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The Federalization of Corporate Law

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Corporate Governance in the Twenty-First Century

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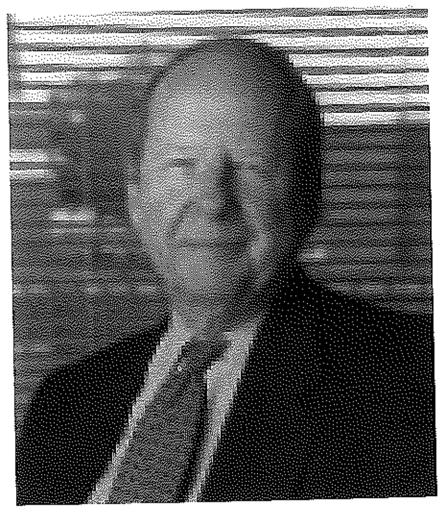

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I. Introduction

The shock of the collapse and bankruptcy of Enron Corp. in the fall of 2001 and of WorldCom, Inc. in the summer of 2002 and the scandals accompanying their demise, shared by a host of lesser players, is still with us.[1] Arthur Andersen LLP, Enron's independent auditors and one of the largest and most distinguished accounting firms in the world, was convicted in 2002 of criminal obstruction of justice in the Enron investigation by the Securities and Exchange Commission (SEC). Although the conviction was later reversed by the United States Supreme Court for error in the jury instructions,[2] this came too late to save the accounting firm, which has gone out of business in a welter of litigation. The Sarbanes-Oxley Act of 2002,[3] passed with great haste by the U.S. Congress and signed by the President in July of 2002, has been followed by an interminably long trail of final and proposed rules and regulations issued by the new Public Company Accounting Oversight Board, the SEC, and the self-regulatory organizations such as the New York Stock Exchange and the National Association of Securities Dealers.

There exists a general impression that we are experiencing an unprecedented crisis in corporate governance and that the federal government has seized control of the law of management of publicly held companies to the exclusion of the states. The truth is otherwise. The disastrous investor losses that accompanied the failures of these huge companies were the result of deliberate financial and accounting fraud, not as such a failure of corporate governance in the sense that a proper exercise of care by the company board of directors would necessarily have prevented it. The federal reforms enacted by Congress address primarily accounting and auditing controls to be put into place and monitored by corporate executives, the auditors, and the legal profession, but the law of corporate governance is still basically state law, supplemented and not replaced by the federal statute.

II. Historical Background and Perspective

Looking back on the last four decades of the Twentieth Century, we can see that each decade was marked by dramatic corporate scandals and securities market frauds, all of which share some features in common with the current crop, and the lesson to be learned from this history is that blame cannot be rested upon the corporate board of directors alone or even primarily. Furthermore, the federal government is not the obvious source of any solution to the problem; in truth, it has been a part of the problem.

In the 1960s, corporate conglomerates such as Gulf and Western Industries, Ling-Temco-Vought, and International Telephone and Telegraph were in vogue.[4] The excesses that accompanied the bull market and the tender offer merger and acquisition boom of the 1960s resulted in new federal securities legislation and culminated in the stock market crash of 1970.[5] The end of the decade saw the

1. For the complete story of the manipulations, deceit, and dishonesty at Enron, *see* Mimi Swartz with Sherron Watkins, Power Failure (2003); Bethany McLean & Peter Elkind, The Smartest Guys in the Room (2003). For the WorldCom story, *see* Lynne W. Jeter, Disconnected: Deceit and Betrayal at WorldCom (2003).

2. Arthur Andersen LLP v. United States, 125 S. Ct. 823 (2005). For the inside story at Arthur Andersen, written by a former partner at the firm, *see* Barbara Ley Toffler, Final Accounting (2003).

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

4. For a history of the era, *see* John Brooks, The Go-Go Years (1973). For an introduction to Bernard Cornfeld and Investors Overseas Services, one of the most colorful scandals of the era, *see* Charles Raw, Bruce Page & Godfrey Hodgson, Do You Sincerely Want to be Rich? (1971).

