Volume 48 | Issue 4 Article 8

2003

# The Sarbanes-Oxley Act and the Reinvention of Corporate Governance

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2003]

# THE SARBANES-OXLEY ACT AND THE REINVENTION OF CORPORATE GOVERNANCE?

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THE legal study of corporate governance is parochial. Since at least Berle and Means, we have been concerned, almost exclusively, with two (and sometimes three) of the corporation's statutory constituent groups—directors and stockholders—with an occasional look at officers (typically incidental to the role of the board).[1] At the same time, we have focused our inquiry on the traditional internal laws of governance created by the various states with, of course, Delaware, the brothel of corporate law, as our principal focus.[2]

The Sarbanes-Oxley Act (the Act),[3] signed into law by President Bush in July 2002, creates the need to re-think the way we approach our study of corporate governance in two ways and has the potential (depending upon the results of, and actions taken in response to, various studies that are required to be completed under that Act during the next year) dramatically to change the way we think about, write about and teach corporate law. The Act makes three specific changes in the way we think about corporate governance: first, it brings into the realm of internal governance the gatekeepers that once stood outside the box, including auditors, analysts and lawyers.[4] Second, it significantly enhances the legal status of, and centrality of corporate governance to, the chief executive officer and the audit committee, two constituents that have received very little recognition in the law and its literature.[5] Third, both in doing this and in other respects (like the prohibition of loans to officers and certain other conflict of interest transactions), it federalizes an important dimension of the in-

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1. Corporate governance has always been interested, to some extent, in issues of compensation and managerial self-dealing, issues which only have increased in importance since the fall of Enron. *See, e.g.*, Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 784-86 (2002).

2. The laxity of Delaware law, or its significance, has long been a subject of dispute. With such shameful and disingenuous opinions as *In re Caremark Int'l*, 698 A.2d 959 (Del. Ch. 1996) and *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997), I believe the matter can no longer be in dispute.

3. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002). The Act itself is largely codified in the Securities Exchange Act of 1934. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78 (2000).

4. *See* Sarbanes-Oxley Act §§ 201, 307, 501 (regulating conduct of auditors, lawyers and analysts).

5. *See id.* §§ 202, 301-02 (holding audit committees and chief executive officers responsible for corporation's various financial statements to public).

ternal laws of corporate governance, creating a new (albeit arguably narrow) duty of care for the CEO and audit committee and reintroducing serious prohibitions on conflict of interest transactions that have eroded to nothingness in the hands of the Delaware judiciary and legislature.[6]

In addition to these potential effects of the Act, it does something that could, in the long run, have much greater significance for the health of American business and our economy. As I have discussed elsewhere, the principal causes of the corporate scandals of 2002 and the accompanying collapse in the stock market can be traced to the development over several decades of an investing and managing ethic that favors short-term increases in stock prices over the long-run profitability and well-being of corporations.[7] While the seemingly endless discussion in the government, the press and academia have not seemed to focus on short-termism,[8] nor is there any evidence yet that investment and managerial norms have changed in this respect as a result of the crisis, it remains the most complete and cogent explanation of an era in which managing earnings, often to the brink of fraud and sometimes crossing that line, and the domination of finance over management, became the characteristics of our business life.

The Act has the potential to reverse this trend. Through its various requirements, largely implemented already by SEC regulations (with a few others proposed and in the comment stage), the Act has the potential to make any attempts to manage earnings entirely transparent to the investment community.[9] In particular, some of the Act's requirements that may affect management of earnings are: (1) the certification of senior executives that financial statements "fairly present" the financial condition of their corporations and the SEC's regulatory addition to the Act of an emphasis on cash flows; (2) the regulatory requirements that issuers explain financial information provided in non-GAAP format (that means, of course, pro forma financial statements projecting earnings);[10] and (3) the required discussion and tabular presentation of off-balance sheet financing and contingent liabilities related thereto in the MD&A portion of issuers' SEC filings. The effect of exposing those attempts (which may have

6. *See id.* § 206 (addressing conflicts of interest transactions).

7. *See* LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 4-7 (2001).

8. *But see* THE CONFERENCE BOARD, COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE (2003) (recognizing short-termism as a significant problem.)

9. Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Release No. 33,8182, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,821 (Jan. 28, 2003).

