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Good News Investors! You've Got A Financial Expert on the Board: The Bad News? It Doesn't Mean Anything

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Article

165 GOOD NEWS INVESTORS! YOU'VE GOT A FINANCIAL EXPERT ON THE BOARD THE BAD NEWS? IT DOESN'T MEAN ANYTHING*Jeffrey M. McFarland [FN1]**

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I. INTRODUCTION

You do not have to be a big investor to be concerned about corporate scandals like those involving Enron and World-Com. The financial shenanigans and misdeeds at those companies, and others, have shaken investor confidence in the financial reporting process. It shook the confidence of Congress, too.

In 2002, Congress swiftly passed the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) to help restore investor confidence. [FN1] Among the provisions of Sarbanes-Oxley was section 407, which required reporting companies to disclose in their annual proxy statements or annual reports whether they had a “financial expert” on the audit committee of their board of directors and required the Securities and Exchange Commission (SEC) to make rules to implement the provision. [FN2] The goal of section 407, and *166 other provisions of Sarbanes-Oxley, was to improve the audit committee's oversight of the financial reporting process. [FN3]

The SEC concluded its rulemaking regarding section 407 in early 2003, and the rules became applicable to companies filing annual reports and proxy statements for fiscal years ending on or after July 15, 2003. [FN4] Most companies have now done their second round of filings with the financial expert rules in place. Based on the SEC's final rulemaking and an examination of a representative sample of those filings, this article proposes modifications to the SEC's rules on audit committee financial experts, including changes to the definition of an audit committee financial expert and the duties, obligations and liabilities associated with being designated as such.

Part I will serve as an overview of the role of the audit committee of the board of directors and the increased legislative focus on that committee. [FN5] Part II will examine the SEC's requirements for “audit committee financial experts” and its liability “safe harbor” for audit committee financial experts. [FN6] Part III will discuss how the companies comprising the Dow Jones Industrial Average, [FN7] the Nasdaq 100 Composite Index, [FN8] and a representative sample of the Russell 2000 Index [FN9] and Russell Microcap Index [FN10] have designated, disclosed and compensated their audit committee financial experts, based on their most recent SEC filings. Finally, Part IV discusses the weaknesses of the Securities and Exchange Commission's final rules on audit committee experts, and proposes modifications.

***167 II. AUDIT COMMITTEES**

Although audit committees have been around for decades, they began to receive serious attention in the 1970s.

[FN11] Financial scandals and misreporting pricked the ears of the SEC in the 1970s. [FN12] It was not long before the SEC began to enter into consent decrees with defendants requiring audit committees to be established, [FN13] or, if already established, better implemented. [FN14] Also, the SEC publicly recommended the use of audit committees for better oversight of financial reporting, and a number of corporate governance bills were proposed in Congress relating to oversight of financial reporting. [FN15] As a result, the New York Stock Exchange (NYSE) and other self-regulatory organizations approved rules requiring listed companies to form audit committees. [FN16]

*168 In 1998, the NYSE and the National Association of Securities Dealers (NASD) sponsored a Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (“Blue Ribbon Committee”) in response to concerns about earnings management. [FN17] After the Blue Ribbon Committee released its report in 1999, the NYSE, the American Stock Exchange (AMEX) and the NASD followed with a new set of listing standards requiring, among other things, that each member of the audit committee be financially qualified in one manner or another. [FN18] The NYSE imposed a financial literacy requirement on audit committee members and required at least one member to have accounting or related financial management expertise. [FN19] The goal was to ensure that audit committee members had a “basic understanding” of financial statements. [FN20] Whether a person met those requirements was left to the judgment of the board of directors. [FN21]

AMEX required the issuer to certify that its audit committee members were able to read and understand basic financial statements, such as the company's balance sheet, income statement and cash flow statement. [FN22] AMEX also required at least one member to have employment experience in finance or accounting, professional certification in accounting, or comparable experience or background that indicated the person's financial sophistication, including experience as a chief executive officer, chief *169 financial officer or other senior officer with financial oversight responsibilities. [FN23] The NASD rule for companies quoted on Nasdaq was similar to the AMEX rule. [FN24]

The consequence of violating an exchange's listing standards is having the corporation's securities de-listed from the applicable exchange or system. A listing standards violation is not a violation of law. The SEC followed with amendments to the Securities Exchange Act of 1934 (Exchange Act) to improve disclosure about the functioning of a company's audit committee. [FN25] The rules required the audit committee to provide a report in the company's proxy statement stating the audit committee had discussed the audit with management and the auditor, received from the auditor disclosure about the auditor's independence, and recommended to the board that the audit be included in the company's annual report. [FN26] The SEC did not require the audit committee to have a charter, but if it had one, it was required to be included in the proxy statement. [FN27]

The SEC said these rules were not designed to increase liability for audit committee members under state law. [FN28] Nevertheless, the SEC did not create a safe harbor to protect against private litigation. The SEC did not expect the disclosure requirements would result in increased liability for audit committee members under state law. [FN29] In fact, the SEC indicated its view that breaches of fiduciary duty litigation against audit committee members would decline, since directors were likely to be more informed under the new rules. [FN30]

As the century turned, a new set of financial scandals motivated Congress to adopt the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), which consists of significant amendments to various portions of the *170 Exchange Act. [FN31] Sarbanes-Oxley incorporates audit committee legislation directly into the Exchange Act, thereby subjecting some companies to the audit committee rules that were not previously subject to the audit committee rules of the NYSE, AMEX and NASD. [FN32] Under Sarbanes-Oxley, the audit committee acquired the role of liaison between the public accounting firm and the board of directors. [FN33] The audit committee is “directly responsible for the appointment, compensation, and oversight of the work” of any public accounting firm hired by the company to prepare or issue the audit report.

[FN34]

In addition, section 407 of Sarbanes-Oxley provides that each reporting company is required to disclose in its annual report or annual proxy statement whether the audit committee has at least one “financial expert.” [FN35] If a reporting company does not have a financial expert, it must explain why. [FN36] Congress then directed the SEC to adopt rules to implement section 407, and it provided the SEC with guidance in determining whether a person qualifies as a financial expert. [FN37] The SEC was directed to do the following:

(b) [C]onsider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions -

(1) an understanding of generally accepted accounting principles and financial statements;

(2) experience in -

(A) the preparation of auditing of financial statements of generally comparable issuers; and

(B) the application of such principles in connection with the accounting for estimates, accruals and reserves;

*171 (3) experience with internal accounting controls; and

(4) an understanding of audit committee functions. [FN38]

The SEC then began the rulemaking process to implement section 407, with the final rules to be in place by January 26, 2003. [FN39]

III. AUDIT COMMITTEE FINANCIAL EXPERTS

A. DEFINING THE FINANCIAL EXPERT

Sarbanes-Oxley provides the SEC with parameters to determine whether a director qualifies as a financial expert and directs the SEC to promulgate rules to implement those requirements. [FN40] On October 22, 2002, the SEC issued its Proposed Rule (Proposed Rule) defining financial expert for purposes of section 407. [FN41] The Proposed Rule focused on a director's actual experience with accounting matters at a public company that had accounting issues similar to those for which the director was currently serving. [FN42] The definition required a person to have all of the following attributes, which must have been gained through education and experience as an accountant or auditor, or as a principal financial officer, controller or principal accounting officer of an Exchange Act reporting company: [FN43]

1. Understanding of GAAP and financial statements;

2. Experience applying GAAP to the types of accounting entries comparable to those used by the company;

3. Experience preparing or auditing financial statements that present accounting issues comparable to those faced at the company;

4. Experience with internal controls and procedures for financial reporting; and

5. Understanding of audit committee functions.

*172 The decision about whether a person qualified under this definition of “financial expert” was left to the business judgment of the board of directors. [FN44] To determine whether someone qualified as a financial expert, the Proposed Rule required the board to evaluate ten factors:

- The level of financial education (advanced degree in finance or accounting);
- Whether the person had been a certified public accountant, and for how long;
- Whether the person was otherwise certified as having accounting or financial experience by a private board that administers standards and for how long;
- Whether the person served as a chief financial officer, controller or principal accounting officer;
- The specific duties performed in past financial roles;
- The level of familiarity and experience with laws and regulations applicable to preparation of financial statements;
- The level of direct experience preparing financial statements that must be included in public reports;
- Past or current membership on one or more audit committees for reporting companies;
- The level of familiarity and experience with the use and analysis of financial statements of public companies; and
- Any other relevant qualifications or experience that would assist him in understanding and evaluating financial information and making knowledgeable and thorough inquiries about the integrity of the financial reporting process. [FN45]

The SEC received over 200 comment letters in response to the Proposed Rule. [FN46] According to the SEC, investors generally supported the *173 proposals and in some cases thought additional disclosure would be appropriate. [FN47] However, many commenters thought the disclosure requirements went too far. [FN48] Many of the public comments to the Proposed Rule showed concern that the qualifications in the definition were too narrow, [FN49] expressing the belief it would be too difficult for companies-especially small ones-to attract an audit committee member that would qualify as a financial expert. [FN50] The comments further expressed concern that naming the financial expert in the public filings would result in the expert being subject to greater liability under federal securities law and state corporate law. [FN51]

*174 In early 2003, the SEC issued its Final Rule implementing section 407 of Sarbanes-Oxley (Final Rule). [FN52] In response to the public comments, the Final Rule provided a less restrictive set of attributes required to qualify as a financial expert, as compared to the Proposed Rule. [FN53] For instance, the Final Rule eliminated the portion of the definition that required the financial expert to have actual experience applying GAAP to estimates, accruals and reserves that were generally comparable to those used in the registrant's financial statements. [FN54] Instead, the Final Rule requires only the ability to *understand* GAAP and *assess* the general application of GAAP in connection with the accounting for estimates, accruals and reserves. [FN55]

In addition, instead of requiring experience preparing or auditing similar financial statements, a financial expert need only have experience preparing, auditing, *analyzing or evaluating* financial statements of similar breadth or complexity or experience *actively supervising* one or more persons engaged in such activities. [FN56] There is a much wider range of people who have analyzed or evaluated financial statements, or supervised persons who do so, than there are persons who have actually prepared or audited such financial statements. Nevertheless, the requirements for active supervision were not specifically delineated by the SEC in the Final *175 Rule, nor did the Final Rule specify the requisite level of financial expertise of the supervisor. [FN57] It is also clear that no experience with internal controls and procedures are required-just an understanding of such controls and procedures. [FN58] Finally, the financial expert must understand the audit committee functions. [FN59]

In addition to providing a less restrictive set of attributes, the SEC revamped the way a board measures whether the person qualifies as a financial expert. [FN60] The list of ten factors which the board was required to consider in the Proposed Rule was shortened to four standards, any one of which is a sufficient way for the financial expert to have acquired the necessary attributes. [FN61] Instead of evaluating ten factors, the board need only evaluate one or more of the fol-

lowing:

- Education and experience as a principal financial officer, principal accounting officer, controller, certified public accountant or auditor (or similar experience in positions that involve similar functions);
- Experience actively supervising one of the foregoing officers or persons;
- Experience overseeing or assessing the performance of companies or public accountants in connection with preparing, auditing or evaluating financial statements; or
- Other relevant experience. If the company relies on this factor, it must disclose the relevant experience.

