2007

Corporate Governance, the Securities and Exchange Commission, and the Limits of Disclosure


Follow this and additional works at: https://scholarship.law.edu/lawreview

Recommended Citation
Available at: https://scholarship.law.edu/lawreview/vol57/iss1/3

This Article is brought to you for free and open access by CUA Law Scholarship Repository. It has been accepted for inclusion in Catholic University Law Review by an authorized editor of CUA Law Scholarship Repository. For more information, please contact edinger@law.edu.
States regulate the substance of corporate governance. Fiduciary duties, director qualifications, and the rights of shareholders all emanate from state law. Regulation of disclosure, on the other hand, falls to the
Securities and Exchange Commission (SEC or the Commission),² at least for public companies.³ It is the Commission that ensures investors⁴ and shareholders⁵ have the information necessary to make informed decisions.

This neat dichotomy has been long accepted but little examined.⁶ In fact, it is not a particularly accurate description. In the public company arena, disclosure means little, absent adequate governance. No matter how many accounting standards are implemented, enforcement proceedings brought, or items added to Regulation S-K, the quality of disclosure hinges on management’s commitment to, and involvement in, the process.

is merely a listing standard, with few penalties for violations. See infra notes 118-29 and accompanying text.

2. U.S. Securities and Exchange Commission, The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Nov. 27, 2007). State law provides inspection rights. See, e.g., DEL. CODE ANN. tit. 8, § 220 (Supp. 2006). In the realm of public companies, those rights are largely supplanted by the periodic reporting system. Two significant exceptions exist. Delaware courts have all but required the use of inspection rights as a precondition to the challenge of the independence of the board of directors. See Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1056-57 (Del. 2004) (affirming the dismissal by the Court of Chancery of a derivative action where plaintiff shareholders failed to establish demand futility, which the Delaware Supreme Court said could have been successfully established if plaintiff “used a Section 220 books and records inspection”). In addition, they are a useful mechanism for obtaining a list of shareholders, something not guaranteed under the federal system. See 17 C.F.R. § 240.14a-7 (2007) (giving companies the choice of either providing a list of shareholders or sending materials to other shareholders on behalf of an insurgent shareholder).

3. Roberta S. Karmel, Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance, 30 DEL. J. CORP. L. 79, 80 (2005) (“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.”). Public companies are those that meet the requirements of section 12(g) of the Exchange Act, or are traded under a national stock exchange under section 12(b). See Securities Exchange Act of 1934 § 12, 15 U.S.C. § 78l(b), (g) (2000 & Supp. V 2005).


5. See id. § 14(a), 15 U.S.C. § 78n(a) (giving the Commission the authority to regulate the proxy process); see also J. I. Case Co. v. Borak, 377 U.S. 426, 431 (1964) (“The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation.”).

6. See Robert A. Prentice, The Inevitability of a Strong SEC, 91 CORNELL L. REV. 775, 806 (2006) (“Federal securities law, not state corporate law, plays the most important role in corporate governance in America today, primarily because disclosure has become the most important method to regulate corporate managers and disclosure has been predominantly a federal, rather than a state, methodology.”) (quoting Robert B. Thompson & Hillary A. Sale, Securities Fraud as Corporate Governance: Reflections Upon Federalism, 56 VAND. L. REV. 859, 861 (2003))).
The division of authority did not arise from a comprehensive analysis of the optimal method of promoting governance or a deliberate decision to keep the Commission out of the substance of corporate governance, but rather as a consequence of path dependence. When Congress adopted the Securities Exchange Act in 1934, the central issue of corporate governance was the absence of adequate disclosure. Management took advantage of secrecy to self perpetuate, pay excessive salaries, and engage in other abusive practices. With such secrecy, the substantive corporate governance standards mattered far less.

Congress sought to fix the corporate governance process by addressing the deficiencies this secrecy created. The disinfectant effect of disclosure had a corresponding impact on the substantive standards, but not the one expected. The pressure of self interest did not abate; it merely lost the protection of secrecy. Instead, pressure built on states to loosen substantive standards. Over time, the duty of care evolved into little more than a wooden process, and the duty of loyalty into a standard largely unmoored from fairness.

At the same time, the disclosure regime implemented by the Commission itself impacted the substance of corporate governance.

---


11. The devolution of substantive standards in state law has been discussed at length in a trilogy of articles. See generally Brown, *supra* note 1 ("Delaware courts have all but eliminated meaningful limits on self-interested transactions."); J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317 (2004) [hereinafter Brown, *Irrelevance*] ("Over time, state courts interpreted the duties [to act with care, loyalty, and good faith] in a manner that left little substance. The business judgment rule and universal adoption of waiver of liability provisions all but eliminated causes of action for breach of the duty of care. The duty of loyalty, particularly self-dealing by officers and directors, could be validated through procedural mechanisms." (footnote omitted)); J. Robert Brown, Jr., *Speaking with Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty*, 54 HASTINGS L.J. 641 (2003) ("Despite the central importance of fairness to the duty of loyalty . . . the trend has been to eliminate any analysis of fairness, replacing substantive review with procedural safeguards.").

Under state law, shareholders had the inherent right to make proposals or nominate directors from the floor of the meeting. 13 The SEC proxy rules, however, made the meeting itself a formality with votes cast as part of the proxy process prior to the meeting. 14 Actions were destined to fail unless shareholders competed for proxies. But the rules made this a time consuming and prohibitively expensive process, effectively depriving shareholders of their substantive rights. 15

With the link between disclosure and substance increasingly clear, the Commission embarked on an effort to regulate substance using a variety of mechanisms, including disclosure. In the 1970s, Congress provided increased authority to regulate the internal process of assembling financial statements. 16 Efforts were also made to influence governance through the imposition of listing standards, an avenue largely foreclosed by the courts. 17 Enforcement proceedings 18 and regulatory admonitions 19 were other avenues employed by the Commission.

None of these had the desired effect. By the 1990s, the Commission began to use disclosure aggressively to alter the substantive behavior of officers and directors. 20 This was something different from the Commission’s past efforts. 21 Much of the required information was, at

13. Jill E. Fisch, From Legitimacy to Logic: Reconstructing Proxy Regulation, 46 VAND. L. REV. 1129, 1134 (1993) (“At common law, it was necessary for shareholders to attend the annual meeting personally in order to exercise their voting rights.”).

14. Id. at 1135; see also infra note 225.


17. See Bus. Roundtable v. SEC, 905 F.2d 406, 408 (D.C. Cir. 1990) (striking down an SEC rule requiring one vote per share and noting that the requirement was “concededly a part of corporate governance traditionally left to the states”).


19. See infra note 250 (discussing Commission efforts to improve quality of disclosure in management discussion and analysis (MD&A)).

20. See Shareholder Communications, Exchange Act Release No. 15,384, Investment Company Act Release No. 10,510, 16 SEC Docket 348, 356 (Dec. 6, 1978) (“While the Commission recognizes that the adoption of this disclosure requirement in some instances may indirectly stimulate the establishment of audit, nominating and compensation committees, the Commission believes that disclosure of the nonexistence of the named committees serves a valid informational purpose.”).

best, marginally material to investors or shareholders. Disclosure was instead designed to cause changes in corporate behavior by illuminating practices that could result in embarrassment or legal liability.\(^{22}\)

The approach, however, was only marginally effective. Sometimes the requirements resulted in a morass of boilerplate or unilluminating discussion.\(^{23}\) In other instances, substantive behavior did not change even with disclosure, in part because of the continuing downward evolution of standards under state law.\(^{24}\) The result was often an additional wave of even more complex disclosure.

More effective authority to influence governance came from the Commission’s growing authority to regulate management’s involvement in the disclosure process.\(^{25}\) The Sarbanes-Oxley Act of 2002 (SOX) required management to develop and assess the internal controls used to formulate financial disclosure.\(^{26}\) Congress largely left it up to the Commission to determine the assessment process and, most importantly, the role particular individuals would play in the process. In other words, the Commission received the authority to impose standards of behavior on officers and directors, at least in the context of financial disclosure. The effects of this authority are only now being felt on the governance process.

This Article will do several things. First, it will briefly examine the role of the states and the Commission in the corporate governance process, something more a product of history than a rational division of authority. Second, it will identify some of the consequences of this division. Third, the Article will look at the varied efforts by the Commission to break out of the realm of disclosure and to regulate the substantive behavior of officers and directors. Finally, the Article will examine the changes wrought by SOX and the potential for a dramatic increase in the role of the SEC in the corporate governance process.

I. SUBSTANCE, DISCLOSURE, AND THE REGULATION OF CORPORATE GOVERNANCE

Adopted during the Great Depression, the Securities Exchange Act of 1934 delegated to the SEC\(^ {27}\) the authority to regulate the disclosure of

\(^{22}\) See id.
\(^{23}\) Brown, Irrelevance, supra note 11, at 354-55.
\(^{24}\) Id. at 355.
\(^{25}\) See id. at 359.
Specifically, section 13(a) enabled the agency to prescribe the “information and documents” required to be filed, something that eventually evolved into a quarterly reporting system. The provision filled an obvious gap in state law and the listing standards of the stock exchanges.

The Exchange Act also addressed governance concerns with respect to shareholders. Section 14(a) of the Exchange Act gave the Commission the authority to regulate proxies, another area of obvious regulatory

Act of 1933 fell to the Federal Trade Commission (FTC). See JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 99 (3d ed. 2003). Ironically, Congress created the SEC because of the perceived regulatory strength of the FTC. In other words, the SEC was created to weaken enforcement. Id. at 97-99.


29. Securities Exchange Act of 1934 § 13(a). The provision requires the disclosure of “such information and documents . . . as the Commission shall require.” Id.

30. See H.R. REP. NO. 73-1383, at 6 (1934); see also 78 CONG. REC. 7705 (1934) (noting that the need for additional disclosure arose from the “growing tendency toward extreme breadth and flexibility in the corporation laws of many States”); see also 78 CONG. REC. 7699 (1934) (statement of Rep. Rayburn) (discussing disclosure requirements in the Act and noting that “we know some of the States do not have any laws with reference to this question and some have very poor laws with respect to it”).

31. Interestingly, the use of listing standards as a vehicle for imposing periodic reporting requirements was discussed. See STOCK EXCHANGE REGULATION: LETTER FROM THE PRESIDENT OF THE UNITED STATES TO THE CHAIRMAN OF THE COMM. ON BANKING AND CURRENCY WITH AN ACCOMPANYING REPORT RELATIVE TO STOCK EXCHANGE REGULATION 17 (Comm. Print 1934) (“Your committee believes that each licensed stock exchange should be required to adopt listing requirements for the various classes of issues listed on the exchange which will give to the public full, complete, and pertinent information with respect to such securities, both at the time the securities are admitted to trading and periodically thereafter.”). Congress rejected the approach at least in part because of concerns over the enforcement of listing standards. See S. REP. NO. 73-1455, at 70 (1934) (“Although the New York Stock Exchange has proclaimed the searching nature of its listing requirements, evidence was adduced before the subcommittee establishing that the exchange authorities were lax in their investigation of listing applications.”). For a description of the opposition of the NYSE to the Exchange Act, see SELIGMAN, supra note 27, at 87-93.

32. Securities Exchange Act of 1934 § 14(a). Historically, states imposed a few ineffective restrictions on management’s use of proxies. For example, a Massachusetts law prevented salaried officers from being proxy holders. See, e.g., E. Merrick Dodd, Jr., STATUTORY DEVELOPMENTS IN BUSINESS CORPORATION LAW, 1886-1936, 50 HARV. L. REV. 27, 33 (1936) (discussing an 1882 Massachusetts statute, MASS. PUB. STAT. (1882) c. 105-06). Early statutes also limited the number of shares voted by any proxy holder. See, e.g., id. Nonetheless, over time, state law ceased to impose any real limits on management’s use of the proxy process. Id. at 36 (noting that 1903 revisions of Massachusetts corporate code “marked the end of any attempt . . . to put obstacles in the way of control of the proxy machinery by the management”).
The provision was intended to remedy a number of abuses chronicled during the hearing process, including the use of proxies "by unscrupulous corporate officials seeking to retain control of the management by concealing and distorting facts" and to obtain approval for "vast bonuses out of all proportion to what legitimate management would justify."

The Commission, therefore, was expected to play a role in the governance process. Disclosure was expected to be the main (but not only) method of addressing these abuses of authority by directors. With shareholders having the substantive authority to limit

33. As the Senate Report expansively stated:

   It is contemplated that the rules and regulations promulgated by the Commission will protect investors from promiscuous solicitation of their proxies, on the one hand, by irresponsible outsiders seeking to wrest control of a corporation away from honest and conscientious corporation officials; and, on the other hand, by unscrupulous corporate officials seeking to retain control of the management by concealing and distorting facts.

S. REP. NO. 73-1455, at 77 (1934). Even the courts have recognized that the Commission's authority in the proxy rules goes beyond disclosure. See, e.g., Bus. Roundtable v. SEC, 905 F.2d 406, 411 (D.C. Cir. 1990) ("We do not mean to be taken as saying that disclosure is necessarily the sole subject of § 14.").

