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A Modest Revolution in Corporate Governance

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INTRODUCTION

The federal securities laws do not embody a general corporation law. The Securities and Exchange Commission's (SEC) involvement in corporate governance long has been largely reactive and incremental. In the period just before and after the Sarbanes-Oxley Act of 2002, however, the pace of SEC initiatives has significantly accelerated and today amounts to a modest revolution in corporate governance.[1]

The background of this modest revolution is the rudimentary state law of corporate governance. In the leading Delaware General Corporation Law, section 141(a) provides that "the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."[2] Section 211(b) provides for an annual meeting of shareholders to elect the board,[3] which section 141(b) provides shall consist of one or more persons[4] and section 141(d) provides may be divided into one, two, or

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* Dean and Ethan A. H. Shepley Professor, Washington University School of Law in St. Louis. I would like to thank the organizers of "The SEC at 70" symposium where I spoke: Notre Dame Law School, Julian Velasco, and Lisa Casey. I am particularly grateful that a symposium was held in honor of A. A. Sommer, Jr., one of the greatest figures in post-World War II securities regulation.

1 *See generally* Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449 (2002) [hereinafter Seligman, *No One Can Serve Two Masters*] (discussing the Sarbanes-Oxley Act).

In the post-World War II period, there have been periodic proposals—none adopted—to totally preempt state corporate law with some form of federal incorporation statute, at least for the largest corporations. *See, e.g.*, RALPH NADER ET AL., TAMING THE GIANT CORPORATION (1976); Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976). For more modest proposals, see William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947 (1990).

2 DEL. CODE ANN. tit. 8, § 141(a) (2001).

3 *Id.* § 211(b).

4 *Id.* § 141(b).

three classes (meaning that all, one-half, or one-third of the directors shall be elected each year).[5] Under section 141(b), there are no required qualifications to be a member of the board.[6] Under section 141(c), the board, by resolution, may delegate specified functions to one or more committees.[7] There are no required officers, but section 142(a) authorizes the corporation to "have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board of directors."[8]

For a considerable period the statutory dominant role of the corporate board of directors has been disputed. As early as 1934 then Professor William O. Douglas decried *Directors Who Do Not Direct*.[9] In 1971 and again in 1979 Harvard Business School Professor Myles Mace characterized the statutory board role as "mythic" and "unrealistic."[10] To manage the corporation, the board has long lacked the time,[11] information,[12] and was limited by a selection process in which

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5 *Id.* § 141(d).

6 *Id.* § 141(b).

7 *Id.* § 141(c).

8 *Id.* § 141(a).

9 William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934).

10 MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1971); Myles L. Mace, *Directors: Myth and Reality—Ten Years Later*, 32 RUTGERS L. REV. 293 (1979). *But see* JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS (1989) (providing a more optimistic view).

11 As practitioner Martin Lipton and Professor Lorsch explained in 1992:

> Based on our experience, the most widely shared problem directors have is a lack of time to carry out their duties. The typical board meets less than eight times annually. Even with committee meetings and informal gatherings before or after the formal board meeting, directors rarely spend as much as a working day together in and around each meeting. Further, in many boardrooms too much of this limited time is occupied with reports from management and various formalities. In essence, the limited time outside directors have together is not used in a meaningful exchange of ideas among themselves or with management/inside directors.

Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 64 (1992).

12 SENATE COMM. ON BANKING, HOUS. & URBAN AFF., 96TH CONG., SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY: A RE-EXAMINATION OF RULES RELATING TO SHAREHOLDER COMMUNICATIONS, SHAREHOLDER PARTICIPATION IN THE CORPORATE ELECTORAL PROCESS AND CORPORATE GOVERNANCE GENERALLY 560 (Comm. Print 1980) [hereinafter SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY].

> Assuring that adequate information is provided to directors remains one of the most critical and difficult problems which boards of directors are facing today. The Business Roundtable's Statement on "The Role and Composition of the Board of Directors" goes so far as to state that "certainly some of the corporate failures of recent years are traceable in large measure to the

even outside or nonmanagement directors depended on management for their tenure as directors.[13] Under state law the corporate chief executive officer (CEO), not the board, historically has dominated corporate governance.[14] At its best the strong-CEO-weaker-board model was consistent with a "monitoring" rather than a managerial role for the board.[15] At its worst, the strong-CEO-weaker-board model has long been associated with the conflicts of interest that

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> fact that directors were inadequately informed. The facts were available at lower levels of the corporation but were not communicated."

Id.

13 *See, e.g.*, Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 875 (1991).

> First, even financially independent outside directors depend on management for their tenure as directors, since management typically selects its own outside directors. Thus, directors who wish to retain their positions are not independent of management. Second, most outside directors share management's ideological disposition toward the single issue most central to their monitoring responsibilities: how intensely outside directors *should* monitor management. Some 63 percent of the outside directors of public companies are chief executive officers of other public companies. These directors are unlikely to monitor more energetically than they believe they should be monitored by their own boards. Third, outside directors are not socially independent. As Victor Brudney put it, "[n]o definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose [performance] he is asked to assess." Finally, in addition to these dependency, ideological, and social obstacles to monitoring, outside directors typically lack an affirmative incentive to monitor effectively. The corporation cannot simply pay outside directors a large sum to induce careful monitoring because the prospect of a large payment itself would undercut their financial independence. Yet any serious effort to monitor inevitably imposes large personal costs on outside directors. As many commentators have pointed out, outside directors lack the time, expertise, staff, and information to challenge management, while management controls not only these resources but also has a direct and powerful incentive to direct corporate policy without interference.

Id.

14 *See generally* JOEL SELIGMAN, CORPORATIONS: CASES AND MATERIALS 133–39 (1995) (discussing the functional limitations on the board's managerial role).

15 See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.02 comment a (1994), describing five primary functions in a monitoring role:

1. Select, regularly evaluate and, if necessary, replace the chief executive officer. Determine management compensation. Review succession planning.
2. Review and, where appropriate, approve the financial objectives, major strategies, and plans of the corporation.
3. Provide advice and counsel to top management.

Adolf Berle and Gardiner Means memorably popularized in their 1932 classic, *The Modern Corporation and Private Property*.[16]

I. THE SEC AND CORPORATE GOVERNANCE BEFORE THE SARBANES-OXLEY ACT OF 2002

A. *The SEC's Proxy Rules*

To the extent that the federal securities law initially addressed corporate governance, it did so through section 14(a) of the Securities Exchange Act of 1934, which empowers the SEC to adopt rules that address the solicitation of proxies by corporations and other juridical persons whose securities are registered with the Commission under section 12.[17] The potential for the SEC to adopt disclosure rules concerning corporate nominees and corporate meetings was a response to the opacity of the pre-1934 blank proxy which often sought outside shareholder delegation of voting authority though a proxy without disclosing what votes would be taken at an annual or periodic shareholder meeting.[18]

The Commission's power under section 14(a) is not limited to ensuring full disclosure.[19] Some of the proxy rules, for example, address the requirement that security holders be given an opportunity to vote for or against each proposal.[20] But the Commission's basic philosophy under its proxy rules has been largely one of disclosure.

