legislative definition. *See, e.g.*, *In re* Oracle Corp. Derivative Litig., 808 A.2d 1206 (Del. Ch. 2003).

[183]15 U.S.C. § 78j-1(2).

[184]*Id.* § 78j-1(4).

[185]*Id.* § 78j-1(5).

[186]15 U.S.C. § 7265 (2002).

[187]*See* Letter from the Committee on Federal Regulation of Securities of the American Bar Association, Section of Business Law, American Bar Association Comment on Proposed NYSE/Nasdaq Corporate Governance Listing Standards, to SEC (June 2, 2002), *available at* http://www.sec.gov/rules/sro/nyse200233/aba060203.htm.

[188]15 U.S.C. § 7265 (2002).

reserves" generally comparable to those of the registrant; experience preparing or auditing financial statements generally comparable to those of the registrant; "experience with internal controls and procedures for financial reporting"; and "an understanding of audit committee functions."[189] Commenters believed that this definition was unduly narrow and limiting and, in addition, were concerned about the possible personal liability of the financial expert.[190]

In its final rule, the SEC changed the term "financial expert" to "audit committee financial expert" and required reporting companies in their annual reports to either disclose that they have at least one such expert or that there is no such expert and explain why.[191] Such an expert must have the following attributes: an understanding of GAAP and financial statements; the ability to assess the general application of GAAP in connection with accounting for estimates, accruals, and reserves; experience preparing, auditing, analyzing, or evaluating financial statements generally comparable to the registrant's; an understanding of internal controls; and an understanding of audit committee functions.

The proposing release seemed to envision that the audit committee financial expert would have to be a public accountant or corporate financial officer. This approach, however, went too far and would have eliminated such personalities as Warren Buffet and Alan Greenspan from qualifying.[192] Although this formulation did not become final, it demonstrates the dangers of bureaucratic approaches to corporate governance. In its final rule, the

---

[189]Disclosure Required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8138, 67 Fed. Reg. 66,208, 66,211 (Oct. 30, 2002).

[190]*See, e.g.*, Comments of Davis Polk & Wardwell on S7-40-02—Disclosure Required by Section 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, at 3 (Nov. 29, 2002), *available at* http://www.sec.gov/rules/proposed/s74002/davispolk.1.htm; Comments of Confederation of British Industry on S7-40-02, SEC Consultation on Proposed Rules Regarding Disclosures Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, at 1 (Nov. 29, 2002), *available at* http://www.sec.gov/rules/proposed/s74002/cedrupt1.htm; Comments of Clearly, Gottlieb, Steen & Hamilton on S7-40-02, Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, at 2 (Nov. 27, 2002), *available at* http://www.sec.gov/rules/proposed/s74002/clearygot1.htm; Comments of the European Commission on S7-40-02, Release Nos. 38-8138, 34-46701, 1C25775, at 2 (Nov. 29, 2002); Comments of Fried, Frank, Harris, Shriver & Jacobson on S7-40-02, Release Nos. 33-8138, 34-46701, 1C-25775, at 3 (Nov. 29, 2002), *available at* http://www.sec.gov/rules/propsed/s74002/friedfrank1.htm.

[191]Regulation S-K, Item 401(h), 17 C.F.R. § 229.401(h) (2004). *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177, 68 Fed. Reg. 5110 (Jan. 31, 2003); Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002; Correction, Securities Act Release No. 8177A, 68 Fed. Reg. 15,353 (Mar. 31, 2003).

[192]SEC Commissioner Cynthia A. Glassman, Speech by SEC Commissioner: SEC Implementation of Sarbanes-Oxley: The New Corporate Governance, *available at* http://www/sec/gov/news/speech/spch040703cag.htm (Apr. 7, 2003).

SEC recognized that a person could have acquired his or her qualifications to be an audit committee financial expert though education and experience as a financial officer or auditor, experience as a supervisor or as a person assessing the performance of companies or public accountants or "other relevant experience."[193] Additionally, a safe harbor was crafted for audit committee financial experts to the effect that such a designation should not impose any greater duties, obligations or liability than such a person would have as a member of an audit committee.[194]

The notion that an audit committee should have a financial expert was derived from the recommendation of the NYSE-NASD Blue Ribbon Committee that audit committee members should be financially literate. There is nothing wrong with this idea, but to have it encapsulated in a governmental definition is a mischievous first step toward governmentally imposed credentials for audit committee members and corporate directors generally. Corporate law has never imposed qualifications upon directors, and the SEC should not be given this authority either. Further, the SEC's assumption in its rulemaking that the audit committee should become some kind of a super-auditor to audit the auditors is unrealistic. If the audit committee were to spend the requisite amount of time needed to do such a job for a large public corporation so many hours would be required that the compensation for audit committee members would make them non-independent as a practical matter. If the auditors and the SEC were unwilling or unable to prevent the financial frauds of Enron and other bubble companies, directors are not going to be able to do so either, however well intentioned, independent and expert they might be. The heightened attention to the possibility of financial fraud that Sarbanes-Oxley has imposed on corporate boards of directors is undoubtedly worthwhile, but the inflexible corporate structure now mandated by SEC rules is troublesome.

### E. *Regulation of Accountants*

The creation of the Public Company Accounting Oversight Board (PCAOB), a new federal watchdog for the regulation of the public accounting profession, is at the heart of the reforms embodied in Sarbanes-Oxley, but this new framework only affects corporate governance indirectly. An explanation of the SEC's efforts and frustrations with regard to the regulation of auditors is a large topic that goes far beyond the scope of this article. Nevertheless, the SEC's new power to regulate auditors will

---

[193] 17 C.F.R. § 229.401(h)(3) (2004).

[194] *Id.* § 229.401(h)(4)(ii).

be briefly described for two reasons. First, it involves the federalization of a power previously assigned to the states—the power to license and discipline accountants. Second, the extent of the SEC's new powers in combination with the reform of audit committees described above will impact the corporate governance of public companies because the alliance of audit committees and auditors has been set up to operate as a counterbalance to the power of management over financial reporting.

When Congress was debating the passage of the Securities Act, certain congressmen proposed that a corps of government auditors be established to audit public companies.[195] Congress instead required that financial statements filed with the SEC be certified by an independent certified or public accountant and gave the SEC power to prescribe the detail and content of such financial statements.[196] In addition, the SEC was empowered to define "accounting, technical and trade terms" and prescribe the form in which required information should be presented, the items to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of accounts.[197] The SEC adopted Regulation S-X and similar regulations to implement these provisions,[198] but also assigned considerable responsibility for formulating accounting principles to private sector organizations, specifically the FASB and its predecessors.[199] The continued existence of the FASB and its mission of establishing GAAP was contemplated by Sarbanes-Oxley, although certain conditions were attached to its continued recognition as an authoritative standard setter, including the composition of its board and the source of its funding, to assure independence from the accounting profession.[200]

Until the enactment of Sarbanes-Oxley, SEC oversight of auditing practices and standards was much more tenuous. As a general matter, the licensing and discipline of accountants is conducted by state boards of accountancy. All accounting firms, however, who practiced before the SEC were required to join the SEC Practice Section (SECPS) of the American

---

[195]*See, e.g.*, A Bill to Provide for the Furnishing of Information and the Supervision of Traffic in Investment Securities in Interstate Commerce: Hearing on S. 875 Before the Senate Comm. on Banking and Currency, 73d Cong., lst Sess. 58-59 (1933) (statements of Sen. Reynolds).

[196]Securities Act, Schedule A, Items 25-27, 15 U.S.C. § 77aa(25)-(27) (2001).

[197]Securities Act, § 19(a), 15 U.S.C. § 77s(a) (2001).

[198]17 C.F.R. Pt. 210 (2004).

[199]*See* Statement of Policy on Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150, 39 Fed. Reg. 1260 (Jan. 7,1974), reaffirming a policy taken in Accounting Series Release No. 4, 11 Fed. Reg. 10,913 (May 10, 1938).

[200]*See* Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Securities Act Release No. 8221, 68 Fed. Reg.23,333 (May 1, 2003).

Institute of Certified Public Accountants (AICPA). Discipline was referred to the AICPA's Professional Ethics Division. The Public Oversight Board (POB) had oversight responsibilities over SECPS, but, after Enron, a fight broke out between the POB and the Chairman of the SEC, and the POB voted to disband.[201]

Auditing standards for accountants who certified financial statements filed with the SEC were indirectly regulated by the SEC through enforcement proceedings, but Congress did not give the SEC authority to formulate or approve auditing standards or otherwise regulate auditing, with one important exception. The SEC was essentially empowered to define "independence" for purposes of enabling an auditor to file financial statements with the SEC.[202] During the 1990s, the SEC attempted to define "independence" in such a way as to prevent auditors from consulting for audit clients,[203] but due to political pressure, was unable to do so. Although the SEC had long disciplined accountants and accounting firms under Rule 102(e) of the SEC's Rules of Practice,[204] and this rule was upheld in the courts,[205] a passionate and "articulate minority" continued to question its validity.[206] Further, it was unclear whether the SEC could sanction

---

[201]*See* Prepared Statement of Mr. Charles A. Bowsher: Hearing on Accounting and Investor Protection Issues Raised by Enron and Other Public Companies Before the Senate Comm. on Banking Housing, and Urban Affairs (Jan. 31, 2002), *available at* http://banking.senate.gov/02.03hrg/031902.bowsher.htm.

[202]Securities Act, Schedule A, Items 25, 26, 15 U.S.C. § 77aa(25), (26). *See* Regulation S-X, Art. 3, 17 C.F.R. § 210.3-01.

[203]*See* LEVITT & DWYER, *supra* note 57, at 125-39; Revision of the Commission's Auditor Independence Requirements, Securities Act Release No. 7919, [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,406, at 83,989 (Nov. 21, 2000).