34. S. REP. NO. 73-1455, at 77; see also 78 CONG. REC. 7705 (1934) ("Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies."); 78 CONG. REC. 7864 (1934) (statement of Rep. Wolverton) (noting under the heading of "no improper regulation of business" that the Act "seeks to make more difficult the use of official positions to self-perpetuate the controlling management and thereby enables the individual stockholder in conjunction with others to have a more reasonable opportunity to change the management when occasion seems to justify").

35. See 78 CONG. REC. 7861 (1934) (statement of Rep. Rayburn). There were limits, but those mostly applied to traditional matters of day-to-day management. See H.R. REP. NO. 73-1838, at 35 (1934) ("The House bill does not contain a provision corresponding to that contained in subsection (d) of section 13 of the Senate amendment providing that 'nothing in this title shall be construed as authorizing the Commission to interfere with the management of the affairs of an issuer.' This provision is omitted from the substitute as unnecessary, since it is not believed that the bill is open to misconstruction in this respect."). For a thorough discussion of the legislative history of the section 14(a), see Williams, supra note 21, at 1235-46.


37. Section 14(a) does not use the word disclosure. Instead, the Commission has the authority to adopt rules that are "in the public interest" or are necessary "for the protection of investors." Securities Exchange Act of 1934 § 14(a). Moreover, the Commission has long accepted that the provision extends beyond disclosure.
management, adequate disclosure would be enough to enable them to cast out misbehaving officials or veto excessive bonuses. Disclosure, in other words, coupled with the authority of shareholders under state law, was enough to solve the identified concerns. Other matters of substance were left to the states.

In the early years, the Commission largely stuck to the prescribed role, promoting disclosure. As a result, shareholders and investors

38. See, e.g., 78 CONG. REC. 8094 (1934) (statement of Rep. McClintic) (noting that abuse of the proxy process occurred because management "realize[d] that when they obtain a sufficient number of proxies they have in their hands the power to vote themselves as high a salary or bonus as they desire").

39. See Lofland v. Cahall, 118 A. 1, 3 (Del. 1922) ("[Directors] have no right to compensation for services rendered within the scope of their duties as directors, unless it is authorized by the charter, by-laws, or the stockholders of the company.").

40. The legislative history does not indicate any significant awareness of the various logistical problems that make collective actions by shareholders difficult. Nonetheless, the problems were raised in a well-known article by William O. Douglas, the third Chairman of the Commission and Justice of the U.S. Supreme Court. See generally William O. Douglas, Directors Who Do Not Direct, 47 HARV. L. REV. 1305 (1934). He called for some type of quasi-public body that could act on behalf of shareholders. See id. at 1307. For a discussion of weaknesses in disclosure's effect on investor behavior, see Susanna Kim Ripken, The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation, 58 BAYLOR L. REV. 139 (2006).

41. There was some discussion of the potential impact of the Commission's role on the "management of the affairs of an issuer." See H.R. REP. No. 73-1838, at 35 (1934) (deleting as unnecessary section 13(d) of the bill, which made explicit that the Commission could not "interfere with the management of the affairs of an issuer"); see also supra note 35. The concern seemed less about governance (that is the relationship between managers and shareholders) and more about interference in day-to-day management.

42. See, e.g., McKesson & Robins, Inc., Exchange Act Release No. 2707, [Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,020, at 62,110-12 (Dec. 5, 1940); see also Standing Audit Committees Composed of Outside Directors, Securities Act Release No. 5237, Exchange Act Release No. 9548, Investment Company Act Release No. 7091, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,670, at 81,424 (Mar. 23, 1972) ("To this end, the Commission, in the light of the foregoing historical recital, endorses the establishment by all publicly-held companies of audit committees composed of outside directors and urges the business and financial communities and all shareholders of such publicly-held companies to lend their full and continuing support to the effective implementation of the above-cited recommendations in order to assist in affording the greatest possible protection to investors who rely upon such financial statements."). Some have criticized the Commission for its overdependence on disclosure, something described as a lack of "regulatory creativity." See, e.g., Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC, 56 STAN. L. REV. 1, 21-22 (2003). The Choi & Pritchard article devoted only one sentence to the scope of regulatory authority and the lack of alternatives to disclosure. See id. at 23 ("Alternatives to disclosure generally would require the SEC to seek statutory authorization from Congress.").

43. The SEC occasionally acknowledged the lack of authority to regulate director behavior. See Franchard Corp., 42 S.E.C. 163, 176 (1964) (explaining that securities laws did not "define Federal standards of directors' responsibility in the ordinary operations of business enterprises and nowhere empowers us to formulate administratively such
received increasing amounts of information, some of which facilitated shareholder enforcement of substantive rights. Within the first decade after adoption of the Exchange Act, the Commission had put in place disclosure obligations applicable to certain types of self-dealing transactions and executive compensation.

Although regulating output, these efforts did not address the process used within public companies to formulate disclosure. Little or no effort was made to ensure accountability or mandate a particular process. Internal responsibility was left to the discretion of each company. Only where the process culminated in inaccurate disclosure did the regulatory standards," and that "[t]he diligence required of registrant's directors in overseeing its affairs is to be evaluated in the light of the standards established by State statutory and common law" (footnote omitted)); SELIGMAN, supra note 27, at 205 (indicating that the proxy provisions in the Exchange Act were considered "a minor first step, to be succeeded by a more comprehensive federal corporate governance statute"); see also id. at 210 (noting an SEC study that recommended a system of federal incorporation to end state "chartermongering").

44. See Securities Act Release No. 2887, Exchange Act Release No. 3347, Investment Company Act Release No. 417, 1942 SEC LEXIS 44, at *2 (Dec. 18, 1942) ("Information must also be given showing all loans to officers and directors not made in the ordinary course of business, together with a brief description of all material transactions of officers and directors and their associates with the company or its subsidiaries."); Exchange Act Release No. 1823, 1938 SEC LEXIS 678, at *19-20 (Aug. 11, 1938) ("If action is to be taken with respect to the election of directors or other officials, [d]escribe briefly any substantial interest, direct or indirect, of such nominee or any of his associates in any property acquired within 2 years or proposed to be acquired by the issuer or any of its subsidiaries, other than property acquired in the ordinary course of business or on the basis of bona fide competitive bidding. State the cost of the property to the issuer or subsidiary and the cost to the vendor if the property was acquired by the vendor within 2 years prior to the acquisition by the issuer or subsidiary." (emphasis omitted)); see also Choi & Pritchard, supra note 42, at 22 ("Managers considering a self-dealing transaction, for example, may choose not to do so when related-party transactions must be disclosed."). The current provision, Item 404, was put in place in 1982. See Securities Act Release No. 6441, Exchange Act Release No. 19,290, Investment Company Act Release No. 12,865 [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,281, at 85,533, 85,539 (Dec. 2, 1982). Thus, the disclosure of related party transactions allowed shareholders to know about transactions that could violate a director's duty of loyalty. See generally Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (setting out the test for duty of loyalty).

45. Exchange Act Release No. 1823, supra note 44, at *21-24; see also Troy A. Paredes, Information Overload and Its Consequences for Securities Regulation, 81 WASH. U. L.Q. 417, 464 (2003) ("Two disclosure items of particular note when it comes to reducing agency costs are Item 402 of Regulation S-K (dealing with executive compensation) and Item 404 of Regulation S-K (dealing with conflict-of-interest transactions). These disclosures have less to do with valuing the company and more to do with deterring insider misconduct or mismanagement, although there is some overlap between the goal of reducing agency costs and informed investor decision making. As Professor Langevoort has stressed, the valuation of a company depends, at least in part, on assessing the management team and the risk of corporate misconduct or mismanagement.").
Commission act, with corporate responsibility determined on a case-by-case basis.\footnote{46}

At the same time, substantive standards of governance continued to weaken. The duty of care evolved into a shill, reduced by an expansive interpretation of the business judgment rule and the ubiquitous presence of waiver of liability provisions.\footnote{47} The duty of loyalty ceased to be about fairness, with "independent" director approval eliminating any review of the substance of the transaction.\footnote{48} Boards of directors had few obligations to seek information and affirmatively monitor the activities of the company.\footnote{49} The evolution favored the interests of management over the rights of shareholders.\footnote{50}

The decline in substantive standards and the resulting impact on the disclosure process surfaced with a vengeance in the 1970s. Arising out of the Watergate investigation, the SEC uncovered a pattern of foreign bribes and illegal campaign contributions by public companies.\footnote{51} In addition to the widespread nature of the problem, the payments demonstrated weaknesses in the process of formulating disclosure, 

\footnote{46. Friedberg, Exchange Act Release No. 43,129, 72 SEC Docket 2553, 2556 (Aug. 8, 2000) ("He allowed his loyalty to a friend to override his obligations to ensure that the company's disclosures were accurate and complete.").}

\footnote{47. See Brown, Irrelevance, supra note 11, at 318-19.}

\footnote{48. For a discussion on the gradual evisceration of the duty of loyalty, see generally Brown, supra note 1.}

\footnote{49. See Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) (discussing that the board did not have an obligation to "put into effect a system of watchfulness which would have brought such misconduct to their attention in ample time to have brought it to an end"). The most recent iterations of the requirements in this area are not much better. See Stone v. Ritter, 911 A.2d 362 (Del. 2006) ("For the plaintiffs' derivative complaint to withstand a motion to dismiss, 'only a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to liability.'" (quoting In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. 1996))).}

\footnote{50. See Prentice, supra note 6, at 784-85 ("In addition to economic incentives, social, behavioral, and psychological factors encourage directors to subordinate shareholder interests. These include friendships with and loyalty to the CEO, collegiality and team spirit that discourage asking the hard questions, deference to the CEO's authority, and the directors' desire not to monitor others more strictly than they would like to be monitored themselves." (footnotes omitted)).}

\footnote{51. As the Commission observed: "'Millions of dollars of funds have been inaccurately recorded in corporate books and records to facilitate the making of questionable payments. Such falsification of records has been known to corporate employees and often to top management, but often has been concealed from outside auditors and counsel and outside directors.'" Exchange Act Release No. 15,570, 16 SEC Docket 1143, 1145 (Feb. 15, 1979) (quoting U.S. SEC. & EXCH. COMM'N, 94TH CONG., REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES (Comm. Print 1976)). For an overview of the Commission's approach during this time period, see SELIGMAN, supra note 27, at 539-51.}
particularly at the board level. The system of corporate record keeping was not sufficiently robust to ensure that the payments were properly reflected on the company's books and records.

When the SEC confronted the issue of corporate impropriety in the 1970s, the Chairman specifically disclaimed the need for federally imposed "behavioral standards." The problem was again viewed through the lens of disclosure, this time at the board level. With adequate information, directors could take proper action. The Exchange Act was amended to require, for the first time, the maintenance of adequate books, records, and internal controls. The new requirements, however, did not address accountability. The provision said nothing about the people responsible for developing and maintaining any system of internal controls.

With accountability still unaddressed in the statute, the Commission cast around for alternatives. Attention focused on listing standards. Pressured by the Commission, the New York Stock Exchange (NYSE) required listed companies to put in place audit committees consisting

52. See SELIGMAN, supra note 27, at 536.
53. Id. at 547.
54. Id. at 545-47.
55. As SEC Chairman Roderick Hills testified before Congress: "[W]e need a more effective reporting system so that directors will be aware of conduct that is clearly incorrect by existing standards." Id. at 547.
57. See generally Melvin A. Eisenberg, The Board of Directors and Internal Control, 19 CARDOZO L. REV. 237 (1997) (arguing that the board of directors should have responsibility in the design and administration of internal controls). Violations of the books and records provision were perceived as technical—merely an additional charge to add whenever fraud was uncovered.
58. As one example, the SEC formed a commission to study the matter. See Langevoort, supra note 56, at 953-54 ("In the face of continuing examples of financial misreporting, . . . the SEC continued to express concern about financial misreporting and made further changes to upgrade the quality of disclosure. . . . In the mid-1980s, a private sector initiative led to the creation of the so-called Treadway Commission on Fraudulent Financial Reporting, chaired by a newly departed SEC Commissioner, which made a series of recommendations to address problems in the internal controls environment.").
59. See New York Stock Exchange, Inc., Exchange Act Release No. 13,346, 1977 SEC LEXIS 2252, at *4 n.9 (Mar. 9, 1977) ("The NYSE first suggested the concept of an audit committee in 1940, and in recent years has strongly recommended that each listed company form an audit committee preferably composed exclusively of outside directors.").
entirely of independent directors.\textsuperscript{60} The initial foray did not accomplish much. For one thing, the definition of independent did not actually ensure independence.\textsuperscript{61} Additionally, the requirement did not define the responsibilities of the audit committee, something left to state law.\textsuperscript{62} Similarly, enforcement of the new audit committee requirement was left to the exchanges, not a particularly robust source.\textsuperscript{63}

Jawboning the self-regulatory organizations (SROs) worked only as long as they all cooperated. As competition among the SROs grew, however, resistance developed, with matters coming to a head over efforts to ensure shareholder voting rights.\textsuperscript{64} Confronting the need to either delist General Motors or to abandon its longstanding policy of one share one vote, the NYSE opted for the latter.\textsuperscript{65} Delisting would have sent GM to NASDAQ, where no comparable rule existed.\textsuperscript{66} The

\textsuperscript{60} See Roberta S. Karmel, \textit{The Future of Corporate Governance Listing Requirements}, 54 SMU L. REV. 325, 340 (2001); see also Audit Committee Disclosure, Exchange Act Release No. 41,987, 64 Fed. Reg. 55,648, at 55,649-50 (Oct. 14, 1999) ("Since the early 1940s, the Commission, along with the auditing and corporate communities, has had a continuing interest in promoting effective and independent audit committees. It was, in large measure, with the Commission’s encouragement, for instance, that the self-regulatory organizations first adopted audit committee requirements in the 1970s." (footnote omitted)); New York Stock Exchange, Inc., supra note 59, at *6 (noting that “support for audit committees independent of management developed in the wake of recent revelations of questionable and illegal corporate payments”).