5. Over-the-counter securities were added to the Securities Exchange Act of 1934 by the Securities Acts Amendments of 1964, Pub. L. 88-467, 78 Stat. 565 (codified at 15 U.S.C. § 78*l*(g)). Federal regulation of tender offers and takeovers was put in place by adoption of the Williams Act in 1968, Pub. L. No. 90-

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criminal conviction of auditors from Lybrand, Ross Bros. & Montgomery, independent auditors for Continental Vending Machine Corporation,[6] and from Peat, Marwick, Mitchell & Co., independent auditors for the National Student Marketing Corporation.[7] The Council of the American Law Institute began work on a proposed Federal Securities Code in 1969.[8]

The decade of the 1970s was overshadowed by the resignation in 1974 of Richard M. Nixon, the President of the United States, amid the Watergate investigations.[9] However, there was no shortage of corporate scandals, such as the Equity Funding fraud[10] and the continued abuse of Investors Overseas Services by Robert L. Vesco.[11] Most dramatic was the procession of corporate confessions by hundreds of U.S. companies of improper or "sensitive" payments to domestic and foreign governments and politicians that led to the enactment of the federal Foreign Corrupt Practices Act of 1977.[12] There were cries for increased federal control of large public companies,[13] and the American Law Institute began its Corporate Governance Project in 1975.[14]

The 1980s witnessed an excess of criminal behavior and federal enforcement actions in the securities markets and the merger and acquisition field that led to the bankruptcy of Drexel, Burnham, Lambert, Inc. and the jailings of Ivan Boeskey and Michael Milken, among others.[15] In response, Congress enacted the Insider Trading Sanctions Act of 1984[16] and the Insider Trading and Securities Fraud Enforcement Act of 1988.[17] At the same time, a series of failures in the thrift industry led to a huge federal bailout of depositors and the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.[18]

The 1990s began with the collapse of the Bank of Credit and Commerce International in 1991[19] and the exposure of illegal manipulation of the government bond market by Salomon Brothers in the same year.[20] Congress addressed what it apparently saw as an excess of securities fraud litigation in the Private Securities Litigation Reform Act of 1995[21] and the Securities Litigation Uniform Standards Act of 1998.[22] Limited preemption of state securities laws was enacted in the National Securities Markets Improvement Act of 1996.[23] Throughout the decade there was a series of financial frauds and failures, including those at Waste Management, Cendant Corporation, Sunbeam Corporation, and Lucent Technologies, that might have provided an indication of more of the same to come, if anyone had been paying attention.[24]

It would not be reasonable to expect that all financial frauds involve essentially the same scam. Quite the contrary, frequently one of the hallmarks of a fraud is that no one can quite understand how the scheme works, but at least in the early stages, it demonstrably does work.[25] This was certainly true of the famed South Sea Bubble in England in 1720[26] and the Mississippi Company of John Law in France the same year.[27] Charles Ponzi, for example, in 1920 was quite willing to explain his business plan for making huge sums by arbitrage in international postal coupons, but no one could quite

5. *(Continued from previous page)*

439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), n(d)-(f)). Insolvency of numerous brokerage firms caused Congress to pass the Securities Investor Protection Act of 1970, codified as amended at 15 U.S.C. §§ 78aaa-78*lll*), which established the Securities Investor Protection Corporation, 15 U.S.C. § 78ccc.

6. *See* United States v. Simon, 425 F.2d 796 (2d Cir. 1969).

7. *See* United States v. Natelli, 527 F.2d 311 (2d Cir. 1975). For a critical view of the Big Eight auditing firms during the 1960s, *see* Abraham J. Briloff, Unaccountable Accounting (1972).

8. *See* 1 ALI Federal Securities Code XIX-XXVI (1980).

9. *See* Carl Bernstein & Bob Woodward, All the President's Men (1974).