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4. Select and recommend to shareholders for election an appropriate slate of candidates for the board of directors; evaluate board processes and performance.
5. Review the adequacy of systems to comply with all applicable laws/regulations.

Id.

16 ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY bk. 1, chs. 5–6 (3d rev. ed. 1991). Berle and Means memorably contended that in the modern corporation there had been a separation of ownership and control with most of the common stock then held by a majority of public or outside shareholders and control of the corporation in fact exercised by management groups with minority stock interests. To Berle and Means, this posed a fundamental threat to the public shareholder. Management groups might pursue their personal interest in higher salaries, favorable stock options, or other conflicts of interest at the expense of the majority of public shareholders.

17 The section 12 registration requirements are analyzed in 4 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION ch. 6.A (3d ed. rev. 2000). The Commission's section 14(a) proxy rules are analyzed in chapter 6.C.

18 *See id.* at 1916–17.

19 *See* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 717–19 (1986).

20 Proxy Rule 14a-4(b), 17 C.F.R. § 240.14a-4(b) (2004).

The Commission's most significant proxy rules require a solicitation on behalf of the issuer with respect to an annual meeting for the election of directors to be accompanied or preceded by an annual report to security holders that includes (1) balance sheets for two years and income and cash flows statements for three, all audited and prepared on a consolidated basis, (2) selected financial data, and (3) management's analysis of financial condition and results of operations.[21]

Rule 14a-8 also allows eligible shareholders at corporate expense to make one proposal for shareholder action, including any accompanying supporting statement if both do not exceed 500 words.[22] Rule 14a-8, however, does not permit outside shareholders to nominate directors at the corporation's expense.

The SEC, on three occasions, has contemplated whether shareholders should have this pivotal power. In 1943 SEC Chairman Ganson Purcell testified to a House Subcommittee of the Committee on Interstate and Foreign Commerce. Purcell indicated that in August 1942 the Commission's staff had proposed a rule to permit shareholders "to use the management's proxy statement to canvass stockholders generally for the election of their own nominees for directorships."[23] The Commission opposed this rule.[24] An accompanying memorandum described the proposal and the Commission's objections. Any security holder could nominate directorial candidates, but management—on an equitable basis—would only be required to include twice as many candidates on the proxy as positions to be filled. According to the memorandum, there were no reasons to support this proposal. But, among other objections, the Commission (1) doubted it had the authority to change the proxy into a ballot, (2) feared unqualified persons might be nominated, and (3) doubted the equitable basis test would be workable.[25]

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21 Proxy Rule 14a-3(b)(1)–(9), *id.* § 240.14a-3(b)(1)–(9). In addition, the proxy statement must contain an undertaking to supply each solicited person who makes a written request the annual Form 10-K or Form 10-KSB report filed with the Commission. Proxy Rule 14a-3(b)(10), *id.* § 240.14a-3(b)(10).

22 *See generally* 4 LOSS & SELIGMAN, *supra* note 17, at 1992–2060 (discussing the security holder proposals of Rule 14a-8).

23 *Securities and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 Before the House Comm. on Interstate and Foreign Commerce,* 78th Cong. 19 (1943) (statement of Ganson Purcell, Chairman, Sec. & Exch. Comm'n).

24 *Id.* (statement of Ganson Purcell, Chairman, Sec. & Exch. Comm'n).

25 *Id.* at 157 (statement of Ganson Purcell, Chairman, Sec. & Exch. Comm'n).

In 1977 the SEC initiated a hearing process to consider a broad reexamination of the shareholders' role in corporate governance.[26] The background of the reexamination was explained in a Commission Release:

> During the last two years, more than three hundred and fifty corporations have made disclosures, in public documents filed with the Commission, of a wide variety of questionable and illegal corporate practices including bribes, kickbacks, illegal political contributions, and improper accounting practices. As noted in the "Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices," submitted to the Senate Committee on Banking, Housing and Urban Affairs (May 12, 1976), "[t]he almost universal characteristic of the cases reviewed . . . by the Commission has been the apparent frustration of our system of corporate accountability . . . ."[27]

Beginning in 1978, as a result of these hearings, the Commission adopted a series of new proxy disclosure requirements concerning the board and shareholder voting, but did not adopt a rule permitting shareholder nomination of directors at corporate expense.[28]

In July 2003, after corporate scandals at Enron, WorldCom, and other major corporations,[29] the SEC Division of Corporation Finance published *Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors* in response to a proposal of the American Federation of State, County, and Municipal Employees Pension Plan to require companies to include in their proxy materials the nominee of any shareholder or group of shareholders beneficially owning three percent or more of a company's outstanding common stock.[30]

The staff described five alternatives to increase shareholders' involvement in the nomination and election of directors, including:

- requiring companies to include shareholder nominees in company proxy materials;

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26 Shareholder Communication, Participation, and Corporate Governance, Exchange Act Release No. 13,482, 42 Fed. Reg. 23,901 (May 11, 1977).

27 *Id.* at 23,902 n.1.

28 Shareholder Communication, Participation, and Corporate Governance, Exchange Act Release No. 15,384, 43 Fed. Reg. 58,522 (Dec. 6, 1978). *See generally* SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY, *supra* note 12 (detailing recommendations). In 1980 the Commission staff did not doubt that the SEC had authority to adopt a shareholder nomination rule. *Id.* at 100, 103–08.

29 *See* Seligman, *No One Can Serve Two Masters*, *supra* note 1, at 451–67.

30 Div. of Corp. Fin., Sec. & Exch. Comm'n, *Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors*, [2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,938 (July 15, 2003).

- requiring companies to deliver nominating shareholder proxy cards along with company proxy materials; . . . [and]
- revising Exchange Act Rule 14a-8 to allow shareholder proposals relating to a company's nomination process.[31]

With respect to shareholder access, the Report stated:

> The Division recommends that the Commission propose and solicit public comment on new proxy rules that would allow a shareholder or a group of shareholders to place their nominees in a company's proxy materials within the following parameters:
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> . . .
>
> - the availability of a shareholder nomination process should be premised upon the occurrence of one or more triggering events that are objective criteria evidencing potential deficiencies in the proxy process such that shareholder views—especially those of a majority—may not otherwise be adequately taken into account;
> - there should be appropriate standards for independence of shareholder nominees; [and]
>
> . . .
>
> - there should be limitations on the total number or percentage of permitted shareholder nominees.[32]

SEC Chair William Donaldson soon asked the Division to prepare rule proposals that would implement its recommendations.[33]

Later in 2003, the Commission proposed Rule 14a-11 based on the Staff Report.[34] Proposed Rule 14a-11 would permit a security holder, either individually or in a group that beneficially owns more than five percent of the registrant's securities, to nominate one or more persons for the board provided that

> [o]ne or more of the following events has occurred during the calendar year in which the meeting that is the subject of the proxy statement is being held or during either of the preceding two calendar years:
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> (i) At least one of the registrant's nominees for the board of directors for whom the registrant solicited proxies received "with-

31 *Id.* ¶ 87,872.