[204]Until changed by rulemaking pursuant to Sarbanes-Oxley, Rule 102(e) purported to give the SEC authority to discipline and sanction "any person" by means of a suspension or a permanent bar from practicing before the Commission, if that person was found:

> (i) Not to possess the requisite qualifications to represent others; or (ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or (iii) To have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

17 C.F.R. § 201.102(e) (2004).

[205]*See* Checkosky v. SEC, 139 F.3d 221 (D.C. Cir. 1998) (dismissing disciplinary proceedings on other grounds); Sheldon v. SEC, 45 F.3d 1515, 1518 (11th Cir. 1995); Davy v. SEC, 792 F.2d 1418, 1421-22 (9th Cir. 1986); Touche Ross & Co. v. SEC, 609 F.2d 570, 577-82 (2d Cir. 1979).

[206]*See* Paul Gonson, *The 1998 Amendment to SEC Rule 102(e) Will Withstand Judicial Scrutiny*, 1999 UTAH L. REV. 609 (1999); Norman S. Johnson & Ross A. Albert, *"Déjà Vu All Over Again": The Securities and Exchange Commission Once More Attempts to Regulate the Accounting Profession Through Rule 102(e) of Its Rules of Practice*, 1999 UTAH L. REV. 553, 580-91.

accountants for negligent conduct.[207] Since professional malpractice utilizes a negligence standard, the SEC's ability to formulate auditing standards in Rule 102(e) proceedings was questionable. Nevertheless, the SEC continued to use Rule 102(e) as an enforcement tool against the auditors of public companies.[208]

The SEC obtained the power it long sought in Sarbanes-Oxley to formulate auditing standards and discipline accountants for improper professional conduct. The heart of the reforms in Sarbanes-Oxley was the creation of the PCAOB, which is supposed to be neither a self-regulatory organization nor a government regulator, although it is patterned to some extent on the NASD.[209] The responsibilities of the PCAOB include: the registration and inspection of all public accounting firms that prepare audit reports for public companies; the adoption and modification of auditing, quality control, ethics, independence, and other standards for public company audits; the investigation of registered firms for violations of rules relating to audits; and the imposition of sanctions for violations.[210] This federalization of the regulation of auditing standards is a significant change from prior oversight mechanisms.

Sarbanes-Oxley also has a number of auditor independence provisions that affect not only auditors, but also audit committees, executives, and directors of public companies. Most of these provisions were a response to egregious conflicts of interest at Enron and other failed companies that the SEC was previously unable to remedy. Under Sarbanes-Oxley, an auditor for an issuer is prohibited from providing a list of non-audit services including bookkeeping; financial information systems design; appraisal or valuation services or fairness opinions; actuarial services; internal audit outsourcing services; human resources functions; broker-

---

[207]*See* Johnson & Albert, *supra* note 206, at 592-600.

[208]*See id.* at 575.

[209]Sarbanes-Oxley, § 101, 15 U.S.C. § 7211 (2002). The PCAOB is a private sector organization in the sense that it is funded by fees levied on accountants and issuers. Its board members are appointed by the SEC after consultation with the chair of the Federal Reserve Board and the Secretary of the Treasury. *Id.* § 101(e). Only two members may be CPAs, and if the chairperson is a CPA, he must have not been practicing as such for five years. *Id.* § 101(e)(2). But the PCAOB will have the ability to request the SEC to issue subpoenas and it will have immunity with respect to its investigative and prosecutorial activities. *Id.* § 105. Although questions could be raised concerning the constitutionality of such an entity, the Congress that passed Sarbanes-Oxley was not interested in fine legal points but in reacting to corporate scandals. Possible litigation over the funding of the PCAOB and the FASB may be brought on the theory that assessments are a transfer between private players without sufficient, direct government oversight of a system being set up under federal law. *See* Steve Burkholder, *Financial Accounting Standards Board, Trustees Note Possible Legal Challenge to FASB Fee-Based Funding Mechanism*, 35 Sec. Reg. & L. Rep. (BNA) 1310 (Aug. 4, 2003).

[210]Sarbanes-Oxley, § 101(c), 15 U.S.C. § 7211 (2002).

dealer, investment adviser, or investment banking services; legal or other expert services unrelated to the audit; and any other services outlawed by the PCAOB.[211] Additionally, the audit committee must pre-approve all services provided by an auditor.[212] The SEC's rule implementing this provision requires disclosures designed to give investors an understanding of how the audit committee is managing the company's relationship with its auditor.[213] Other provisions of Sarbanes-Oxley require rotation of an audit partner every five years,[214] and direct the SEC to study the possible mandatory rotation of audit firms.[215] A conflict of interest provision prohibits anyone who was employed by an auditor for an issuer from becoming the CEO, controller, CFO, or chief accounting officer of the issuer within one year of employment.[216]

### F. *Regulation of Attorneys*

The SEC's new regulatory authority over attorneys is an additional topic that gives cause for concern. This issue also indirectly impacts corporate governance and federalizes an area of the law, which has been extremely controversial and where the SEC's reach has long exceeded its grasp. The furor over the SEC's proposed rules implementing Sarbanes-Oxley with respect to lawyers indicates that this controversy will continue.

Since the SEC's Rule 102(e) and its predecessor Rule 2(e) were passed, the SEC's disciplinary authority and its enforcement program against attorneys has been questioned, even by sitting SEC Commissioners.[217] Law review articles galore have been written on the subject.[218] With Sarbanes-Oxley, the SEC finally received legislative

---

[211]Sarbanes-Oxley, § 201, 15 U.S.C. § 78j-1(g) (2002).

[212]Sarbanes-Oxley, § 202, 15 U.S.C. § 78j-1(i) (2002).

[213]Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, 68 Fed. Reg. 18,788 (Apr. 16, 2003).

[214]Sarbanes-Oxley,§ 203, 15 U.S.C. § 78j-1(j) (2002).

[215]Sarbanes-Oxley, § 207, 15 U.S.C. § 7232 (2002). Now that there are only four big firms, thanks to the decision by the Justice Department to close down Arthur Anderson, such a system would accomplish little. The GAO was instructed to study the concentration within the accounting profession. Sarbanes-Oxley, § 701, 15 U.S.C. § 7201 (2002).

[216]Sarbanes-Oxley, § 206, 15 U.S.C. § 78j-1 (2002).

[217]*See In re* Keating, Muething & Klekamp, 47 S.E.C. 95, 109-12 (1979) (Karmel, Comm'r, dissenting); *In re* Allied Stores Corp., No. 3-6869, 1987 SEC LEXIS 4306, at *19 (June 29, 1987) (Fleischman, Comm'r dissenting). *See also In re* Checkosky, Exchange Act Release No. 38,183, 63 SEC Docket 1691, 1997 WL 18303, at *14 (Jan. 21, 1997) (Johnson, Comm'r, dissenting) (arguing that the SEC's use of Rule 2(e), while necessary, has become too broad).

[218]Johnson & Albert, *supra* note 206, at 563-64 n.33.

blessing for its ability to bring administrative actions against both attorneys and accountants and to censure, suspend, or bar any person from appearing or practicing before the Commission.[219] The standard for improper professional conduct was defined to be "intentional or knowing conduct, including reckless conduct" and highly unreasonable negligent conduct or repeated instances of unreasonable negligent conduct.[220] In addition to giving the SEC the power to bring malpractice cases against attorneys, Sarbanes-Oxley directed the SEC, not later than 180 days after the enactment of the statute, to issue rules setting minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of issuers, including a rule requiring an attorney to report evidence of a material violation of securities law, breach of fiduciary duty, or similar violation by the company or one of its agents to the chief legal counsel or CEO.[221] If these officers do not appropriately respond to the evidence, the attorney must report it to the board's audit committee, another committee of independent directors, or to the full board.[222] Although this "up the ladder" system of reporting of violations of law was permitted or even mandated by most state ethics rules applicable to attorneys, the American Bar Association rules did not go quite so far.[223] The American Bar Association subsequently amended its model ethics

---

[219]Sarbanes-Oxley, § 602(a), 15 U.S.C. § 78d-3(a) (2002). The grounds for such disciplinary sanctions are:

> (1) not to possess the requisite qualifications to represent others; (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations issued thereunder.

*Id.*

[220]*Id.* § 602(b).

[221]Sarbanes-Oxley, § 307, 15 U.S.C. § 7245 (2002).

[222]*Id.* This provision was an amendment by Senator Edwards trying to make clear that a lawyer for a public corporation represents the corporation and its shareholders and not the corporate officers. *See* 148 CONG. REC. 5651-52 (daily ed. July 10, 2002) (remarks of Sen. John Edwards).