\textsuperscript{61} The definition of independent merely required that the directors be “independent of management and free from any relationship that, in the option of its Board of Directors, would interfere with the exercise of independent judgment as a committee member.” Filing of Amendment to Proposed Rule Change, Exchange Act Release No. 20,767, 30 SEC Docket 72, 73 n.5 (Mar. 20, 1984). NASDAQ merely required that a majority of the directors on the audit committee be independent.

\textsuperscript{62} At the time, Delaware, for example, required little if any attention by the board to the internal systems needed to provide information. See Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) ("[D]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong.").

\textsuperscript{63} See Karmel, supra note 3, at 108 (describing a Blue Ribbon Committee created by the NYSE and the NASD to “inquire into the adequacy of the audit oversight process by independent directors”); infra notes 129-30 and accompanying text.


\textsuperscript{65} Id. at 698-99. In 1926, the NYSE put in place the one share, one vote requirement for shareholders, with minimum voting rights for preferred shareholders instituted 14 years later. See Karmel, supra note 60, at 328-29. For a brief overview of the listing standards in place prior to 1977, see New York Stock Exchange, Inc., supra note 59, at *2 n.6.

\textsuperscript{66} See Rock, supra note 64, at 698-99.
decision, therefore, was not about good corporate governance but rather the result of competitive pressures. The Commission tried, behind the scenes, to induce the NYSE and the NASD (the owner of NASDAQ) to adopt comparable voting rules. Unsuccessful, the Commission simply required national exchanges and NASDAQ to implement a one share, one vote standard, thereby ensuring uniformity. In what will no doubt be viewed as a Pyrrhic victory, the Business Roundtable challenged the rule and ultimately prevailed, inducing the D.C. Circuit to conclude that the Commission lacked authority to regulate the substance of corporate governance through the mechanism of listing standards.

With the use of mandatory listing standards to regulate governance foreclosed, the Commission turned to enforcement proceedings to increase accountability, particularly at the board level. In *W.R. Grace*, a section 21(a) report, the company made inaccurate statements about

---

67. See id. at 699.

68. See Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1, 7 (1988) ("[T]he SEC attempted to broker an agreement on a uniform voting rights rule among the NYSE, the Amex, and the NASD. However, these negotiations broke down, largely because of the Amex's insistence on a one share, one vote standard.").

69. 17 C.F.R. § 240.19c-4(a) (2007) (prohibiting the exchanges from taking any action "with the effect of nullifying, restricting or disparately reducing the per share voting rights of holders of an outstanding class of classes of common stock").

70. The Commission relied on listing standards. Had this avenue been kept open, it is possible that most corporate governance provisions would have been implemented in this manner without the need for additional federal legislation. Listing standards, though meaningful, are the least threatening source of regulation to public companies because stock exchanges rarely take significant actions against violations, and no private right of action exists.

71. Bus. Roundtable v. SEC, 905 F.2d 406, 411-12 (D.C. Cir. 1990) ("[S]tate corporate law ... regulates the distribution of powers among the various players in the process of corporate governance, and the Commission's present leap beyond disclosure is just that sort of regulation.").


73. See generally Securities Exchange Act of 1934 § 21(a), 15 U.S.C. § 78u(a)(1) (Supp. V 2005). Section 21(a) allows the Commission "to publish information concerning any ... violations, and to investigate any facts, conditions, practices, or matters which it
benefits paid to a retiring officer. The Commission took the opportunity to instruct the board on the need to maintain adequate procedures to ensure accurate and complete disclosure. As the W.R. Grace report emphasized:

Serving as an officer or director of a public company is a privilege which carries with it substantial obligations. If an officer or director knows or should know that his or her company’s statements concerning particular issues are inadequate or incomplete, he or she has an obligation to correct that failure. An officer or director may rely upon the company’s procedures for determining what disclosure is required only if he or she has a reasonable basis for believing that those procedures have resulted in full consideration of those issues.

The report suggested that directors could be charged for failing to implement adequate procedures, a task typically regulated under state law fiduciary duties.

Although calling on officers and directors to play a more active role in the disclosure process, the legal premise for the approach was unclear. The disclosure process mostly involved areas traditionally regulated under fiduciary obligations rather than the federal securities laws and was, therefore, outside the bailiwick of the Commission. Perhaps as a

may deem necessary or proper” in fulfilling its responsibilities under the Exchange Act. Id.

75. W.R. Grace & Co., supra note 18, at 1244 n.16 (“Procedures or mechanisms established to identify and address disclosure issues are effective only if individuals in positions to affect the disclosure process are vigilant in exercising their responsibilities.”); see also Cooper Companies, Inc., supra note 72, at 596 (“The Commission considers it essential for board members to move aggressively to fulfill their responsibilities to oversee the conduct and performance of management and to ensure that the company’s public statements are candid and complete.”).
76. W.R. Grace & Co., supra note 18, at 1244; see also Cooper Companies, Inc., supra note 72, at 596 (“By failing to take immediate and decisive corrective action on these matters, the Cooper Board appeared to prefer management’s interest in keeping the facts secret over the investors’ interest in full, fair and accurate disclosure under the federal securities laws.”).
77. See W.R. Grace & Co., supra note 18, at 1244.
78. One commissioner dissented from the W.R. Grace report, noting that the company had policies and procedures in place that were designed to ensure accurate disclosure. Id. at 1245. Moreover, he observed that “there do not appear to have been any ‘red flags’ or warnings to indicate that this system—which included the employment of respected and competent securities counsel—was breaking down, or was inadequate to produce documents that would comply with the federal securities laws.” Id.; see also Cooper Companies, Inc., supra note 72, at 596 (“The Commission has long viewed the issue of corporate governance and the fiduciary obligations of members of management
result, there was little follow-up, with the decision having at best marginal impact on board behavior.

The Commission also used enforcement proceedings to reform corporate governance within particular companies, sometimes requiring officers to report directly to the board or to particular committees (often the audit committee), and sometimes mandating training for the board. In a handful of instances, the Commission has required a complete change in the corporate governance structure of a company.


80. A search of the LexisNexis database reveals only five citations to the W.R. Grace report, all for relatively modest propositions. The Commission has, however, continued to stress the importance of the board in the disclosure process. See Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8820, Exchange Act Release No. 47,654, Investment Company Act Release No. 26,001, 79 SEC Docket 2876, 2878 (Apr. 9, 2003) ("Effective oversight of the financial reporting process is fundamental to preserving the integrity of our markets. The board of directors, elected by and accountable to shareholders, is the focal point of the corporate governance system. The audit committee, composed of members of the board of directors, plays a critical role in providing oversight over and serving as a check and balance on a company's financial reporting system.").

81. See, e.g., Warnaco Group, Inc., Exchange Act Release No. 49,675, 82 SEC Docket 2934, 2943 (May 11, 2004) (requiring that "Warnaco's general counsel continue to report directly to the audit committee of the board of directors on any matter relating to Warnaco's financial reporting obligations").


84. See, e.g., SEC v. Cedric Kushner Promotions, Inc., Litigation Release No. 19,485, 86 SEC Docket 2224, 2225 (S.D.N.Y. Dec. 5, 2005) ("The remedial undertakings include appointment of new Chief Executive and Financial Officers, creation of an independent audit committee and majority independent board of directors, and retention of an independent consultant to analyze the company's internal accounting controls, recommend improvements and oversee implementation of those improvements. These undertakings represent an unusual departure from the Commission's policy of limited intrusion into corporate governance, but were required by the unique facts of this case: the company's current two person board of directors consists of its Chairman, President and CEO Kushner who will now be barred from serving as an officer or director of any public company, and its Principal Financial and Accounting Officer James Di Lorenz who is a defendant litigating similar charges of fraud brought by the Commission.").
including at least one instance of mandatory term limits for board members.85

These enforcement proceedings, however, have not broadly affected the governance process. The Commission's undertakings to alter the governance structure of particular companies have not provided broad lessons encouraging duplication. Instead, they have largely been solutions designed to remedy specific problems and have been rather idiosyncratic in application.

II. SUBSTANCE AND DISCLOSURE: THE EARLY YEARS

With continued concerns about both the governance process and accountability, the Commission found itself back at the beginning, largely limited to disclosure to affect practices. Increasingly, therefore, the Commission began to use disclosure to directly influence substantive behavior of directors and officers.86

Early efforts focused on compliance with specific provisions of the securities laws.87 Other efforts sought to provide directors inside the boardroom with leverage to address misbehavior.88 Gradually, however, the requirements extended to a wider array of practices and a wider array of behavior involving traditional areas of corporate governance.89

85. See SEC v. Parmalat Finanziaria, Litigation Release No. 18,803, 83 SEC Docket 1416, 1417 (S.D.N.Y. July 28, 2004) ("Parmalat Finanziaria has agreed to adopt changes to its corporate governance to promote future compliance with the federal securities laws, including adopting by-laws providing for governance by a shareholder-elected board of directors, the majority of whom will be independent and serve finite terms; specifically delineating in the by-laws the duties of the board of directors; adopting a Code of Conduct governing the duties and activities of the board of directors; adopting an Insider Dealing Code of Conduct; and adopting a Code of Ethics. The by-laws will also require that the positions of chairman of the board of directors and managing director be held by two separate individuals." (emphasis added)).
86. Williams, supra note 21, at 1211 & n.62.
87. See discussion infra Part II.A.
88. See discussion infra Part II.B.
89. See Williams, supra note 21, at 1270-71 (discussing the disclosure requirement and noting that "the SEC explicitly recognized its power to adopt disclosure regulations concerning quintessentially corporate governance issues with the purpose of influencing corporate conduct, as well as to provide information to shareholders"); see also Paredes, supra note 45, at 463 ("A.A. Sommer drew the following analogy: 'Very simply put, if every instance of adultery had to be disclosed, there would probably be less adultery,' and Louis Loss put it this way: 'People who are forced to undress in public will presumably pay some attention to their figures.' William O. Douglas contributed the following: '[T]he terroristic phases of the [Securities] Act are dominant. Real protection is afforded investors by scaring other people.'") (footnotes omitted) (alterations in original)).
A. Disclosure and Compliance

Early efforts to regulate substantive behavior of officers and directors focused on improving compliance with the securities laws. This occurred most noticeably in connection with the beneficial ownership reporting requirements. Section 16(b) of the Securities Exchange Act prohibited short swing profits and gave shareholders a private right of action for violations. The provision depended upon disclosure by corporate insiders and large shareholders of changes in their equity holdings. These reporting obligations, however, were routinely ignored, and the Commission had few weapons to combat the delinquencies.


91. See Securities Exchange Act of 1934 § 16(b); see also Owners Reports and Trading by Officers, Directors, and Principal Security Holders, Securities Act Release No. 8600, Exchange Act Release No. 52,202, Investment Company Act Release No. 27,025, 85 SEC Docket 3368, 3369 (Aug. 3, 2005) (“Unlike insider trading prohibitions under general antifraud provisions, Section 16(b) operates without consideration of whether an insider actually was aware of material non-public information. Section 16(b) operates strictly, providing a private right of action to recover short-swing profits by insiders, on the theory that short-swing transactions (a purchase and sale within six months) present a sufficient likelihood of involving abuse of inside information that a strict liability prophylactic approach is appropriate.” (footnotes omitted)).

92. See Securities Exchange Act of 1934 § 16(b) (describing the required disclosures); see also Owners Reports and Trading by Officers, Directors, and Principal Security Holders, Exchange Act Release No. 27,148, Investment Company Act Release No. 17,112, 44 SEC Docket 526, 545 (Aug. 18, 1989) (“The Commission is particularly disappointed to find that notwithstanding the publicity and concerns expressed about the substantial delinquency in filings, there has not been a substantial improvement in compliance. In a recent study, the Commission found 36.7 percent of the transactions reported in calendar year 1988 were reported more than three days late. As of June 10, 1989, the delinquency rate was 34.7 percent for transactions reported in the first five months of 1989. This reinforces the Commission’s conclusion that the proposed proxy disclosure and fines are necessary.”).


Frustrated, the Commission proposed disclosure obligations that effectively required the company to police compliance. Proxy statements had to reveal violations of the reporting obligations. The disclosure would potentially embarrass the company and alert the Commission to violations. The Commission all but admitted that the requirements were designed to increase compliance rather than to provide investors and shareholders with material information.

The Commission's effort worked. Behavior changed. Compliance improved. But it was not a model easily duplicated. The rules did not actually affect the actions of the executive officers or directors as much as it imposed responsibility on the company for ensuring compliance.