10. *See Coke to End Forecasting of Earnings*, N.Y. TIMES, Dec. 14, 2002, at C2 (reporting that some companies—notably Warren Buffett corporations Coke, Gillette and The Washington Post—have already announced that they will no longer issue quarterly or annual earnings projections). This represents at least one important acknowledgement, from our premier value-investor, that short-termism is at the root of the problem. *Cf. id.*

been evident to professional analysts who, as we have seen and the Act recognizes, were themselves part of the problem) makes clear to the entire investing public the true financial picture of the corporation, regardless of managements' attempts to conceal less-than-stellar earnings behind a veil of complex financial and accounting mechanisms.[11] As a result, the Act may well succeed in making the practice of managing earnings a fruitless exercise. No longer will anybody—from individual investor to institutional investor to sophisticated analyst—be able to claim they were fooled.[12]

In addition, if the Act succeeds in making disclosure, especially financial disclosure, sufficiently transparent for the average investor easily to understand, it may also have the salubrious effect of encouraging individuals to become investors rather than traders. To this end, the Act may induce them actually to read a corporation's 10K prior to making (and holding) an investment, instead of treating market prices as the expression of actual value—prices driven not only by shady disclosure practices and analysts' hype, but also by short-term trading and managing mentalities.

If the Act achieves these goals, it has the potential to reverse a trend that has been pronounced in American business over the last thirty years or so—the dominance of finance over management.[13] While there are many reasons to complain about the lackluster performance of American corporations in the era of managerialism of the 1950s and 1960s, with its accompanying excesses of economically irrational and managerially unwieldy conglomeration, the basic goal of managing business was not in doubt.[14] Since that time, the rise and dominance of finance has forced corporate business management to take a back seat to corporate finance, with the result that the business of business is managing finance, driven by the stock market, reversing the presumably more rational (and economically sound) strategy of allowing the stock market to reflect business—its sales, its profits, its cash flows, its investments and its future prospects.[15] To the extent that exposure under the Act limits, if not destroys, the utility

11. The SEC's emphasis in the adopted and proposed regulations on cash flows is particular evidence of this.

12. Except, of course, in cases of fraud and deliberate noncompliance, which always remain distinct possibilities.

13. *See* OFFICE OF EDUC. RES. & IMPROVEMENT, U.S. DEP'T OF EDUC., DIGEST OF EDUC. 304-15 (2002); DIV. OF EDUC. STATS., U.S. DEP'T OF HEALTH, EDUC. & WELFARE 70 (1962).

14. One of the best descriptions of the excesses of this era remains the depiction of the ITT managers' meeting in RALPH NADER ET AL., TAMING THE GIANT CORPORATION 76-77 (1976).

15. This is not to suggest that managers did not care about stock price in the age of managerialism. Rather, it is to suggest that stock price was seen as a consequence of management, not the goal of management. Notably, over the past decade, stock subject to managerial stock options has come to represent approximately fifteen percent of market capitalization, an undoubtedly strong inducement to managers to focus on their corporation's stock prices. *See* MITCHELL,

of the tools of financial manipulation, corporate managers will find themselves once again required to attend to business. To the extent that rising stock prices are desired, they will have to come from increased profitability, not financial manipulation.[16]

In Part I, I set the background of the traditional roles of the gatekeepers now to be brought within the gates.[17] Part II explains how the Act and the regulations link up these gatekeepers with aspects of corporate governance traditionally treated as internal to the corporation and their potential effects on corporate governance. The message is that it is finally time for scholars of corporate governance to look inside the corporate box, not just at the structure, in order to understand and evaluate the important linkages between outside parties, corporate structure and actual corporate behavior.[18] Part III concludes with a more detailed examination of the ways in which the Act has the potential to defeat the hegemony of finance over business and, in the process, reverse the ethic of stock price short-termism to long-run business management, as well as the ways in which this not only will benefit corporations and their shareholders but their constellation of constituents as well.[19]

These insights are necessarily speculative. The Act is new. Regulations are in the process of being adopted. We have hardly begun to sort through the various causes of the corporate crisis of 2002. Moreover, corporate managers, investment bankers, accountants and lawyers have shown themselves to be enormously adept at evading the substance of regulation even as they may comply with its form. In the absence of detailed regulation and vigorous enforcement, the Act could turn out to be so much sound and fury signifying nothing. I therefore present these observations in the spirit of suggesting what the Sarbanes-Oxley Act can be at its best.[20] Whether in practice it achieves these results remains to be seen.

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*supra* note 7, at 223 (noting that stock option incentive plans have made many executives rich).

16. This is also one of the clear implications of President Bush's recently enacted proposal to eliminate the tax on corporate dividends. It is far more difficult to manufacture cash than it is to manufacture stock price. While I have reservations about the proposal, it is consistent with the idea in the Act that businesses should be run for business (and thus increasing profits), not speculators.

17. For a further discussion on the traditional functions of auditors, lawyers and analysts compared to their current responsibilities and functions, see *infra* notes 21-40 and accompanying text.

18. For a further discussion on the new role of corporate governance, see *infra* notes 41-94 and accompanying text. I earlier suggested the importance of this endeavor in Lawrence E. Mitchell, *Trust and Team Production in Post-Capitalist Society*, 24 J. CORP. L. 869, 877 (1999).