[223]*See* Pamela Atkins & Joan Rogers, *ABA Task Force Revised Proposals on Ethics Rule Changes Generally Welcomed*, 35 Sec. Reg. & L. Rep. (BNA) 754 (May 5, 2003). The Taskforce stopped just short of requiring an attorney to breach confidentiality to prevent serious financial harm and instead recommended allowing an attorney to act in such a case. Lisa H. Nicolson, *A Hobson's Choice For Securities Lawyers in the Post-Enron Environment: Striking a Balance Between the Obligation of Client Loyalty and Market Gatekeeper*, 16 GEO. J. LEGAL ETHICS 91, 136-37 (2002). In fact, the origin of this provision seems to have been the idea of six professors of legal ethics who were having a disagreement with the ABA. *See The Evolving Legal and Ethical Role of the Corporate Attorney After the Sarbanes-Oxley Act of 2002*, 52 AM. U. L. REV. 613, 615-20 (2002) (remarks of Prof. Painter).

rules to require "up the ladder" reporting to protect a corporate client from substantial harm.[224]

The SEC rulemaking proposal to implement the Sarbanes-Oxley provisions regarding attorneys' professional responsibilities far exceeded the statutory provisions by including a requirement that any attorney who reports evidence of a material violation of the securities law or breach of a fiduciary duty and is not satisfied that the chief legal officer or CEO has responded appropriately, must make a "noisy withdrawal" from continued representation of the corporation.[225] An alternative proposed by the SEC was that issuers could form a Qualified Legal Compliance Committee (QLCC), which would have the responsibility of notifying the SEC of an attorney's withdrawal. This proposed rule would have covered all attorneys, licensed in any jurisdiction in the world, who prepare filings or submissions to the Commission.[226]

The SEC's proposed rule was an attempt to make corporate attorneys responsible for documenting their clients' violations of law and then reporting those violations to a government prosecutor. This proposal represents a return to the much discredited and ultimately abandoned whistleblower theory of the SEC in *SEC v. National Student Marketing Corp.*,[227] which was never accepted by any court. The SEC's proposal included determining questions of attorney-client privilege involved in whistleblowing, thereby pre-empting any state law rules preventing such conduct.[228] Whether the SEC may pre-empt state laws in this way has been questioned by at least one state bar association.[229] The proposed rule would have applied to any breach of fiduciary duty recognized at common law, and Sarbanes-Oxley admittedly contains the phrase "breach of fiduciary

---

[224]MODEL RULES OF PROF'L CONDUCT Rules 1.13 & cmt. 4, 4.1 (2004). *See* REPORT OF THE AMERICAN BAR ASSOCIATION TASK FORCE ON CORPORATE RESPONSIBILITY, Mar. 31, 2003, at 31-64; Greg Pease, *ABA Amends Model Ethics Rules to Permit Up the Ladder Reports of Corporate Wrongs,* 35 Fed. Sec. Reg. & L. Rep. (BNA) 1358 (Aug. 18, 2003). This revised rule permits attorneys to reveal information outside the organization only to the extent necessary to prevent substantial injury to the organization. *Id.*

[225]This requirement essentially would require resignation from the engagement and notification to the SEC. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8150, 67 Fed. Reg. 71,670 (Dec. 2, 2002).

[226]*Id.* at 71,674, 71,677.

[227]457 F. Supp. 682 (D.D.C. 1978). The *National Student* court ultimately did not find the attorneys liable under the proposed whistleblower theory, but instead found violations under Rule 10b-5. *Id.* at 712-15.

[228]Implementation of Standards of Professional Conduct for Attorneys, *supra* note 225, at 71,674-75.

[229]*See Washington Ethics Opinion Portends Clash Between SEC, State Rules on Revealing Fraud,* 35 Sec. Reg. & L. Rep. (BNA) 1334 (Aug. 11, 2003).

duty or similar violation" in describing the types of problems that must be reported "up the ladder." Whether Congress meant by these hastily drafted words to overturn Supreme Court case law and draw a distinction between the federal securities laws and state corporation laws concerning fiduciary duty is an interesting question.

After a comment letter process in which there were a multitude of negative comments, the SEC cut back on its proposal and extended the comment period on the "noisy withdrawal" provisions.[230] As an alternative, the SEC floated the idea of compelling public companies to file a report with regard to any resignation by an attorney dissatisfied with a corporate counsel or CEO reaction to evidence of a material violation of securities law or breach of fiduciary duty.[231] Although this story relates primarily to the federalization of ethics regulation of attorneys, the issue clearly affects corporate governance.

Attorneys are charged with the zealous representation of their clients[232] and are directed to maintain the confidentiality of client communications and information so that there will be honest and unfettered communications between attorneys and their clients.[233] Although attorneys have an obligation of independence, they are agents of their clients, not adversaries.[234] Yet, the SEC seems intent on making attorneys, as well as accountants, SEC agents for the purpose of policing the securities law compliance of public companies. Further, the SEC is shifting corporate governance from a state law model, where a board may at times be responsive to several constituents, to an exclusive shareholder primacy model. According to the SEC, this action is necessary because attorneys are agents of the company shareholders, and those shareholders require protection.

---

[230]Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185, 68 Fed. Reg. 6296 (Feb. 6, 2003). The extended sixty day comment period has long since expired, and the Commission has taken no further action on this proposal.

[231]Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8186, 68 Fed. Reg. 6324, 6328 (Feb. 6, 2003).

[232]*See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.3 Cmt. 1 (2004); NEW YORK CODE OF PROF'L RESPONSIBILITY EC 7-1 (2004).

[233]*See, e.g.*, RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §§ 112, 118-123 (proposed Final Draft No. 1, Mar. 29, 1996); Fellerman v. Bradley, 493 A.2d 1239, 1242 (N.J. 1985).

[234]*See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.2 (2004); NEW YORK CODE OF PROF'L RESPONSIBILITY DR 1-107 (2004).

### G. *Added SRO Requirements*

In June 2002, a committee of the NYSE issued a report on recommended changes to the NYSE listing standards subsequent to a request by the chairman of the SEC.[235] This report had a variety of recommendations for changes in NYSE listing standards that went beyond Sarbanes-Oxley including: a requirement for listed companies to have a majority of independent directors, with a more stringent definition of the term "independent"; a provision for regularly scheduled executive sessions of boards chaired by a lead director or independent chairman; a requirement that listed companies have nominating and compensation committees composed entirely of independent directors; and a requirement that shareholders vote on equity-compensation plans.[236] These recommendations were then transmitted to the NYSE board of directors and several of them were filed with the SEC as proposed new listing standards.

In addition to proposals that relate to audit committees, the NYSE proposed requirements that non-management directors meet at regularly scheduled independent executive sessions and that nominating and compensation committees be composed entirely of independent directors.[237] Similar although slightly different listing proposals were filed with the SEC by Nasdaq.[238] A new listing requirement proposed by both the NYSE and Nasdaq that shareholders vote on stock compensation plans was approved by the SEC.[239]

The final SRO listing rules approved by the SEC implementing Sarbanes-Oxley include provisions mandating executive sessions of non-management directors, defining committee independence for audit and

---

[235]REPORT OF THE NEW YORK STOCK EXCHANGE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE 1 (June 6, 2002) [hereinafter NYSE CORPORATE ACCOUNTABILITY REPORT].

[236]*Id.* at 1-2.

[237]*See* Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance, Exchange Act Release No. 47,672, 68 Fed. Reg.19,051 (Apr. 17, 2003).

[238]Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Nat'l Ass'n of Securities Dealers, Inc. Relating to Proposed Amendments to NASD Rules 4200 and 4350 Regarding Board Independence and Independent Committee, Exchange Act Release No. 47,516 (Mar. 17, 2003), *available at* http://www.sec.gov/rules/sro/34-47516.htm.

[239]*See* Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving NYSE and Nasdaq Proposed Rule Changes and Nasdaq Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to NYSE Amendments No. 1 and 2 and Nasdaq Amendments No. 2 and 3 Thereto Relating to Equity Compensation Plans, Securities Exchange Act Release No. 48,108, 68 Fed. Reg. 39,995 (July 3, 2003).

nominating committee members, defining audit committee financial experts, setting forth specific size requirements and obligations of the audit committee and requiring companies to have codes of business conduct and ethics.[240] Continuing education for directors is suggested.[241] In some respects, the NYSE rules are more specific and rigorous than Nasdaq's rules. For example, the NYSE rules set forth specific requirements for the charters of nominating and compensation committees, while the Nasdaq rules do not.[242]

These are far reaching changes in corporate governance in matters state law has never regulated, but instead left to the discretion of corporate boards. On the other hand, the business groups that commented to the NYSE's Committee on Corporate Accountability and Listing Standards were in agreement as to the efficacy of the changes the committee recommended. For example, the Business Roundtable, which sued the SEC with regard to its authority to promulgate a voting rights rule, expressed the view that public corporations should have corporate governance and compensation committees composed of independent directors, that independent directors should have the opportunity to meet without management representatives present, and that shareholders should have the opportunity to vote on stock option and restricted stock compensation plans in which officers and directors participate.[243] The National Association of Corporate Directors similarly endorsed the idea of independent nominating and compensation committees and independent director only executive sessions.[244]

Assuming that in today's world both business and government leaders believe that these are good corporate practices, there is still a serious question as to whether independent nominating and compensation committees should be made a matter of federal law. While stock exchange listing requirements were once a matter of state contract law, they have

---

[240]Listing Rules Approval, *supra* note 179.

[241]Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance, Exchange Act Release No. 47,672 (Apr. 11, 2003), at 14-15, *available at* http://www.sec.gov/rules/sro/34-47672.htm (director orientation and continuing education must be described in corporate governance guidelines); Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the American Stock Exchange LLC Relating to Enhanced Corporate Governance Requirements Applicable to Listed Companies, File No. SR-Amex-2003-65, Exchange Act Release No. 48,706, 68 Fed. Reg. 62,109, at 62,119 (Oct. 31, 2003) (listed companies urged to develop and implement continuing education programs for all directors).

[242]Listing Rules Approval, *supra* note 179, at 64,158, 64,161-66.

[243]NYSE CORPORATE ACCOUNTABILITY REPORT, *supra* note 235, at A-38-47.

[244]*Id.* at A-91-92.

probably been transmogrified into federal law through the Exchange Act.[245] Yet, whether they have the force of federal regulation, which pre-empts state law, remains unclear. Where federal law ends and state law begins is murky. The D.C. Circuit grappled with this issue in *Business Roundtable,* but failed to resolve the matter.[246] Sarbanes-Oxley clarified the SEC's authority to mandate the structure of corporate audit committees, but did not address other board committees or stock option or restricted stock plans. With respect to audit committees, Sarbanes-Oxley directs the SEC to set down a standard for stock exchange listing requirements. This is a sub-delegation of delegated authority, which is troubling as a federal lawmaking methodology.

If the SEC had not been satisfied with Nasadaq's proposals on board committees, and had been unable to persuade the NYSE and Nasadaq to conform their listing standards, could the SEC have passed its own regulation mandating that all public corporations have nominating and compensation committees composed entirely of independent directors? In 1979 the SEC flirted with such a rule but backed down, and then *Business Roundtable* strongly suggested the SEC had no authority for such regulation. The question therefore remains whether Sarbanes-Oxley has altered the balance between state and federal authority over internal corporate affairs.