10. *See* Raymond L. Dirks & Leonard Gross, The Great Wall Street Scandal (1974); Dirks v. Securities and Exchange Commission, 463 U.S. 646 (1983). By way of contrast, the collapse of the Penn Central Railroad in 1970 appears to have been attributable to mismanagement rather than fraud. *See* Joseph R. Daughen & Peter Binzen, The Wreck of the Penn Central (1999).

11. *See* Robert A. Hutchison, Vesco (1974).

12. Pub. L. No. 95-213, 91 Stat. 1494 [amended 1988 and 1998]. *See generally*, Don Zarin, Doing Business Under the Foreign Corrupt Practices Act (2003).

13. *See* Ralph Nader, Mark Green, & Joel Seligman, Taming the Giant Corporation (1976).

14. *See* 1 ALI Principles of Corporate Governance: Analysis and Recommendations XI-XXIV (1994).

15. *See* James B. Stewart, Den of Thieves (1992). For an account of the era at Salomon Brothers, *see* Michael Lewis, Liar's Poker (1989). For activities in the accounting profession during the 1980s, *see* Mark Stevens, The Big Six (1991).

16. Pub. L. No. 98-376, 98 Stat. 1264 (1984).

17. Pub. L. No. 100-704, 102 Stat. 4677 (1988).

18. Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified in scattered sections of 12 and 15 U.S.C.). For a history of the time, *see* Martin Mayer, The Greatest-Ever Bank Robbery (1990). For an account of the Penn Square Bank failure in 1982, *see* Mark Singer, Funny Money (1985); Phillip L. Zweig, Belly Up (1986).

19. *See* James Ring Adams & Douglas Frantz, A Full Service Bank (1992).

20. *See* Martin Mayer, Nightmare on Wall Street (1993); Norwood P. Beveridge, *Does the Corporate Director Have a Duty Always to Obey the Law?*, 45 DePaul L. Rev. 729, 759-769 (1996).

21. Pub. L. No. 104-67, 109 Stat. 737 (1995).

22. Pub. L. No. 105-353, 112 Stat. 3227 (1998).

23. Pub. L. No. 104-290, 110 Stat. 3416 (1996).

24. *See generally*, Arthur Levitt, Take on the Street (2002); Alex Berenson, The Number (2003); Frank Partnoy, Infectious Greed (2003); Joseph E. Stiglitz, The Roaring Nineties (2003). Professor Galbraith has observed that, at any given time, there are undiscovered frauds in the market which only come to light when the market turns down. "One of the uses of depression is the exposure of what auditors fail to find." John Kenneth Galbraith, The Great Crash of 1929 at 135 (1997). For example, the spectacular fraud by Nick Leeson that brought down Barings Bank in 1995 went undetected by management; *see* Judith H. Rawnsley, Total Risk (1995). In contrast, the collapse of Long-Term Capital Management in 1998 was apparently the result of hubris and miscalculation rather than fraud; *see* Roger Lowenstein, When Genius Failed (2000).

25. Professor Charles P. Kindleberger observes in his classic work Manias, Panics, and Crashes at 16 (2000):

> The object of speculation may vary widely from one mania or bubble to the next. It may involve primary products, especially those imported from afar (where the exact conditions of supply and demand are not known in detail), or goods manufactured for export to distant markets, domestic and foreign securities of various kinds, contracts to buy or sell goods or securities, land in the country or city, houses, office buildings, shopping centers, condominiums, foreign exchange. At a late stage, speculation tends to detach itself from really valuable objects and turn to delusive ones. A larger and larger group of people seeks to become rich without a real understanding of the processes involved.

For other treatments of the nature of financial frauds, *See* Charles Mackay, Extraordinary Popular Delusions and the Madness of Crowds (1841 and 1852, republished 2002); Edward Chancellor, Devil Take the Hindmost (1999).