B. Disclosure and Leverage

Other disclosure requirements sought to improve the governance process by increasing the leverage of dissenting directors. Companies were made to disclose any disagreement that resulted in a director resigning or deciding not to stand for re-election. This information was ostensibly designed to assist shareholders in assessing the "quality of management." More to the point, the information "could enhance the effectiveness of directors by assuring them a forum in which to express differences of opinion on matters that are sufficiently serious to result in termination of the director's association with the issuer."

In other words, the provision gave the dissenting director leverage. Any resignation over a disagreement would result in public disclosure of the underlying conflict, potentially generating bad publicity and inviting

95. See Ownership Reports and Trading by Officers, Directors, and Principal Stockholders, supra note 93, at 545-46 (describing the Commission's concerns about "widespread lack of compliance with the reporting requirements" and its subsequent revision of the disclosure requirements in response).

96. See id. at 528.

97. See id. at 545.

98. Shareholder Communications, supra note 20, at 363.


100. Id. The provision did not apply to a resignation or failure to stand for re-election for "personal reasons." Id.

101. Commentators complained about the impact on governance, contending that it would discourage the development of stronger boards and hamper debate. See Shareholder Communications, supra note 20, at 358 ("Some commentators who opposed adoption of the proposal were concerned that this disclosure would discourage the evolution of stronger boards by increasing divisiveness among board members. Others noted that the proposal might make it more difficult to attract and retain directors with divergent viewpoints.")
The Limits of Disclosure

legal scrutiny. This threat, therefore, provided the dissenting director additional bargaining power in connection with any disagreement at the board level.

The structure of the provision made clear that it was designed to provide leverage rather than material information to investors. As originally adopted, the rules gave the resigning director sole discretion to determine whether disclosure of the disagreement should occur. Thus, disclosure depended not upon its importance to investors or shareholders but upon the predilections of the departing director. Only in 2004 did the Commission finally eliminate this discretion and impose an affirmative duty to disclose a disagreement, irrespective of the wishes of the resigning director.

The impact of the provision is hard to assess since it sought to use the threat of disclosure to encourage resolution of differences at the board level. The potential impact on governance, however, has always been limited. The provision applies only to conflicts at the board level. It does nothing to ensure that the board has any particular information about the activities of the company, or that conflicts or problems are addressed at the board level in the first instance.

C. Disclosure and Attendance

Other efforts focused more generally on altering board behavior. Board involvement in the disclosure process meant little if directors did


103. Only where the resigning director provided the board with a letter explaining the disagreement was disclosure mandated. Shareholder Communications, supra note 20, at 359 (“[T]he Commission believes that, on balance, it is more appropriate to require disclosure only upon the request of the director. If disclosure is triggered by director request, the director will have a forum if he chooses to use it, and the issuer will be relieved of any obligation to document and characterize what it believes are the reasons for director resignations.”). Originally, the Commission required the disclosure to be filed within fifteen calendar days, but it eventually reduced the filing period to five business days. See Acceleration of the Timing for Filing Forms 8-K, Securities Act Release No. 6822, Exchange Act Release No. 26,587, Investment Company Act Release No. 16,844, 42 SEC Docket 1348, 1348 (Mar. 2, 1989).

104. Additional Form 8-K Disclosure Requirements, Securities Act Release No. 8400, Exchange Act Release No. 49,424, 82 SEC Docket 1480, 1497 (Mar. 16, 2004). The director still had the right to file a letter with the company and the letter had to be filed as an exhibit. Id.

105. See id.
not participate in the governance process by attending the meetings. State law, however, imposed no specific obligations on director attendance. In response, the Commission adopted rules requiring disclosure of any director who attended fewer than seventy-five percent of the combined total of board and committee meetings. The Commission noted that this information would assist shareholders in evaluating the director's performance.

In fact, the disclosure requirement was designed to affect director behavior. Directors would presumably attend meetings more often rather than confront the embarrassment associated with poor attendance. This requirement may or may not have increased attendance, but in any case it did little to affect the actual process of deliberations within the boardroom, a matter determined under state law. Nor did the requirement ensure that directors take greater

---

106. 17 C.F.R. § 229.407(b) (2007); see also Shareholder Communications, supra note 20, at 358 ("The Commission recognizes that in particular instances directors may provide the board with valuable insight and expertise without actually attending formal meetings on more than an intermittent basis. However, we believe that these occasions are likely to be the exception and that, in general, attendance is an indication of effective board and committee functioning and is relevant to an evaluation of directors for election purposes. In addition, the Commission is not persuaded that the contemplated disclosure would deter responsible boards from holding meetings when it is appropriate to do so.").

107. Proposed Rules Relating to Shareholder Communications, supra note 99, at 299 ("While the Commission believes that, as a general matter, disclosure of attendance records would be of limited usefulness, it has tentatively concluded that disclosure of a director's failure to achieve a certain minimum level of attendance could provide information which would facilitate shareholder assessment of his performance as well as the effectiveness of an issuer's board and committee system generally. In the Commission's view, the approach reflected in proposed Item 6(e) would elicit such information in the briefest and least burdensome manner."). In rare cases, the disclosure of attendance might lead to the reelection defeat of a director. See CLAUDIA H. ALLEN, NEAL, GERBER & EISENBERG LLP, STUDY OF MAJORITY VOTING IN DIRECTOR ELECTIONS 1 (2007), http://ngelaw.com/files/upload/majoritystudy111207.pdf ("[I]n 2007, only one director received a majority against vote at a company with majority voting. Mae Jemison, an incumbent director at Gen-Probe, Inc., received a majority against vote based upon her failure to attend at least 75% of board meetings held in 2006. After consulting with ISS, the board declined to accept her resignation, with the understanding that the attendance issue would be addressed.").

108. See Williams, supra note 21, at 1265 ("This newly required disclosure was wholly unrelated to any theory of economic materiality. Rather, its stated purpose was to increase the corporation's accountability to society by encouraging the board to be more active and independent in monitoring management's actions with respect to compliance with the law."). This may be even truer today. A growing number of companies have adopted by-laws that require director candidates to receive a majority of the votes cast to be elected. Poor attendance might make this majority harder to obtain.

109. Cf. Lisa M. Fairfax, Spare The Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability, 42 HOUS. L. REV. 393, 452 n.317 (2005) ("In 2000, all Enron directors attended at least 75% of the total number of meetings, which
ownership of corporate disclosure issues or engage in more protracted deliberations on matters of concern to shareholders.

III. THE DISCLOSURE OF SUBSTANCE: THE SEC, THE SROs, AND SOX

Early efforts at using disclosure to affect governance were modest in scope and effect. In the aftermath of Business Roundtable, this changed. Disclosure became a mechanism designed to directly affect the deliberative process within the board room. It did so in three broad ways.

First, the Commission sought to use disclosure to ensure greater independence of those on the board.110 Second, the Commission sought to increase the transparency of the decision making process.111 Third, the SEC designed disclosure requirements to limit the influence of the CEO in the governance process.112

The rules often operated by requiring disclosure of a company's compliance with listing standards.113 This approach created an additional enforcement mechanism, at least in cases where compliance was misstated.114 The rules also expanded upon the obligations imposed by SOX.115

A. Disclosure and Listing Standards

Despite the loss in Business Roundtable, the Commission did not entirely give up on listing standards as a mechanism for influencing
corporate governance. In the aftermath of Enron and Worldcom, the exchanges and NASDAQ were once again pushed to adopt more stringent standards. Wanting to head off increased federal regulation, the SROs had an incentive to cooperate, and an NYSE committee recommended amendments to the listing standards that went beyond the requirements of SOX.

The SROs ultimately implemented a number of additional governance requirements. Boards of listed companies had to have a majority of independent directors and to create three specific committees—nominating, compensation, and audit—with each containing only independent directors. The definition of independence was strengthened, particularly through the addition of a number of categorical disqualifications.

Although an improvement on the existing state of affairs, the new listing standards suffered from a number of limitations. For one thing, the standards were not sufficiently rigorous. The definition of independent did not adequately capture all potentially disqualifying relationships. The listing standards did not address non-family

118. See Karmel, supra note 3, at 109 (“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.”); see also New York Stock Exchange: Plus ça Change, THE ECONOMIST, Aug. 16, 2003, at 67.
119. The proposed reforms emerged from a study completed in the summer of 2002, just before the enactment of SOX. See generally REPORT OF THE NEW YORK STOCK EXCHANGE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE, supra note 116; see also Karmel, supra note 3, at 109. In fact, the exchanges and NASDAQ emerged almost unscathed from the enactment of SOX.
120. See NYSE, Inc., Listed Company Manual § 303A.01, .04-.07 (2004); Amex Company Guide § 121(A), (B)(2)(c) (requiring that a majority of directors be independent with certain exceptions for small business issuers). The definition of independent is different for members of the audit committee, a consequence of SOX. See infra notes 173-79 and accompanying text.
122. The Amex independence standards, for example, provide that “an independent director of a listed company may not be an officer or employee of the company or any parent or subsidiary thereof, or have a material relationship with the listed company that would interfere with the exercise of independent judgment.” Self-Regulatory
relationships, nor did they address outside business relationships with executive officers. The standards also generally excluded the consideration of fees in determining material financial relationships with the listed company, irrespective of the amount.

Most important, however, was the problem of enforcement. Shareholders lacked a private right of action for violations. Nor did the Commission enforce the requirements. That left only the SROs, and they had a history of weak enforcement. The exchanges possessed only a limited array of potential sanctions largely limited to delisting, suspension from trading, or a letter of censure.

Organizations Notice of Filing, Exchange Act Release No. 54,851, 89 SEC Docket 1175, 1179-80 (Nov. 30, 2006). All of the exchanges had the same or similar definitions. Id. at 1179 ("[The Amex] independence standards are substantially the same as NASDAQ standards and are conceptually similar to NYSE standards." (footnote omitted)).

123. The rule says nothing about non-family personal relationships. Moreover, the rule does not specifically address outside business relationships between the CEO and a director. Take, for example, the issues surrounding the backdating scandal that engulfed the CEO of UnitedHealth Group. An internal investigation uncovered that one of the "independent" directors had undisclosed ties to the CEO. See James Bandler & Charles Forelle, How a Giant Insurer Decided to Oust Hugely Successful CEO, WALL ST. J., Dec. 7, 2006, at A1.

124. See Amex Company Guide § 121(A)(2)(b) (2003) (disqualifying anyone making in excess of $100,000 during any twelve month period within the prior three years, but excluding "compensation for board or board committee service"). The deliberate nature of this approach can be seen from the exchanges' reaction to SOX. Congress included a far stricter definition of independent in SOX, but applied it only to members of audit committees. The exchanges could have made the definition universal, but did not. Amex Company Guide § 121(B)(2)(a)(i) (2003) (requiring directors on an audit committee to satisfy "the independence standards specified in Section 121A and Rule 10A-3 under the Securities Exchange Act of 1934"). Thus, two different standards apply under the listing requirements: one for audit committees and another for the rest of the board.

125. The Commission can only sanction the exchanges and NASDAQ for not enforcing their own listing standards. See Covered Securities, Securities Act Release No. 7494, Exchange Act Release No. 39,542, 66 SEC Docket 583, 587 (Jan. 2, 1998) ("Finally, the Commission notes that enforcement of an SRO's listing standards is subject to periodic inspections by Commission staff, as is enforcement of all SRO rules, and should the Commission find that an exchange designated in Rule 146(b) is not adequately enforcing its requirements for initial and continued listing, the Commission will take appropriate action to revoke that exchange's exemption."); see also American Stock Exchange, Exchange Act Release No. 55,507, 2007 SEC LEXIS 535, at *1-2 (Mar. 22, 2007) (Commission brought cease and desist action against Amex for, among other things, failing to adequately enforce its own rules).

126. See supra notes 31 and 125; see also infra note 128.

127. Any notice from the exchange about non-compliance must be disclosed. See Item 3.01, Current Report (Form 8-K). The disclosure requirement does not apply, however, to an "early warning" notice of an impending violation. See Additional Form 8-K Disclosure Requirements, supra note 104 ("An early warning notice that merely informs the company that it is in danger of falling out of compliance with a rule or standard for continued listing on the exchange or association is not a notice that the company no longer satisfies that
Rigorous enforcement, however, was also bad for business. Delisting would result in a loss of fees paid by the company and would therefore reduce the trading volume of the exchange. The consequences were even more severe in an era when the exchanges had largely shifted to "for profit" businesses.

The Commission used disclosure to alter this basic framework. Public companies were essentially required to reveal compliance with the rules of the exchange. They had to identify the directors who met the definition of independent and the existence and membership of auditing, nominating, and compensation committees.

rule or standard. Thus, a company's receipt of such a notice will not trigger a disclosure obligation under the item. However, if the warning notice informs the company that it is out of compliance with a rule or standard for continued listing, but that the company will not be delisted if it cures the problem within a specified time, such a notice will trigger a Form 8-K filing requirement.