32 *Id.* ¶ 87,887.

33 Press Release, Securities and Exchange Commission, SEC Publishes Staff Report on Proxy Process Review (July 15, 2003), *available at* http://www.sec.gov/news/press/2003-83.htm.

34 Security Holder Director Nominations, Exchange Act Release No. 48,626, 68 Fed. Reg. 60,784 (proposed Oct. 14, 2003).

hold" votes from more than 35% of the votes cast at an annual meeting of security holders . . . ; or

(ii) A security holder proposal providing that the registrant become subject to [Rule] 14a-11 that was submitted pursuant to [Rule] 14a-8 by a security holder or group of security holders that held more than 1% of the securities entitled to vote on that proposal for at least one year as of the date the proposal was submitted and provided evidence of such holding to the registrant, received more than 50% of the votes cast on that proposal at an annual meeting of security holders . . . .[35]

Under proposed Rule 14a-11(d)(1) a registrant would not be required to include more than one nominee if there were fewer than eight directors; two, if there were more than eight but fewer than twenty; and three, if there were more than twenty directors.[36]

Proposed Rule 14a-11 represents the first SEC rule that would permit direct shareholder nomination of directors. As such it is a significant proposal.[37] It is worth stressing, however, how limited the proxy access proposal, in fact, is. The two key trigger events, (i) the thirty-five percent withheld vote for at least one board nominee and (ii) the receipt of fifty percent or more of a vote for a Rule 14a-8 proposal by a one-percent owner of stock, are both extremely rare events. Based on a sample of 2227 director elections during the past two years, the Commission reported that approximately 1.1% had total withheld votes in excess of thirty-five percent cast.[38] A review of a sample of 237 security holder proposals submitted in 2002 found that only three were submitted by an owner of more than one percent of

35 *Id.* at 60,819.

36 *Id.* at 60,822.

37 The proposal release was notable for not addressing SEC authority to adopt a director nomination rule, an issue that wisely should have been raised given *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990). *See generally* Task Force on S'holder Proposals of the Comm. on Fed. Regulation of Sec., Am. Bar Ass'n, *Report on Proposed Changes in Proxy Rules and Regulations Regarding Procedures for the Election of Corporate Directors*, 59 BUS. LAW. 109, 130–36 (2003) (outlining basic issues in SEC authority and federalism concerns).

On December 22, 2003, the Business Roundtable filed a seventy-six page comment on the SEC's proposed election contest rules stressing its belief "that the Commission lacks the statutory authority to adopt the Proposed Election Contest Rules." DETAILED COMMENTS OF BUSINESS ROUNDTABLE ON THE "PROPOSED ELECTION CONTEST RULES" OF THE U.S. SECURITES AND EXCHANGE COMMISSION 1 (2003), *available at* http://www.sec.gov/rules/proposed/s71903/brt122203.pdf; *see also U.S. Chamber Urges SEC to Drop Proposed Shareholder Access Rule*, 36 Sec. Reg. & L. Rep. (BNA) 1029 (2004). Chamber Senior Vice President David Hirschmann stated: "If the Commission proceeds with this proposal, we will challenge it in court." *Id.*

38 Security Holder Director Nominations, 68 Fed. Reg. at 60,789.

the shares outstanding. Of the three, only one received more than fifty percent of the votes cast.[39]

When a proposal is able to satisfy either of these triggering events, outside shareholder nomination of one or more directors can only occur at a subsequent annual meeting of shareholders. This temporal delay is itself a novel impediment to the benefits that might be achieved under the proposed rule.

B. *Audit Committee Requirements*

A second SEC corporate governance initiative occurred in 1977 when the Commission approved a rule change in the listing requirements of the New York Stock Exchange (NYSE) to require each domestic company with common stock listed on that exchange "to establish . . . and maintain . . . an audit committee comprised solely of directors independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment as a committee member."[40] This was a salutary, if modest, reform. On March 11, 1976, when SEC Chairman Roderick Hills had requested that the NYSE make this amendment to its listing requirements, he estimated that almost ninety percent of the nation's largest corporations already had established audit committees.[41]

After a 1999 Blue Ribbon Committee on Improving the Effectiveness of Corporate Audits[42] led to SEC adoption of new stock exchange audit committee rules,[43] the audit committee again became a topic of

39 *Id.* at 60,790–91.

40 *In re* Unagusta Corp., Exchange Act Release No. 13,345, 11 S.E.C. Dock. 1945 (Mar. 9, 1977).

41 Roderick Hills, Addresses (June 21, 1976 & June 30, 1976), *summarized in* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 546–47 (3d ed. 2003).

42 The Blue Ribbon Committee recommended that all members of the audit committee of an NYSE or NASD firm be independent directors and that each audit committee member be financially literate. BLUE RIBBON COMM. ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMS., REPORT AND RECOMMENDATIONS (1999), *reprinted in Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 54 BUS. LAW. 1067 (1999).

43 In 1999, new audit requirements in response to the Blue Ribbon Committee were approved by the NYSE, the American Stock Exchange, and the NASD. New York Stock Exchange, Inc., Amending Audit Committee Requirements, Exchange Act Release No. 41,980, 64 Fed. Reg. 55,514 (proposed Oct. 13, 1999); New York Stock Exchange, Inc., Amending Audit Committee Requirements, Exchange Act Release No. 42,233, 64 Fed. Reg. 71,529 (Dec. 21, 1999); The American Stock Exchange Amending Audit Committee Requirements, Exchange Act Release No. 41,981, 64 Fed. Reg.

controversy. During the Senate Banking, Housing & Urban Affairs Committee hearings in 2002 that preceded Sarbanes-Oxley, the audit committee was sharply criticized for its ineffectuality. Former SEC Chairman Roderick Hills, during whose term in 1977 the NYSE adopted the requirement of the independent audit committee, was detailed in his articulation of audit committee shortcomings:

- Audit committees may consist of people who satisfy the objective criteria of independence, but their election to the board is too often the whim of the CEO, who decides each year who will sit on the audit committee and who will chair it.
- Audit committees too often seek only to reduce the cost of the audit rather than to seek ways to improve its quality. They do not play a sufficient role in determining what the fair fee should be.
- Audit committees seldom ask the auditor if there is a better, fairer, way to present the company's financial position.
- Audit committees seldom play a role in selecting a new audit firm or in approving a change in the partner in charge of the audit. They may well endorse an engagement or the appointment of a new team, but they are not seen as material to the selection process.
- Audit committees seldom establish themselves as the party in charge of the audit.[44]

C. *Why Was Corporate Governance Not a Greater Priority?*

Compared to the more significant SEC mandatory disclosure program and the fraud and other remedies enforced by the SEC, the Justice Department, and private litigants, the Commission's contributions to corporate governance before the Enron-Sarbanes-Oxley period were minor, intermittent, and relatively ineffectual.