[FN62]

The following key factors were eliminated from the Proposed Rule: evaluation of whether the person has ever been certified as a public accountant or equivalent; any requirement that the relevant expertise be tied to an SEC reporting company; familiarity and experience with SEC reporting requirements; and whether the person has served on an audit committee for a reporting company. [FN63] Those factors were eliminated to broaden the pool of candidates that would be available to serve as financial *176 experts. [FN64] The NYSE, AMEX and Nasdaq retained their requirements that at least one member of the audit committee have accounting or financial experience, but stated that satisfying the SEC's definition of financial expert satisfied the listing standards. [FN65]

B. LIABILITY OF FINANCIAL EXPERTS

In the Proposed Rule, the SEC stated that mere designation of a person as a financial expert should not impose a higher degree of individual responsibility or obligation on one member of the audit committee. [FN66] Nor was the Proposed Rule designed to decrease the duties and other obligations of other board members. [FN67] The SEC sought comments on whether it should directly address potential increased liabilities of financial experts in the final rule. [FN68]

It is no surprise that such comments were forthcoming. Based on the comments, the SEC adopted in the Final Rule a “safe harbor” [FN69] as follows:

1. The financial expert is not an expert for any purpose under federal securities laws, in particular section 11 of the Securities Act of 1933, by virtue of such person's designation as a financial expert. [FN70] Section 11 holds certain experts (and officers) responsible for statements in registration statements and other publicly filed reports. [FN71] For instance, accountants would be subject to liability under section 11 for signing off on misleading financial statements included in a registration statement, *177 and there is no scienter requirement as there is with the antifraud provisions of the securities laws. [FN72]

2. Designation as a financial expert does not impose on such person any duties, obligations or liabilities greater than those imposed on the members of an audit committee or board in the absence of such designation or identification. [FN73]

3. Designation of a financial expert does not alter the duties, obligations or liability of any other member of the audit committee. [FN74]

It remained to be seen whether in practice the Final Rule permitted a sufficiently large pool of qualified persons to serve as financial experts, taking into account the definition of financial expert and the liability safe harbors. The evidence indicates the Final Rule has been successful in that regard, but it cost investors much of the protection originally intended by section 407 of Sarbanes-Oxley. [FN75]

IV. FINANCIAL EXPERT RULES IN PRACTICE

An examination of reports filed with the SEC provides insight into the way companies have reacted to the SEC's Final Rules on audit committee financial experts. [FN76] The author reviewed SEC filings for the thirty companies comprising the Dow Jones Industrial Average (Dow), [FN77] the 100 companies comprising the Nasdaq 100 Composite Index (Nasdaq 100), [FN78] fifty selected companies included in the Russell 2000 Index (Russell *178 2000) [FN79] and fifty selected companies included in the Russell Microcap Index (Russell Microcap). [FN80]

The Dow was selected for the study to represent companies with large market capitalizations. The Nasdaq 100 and Russell 2000 indices were selected to represent companies with mid-sized and small market capitalizations, respectively. The Russell Microcap Index was selected to reflect some of the smallest public companies. Because of certain overlaps, there were ultimately 228 companies in the survey. [FN81]

*179 The following table shows the median market capitalizations of the four groups as of June 21, 2005: [FN82]

| Index | Market Cap (in billions) |
|---------------------------------------|--------------------------|
| Dow ^{FN [FN83]} | \$91.05 |
| Nasdaq 100 ^{FN [FN84]} | 8.00 |
| Russell 2000 ^{FN [FN85]} | 0.77 |
| Russell Microcap ^{FN [FN86]} | 0.24 |

An examination of the annual reports and proxy statements for these companies indicates at least four things regarding audit committee financial experts:

1. Companies are not struggling to find audit committee financial experts, although larger companies appear to have a larger pool of candidates. [FN87]
2. Most of the designated financial experts have experience as chief financial officers (CFO) and/or chief executive officers (CEO) at public companies, or as certified public accountants (CPA) at large accounting firms. [FN88]
- *180 3. Very few companies are concerned enough about increased liability for audit committee financial experts to include a disclaimer of liability or a reference to the SEC safe harbor. [FN89]
4. Possibly as a result of the third conclusion, it is extremely rare for a company to pay additional compensation to its audit committee financial expert to compensate for additional risk (or duties) beyond those of other audit committee members or chairpersons. [FN90]

A. AVAILABLE POOL OF AUDIT COMMITTEE FINANCIAL EXPERTS

The SEC broadened its criteria for qualifying as an audit committee financial expert between the Proposed Rule and the Final Rule, primarily to ensure that a sufficient number of people would be available to fill that role, particularly in small companies. [FN91] Section 407 of Sarbanes-Oxley and the Final Rule do not require a company to designate a financial expert, but require companies without a financial expert to disclose in their annual report (or as part of the annual proxy statement) the reason for not designating a financial expert. [FN92] Of the 228 companies surveyed, only four

failed to identify an audit committee financial expert in their SEC filings. [FN93] The 224 other companies in the survey have at least one financial expert.

Of the four companies that failed to designate an audit committee financial expert, two complied with the disclosure requirement and provided a reason. [FN94] Molex Corporation, part of the Nasdaq 100, said, “[g]iven the level of financial sophistication and business experience of the Audit Committee members, the board of directors believes that the Audit Committee members can perform the audit committee functions as *181 required.” [FN95] Topps, part of the Russell Microcap, said something similar. Its filing says, “[t]he board believes that each of the current members of the Audit Committee is able to read and understand fundamental financial statements and is ‘financially sophisticated’ ... [t]herefore, our Board of Directors has concluded that the appointment of an additional director to the Audit Committee is not necessary at this time.” [FN96]

Two companies not only failed to designate an audit committee financial expert, but also failed to provide a reason as required by SEC rules. [FN97] There is some evidence that this was merely an oversight because both companies—Network Appliance and Yak Communications—failed to mention the financial expert concept or the Sarbanes-Oxley requirement altogether. [FN98] In addition, their annual reports and proxy statements are not yet due in 2005. Thus, the only available filings are from 2004, the first year in which the financial expert disclosures were required by law. Yak Communications has two audit committee members who would easily qualify as audit committee financial experts under the Final Rule, and Network Appliance has one. [FN99]

As noted, the SEC expressed concern that its definition in the Proposed Rule would make it difficult for companies to find qualified people to serve as financial experts. [FN100] The study shows that larger companies have had an easier time finding financial experts, but that ninety-nine percent of the companies were able to find at least one. [FN101] Of the 224 companies with a financial expert, approximately thirty-five percent (seventy-eight *182 companies) designated more than one financial expert. The companies in the Russell Microcap were less likely to designate more than one financial expert. [FN102] That does not mean the companies designating only one financial expert *had* only one financial expert. It simply means they only designated one. [FN103]

The following table shows by index group the number of companies designating a financial expert, the number of financial experts designated, the average number of financial experts designated and the percentage of companies who designated all members of their audit committee as financial experts.

| Index | Number of Companies | Number of Fin. Experts | Avg. Fin. Experts per Company | Companies Where All Members are Financial Experts |
|-------------------------------------|---------------------|------------------------|-------------------------------|---|
| Dow | 30 | 65 | 2.2 | 20% |
| Nasdaq 100 ^{FN} [FN104] | 96 | 155 | 1.6 | 13% |
| Russell 2000 | 50 | 77 | 1.5 | 12% |
| Russell | 48 | 56 | 1.2 | 2% |

| | | | |
|----------|-------|-------|-------|
| Microcap | _____ | _____ | _____ |
| Totals | 224 | 350 | 1.6 |

The table shows that the number of designated financial experts bears a direct relationship to the size of the company, at least when measured in *183 these groupings by index. The largest companies in the study on average-members of the Dow-designated more financial experts on average and were more likely to designate all members of their audit committee as financial experts. By contrast, the smallest companies in the study on average-members of the Russell Microcap Index-designated fewer financial experts on average, and were unlikely to designate all members of their audit committee as financial experts.