### H. *Shareholder Nominations*

Institutional investors include government pension funds, labor unions, corporate pension funds, mutual funds, insurance companies, and bank trust departments. In the wake of the financial scandals that exploded with Enron, some politically motivated institutions and others campaigned for shareholder nominations to be included on management's proxy statement. There is nothing to prevent any shareholder from nominating a director in opposition to a director nominated by a current board, though it can be a costly endeavor.[247] Shareholders who desire to use management's proxy therefore sought a cheaper way to put forward candidates in opposition to candidates selected by a corporation's current board.

---

[245]*See* Special Study, *supra* note 69, at 1516-30.

[246]*Supra* notes 79-82 and accompanying text.

[247]THE CONFERENCE BOARD COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE, FINDINGS AND RECOMMENDATIONS PT. 1: EXECUTIVE COMPENSATIONS 16 (2002), *available at* http://www.conference-board.org/pdf_free/758.pdf [hereinafter CONFERENCE BOARD COMMISSION].

Because public pension funds devote an increasing amount of their assets to equities, they are the most activist institutions on corporate governance matters and have increasing clout.[248] State comptrollers and treasurers in their capacity as trustees of state employee pension funds, and trustees of labor union pension funds have been in the forefront of an initiative to give shareholders a right to nominate directors in opposition to nominees selected by a board of directors and shift regulation of internal corporate affairs from state law to federal law. The SEC has responded by proposing such a rule.[249] A group of state pension fund managers from New York, California, and elsewhere—termed self-declared "representatives of shareholders"—advocated broad shareholder access to the company's proxy card on the ground that "[c]ompetition for board seats and the accountability that contested elections impose will raise standards for those who serve as directors."[250] The American Federation of Labor and Congress of Industrial Organizations likewise urged shareholder nominations as "necessary to restore genuine accountability to a boardroom culture that for too long has been characterized by cozy relationships and a resulting unwillingness to challenge management."[251] By contrast, the Business Roundtable attacked the SEC's proposals as presenting "the possibility of special interest groups hijacking the director election process."[252] The politically charged atmosphere may obscure the complicated and difficult federalism issues raised by the pending regulation.

The SEC's proposed rule would create a mechanism whereby director nominees of long-term security holders, or groups of long-term security holders, with significant holdings could be included in company proxy materials where there are indications that the proxy process has been

---

[248]Symposium, *The Institutional Investor's Goals for Corporate Law in the Twenty-First Century*, 25 DEL. J. CORP. L. 35, 38-39 (2000).

[249]Security Holder Director Nominations, Exchange Act Release No. 48,626, 68 Fed. Reg. 60,784 (Oct. 23, 2003).

[250]Letter from Alan G. Hevesi et al., Comptroller, State of New York, to Chairman William Donaldson, Chairman, Securities and Exchange Commission (Oct. 1, 2003), *available at* http://www.calpers.ca.gov/eip-docs/about/press/news/invest-corp/reforming/10-01-03donaldson-letter.pdf. *See also* Alison Carpenter, *AFSCME, CalPERS Seek Investor Access to Nomination Process*, 35 Sec. Reg. & L. Rep. (BNA) 1599 (Sept. 29, 2003) (discussing the increasing number of shareholders advocating for increased access to the board nomination process).

[251]Letter from Richard A. Trumka, Secretary-Treasurer, The American Federation of Labor and Congress of Institutional Organizations, to Jonathan Katz, Secretary, SEC (Dec. 19, 2003), *available at* http://www.sec.gov/rules/proposed/s71903/aflcio121903.htm.

[252]Rachel McTague, *SEC Proposes Groundbreaking Rules on Shareholder Nomination of Directors*, 35 Sec. Reg. & L. Rep. (BNA) 1689 (Oct. 13, 2004).

ineffective or that security holders are dissatisfied with that process.[253] The proposal would apply to all companies subject to the proxy rules and once applicable, shareholder access would apply for two years.[254] Two circumstances would trigger shareholder access: the receipt of more than thirty-five percent "withhold" votes of any director; or a shareholder proposal to activate the shareholder access process proposed by a shareholder or group who have held at least one percent of outstanding shares for one year and received a majority of shareholder votes cast.[255]

The names of shareholder nominees proposed through this mechanism may be submitted by a shareholder or group who have beneficially owned at least five percent of shares outstanding for at least two years and express their intent to hold the shares through the annual meeting. Any shareholder or group nominating a candidate must be eligible to report beneficial ownership on Exchange Act Schedule 13G and have filed such a schedule.[256] The candidacy or election of board nominees must not violate controlling state law, federal law, or the rules of any applicable national securities exchange or association. Further, the nominee must satisfy the objective independence criteria of the listing standard applicable to the issuer and have no specified relationships with the nominating shareholder or group or agreements with the issuer regarding the nomination. The maximum number of nominees that may be proposed is as follows: one nominee if the board has eight or fewer directors; two nominees if the board has between nine and nineteen directors; three nominees if the board has twenty or more directors. If a company receives nominees in excess of the applicable numbers, those nominees from a shareholder or group with the largest share ownership would be selected as nominees.[257]

The SEC's shareholder access proposals were preceded by the publication of a staff report on shareholder access to proxies[258] and new disclosure requirements with regard to board nominating committees.[259] The staff report discussed the possibility that proxy mechanisms could raise

---

[253]Security Holder Director Nominations, 68 Fed. Reg. 60,784, at 60,785.

[254]*Id.* at 60,787, 60,792.

[255]*Id.* at 60,789-92.

[256]*Id.* at 60,794.

[257]Security Holder Director Nominations, 68 Fed. Reg. 60,784, at 60,787-88.

[258]Division of Corporation Finance, Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, Division of Corporation Finance [2003] Fed. Sec. L. Rep. (CCH) ¶ 86,938 (July 15, 2003).

[259]Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Boards of Directors, Exchange Act Release No. 48,301, 68 Fed. Reg. 48,724 (Aug. 14, 2002) (Proposed Rule).

questions under applicable state law concerning the triggering of "poison pill" takeover defenses but suggested ways to encourage shareholder nominees[260] essentially through methods now proposed by the Commission.[261] Although the new disclosure requirements do not raise federalism issues to the extent that they are raised by the SEC's shareholder nomination proposals, they nevertheless may intrude on companies' governance processes governed by state law.

Companies are already required to disclose in their proxy statements whether they have a standing nominating committee, and if so, to describe its members, functions and processes, including whether the committee considers shareholder recommendations for board nominees.[262] Under the SEC's new disclosure rules, beginning January 1, 2004, companies are required to provide further information about a board's processes for director selection, its consideration of candidates recommended by shareholders and the procedure by which shareholders may submit candidates for consideration to the board. If a company does not have a nominating committee it will have to state why it does not. If a company does have a nominating committee it will have to make the charter of the nominating committee and information on the independence of the nominating committee available on its website or as an attachment to its proxy statement at least once every three years. Among other new required disclosures are a statement as to whether the nominating committee has received a nomination from a shareholder or a group of shareholders who beneficially own more than five percent of the company's voting common shares, a statement as to whether the candidate was nominated by the committee. Further, issuers will have to describe any minimum director qualifications sought by its nominating committee, the process by which its nominating committee identifies and evaluates nominees, and the source for the recommendation of any nominees such as a security holder, a non-management director, an executive officer or a third party search firm.[263]

Although a variety of questions could be raised about the SEC's proposal to encourage shareholder access to management's proxy, two issues are the most important: Does the SEC have the statutory authority to pass such a regulation; and is it a good idea as a policy matter? At least one sitting SEC Commissioner has expressed serious doubt about the SEC's

---

[260]Staff Report, *supra* note 258, at 87,875-95.

[261]Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Securities Act Release No. 33-8340, 68 Fed. Reg. 66,992 (Nov. 28, 2003).

[262]*Id.*

[263]*Id.*

authority to promulgate a rule mandating shareholder access to management's proxy.[264] Although the law is not entirely clear, such doubts are certainly justified.

Section 14(a) of the Exchange Act authorizes the SEC to prescribe proxy rules and regulations as are "necessary or appropriate in the public interest or for the protection of investors."[265] In providing for proxy regulations, Congress assumed that an adequate system of shareholder voting rights was established under state laws, but sought to protect investors from the solicitation of proxies by outsiders seeking to take control of the corporation and also to guard against corporate executives and directors attempting to perpetuate themselves by misuse of corporate proxies.[266] Notwithstanding its potential breadth, section 14(a) has been interpreted primarily as a disclosure rather than a regulatory provision.[267]

Federal law, until the enactment of Sarbanes-Oxley, did not directly regulate the internal corporate governance of public securities issuers. Nothing in Sarbanes-Oxley, addresses or enlarges the SEC's authority with regard to proxy rules. A draft of the initial Exchange Act included a provision that "nothing in this title shall be construed as authorizing the [SEC] to interfere with the management of the affairs of an issuer."[268] This provision was ultimately omitted from the statute. The Supreme Court has held that the anti-fraud provisions of the Exchange Act require deception, manipulation or non-disclosure, rejecting the notion that the securities laws "federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden" where clear congressional intent does not exist.[269]

In *Business Roundtable v. SEC*,[270] the D.C. Circuit Court invalidated a SEC rule attempting to regulate corporate deviations from a one share, one vote regime. The court held that the SEC's rule exceeded the agency's

---

[264]*See* Paul S. Atkins, Statement by SEC Commissioner: Remarks at Open Meeting Regarding Shareholder Access Proposal (Oct. 8, 2003), *available at* http://www.sec.gov/news/speech/spch101003psa.htm.

[265]Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a) (2001).

[266]S. REP. NO. 792, 73d Cong., 2d Sess., at 12 (1934). *See also* SEC v. Transamerica Corp., 163 F.2d 511, 518 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948) (holding that Congress's intent to preserve access to corporate nominations cannot be frustrated by corporate bylaws).