55,505 (proposed Oct. 13, 1999); The American Stock Exchange Amending Audit Committee Requirements, Exchange Act Release No. 42,232, 64 Fed. Reg. 71,523 (Dec. 21, 1999); The American Stock Exchange Amending Audit Committee Requirements, Exchange Act Release No. 44,256, 74 S.E.C. Dock. 9187 (May 3, 2001) (amending Amex section 121 to clarify that domestic listed companies are required to have a sufficient number of independent directors to satisfy the Exchange's audit committee standard); Amending Nasdaq's Audit Committee Requirements, Exchange Act Release No. 41,982, 64 Fed. Reg. 55,510 (proposed Oct. 13, 1999); The American Stock Exchange Amending Audit Committee Requirements, Exchange Act Release No. 42,213, 64 Fed. Reg. 71,523 (Dec. 21, 1999).

44 *Accounting Reform and Investor Protection: Hearings on H.R. 3763 Before the Senate Comm. on Banking, Hous. & Urban Affairs*, 107th Cong. 78, 81 (2002) (prepared testimony of Roderick M. Hills, former Chairman, Sec. & Exch. Comm'n).

There were practical reasons for the Commission's modest record in corporate governance.

First, the Commission's most significant foray into corporate governance, its 1988 rule that generally required each common share to have one vote, was held to exceed its authority in 1990 in the *Business Roundtable* case.[45]

Second, corporate governance was generally considered to be a matter of state law outside the scope of what the SEC *should* address. There was no real question given the United States Constitution's Supremacy Clause that the SEC could seek legislation that would supplant the states in corporate law for a specified category of corporations and that the federal law would preempt or exist concurrently with state law. The federal securities laws did exactly this with respect to state disclosure and fraud remedies during the New Deal. But over time there had evolved an implicit understanding that absent countervailing circumstances requiring federal preemption, areas such as corporate governance would remain exclusively or largely matters of state law.[46]

Third, this federalist approach was reinforced by a powerful prudential consideration. The SEC is a relatively small federal agency, often stretched quite thin in terms of resources, which is often challenged to effectively address its core responsibilities.[47] New initiatives in corporate governance rarely rose to the top of the Commission's list of priorities.

II. The SEC and Corporate Governance After Sarbanes-Oxley

Then came Enron. Virtually overnight auditing and corporate governance became two of the Commission's leading priorities. Elsewhere I have focused on auditing and the initial experience of the Public Company Accounting Oversight Board (PCAOB).[48] Let me here address corporate governance.

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45 Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

46 *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) ("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." (quoting Cort v. Ash, 422 U.S. 66, 84 (1975))).

47 *See generally* Seligman, *supra* note 41, at 630–39 (detailing how limited resources impaired core responsibilities during the 1993–2000 Levitt chairmanship).

48 *See* 2 Loss & Seligman, *supra* note 17, ch. 2.D.3.c; Seligman, *supra* note 41, at 714–41.

A. *Board Independence Requirements*

Before the July 2002 enactment of the Sarbanes-Oxley Act, the NYSE Corporate Accountability and Listing Standards Committee "in the aftermath of the 'meltdown' of significant companies due to failures of diligence, ethics, and controls," recommended a broad set of corporate governance reforms to the NYSE Board of Directors, which generally adopted the recommendations and proposed them to the SEC for approval.[49] These recommendations included requirements that each NYSE-listed company have a majority of independent directors; the nominating or corporate governance committee, compensation committee, and audit committee be comprised solely of independent directors; and the audit committee have sole authority to hire and fire independent auditors.[50]

In Sarbanes-Oxley, Congress focused on the audit committee. Section 301 of the Act adds section 10A(m)(2) to the Securities Exchange Act and expressly directs that

> the audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.[51]

The audit committee is required to be comprised entirely of independent directors and is authorized to engage independent counsel and other advisers.[52]

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49 *See* CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMM., N.Y. STOCK EXCH., FINAL REPORT 1 (2002), *available at* http://www.nyse.com/pdfs/corp_govreport.pdf.

50 See the summary in Seligman, *No One Can Serve Two Masters*, *supra* note 1, at 495 n.111.

51 Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C.A. § 78j-1(m) (West Supp. 2004).

52 Section 10A(m)(3)(B) defines "independence" for the purposes of section 10A(m) to mean

> a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee –
>
> (i) accept any consulting, advisory, or other compensatory fee from the issuer; or
>
> (ii) be an affiliated person of the issuer or any subsidiary thereof.

Id. § 78j-1(m)(3)(B).

In 2003 the Commission, to implement § 10A(m)(1), adopted Rule 10A-3 as well as confirming amendments to specified forms and disclosure rules. Rule 10A-3(a) requires each national securities exchange and each national securities association to adopt the audit committee listing standards specified in Rule 10A-3(b)[53] and provide the exemptions specified in Rule 10A-3(c).[54]

Rule 10A-3(b)(1)(ii) defines independence for noninvestment companies to mean

> a member of an audit committee . . . may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:
>
> (A) Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof, provided that, unless the rules of the national securities exchange or national securities association provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that such compensation is not contingent in any way on continued service); or

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53 Rule 10A-3(b)(2) specifies the responsibilities required of registered public accounting firms:

> The audit committee of each listed issuer, in its capacity as a committee of the board of directors, must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee.

17 C.F.R. § 240.10A-3(b)(2) (2004).

The audit committee under Rule 10A-3(b)(4) is authorized to engage independent counsel and other advisers "as it deems necessary to carry out its duties." *Id.* § 240.10A-3(b)(4).

Similarly under Rule 10A-3(b)(5) the issuer must provide appropriate funding "as determined by the audit committee" for payment of "(i) [c]ompensation to any registered public accounting firm engaged for the purpose of preparing or issuing an audit report." *Id.* § 240.10A-3(b)(5).

54 Rule 10A-3(c) includes exemptions for (1) other classes of securities when an issuer has a listed security, (2) a direct or indirect consolidated subsidiary or an at least fifty percent beneficiary-owned subsidiary of the issuer, (3) specified foreign private issuers, (4) a security futures product, (5) a standardized option, (6) asset-based issuers and foreign governments, and (7) specified listed issuers organized as a trust or other unincorporated association which does not have a board or similar body and limits its activities to passive ownership. *Id.* § 240.10A-3(c).

(B) Be an affiliated person of the issuer or any subsidiary thereof.[55]

In 2003, after amendments, the Commission also approved new NYSE corporate governance standards.[56] The NYSE revised *Manual of Listing Standards* section 303A(1) requires the board of each listed company to consist of a majority of independent directors. Under section 303A(2) no director would qualify as independent unless the board of directors determines that the director has no material relationship with the company. Specifically, the NYSE tightened its definition of *independent director* in section 303A(2)(b), as the adoption release explained:

> First, a director who is an employee, or whose immediate family member is an executive officer, of the company would not be independent until three years after the end of such employment relationship ("NYSE Employee Provision"). . . . Second, a director who receives, or whose immediate family member receives, more than $100,000 per year in direct compensation from the listed company, except for certain permitted payments, would not be independent until three years after he or she ceases to receive more than $100,000 per year in such compensation ("NYSE Direct Compensation Provision").
>
> Third, a director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company would not be independent until three years after the end of the affiliation or the employment or auditing relationship.
>
> Fourth, a director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee would not be independent until three years after the end of such service or the employment relationship ("NYSE Interlocking Directorate Provision").