128. As a result of the business consequences, the NYSE has a weak record in delisting companies for noncompliance. See Self-Regulatory Organizations, Exchange Act Release No. 41,634, 70 SEC Docket 342, 344 (July 21, 1999) ("Over the past sixty years, only one issuer has delisted its securities from the NYSE."") (footnote omitted)). Indeed, a bias against delisting larger companies is built into the rules of the NYSE. See NYSE, Inc., Listed Company Manual § 802.01E (2007) (providing that the exchange has discretion to continue listing where company “may have a position in the market (relating to both the nature of its business and its very large publicly-held market capitalization) such that its delisting from the Exchange would be significantly contrary to the national interest and the interests of public investors”); see also Navistar Int’l Corp., Exchange Act Release No. 55,304, 2007 SEC LEXIS 319, at *2-4 (Feb. 13, 2007) (discussing Rule 802.01E).


130. 17 C.F.R. § 229.407(a) (2007). A company must use the definition of the exchange where it is traded, assuming the exchange requires that at least a majority of the board be independent. Id. § 229.407(a)(1)(i). If the company is not traded on such an exchange, it must pick a definition from one of the exchanges that does require a majority of independent directors and disclose the choice. Id. § 229.407(a)(1)(ii).

131. In the absence of a separate audit committee, the entire board will be treated as the audit committee. Id. § 229.407(a). The requirement applies in connection with a proxy statement or annual report filed in connection with the election of directors. Id. § 229.407(d)(4)(i). Certain narrow exceptions exist to the requirements. Id. § 229.407(d)(4)(i)(C).

132. Id. § 229.407(c). The Commission has long required disclosure of the existence of a nominating committee. See Shareholder Communications, supra note 20, at 355-56 (requiring disclosure of the existence of a nominating committee, the policy on whether shareholders could nominate new directors, and the process for submission of nominees).

133. 17 C.F.R. § 229.407(e). Companies without one of these three committees must disclose all the non-independent directors on the entire board. Id. § 229.407(a) ("If the registrant does not have a separately designated audit, nominating or compensation committee or committee performing similar functions, the registrant must provide the
These requirements altered the compliance calculation. Violations of the rules of the exchange previously raised few enforcement concerns. Transforming them into disclosure requirements implicated the rules of the Exchange Act. The Commission could bring actions against companies for violations of the periodic reporting requirements. In addition, shareholders and investors could bring actions for misstatements about compliance with listing standards, whether under the general antifraud provisions or the proxy rules.

The requirements are of recent vintage and their impact on compliance remains uncertain. The Commission is unlikely to target the area. As for private actions, plaintiffs need to meet all of the elements of the antifraud provision, including the requirements of scienter, materiality, and damages. In many instances, actions alleging inaccurate disclosure of directors that are not independent with respect to all members of the board of directors applying such committee independence standards.

134. See, e.g., Walt Disney Co., supra note 79, at 1832 (emphasizing the need for "scrupulous adherence to the disclosure requirements" in an action against the Walt Disney Company for violations).


of listing standards will founder on these elements.\textsuperscript{137} When combined with other disclosure issues, however, they may remain important components in a broader fraud suit against the company.\textsuperscript{138}

The corporate governance disclosure requirements also highlight a central weakness in the Commission's entire approach to the area. Disclosure of compliance is only as good as the quality of the underlying standards. Because the definition of independent adopted by the SROs does not ensure that the directors are in fact independent, the disclosure requirements may actually mislead shareholders into believing that a company in fact has an independent board.

\section*{B. Disclosure and Limits on CEO Influence}

The Commission went beyond compliance with listing standards. Additional disclosure requirements were intended to influence behavior by increasing the transparency of the decision making process at the board level.

With respect to compensation decisions, the rules initially required companies to include a report of the compensation committee in the proxy statement.\textsuperscript{139} The report had to include the criteria used in making awards and the policies for determining the CEO's compensation.\textsuperscript{140} In particular, the report had to include a specific discussion of the relationship between the CEO's performance and his or her compensation.\textsuperscript{141}

Although the Commission disclaimed any intent to change substantive behavior,\textsuperscript{142} the provision was intended to do exactly that, something not lost on commentators to the rule.\textsuperscript{143} With the increased disclosure of the liability of corporate outsiders. Adams v. Standard Knitting Mills, 623 F.2d 422, 428 (6th Cir. 1980).

\textsuperscript{137} See, e.g., Adams, 623 F.2d at 436 (reversing district court judgment for plaintiff shareholders because they failed to show that defendant company's error was material); Gersite, 478 F.2d at 1307 (finding damages awarded to be too severe).

\textsuperscript{138} For example, the Commission requires the CEO and CFO of a company to certify all financial statements. 17 C.F.R. § 240.13a-14. Consequently, any statements made in the certification may themselves be the basis for liability. See, e.g., Limantour v. Cray Inc., 432 F. Supp. 2d 1129, 1158-60 (W.D. Wash. 2006).


\textsuperscript{140} Id. at 48,127.

\textsuperscript{141} Id. at 48,138.

\textsuperscript{142} Id. ("The disclosure does not impose new fiduciary standards on directors, or require any particular actions or procedures.").

\textsuperscript{143} See id. ("While shareholders expressed great enthusiasm for the report, the corporate community and practicing bar raised substantial concerns. Some argued that the report was an undue intrusion into the internal affairs of the company and interfered with the operation of the state-law business judgment rule; others argued that the report
requirements, boards presumably would be less inclined to pay an amount simply because it was desired by the CEO, and would instead base compensation decisions on objective criteria.

Almost from the very beginning, however, the reports proved uninformative, telling little about the actual process of arriving at compensation decisions. The Commission ultimately abandoned the approach, replacing the report with something resembling management's discussion and analysis (MD&A). The compensation committee merely had to disclose that it reviewed management's analysis and recommended to the board that it be included in the requisite filing. There has already been concern that this requirement may devolve into boilerplate.

With respect to the nomination of directors, the proxy statement must disclose the method used to identify and evaluate director nominees. This includes identifying the source of the nominee by category, with the categories encompassing "security holder, non-management director, chief executive officer, other executive officer, third-party search firm, or other, specified source" and the function of any firm hired to "identify would interfere unduly with the functioning of the Committee and would deter people from serving as directors.")

144. See Executive Compensation Disclosure, Exchange Act Release No. 32,723, 58 Fed. Reg. 42,882, at 48,883 (Aug. 12, 1993) ("[M]ore than 5,000 registrants filed their annual meeting proxy statements containing the new compensation disclosure.... Overall, the registrants' disclosures under the new rules were quite good. However, the quality of the compensation committee reports varied considerably.").


147. See Executive Compensation and Related Person Disclosure, supra note 145, at 2363 ("The Compensation Discussion and Analysis should reflect the individual circumstances of a company and should avoid boilerplate disclosure.").

148. 17 C.F.R. § 229.407(c)(2); id. § 229.407(c)(2)(vi) (requiring disclosure of "any differences in the manner in which the nominating committee evaluates nominees for director based on whether the nominee is recommended by a security holder"); see also Disclosure Regarding Nominating Committee Functions, Securities Act Release No. 8340, Exchange Act Release No. 48,825, Investment Company Act Release No. 26,262, 81 SEC Docket 2135, 2137 (Nov. 24, 2003) ("Disclosure as to whether and how [security holders] may participate in a company's nomination process, and the manner in which their candidates are evaluated, including differences between how their candidates and how other candidates are evaluated, therefore, represents important information for security holders.").

149. See Disclosure Regarding Nominating Committee Functions, supra note 148, at 2139; see also id. at 2141 ("In disclosing the category of persons or entities that initially
or evaluate" potential nominees.\textsuperscript{150}

The disclosure extends to shareholder nominees. The company must reveal any policies regarding the consideration of these nominees,\textsuperscript{151} including the procedures for submission.\textsuperscript{152} The company must disclose any minimum qualifications, including any specific qualities or skills deemed necessary by the committee,\textsuperscript{153} and to the extent a nominee comes from a shareholder with more than five percent of the voting stock, the company should identify the shareholder (or group of shareholders), the nominee, and the board's decision with respect to the nomination.\textsuperscript{154} The company is not, however, required to disclose the

---

\textsuperscript{150} Id. at 2139.

\textsuperscript{151} 17 C.F.R. § 229.407(c)(2)(ii). The policy may be a simple as a statement that the committee "will consider director candidates recommended by security holders." Id. If no such policy exists, an explanation of "the basis for the view" must be provided. Id. § 229.407(c)(2)(iii).

\textsuperscript{152} Id. § 229.407(c)(2)(iv). Material changes to those procedures also must be disclosed. Id. § 229.407(c)(3). Changes need only appear in a quarterly or annual report. Id. § 229.407(c)(3) instruction 1.

\textsuperscript{153} Disclosure Regarding Nominating Committee Functions, supra note 148, at 2138-39; see also id. at 2141 ("Many commenters that supported the disclosure requirements suggested that we expand the requirements to require companies to disclose the extent to which they take into consideration diversity, in particular race and gender, in nominating candidates. We have not included such a requirement in the standards we are adopting today, as we believe this particular consideration, as well as other considerations made by a company, will likely be addressed adequately by the new disclosure item requiring companies to disclose their criteria for considering board candidates. Further, we do not view it as appropriate to identify any specific criteria that a company must address in describing the qualities it looks for in board candidates." (footnote omitted)).

\textsuperscript{154} Id. at 2139; see also id. at 2137 ("Finally, an additional, specific disclosure requirement regarding the treatment of candidates put forward by large security holders or groups of security holders that have a long-term investment interest is appropriate, as it will provide investors with information that is useful in assessing the actions of the nominating committee."). Disclosure need not occur unless the group of shareholders and the identified candidate both provide written consent. See id. at 2139. As the instructions indicate, this is an affirmative requirement imposed on the shareholder group. See id. at 2143 ("The company would not be obligated to request such materials where a security holder or group does not otherwise provide their consent and proof of ownership."). The Commission has also proposed, but never adopted, a rule that would permit large shareholders to insert nominees into management's proxy statements. See Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company
reasons for rejecting a nominee.\textsuperscript{155}

The disclosure of the process used to identify nominees was ostensibly designed to increase transparency.\textsuperscript{156} In fact, the approach was meant to encourage consideration of shareholder nominees and reveal the role of the CEO in the process.\textsuperscript{157} Neither is likely to result from the disclosure requirements. Nothing in the disclosure process requires substantive consideration of shareholder nominees or prevents the nomination committee from seeking opinions from the CEO with respect to a nominee.

C. Disclosure and SOX

Other disclosure requirements center around the obligations imposed in the aftermath of the adoption of SOX. With the exception of officer certification and financial expertise, the portions of SOX addressing governance do not rely on disclosure. They impose substantive obligations (although not all of a self-executing nature) that range from an assessment of internal controls, to an increase in authority of the audit committee, to the adoption of a stricter definition of independent director.\textsuperscript{158} The Commission added to this regime an overlay of disclosure largely centering on compliance with the new requirements.\textsuperscript{159}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{155} Act Release No. 26,206, 81 SEC Docket 770, 770 (Oct. 14, 2003). Because it was highly controversial, no action was ever taken on the proposal.
\item \textsuperscript{156} Disclosure Regarding Nominating Committee Functions, supra note 148, at 2143 ("[T]he disclosure standard that we are adopting today does not include the proposed requirement that companies disclose the specific reasons for not nominating a candidate. . . While not required, a company could, of course, choose to explain why it did not nominate one or all of the security holder-recommended candidates.”).
\item \textsuperscript{157} Id. at 2136 (“This enhanced disclosure is intended to provide security holders with additional, specific information upon which to evaluate the boards of directors and nominating committees of the companies in which they invest. Further, we intend that increased transparency of the nomination process will make that process more understandable to security holders.”).
\item \textsuperscript{158} See Proposed Rules Relating to Shareholder Communications, supra note 99, at 297 ("[I]nformation relating to nominating committees would be important to shareholders because a nominating committee can, over time, have a significant impact on the composition of the board and also can improve the director selection process by increasing the range of candidates under consideration and intensifying the scrutiny given to their qualifications. Additionally, the Commission believes that the institution of nominating committees can represent a significant step in increasing shareholder participation in the corporate electoral process, a subject which the Commission will consider further in connection with its continuing proxy rule re-examination.”).
\item \textsuperscript{158} See generally 17 C.F.R. pt. 229 (2007).
\end{itemize}
\end{footnotesize}
Section 301 of SOX addresses audit committees, with listing standards employed as the mechanism for implementation. The committees have the right to hire and fire the independent auditor. The committee also must consist entirely of independent directors, with SOX containing a unique definition. SOX also requires disclosure of financial expertise of the members of the audit committee.

The Commission adopted a rule prohibiting exchanges from listing any company that lacks an audit committee in compliance with SOX. Designed "to enhance the independence of the audit function, thereby furthering the objectivity of financial reporting," Rule 10A-3 requires that the committee be "directly responsible for the appointment, compensation, retention and oversight" of the outside auditor, and the firm "must report directly to the audit committee." This includes hiring, firing, and the setting of all engagement fees and terms. As the

---

160. The term "audit committee" is defined in section 3(a)(58) of the Exchange Act and consists of a committee (or, in the absence of a committee, the entire board) created "for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer." 15 U.S.C. § 78c(a)(58)(A) (Supp. V 2005).