[267]*See* J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964); Roosevelt v. E.I. Du Pont de Nemours & Co., 958 F.2d 416, 421-22 (D.C. Cir. 1992).

[268]Federal Securities Exchange Act of 1934, S. 3420, 73d Cong. § 13(d) (1934).

[269]Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977).

[270]905 F.2d 406 (D.C. Cir. 1990).

authority under the Exchange Act because if the SEC were permitted to control the distribution of voting power, it would assume an authority that the Exchange Act's proponents disclaimed any intent to grant.[271] Rather, Congress believed that so long as investors received enough information, shareholder voting could work, and therefore it gave the SEC power over voting procedure instead of substantive control of voting power.

In its rule proposal regulating shareholder access to the proxy process, the SEC recognized that provisions of state law regarding director elections are fundamental factors upon which many of the assumptions, projections and analyses in the proposing release depend although those provisions are not identified.[272] The proposing release attempts to avoid a conflict with state law by asserting that its proposed rules are conditioned on the existence of shareholders rights under state law, but does not cite to any such laws.[273] Rather, the proposing release states that a company would not be required to include a director nominee if that would violate state law.[274]

Much could be said about corporate abuses over the past few years and the detrimental effect of the bursting of the 1990s stock market bubble on investors and particularly pension fund beneficiaries. Such rhetoric forms much of the basis for the SEC's new proxy rules. Older Americans who contemplated retirement are angry, and pension funds are embarrassed. Still, a large shareholder or group is not necessarily more representative of the interests of the shareholders as a body, than management and the board who owe fiduciary duties to all of the shareholders.[275] By contrast, one shareholder or a minority group does not have any fiduciary duties to other shareholders.[276]

The SEC twice before proposed the idea of shareholder nominations as a way to ensure better corporate governance, but backed away for, among other reasons, doubts concerning its authority to mandate such a regulation.[277] In the current business-bashing political climate, such doubts seems to have been pushed aside. They should not be. Regulatory intrusion into the shareholder nomination process goes to the very heart of

---

[271] *Id.* at 411.

[272] Security Holder Director Nominations, 68 Fed. Reg. 60,784, at 60,787-97.

[273] *Id.* at 60,808.

[274] *Id.* at 60,787.

[275] *See* DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 560-70 (4th ed. 1993).

[276] *See* BAINBRIDGE, *supra* note 98, at 335-36. A controlling shareholders may have a duty to minority shareholders, but this is an exception to the general rule. *Id.*

[277] Statement by SEC Commissioner Paul S. Atkins, *supra* note 264.

corporate governance and would drastically alter federal and state power to regulate internal corporate affairs.

## IV. IMPLICATIONS OF SARBANES-OXLEY

### A. *Aggressive Enforcement and Overregulation*

Sarbanes-Oxley added a host of increased or new civil and criminal penalties for violations of the federal securities laws and related statutes. Among other things, Sarbanes-Oxley created a new federal felony for securities fraud;[278] two new anti-shredding penalties;[279] broadened the scope of an obstruction of justice crime;[280] increased the maximum prison term for mail and wire fraud;[281] directed the U.S. Sentencing Commission to review the sentencing guidelines that apply to acts of corporate misconduct;[282] created federal protection for whistleblowers;[283] amended the Exchange Act to increase the criminal penalties for those who file false statements with the SEC;[284] and amended the Employment Retirement Security Act of 1974 to increase the penalty for criminal violation of squandering someone's pension.[285] In July 2002, a multi-agency task force was created to consolidate the federal government's prosecution of white-collar crimes, and, in July 2003, the White House was happy to report that task-force prosecutors had obtained more than 250 corporate-fraud convictions or guilty pleas.[286] The Chairman of the SEC suggested that this record of criminal prosecutions had led to a renewed public confidence that partially accounted for recent stock market strength.[287] The SEC is nevertheless urging Congress to give the agency even more remedies in administrative actions, make its investigations easier by improving access

---

[278]Sarbanes-Oxley, § 807, 18 U.S.C. § 1348 (2002).

[279]Sarbanes-Oxley, § 802, 18 U.S.C. §§ 1519, 1520 (2002).

[280]Sarbanes-Oxley, § 1102, 18 U.S.C. §§ 1512 (2002).

[281]Sarbanes-Oxley, § 903, 18 U.S.C. § 1341, 1343 (2002).

[282]Sarbanes-Oxley, § 1104, 28 U.S.C. § 994 (2002).

[283]Sarbanes-Oxley, §§ 806, 1107, 18 U.S.C. §§ 1514A(a), 1513 (2002).

[284]Sarbanes-Oxley, § 1106, 15 U.S.C. § 78ff(a) (2002).

[285]Sarbanes-Oxley, § 904, 29 U.S.C. § 1131 (2002).

[286]*See* Greg Hitt, *Corporate Reform: The First Year: SEC Chief Says Worst of Fraud Is Likely Past; Federal Task Force Set Up to Investigate Wrongdoing Marks a Year on the Beat*, WALL ST. J., July 23, 2003, at C9.

[287]*Id.*

to bank records and grand jury information, and remove barriers to the production of privileged information.[288]

It could be argued that such prosecutorial zeal is an appropriate reaction to the infectious greed and financial frauds of the past decade. It could also be argued that it is inappropriate and bad policy for the SEC to have the means, as a practical matter, through the new regulatory tools given by Sarbanes-Oxley, to investigate and prosecute every CEO and CFO of every public company. Coupled with the SEC's new mandates regarding corporate governance, the SEC now possesses enormous leverage to shape the boardroom to fit its ideas about corporate conduct. These ideas are bureaucratic and based on an adversarial model of corporate structure in which independent directors wrest control from corporate managers and become accountable to the SEC as a surrogate for shareholders. Proposals that thus far have not yet become law, like the initial model for a "financial expert"[289] and the QLCC,[290] suggest the SEC's ambitions to regulate the corporate boardroom are designed to make the board and its advisors answerable to the SEC, rather than other constituencies.

Excessively zealous prosecution and overregulation can lead to a number of results contrary to the interests of shareholders or the public. Corporate managers and directors may become overly conservative and adverse to taking risks, concerned more about complying with SEC regulations than tending to their business affairs.[291] Shareholders may become lulled into thinking the SEC is monitoring corporate behavior so there is no need for them to do the difficult work of assessing investment opportunities.[292] Smaller companies, unable to bear the costs of compliance with Sarbanes-Oxley, could also go private to the detriment of existing public shareholders.[293] Finally, accountants and lawyers may become more concerned about protecting themselves from possible liabilities than representing client interests.

---

[288] *See* Stephen M. Cutler, Testimony Concerning the Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179, Before the House Subcomm. on Capital Markets, Insurance, and Gov't Sponsored Enterprises, Comm. on Fin. Serv. (June 5, 2003), *available at* http://www.sec.gov/news/testimony/060503tssmc.htm.

[289] *See supra* notes 188-91.

[290] *See supra* notes 223-29.

[291] *See* Peter J. Wallison, *Blame Sarbanes-Oxley*, WALL ST. J., Sept. 3, 2003, at A16. Among other things, the cost of D & O insurance is skyrocketing. *See* Theo Francis, *It Still Costs Big to Insure Against a Boardroom Scandal; Despite the Sarbanes-Oxley Bill, "D&O" Policy Prices Rise 30%, and Cancellation Clauses Swell*, WALL ST. J., July 31, 2003, at C1.

[292] *See* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 41-43 (2002).

[293] *See* Peter A. McKay, *Though Their Stock Is Publicly Held, Companies Adopt a Private Mentality*, WALL ST. J., July 28, 2003, at C1.

On the other hand, all of these horrible consequences may not come to pass and corporations may instead engage only in honest and transparent financial reporting. In a report marking the one-year anniversary of Sarbanes-Oxley, the House Financial Services Committee expressed the view that the statute had led to improvements in accounting, auditing and corporate governance and that startup costs for implementing the act had been unsubstantial.[294] Further, the Report asserted that there was no evidence that Sarbanes-Oxley was creating a trend toward going private.[295] The current chairman of the SEC similarly expressed the view that Sarbanes-Oxley has restored investor confidence in the securities markets.[296]

Much of the criticism of Sarbanes-Oxley by the business community has centered on section 404 and PCAOB Auditing Standard 2.[297] These rules require auditors to do a full scale audit of a company's internal controls and then opine on their effectiveness.[298] It has been estimated that this effort may increase auditing costs of U.S. companies by forty percent.[299] The chairman of the NYSE has questioned whether the cost of compliance with Sarbanes-Oxley is worth the cost.[300] Still, some believe that the corporate backlash against these costs proves that Sarbanes-Oxley is a good law.[301] A former Federal Reserve Board chairman and former SEC chairman have argued that the burdens of Sarbanes-Oxley are worth its costs.[302]

---

[294]HOUSE COMM. ON FINANCIAL SERVICES, 107TH CONG., REBUILDING INVESTOR CONFIDENCE, PROTECTING U.S. CAPITAL MARKETS, THE SARBANES-OXLEY ACT: THE FIRST YEAR (Comm. Print 2003) *available at* http://financialservices.house.gov/media/pdf/Sarbanes-Oxley%20One%20Year%20Later.pdf.

[295]*Id.* at 22.

[296]*See* Hitt, *supra* note 286, at C9.

[297]*See* Management's Reports on Internal Controls Over Financial Reporting and Certification in Exchange Act Periodic Reports, Securities Act Release No. 8392, 2004 WL 349829 (June 5, 2003); PCAOB Auditing Standard No. 2: An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements (Mar. 9, 2004).

[298]*See* John C. Coffee, Jr., *Sarbanes-Oxley Section 404 and Auditing Standard No. 2*, N.Y.L.J. (May 20, 2004).

[299]*Id.* at 3. It has been estimated that the increased auditing costs of foreign companies will increase by one hundred percent. *See* John Thain, *Sarbanes-Oxley: Is the Price Too High?*, WALL ST. J., May 27, 2004, at A20.

[300]Thain, *supra* note 299.