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55 *Id.* § 240.10A-3(b)(1)(ii). Section 407 of the Sarbanes-Oxley Act also requires an audit committee to have a financial expert or explain why one was not selected for the audit committee. Sarbanes-Oxley Act of 2002 § 407, 15 U.S.C.A. § 7265. In 2003, the Commission adopted new or amended rules to implement section 407 of the Sarbanes-Oxley Act. Disclosure Required by Sarbanes-Oxley Act, Exchange Act Release No. 47,235, 68 Fed. Reg. 5110 (Jan. 31, 2003).

56 New York Stock Exchange Corporate Governance Amendment, Exchange Act Release No. 47,672, 68 Fed. Reg. 19,051 (proposed Apr. 11, 2003); New York Stock Exchange Corporate Governance Amendment, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154 (Nov. 4, 2003); *see also* NYSE LISTED COMPANY MANUAL § 303A CORPORATE GOVERNANCE LISTING STANDARDS FREQUENTLY ASKED QUESTIONS (2004), *available at* www.nyse.com/pdfs/section303Afaqs.pdf.

> Fifth, a director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues, would not be independent until three years after falling below such threshold ("NYSE Business Relationship Provision").[57]

Non-management directors, under section 303A(3), would be required to meet at regular intervals without management.

Each listed company, under section 303A(4)(a) and 303A(5), would be required to have a nomination/corporate governance committee and a separate compensation committee composed entirely of independent directors.[58]

Section 303A(6) and (7) requires each NYSE-listed company to have a minimum three person audit committee that meets the independence standards of *both* section 303A(2) and SEC Rule 10A-3. NYSE section 303A(7) also requires each member of the audit committee to be financially literate as that term is interpreted by the full board or to become financially literate within a reasonable period of time after being appointed to the audit committee. In addition, at least one member of the audit committee would be required to have accounting or related financial marketing expertise.[59]

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57 NYSE and Nasdaq Rules of Corporate Governance, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154, 64,157 (Nov. 4, 2003) (footnotes omitted). This release added:

> The NYSE [defines] "immediate family member" to include a person's spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. The NYSE [intends] references to "company" include any parent or subsidiary in a consolidated group with the company.

Id. (footnotes omitted).

58 *Id.* at 64,158.

59 There are exceptions to the requirement that a company have a majority of independent directors and nominating/corporate governance and compensation committee comprised entirely of independent directors for (1) any listed company of which more than fifty percent of its voting power is held by an individual, group, or another company; (2) limited partnerships; and (3) companies in bankruptcy proceedings. *Id.* at 64,159. The NYSE generally excepts from section 303A management investment companies registered under the Investment Company Act. *Id.* at 64,159–60. A more limited series of exceptions is available for business development companies that are *not* registered under the Investment Company Act. *Id.* at 64,160.

Except as otherwise required by Rule 10A-3, the new requirements would not apply to trusts, derivatives, special purpose securities, or listed companies listing only preferred or debt securities on the NYSE. *Id.*

Nasdaq adopted similar, but less demanding, standards.[60]

With respect to investment companies, the SEC separately requires covered funds to have a board usually with at least seventy-five percent independent directors; the independent directors meet at least once each quarter without any interested persons present; and the independent directors be authorized to hire staff to help fulfill the board's fiduciary duties.[61]

In pursuing these initiatives with respect to investment companies, the three-Commissioner majority stressed:

Foreign private issuers would be permitted to follow home country practice except that these companies would be required to

> (1) [h]ave an audit committee that satisfies the requirements of Rule 10A-3; (2) notify the NYSE in writing after any executive officer becomes aware of any non-compliance with any applicable provision; and (3) provide a brief, general summary of the significant ways in which its governance differs from those followed by domestic companies under NYSE listing standards.

Id.

60 Nasdaq Rules Regarding Board Independence, Exchange Act Release No. 47,516, 68 Fed. Reg. 14,451 (proposed Mar. 17, 2003); Nasdaq Rules Regarding Board Independence, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154 (Nov. 4, 2003).

Under NASD Rule 4350(c)(1) a majority of the directors of the board of each Nasdaq-listed company would be required to be independent as defined in Rule 4200. *Id.* at 64,161.

NASD Rule 4350(c)(2) requires independent directors to have regularly scheduled meetings at which only independent directors attend. *Id.* at 64,162.

NASD Rule 4350(c)(3)(A)–(B) requires the compensation of the CEO and all the other officers of a listed company to be determined or recommended to the board for determination either by a majority of the independent directors or by a compensation committee that only includes independent directors. *Id.*

Similarly under NASD Rule 4350(c) directors must be selected or recommended to the full board either by a majority of independent directors or by a nominations committee that only includes independent directors. *Id.* at 64,163.

NASD Rule 4350(d)(2)(A) continues the requirement that at least one member of the audit committee "have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities." *Id.* at 64,163–64.

There are limited exceptions from the NASD corporate governance rules for management investment companies, including business development companies, cooperative entities, asset backed issuers, and passive issuers such as unit investment trusts. *Id.* at 64,175.

61 Investment Company Governance, Investment Company Act of 1940 Release No. 26,323, 69 Fed. Reg. 3472 (proposed Jan. 15, 2004); Investment Company Governance, Investment Company Act of 1940 Release No. 26,520, 69 Fed. Reg. 46,378 (Aug. 2, 2004).

> Management-dominated boards may be less likely to effectively undertake the many important responsibilities assigned to them. The breakdown in fund management and compliance controls evidenced by our enforcement cases raises troubling questions about the ability of many fund boards, as presently constituted, to effectively oversee the management of funds. The failure of a board to play its proper role can result, in addition to serious compliance breakdowns, in excessive fees and brokerage commissions, less than forthright disclosure, mispricing of securities, and inferior investment performance.
>
> We believe that a fund board must be "an independent force in [fund] affairs rather than a passive affiliate of management." Its independent directors must bring to the boardroom "a high degree of rigor and skeptical objectivity to the evaluation of [fund] management and its plans and proposals," particularly when evaluating conflicts of interest. To empower independent directors to better serve as an effective check on fund management, we are proposing to require funds to adopt better governance practices. Publicly traded companies now are required by exchange listing standards to have similar practices in place. Many have been adopted voluntarily by some fund complexes.[62]

B. The Separation of the Board Chair from the Corporate Chief Executive Officer

Twice in the period after the Sarbanes-Oxley Act, in contexts other than general corporations, the SEC has also required a separation of the chair of the board of directors from the corporate chief executive officer.

In December 2003, at an open meeting when the Commission approved a reorganization of the New York Stock Exchange,[63] SEC Chair William Donaldson announced that the NYSE had agreed to split the jobs of NYSE Chairman and Chief Executive Officer.[64]

In 2004 the Commission went further and required each registered investment company also to have a separate and independent chair.[65]

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62 Investment Company Governance, 69 Fed. Reg. at 3473.