26. *See* Malcolm Balen, The Secret History of the South Sea Bubble (2003); John Carswell, The South Sea Bubble (1960); Virginia Cowles, The Great Swindle (1960); Lewis Melville, The South Sea Bubble (1921); 3 William Robert Scott, Joint Stock Companies to 1720 at 288-360 (1910-12, republished 1995).

27. *See* Janet Gleeson, Millionaire (1999).

understand how he made money with the scheme.[28]

There have been numerous other spectacular undetected financial frauds in the nation's history, such as the exposure in 1938 of the President of McKesson & Robbins, F. Donald Coster, whose real name was Philip Musica, a twice convicted felon,[29] or the amazing exploits of the Swedish Match King, Ivar Kreuger which came to light after his suicide in Paris in 1932.[30] An examination of these and other financial frauds shows that the common elements of a corporate fraud may include the following:

- Self-dealing and manipulation by top corporate management.
- New and poorly understood financial techniques or business plan.
- Early brilliant and notorious success of the business model.
- Ineffectiveness or corruption of high government officials.
- Ineffectiveness or complicity of company accountants.
- Ineffectiveness or complicity of company Board of Directors.
- Ineffectiveness or complicity of company attorneys.

III. The Law of Corporate Governance Is State Law, Not Federal

Since the beginning of the nation's history, business corporations have been chartered primarily by the states, not by the federal government.[31] State general incorporation statutes were common by the mid-nineteenth century.[32] Since a large part of corporate law is statutory, the law has been primarily a state statute that has governed a state-created corporation.[33] Under the internal affairs doctrine, applicable state law of a corporation generally has been the state law of the state of incorporation.[34]

The federal government has chartered business corporations, notably banking and thrift institutions such as the Second Bank of the United States, which led to a United States Supreme Court holding that such powers were within the implied although not the express powers of the Congress under the Constitution.[35] The federal government also has on occasion chartered other types of corporations such as the Union Pacific Railroad.[36] For a federally-chartered corporation such as a national bank, obviously its charter is governed by federal law.[37]

While there have been over the years a number of proposals to require federal licensing or federal incorporation of large publicly-held corporations, for a variety of reasons this has never been seen as a practical or appropriate approach.[38] In light of the experience with the Union Pacific Railroad, which led to the notorious Credit Mobilier scandal in 1873, it should be obvious that federal incorporation is not a guarantee of effective corporate governance or freedom from corporate fraud.[39] This has been more recently illustrated by the furor over improper accounting by government sponsored enterprises (GSEs) such as the Federal Home Loan Mortgage Corporation.[40]

Apart from statutes, a good deal (if not most) of important corporate law is judge-made corporate common law. Until 1938, the federal courts made a good deal of corporate common law.[41] However, as every lawyer knows, the U.S. Supreme Court declared in that year that there no longer exists any general federal common law.[42] Since that time, the Supreme Court has established what may be called the Creature Doctrine, under which corporations are deemed to be creatures of state law and therefore governed by state, not federal law, with respect to their internal affairs.[43] This is

28. *See* DONALD H. DUNN, PONZI (1975).

29. *See* CHARLES KEATS, MAGNIFICENT MASQUERADE (1982).

30. *See* ROBERT SHAPLEN, KREUGER: GENIUS AND SWINDLER (1960).

31. *See* 2 JOSEPH STANCLIFFE DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 22-23 (1917).

32. *See* Edwin Merrick Dodd, American Business Corporations Until 1860 448-50 (1954).

33. During the nineteenth century, quite a number of provisions governing state-chartered corporations were also included in state constitutions. These provisions have for the most part been repealed or otherwise rendered unimportant in the Twentieth Century.

34. *See* Norwood P. Beveridge, *The Internal Affairs Doctrine: The Proper Law of a Corporation*, 44 Bus. Law. 693 (1989).

35. *See* McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819).