B. EXPERTISE OF THE FINANCIAL EXPERTS

The vast majority of companies with a financial expert did not list the criteria by which they made the determination that the person qualified as a financial expert. The Final Rule does not require such disclosure, except in limited circumstances, and the filings indicate that most companies chose to disclose the bare minimum. [FN105] A few companies-mostly in the Russell 2000 and Russell Microcap indices-included specific statements about why their designated financial experts qualified under the Final Rule. [FN106] Nevertheless, the SEC's proxy statement rules require proxy statements to describe the relevant business background of the company's directors. [FN107] Because all of the audit committee financial experts are by definition directors, a sophisticated and diligent investor can look to the director "bios" to see the director's qualifications, though the information may not reveal his or her financial qualifications. [FN108]

The following table shows the ten most common experiential or educational attributes listed in the director biographies for those designated as financial experts, with a breakdown of the frequency by index group studied: [FN109]

| Position | Dow | Nasdaq 100 | Russell 2000 | Russell Microcap |
|--------------------------------------|-----|------------|--------------|------------------|
| CFO of Public Company FN [FN110] | 3 | 50 | 23 | 16 |
| CEO of Public Company FN [FN111] | 37 | 27 | 18 | 4 |
| CPA (large acctg firm) | 3 | 26 | 8 | 23 |
| CEO of Private Company FN [FN112] | 3 | 12 | 7 | 6 |
| Investor/Venture Capitalist | 2 | 8 | 6 | 1 |

| | | | | |
|---|---|---|---|---|
| MBA Degree ^{FN} [FN113] | 1 | 9 | 1 | 5 |
| Lawyer ^{FN} [FN114] | 0 | 3 | 4 | 3 |
| Investment Banker ^{FN} [FN115] | 1 | 8 | 5 | 2 |
| Chair of Public Company ^{FN} [FN116] | 1 | 5 | 3 | 0 |
| Director of Public Company ^{FN} [FN117] | 2 | 3 | 1 | 2 |

***185** Under the more restrictive definition of the Proposed Rule, it is clear that a CEO of a private company would not qualify as a financial expert because the Proposed Rule would have required the person's financial expertise to be obtained in connection with an Exchange Act reporting company. [FN118] In addition, most public company CEOs, investor/venture capitalists, MBAs, lawyers, investment bankers, chairs of public companies and public company directors would not have qualified under the Proposed Rule if those were their highest and best qualifications for the position. In most cases, they would fail to meet the definition by not having actual experience preparing or auditing financial statements, which would have been required by the Proposed Rule. [FN119] All were determined by their respective boards to qualify as financial experts under the Final Rule.

C. DISCLAIMERS REGARDING FINANCIAL EXPERT LIABILITY

In the Final Rule, the SEC created safe harbors to protect audit committee financial experts from potential increased liability as a result of being designated as a financial expert. [FN120] Company counsel advising reporting companies about disclosure might be inclined to include disclaimers about the audit committee financial experts' potential liability if they felt the safe harbor was insufficient protection. Alternatively, company counsel might advise disclosure that reiterated the SEC's safe harbor. Yet, of the 224 companies in the study that designated at least one financial expert, only twelve included such a disclaimer, and in each case the disclaimer essentially reiterated the SEC's safe harbor. [FN121]

The companies in the Dow and the Nasdaq 100 were more likely to have disclaimers. Ten percent of the Dow companies and six percent of the Nasdaq 100 companies included disclaimers, as compared to two percent and four percent for the Russell 2000 and Russell Microcap samples, respectively. Those results may be related to the sophistication of company counsel, which often is a function of company size, but most public companies have sophisticated securities counsel. [FN122]

***186** The disclaimers emphasize part two of the safe harbor, explaining that the financial expert has no duties, obligations or liabilities greater than the other audit committee members or the board. [FN123] Below is representative language from a Nasdaq 100 company filing:

Shareholders should understand that this designation is an SEC disclosure requirement relating to Mr. Fried-

man's and Mr. Hiram's experience and understanding of certain accounting and auditing matters, which the SEC has stated does not impose on the directors so designated any additional duty, obligation or liability than otherwise is imposed generally by virtue of serving on the Audit Committee and/or the Board of Directors. [FN124]

Most of the disclaimers are equally brief, but SBC Communications, one of the Dow companies, includes a much longer disclaimer that incorporates some of the SEC's background comments from the Final Rule release. [FN125] For instance, the SBC disclosure adds, "[t]hey are not auditors or accountants, do not perform 'field work' and are not full-time employees." [FN126]

Those, however, are the exceptions. Nearly 95% of the companies in the study appear comfortable the safe harbor adequately protects their audit committee financial expert or experts.

D. COMPENSATION OF FINANCIAL EXPERTS

One might expect the specter of potential increased liability and duties of the financial experts, as well as the limited pool of qualified candidates- which were the principle objections expressed to the SEC in reaction to its Proposed Rule- would cause companies to pay additional compensation to persons serving as financial experts. Yet, of the 224 companies surveyed that designated at least one financial expert, only one company provided a special fee to its financial expert because of his status *187 as a financial expert. [FN127] One other company specifically mentions that the audit committee chair's designation as a financial expert was a factor in determining his compensation. [FN128]

That being said, audit committee chairs are frequently paid more than other directors and more than regular audit committee members. [FN129] This is significant because more than four-fifths of the board members designated as financial experts in the subject companies are chairing the audit committee. [FN130]

Based on the study, the chart below shows how the companies in the Dow, the Nasdaq 100, the Russell 2000 and the Russell Microcap compensated, on average, their audit committee chairs in relation to ordinary board members, ordinary committee members, regular audit *188 committee members and the chair of the compensation committee (dollar figures rounded to nearest hundred):

| Index | Board Member | Comm Member | Audit Comm Member | Compensation Chair | Audit Chair |
|------------------|--------------|-------------|-------------------|--------------------|-------------|
| Dow | \$112,500 | \$116,300 | \$122,000 | \$126,400 | \$136,20 |
| Nasdaq 100 | 45,100 | 48,800 | 55,400 | 55,100 | 66,90 |
| Russell 2000 | 33,800 | 37,300 | 42,800 | 42,200 | 51,80 |
| Russell Microcap | 22,400 | 23,500 | 26,300 | 26,600 | 31,00 |
| Average | \$ 46,800 | \$ 49,900 | \$ 55,200 | \$ 55,700 | \$ 65,10 |

Among companies in the study, the audit committee chair received an average of approximately 39% more in fees

than an ordinary board member, 30% more than an ordinary committee member and 18% more than a regular audit committee member. On average, they also receive approximately 17% more than the chair of the compensation committee, which tends to be the second ranking committee in the board committee hierarchy. [FN131]

Based on the study, the following table shows on a percentage basis how much more compensation the audit committee chairs receive, on average, than ordinary board members, ordinary committee members, regular audit committee members and the chair of the compensation committee:

| Index | Board Member | Committee Member | Audit Comm Member | Compensation Chair |
|------------------|--------------|------------------|-------------------|--------------------|
| Dow | 21% | 17% | 12% | 8% |
| Nasdaq 100 | 48% | 37% | 21% | 21% |
| Russell 2000 | 54% | 39% | 21% | 23% |
| Russell Microcap | 38% | 32% | 18% | 17% |
| Overall | 39% | 31% | 18% | 17% |

***189** In the study, the Nasdaq 100 and Russell 2000 companies paid the audit committee chair more fees in relation to the ordinary board member, ordinary committee member, regular audit committee member and chair of the compensation committee than companies in the Dow or Russell Microcap. The lowest compensation disparities among the audit committee chairs and the other groups were found in the Dow companies. Since the biggest disparities were for the selected Russell 2000 companies, followed by the Nasdaq 100, the selected Russell Microcap companies and then the Dow, there appears to be very little direct correlation with company size—at least when measured by these clusters of companies in the respective indices.

Based on the study, there is no significant evidence that companies are paying financial experts solely for being designated as such, particularly since only two companies do so. And while the audit committee chairs, most of whom are financial experts, receive significant additional compensation, the additional fees appear to be tied to the additional work involved with chairing the most high profile committee in the current corporate environment. Many of the filings specifically say that the audit committee members, and the chair, receive significant additional compensation because of the additional work and meetings involved. In fact, audit committees appear to meet at least twice as often (and sometimes much more frequently) than a typical board committee. [FN132]

It is possible that fees for being a financial expert are hidden in the audit committee chair fees. In the study, twenty-five companies designated every member of their audit committee as a financial expert. If companies were factoring in increased duties or liabilities of the financial expert into ***190** the audit committee chair's compensation, we would expect to see significantly smaller differences between the fees of the audit committee chairs and regular audit committee members in those twenty-five companies, since all of the audit committee members are designated financial experts and ought to be paid about the same.

For those twenty-five companies, the audit committee chair compensation exceeds the compensation of regular audit committee members by approximately 13%, compared to the other companies in the study (18%). So while there is some difference, the difference is not significantly smaller, particularly when taking into account that those twenty-five have significantly larger market capitalizations and pay their audit committee members and audit committee chairs approximately \$18,000 more per year, on average, than the other 199 companies in the study. [FN133]

V. A BETTER FINANCIAL EXPERT RULE FOR INVESTORS

The intent of section 407 of Sarbanes-Oxley and the financial expert rules is to provide an additional layer of oversight of financial reporting and therefore more protection for investors. [FN134] When the SEC issued its Proposed Rule regarding audit committee financial experts, it received comments from practitioners, scholars and the business community indicating two primary concerns. First, there was concern that the restrictive definition of audit committee financial experts would create a pool of candidates that was too narrow. [FN135] There was particular concern that small companies would face an uphill battle in finding people to serve as audit committee financial experts. [FN136] Second, there was concern that labeling a board member a “financial expert” would put a target on the person's back and subject the financial expert to increased risk under section 11 of the Securities Act of 1933 and state law fiduciary duty principles. [FN137]

***191** In reaction to the comments, the SEC issued its Final Rule, broadening the definition of audit committee “financial expert” and adding the safe harbors from liability. [FN138] By doing so, the SEC diminished the significance of having a financial expert on the audit committee, and deprived investors of the additional layer of oversight of financial reporting that Congress originally intended when enacting section 407.