63 *See generally* Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First 70 Years of the Securities and Exchange Commission*, 59 BUS. LAW. 1347 (2004).

64 *Id.* at 1377.

65 Investment Company Governance, 69 Fed. Reg. 3472 (proposal); Investment Company Governance, 69 Fed. Reg. 46,378.

On several occasions the Commission or its representatives have articulated justifications for a separation of the chair from the CEO.

In 1979 SEC Chair Harold Williams endorsed the separation of the board chair from the CEO, stating in part:

> The ties which board members will feel to the CEO and their basic desire to be supportive are compelling. The consequences of adding to that power the power of the chair and of the agenda process must be weighed cautiously . . . the intimidating power of the chair, especially when occupied by a chief executive to whom many on the board owe their directorships and perhaps their livelihood, is a factor which deserves serious consideration.[66]

Chairman Williams stressed the different roles that the chair and CEO have to perform: "[I]n the board environment, the role of the chairman . . . is to create the kind of open, contributing and questioning environment . . . The CEO's role is to speak for management."[67]

Witnesses at SEC corporate governance hearings in the late 1970s separately stressed the greater accountability of corporate management that can be achieved when the board chair and CEO are separated.[68]

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66 Harold M. Williams, Corporate Accountability and Corporate Power, A Paper Presented at the Fairless Lecture Series, Carnegie-Mellon University, Pittsburgh, Pa. 9 (Oct. 24, 1979), *quoted in* SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY, *supra* note 12, at 473.

67 *Id.*, *quoted in* SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY, *supra* note 12, at 474.

68 *See* SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY, *supra* note 12, at 471–75.

> Commentators set forth several advantages which they perceived in having a separate chairman of the board and chief executive officer. One commentator, Joseph Alibrandi, President of Whitaker Corporation, described the structure of that corporation's board, in which the chairman of the board is an outside director, as having the following advantage:
>
> > . . . let's say [a director] had a question with regard to some financial data or disclosure . . . he would not have to put himself in the position where he would have to go to management and say. [sic] "I would like more information on such and such." He would go to the Chairman of the Board who has the power to use an outside law firm to investigate something that the company is doing. He can hire an outside consultant completely on his own to evaluate or develop information . . . [S]o, in effect, the outside directors would have the maximum capability . . . to develop that objective view of how management was doing. . . .
>
> Courtney Brown has suggested that without differentiating the functions of the chairman and the chief executive officer,
>
> > it is difficult to see how the board of the future can be organized to discharge fully the complex responsibilities required for the healthy de-

Other commentators, however, expressed concern that if the board chair or CEO were not compatible corporate performance could be hindered.[69]

More recently in enforcement actions the Commission has required the separation of the board chair and CEO "to promote future compliance with the federal securities laws"[70] or because, as the SEC explained with respect to investment companies:

> Perhaps more important, the chairman of the board can have a substantial influence on the fund boardroom's culture. The boardroom culture can foster (or suppress) the type of meaningful dialogue between fund management and independent directors that is critical for healthy fund governance. It can support (or diminish) the role of the independent directors in the continuous, active engagement of fund management necessary for them to fulfill their duties.[71]

> > velopment of the corporation and the security of board members from excessive liability.
>
> According to Brown, the chairman should have two principal functions. First, he or she should make certain that the board is properly discharging its responsibility. "In the broadest outline, his job should be to encourage . . . consensus decisionmaking by a group of independently minded board members in collaboration with management. . . ." Second, the chairman should assume the "burden of representing the company to its external publics: consumer groups, environmentalists, certain government agencies, business associations, institutional investors, even Wall Street analysts." The chief executive officer, on the other hand, would be responsible for "managing" the corporation, and would not report directly to the chairman of the board, but rather to the collective board, of which both he and the chairman would be members.

Id. at 471–73 (footnotes omitted).

69 *See id.* at 475; *cf.* Patrick McGeehan, *Breaking Up Is Still Hard to Do*, N.Y. TIMES, Aug. 1, 2004, § 3 (Sunday Business) at 4 (reporting that Board Chair Charles Schwab, who earlier had separated positions of CEO and Chair at firm named after him, reassumed position of CEO). Alternatively a chair may prove too deferential to the CEO. *See, e.g.*, Kate Kelly, *Painful Progress at the NYSE*, WALL ST. J., Aug. 27, 2004, at C1 (noting that NYSE Chair Reed has taken a small office at the NYSE once occupied by a secretary, and has taken a hands-off approach, largely limited to Monday morning telephone calls).

70 *See, e.g.*, Parmalat Finanziaria, S.p.A., Litigation Release 18803, (July 28, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18803.htm.

71 Investment Company Governance, Investment Company Act of 1940 Release No. 26,323, 69 Fed. Reg. 3472, 3474 (proposed Jan. 23, 2004); Investment Company Governance, Investment Company Act of 1940 Release No. 26,520, 69 Fed. Reg. 46,378 (Aug. 2, 2004). The release continued:

> A boardroom culture conducive to decisions favoring the long-term interest of fund shareholders may be more likely to prevail when the board chairman does not have the conflicts of interest inherent in his role as an executive of

The most detailed elaboration of the differences in functions of a separate CEO and chair approved to date by the SEC concerns the Boston Stock Exchange (BSE).[72] The BSE amended its Constitution in 2004 to permit, but not require, the separation of the chair and CEO to "allow for the independence of the Exchange's regulatory functions from its marketplace functions."[73] The adoption release explained:

> If the Chairman and CEO are not the same person, then according to the proposed revisions to the Constitution, the Chairman, as an executive officer of the Exchange, among other duties, would: (1)

> the fund adviser. Moreover, a fund board may be more effective when negotiating with the fund adviser over matters such as the advisory fee if it were not at the same time led by an executive of the adviser with whom it is negotiating. If such negotiation leads to lower advisory and other fees, shareholders would stand to benefit substantially.

Investment Company Governance, 69 Fed. Reg. at 3475.

This theme was amplified in a *Report of the Mutual Fund Directors Forum, Best Practices and Practical Guidance for Mutual Fund Directors*, a nonprofit organization of mutual fund directors who made recommendations at the request of SEC Chair Donaldson, and stated in part:

> The Forum recognizes that the belief that a fund's chairman should be independent of the fund's adviser is not today accepted by some in the mutual fund industry. Nonetheless, the Forum has concluded, on balance and in light of the importance of the role of a fund's board chairman in creating and steering the agenda of board meetings and in guiding discussions of the board on various matters, that the goal of seeking to ensure that the interests of a fund's shareholders are protected from conflicts involving the fund's adviser can best be met when the fund's board is chaired by an independent director.
>
> Although a fund's board chairman should be an independent director, the independent chairman's duties should not include supervision of the fund's day-to-day operations, which should remain with its adviser. The role of the independent chairman, by contrast, should be to assure that the independent directors control meeting agendas, the tone and tempo of board meetings, the topics discussed, the amount of time spent on each topic and the order in which topics are addressed. To enhance the participation and effectiveness of the independent directors, the independent chairman should endeavor to ensure, both directly and through regular communication with the fund's external service providers, that the fund's independent directors are kept informed of developments between meetings on a regular basis, as well as, of course, any significant events.