36. Act of Congress approved July 1, 1862, 12 Stat. 489. *See Generally* JOHN P. DAVIS, THE UNION PACIFIC RAILWAY (1894, Reprint Ed. 1973); THE HISTORY OF THE UNION PACIFIC (Marie Cahill & Lynne Piade, eds., 1989).

37. The National Bank Act is the Act of June 3, 1864, 13 Stat. 99, codified at 12 U.S.C. §§ 21-216d (2004). The Director of the Office of Thrift Supervision has statutory power to incorporate federal savings associations under the Home Owners' Loan Act, Act of June 13, 1933, 48 Stat. 128, codified as amended at 12 U.S.C. §§ 1461-1470 (2004). The Federal Home Loan Mortgage Corporation (Freddie Mac) is privately owned and listed on the New York Stock Exchange, but it is chartered by the federal government; *see* Act of July 24, 1970, 84 Stat. 451, codified at 12 U.S.C. § 1451 (2004).

38. For a sampling of the literature, *see* Symposium, *Federal Chartering of Corporations: An Introduction*, 61 Geo. L. J. 71 (1972) (asserting that state chartering has failed); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 Yale L. J. 663 (1974) (asserting a need for minimum federal standards of conduct); Joseph C. O'Mahoney, *Federal Charters To Save Free Enterprise*, 1949 Wis. L. Rev. 407 (asserting a need to prevent monopoly and excessive concentration of
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38. *(Continued from previous column)*
economic power); John W. Brabner-Smith, *Federal Incorporation of Business*, 24 Va. L. Rev. 159 (1937) (need to protect the public from abuses of corporate bigness); H. L. Wilgus, *Need of a National Incorporation Law*, 2 Mich. L. Rev. 358 (1904) (state law laxity requires federal intervention).

39. *See* Davis, *supra* note 36. The thrift crisis of the 1980s provides a more recent, but equally dramatic, example. *See supra* note 18 and accompanying text.

40. *See* Karen Richardson & Patrick Barta, *Freddie Mac Stance Sets Showdown*, Wall St. J., Dec. 15, 2003 at A5 (Office of Federal Housing Enterprise Oversight fined Freddie Mac $125 million for manipulating earnings and misleading investors); Joann S. Lublin, *Career Journal: Windfalls Are Common in Ousters Over Alleged Ethics Violations*, Wall St. J. Nov. 25, 2003 at B8 (Freddie Mac Chief Executive and finance chief left company after an internal examination found earnings manipulations).

41. During the entire nineteenth century, Justice Story's views on the corporate trust fund doctrine dominated the thinking on this subject; *see* Norwood P. Beveridge, *Does a Corporation's Board of Directors Owe a Fiduciary Duty to Its Creditors?*, 25 St. Mary's L. J. 589, 594-622 (1994) (unpaid corporate creditors can pursue distributed corporate capital in the hands of shareholders).

42. Erie R. R. v. Tompkins, 304 U. S. 64 (1938).

43. *See* Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991) (fairness of freezeout merger is not as such a matter of federal concern where alleged violations of federal law did not cause injury); Burks v. Lasker, 441 U.S. 471 (1979) (decision of special litigation committee to terminate shareholders's derivative suit alleging violation of federal law will be respected if permitted by state law); Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) (breach of fiduciary duty under state law does not give rise to federal cause of action under the securities laws).

so even where a shareholders' derivative suit is brought charging violations of federal law.[44] More importantly, the Supreme Court has also declined to create federal common law with respect to the duty of care of directors of a federally-chartered corporation, even where a federal statute established minimum standards of care for those directors.[45]

IV. The Federal Role

Of course, it is obvious that the federal government has found ways of dealing with the economic power of large corporations, through the federal antitrust laws and direct regulation by federal administrative agencies, and through the federal labor laws and tax laws, as well as extensive other social legislation. The federal securities laws, the SEC, and the self-regulatory organizations such as the New York Stock Exchange and the National Association of Securities Dealers have imposed significant regulation on the securities markets and the governance of publicly held companies. In a federal system of government, it would be unrealistic not to expect federal intervention in matters of national importance, and it is clear that the investment rights and savings of millions of public shareholders is of national importance. The question therefore is to assess the extent of intervention and threatened intervention by the federal government and its impact on state regulation of corporate governance.