161. See Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m); see also S. REP. NO. 107-205, at 23-24 (2002) ("Witnesses at the Committee's hearings suggested that the auditing process may be compromised when auditors view their main responsibility as serving the company's management rather than its full board of directors or its audit committee. For this reason, the bill requires audit committees to be directly responsible for the appointment, compensation, and oversight of the work of auditors, and requires auditors to report directly to the audit committee.").


163. Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m)(3)(A)-(B) ("In order to be considered . . . independent . . . 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."); see also S. REP. NO. 107-205, at 24-25.


166. Standards Relating to Listed Company Audit Committees, supra note 80, at 2888.

167. 17 C.F.R. § 240.10A-3(b)(2); see also Standards Relating to Listed Company Audit Committees, supra note 80, at 2888.

168. Standards Relating to Listed Company Audit Committees, supra note 80, at 2888-89 ("In addition to services necessary to perform an audit or review in accordance with Generally Accepted Auditing Standards (GAAS), [the scope of services performed by an auditor and overseen by an audit committee] also may include services that generally only the independent accountant reasonably can provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the Commission." (footnote omitted)).
Commission has noted, the authority will "help to align the auditor's interests with those of shareholders."169

The Commission also requires that the audit committee “have the authority to engage independent counsel and other advisors” as necessary. Companies also “must provide for appropriate funding, as determined by the audit committee,” including ordinary administrative expenses.170 It must maintain a system for receiving, retaining, and treating complaints from the auditor and employees171 that permits confidential submissions to protect anonymity.172

Members also must meet a stricter definition of independent than those serving on other committees.173 Rule 10A-3 prohibits a member from being an affiliate of the issuer174 or from accepting “directly or


170. 17 C.F.R. § 240.10A-3(b)(4)-(5). Advisors may include those with expertise in “accounting, financial reporting or legal matters,” and may be needed to provide advice “necessary to identify potential conflicts of interest and assess the company’s disclosure and other compliance obligations with an independent and critical eye.” Standards Relating to Listed Company Audit Committees, supra note 80, at 2892. The advisors may also need to “independently investigate questions that may arise regarding financial reporting and compliance with the securities laws.” Id. The Commission did not set limits on funding, apparently accepting the view that this is sufficiently controlled by the fiduciary obligations of directors on the committee. See id. at 2893 (“These commenters argued that audit committee members' own fiduciary duties to the issuer and natural oversight by the board of directors as a whole over the audit committee would address any concerns over abuse. The final rule does not set funding limits.”); see also S. REP. NO. 107-205, at 25 (2002) (“Comptroller General Walker agreed that audit committee members must be 'adequately resourced,' suggesting that audit committee members 'may need their own staff.'”).


172. Standards Relating to Listed Company Audit Committees, supra note 80, at 2891. In requiring systems for employee complaints, the Commission recognized that “[m]anagement may not have the appropriate incentives to self-report all questionable practices” and that employees often fear “management reprisal.” Id. The Commission declined to proscribe specific complaint procedures. See id. (“The procedures that will be most effective to meet the requirements for a very small listed issuer with few employees could be very different from the processes and systems that would need to be in place for large, multi-national corporations with thousands of employees in many different jurisdictions. We do not believe that in this instance a 'one-size-fits-all' approach would be appropriate.'”).

173. See 17 C.F.R. § 240.10A-3(b)(1). The rule contains certain exceptions to the independence requirements. See id. § 240.10a-3(b)(1)(iv). Any reliance on an exception must be disclosed. See id. § 240.10a-3(d).

174. Id. § 240.10A-3(b)(1)(ii)(B); see also id. § 240.10A-3(e)(1) (2007) (defining the term affiliate).
indirectly” any fee other than fixed compensation under retirement plans or director’s fees. Indirect fees include those paid to certain family members or to businesses providing “accounting, consulting, legal, investment banking or financial advisory services.”

The Commission added layers of disclosure to these substantive requirements, including whether the financial statements were discussed with management and the independent auditors. Other provisions

175. Id. § 240.10A-3(b)(1)(ii)(A). The Commission specifically rejected a de minimis exception for payments to directors. Standards Relating to Listed Company Audit Committees, supra note 80, at 2884. (“[G]iven the narrow class of services covered by the final rule, the lack of a de minimis exception should be less necessary. Moreover, if the level of compensation that the member or associated entity receives is truly de minimis and immaterial, we are not persuaded that requiring an issuer to locate another provider so that the member can remain qualified for audit committee service would be overly burdensome.”).

176. Standards Relating to Listed Company Audit Committees, supra note 80, at 2883 & n.57 (“The requirement that the compensation be fixed precludes retirement payments that are tied to the continued performance of the relevant entity. The requirement that the compensation be fixed does not preclude customary objectively determined adjustment provisions such as cost of living adjustments.”).

177. See id. at 2882 n.46 (“The final rule does not specify any limits or restrictions on fees paid for capacity as a member of the board of directors or any board committee.”); see also S. REP. NO. 107-205, at 24 (2002).

178. 17 C.F.R. § 240.10A-3(e)(8) (describing indirect fees as those paid to “a spouse, a minor child or stepchild or a child or stepchild sharing a home with the member”).

179. See id. (further describing indirect fees as those paid to “an entity in which such member is a partner, member, [or] an officer . . . and which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary of the issuer”); see also Standards Relating to Listed Company Audit Committees, supra note 80, at 2882-83 (“Other commercial relationships are not covered by the final rule, although, . . . we expect that SROs will contain restrictions on additional services and activities in their own listing standards. For example, the prohibitions in Exchange Act Rule 10A-3 do not include non-advisory financial services such as lending, check clearing, maintaining customer accounts, stock brokerage services or custodial and cash management services.” (footnote omitted)).

require disclosure if any director does not meet the independence requirements. With respect to financial experts, the Commission defined the term and required disclosure of the person designated as the expert, or an explanation as to why the committee included no such expert. The Commission coupled the disclosure requirements with increased enforcement. The Commission brought an action against the chairperson of an audit committee that improperly recommended that the company not file an annual report on a timely basis. Similarly, the Commission sanctioned a company that misrepresented the status of an internal investigation and the conclusions of the audit committee. In another instance, the Commission required the audit committee to retain

The report, therefore, does not explore the decision making process as much as it requires disclosure of the process used in reviewing the financial statements.

181. In the absence of a committee, the entire board will be treated as the audit committee. See 15 U.S.C. § 78c(a)(58) (Supp. V 2005) (defining audit committee). This requirement applies to proxy statements or annual reports filed in connection with the election of directors. 17 C.F.R. § 229.407(d)(4). Certain narrow exceptions exist to the requirements. See id. § 229.407(d)(4)(i)(C).


183. Audit committees must disclose the existence of a financial expert on the committee, including the name of the individual and whether he or she qualifies as independent based upon the relevant listing standard. Id. § 229.407(d)(5)(i)(A)-(B). The designation does not automatically qualify the individual as an expert under the securities laws—including for purposes of section 11 of the Securities Act—or increase that director's duties or obligations. See id. § 229.407(d)(5)(iv)(A)-(B) (“The designation or identification of a person as an audit committee financial expert pursuant to this Item 407 does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification.”). Similarly, the presence of someone with the requisite expertise does not change the responsibilities of the other directors. See id. § 229.407(d)(5)(iv)(C) (“The designation or identification of a person as an audit committee financial expert pursuant to this Item does not affect the duties, obligations or liability of any other member of the audit committee or board of directors.”).

184. Id. § 229.407(d)(5)(i)(C). The rules of the NYSE require at least one member to have accounting or financial expertise. See NYSE, Inc., Listed Company Manual § 303A.07(a) commentary (2004) (“Each member of the audit committee must be financially literate, as such qualification is interpreted by the company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the company's board interprets such qualification in its business judgment.”). The definition of financial expert for purposes of Item 407 is much more specific. See supra note 183.


independent counsel and defined the committee's role in the disclosure process.\textsuperscript{187}

This disclosure increases the legal risks for directors on the audit committee.\textsuperscript{188} It also provides a mechanism for private enforcement.\textsuperscript{189} SOX only mandated the implementation of the audit committee requirements through the vehicle of listing standards.\textsuperscript{190} By requiring disclosure of conformity with various requirements, particularly the independent director requirement, the Commission created a potential enforcement avenue that went well beyond the stock exchanges.

IV. THE SEC AND SUBSTANTIVE BEHAVIOR

At this point, a number of observations can be made about the role of the Commission in the corporate governance process. First, the separation of substantive standards of corporate governance and disclosure is the product of an historical anomaly, not a reasoned division of authority. Second, the separation of substance and disclosure in and of itself contributed to the race to the bottom and the weakening of state law fiduciary standards.

Third, in adopting the proxy provisions of the Exchange Act, Congress was not trying to reserve a discrete niche for the Commission but to solve what it perceived as the most severe governance problems. Disclosure was seen as an appropriate means of addressing the problems of self-perpetuation and excessive compensation. Fourth, the declining standards under state law have made Commission intrusion into the governance process inevitable, primarily to ensure the efficacy of the disclosure process and secondarily to empower shareholders. Arguments about whether the Commission should play a significant role in the governance process, therefore, are beside the point. It already does.

Fifth, the Commission was initially content to eschew direct oversight and leave regulation of governance to others, particularly the stock

\textsuperscript{187} See Coca-Cola Company, Securities Release Act No. 8569, Exchange Act Release No. 51,565, 85 SEC Docket 601, 606-07 (Apr. 18, 2005) (requiring the audit committee to take several actions to enhance the disclosure process at the management level within the company).

\textsuperscript{188} Given the absence of aiding and abetting liability under Rule 10b-5, the antifraud prohibition only extends to primary violators. See Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 179 (1994), superseded in part by statute, 15 U.S.C. § 78t(f) (2000), as recognized in Trs. of Boston Univ. v. ASM Commc'ns., Inc., 33 F. Supp. 2d 66 (D. Mass. 1998). See generally 17 C.F.R. § 240.10b-5. The more involved someone is in the actual disclosure process, the more likely they will meet this definition.

\textsuperscript{189} See Central Bank, 511 U.S. at 179 (discussing private rights of action under the Exchange Acts).

exchanges. With that approach upended by the D.C. Circuit in *Business Roundtable*, the Commission shifted toward direct regulation, with disclosure as the primary mechanism used to alter behavior. The use of disclosure to regulate substance, however, creates anomalies and problems.

Sixth, the traditional state of affairs has largely been upended by SOX.¹⁹¹ The Act interjected the Commission more deeply into the governance process, partly through the regulation of audit committees and partly through the authority to assign specific duties and obligations in connection with the development of internal controls.

With the ongoing race to the bottom, the use of disclosure as a means of influencing behavior has, however, struck limits. Disclosure works best where it relates to a preexisting substantive right and creates the specter of increased legal attention. The disclosure of conflicts of interest by fiduciaries represents an example. In those circumstances, officer and director behavior can be influenced through increased disclosure.

In the absence of strong underlying legal obligations, the use of disclosure as a tool to regulate substantive behavior is far less effective. It is true that the threat of embarrassment may have an affect on behavior.¹⁹² Embarrassment, however, only goes so far.¹⁹³ A director may not appreciate public disclosure of the fact that he or she missed a large number of board meetings, but in the end it is unlikely to result in a resignation, leaving shareholders with little recourse.¹⁹⁴ At most, it imposes modest pressure to attend more meetings the following year.

The disclosure requirements can also be counterproductive. For instance, disclosure may produce a wealth of complicated but ultimately

---

¹⁹¹. See Jeffrey Y. Wu, Essay, *Revisiting Business Roundtable and Section 19(c) in the Wake of the Sarbanes-Oxley Act*, 23 YALE J. ON REG. 249, 251 (2006) ("With corporate governance regulation now itself an essential component of the Exchange Act's anti-fraud regime, it is no longer tenable to take the position, as *Business Roundtable* did, that corporate governance regulation is beyond the purview of the Exchange Act.").

¹⁹². See Donald C. Langevoort, *Seeking Sunlight in Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 453-54 (2001) ("The compensation disclosure requirements of Item 402 reveal one place where the Commission has plainly tried to have an effect on primary behavior, with almost a 'shaming' objective as compensation measures are displayed adjacent to performance results. Whether this works is another question entirely; it has as likely fueled the upward spiral in salaries as operated as a check. . . . [H]uman nature responds differently to disclosure rules than we often predict." (footnotes omitted)).


unimportant information. Moreover, disclosure may have unintended consequences. There has been speculation that detailed disclosure of executive compensation actually accelerated the upward trend in compensation. Indeed, disclosure requirements themselves have probably contributed to the continued race to the bottom.

One response would be to leave things exactly where they are. Delaware will continue to minimize the responsibilities of directors and officers while the Commission will continue to impose increasingly complex disclosure obligations. Internal accountability will largely be a case-by-case determination and the role of the directors in the disclosure process will continue to be minimal. Another possibility would be an increase in Commission authority, acceding to the agency the right to regulate directly substantive behavior. To some degree, SOX took this approach.

There is, however, a middle ground where the Commission can increase its role in the governance process with existing regulatory authority and, at a minimum, ensure greater effectiveness of the disclosure process. This approach would, however, require a fundamental shift in agency thinking. The Commission would philosophically need to move away from disclosure as its primary regulatory mission in favor of more direct involvement in the governance process.