19. For a further discussion of how the Act may force firms to focus on long-term business management and the associated beneficial impact of such, see *infra* notes 95-121 and accompanying text.

20. In this respect I suppose I adopt something of the posture of Ronald Dworkin's Hercules, albeit in a regulatory context, telling the best story of the law that can be told in light of our collective interests and traditions. *See* RONALD

## I. THE FOXES IN THE HENHOUSE

The traditional function of the gatekeepers of our corporate system—auditors, lawyers and analysts—was to stand outside the corporate structure and evaluate, from the perspective of their respective expertise, the financial condition, legal conduct and business prospects of the corporation. Each of these gatekeepers had, and continues to have, a different relationship with the corporation than the others. Auditors, for example, have been charged with an independent role in verifying the corporation's financial reporting compliance with generally accepted accounting principles.[21] Lawyers, consistent with their professional obligations, are more closely identified with the corporation, its secrets and interests, appearing in the public interest only indirectly to help keep the corporation's behavior within the boundaries of the law and, rarely, directly in the case of major corporate criminal behavior.[22] Both of these gatekeepers are compensated by the corporation for their services, although in the case of the auditor that fact has always created some conflict in the auditor's independence and leaves it subject to pressure by the audited corporation.[23] Analysts have no direct relationship to the corporation, serving instead as their clients the brokerage houses for which they work and, indirectly, the commission-paying clients of those houses who rely upon the analysts' independent financial and business evaluations of the corporation's health and prospects in making investment decisions.[24]

Each of these gatekeepers has, of course, its own body of regulation with which it must comply. That of the accounting industry is, perhaps, most Byzantine. The accounting profession has been, until the Act, an entirely self-regulating one—except to the extent that the SEC has disciplinary jurisdiction over accountants practicing before it and the statutory authority to set substantive accounting rules (as to which it typically defers to the accounting profession). Auditing standards have been generally promulgated by the Accounting Standards Board of the American Institute of Certified Public Accountants (AICPA); auditing rules and princi-

DWORKIN, LAW'S EMPIRE 397-99 (1986). Those approaching these issues with a more cynical perspective could, quite reasonably, have different insights.

21. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 204(k)(2), 116 Stat. 745, 733 (2002) (requiring auditors to report any alternative treatments of financial information within generally accepted accounting principles).

22. *See* Robert W. Tuttle, *The Fiduciary's Fiduciary: Legal Ethics in Fiduciary Representation*, 4 U. ILL. L. REV. 889, 917 (1994) (stating that attorney has "utmost loyalty toward the corporation").

23. I admit to having been puzzled by the hue and cry over accounting firms' consulting businesses during the crisis. While this development may have raised the numbers, it is clearly the case that accountants have always suffered from a conflict of interest between their own pocketbooks and the public interest for at least as long as we have permitted them to be paid by the corporations they were charged with publicly auditing.

24. *See* Frank Partnoy, *Barbarians as the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 525 (2001) (discussing role of analysts and their conflicts of interest).

ples by the Financial Accounting Standards Board (FASB).[25] As a result, and despite the inchoate regulatory authority of the Commission, accounting rules and standards are promulgated by accountants, and therefore subject to the influence and pressure of paying clients.[26] Policing of accounting standards is left to the accounting firms which, on a rotating basis, sample and test each others' work.

The cartelization of the accounting industry has exacerbated the potential weakness of this system. From the Big Eight firms a decade ago (itself a small number) we are, with the demise of Arthur Andersen following its federal conviction for obstruction of justice in the Enron case, down to the Big Four. The effect of this is, obviously, to leave these gatekeepers themselves unguarded, a dangerous proposition in light of the financial incentives to serve the wills of the audited corporations rather than to maintain their independence.

Lawyers are in a somewhat different position. As I noted earlier, their job is not to protect the public interest, at least not directly, but to protect the interest of the corporation. While lawyers, like industry, can lobby Congress and state legislatures, the rules they apply are the output of the legislative process and, even recognizing the insights of public choice theory, less manipulable by lawyers for their clients' interests than are the accounting rules and standards. To the extent the creation of these laws is manipulable, they are theoretically more likely to be manipulated by lawyers in the interests of their corporate clients than against them.

But here is the rust in the hinges of the gate kept by lawyers. While we know, and while ethics rules recognize, that the corporate lawyer's client is the corporation, and it is the interests of the corporate body the lawyer is obligated to represent, we also know (and especially those of us that have practiced corporate law know) that the interest of the corporation is expressed by a body of humans: the board of directors. But even that expression of corporate interest is more exceptional than typical, occurring only in the cases of major corporate decisions and transactions which are, by definition, infrequent, but which are the grist for the corporate lawyer's daily practice.