There is no general agreement on the actual or appropriate extent of federal intervention. To some observers, it seems that the federal government is the chief regulator of corporate governance.[46] Others believe that the threat of federal intervention has been essential to restrain state law within healthy boundaries.[47] Some take an intermediate view.[48] Some believe that neither state law nor federal law provides any meaningful standards for director behavior.[49] The thesis of this article is that while significant federal intervention has been made into all aspects of public company financial control and reporting, the law of fiduciary duty remains primarily state law.[50]

V. The Sarbanes-Oxley Act of 2002 Covers but Does Not Preempt the Field

There is no doubt that the Sarbanes-Oxley Act (the Act or Sarbanes-Oxley) casts a wide net over all significant actors in the financial and securities market, including the public company's officers and directors, independent auditors, counsel, securities analysts, and credit rating agencies. The Act includes the provisions discussed below.

A. Regulation of Attorneys Practicing Before the SEC

Just as it appeared that the SEC had given up its long-running efforts to control the securities bar, section 307 of Sarbanes-Oxley directed the SEC to promulgate minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of issuers.[51] The SEC's proposed rules drew heavy fire from the organized bar (and the Conference of Chief Justices) for the inclusion of a provision requiring counsel to notify the SEC if a perceived violation of law reported to the company's chief legal officer or chief executive officer and board of directors was not corrected. This "noisy withdrawal" provision was not included in the final rules adopted January 23, 2003, but it was not withdrawn either. The final rules are now in effect, and they require reporting within the corporation up the ladder, but a noisy withdrawal and notice to the SEC is permitted, not required.[52] The former SEC Chairman had stated that the SEC has not decided to adopt or to withdraw the mandatory noisy withdrawal rule.[53]

B. Regulation of Independent Auditors

For the first time in history, section 101 of the Act creates a Public Company Accounting Oversight Board (Board) to oversee the audit of public companies and

44. *See* Kamen v. Kemper Financial Services, Inc., 500 U.S. 90 (1991) (state law governs the question of necessity for a demand on the board of directors as a prerequisite to bringing a shareholders' derivative suit under the Investment Company Act); *cf.* O'Melveny & Myers v. Federal Deposit Insurance Corporation, 512 U.S. 79 (1994) (state law governs the question of imputation of a corporate officer's knowledge of fraud to a federally-insured, state-chartered corporation in a malpractice suit against the corporate counsel).

45. *See* Atherton v. Federal Deposit Insurance Corporation, 519 U.S. 213 (1997) (there is no federal common law standard of care for directors of federally-chartered and federally-insured savings institutions; probably the law of the state of principal business would govern).

46. *See* Douglas M. Branson, *Enron--When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?*, 48 Will. L. Rev. 989 (2003) (Sarbanes-Oxley does violence to federalism principles); William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. Pa. L. Rev. 953 (2003) (Sarbanes-Oxley is a destabilizing influence); Mark J. Roe, *Delaware's Competition*, 117 Harv. L. Rev. 588, 644-45 (2003):

> A great deal of the corporate law that is important to the corporation is federal, not state, law. What remains with the states is the corporate law that the federal players tolerate, and what gets reversed is that which they do not. The structure of corporate law has to be a mixed federal-state one, even if Delaware never reacts (though it has). Delaware may say the words, but it gets to do so only when the federal authorities do not take away the microphone.

47. *See* Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. Corp. L. 625, 628 (2004) (only the federal government can offer an alternative regulatory scheme that can compete with Delaware).