What might the Commission do? Two possibilities come to mind. First, the Commission could use existing authority to fix problems of state law by making aspects of the securities laws contingent upon improved governance. Second, it could use newly granted authority under section 404 of SOX to increase the direct responsibilities of boards of directors in the governance area.


196. By forcing boards to justify certain decisions, disclosure requirements are likely to push Delaware courts to find compliance with fiduciary obligations. See, e.g., In re J.P. Morgan Chase & Co. S'holder Litig., 906 A.2d 808, 823 (Del. Ch. 2005), aff'd, 906 A.2d 766 (Del. 2006) (relying on NYSE definition of independence to conclude that a director was independent under state law).

197. See Mark J. Loewenstein, The SEC and the Future of Corporate Governance, 45 ALA. L. REV. 783, 784-85 (1994) ("I propose that the Securities Act of 1933 be amended to authorize the Commission to condition the availability of certain simplified methods of issuing securities under the Act on the existence of an independent board.").

198. See, e.g., 15 U.S.C. § 7202 (Supp. V 2005) ("The Commission shall promulgate such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of this Act."); see also Wu, supra note 191, at 258 (discussing SOX's audit committee provisions).
The Limits of Disclosure

A. Federal Definition of Independent Director

One of the areas of failed governance concerns the definition of independent director. Neither the definition under Delaware law nor the one used by the SROs adequately controls the types of relationships that could impair independence.\textsuperscript{199} SOX improved the definition in connection with audit committee membership but did not fix all of the weaknesses.\textsuperscript{200} Moreover, the exchanges have proved unwilling to extend the SOX definition to the remainder of the directors on the board.

Companies must disclose the directors who meet the definition of independent.\textsuperscript{201} Moreover, they often adopt standards requiring the board to have a higher percentage of independent directors than is required by the exchanges.\textsuperscript{202} All of this projects an image of a board that can act in a neutral manner. But in fact, this is often misleading. The disclosure merely reflects compliance with a definition that does not at all ensure independence or neutrality.

The Commission could adopt its own definition, one stricter and more likely to ensure independence, entitling companies that meet the definition to regulatory benefits. It is not a fanciful suggestion. The issue came up in connection with amendments to Rule 14d-10, the all holders rule adopted under the Williams Act.\textsuperscript{203} The amendments provide a safe harbor from the best price rule for compensation approved by a committee of independent directors.\textsuperscript{204} In effect, the Commission determined that the securities laws benefited from reliance on independent director approval.

The Commission could have conditioned application of the safe harbor on its own definition. Had it done so, public companies would have been encouraged to include directors who met the definition. Despite some calling for this approach,\textsuperscript{205} the Commission opted to rely on the

\textsuperscript{199} The deficiencies at state law are chronicled in Brown, \textit{supra} note 2. For problems with the NYSE definition, see \textit{supra} notes 122-124, and accompanying text.

\textsuperscript{200} See Brown, \textit{supra} note 2, at 99-100.

\textsuperscript{201} 17 C.F.R. § 229.407(a) (2007).

\textsuperscript{202} See Letter from Anne M. Mulcahy, Chairman, Bus. Roundtable Corporate Governance Task Force, to Nancy Morris, Secretary, U.S. Sec. & Exch. Comm’n, at 3 (Oct. 1, 2007), \textit{available at} http://www.sec.gov/comments/s7-17-07/s71707-77.pdf (noting that ninety percent of companies belonging to Business Roundtable have boards that are at least eighty percent independent).

\textsuperscript{203} See generally 17 C.F.R. § 240.14d-10.

\textsuperscript{204} Id. § 240.14d-10(d)(2). The same safe harbor applied to the issuer tender offer rule. See id. § 240.13e-4.

definitions of independent used by the stock exchanges.\textsuperscript{206} As the agency explained:

Other commentators suggested that codifying an independence definition similar to other definitions provided in some Exchange Act rules—as opposed to relying upon a definition that is determined by reference to the listing standards, as we have in other Exchange Act rules—would be a better approach because this would provide a consistent definition. We disagree and are adopting the provisions related to the independence standards as proposed, with an accommodation for foreign private issuers. We believe this approach is appropriate because the definitions under the listing standards have previously been approved by us and are consistent with the approach we have followed in the past.\textsuperscript{207}

The Commission, therefore, receded from the opportunity to adopt its own rule. It has similarly done so in the context of articulating rules with respect to the assessment of internal controls.\textsuperscript{208}

The hesitancy is understandable. Providing a federal definition crosses a Rubicon and directly competes with the exchanges and state law. Moreover, crafting a workable, effective definition of independent director is by no means an easy task.

Nonetheless, if the Commission expects to see benefits in the disclosure process as a result of director independence, it must accept the fact that the existing definitions will not accomplish the task. Efforts should be made to improve the definition or to refrain from deferring to definitions that do not in fact ensure independence. At a minimum, the

\textsuperscript{206} See 17 C.F.R. § 240.14d-10(d)(2) instruction 1 ("If the bidder or subject company, as applicable, is a listed issuer (as defined in § 240.10A-3 of this chapter) whose securities are listed . . . on a national securities exchange . . . that has independence requirements for compensation committee members that have been approved by the Commission (as those requirements may be modified or supplemented), apply the bidder's or subject company's definition of independence that it uses for determining that the members of the compensation committee are independent in compliance with the listing standards applicable to compensation committee members of the listed issuer."). Essentially the same definition is included in id. § 240.13e-4(f)(12) instruction 1.

\textsuperscript{207} Amendments to the Tender Offer Best-Price Rules, supra note 205, at 585 (footnote omitted).

\textsuperscript{208} See Management's Report on Internal Control over Financial Reporting, Securities Act Release No. 8762, Exchange Act Release No. 54,976, 89 SEC Docket 1639, 1655 n.78 (Dec. 20, 2006) ("If no audit committee exists, all references to the audit committee apply to the entire board of directors of the company. When a company is not required by law or applicable listing standards to have independent directors on its audit committee, the lack of independent directors at these companies is not indicative, by itself, of a control deficiency. In all cases, management should interpret the terms 'board of directors' and 'audit committee' as being consistent with provisions for the use of those terms as defined in relevant SEC rules.").
Commission is in a position to apply the definition of independent that arises out of SOX rather than the more generic definition used by the exchanges.\footnote{209} To the extent progress is not made, federal intervention remains a risk. This is what occurred in connection with the independence standards for auditors. Prior to the adoption of SOX, the Commission had genuine concerns about the independence issue. The concerns arose in large part because of economic ties that potentially impaired neutrality.\footnote{210} Commission reforms, however, were too tepid. Congress stepped in and imposed a far more dramatic set of reforms in SOX, essentially separating consulting and auditing functions in order to enhance the independence of the company’s auditors.

**B. SOX and Accountability**

The other potential area of Commission involvement in the governance process concerns accountability. SOX went beyond the case-by-case method used by the Commission and identified specific persons responsible for the disclosure process. The Act assigned specific responsibilities to the audit committee, the independent auditors, and the top executive officers.\footnote{211} Most importantly, however, the Act identified those responsible for the process of formulating internal controls.

Most of this responsibility falls to the top officers. The CEO and CFO must design (or oversee the design of), establish, and maintain internal controls.\footnote{212} In addition, they must evaluate the effectiveness of the

\footnote{209. The Commission has applied this definition once already. See 17 C.F.R. § 205.2(k)(1) (defining a qualified legal compliance committee as a committee that contains one member of the issuer’s audit committee, which would require that the director meet the definition of independent under SOX). As a practical matter, this could be done by requiring approval by the audit committee since these directors must already meet the tougher definition contained in SOX. See supra note 163.}

\footnote{210. See Revision of the Commission’s Auditor Independence Requirements, Securities Act Release No. 7919, Exchange Act Release No. 43,602, Investment Company Act Release No. 24,744, 73 SEC Docket 1885, 1887 (Nov. 21, 2000) (“The amendments identify certain relationships that render an accountant not independent of an audit client under the standard in Rule 2-01(b). The relationships addressed include, among others, financial, employment, and business relationships between auditors and audit clients, and relationships between auditors and audit clients where the auditors provide certain non-audit services to their audit clients.”).}


\footnote{212. 17 C.F.R. § 229.601(b)(31)(i); see also S. REP. NO. 107-205, at 25 (“The bill therefore clearly establishes that CEOs and CFOs are responsible for the presentation of material in their company’s financial reports.”).}
controls and make the audit committee aware of any "significant deficiencies." 213

SOX, however, goes even further, giving the Commission the authority to specify the duties of particular individuals within a company. 214 Section 404(a) mandates an annual internal control report 215 that discloses the "responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and . . . contain[s] an assessment . . . of the effectiveness of the internal control structure and procedures [used] . . . for financial reporting." 216 As the legislative history indicates, the provision was designed to increase the accountability of management "for the financial representations of their companies." 217

With responsibility for much of the internal control process assigned generally to "management," this term presumably can include the board of directors in addition to the CEO and CFO. 218 The provision, therefore, provides the Commission with the rulemaking authority to impose specific obligations and duties on the board, at least with respect to the development and supervision of internal controls.

The Commission has adopted some requirements in the area. 219 "[I]nternal control over financial reporting" has been defined as a

\[\text{References} \]

213. 17 C.F.R. § 229.601(b)(31)(i); see also S. REP. NO. 107-205, at 25 (The CEO and CFO must certify that "financials and disclosures fairly present the company's operations and financial condition.").

214. See 15 U.S.C. § 7262; see also Management's Report on Internal Control over Financial Reporting, supra note 204, at 1640 ("Effective [internal control over financial reporting (ICFR)] can also help companies deter fraudulent financial accounting practices or detect them earlier and perhaps reduce their adverse effects. While controls are susceptible to manipulation, especially in instances of fraud involving the collusion of two or more people, including senior management, these are known limitations of internal control systems. Therefore, it is possible to design ICFR to reduce, though not eliminate, instances of fraud.").

215. 15 U.S.C. § 7262; see also Management's Report on Internal Control over Financial Reporting, supra note 204, at 1640 ("The significance of Section 404 of Sarbanes-Oxley is that it re-emphasizes the important relationship between the maintenance of effective ICFR and the preparation of reliable financial statements.").


218. See generally 15 U.S.C. § 7262; see also S. REP. NO. 107-205, at 31 ("In order to enhance the quality of reporting and increase investor confidence, the bill requires that annual reports filed with the SEC must be accompanied by a statement by the management of the issuer that management is responsible for creating and maintaining adequate internal controls. Management must also present its assessment of the effectiveness of those controls.").

219. See Management's Report on Internal Control over Financial Reporting, supra note 204, at 1640 ("Instead of providing specific guidance regarding the evaluation, we expressed our belief that the methods of conducting evaluations of ICFR will, and should, vary from company to company and will depend on the circumstances of the company and
"process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel." 220

The provision, therefore, not only codifies the responsibilities of the CEO and CFO, but also contemplates a role for the board of directors, although only to "effect" the process. The term encompasses some level of oversight. 221 An interpretive release issued by the Commission notes only the expectation that the board be "knowledgeable and informed" about the assessment. 222 In addition, the audit committee must be told of any significant deficiencies in the internal controls. 223

The requirements imposed on the board are admittedly vague. Nonetheless, they directly regulate substantive behavior. Not left to state law fiduciary obligations, the federal securities laws require directors to remain informed about internal controls and problems with internal controls. The failure to do so can result in sanctions, even if there is no actual harm to the corporation.

Authority included in SOX, therefore, provides an avenue for increased federal intrusion into the governance process. The Commission could, by rule, substantially increase the obligations of the board in its oversight of the reporting process, particularly with respect

the significance of the controls. We continue to believe that it is impractical to prescribe a single methodology that meets the needs of every company.” (footnote omitted)).

220. 17 C.F.R. § 240.13a-15(f) (2007) (emphasis omitted); see also id. § 240.15d-15(f).

221. See Management's Report on Internal Control over Financial Reporting, Securities Act Release No. 8238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068, 80 SEC Docket 1014, 1020 n.50 (June 5, 2003) ("[T]he composition of a company's board and audit committee, and how the directors fulfill their responsibilities related to the financial reporting process, are key aspects of the company's control environment. An important element of the company's internal control over financial reporting . . . is the involvement of the board or audit committee in overseeing the financial reporting process, including assessing the reasonableness of management's accounting judgments and estimates and reviewing key filings with regulatory agencies.” (alteration in original) (internal quotations omitted)).

222. See Management's Report on Internal Control over Financial Reporting, supra note 204, at 1645 n.40 ("Because management is responsible for maintaining effective internal control over financial reporting, this proposed interpretive guidance does not specifically address the role of the board of directors or audit committee in a company's evaluation and assessment of ICFR. However, we would ordinarily expect a board of directors or audit committee, as part of its oversight responsibilities for the company's financial reporting, to be knowledgeable and informed about the evaluation process and management's assessment, as necessary in the circumstances.").

to the maintenance of the internal controls, imposing duties where, under
state law, they hardly exist.