As a practical matter, the lawyers handling a corporation's problems, whether in-house or outside counsel, are likely to take their orders (and thus the expression of corporate interest) from a variety of human beings, ranging from the chief executive officer to, in the case of lower level in-

25. *See* Jack Friedman, *Chapter 11 Financial Reporting Rules for Debtors: The Impact on Creditors, Shareholders, New Investors, and the Bar*, 9 BANKR. DEV. J. 257, 258 (1992) (discussing how AICPA promulgated new rules for financial reporting by companies); *see also* RALPH ESTES, DICTIONARY OF ACCOUNTING 60 (2d ed. 1985) (showing how regulations come partly from widely followed accounting literature and practices).

26. This has been true ever since we determined that auditors would be paid by their clients, despite the recent public focus on accounting firms providing consulting services and the additional conflicts that practice creates.

house counsel, middle-level managers. While each in their respective capacities, and subject to the levels of authority granted to them, these actors speak for the corporation, they all also have their own self-interests to pursue, self-interests regulated in part by the traditional state rules of corporate law. The problem, of course, is that while the lawyer is conscious of his role as representing the corporation's interest, it is also the case (as any practicing lawyer knows) that it becomes easy to identify with an individual or individuals representing that client. Thus, it is easy for those individuals to rationalize the reconciliation of corporate interest and their own interest, and it is often difficult, except in the most blatant of cases, for the lawyer to determine where one ends and the other begins—and even more so to challenge the individual when the lawyer believes that the orders he is given serve the individual's interest at the expense of the corporation.[27]

Lawyers also self-regulate through state supreme courts and bar associations, subject to the individual states' rules of professional responsibility. (The Commission also has disciplinary power over lawyers practicing before it who violate its rules.)[28] Those rules, mired in a tradition of fiduciary loyalty to clients' interests, are far less subject to manipulative pressure than accountants' rules because they are, for the most part and unlike the accountants' rules, designed to align the lawyers' behavior with the clients' interests.[29] But this, too, presents a problem. To the extent that lawyers come to identify with the individuals with whom they daily deal, instead of the intangible corporation they are bound to represent, they too are subjected to tangible and psychological pressures to conform their advice and behavior to the interests of those individuals.[30] Thus another aspect of our gatekeeper system, while not quite the Maginot Line presented by the regulatory structure of the accounting profession is, at a minimum, seriously weakened.

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27. The SEC has, in attorney conduct rules under the Act, taken the opportunity to lecture corporate lawyers on this issue. *See* Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 33,8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823 (Jan. 29, 2003); *see also* Lawrence E. Mitchell, *Professional Responsibility and the Close Corporation: Toward a Realistic Ethic*, 74 CORNELL L. REV. 466, 476-81 (1989) (illustrating exaggerated way in which this problem is manifested in close corporations).

28. *See* SEC Rules of Practice, 17 C.F.R. § 201.102(e) (2003); *In re* Carter, 47 S.E.C. 471, 472 (1981); *In re* Keating, 47 S.E.C. 95, 95 (1979).

29. *See* Tuttle, *supra* note 22, at 895-900 (arguing that lawyers who serve clients in fiduciary roles serve their clients' interests by understanding those interests in light of fiduciary functions lawyers serve).

30. For example, attorneys at Vinson & Elkins were significantly involved in crafting Special Purpose Entities (SPEs) for Enron. Under this structure, "independent" investors, who were sometimes high-ranking Enron executives, would maintain equity investment in the SPE to at least three percent of the SPE's total assets so that Enron could claim it did not exercise control over the SPE. Therefore, Enron would not have to record the debt as its own or write-down the assets if they became impaired. *See* Jeremy Kahn, *Off Balance Sheet—And Out of Control*, FORTUNE, Feb. 4, 2002.

The third major barrier is the community of securities analysts.[31] Unlike accountants and lawyers, analysts are neither retained by nor paid by the corporation.[32] In fact, they choose or are assigned the corporations on which they focus. But they serve an important gate-keeping function for all that.

Analysts are hired by brokerage firms to analyze the financial past, present and future of each of the corporations they follow, compare their assessments with the market price of their respective stock, evaluate the quality of that corporation as an investment, and provide that information to their firms' brokers who, in consideration of the commissions charged to investors in trades, will recommend investments based on the analysts' conclusions.[33] While analysts are financially trained in a manner that is usually superior to that of the average client, their work is nothing that the client could not do himself or herself if he or she had the time. The analysts' principal value lies in saving the investor that time, thus allowing the investor more broadly to diversify the investor's portfolio. Analysts also, as a practical matter and because of their access to company officials, can obtain soft information that otherwise would not be available to the average investor. In that respect, the analyst is capable of giving a more nuanced assessment of the investment merits of a particular corporation than even well-trained average investors willing to put in the time.