48. *See* Robert B. Thompson and Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 Vand. L. Rev. 859, 861 (2003) (state law has been displaced by a federal law of corporate governance except in acquisitions and self-dealing transactions); Jonathan R. Macey, *A Pox On Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 Wash. U. L. Q. 329 (2003) (mandatory rules have failed since there are no effective capital market monitors); Brett H. McDonnell, *In the Wake of Corporate Reform: One Year in the Life of Sarbanes-Oxley–a Critical Review Symposium Issue*, 2004 Mich. St. L. Rev. 505 (significant but not revolutionary change is here).

49. *See* J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. Rich. L. Rev. 317, 380 (2004) (state law puts no effective restraint on management and Sarbanes- Oxley doesn't address the real problems of management self-dealing).

50. *See* Lyman P. Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 Wm. Mitchell L. Rev. 1149 (2004) (federal law will be pervasively influential but only modestly preemptive).

51. 15 U.S.C. § 7245 (2004).

52. *See* Roger C. Cramton, George M. Cohen, and Susan P. Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 Vill. L. Rev. 725 (2004) (SEC rules are too lax); Thomas Lee Hazen, *Administrative Law Controls On Attorney Practice–A Look At The Securities and Exchange Commission's Lawyer Conduct Rules*, 55 Admin. L. Rev. 323 (2003) (new rules should have a beneficial effect).

53. *See* William H. Donaldson, Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002 before the Senate Committee on Banking, Housing and Urban Affairs, September 9, 2003, item F.3., *available on* the SEC web site, www.sec.gov.

to register and discipline public accounting firms.[54] The Board is composed of five members serving staggered five year terms, two (and only two) of whom shall be certified public accountants.[55] Under section 103 of the Act, the Board has authority to establish auditing and related attestation standards, quality control standards, and ethics standards for registered public accounting firms.[56] Under sections 108 and 109 of the Act,[57] generally accepted accounting principles (as opposed to auditing standards) may continue to be set by the Financial Accounting Standards Board (FASB), an industry group, but FASB will in the future be funded by fees payable by public company issuers.

In order to ensure auditor independence, section 201 of the Act prohibits independent auditors from providing nine enumerated kinds of non-audit services, including bookkeeping, systems design, appraisal, actuarial, internal audit, management, investment banking, legal, or other services as determined by the Board. Under section 202 of the Act, other non-audit services must (with certain de minimus exceptions) be approved by the issuer's audit committee in advance.[58] Under section 203, audit partners must be rotated after five years.[59]

C. Regulation of Public Company Governance

Under section 301 of the Act, the SEC is ordered to direct the national securities exchanges and national securities associations to prohibit the listing of securities of any issuer not having an audit committee of the board of directors (committee) in compliance with the requirements of the Act.[60] These requirements include: (1) all members of the committee must be independent, defined to mean not an affiliate of the issuer or any subsidiary and not accepting any consulting or advisory or other fee other than directors' fees from the issuer; (2) the committee must establish a complaint procedure for the receipt of confidential or anonymous submissions regarding questionable accounting or auditing matters; (3) the committee must have authority to engage counsel and other advisers; and (4) the committee must have funding for the independent auditors and committee advisers.[61]

Section 302 of the Act[62] requires the SEC to issue rules mandating the principal executive officer and the principal financial officer to certify in each annual or quarterly report filed under section 13(a) or 15(d) of the Securities Exchange Act of 1934[63] a number of things, including that the report does not contain any material misstatement or omission and that it fairly presents the financial condition and results of operations of the issuer. Section 302 also requires the Chief Executive Officer and the Chief Financial Officer to certify that they have evaluated the effectiveness of the issuer's internal controls within the past ninety days and to present and disclose to the auditors and audit committee any significant deficiencies or fraud.[64] Furthermore, under section 404 of the Act, the annual report to the SEC of the issuer must have an internal control effectiveness report by management, and its assessment must be reported on by the issuer's independent auditors.[65]