V. OBSERVATIONS AND RECOMMENDATIONS

The system of corporate governance in the United States is not
optimal but Rube Goldberg-like: a product of path dependence resulting
from historical accident rather than deliberate design. Moreover, the
respective roles of the SEC and the states were largely defined in the
1930s. Much has changed since then, particularly as a result of the
continued race to the bottom. The Commission has come under
increased pressure to regulate substantive behavior under SOX, and
Congress is increasingly likely to further involve the Commission in the
governance process. 224

Where does this leave the Commission? The SEC needs to recognize
its role in the corporate governance process. In part this means accepting
the limits of disclosure and taking advantage of its rulemaking authority
to alter substantive behavior. As the Commission becomes more overtly
involved in the governance process, some general principals should guide
the approach.

A. Rule #1: Do No Harm

Whatever the level of involvement, the Commission should take care
not to make matters of governance worse. Yet it has harmed the
governance process in the past. For example, the proxy rules themselves
make it more difficult for shareholders to exercise their governance
rights. With the proxy process having supplanted the shareholder
meeting as the forum for the election of directors, 225 the costs associated

224. The most recent example is the House of Representatives' adoption of legislation
regarding advisory votes on executive compensation. See Shareholder Vote on Executive
Compensation Act, H.R. 1257, 110th Cong. § 2 (2007) (mandating an advisory vote by
shareholders on executive compensation and providing the Commission with rulemaking
authority). The provision essentially gives the Commission the authority to define,
through rulemaking, the precise matters subject to shareholder approval. If passed,
therefore, the Act would further interject the Commission into the substance of the
governance process.

225. The proxy process has largely supplanted the annual meeting as a vehicle for
exercising shareholder franchise. As one commentator stated: "It is well known that
proxy voting has become the dominant mode of shareholder decisionmaking in publicly
held corporations." Melvin Aron Eisenberg, Access to the Corporate Proxy Machinery, 83
HARV. L. REV. 1489, 1490 (1970); see also JAMES WILLARD HURST, THE LEGITIMACY OF
(1970) ("[T]he core reality of stockholder suffrage in the big company lay in the use of
proxy machinery."); U.S. SEC. & EXCH. COMM'N, 77TH CONG., REPORT OF THE
SECURITIES AND EXCHANGE COMMISSION ON PROPOSALS FOR AMENDMENTS TO THE
SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, at 35 (Comm.
with regulatory compliance make it prohibitive for most shareholders to nominate directors or propose matters from the floor of the meeting.\textsuperscript{226}

The Commission somewhat ameliorated this effect through the adoption of Rule 14a-8, which allows shareholders to insert proposals into management's proxy statements in certain circumstances.\textsuperscript{227} At the same time, however, the rule excepted the nomination of directors, among other important categories of shareholder proposals.\textsuperscript{228} The courts have occasionally admonished the often narrow interpretation of this rule.\textsuperscript{229}

An example of the negative consequences of the proxy rules can be seen from the battle for control of the board of directors of Take-Two Interactive Software. The Company scheduled a shareholder meeting for March 29, 2007.\textsuperscript{230} A group of large investors owning more than forty-six percent of the voting shares decided to run an opposition slate of directors.\textsuperscript{231} Rather than engage in a proxy solicitation and incur the necessary expense and delay, the shareholders simply nominated candidates at the meeting.\textsuperscript{232} The only regulatory filings were Schedule

Print 1941) ("[O]wnership of securities is so widely diffused that voting by stockholders in corporate meetings is today effected almost entirely by proxies . . . ."); Shareholder Proposals, Exchange Act Release No. 56,160, 2007 SEC LEXIS 1651, at *49 (July 27, 2007) ("Our regulations have been designed to facilitate the corporate proxy process so that it functions, as nearly as possible, as a replacement for an actual, in-person gathering of security holders, thus enabling security holders 'to control the corporate as effectively as they might have by attending a shareholder meeting.'" (quoting Bus. Roundtable v. SEC, 905 F.2d 406, 410 (D.C. Cir. 1990)).

226. Perhaps recognizing these difficulties, the Commission has taken a number of steps designed to reduce the costs of solicitations, including the right to distribute proxy materials over the Internet. See 17 C.F.R. § 240.14a-16.


228. \textit{Id.} § 240.14a-8(j)(8) (providing a company with authority to exclude a shareholder proposal if it relates "to an election for membership on the company's board of directors or analogous governing body"). In fact, the Commission has gradually changed its position with respect to many topics sought to be included in shareholder proposals.


232. \textit{Id.}
13Ds that revealed the existence of the group and the plan to replace management.\textsuperscript{233}

By not using the proxy rules, the insurgents were able to maintain stealth and avoid cost.\textsuperscript{234} When management learned of the shareholders' plans on March 7, there was little it could do to counter the voting strength of the insurgents.\textsuperscript{235} As a result, the insurgents took over the board, electing six directors.\textsuperscript{236} At the same time, the insurgent shareholders did not circulate a proxy statement containing the background information on their candidates or allow the other shareholders to participate.\textsuperscript{237}

The Commission, therefore, should recognize the dynamics caused by the imposition of its own regulations on the governance process. Recent efforts by the Commission suggest that this is not a lesson that will come easily to the agency. After the Second Circuit's decision in the \textit{American Federation of State, County \& Municipal Employees v. American International Group} case striking down the staff's interpretation of the exclusion of proposals that "relate to the election" of directors,\textsuperscript{238} the Commission issued two rule proposals designed to clarify any uncertainty.\textsuperscript{239} The one ultimately adopted gave management the right to exclude bylaw proposals that would sometimes require companies to include shareholder nominees in the proxy statement.\textsuperscript{240} By forcing shareholders seeking the adoption of these bylaws to incur the costs of proxy solicitation, the Commission effectively denied them rights that exist under state law. In other words, the Commission intervened into


\textsuperscript{234}. \textit{See id.}

\textsuperscript{235}. \textit{Id.}

\textsuperscript{236}. Pruitt \& Whitehouse, \textit{supra} note 227.

\textsuperscript{237}. \textit{See id.}

\textsuperscript{238}. Am. Fed'n of State, County \& Mun. Employees v. Am. Int'l Group, 462 F.3d 121 (2d Cir. 2006).


the governance process in a manner designed to reduce rather than promote shareholder governance rights.

B. Rule #2: Observe No Charades

The Commission sometimes relies on legal obligations imposed by other regulators, integrating them into the requirements of the securities laws. This might include the requirements of, or definitions from, the stock exchanges (particularly those relating to independent directors), or from state law, such as fiduciary obligations. The Commission, however, must acknowledge the weaknesses in these respective regimes. It does no good to rely on them if they do not work properly.

The NYSE definition of independent director suffers from a number of deficiencies. Most importantly, in determining independence, the definition excludes in practice the fees paid to directors. It likewise excludes directors affiliated with non-profit organizations where the company or its employees make significant contributions, does not screen for relationships between directors and executive officers, and does not pick up other non-family personal relationships on the board. The rule also allows directors to make $100,000 in addition to fees without losing their independence, something not permitted under SOX. The weaknesses in the definition have not been entirely lost on the Commission. Similarly, state law fiduciary duties have become


242. The consideration of fees is excluded from the categorical restriction that disqualifies anyone who has been paid directly more than $100,000 within any twelve-month period during the prior three years. See NYSE, Inc., Listed Company Manual § 303A.02(b)(ii) (2003). The definition also disqualifies anyone with a material financial relationship with the company. Id. § 303A.02(a). That provision does not expressly exclude consideration of fees. Nonetheless, companies do not disqualify as non-independent directors who receive payments as high as $1 million. Id. § 303A.02(b)(v). The problem may be the definition, but just as likely it is a failure of management to properly apply the definition and the failure of the NYSE to enforce its listing standards by sanctioning companies who misapply the definition.

243. Thus, when it was disclosed that an "independent" director on the compensation committee of UnitedHealth had an outside business relationship with the CEO, the director still apparently qualified as independent under NYSE’s definition. See Steven Pearlstein, UnitedHealth's Options Scandal Shows Familiar Symptoms, WASH. POST, Oct. 18, 2006, at D1.

244. See NYSE, Inc., Listed Company Manual § 303A.02(b)(ii).

245. See Fog Cutter, Exchange Act Release No. 52,993, 2005 SEC LEXIS 3280, at *8 n.6 (Dec. 21, 2005), aff'd, 474 F.3d 822 (D.C. Cir. 2007) (noting that while five of seven
progressively weaker. The Commission should not ignore the low standards applicable under the duty of care and the use of process to fulfill the duty of loyalty.

When relying on the NYSE definition of independent director or the mandates of state fiduciary obligations, the Commission needs to take these weaknesses into account. This could include a regulatory fix.\textsuperscript{246} In the case of the definition of independent director, the Commission could do a number of things, including adopting a different, more effective definition. But even in addition to this, it could add other categorical restrictions beyond those contained in the NYSE definition. The Commission could, for example, require that the independent directors meet the stricter definition contained in SOX, and require that in determining a material financial relationship the board consider the payment of fees.\textsuperscript{247}

\textbf{C. Rule #3: Corporate Governance and Ensuring the Integrity of the Disclosure Process}

Accurate disclosure cannot be ensured by mandating rules and waiting for compliance. Inaccurate disclosure may occur because of fraud but it is far more likely to occur because of misapplication of existing rules and processes. Human error, sloppiness, and lack of attention all play a role.\textsuperscript{248} There needs to be a system in place designed to ensure the quality of the external disclosure. Much of the criticism of Enron centered on disclosure. In some ways, Enron's disclosures were accurate, but they conveyed a misleading impression about the financial health of the company.\textsuperscript{249}

\begin{itemize}
\item directors on the company's board were “independent” under rules of NASD, all of the directors had “family, business, or social ties” to the CEO).
\item See Microstrategy, Inc., Exchange Act Release No. 43,724, 73 SEC Docket 2860, 2866 (Dec. 14, 2000) (“The new independent member of the Board of Directors, appointed pursuant to these undertakings, shall review the Company's implementation of and compliance with these undertakings.”).
\item The Commission has already employed the SOX definition in at least one instance. See \textit{supra} note 205.
\item See David Reilly, Restatement Blame: Basic Mistakes, \textit{WALL ST. J.}, Nov. 20, 2006, at C4 (“Research by the SEC's Office of the Chief Accountant found about 55% of recent restatements were due to companies misapplying basic accounting rules or to problems with records that meant they didn't have the correct data to get the accounting right . . . . [M]any restatements were 'just from flat-out errors.'” (quoting SEC Deputy Chief Accountant Scott Taub)).
\item See, e.g., Jonathan R. Macey, \textit{Efficient Capital Markets: Corporate Disclosure and Enron}, 89 \textit{CORNELL L. REV.} 394, 397 (2004) (“The special purpose entities hid Enron's true financial condition so that the company's books indicated that Enron was in far better shape than it truly was, and one would have had to do an almost impossible inspection to know the true financial condition of the company.” (internal quotation marks omitted)).
\end{itemize}
The Commission spent much of the 1980s and 1990s trying to get qualitatively better MD&A disclosure. The agency devoted considerable resources to the project, issuing a number of lengthy interpretive releases and bringing a significant number of enforcement actions. Throughout the period, the agency repeatedly instructed companies that the disclosure should be "through the eyes of management." The approach did not work, and ultimately the Commission gave up.

The quality of disclosure and the vibrancy of the internal controls depends upon the process used within the company for putting the disclosure together. Defining the responsibilities of particular persons or offices and defining the necessary set of procedures is a matter of substance. With SOX already increasing the accountability of the CEO and CFO, this primarily means developing the role of the board of directors in the disclosure process.

In some ways, the nexus with the disclosure process provides limits on the involvement of the Commission in the governance process. Regulatory efforts need not attempt to entirely supplant state fiduciary obligations. Thus, there is no need to define the circumstances in which a board will be acting in the best interests of the shareholders or the instances that trigger application of the duty of loyalty. Intervention would be limited to those efforts designed to protect the integrity of the disclosure process.

D. Rule #4: Absent Commission Action, Congress Will Intervene

Whatever the history in this area, SOX changed the landscape. For the second time, Congress has inserted the Commission directly into the


252. See supra notes 218-23 and accompanying text.
governance process. The old adage that the Commission is limited to disclosure, while never entirely accurate, is now entirely inaccurate. The newly granted authority to some degree overrules the court's decision in Business Roundtable.

VI. CONCLUSION

In the post-SOX landscape, the Commission can no longer stay above the governance fray, comfortable that its only role is the regulation of disclosure. In the specific area of audit committees there will be a need to monitor performance and potentially impose additional substantive obligations and duties on the committee. It may be necessary to further tighten the definition of independent director.

At the same time, the Commission has real authority to ensure accountability for disclosure within the company, particularly with respect to the board of directors. Over time, the Commission will likely need to impose specific requirements and specific roles on the board, particularly in the context of setting up and reviewing the internal controls. Directors will come to learn that inattention in this area will create the specter of liability under the securities laws and will respond accordingly. As state law continues its downward spiral and the exchanges embrace the "for profit" motivation, the exercise of this authority becomes even more critical.


254. See Wu, supra note 191, at 251 ("Because Sarbanes-Oxley's corporate governance provisions are aimed primarily at ensuring audit committee independence, any corporate governance standard the SEC promulgates under section 19(c) must serve that same goal to survive judicial scrutiny.").