But the analysts' importance goes well beyond providing advice to their firms' clients. As the central players in the financial analysis of corporate America in an age of diversification, they are the actors best situated to evaluate the veracity of a corporation's public information as well as the actors who, by position and training, ought to be the first line of skepticism. As recent events have shown, in those respects they have dismally failed.

Analysts are not a self-regulating profession.[34] They, or at least the brokers they serve, are subject to the broker-dealer rules promulgated by the Commission, and to the rules of the various stock exchanges. They are also regulated by the National Association of Securities Dealers, whose rules are designed to prevent bad practices like churning accounts, at the same time as they work to encourage analysts (and the brokers who use their information) to, at a relatively low level of intensity, work in the cli-

31. One could talk sensibly here about the rating agencies as well, but since corporate governance has not traditionally focused on creditors, nor is it likely to any time soon, to do so would be off point.

32. *See* Employment Dev. Dept., Labor Mkt. Info.: Cal. Occupational Guide Number 260: Investment Analysis (1995), *at* http://www.calmis.cahwnet.gov/file/occguide/INVEST.htm (noting that investment analysts' services are used by investment brokers, banks, pension funds, insurance companies and investment banking firms).

33. *See id.*

34. *See* Joel S. Demski, *Corporate Conflicts of Interest* 19-23, *at* http://bear.cba.ufl.edu/demski/PDFJUNK/conflict3.pdf.

ents' interests.[35] Nonetheless, analysts are subject to pressures and perverse incentives of their own. In the first place, to the extent that they are rewarded with valuable, nonpublic information (soft information, that is, not the material information that would be the subject of insider trading), they have incentives to keep their corporate contacts happy which, presumably, means recommending stock.[36] Moreover, to the extent that their compensation is dependent upon the success of the brokerage firm for which they work, analysts have an incentive to ensure that brokers are able to generate commissions, and thus to ensure a steady flow of information that justifies stock trading.[37] Third, as has become a central act in the corporate follies of 2002, to the extent that they work for firms that also do investment banking, they have incentives to say nice things about corporations that might become investment banking clients of their firms and thus enrich them.[38] In the face of these pressures, the relatively weak rules that regulate analysts clash with their financial incentives and further weaken the gates our legal and financial systems have erected to keep corporations honest.[39]

Students of corporate governance have not traditionally treated any of these three groups as relevant to their subject of study, the relationship among boards, officers and stockholders. To the extent they intersect with corporate governance issues in the context of securities regulation, which itself has largely been treated as peripheral to corporate governance, lawyers and accountants in particular have received some attention, but not much. The Sarbanes-Oxley Act changes that. By directly connecting the functions of these gatekeepers to the traditional corporate governance machinery (and by creating the potential for even further connections), it compels us to recognize these actors as centrally involved in the processes of corporate governance. And by creating (or authorizing the creation of) substantive rules to govern their outputs and behavior, it serves not only to alter the ways in which we look at the corporation but also to strengthen the relatively weak rules state law provides to regulate corporate governance, much in the way that an earlier generation of reformist scholars hoped that the securities laws themselves would.[40]

35. *See* NATIONAL ASSOCIATION OF SECURITIES DEALERS, NASD MANUAL (2002), *available at* http://www.nasdr.com.

36. *Cf.* Demski, *supra* note 34, at 17-18.

37. *See id.*

38. *See id.*

39. Notably, the Act does not address the particular problems presented by the credit rating agencies, presumably because the corporate scandals of 2002 principally involved stock. *See* Lynn Hume, *Rating Agencies: Panel: SEC Should Draft Standards for Raters*, BOND BUYER, Oct. 8, 2002, at 5.

40. *See generally* Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); Ernest L. Folk, *Civil Liabilities Under the Federal Securities Acts: The* BarChris *Case*, 55 VA. L. REV. 1, 6 (1969); Partnoy, *supra* note 24, at 514-15. As we all know, these reformist efforts withered on the vine as the Supreme Court first narrowly interpreted the securities laws in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977) and, eventually with the aid of Congress, substantially deregulated them.

## II. BRINGING THE BARBARIANS INSIDE THE GATE

### A. *Accountants and the Federalization of Corporate Governance*

The Act connects auditors with the board and management in a way that brings them inside the corporate box. Title II of the Act gives the corporation's audit committee a substantial role in monitoring auditor independence and avoiding conflicts of interest.[41] But most interesting for the link between accounting reform and the federalization of corporate governance is the manner in which Title III, the Corporate Responsibility portion of the Act, links accounting reform with the internal affairs of the corporation.[42] A simple listing of those provisions would make this clear, but I shall indulge in somewhat more detailed discussion.