[301]*See Long & Short Corporate Regulation Must Be Working—There's a Backlash*, WALL ST. J., June 16, 2004, at C1.

[302]*See* Paul Volcker & Arthur Levitt, Jr., *In Defense of Sarbanes-Oxley*, WALL ST. J., June 14, 2004, at A16.

During the one year since Sarbanes-Oxley was passed, a multi-agency task force obtained 250 corporate fraud convictions or guilty pleas, including those of twenty-five CEOs.[303] When a high percentage of public corporations and their chief executive and financial officers have engaged in the dissemination of fraudulent financial information, it may be concluded that there has been a serious ethical failure in the top echelons of the business community and that the proper response is new regulation and a prosecutorial crackdown on white collar criminals. On the other hand, one could conclude that the regulatory system and financial reporting standards are faulty and that more of the same—more financial regulation, more prosecutions, more power to the SEC—will not solve the underlying economic, political and sociological causes of the 1990s stock market bubble and its inevitable collapse. Causes other than executive misconduct could be found. The sheer complexity of financial reporting could lead to a search for a better accounting framework.[304] The disconnect between tax and financial reporting and the resulting distortions in corporate finance caused by tax law and policy could be addressed.[305] The relentless push by institutional investors for ever-increasing quarterly earnings was irresponsible and unhealthy, but the only way in which the SEC addressed investor obsession with quarterly results was through a regulation dealing with inside information abuses.[306] Since SEC regulatory policy is based on investor protection, the SEC is disinclined to focus on questionable behavior by investors and portfolio managers because this might unmask the fiction upon which all SEC financial regulation is based.

The focus of enterprise should be on business profitability. This focus is increasingly difficult in a complex, highly competitive global economy where there is a demand for ever greater productivity. Without

---

[303]*See* Hitt, *supra* note 286.

[304]The SEC has begun to address this problem. *See* Staff of Sec. & Exch. Comm'n, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the U.S. Financial Reporting System of a Principles-Based Accounting System, *at* http://www.sec.gov/news/studies/principlesbasedstand.htm.

[305]*See* Gil B. Manzon, Jr. & George A. Plesko, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 TAX L. REV. 175, 181-82 (2002). Stock options are a deduction for corporate tax purposes but not for financial reporting purposes. *See id.* at 190-92; Constantine N. Katsoris, *Symposium Addendum*, 8 FORDHAM J. CORP. & FIN. L. S47, S49-S51 (2002). Perhaps this led to an unhealthy reliance on stock options as corporate compensation mechanisms.

[306]Selective Disclosure and Insider Trading, Securities Act Release No. 7881, 65 Fed. Reg. 51,716 (Aug. 24, 2000).

condoning the "infectious greed"[307] of the higher echelons of corporate America in the 1990s, or the intentional manipulation of financial reporting at many corporations, this article questions the Sarbanes-Oxley solutions of imposing more regulations on public companies and increasing the sanctions for financial fraud. The financial misreporting at Enron, Adelphia, WorldCom, and elsewhere was already illegal, indeed criminal. Sarbanes-Oxley has caught the attention of corporate managers and directors and no doubt will result in better financial disclosure, at greatly increased expense, for the immediate future. But will it prevent a reoccurrence of irrational exuberance and financial fudge at the top of the next bull market? Perhaps more importantly, will officers and directors and their accountants and attorneys become so bogged down in procedures to comply with Sarbanes-Oxley that they have no time for core business decision making, problem solving, and strategic thinking?[308] Although the problems with regard to practical implementation of Sarbanes-Oxley and the federalization of corporate governance are separate issues, these issues are related. State law regulation of corporate governance has been largely permissive with flexible judicial oversight and has encouraged differentiation and experimentation. Federal regulation under Sarbanes-Oxley, on the other hand, is proscriptive and applies to all public companies regardless of their size, age, or business structure.

### B. *Federalization of Corporate Governance*

William O. Douglas envisioned a federal agency with the mandate to regulate large multinational corporations by directing their governance. Realizing that this was a task too great for a small agency like the SEC, he set forth a model of self-regulation with business codes of conduct to be developed by business leaders under government oversight. This was a model designed to save capitalism during the Great Depression when even Americans were flirting with the idea that socialism might be better than the existing economic system that had failed so badly. Has the vision of William O. Douglas finally been realized in Sarbanes-Oxley? The answer is not yet, but the groundwork has been laid.

---

[307]Alan Greenspan is reported to have said: "[A]n infectious greed seemed to grip our business community, our historical guardians of financial information were overwhelmed." John M. Berry, *Fed Chief Says Economy is on Recovery Path*, WASH. POST, July 17, 2002, at A01.

[308]*See* Chandler & Strine, *supra* note 34, at 7-8, 46. The cost of Sarbanes-Oxley is not only the out of pocket costs to lawyers and accountants to assure regulatory compliance with bureaucratic regulations, but also the cost in management time and attention. *See* Deborah Solomon & Cassell Bryan-Low, *Companies Complain About Cost of Corporate-Governance Rules*, WALL ST. J., Feb. 10, 2004, at A1.

The creation of the PCAOB may be seen as the kind of regulatory initiative that Douglas had in mind when describing the relationship between securities regulation and business. This model has not yet been imposed on business generally, but rather only the accounting profession now dominated by four large multinational firms. If the SEC eventually obtains the ability to license and discipline all executive officers and directors of public companies, one can envision the creation of a self-regulatory organization like the NASD to develop fair and equitable standards of business conduct and to then extend the SEC's prosecutorial powers by disciplining its members for failure to live up to those standards. In the wake of the scandals over executive compensation at the NYSE, there have been calls for the creation of a body like the PCAOB to oversee the regulation of listed companies.[309] Before the next series of financial scandals occur, it might be worthwhile for policy makers to inquire whether this is the kind of regulatory infrastructure that would serve the country well.

The keystone of the SEC's corporate governance policy is the independent director. The author has long felt that this model is flawed.[310] Independent directors are part-time participants in a corporation's affairs. By definition they are outsiders. However intelligent, hardworking or strong-minded they may be, they do not have the time or the mandate to challenge management's judgements, except as to a discrete number of issues. If they spend all of their time trying to audit the auditors and assure that executive compensation is reasonable, then they will have no time to focus on important business and strategy matters. If they become essentially full-time directors, then they will no longer be independent. If they repeatedly challenge the judgments of a CEO, then the CEO will lose authority and be forced to resign. Corporations are essentially hierarchical and need a strong leader. Some of the most highly regarded U.S. corporations have had authoritarian CEOs who have rewarded shareholders over a long period of time.[311] This does not mean that independent directors are a bad idea, but corporations should have greater freedom to experiment with board structures than Sarbanes-Oxley permits. Further,

---

[309]*See* Rachel McTague, *New York Stock Exchange Consumer Federation Believes Solution to NYSE Governance Is "Single Regulator,"* 35 Sec. Reg. & L. Rep. (BNA) 1659 (Oct. 6, 2003).

[310]*See* ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VERSUS CORPORATE AMERICA 163-64 (1982); Roberta S. Karmel, *The Independent Corporate Board: A Means to What End?*, 52 GEO. WASH. L. REV.534 (1984).

[311]The corporations run by Warren Buffet (Bershire Hathaway), Jack Welch (General Electric), and Bill Gates (Microsoft) come to mind as examples. *See* Helen Stock, *Buffet Admonishes Fund Directors*, WASHINGTON POST, Mar. 7, 2004, at A15.

since the independent director board simply cannot carry the freight the SEC has placed upon it, it is bound to disappoint and cause investor and public dissatisfaction as well as a loss of confidence. The collegial board has its flaws and there are times when management deserves to be challenged and even thrown out of office, but the prevailing model has actually served the U.S. economy well over a long period of time. The consequences of changing it, and giving control of board structure to a federal government agency are unknown.

In addition to setting up an adversarial relationship between the board, and especially the audit committee and the CEO, Sarbanes-Oxley has given the SEC extensive authority over CFOs and outside auditors and attorneys, which the SEC is likely to use to set up adversarial tensions with CEOs. Indeed, one of the most important consequences of Sarbanes-Oxley is that it has strengthened the SEC's authority to regulate CFOs.[312] The proposed "noisy withdrawal" provisions and the idea of a QLCC are examples of the premises underlying the SEC's implementation of Sarbanes-Oxley. In the view of the SEC, different players on the corporate team should be watching one another suspiciously to assure compliance with the federal securities laws, and should be prepared to blow the whistle. Although such checks on the power of a bad CEO may be salutary, such checks on the power of a good CEO may undermine his or her leadership to the point of diminishing the competitiveness of a business corporation. Perhaps business leaders deserve enhanced scrutiny in view of their wrongdoing during the 1990s, but whether the prescriptions of Sarbanes-Oxley will benefit the national economy over time is unclear.

### C. *Effect on State Law*

There are two opposite paths state law could take as a result of Sarbanes-Oxley. State officials may try to be stricter policemen than the SEC under state anti-fraud statutes and in judicial decisions involving corporate governance. On the other hand, state law could atrophy with respect to corporate governance matters. The first response is evident in the actions by the New York Attorney General in cases involving post-Enron scandals on Wall Street. With respect to the regulation of research analysts, the Attorney General instituted prosecutions against the largest Wall Street firms at a time when rulemaking and enforcement cases were

---

[312] *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859 (2003).

pending at the SEC.[313] State attorney generals similarly took the lead away from the SEC with regard to illegal mutual fund trading.[314] The second response is evident in the failure of the states to adopt legislation requiring corporations to provide their shareholders with annual financial reports.