A. A BETTER DEFINITION OF AUDIT COMMITTEE FINANCIAL EXPERT

The study indicates that most of the subject companies found little difficulty in finding someone to serve as the audit committee financial expert, although companies in the Russell Microcap had fewer financial experts overall. [FN139] In fact, more than one-third of the companies were able to designate more than one financial expert, and more than 10% were able to designate every member of the audit committee as a financial expert. [FN140] Most of the designated financial experts had experience as the CFO or CEO of a public company, or as a CPA at a large accounting firm. [FN141]

It appears that the Final Rule regarding audit committee financial experts was a significant improvement on the Proposed Rule, and perhaps has successfully addressed concerns about a limited pool of candidates. However, there was a significant trade-off in the SEC's decision to broaden its definition of audit committee financial expert. The end result is a definition that allows directors to be designated financial experts without having the sort of financial expertise investors would want or expect on the audit committee. Accordingly, the Final Rule gives investors the illusion that they have additional safeguards through the financial expert, when in fact virtually nothing changed. [FN142]

Ensuring a sufficient pool of available candidates is clearly an important part of the SEC's rulemaking. However, expanding the definition too much, as the SEC has done in the Final Rule, allows directors to be designated financial experts without inspiring investor confidence in the selection. For example, what comfort can an investor take in knowing that the financial expert on a company's audit committee is a former ***192** consultant, or a lawyer, or a professor of chemistry, or a director of a public company? If those are the financial expert's best qualifications for the position, the investor has no reason to feel any more confidence in the oversight of the financial reporting process than before the enactment of section 407 of Sarbanes-Oxley. [FN143]

The definition in the Proposed Rule was undoubtedly too restrictive, as it tended to eliminate anyone who was not a former public company CFO or certified public accountant. However, it would not have been difficult for the SEC to examine a representative set of public company filings to determine if companies had board members who would qualify as financial experts and tailor a rule that created a sufficiently broad pool of candidates while permitting only truly qualified board members to be designated as the financial expert.

The source of the flaw in the final definition is partially found in the “other relevant experience” factor, which is a back door for marginally qualified candidates. [FN144] The Proposed Rule had a very restrictive set of required attributes, which focused on actual experience applying GAAP and preparing or auditing financial statements, all in connection with an Exchange Act reporting company. [FN145] It then contained ten factors for the board to consider in evaluating whether the person had those attributes. [FN146] The tenth factor was a catchall provision designed to take into account other qualifications and experience. [FN147] But the Proposed Rule's catchall provision included detailed language regarding the person's ability to understand and evaluate financial information. [FN148] In addition, it was only one of ten factors and the board was required to consider all ten. [FN149]

The Final Rule eliminated some of the required attributes, permitting experience assessing, analyzing and evaluating GAAP financial statements as opposed to experience actually preparing and auditing, as was the case *193 with the Proposed Rule. [FN150] It also allowed supervision of financial personnel to substitute for that experience. [FN151] Those changes created a potentially broader pool of candidates because people with experience as a CEO or securities analyst, for example, could potentially qualify as financial experts with the required attributes.

The Final Rule also reduced the number of factors to be considered by the board to one of four, and replaced the more detailed catchall provision in the Proposed Rule with the simple phrase “other relevant experience.” [FN152] Such a broad catchall, on the heels of more permissive attributes, opened the door too widely. It also permitted the board to hide the ball from investors. Although the Final Rule requires the board to disclose the person's relevant experience if the catchall category is used, it can satisfy this requirement simply by including the director bios that the company is already required to provide under the proxy statement rules. [FN153] Thus, investors get no new disclosure about the person's qualifications as a financial expert based on “other relevant experience.”

The SEC should make three significant changes to the Final Rule definition of audit committee financial expert:

- (1) eliminate the “other relevant experience” item as way to acquire the required attributes;
- (2) require the education and experience of the financial expert to be with issuers required to file reports pursuant to Section 13(a) or 15(d) of the Exchange Act or registered investment companies; and
- (3) require the company to disclose the attributes and qualifications of the designated financial expert *proximately* to the designation in the proxy statement or annual report. [FN154]

*194 What the proposed amendments seek to accomplish is designation of a financial expert with sophisticated knowledge of financial reporting and experience, actually applying that knowledge or actively supervising people with that experience, [FN155] all in the same context in which the person will be fulfilling the role of financial expert: that of an Exchange Act reporting company. The amendments also would give an investor the ability to assess the value of a particular financial expert by requiring the company to include a sentence or two, proximate to the disclosure of the financial expert, explaining why the financial expert qualifies as such.

Below are some of the common experience and educational backgrounds held by designated financial experts at companies in the study, and how they would fare under the amendments proposed in this article, if the positions below were the person's *best* financial qualifications: [FN156]

1. Public Company CEO

A public company CEO often will qualify under the Final Rule because many CEOs have the “ability to assess” application of GAAP and have either analyzed or evaluated financial statements or actively supervised personnel who have done so. Likewise, the public company CEO would often qualify under the amendments proposed in this article because the CEO's experience supervising financial personnel and involvement in assessing the company's financial statements would qualify even in the absence of “other relevant experience,” and the experience would be in a ***195** public company context. [FN157] Thus, the amendments proposed in this article would not adversely affect the ability of a public company CEO to qualify as a financial expert.

2. Private Company CEO

A private company CEO may qualify under the Final Rule for the same reason as a public company CEO. In fact, directors whose best financial experience was as a private company CEO have been frequently designated financial experts by the companies in the study. [FN158] However, the private company CEO would not qualify under the amendments proposed in this article because the CEO's experience would not have been with an Exchange Act reporting company.

As anyone who has worked with public companies would attest, there is a world of difference between financial statements for a reporting company, with its complex layer of SEC regulation, and financial reporting for a private company. At a private company, there are few rules: audits are not required, and they are not subject to scrutiny by the public at large. Since the financial expert on an audit committee is the principal liaison and overseer of the work done by the financial managers and the public accountants, experience with audits and public reporting is a key component. Former CEOs of private companies, without more, should not qualify as financial experts.

3. Investment Bankers

Many investment bankers assess and evaluate financial statements. Accordingly, they likely qualify under the Final Rule. They also likely qualify under the amendments proposed in this article, so long as their investment banking experience related to Exchange Act reporting companies. Because they often have experience assessing the performance of companies with respect to the preparation, auditing or evaluation of financial statements, they do not need to rely on the “other relevant experience” provision.

***196** One might argue that investment bankers do not have the correct perspective for an audit committee financial expert, since “spin” is a large component of what many investment bankers do. Investors do not want spin when it comes to financial reporting. However, investment bankers are extremely sophisticated financial analysts and highly attuned to the market and needs of investors. The financial expert will not have a direct hand in the preparation of the financial statements, so the opportunity for financial manipulation is not as significant. In fact, having a financial expert well-versed in financial statement spin is probably good for investors, because in the oversight role, the financial expert will be in a unique position to recognize financial manipulation and stamp it out.

4. Investors, Venture Capitalists and Lawyers

Investors, venture capitalists, and lawyers would apparently qualify under the Final Rule, especially considering that many of the companies in the study designated them as financial experts. [FN159] Investors, venture capitalists and lawyers usually would not qualify under the amendments proposed in this article, if those were their best qualifications.

Most investors, venture capitalists and lawyers have no direct experience with a company's preparation, auditing or evaluation of financial statements in a public company context.

Investors may evaluate for their own purposes, but not in connection with the company's responsibilities. Thus, investors qualify in the Final Rule under the "other relevant experience" category. Venture capitalists are typically more directly involved with a company's financial reporting, but generally only when the company is still at the private company stage. And while securities lawyers frequently brush against issues associated with financial reporting, they are primarily concerned with including accurate information in the disclosure document, as opposed to evaluating the accuracy of the financial statements themselves and the internal controls associated with financial reporting. Those matters are left to financial managers, accountants and investment bankers.

The amendments proposed in this article would not categorically exclude investors, venture capitalists and lawyers, but would certainly narrow the number of them who would qualify.

*197 5. Chairs of Public Companies/Directors of Public Companies

These positions appear to qualify under the Final Rule, considering that many of the companies in the study designated them as financial experts. [FN160] Chairs and directors of public companies usually would not qualify under the amendments proposed in this article if they did not play a significant role on the audit committee. A chairperson or ordinary board member has no role in actual preparation of financial statements, and very little, if any, role in oversight of the preparation, auditing or evaluation of financial statements, apart from receiving reports from financial managers and the audit committee.

6. Other Experience

It is impossible to exhaust the range of experiences of potential financial experts. However, some other experience that boards have determined qualify under the Final Rule would not qualify under the amendments proposed in this article. Examples include most consultants, officers of non-profit corporations, professors of science and even professors of finance, assuming those were their best financial qualifications. None of that experience, without more, qualifies a board member to oversee the company's management and auditors in the financial reporting process, at the level of sophistication of an Exchange Act reporting company, except in special circumstances.

The proposed amendments to the definition of "audit committee financial expert" would narrow the pool of available candidates, but would strike a useful balance between the Proposed Rule and the Final Rule. Of the 224 companies in the study who designated a financial expert, an estimated thirty-eight would not have a financial expert who would qualify under the amendments proposed by this article. The estimate is based solely on positions held by the financial experts as disclosed in their director bios. They may have experience that would qualify them under the amendments proposed in this article, but since their specific qualifications *as financial experts* are not required to be disclosed, this is unclear.

It does not necessarily follow that financial experts would be unavailable to those thirty-eight companies. It simply means the companies might have to do a little more work to find them. That seems a *198 small price to pay, since the goal of section 407 is to provide investors with additional protection in the oversight of financial reporting. [FN161] Smaller companies, like those in the Russell Microcap, may have more difficulty finding directors who qualify as financial experts under the amendments proposed by this article. Or, they may not. It is an insufficient argument to speculate that complying with the intent of Congress and the needs of investors is going to be too burdensome, at least until the

waters have been tested.

B. A BETTER SAFE HARBOR

The SEC filings in the study indicate companies and their legal counsel are not particularly concerned about increased liability for financial experts, as only approximately 5% of the companies with a financial expert included any disclaimers about financial expert liability. [FN162] As of July 12, 2005, a Westlaw search revealed no reported decisions claiming breach of fiduciary duty by a financial expert. Perhaps for this reason only two companies out of 224 in the study took a director's status as a financial expert into consideration in determining the director's compensation. Presumably if the companies associated additional duties or risks with the financial expert, the financial expert consistently would receive additional cash or equity compensation as a result. [FN163]

It appears that the Final Rule successfully addressed the companies' concerns about whether the financial experts will be subjected to additional liability. However, as with the definition of financial expert in the Final Rule, there was a trade-off in the SEC's decision to explicitly comment on potential liability under state law. The way the SEC has written the safe harbor, financial experts are not required to do anything. Investors might ask, "What is the point of having a financial expert on the audit committee?"