The real action lies in the way the Act specifies the duties of a corporation's board of directors. In the first place, every listed corporation is required either to have an audit committee composed solely of independent directors or to treat the board as a whole as the audit committee.[43] Two things about the corporate governance aspect of this requirement are notable. First, the Act specifies not only the composition of the audit committee but also the procedures by which the audit committee is to operate, requiring each corporation to provide "appropriate funding" for its audit committee and requiring that the audit committee establish procedures for "the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."[44] While the Act does not specify the exact procedures the audit committee is to adopt, the fact that it specifies the nature of the procedures, including the very substantive one of establishing whistle-blowing chains, goes far toward setting a standard of care that seems already to be substantially in excess of that required generally by state corporate law.

Moreover, the Act not only requires that the audit committee consist of independent directors, but it also defines the meaning of independence, a definition heretofore left to state law, and in a more rigorous way than does, for example, Delaware or New York. The Act defines "independent" as a director who may not "accept any consulting, advisory, or other compensatory fee from the issuer; or be an affiliated person of the issuer or any subsidiary thereof."[45] Both Delaware and New York, at least for some purposes (derivative suit dismissal, for example) have less stringent requirements for independence.[46] In this respect, the Act can be said to

41. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 §§ 202, 204, 206, 116 Stat. 745 (2002).

42. *See id.* § 303.

43. *See id.* § 301.

44. *Id.* § 301(m)(4)(A)-(B).

45. *Id.* § 301(m)(3)(B)i-ii.

46. *See generally* Grobow v. Perot, 539 A.2d 180 (Del. Ch. 1988).

have established a higher duty of loyalty for public corporations than currently exists under state law. At a minimum, it federalizes the definition of independent director for general purposes.

The regulations go further than does the Act.[47] Section 407 of the Act directs the Commission to adopt disclosure rules defining the term "audit committee financial expert" and requiring an issuer to disclose whether its audit committee includes a financial expert.[48] Not only does the regulation require this disclosure, but it imposes on the board the obligation to specifically identify that person or persons it has determined to meet the definition and fill the role of "audit committee financial expert."[49] In addition, the regulation goes beyond the Act in requiring disclosure of whether the audit committee financial expert is independent.[50]

The Commission's regulations have the potential to have significant impacts on corporate governance. In addition to the board and its committees, we will now have the ability to identify a new kind of director, an "audit committee financial expert" who is far more likely than not to be independent in light of the Commission's requirement that this fact be disclosed. And while the Commission is explicit in noting that the financial expert is not, by that designation alone, subject to a "higher degree of individual responsibility or obligation as a member of the audit committee,"[51] nor does such a designation constitute the financial expert an "expert" for liability purposes under Section 11 of the Securities Act of 1933, it undoubtedly is the case that the designation of a director as a financial expert will, as a psychological matter, impose upon that director a greater sense of responsibility for the corporation's financial affairs than would be the case in the absence of such designation.[52] The financial expert will undoubtedly spend far more time with the corporation's accountants as well, further bringing them inside the gate.

Finally, the fact that an identifiable person is disclosed to be the corporation's financial expert will allow investors to demand specific accountability from a member of the board (even if the regulations do not impose greater duties on that person.) This is likely to have the salubrious effect of diminishing the fractured accountability (or the ability of a director to hide in the group) that currently characterizes our corporate governance structure. This exposure is likely to lead the financial expert to be vigilant in a manner that is unusual for the average director, and will most likely (because of the financial expert's public exposure) give her greater au-

47. *See* Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 33,8177, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,818, at 86,886 (Jan. 23, 2003).

48. *See id.*

49. *See id.*

50. *See id.*

51. *See id.* ¶ 86,818, at 86,893.

52. For the moral psychological processes that lead to this result and the result described in the text following, see MITCHELL, *supra* note 7.

thority on the board. To the extent that the corporation and its accountants engage in financial shenanigans, the financial expert is the person left hanging out to dry. The effect of the Act and the proposed regulations is likely to be a substantially greater presence of accountants in the boardroom.

In addition, the highly publicized certification of the financial statements required of the chief executive officer and chief financial officer serves an important function.[53] This provision accomplishes three things in terms of reforming internal corporate governance. In the first place, it makes the audit central to the nature of care in corporate governance, linking the public auditor to the two most important officers of the corporation. Going forward, CEOs and CFOs have no choice but to work directly with auditors in evaluating financial statements and thus defining the determinants of corporate performance.