REPORT OF THE MUTUAL FUND DIRECTORS FORUM: BEST PRACTICES AND PRACTICAL GUIDANCE FOR MUTUAL FUND DIRECTORS 6 (2004), *available at* http://66.216.74.187/PDFs/best_pra.pdf.

72 Separation of Board and Chief Executive Officer Positions, Boston Stock Exchange Rules, Exchange Act Release No. 49,611, 69 Fed. Reg. 23,833 (Apr. 23, 2004).

73 *Id.* at 23,834.

> Preside over all meetings of the Board; (2) be responsible to the Board for the management of the BSE's regulatory affairs; (3) be responsible for management of the regulatory affairs of all exchange facilities, subsidiaries, or other legal entities to which the Exchange is party; and (4) act as Board liaison to the Exchange's CEO and management. Similarly, if the Chairman and CEO positions are held by different individuals, then the CEO, among other duties, would: (1) Be responsible for the management and administration of the affairs of the Exchange's marketplace functions; (2) not participate in executive sessions of the Board; and (3) be subject to the authority of the Board.[74]

The Commission approved this restructuring because "the proposed rule change is designed to help improve the governance structure of the Exchange by ensuring that the Exchange's regulatory function is cordoned off from management of the marketplace function when two individuals hold the positions of Chairman and CEO."[75]

C. *The Chief Regulatory Officer*

The 2003 NYSE reorganization also inspired a separate new idea in corporate governance. In approving this reorganization, the Commission stressed the significance of the new Chief Regulatory Officer: "The Commission believes that the proposed amendments to the NYSE's governance structure, and in particular the creation of a Chief Regulatory Officer reporting directly to an independent Regulatory Oversight & Regulatory Budget Committee, add a significant degree of independence that should insulate regulatory activity from economic pressures . . . ."[76]

This may be the most significant innovation in the NYSE reorganization. It means that a full-time Exchange employee will focus on regulatory compliance and will report to the board without filtration by other senior executives.

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74 *Id.* Footnote 6 added:

> The Exchange also proposes a Constitutional provision to clarify that the general powers of the Board also would include the administration of the regulatory function of the Exchange. Thus, while the person serving in the capacity of Chairman or Chairman/CEO would be responsible for the management of the Exchange's regulatory affairs, the Exchange's Board would continue to have ultimate oversight responsibility for the Exchange's regulatory functions.

Id. at 23,834 n.6.

75 *Id.* at 23,834.

76 NYSE Constitutional Amendment Regarding Corporate Governance, Exchange Act Release No. 48,946, 68 Fed. Reg. 74,678, 74,687 (Dec. 17, 2003).

Subsequently the Commission proposed a similar chief compliance officer for hedge funds[77] and the NASD proposed Rule 3013 to require each of the NASD members to designate a chief compliance officer.[78]

D. *Officer Certification and Internal Accounting Controls*

In former Secretary of the Treasury Paul O'Neill's account of his service in George W. Bush's administration, there is a memorable account of a debate between O'Neill and Federal Reserve Chair Alan Greenspan on the one hand and SEC Chair Harvey Pitt on the other over what should be the Bush administration's response to Enron and other corporate scandals.[79] O'Neill initially sought a negligence standard for CEO culpability for corporate financial statements under the federal securities laws.

Ultimately Pitt and the SEC took the lead in proposing executive certification rules before the adoption of Sarbanes-Oxley.[80]

Section 302 of the Sarbanes-Oxley Act requires each quarterly and annual report filed under section 13(a) or section 15(d) of the 1934 Act to be certified by the principal executive officer or officers *and* the principal financial officer or officers.[81]

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77 Registration Under the Advisor's Act of Certain Hedge Fund Advisers, Investment Advisors Act Release No. 2266, 69 Fed. Reg. 45,172, 45,180 (proposed July 28, 2004).

78 Nasdaq Rule Relating to CEO and CCO Certification, Exchange Act Release No. 48,981, 68 Fed. Reg. 75,704 (proposed Dec. 23, 2003).

79 RON SUSKIND, THE PRICE OF LOYALTY: GEORGE W. BUSH, THE WHITE HOUSE, AND THE EDUCATION OF PAUL O'NEILL 224–30 (2004).

80 Certification of Disclosure in Companies' Reports, Exchange Act Release No. 46,079, 67 Fed. Reg. 41,877 (proposed June 14, 2002); *see also* Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Exchange Act Release No. 46,300, 67 Fed. Reg. 51,508 (Aug. 8, 2002) (presenting supplemental information on the proposed rule, issued after enactment of Sarbanes-Oxley Act).

81 Under section 302, each signing officer must certify that

> (1) the signing officer has reviewed the report;
>
> (2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
>
> (3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
>
> (4) the signing officers –
>
> (A) are responsible for establishing and maintaining internal controls;

The personal responsibility imposed on the signing officers in section 302 makes this among the most draconian sections of the Sarbanes-Oxley Act. While the Act does not go so far as to require certification by board chairs, as earlier considered, the demand for personal responsibility virtually screams from the legislative page.

There are, however, countervailing considerations. At many corporations the chief executive officers had become "salespersons in chief." The certification requirement is a powerful reminder of the need for chief executive and financial officers to be personally involved with a corporate compliance system. Certification also has the collateral advantage of signaling to the securities market that it is less likely that covered corporations will engage in future dysfunction.[82] Moreover, the Commission had to take into account that section 13(b)(2) adopted in 1977 to require each reporting corporation to

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(B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C.A. § 7241 (West Supp. 2004).

82 In August 2002 the Commission adopted rules that implement the certification mandate in section 302 of the Sarbanes-Oxley Act instead of the certification contained in its June 2002 proposal. Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 46,427, 78 S.E.C. Dock. 875 (Aug. 28, 2002).

"devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that . . . transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles" had not appeared to be effective in the period preceding Enron. Section 13(b)(2) was neither detailed and precise nor required executive certification.

Where section 302 addressed executive certification, section 404 of Sarbanes-Oxley was intended to require a detailed system of internal controls. In 2003 the Commission adopted or amended several Rules and Forms to implement the Sarbanes-Oxley Act section 404 requirement that companies reporting under the 1934 Act include in their annual report a management report on the company's internal control over financial reporting.[83]

For many boards of directors and outside auditors section 404 has emerged as a key new responsibility of the board. Under most state corporate law statutes, the board is "fully protected" when it relies on the report of an outside accountant or management.[84] Section 404 and the new SEC rules, in contrast, place responsibility on the management "to [establish] and [maintain] an adequate internal control structure and procedures for financial reporting" and to annually assess its effectiveness. The registered public accounting firm is required to attest to this assessment.[85]

Subsequently the PCAOB adopted Audit Standard No. 2, An Audit of Internal Controls over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. As approved by the SEC, the new standard was estimated to increase audit costs by as much as thirty percent to 100%.[86]

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83 Disclosure Required by Sarbanes-Oxley Act, Exchange Act Release No. 46,701, 78 S.E.C. Dock. 1907 (proposed Oct. 22, 2002); Disclosure Required by Sarbanes-Oxley Act, Exchange Act Release No. 47,986, 80 S.E.C. Dock. 1014 (June 6, 2003).