***199** The safe harbor providing that financial experts are not "experts" for purposes of section 11 of the Securities Act of 1933 was an understandable idea. It was never the intent of section 407 of Sarbanes-Oxley to elevate the financial expert to the expertise level of the certified public accountants directly responsible for preparing and auditing the financial statements. The financial expert, as a board member, serves in an oversight role. [FN164]

The SEC went further, though, and provided that financial experts do not have any duties, obligations or liabilities greater than those imposed on other members of the audit committee or board. This safe harbor is aimed primarily at state law fiduciary duty claims, over which the SEC has no direct authority. Yet the SEC's position is likely to be influential. While the concern about increased financial expert liability might be legitimate, state law is well-equipped to handle the responsibilities of directors and their fiduciary duties to investors. [FN165] The financial experts might argue that potential liability stifles creativity, but in the current corporate environment, investors are likely happy to curtail creativity with respect to financial reporting.

If the financial expert has no duties, obligations or liabilities greater than that of the other audit committee members, then investors can take little additional comfort in having a financial expert involved. Since the 1970s, ordinary audit committee members have been required under exchange rules to be financially literate, with at least one member having accounting or related financial management expertise. [FN166] With a statement in the Final Rule that the financial expert's duties, obligations and liabilities are no greater than that of the other audit committee members, section 407 of Sarbanes-Oxley adds nothing to the investor protection ***200** landscape. [FN167] The designation of a financial expert appears to be nothing more than a public relations move to quell investor fears. [FN168]

The SEC should amend the safe harbor to delete part two of the provision, which addresses the duties, obligations and liability of the financial expert in relation to other board members and audit committee members. [FN169] It should retain the portions of the safe harbor protecting financial experts from liability as an "expert" under federal securities law and making it clear that other board and committee members do not have altered duties, obligations or liability as the result of having a financial expert on the audit committee. [FN170]

Such an amendment would leave the liability of a financial expert where it belongs: in the state courts under long-

established fiduciary duty principles. Those principles are well-equipped to deal with the oversight role of board and committee members. And while the specter of liability for a breach of fiduciary duty is no longer what it used to be, it might provide some additional incentive for a financial expert to be attentive to his or her duties. [FN171]

In addition, such an amendment would eliminate the SEC's statement that a financial expert has no additional "duties [or] obligations" beyond that of an ordinary member of the audit committee or the board. [FN172] The SEC has effectively taken away the very purpose of designating a financial expert in the first place: to provide an additional layer of oversight of financial reporting and additional protection of investors. If the financial expert has nothing special to do, then nothing has been accomplished by designating a financial expert, except that investors will have received a tonic to mask the real illness.

*201 VI. CONCLUSION

Congress enacted Sarbanes-Oxley recognizing that investor confidence was waning due to the malfeasance of numerous corporate executives and individuals at public accounting firms. [FN173] One of the measures designed to improve investor confidence was section 407, requiring disclosure of whether a company had a financial expert on its audit committee. [FN174] Presumably, Congress did not intend to achieve investor confidence by providing investors with only an illusion of protection. Yet that is exactly what the SEC's Final Rule implementing section 407 does. Investors believe they have a true expert on the audit committee, who will use his or her special expertise to oversee the financial reporting process. Instead, investors may have a professor of engineering who does not have "any duties, obligations or liability that are greater than the duties, obligations and liability imposed on ... member[s] of the audit committee and the board of directors" [FN175]

If the SEC wants the audit committee financial expert to help restore investor confidence in financial reporting, as Congress intended, then it needs to tighten the definition of "audit committee financial expert" by closing the back door that permits "other relevant experience" [FN176] as a means to achieving the required attributes. The SEC also ought to require that a financial expert's experience be related to an Exchange Act reporting company, and ought to require companies to justify the financial expert's qualifications in its proxy statement disclosure. Finally, the SEC ought to eliminate its statement that audit committee financial experts have no duties, liabilities or obligations beyond that of an ordinary board or audit committee member, because that statement strips the financial expert of any requirement to put his or her expertise to work for investors.

As the Final Rule stands, the only investors who have regained their confidence in public company financial reporting as a result of section 407 are those who are willing to hear the good news that there is an audit committee financial expert on board, without paying heed to the bad news *202 that the financial expert may be less qualified than expected and has no special responsibility to apply any financial expertise to the oversight of the financial reporting process.

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[FN1]. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 & 29 U.S.C.).

[FN2]. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407, 116 Stat. 790 (codified in scattered sections of 11, 15, 18, 28 & 29 U.S.C.).

[FN3]. Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 34-46701, 2002 WL 31370458 (Oct. 22, 2002).

[FN4]. Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 34-47235, 79 S.E.C. Docket 1077, available at <http://www.sec.gov/rules/final/33-8177.htm> (Jan. 24, 2003).

[FN5]. See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 204, 301 and 407, 116 Stat. 773, 775, 790 (codified in scattered sections of 11, 15, 18, 28 & 29 U.S.C.).

[FN6]. *Id.* at § 407; Regulation S-K, 17 C.F.R. § 229.401(h) (2005).

[FN7]. *Component Weightings: Dow Jones Industrial Average*, at <http://djindexes.com/mdsidx/index.cfm?event=showComponentWeights&rptsymbol=DJI&sitemapid=20> (last visited Nov. 7, 2005).

[FN8]. *Nasdaq 100 Index*, at http://dynamic.nasdaq.com/dynamic/nasdaq100_activity.stm (last visited Nov. 7, 2005).

[FN9]. *Russell 2000 Index Membership List*, at <http://www.cboe.com/products/R2000.pdf> (as of June 30, 2004). See *infra* note 79 and accompanying text.

[FN10]. *Members: Russell Microcap Index*, at http://russell.com/us/indexes/us/reconstitution/microcap_adds.asp (as of June 24, 2005). See *infra* note 80 and accompanying text.

[FN11]. Special Committee on Audit Committees-American Institute of Certified Public Accountants, *An AICPA Requirement for Audit Committees: An Analysis of the Issues* 4 (1978), available at http://www.aicpa.org/audcommctr/download/33_requir_audit_cmte.pdf (last visited Nov. 7, 2005).

[FN12]. One of the most prominent collapses was Penn Central. For a description of its demise, see Brian Trumbore, *The Collapse of Penn Central*, at http://www.buyandhold.com/bh/en/education/history/2001/the_collapse_of_penn_central.html (last visited Nov. 7, 2005).

[FN13]. See *S.E.C. v. Mattel, Inc.*, 74 Civ. 1185, 1974 WL 449 at *6 (D.D.C. October 1, 1974).

[FN14]. See, e.g., Report of Investigation in the Matter of National Telephone Co., Inc., Relating to Activities of the Outside Directors of National Telephone Co., Inc., Exchange Act Release No. 34-14380, 13 S.E.C. Docket 1393 (Jan. 16, 1978); *S.E.C. v. Killearn Props., Inc.*, No. TCA-75-67, 1977 WL 1065, at *2-3 (N.D. Fla. May 1977).

[FN15]. See *Standing Audit Committee Composed of Outside Directors*, Exchange Act Release No. 34-9548, 1972 WL 125505 (Mar. 23, 1972); *Notice of Amendments to Require Increased Disclosures of Relationships Between Registrants and Their Independent Public Accountants*, Exchange Act Release No. 34-11147, 5 S.E.C. Docket 799 (Dec. 20, 1974); *Shareholder Communications, Shareholder Participation In the Corporate Electoral Process and Corporate Governance Generally, Final Rules*, Exchange Act Release No. 34-15384, 1978 WL 195744 (Dec. 6, 1978); LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 25-26 (3d ed. 1998).

[FN16]. See *Standards Relating to Listed Company Audit Committees*, Exchange Act Release No. 34-47654, 79 S.E.C. Docket 2876 (Apr. 9, 2003). The American Stock Exchange (AMEX) also adopted a rule at the same time, but merely recommended that listed companies have an audit committee comprised of independent directors. In the *Matter of American Stock Exchange, Inc.*, Exchange Act Release No. 34-16722, 19 S.E.C. Docket 1980 (Apr. 3, 1980). In 1991, AMEX adopted a rule requiring its listed companies to have an audit committee comprised of a majority of independent direct-

ors. Self-Regulatory Organizations; the American Stock Exchange; Order Approving Proposed Rule Change and Notice and Order Granting Accelerated Approval to Amendment No. 1 Relating to Independent Directors and Audit Committees, Exchange Act Release No. 34-29796, 49 S.E.C. Docket 1492 (Oct. 8, 1991).

[FN17]. Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees 2 (1999), *available at* [http:// www.nasdaq.com/about/Blue_Ribbon_Panel.pdf](http://www.nasdaq.com/about/Blue_Ribbon_Panel.pdf) (last visited July 13, 2005).

[FN18]. Self-Regulatory Organizations; Order Approving Proposed Rule Change by the New York Stock Exchange, Inc. Amending the Exchange's Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto, Exchange Act Release No. 34-42233, 71 S.E.C. Docket 639 (Dec. 14, 1999) [hereinafter NYSE Amendment]; Self-Regulatory Organizations; Order Approving Proposed Rule Change by the American Stock Exchange LLC Amending the Exchange's Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto, Exchange Act Release No. 34-42232, 71 S.E.C. Docket 632 (Dec. 14, 1999) [hereinafter AMEX Amendment]; Self-Regulatory Organizations; Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. Amending its Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto, Exchange Act Release No. 34-42231, 71 S.E.C. Docket 624 (Dec. 14, 1999) [hereinafter NASD Amendment].

[FN19]. NYSE Amendment, *supra* note 18.

[FN20]. *Id.*

[FN21]. *Id.*

[FN22]. AMEX Amendment, *supra* note 18.