Second, it makes these non-statutory (as a state law matter) corporate actors statutorily required (as a federal matter) for publicly held corporations. In so doing, it expands upon state requirements of corporate governance as a legal matter (even if such officers already have a central place as a practical matter) and thus directs corporate governance scholars to focus more sharply on the role of these corporate actors in a way that, while familiar to management scholars, is less so to lawyers. It forces us to look inside the box we have defined as the parameters of corporate governance and, having opened that box, will almost certainly lead us to explore, in far greater detail than is yet common in the literature, the relationship among these officers, the board, and officers lower down the executive chain. One might even go so far as to say (although it is premature to say so in a strong way) that it ought to diminish our obsession with the board as the central focus of corporate governance and instead lead us to spend more time examining where the real power (and now where meaningful federal regulation) lies, the corporation's executives.

Third, Title III, by linking accounting reform with the internal affairs of a corporation, imposes on officers a substantial duty of care with respect to the corporation's financial statements which, on its face and without the benefit of judicial interpretation, seems to be significantly more stringent than that required of the board (and certainly of the officers) under state corporate law. Not only does the Act require certification of the financials, which already goes beyond state law, but it also makes these officers "responsible for establishing and maintaining internal controls; . . . design[ing] such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers; . . . [and] evaluat[ing] the effectiveness of the issuer's internal controls . . . ."[54] Moreover, it requires these officers to

53. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 302, 116 Stat. 745, 777 (2002).

54. *Id.* § 302(a)(4)(A)-(C).

disclose to the audit committee "all significant deficiencies" in the design and operation of internal controls, as well as to report any material or immaterial fraud that involves employees who have responsibilities for internal controls.[55]

The regulations under the Act take matters still further. First, as I noted above, is the virtual requirement of a designated financial expert on the board whose responsibility for the integrity of the corporation's financial condition follows as a corollary from her public identification and accountability.[56]

But it does far more. In the first place, and as will become more relevant in Part III, the Commission requires that certification not be just of compliance of the corporation's financial statements with GAAP, but include a requirement that these officers certify that the corporation's financial statements "and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer . . . ."[57] Thus, the CEO and CFO are required to represent that any financial information presented (which presumably includes pro forma financial statements not in accordance with GAAP) give a fair picture of the corporation's financial status. Moreover, while the Act does not require this certification to cover cash flows, the Commission has added this requirement as consistent with the need for fair presentation.[58] The certification responsibilities of the CEO and CFO impose upon them a greater centrality in the corporate governance process (at least with regard to finance) than the law of corporate governance now contemplates.

This is further illustrated by additional certification requirements (which meet up with disclosure requirements; that which is to be certified must also be disclosed.)[59] Among the disclosures to be made are the issuer's "disclosure controls and procedures," a new concept introduced in the regulations.[60] Disclosure controls and procedures are designed to ensure that information the issuer is required to disclose in its filings with the Commission is properly collected and processed so that disclosure occurs in a timely manner.[61] Moreover, the CEO and CFO are required to certify that they not only are responsible for designing and maintaining those controls, but that they also have evaluated their effectiveness and disclosed their evaluations.[62] With respect to the issuer's internal con-

55. *Id.* § 302(a)(5)(A).

56. *See id.* § 407.

57. Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Act Release No. 33,8124, [2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,720, at 86,128 (Aug. 28, 2002).

58. *See id.*

59. *See id.* ¶ 86,720, at 86,133.

60. *See id.*

61. *See id.* (discussing rule requirements).

62. *See id.*

trols, CFOs and CEOs must further certify that they have identified any "significant" deficiencies to the corporation's auditors and audit committee, as well as any fraud, whether or not material, involving employees who have a role in the issuer's internal controls.[63] Moreover, these reports are to be included in the issuer's Commission filings.[64] It seems clear that, at least as to the presentation of financial information and the corporation's internal processes both for SEC reporting and for auditing, these two officers have been burdened with what is, in effect, a federal duty of care.

But there is more that goes to issues traditionally thought of within the context of governance. Among the disclosures the corporation is required to make is whether it has adopted a code of ethics governing the corporation's "principal executive officer, principal financial officer, [and] principal accounting officer or controller" and an explanation, in the absence of such a code, of such absence.[65] The Act defines "code of ethics" to mean standards "reasonably necessary to promote honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; [and] full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer . . . ."[66] The Commission, in its regulations, goes beyond the Act and requires such a code to focus on senior financial officers and adds "principal executive officer."[67] Moreover, whereas the Act's definition of code of ethics is largely that presented above, the rules add that such a code also must be a "codification of standards that is reasonably designed to deter wrongdoing" and promote "avoidance of conflicts of interest" in the first place and "prompt internal reporting" of violations of the code, as well as disclosure of "accountability for adherence to the code."[68]

While the Commission (rightly, at least in form) claims that its approach to codes of ethics is consistent with the general securities law policy of disclosure, the claim is somewhat disingenuous in two respects. First is the definition of codes of ethics noted above, which clearly specifies the substance that such a code of ethics is required to address. Second (and this is the formal truth) is the fact that the requirement that such a code of ethics be disclosed and filed more or less assures that every reporting company will adopt such a code or something that is substantially similar. In

63. The Commission does not define the term "internal controls," which has a pre-existing meaning and relates to auditing standards. *See* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS CODIFICATION OF STATEMENTS ON AUDITING STANDARDS § 319 (1998) (giving meaning of term in required certification).