State blue sky commissioners and attorney generals have not traditionally utilized blue sky laws to sue public companies or their officers or directors for fraud. Yet, some of these statutes are very broad and could be utilized in such a fashion. The New York Martin Act, for example, prohibits any device, scheme, or artifice to defraud or obtain money by means of any false pretense, representation or promise, fictitious or pretended purchase or sale, any concealment, suppression, fraud, false pretense or false promise in connection with the sale of securities, or offering investment advice.[315] The New York Attorney General has taken the position that no purchase or sale of stock is required, nor are intent, reliance or damages required elements of a violation of the Martin Act, in

---

[313]The SEC approved new NASD Rule 2711 and amendments to NYSE Rule 472 with respect to research analysts and research reports on May 10, 2002. Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. and Amendment No. 1 to the Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 45,908, 67 Fed. Reg. 34,968 (May 16, 2002). On May 21, 2002, the New York Attorney General announced an agreement by Merrill Lynch to enact "significant and immediate reforms that will further insulate securities research analysts from undue influence from its investment banking division" and to change the way analysts are compensated. Press Release, Office of N.Y.S. Attorney General, Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices, *at* http://www.oag.state.ny.us/press/2002/may/may21a_02.html. (May 21, 2002). This competition between the SEC and Eliot Spitzer continued as further actions were brought both with regard to research analysts and underwriters. *See* Kip Betz & Richard Hill, *Regulation of Securities: Financial Services Chairman, SEC Talking About Role of State Securities Regulators*, 35 Sec. Reg. & L. Rep. (BNA) 643 (Apr. 21, 2003). Pending legislation would require the states to remit any civil penalties or disgorgement from prosecutions that set national market system standards to the SEC. Securities Fraud Deterence & Investor Restitution Act, H.R. 2179 § 8(b), 108th Cong. (2003).

[314]*See* Richard Hill, *Conn. Regulator Declares State Oversight of Industry Trumps Distant Federal Efforts*, 35 Sec. Reg. Law Rep. (BNA) 2103 (Dec. 15, 2003); Kip Betz & Rachel McTague, *Spitzer Brings Criminal Charges, SEC Sues Over Alleged Late Trading in Funds*, 35 Sec. Reg. L. Rep. (BNA) 2018 (Dec. 8, 2003); Phyllis Diamond & Kep Betz, *Invesco, Its CEO Face SEC, N.Y. Charges Over Market Timing*, 35 Fed. Sec. L. Rep. (BNA) 2020 (Dec. 8, 2003); Martha Kessler, *Mass. Regulators Charge Prudential Over Late-Trading Issues*, 35 Sec. Reg. L. Rep. (BNA) 2100 (Dec. 15, 2003); Rachel McTague, *Kerry Introduces Mutual Fund Measure to Address Trading Abuses, Fee Issues*, 35 Sec. Reg. L. Rep. (BNA) 2033 (Dec. 8, 2003).

[315]N.Y. GEN. BUS. LAW § 352(c) (McKinney 1996).

contrast to section 10(b) of the Exchange Act.[316] Although the NSMIA prohibits any state from directly or indirectly prohibiting, limiting, or imposing any conditions on the use of any proxy statement, report to shareholders, or other disclosure documents relating to a covered security,[317] there is an exception for "the laws, rules, regulations, or orders, or other administrative actions of the State of incorporation of the issuer."[318] Thus far, the New York Attorney General has not used the Martin Act in connection with post-Enron scandals against broker-dealers and their customers, though he has shown a willingness to go into other areas.[319] Whether the New York Attorney General and other similar state officials will be so inspired by their financial and political success in cases against broker-dealers and tobacco companies as to sue issuers of fraudulent financial statements remains to be seen.[320] It would not be the first time that multiple law enforcement officials "pile on" in cases involving egregious facts. Further, it is unclear whether Congress will have the desire to further preempt state action in favor of SEC regulation.[321]

State legislation in response to Sarbanes-Oxley is also possible. For example, two Delaware Chancery Court judges have suggested that the Sarbanes-Oxley reforms will result in boards with few officers and, therefore, the traditional Delaware method for testing breaches of fiduciary duty in suits against directors may not be adequate in the future. Therefore, they recommend that the Delaware legislature consider amending Delaware corporate law so that officers are liable for breaches of fiduciary duty even

---

[316] Aff. in Support of Application for an Order Pursuant to General Business Law Section 354, at 7, In re Eliot Spitzer (N.Y. Sup. Ct. N.Y. County Apr. 2002) (No. 02-4015-22), *at* http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf.

[317] A covered security is, essentially, a security listed on a national securities exchange or Nasdaq. 15 U.S.C. § 77r(a)(2) (2001).

[318] 15 U.S.C. § 77r(a)(2)(B) (2001). There is also an exception permitting any "[s]tate to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions." 15 U.S.C. § 77r(c)(1) (2001).

[319] *See* Press Release, Office of N.Y.S. Attorney General, Galvin, Spitzer Announce Joint Inquiry into Sale of Mutual Funds by Morgan Stanley, *at* http://www.oag.state.ny.us/press/2003/jul/jul14a_03.html (July 14, 2003).

[320] *See* Russell Gold & Andrew Caffrey, *United Crime Buster—Chasing Bad Guys Together, State Attorneys General Win Big Cases, Attain New Clout*, WALL ST. J., Aug. 1, 2002, at B1. Recoveries from these settlements have been used to help balance state budgets in difficult economic times, a possible spur to further activism by state blue sky commissioners and attorney generals. *Id.* A recent North Carolina statute strengthened its securities laws to prohibit the use of a deceptive device to manipulate the market, including issuance of false or misleading financial statements. 2003 N.C. Sess. Laws 413.

[321] *See* Hill, *supra* note 92.

if they are not directors.[322] They also recommend that Delaware consider new regulation of the director election process to install a more open process for the election of directors.[323] The SEC is also considering how to make the director selection process more open, an example of what may become a competitive race between the SEC and the states for further reform.[324] States may also believe that new legislation is necessary concerning the disciplining of accountants and attorneys, since the SEC can prevent a professional from practicing before the SEC but cannot disbar a professional for all purposes.

Traditionally, derelictions of duty by officers and directors have been tested in derivative actions or injunctive actions in state courts. Since Sarbanes-Oxley does not create new civil liabilities, with a few exceptions,[325] failure to comply with its provisions may result in state court actions. This could involve suits over failure to comply with stock exchange listing requirements or executive compensation, among other things.[326] Civil litigation under the federal securities laws has given rise to many corporate governance reforms.[327] It can be anticipated that this trend will continue under Sarbanes-Oxley in the state courts as well as in the federal courts.

A very different reaction to Sarbanes-Oxley may be a hollowing out of state law protections for shareholders as the result of a comprehensive federal regulatory scheme. This can result in a kind of *de facto*, as opposed to a *de jure*, preemption. Although state law could legally impose shareholder protection requirements on corporations, they would be duplicative of federal regulation, and therefore of little practical value or efficacy under a cost-benefit analysis. One of many examples that could be chosen is the failure of state law to develop a requirement that corporations provide their shareholders with annual financial statements.

The obligation to provide shareholders with an annual financial statement in advance of an annual meeting was first imposed upon public companies by a NYSE listing requirement.[328] This obligation was then picked up in the Exchange Act, initially as to listed companies and later to

---

[322]Chandler & Strine, *supra* note 34, at 72-3. They point out that this will involve changes not only to the substantive law, but the service of process provisions.

[323]*Id.* § 5.

[324]*See supra* text accompanying notes 246-57.

[325]An exception is section 306(a) of Sarbanes-Oxley, 15 U.S.C. § 7244(a) (2002), which creates liability for insider trading during pension fund blackout periods.

[326]Chandler & Strine, *supra* note 34, §§ 3, 5.

[327]Thompson & Sale, *supra* note 312, at 903-04.

[328]Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461, 1467-68 (1992).

almost all publicly held companies.[329] Although the Revised Model Business Corporation Act requires that every corporation must furnish to its shareholders annual financial statements, including a balance sheet and an income statement,[330] most state corporation law statutes do not require corporations to provide shareholders with annual financial statements. Some states, like New York and New Jersey, provide that upon a shareholder's request such financial information must be furnished.[331] California follows the Revised Model Business Corporation Act and requires a board of directors to send an annual financial report to shareholders containing a balance sheet and an income statement.[332] Delaware has no requirement that shareholders be furnished annual financial statements. While state corporation law is often criticized for being overly protective of managers and not sufficiently protective of shareholders,[333] in an area where federal law is so comprehensive and detailed, such as the financial disclosure provisions of the federal securities law, there is little incentive for states to enact legislation. Indeed, businesses would likely complain about redundancy and unnecessary costs of compliance.

One problem with the allocation of responsibilities for shareholder protection, however, is that smaller companies are either excessively regulated if they have become public or hardly regulated at all if they have remained private. Although the SEC and the SROs have paid some lip service to the problems that smaller public companies may have in complying with Sarbanes-Oxley, few concessions have been made to them.[334] By contrast, non-public companies will not be subject to any of

---

[329]Initially the Exchange Act regulated only listed issuers, but in 1964 was amended to extend to almost all public companies. These are commonly known as registered and reporting companies. *See* 15 U.S.C. § 781 (2002). Issuers which are registered and reporting companies must send shareholders annual audited financial statements prior to their annual meetings. *See id.* § 78n-1.

[330]MODEL BUS. CORP. ACT § 16.20 (rev. 2002).

[331]N.J. STAT. ANN. § 14A:5-28 (West 2003); N.Y. BUS. CORP. L. § 624(e) (2003).

[332]CAL. CORP. CODE § 1501(a) (West 1990)

[333]*See* Cary, *supra* note 42, at 670-72; Comment, *Vestiges of Shareholder Rights Under the New Delaware Corporation Law*, 57 GEO. L. J. 599 (1969); Comment, *Law For Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969).

[334]*See* Chairman William H. Donaldson, Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002 before the Senate Committee on Banking, Housing and Urban Affairs, *available at* http://www.sec.gov/news/testimony/090903tswhd.htm (Sept. 9, 2003), at 19; Summary of Comments: Related to Proposed Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8173, *available at* http://www.sec.gov/rules/extra/s70203summary.htm (Mar. 25, 2003), at 45; Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220 (Apr. 9, 2003), at 32.

the Sarbanes-Oxley reforms unless there is state legislation passed addressing board structure and composition.