[FN23]. *Id.*

[FN24]. NASD Amendment, *supra* note 18.

[FN25]. Audit Committee Disclosure, Exchange Act Release No. 34-42266, 71 S.E.C. 787 (Dec. 22, 1999); Regulation S-K, 17 C.F.R. § 229.306 (2005).

[FN26]. Audit Committee Disclosure, Exchange Act Release No. 34-42266, 71 S.E.C. 787 (Dec. 22, 1999); Regulation S-K, 17 C.F.R. § 229.306 (2005).

[FN27]. Audit Committee Disclosure, Exchange Act Release No. 34-42266, 71 S.E.C. 787 (Dec. 22, 1999); Schedule 14A, 17 C.F.R. § 240.14a-101, Item 7(e)(3)(iii) (2005).

[FN28]. Audit Committee Disclosure, Exchange Act Release No. 34-42266, 71 S.E.C. 787 (Dec. 22, 1999).

[FN29]. *Id.*

[FN30]. *Id.*

[FN31]. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002) (codified in scattered sections of 11, 15, 18, 28 & 29 U.S.C.); *See, e.g.*, Troy A. Paredes, *Enron: The Board Corporate Governance, and Some Thoughts on the Role of Congress*, in ENRON CORPORATE FIASCOS AND THEIR IMPLICATIONS (Nancy B. Rapoport & Bala G. Dharan eds.)

(2004).

[FN32]. Some companies are covered by the provisions of the Exchange Act but are not listed on the NYSE, AMEX or Nasdaq.

[FN33]. Sarbanes-Oxley Act of 2002, § 301.

[FN34]. *Id.* Sarbanes-Oxley directed the national securities exchanges and national securities associations to adopt listing rules complying with § 301.

[FN35]. Sarbanes-Oxley Act of 2002, § 407

[FN36]. *Id.*

[FN37]. *Id.*

[FN38]. *Id.*

[FN39]. *Id.*

[FN40]. *Id.*

[FN41]. Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 34-46701, 2002 WL 31370458 (Oct. 22, 2002) [hereinafter Proposed Rule].

[FN42]. *Id.*

[FN43]. *Id.* In lieu of that experience, the Board could determine that the person gained the experience in positions involving the performance of similar functions, or held positions that would result in the person having similar expertise and experience.

[FN44]. *Id.*

[FN45]. *Id.*

[FN46]. Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 34-47235, 79 S.E.C. Docket 1077 (Jan. 24, 2003) [hereinafter Final Rule]. A fair number of the comment letters addressed sections 404 and 406 of Sarbanes-Oxley, as opposed the financial expert rules in section 407. *See, e.g.*, Letter from Francis W. Holman, Jr., Vice President and Secretary, Manufacturers Alliance/MAPI Inc. to SEC (Mar. 4, 2003), available at <http://www.sec.gov/rules/proposed/s74002/manufact030403.htm>. Also, many of the comment letters were submitted after the comment deadline of November 29, 2002 stated in the Proposed Rule.

[FN47]. Final Rule, *supra* note 46.

[FN48]. *Id.* Apart from comments on the proposed rules designed to clarify or modified the proposed rules, some commenters clearly were unhappy with the entire concept, as opposed to the SEC's rulemaking effort. For instance, several commenters did not approve of making any distinctions among the capabilities of one audit committee member and the other audit committee members. *See, e.g.*, Letter from Ernst & Young LLP to SEC (Nov. 29, 2002), available at <http://www.sec.gov/rules/proposed/s74002/ernstyoungl.htm>. Of course, the Sarbanes-Oxley legislation itself makes a dis-

tion, so the SEC had no latitude in that regard. *See* Sarbanes-Oxley Act of 2002, [Pub. L. No. 107-204](#), [116 Stat. 745](#) (codified in scattered sections of 11, 15, 18, 28 & 29 U.S.C.).

[FN49]. Final Rule, *supra* note 46.

[FN50]. Final Rule, *supra* note 46. Another factor limiting the pool of candidates was the requirement in the Proposed Rule that the financial expert be independent of management, thus excluding the company's officers. Proposed Rule, *supra* note 41. Some of the comments seemed self-serving. For example, a finance professor at Georgetown University thought the rule unnecessarily excluded eligibility of finance professors, and suggested broadening the definition to put more emphasis on education, as well as experience as a consultant, expert witness or financial educator. Letter from James J. Angel to SEC (via email) (Jan. 8, 2003), *available at* <http://www.sec.gov/rules/proposed/s74002/jjangell.txt>.

[FN51]. Final Rule, *supra* note 46. A director's fiduciary duty of care under state law is normally to discharge his duties with the care a person (or an ordinarily prudent person) in a like position would reasonably believe appropriate under similar circumstances. *See, e.g.*, [CAL. CORP. CODE § 309\(a\)](#) (West 2004); [FLA. STAT. § 607.0830\(1\)\(b\)](#) (2004). Delaware does not have a statutory standard, but seems to apply "gross negligence." *See, e.g.*, [Guttman v. Jen-Hsun Huang](#), [823 A.2d 492](#), [507 n. 39](#) (Del. Ch. 2003). State statutes avoid requiring any particular skill as a pre-condition to election as a director. *See, e.g.*, [DEL. CODE ANN. tit. 8 § 142\(a\)](#) (2004); [FLA. STAT. § 607.0802](#) (2004). Nevertheless, a director's specialized knowledge, qualifications or responsibilities is often relevant in determining his compliance with the duty of care. MOD. BUS. CORP. ACT, § 8.30 cmt. 2(6) (2000). Even so, most states have statutory provisions protecting directors from personal liability for violations of the duty of care. *See, e.g.*, [CAL. CORP. CODE § 309\(c\)](#) (West 2004); [FLA. STAT. § 607.0831\(1\)](#) (2004).

[FN52]. Final Rule, *supra* note 46. The Final Rule has been incorporated into Item 401(h) of Regulation S-K and Item 401(e) of Regulation S-B, which provide the requirements for disclosure in annual reports, among other things, and in the forms used to file annual reports. Regulation S-K, [17 C.F.R. § 229.401\(h\)](#) (2005); Regulation S-B, [17 C.F.R. § 228.401\(e\)](#) (2005). For convenience they are collectively referred to in the text as the "Final Rule." In addition, the Final Rule changed the terminology from "financial expert" to "audit committee financial expert," with an acknowledgement that no change in meaning was intended. Final Rule, *supra* note 46. The two terms are used interchangeably in this article.

[FN53]. Regulation S-B, [17 C.F.R. § 228.401\(e\)](#) (2005).

[FN54]. Regulation S-B, [17 C.F.R. § 228.401\(e\)](#) (2005). A number of the comments submitted to the SEC complained about the focus on accounting expertise, and various other organizations noted the inapplicability of GAAP to their financial reporting. *See, e.g.*, Letter from Craig L. Evans, Shook, Hardy & Bacon L.L.P., to SEC (Nov. 29, 2002), *available at* <http://www.sec.gov/rules/proposed/s74002/clevansl.htm> (last visited Nov. 7, 2005); Letter from Stan Hung, Director and Chief Financial Officer, United Micro Electronics Corporation, et al., to SEC (Nov. 29, 2002), *available at* <http://www.sec.gov/rules/proposed/s74002/shungl.htm> (last visited Nov. 7, 2005).

[FN55]. Final Rule, *supra* note 46.

[FN56]. *Id.* (emphasis added). Many of the comments on the Proposed Rule objected to the exclusion of financially sophisticated persons such as investment bankers, finance and accounting professors and even experienced top-level management like chief executive officers. *See, e.g.*, Letter from Craig L. Evans to SEC, *supra* note 54; Letter from Roman L. Weil, V. Duane Rath Professor of Accounting, Graduate School of Business, University of Chicago, to SEC (Nov. 29, 2002), *available at* <http://www.sec.gov/rules/proposed/s74002/rlweill.htm> (last visited Nov. 7, 2005).

[FN57]. Final Rule, *supra* note 46.

[FN58]. *Id.*

[FN59]. *Id.*

[FN60]. *Id.*

[FN61]. *Id.* Cf. *supra* note 41.

[FN62]. Final Rule, *supra* note 46. See also Regulation S-K, 17 C.F.R. § 229.401(h)(3) (2005).

[FN63]. Final Rule, *supra* note 46; Regulation S-K, 17 C.F.R. § 229.401(h)(3) (2005).

[FN64]. Final Rule, *supra* note 46.

[FN65]. New York Stock Exchange Section 303A Corporate Governance Rules 11 (Nov. 3, 2004), available at http://www.nyse.com/pdfs/section303A_final_rules.pdf (last visited Nov. 7, 2005); AMEX Company Guide § 121B.(2)(a)(ii) (2005), available at <http://wallstreet.cch.com/AmericanStockExchangeAMEX/AmexCompanyGuide> (last visited Nov. 7, 2005); Nasdaq Corporate Governance Summary of Rule Changes 3 (Nov. 2003), available at <http://www.nasdaq.com/about/CorpGovSummary.pdf> (last visited Nov. 7, 2005); See *supra* notes 18-24 and accompanying text.

[FN66]. Proposed Rule, *supra* note 41.

[FN67]. *Id.*

[FN68]. *Id.*

[FN69]. Final Rule, *supra* note 46; Regulation S-K, 17 C.F.R. § 229.401(h)(4) (2005). The “safe harbor” characterization is a bit of a misnomer. The so-called safe harbors in the Final Rule are simply pronouncements by the SEC that the financial expert is protected from any special liabilities and responsibilities by virtue of the designation. In other words, the financial expert need not take any particular action to find his or her way to the safe harbor. The financial expert is essentially born in the safe harbor.

[FN70]. Final Rule, *supra* note 46.

[FN71]. Securities Act of 1933, 15 U.S.C. § 77k (2004).

[FN72]. *Id.* This portion of the safe harbor makes sense, because no member of the audit committee is charged with actual preparation of the financial statements. Audit committee members serve merely in an oversight role. AM. LAW INST, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.05 (1994).