There are many other provisions of the Act. Under section 303, it is unlawful for an issuer's officers or directors, or any person acting under them, to fraudulently influence, coerce, manipulate, or mislead the independent auditors.[66] Under section 304, the chief executive and chief financial officers must reimburse the issuer for any bonus or profit from the sale of securities during a period for which the financial statements are restated due to misconduct.[67] Under section 305, the SEC may seek a director or officer bar, now for "unfitness" rather than "substantial unfitness."[68] Under section 306, no director or executive officer may trade in the issuer's equity securities during any blackout period prohibiting trading by participants in the issuer's individual account retirement plans.[69] Under section 402, it is unlawful for issuers to loan money to any director or executive officer.[70]

VI. The SEC's Proposed Security Holder Director Nominations Rules

Perhaps the most controversial proposal by the SEC has been the proposed rules that would allow public shareholders of reporting companies to nominate individuals for election to the board of directors and to have those nominees included in management's proxy statement.[71] This proposal has not been adopted, but it has generated over 10,000 comment letters, which are available on the SEC's web site.

The proposal would provide that upon the happening of either of two triggering events, a more than five percent shareholder for more than two years would have the right to nominate one or more independent candidates for the board (one if eight or fewer board members, two if more than eight and less than twenty, and three if twenty or more).[72] The triggering

54. 15 U.S.C. § 7211 (2004). For a guide to the development of the accounting profession in America, *see* Gary John Previts and Barbara Dubis Merino, A History of Accountancy in the United States (1998); Mark Stevens, The Big Eight (1981).

55. 15 U.S.C. § 7211 (2004).

56. 15 U.S.C. § 7213 (2004).

57. *Id.* §§ 77s(b) and 7219 (2004).

58. *Id.* § 78j-1(i) (2004).

59. *Id.* § 78j-1(j) (2004).

60. *Id.* § 78f(m) (2004).

61. *Id.*

62. *Id.* § 7241 (2004).

63. *Id.* §§ 78m and 78o(d) (2004).

64. *Id.* § 7241 (2004).

65. *Id.* § 7262 (2004).

66. *Id.* § 7242 (2004).

67. *Id.* § 7243 (2004).

68. *Id.* §§ 78u(d)(2) & 77t(e) (2004).

69. *Id.* § 7244 (2004).

70. *Id.* § 78m(k) (2004).

71. Rel. No. 34-48626, 68 Fed.Reg. 60784 (October 23, 2003).

72. *Id.*

events would be: (1) withholding of more than thirty-five percent of the votes cast for any board nominee of management; or (2) a more than fifty percent vote by shareholders on a proposal by a more than one percent shareholder for one year to allow shareholders' nominations in management's proxy statement.[73] The American Bar Association opposed the proposed rule as beyond the SEC's authority and unwise in principle and effect.[74]

The SEC proposal on director nominations by public shareholders is not required by Sarbanes-Oxley; it was an initiative of the SEC, which split on the wisdom of its adoption. The SEC has also adopted rules requiring mutual funds to have a Chair and at least seventy-five percent of the members of the board of directors independent of the investment advisor.[75] These rules have been upheld by the Court of Appeals for the D.C. Circuit in a suit brought by the U.S. Chamber of Commerce as properly within the authority of the Commission, although the court also held that the procedure followed violated the Administrative Procedure Act.[76]

VII. Conclusion

It remains to be seen what further developments we may expect in this area of law. Congress does not appear inclined to enact further legislation, and the SEC has been divided, with changes in personnel. The federal courts, as discussed, will not be receptive to creating a parallel universe of federal corporate law to challenge the states. It appears that state law will continue to be paramount with regard to corporate governance, with the exception of some requirements under federal law, at least for the time being.

73. *Id.*

74. Comment letter of American Bar Association dated January 7, 2004 available on the SEC's web site. Professor Stephen M. Bainbridge of the UCLA School of Law filed a comment letter on December 19, 2003 with the SEC in which he opined that the SEC probably has the authority, but the proposal is a bad idea which will cost more than $100 million to implement.

75. Rel. No. IC-26520, 69 Fed. Reg. 46378 (August 2, 2004).

76. Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).