84 *See* Delaware General Corporate Law § 141(e), DEL. CODE ANN. tit. 8, § 141(e) (2001).

85 Sarbanes-Oxley Act § 404(b), 15 U.S.C.A. § 7262.

86 *Experts Split on Costs and Benefits of PCAOB's Proposed Audit Standard,* 36 Sec. Reg. & L. Rep. (BNA) 163 (2004); ERNST & YOUNG, EMERGING TRENDS IN INTERNAL CONTROLS: INTERNAL CONTROLS: INITIAL SURVEY 1 (Jan. 2004) (reporting on a survey of 100 major companies that found initial budgets of 10,000 to 200,000 new hours for section 404 compliance), *available at* http://www.ey.com/global/download.nsf/US/Library85/$file/EmrIntCtrls.pdf.

PCAOB Audit Standard No. 2 stated in part in paragraphs two of four:

2. A company subject to the reporting requirements of the Securities Exchange Act of 1934 (an "issuer") is required to include in its annual report a report of management on the company's internal control over

The ultimate purpose of this new audit standard is to strengthen the burden placed upon the board of directors and the chief executive and chief financial officers, who certify corporate financial statements, to be responsible for their integrity. It is a powerful, albeit extraordinarily detailed, set of standards intended to significantly enhance the role of the corporate audit committee and the independent auditor in reviewing the processes by which honest and accurate accounting and auditing can be produced within each covered firm.

III. The Modest Revolution Assessed

Within two years of the Sarbanes-Oxley Act the basic model of corporate governance for covered corporations has been revised.

Before the Act, corporations were required under NYSE and other stock market listing standards to have an audit committee.

After the Act, NYSE and Nasdaq corporations are required to have three committees (audit, compensation, and corporate governance and/or nomination), each of which at all times on the NYSE

> financial reporting. . . . The report of management is required to contain management's assessment of the effectiveness of the company's . . . most recent fiscal year, including a statement as to whether the company's internal control over financial reporting is effective. The auditor that audits the company's financial statements included in the annual report is required to attest to and report on management's assessment. The company is required to file the auditor's attestation report as part of the annual report.
>
> . . . .
>
> 4. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting. To form a basis for expressing such an opinion, the auditor must plan and perform the audit to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's assessment. The auditor also must audit the company's financial statements as of the date specified in management's assessment because the information the auditor obtains during a financial statement audit is relevant to the auditor's conclusion about the effectiveness of the company's internal control over financial reporting. Maintaining effective internal control over financial reporting means that no material weaknesses exist; therefore, the objective of the audit of internal control over financial reporting is to obtain reasonable assurance that no material weaknesses exist as of the date specified in management's assessment.

PCAOB Audit Standard No. 2, Exchange Act Release No. 49,544, 69 Fed. Reg. 20,672, 20,673–74 (proposed Apr. 8, 2004); PCAOB Audit Standard No. 2, Exchange Act Release No. 49,884, 69 Fed. Reg. 35,083 (June 17, 2004).

would be composed entirely of independent directors. The audit committee now by statute has the power to hire and fire the outside auditor. Moreover, a majority of the board itself also must be independent.

Significantly, Sarbanes-Oxley and implementing SEC and PCAOB rules focus on the mechanics of corporate governance to a much greater degree than the earlier section 13(b)(2) of the Securities Exchange Act. Now there are detailed requirements for executive certification and internal accounting controls. Under the NYSE Listing Standards, nonmanagement directors are required to meet without management present.

At the same time, several of the most significant potential rules for corporate governance either have not been adopted or have not been adopted for corporations generally. The SEC failure to adopt a shareholder access rule is particularly noteworthy. But so are several ideas that have been adopted elsewhere such as the separation of the corporate CEO from the board chair, the requirement that seventy-five percent of the board be independent, and the requirement of a chief regulatory officer.

Underlying this modest and incomplete revolution are several overlapping themes.

First, there is a general conviction, often articulated by the Commission, that greater compliance with federal securities and other relevant laws is more likely if the board is separate from senior corporate executives. This theme accounts for the movement for a majority of independent directors generally as well as requirements of board committees comprised entirely of independent directors as well as the nascent efforts to separate the corporate CEO from the board chair.

Second is a view not rooted in compliance considerations. Board members' access to information and participation in the board is more likely to be effective if the board chair and CEO are separate. This recognizes a general conflict of interest. The board ultimately is responsible for reviewing the performance of the corporate CEO. It is difficult to do this if the CEO controls the operation of the board. Similar considerations also support a majority or supermajority of the board being independent or nonmanagement directors.

Third, more globally is a general concern that both boards and outsiders including shareholders and regulatory agencies were not receiving full and accurate information about corporate finances. The emphasis in Sarbanes-Oxley on the audit committee, new executive certification and internal accounting requirements, and the creation of the new PCAOB to regulate public accounting are all testimony to a policy preference to improve the integrity of mandatory corporate disclosure.

Less emphasized as a policy concept to date has been the notion that improving the diversity of board membership through director electoral rules that increase the likelihood of outside shareholder factions successfully nominating directors is also likely to improve law compliance, board function, or the integrity of the mandatory corporate disclosure.

What is missing from the SEC's initiatives to date has been a systematic review. When the SEC last seriously reviewed corporate accountability in 1980, it did so after detailed and thoughtful hearings and with its staff producing a comprehensive reexamination of the shareholder's role in corporate governance, the role of the board of directors, and how both had significantly changed in the recent past. This type of broad reexamination of corporate governance is overdue today. Never in the history of the SEC has the integrity of corporate governance been as sharply questioned as it was in the period of Enron and Sarbanes-Oxley. There has been no systematic effort by the Commission outside of its staff proxy process report to examine how well existing rules are functioning. Nor has there been an examination of what problems were associated with the major corporate dysfunctions that prompted and succeeded Sarbanes-Oxley or a review of how the alternative remedies that have been advanced by the Commission and others work together.

The purpose of such a reexamination should not solely be to augment corporate regulatory requirements. There is a significant challenge for both the SEC and for the PCAOB with respect to the corporate governance changes to date. The burden of compliance with these standards is greater for small and medium sized firms than for corporate giants. Over time it is reasonable to assume the SEC and the PCAOB may take steps similar to those earlier taken by the SEC with respect to the mandatory disclosure system to modulate these requirements based upon the size and economic significance of relevant firms. It may well prove to be the case that with our very largest firms steps towards full separation of chairs of the board from CEOs and establishment of chief regulatory officers are now long overdue, while with our smallest firms the existing burden of full compliance with the new audit standard may prove particularly onerous. The genius of an effective regulatory agency, if genius there be, is the ability to modulate rules and standards over time as experience teaches us about their effectiveness. The modest revolution in corporate governance may evolve as much by modulation of its burdens as it does through further new requirements.