[FN73]. Final Rule, *supra* note 46; Regulation S-K, 17 C.F.R. § 229.401(h)(4) (2005).

[FN74]. Final Rule, *supra* note 46; Regulation S-K, 17 C.F.R. § 229.401(h)(4) (2005).

[FN75]. See *infra* Parts III and IV.

[FN76]. The study described in this Part is based on company SEC filings found on the SEC's web site (www.sec.gov)

between June 21, 2005, and July 6, 2005. In most cases, those filings represented data for the calendar year 2004, but many companies with non-standard fiscal years have not yet filed proxy statements and annual reports in 2005. For those companies, the data represents only a portion of calendar year 2004, depending on the company's fiscal year end. The companies used in the study were members of the respective indices as of the dates set forth in notes 7 through 10, *supra*.

[FN77]. *See supra* note 7.

[FN78]. *See supra* note 8.

[FN79]. *See supra* note 9. An effort was made to include companies in the Russell 2000 Index with a variety of market capitalizations and from a variety of industries. The 50 companies selected from the Russell 2000 Index are: 1-800 Flowers.com; Alaska Air Group; Aquila; Bluegreen; Boston Beer Company; Carmike Cinemas; Chiquita Brands International; Cooper Tire & Rubber; Ditech Communications; Discovery Laboratories; East West Bancorp; Elizabeth Arden; Federal Signal; Frontier Oil; Getty Realty; Guess; Haverty Furniture; Imation; Ivillage; Joy Global; Kirby; Lexar Media; Mapics; Medcath; Mesa Air Group; Movado Group; Netratings; OpLink Communications; Panera Bread; Playboy Enterprises; Reader's Digest Association; Ryan's Restaurant Group; Scholastic; Sharper Image; South Jersey Industries; Sunoco; Teledyne Technologies; Titan Corporation; Trustmark Corporation; Tupperware; United Rentals; Unova; ValueClick; Vital Signs; Vitesse Semiconductor; Werner Enterprises; Winnebago Industries; Yankee Candle Company; and Zale.

[FN80]. *See supra* note 10. An effort was made to include companies in the Russell Microcap Index with a variety of market capitalizations and from a variety of industries. The 50 companies selected from the Russell Microcap Index are: Aceto; Agilisys; Anworth Mortgage Asset; Beasley Broadcast Group; Blair; Blue Nile; Buffalo Wild Wings; Candies; Carrier Access; Ciber; Craftmade International; Cyberguard; Dusa Pharmaceuticals; EFC Bancorp; Evergreen Solar; EZ-Corp; Farmer Bros.; Five Star Quality Care; Gehl; Goodrich Petroleum; Harris & Harris Group; Huron Consulting Group; Illumina; International Aluminum; Kentucky First Federal; Krispy Kreme Doughnut; Ladish; Lasercard; Magma Design Automation; MarineMax; Micromuse; National Beverage; Netbank; Nexstar Broadcasting; Omega Protein; Packeteer; PC Mall; Peregrine Pharmaceuticals; Radiation Therapy Services; Retail Ventures; SEMCO Energy; Smith & Wesson Holdings; Sport Chalet; Steinway Musical Instruments; Sykes Enterprises; Tipperary; Topps; Utah Medical Products; Vitria Technology; and Yak Communications.

[FN81]. Two companies are in both the Dow and the Nasdaq 100: Home Depot and United Technologies.

[FN82]. Market capitalization data is from <http://finance.yahoo.com> (last visited June 21, 2005).

[FN83]. The largest company in the Dow is General Electric, at \$384.3 billion, while the smallest is General Motors, at \$20.3 billion.

[FN84]. The largest company in the Nasdaq 100 is Cisco Systems, at \$126.7 billion, and the smallest is Level 3 Communications, at \$1.5 billion.

[FN85]. The largest of the fifty companies selected from the Russell 2000 is Sunoco, at \$7.9 billion, and the smallest is Sharper Image, at \$200 million. The market capitalization of Mapics is not included in the Russell 2000 market capitalization figure because Mapics was acquired and taken private during the study, and thus had no public market capitalization as of June 21, 2005.

[FN86]. Market capitalization data is from <http://finance.yahoo.com> (visited on June 21, 2005). The largest of the fifty

companies selected from the Russell Microcap is Radiation Therapy Services, at \$620 million, and the smallest is PC Mall, at \$50 million.

[FN87]. *See infra* notes 91-103 and accompanying text.

[FN88]. *See infra* notes 106-119 and accompanying text.

[FN89]. *See infra* notes 120-126 and accompanying text.

[FN90]. *See infra* notes 127-132 and accompanying text.

[FN91]. *See supra* notes 49, 51-65 and accompanying text.

[FN92]. Sarbanes-Oxley Act of 2002, [Pub. L. No. 107-204, § 407, 116 Stat. 790](#) (codified in scattered sections of 11, 15, 18, 28 & 29 U.S.C.); Final Rule, *supra* note 46; Regulation S-K, [17 C.F.R. § 229.401\(h\)\(1\) \(2005\)](#).

[FN93]. This finding is consistent with a survey conducted by Governance Metrics International, a corporate governance research firm, which found 95% of 1,157 U.S. companies surveyed had a financial expert on the audit committee. New York Stock Exchange, *Good Governance Tied to Performance*, THE EXCHANGE 5 (Vol. 11, No. 11) (Nov. 2004), at <http://www.nyse.com/pdfs/xnlvllnll.pdf>.

[FN94]. Network Appliance and Yak Communications provided no reason for failing to designate a financial expert. In fact, they do not mention financial experts at all. *See infra* notes 98-99. Molex and Topps clearly made the decision that investors would not shy away from those companies for failing to designate a financial expert.

[FN95]. Molex Corporation, Schedule 14A Definitive Proxy Statement (filed Sep. 15, 2004) (data obtained using the SEC's "Edgar Search System," at <http://www.sec.gov/edgar/searchedgar/companysearch.html>).

[FN96]. Topps Inc., Schedule 14A Definitive Proxy Statement (filed Jun. 13, 2005) (data obtained using the SEC's "Edgar Search System," at <http://www.sec.gov/edgar/searchedgar/companysearch.html>).

[FN97]. Regulation S-K, [17 C.F.R. § 229.401\(h\)\(1\)\(iii\) \(2005\)](#).

[FN98]. Network Appliance, Schedule 14A Definitive Proxy Statement (filed Jul. 15, 2004); Yak Communications, Schedule 14A Definitive Proxy Statement (filed Nov. 15, 2004) (data obtained using the SEC's "Edgar Search System," at <http://www.sec.gov/edgar/searchedgar/companysearch.html>).

[FN99]. *Id.* Yak has two former public company chief financial officers. Network Appliance has only one returning audit committee member, but he is a certified public accountant.

[FN100]. *See supra* notes 49, 51-65 and accompanying text.

[FN101]. *See supra* note 93 and accompanying text. This calculation assumes that Network Appliance and Yak Communications will designate a financial expert in their 2005 proxy statements since they each have audit committee members who clearly qualify under the Final Rule's definition.

[FN102]. Only seven of the forty-eight Russell Microcap companies with a financial expert designated more than one.

[FN103]. It is not uncommon for a company to state in its filings that it has "at least one audit committee financial ex-

pert” but then designate only one. *See, e.g.*, Xilinx, Schedule 14A Definitive Proxy Statement (filed Jun. 1, 2005) (data obtained using the SEC's “Edgar Search System,” at <http://www.sec.gov/edgar/searchedgar/companysearch.html>). In some cases, use of such language is simply mimicking the SEC rule and the company does not appear to have more than one audit committee member who qualifies. In other cases, the use of such language may indicate a reluctance to name more than one, since only one is required to be disclosed.

[FN104]. Data excludes Home Depot and United Technologies, which are also members of the Dow.

[FN105]. Final Rule, *supra* note 46.

[FN106]. *See, e.g.*, Steinway Musical Instruments, Schedule 14A Definitive Proxy Statement (filed Apr. 25, 2005) (data obtained using the SEC's “Edgar Search System,” at <http://www.sec.gov/edgar/searchedgar/companysearch.html>).

[FN107]. Schedule 14A, Item 7(b) says the annual proxy statement must include the disclosure required by Item 401 of Regulation S-K, which includes the director's business experience during the last five years. Schedule 14A, 17 C.F.R. § 240.14a-101, Item 7(b) (2005); Regulation S-K, 17 C.F.R. § 229.401(e). “What is required is information relating to the level of his professional competence....” Regulation S-K, 17 C.F.R. § 229.401(e) (2005).

[FN108]. Regulation S-K, 17 C.F.R. § 229.401(e) (2005).

[FN109]. Some of the financial experts qualify under more than one category of experiences or education. A frequent combination is the CFO/CPA qualification. The table lists the ten most common qualifications from the company filings, but more than thirty different categories were compiled in the study for financial experts at the subject companies. Everything from consultants and general business experience, to professors of chemistry and engineering, to former SEC commissioners and a former Deputy Secretary of Agriculture are included.

[FN110]. The determination of whether a company is a public company or private company was made using Internet research using <http://www.google.com> (searches conducted from June 21, 2005 through July 12, 2005). It is possible that a company was public at the time of a director's relevant experience, but not a public company at the time of the search; and vice versa.

[FN111]. *Id.*

[FN112]. *Id.*

[FN113]. As a rule, the MBAs on this list are from well-recognized institutions of higher education. In addition, nearly all of the financial experts with an MBA had other relevant experience that qualified them as a financial expert. It is questionable whether a bare MBA alone could satisfy the Final Rule's requirements.

[FN114]. As a rule, the lawyers are from large well-recognized law firms in major metropolitan areas.

[FN115]. The majority of directors in the investment banker category were investment bankers, but seven were executive directors or managing directors of investment banks. In this category, there is some variation in the size of the investment banking firms.

[FN116]. *See supra* note 110.

[FN117]. *See supra* note 110.

[FN118]. Proposed Rule, *supra* note 41.