### D. *The Shareholder Primacy Model*

Sarbanes-Oxley is premised on a shareholder primacy model. Since the SEC is charged with investor protection, all of its policies necessarily take that objective into account. Yet, shareholders have changed dramatically since 1934 when the SEC was created. Instead of individual retail shareholders, the stock market is dominated by institutional investors who rely on their portfolio managers for decisions as to when to buy and sell stocks. Institutions owned 61.4% of the equity in the top 1,000 corporations in 2000, and 55.8% of equities in the market overall in 2001.[335] While some of these investors hold for the long term, many do not. Average turnover on the NYSE was only 19% in 1970, but increased to 36% in 1980, 46% in 1990 and by 2001 was 100%.[336] Further, their portfolio managers are interested in quarterly performance, not long-term returns. This is not a healthy environment in which to expect shareholders to monitor corporate governance.

Many of the evils of the dot-com bubble were caused by institutional investors and their portfolio managers, who first insisted that corporate officers have equity interests in their companies instead of relying upon cash compensation and who then pressured issuers to achieve higher earnings every quarter. Compensated with stock and stock options, CEOs and other officers and directors naturally became preoccupied with share prices instead of earnings per share or price earnings ratios. Even outside advisors, including attorneys, caught this equity fever and came to be compensated in stock options.[337] Director pension plans were eliminated on the theory that they made directors think more like employees than stockholders, and they were generally replaced with stock option plans.[338]

---

[335]CONFERENCE BOARD COMMISSION, *supra* note 247, at 25.

[336]*Id.* at 26.

[337]*See* Christine Hurt, *Counselor, Gatekeeper, Shareholder, Thief: Why Attorneys Who Invest in Their Clients in a Post-Enron World Are "Selling Out," Not "Buying In,"* 64 OHIO ST. L.J. 897, 911-13 (2003). This creates conflicts of interest and undermines the lawyers role as a gatekeeper. *Id.* at 933-38. *Cf.* James D. Cox, *The Paradoxical Corporate and Securities Law Implications of Counsel Serving on the Client's Board*, 80 WASH. U. L. Q. 541, 557-60 (2002) (arguing that attorneys who become involved in corporate management have significant exposure to liability under section 11 of the Securities Act).

[338] In fact, a pension plan can encourage a director to think like a creditor—which might not have been such a bad result for the many high flying companies now in bankruptcy. Nevertheless, corporations were urged to compensate directors in stock and stock options. *See* Edward S. Adams, *Corporate Governance After Enron and Global Crossing: Comparative*

Sarbanes-Oxley reinforced rather than questioned this shareholder primacy model.

Yet, Sarbanes-Oxley also makes shareholder primacy something of a legal fiction. For purposes of service on the audit committee, a director is deemed "independent" by Sarbanes-Oxley only if he is not an "affiliated" person of the company or one of its subsidiaries.[339] This was interpreted in SRO rulemaking as ownership of ten percent or more of an issuer's equity securities.[340] Therefore, venture funds, leveraged buy-out owners or other large stockholders who are not managers of the corporation may not serve as audit committee directors, and if the audit committee definition of independence is carried over onto the compensation and nominating committees, will not be able to serve as directors at all. Yet, these are the very stockholders who have the greatest incentive to assure that a corporation's financial reporting and compliance with other securities law requirements are up to standard. If managers who own shares and major shareholders are not fit to serve as directors, and a high percentage of other shareholders operate as traders rather than owners, exactly which shareholders is the SEC protecting?

While a discussion of problems with the shareholder primacy model goes beyond the scope of this article, these problems are significant to a consideration of whether Sarbanes-Oxley is an appropriate solution to the problems of the wave of financial fraud that broke out in the 1990s. Moreover, the SEC may be embarked on a program to push the reforms of Sarbanes-Oxley further by mandating contested elections for corporate directors. This notion has unleashed a barrage of negative comment because it would upend the selection of corporate directors in the United States and give institutional shareholders the power to challenge CEOs and other managers. Many of these shareholders are short-term traders who have no real interest in a corporation's long-term business success. Many others are political players, such as state and local governmental pension funds. Some shareholders might well be appropriate and responsible parties to propose replacements for ineffective board members, but before such a radical reform is instituted the SEC should further consider whether further reinforcement of the shareholder primacy model is a good idea. If

---

*Lessons for Cross-National Improvement*, 78 IND. L. J. 723, 743 (2003). *See also* Robin Goldwyn Blumenthal, *Director's Cut: Study Links Corporate Performance to Boards' Equity Stakes*, BARRON'S, Aug. 2, 1999, at 22 (describing director compensation stock options as a good method of ensuring loyalty).

[339]Sarbanes-Oxley, § 301, 15 U.S.C. § 78j-1(3)(B) (2002).

[340]Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, 68 Fed. Reg. 18,788, at 18,793 (Apr. 16, 2003).

shareholders are to be given more power, they should also be allocated much more responsibility for assuring long-term corporate success.

## V. CONCLUSION

In 1937, when the president of the NYSE was caught misappropriating a client's securities, the gleeful reaction of William O. Douglas, then chairman of the SEC, was that "the Stock Exchange was delivered into my hands."[341] Douglas was then able to investigate the NYSE and disclose "the whole anatomy of Wall Street chicanery and corruption" and arrange for the appointment of William McChesney Martin as chairman.[342] The reaction of the SEC to the financial scandals that preceded the enactment of Sarbanes-Oxley was similar. Corporate America was finally delivered into the hands of the SEC because of widespread chicanery and corruption during the dot-com boom years. The imperial CEOs of large public companies could finally be brought to heel and some to jail. The SEC could at last obtain the power to direct the corporate governance of public companies.

Is this simply a matter of politics and wresting power from business into the hands of government, or has the SEC long had a vision of the purpose of enterprise that is different from the vision of business leaders? If one returns to the initial criticism that William O. Douglas made of the Securities Act, during the year after its passage, the answer could be yes. Douglas asserted that the Securities Act was politically significant. "It is symbolic of a shift of political power. That shift is from the bankers to the masses; from the promoter to the investor. It means the government is taking the side of the helpless, the suckers, the underdogs."[343] Then Douglas expressed the view that the Securities Act "falls far short of making significant progress because of the really superficial way in which it covers the object of its control. It is safe to say that the greatest impact of the Act is on well-established going concerns . . . ."[344] According to Douglas, what was needed instead of a full disclosure statute was serious merit regulation.

> It is apparent that the thing industry needs is constructive planning and organization conditioned by the requirements of the public good. When these become articulate, security

---

[341] WILLIAM O. DOUGLAS, GO EAST YOUNG MAN 289 (1974).

[342] *Id.* at 290-91.

[343] Douglas, *supra* note 8, at 522.

[344] *Id.* at 527.

> regulation will be seen to be an integral part of the whole programme of industrial organization and regulation.... Any comprehensive and consistent control of the type which ... the New Deal envisage[s] must inevitably embrace within it control over security issues. That in essence means control over access to the market.[345]

The debate over the efficacy of the Securities Act in which Douglas participated resonates in the debate today over Sarbanes-Oxley. There is no doubt that Sarbanes-Oxley has been politically significant. Some claim that it is extremely important and far reaching legislation that will restore investor confidence.[346] Others argue that it is superficial and a ploy to bolster the status quo.[347] It is unlikely that the current SEC operating in a very conservative administration is planning to implement a New Deal merit regulation system where only corporations with good corporate governance will be allowed to access the capital markets. But one of the arguments this article sets forth is that the SEC is an agency with a very long institutional memory that has always acquired more power in response to crisis and scandal, and the future use it may make of the additional power it has acquired pursuant to Sarbanes-Oxley is unknown. The SEC now has the leverage to impose its model of corporate governance—a board of independent directors serving as a check on the CEO; a regulated CFO; and auditors and attorneys who must divide their allegiance to their clients with an allegiance to the SEC—on SEC registered corporations. The next step in these reforms will be greater shareholder democracy, whatever that means. The questions that deserve some debate are: What are the objectives or ends to be served by this reformed corporate governance? Will the SEC try to ameliorate the profit motive to serve general social needs or will the SEC be concerned with total return to shareholders over time? Will problems of agency capture result in an alliance between the SEC and big business which will stifle competition and be detrimental to entrepreneurial activity by small business or startups?

---

[345] *Id.* at 530-31.

[346] Sara Hansard, *The Word in Washington: Passage of Law is Just a Start*, INVESTMENT NEWS, Aug. 4, 2003, at 3; Joshua Chaffin & Adrian Michaels, *SEC Chief Set to Prioritise Executive Pay Reform*, FINANCIAL TIMES, July 31, 2003, at 29.

[347] *See, e.g.*, Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 917-923 (2003); Jeffrey L. Oldham, *Taking "Efficient Markets" Out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act*, 97 NW. U.L. REV. 995, 998 n.20 (2003); Alison Grant, *Law Helps to Restore Investor Confidence*, THE PLAIN DEALER, Sept. 21, 2003, at G1.

There are two important justifications for federal securities regulation. One is to foster investor confidence in order to encourage capital formation; the other is to put reasonable safeguards around the pension fund savings of millions of workers. To some extent these justifications are contradictory, not complementary. While many dot-coms went bust, many others have become scions of American industry and stalwarts of the U.S. economy. Without free access to capital, these new enterprises would not have flourished. On the other hand, when the stock market collapsed after the dot-com bubble, many Americans lost their retirement savings. Still it is unclear how Sarbanes-Oxley and its future administration by the SEC will address these needs of the national economy. Much of the legislation, and much of the SEC's efforts since it was passed, are intended to punish those businessmen and women who failed and whose companies went down in financial scandal. While after the fact enforcement, which is the SEC's strongest suit, may give some satisfaction to those who lost their jobs and their savings, it is not a substitute for the encouragement of capital formation and the protection of pension fund investments.