[FN119]. *Id.*

[FN120]. Disclosure Required By Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177, Exchange Act Release No. 47,235, 79 SEC Docket 1077 (January 23, 2003).

[FN121]. Regulation S-K, 17 C.F.R. § 401(h)(4) (2005).

[FN122]. Based upon the author's experience as a corporate lawyer for eight years at a national law firm.

[FN123]. *See supra* text accompanying note 73.

[FN124]. Comverse Technology, Inc., Schedule 14A Definitive Proxy Statement (filed May 9, 2005) (data obtained using the SEC's "Edgar Search System," at <http://www.sec.gov/edgar/searchedgar/companysearch.html>). Interestingly, Comverse did not include a disclaimer in its proxy statement for the prior year, although it did designate an audit committee financial expert. Comverse Technology, Schedule 14A Definitive Proxy Statement (filed May 3, 2004).

[FN125]. SBC Communications, Inc., Schedule 14A Definitive Proxy Statement (filed Mar. 11, 2005) (data obtained using the SEC's "Edgar Search System," at <http://www.sec.gov/edgar/searchedgar/companysearch.html>).

[FN126]. *Id.*

[FN127]. Linear Technology, Inc., a Nasdaq 100 company, pays its financial expert an \$115,000 annual fee. Linear Technology, Schedule 14A Definitive Proxy Statement (filed Sep. 24, 2004) (data obtained using the SEC's "Edgar Search System," at <http://www.sec.gov/edgar/searchedgar/companysearch.html>).

[FN128]. Krispy Kreme Doughnuts, Inc., a Russell Microcap company, discloses that its audit committee chairperson is paid more because he is also a financial expert. Krispy Kreme Doughnuts, Schedule 14A Definitive Proxy Statement (filed Apr. 26, 2004) (data obtained using the SEC's "Edgar Search System," at <http://www.sec.gov/edgar/searchedgar/companysearch.html>).

[FN129]. For purposes of the study, compensation ignores the value of options granted to directors but includes annual stock-based compensation when the stock award is based on a specified dollar amount. Nearly every company grants options to directors, but the value of such awards varies with the company and the timing of the grant. Also, the study focused on directors who were not serving as chair of the board, because the chair of the board sometimes receives additional compensation for chairing the board. In addition, companies often pay a fee for attending board meetings and committee meetings. For simplicity of calculation, the figures in this article assume the board committees, other than the audit committee, meet four times a year, which is the most common frequency. The figures in this article assume the audit committee meets eight times a year, which seems to be the most common frequency among the companies studied, although there is significant variation. For instance, the audit committee of Adobe Systems met twenty times in 2004. Adobe Systems Inc., Schedule 14A Definitive Proxy Statement (filed Mar. 14, 2005) (information obtained using the SEC's "Edgar Search System," at <http://www.sec.gov/edgar/searchedgar/companysearch.html>). The figures further assume that all committee meetings are on the same day as regular board meetings and that all meetings are attended in person.

[FN130]. In the study, 171 of the companies had their financial expert serving as chair. Forty-one companies had a chair who was not designated the financial expert. Twelve companies did not report sufficient information about the audit

committee to make a determination about who was chairing the committee. The remaining four did not designate a financial expert.

[FN131]. It is interesting to note that ordinary audit committee members receive approximately the same fees as the compensation committee chair. In large measure this is due to per-meeting fees and the fact that the audit committee typically meets at least twice as often as other committees, which allows the audit committee members to “catch up” their compensation to that of the compensation committee chair.

[FN132]. See Adobe Systems, Inc., *supra* note 129.

[FN133]. The median market capitalization of the 25 companies that designated all of their audit committee members as financial experts was \$6.2 billion. The median market capitalization of the 199 other companies with a financial expert, other than Mapics (for which a market capitalization could not be computed as of June 21, 2005) was \$3.5 billion. Market capitalization data is as of June 21, 2005 from <http://finance.yahoo.com> (last visited June 21, 2005).

[FN134]. Proposed Rule, *supra* note 41.

[FN135]. See *supra* notes 49-50 and accompanying text.

[FN136]. *Id.*

[FN137]. See *supra* note 51 and accompanying text.

[FN138]. Final Rule, *supra* note 46. See *supra* notes 52-74 and accompanying text.

[FN139]. See *supra* note 103 and accompanying table.

[FN140]. See *supra* notes 93-103 and accompanying text.

[FN141]. See *supra* notes 106-119 and accompanying text.

[FN142]. One might argue that the real purpose of section 407 of Sarbanes-Oxley was to restore investor confidence and that illusory measures accomplish that goal just as well as real ones. False confidence tends to be short-lived, however.

[FN143]. In effect, the investor still has to simply trust the board's judgment. That is, of course, a long-standing principle of corporate governance. Investors who do not like a board's decisions, and who do not have sufficient voting power to control the board composition, may “vote with their feet” - that is, sell their shares. However, with section 407, Congress intended to give investors *additional* protection.

[FN144]. See *supra* text accompanying note 62.

[FN145]. Proposed Rule, *supra* note 41 and text accompanying note 43.

[FN146]. Proposed Rule, *supra* note 41 and text accompanying note 45.

[FN147]. Proposed Rule, *supra* note 41.

[FN148]. *Id.*

[FN149]. Proposed Rule, *supra* note 41 and text accompanying note 45.

[FN150]. Final Rule, *supra* note 46. It goes without saying that more people have analyzed and evaluated financial statements than have audited and prepared them, which is a more specialized skill.

[FN151]. *Id.*

[FN152]. Regulation S-K, 17 C.F.R. § 229.401(h)(3)(iv) (2005).

[FN153]. Regulation S-K, 17 C.F.R. § 229.401(h), Instruction 2 (2005).

[FN154]. Companies may fear disclosing the basis for the board's decision that a financial expert qualifies as such because doing so might open the board's actions to additional scrutiny by investors. That, however, is the whole concept of transparency. Besides, the board's decisions in that regard would be protected by the business judgment rule, so if there was any rational basis for determining a financial expert is qualified, there would be no breach of fiduciary duty. Books and articles too numerous to catalog here detail the operation of the business judgment rule and the policy reasons to support it. *See, e.g., DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* (5th ed. 1998).

[FN155]. Some would argue the board already is motivated to get the best qualified person as a financial expert. However, companies often prefer to do the bare minimum to meet disclosure requirements. This is particularly true if the disclosure is a single sentence swallowed by a sea of paragraphs in a fifty-page disclosure document. In addition, once the SEC took away any significant responsibility of the financial expert, beyond the responsibilities as a director and audit committee member, some of the company's incentive was taken away too.

[FN156]. None of these positions would have qualified under the Proposed Rule because they do not involve the preparation and auditing of financial statements for a reporting company. CFOs of public companies and CPAs would have qualified under the Proposed Rule, under the Final Rule, and under this article's proposed amendments. Indeed, they can be considered the most qualified in terms of experience and education.

[FN157]. This does not imply that all public company CEOs qualify under either the Final Rule definition or the amendments proposed in this article. They must meet the required attributes.

[FN158]. *See supra* note 112 and accompanying text.

[FN159]. *See supra* text accompanying note 109.

[FN160]. *Id.*

[FN161]. Proposed Rule, *supra* note 41. The actual "price" of adding a director to serve on the audit committee is about \$55,000 on average, plus stock-based compensation. For the Russell Microcap companies, the number would be closer to \$26,000. Neither is a significant expense for multi-million dollar companies.

[FN162]. *See supra* text accompanying note 89.

[FN163]. As noted earlier, most of the audit committee chairs for the subject companies have been designated financial experts. Most audit committee chairs receive greater fee compensation than other board and committee members. However, the filings indicate audit committee chairs are more highly compensated because of the additional responsibilities associated with chairing the most prominent board committee, as opposed to their frequent coterminous designation as financial experts.

[FN164]. AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.05 (1994).

[FN165]. Investors also want the financial expert to have sufficient incentive to actually use the experience that qualifies the person for the role in the first place. State law often protects directors from personal liability for fiduciary duty claims, and most companies have directors and officers insurance. Accordingly, liability may not be a motivating factor in director decision making and oversight. However, even if the financial expert would not ultimately be out-of-pocket for damages, she might find herself embroiled in a greater number of lawsuits. The intangibles-personal loss of reputation, bad press, litigation costs to the company, potential adverse effect on stock price, time extended and the trauma of litigation-would still serve as deterrents to poor oversight of the financial reporting process.

[FN166]. *See supra* notes 18-24 and accompanying text.

[FN167]. In fact, it may subtract, since the NYSE, AMEX and NASD all say that qualifying as a financial expert under the Final Rule satisfies the financial experience requirements under their own rules. *See supra* note 65 and accompanying text.

[FN168]. The language included in the few disclaimers is illustrative. *See supra* text accompanying note 124 (“Shareholders should understand this designation is an SEC disclosure requirement ...”). To paraphrase, the SEC is making the company disclose the designation, but it has no practical effect.

[FN169]. Regulation S-K, 17 C.F.R. § 229.401(h)(4)(ii) (2005).

[FN170]. Regulation S-K, 17 C.F.R. §§ 229.401(h)(4)(i), 229.401(h)(4)(iii) (2005).

[FN171]. *See supra* note 165.

[FN172]. Regulation S-K, 17 C.F.R. § 229.401(h)(4)(ii) (2005).

[FN173]. Proposed Rule, *supra* note 41.

[FN174]. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407 (2002) (codified in scattered sections of 11, 15, 18, 28 & 29 U.S.C.).

[FN175]. Regulation S-K, 17 C.F.R. § 229.401(h)(4)(ii) (2005); *See* Maxim Integrated Products, Schedule 14A Definitive Proxy Statement (filed Oct. 18, 2004), (information obtained using the SEC's “Edgar Search System,” at <http://www.sec.gov/edgar/searchedgar/companysearch.html>).

[FN176]. Regulation S-K, 17 C.F.R. § 229.401(h)(3)(iv) (2005).
2 Hastings Bus. L.J. 165

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