64. *See* Securities Act Release No. 33,8177 [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,818, at 86,895 (Jan. 23, 2003).

65. *Id.*

66. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 406(c)(1)-(2), 116 Stat. 745, 789-90 (2002).

67. *See* Securities Act Release No. 33,8177, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,818, at 86,895 (Jan. 23, 2003).

68. *Id.*

these respects, and given the fairly rigorous substantive requirements of the code (standards "preventing" conflicts of interest), the Act and regulations rather clearly impart substantive governing principles into the corporation, and indeed, when added to the certification requirement, seem to establish a rather rigorous federal duty of care.

Compare what the Act does in this respect to the incredibly weak system of corporate monitoring approved by the Delaware Chancery Court in that most disingenuous of opinions, *In re Caremark*.[69] In that case, Chancellor Allen gave a great deal of lip service to Delaware's standards of supervision and the extent to which they were met by Caremark's cosmetic policies in a case in which it was obvious, to the even marginally sophisticated observer, that Caremark's compensation system and management structure were set up in every way possible to create incentives for employees to disregard the Anti-Referral Payment Law and defraud the Medicare program.[70] The Act actually creates serious incentives for executives to ensure that an effective internal monitoring standard exists.[71] The teeth behind the Act are that it makes the CEO and CFO subject not only to securities law violations, but also to disgorgement of potentially substantial portions of their compensation, if they fail to fulfill those standards. Thus is a federal duty of care clearly introduced by the Act, tied in large measure to the motivating ideal of accounting reform.

The Act also provides its own duty of loyalty rules which are far more stringent than the flabby rules that dominate state law. Section 402 severely restricts the circumstances under which corporations can make loans to insiders such that only loans of a certain type and under standards made in the ordinary course of business by that corporation (which, for the most part, means credit card companies, banks and brokerage houses) are permitted.[72] This is something that responsible state corporate governance should already have dealt with. After all, the only "fair" basis upon which loans can truly be said to be made to insiders are those as to which the interest rate is equal to the corporation's average rate of return on its business projects. Of course this is often not the case. To the extent that such loans are, as they clearly are, a form of compensation, the fact that such compensation is made in the form of loans makes it more difficult for stockholders to value. State law disclosure requirements as to such loans are, at best, insipid.

Again, we can look to one of the more disingenuous opinions of the Delaware Chancery Court, Chancellor Allen's opinion in *Lewis v. Vogelstein*,[73] for confirmation. There the issue was disclosure of an admittedly

69. 698 A.2d 959 (Del. Ch. 1996).

70. *See generally id.* (holding directors of Caremark did not breach duty to monitor and supervise enterprise).

71. *See* Sarbanes-Oxley Act § 404 (discussing "Management Assessment of Internal Controls").

72. *See id.* § 402 (discussing "Enhanced Conflict of Interest Provisions").

73. 699 A.2d 327 (Del. Ch. 1997).

difficult to value grant of stock options. The Chancellor, noting that the options were not susceptible to valuation under the commonly used Black-Scholes model, concluded that no disclosure was required.[74] According to the Chancellor, disclosure might, after all, mislead or confuse stockholders.[75] But unmentioned in the opinion is a simple fact that the Chancellor had to have known: the directors who were the recipients of those options had some opinion as to their value. How could they not? After all, nobody accepts an offer of compensation without some clear sense of what it is worth. Nonetheless, the Chancellor did not require the directors' own estimates (clearly material information) to be disclosed to the stockholders. Moreover, there is another indication that the directors had to have had some sense of the value of the options. Surely to approve compensation in amounts that were indeterminable would be uninformed compensation and thus, without such knowledge (or at least opinion), the directors would have been unable to satisfy even Delaware's minimal requirements of the business judgment rule. The Act dispenses with such nonsense by, at least in the case of publicly held corporations, supplanting substantive state law rules with federal rules of internal corporate governance.

### B. *Lawyers*

The next category of gatekeeper brought by the Act within the corporate governance system is the lawyer, and the Act potentially radically changes the lawyer's role. Not surprisingly, this has proven to be perhaps the most controversial portion of the Act. The Commission implicitly acknowledges this in its proposed release, which is highly defensive and as much constitutes a brief in support of Congress's and the Commission's position as it is an explication of the rules.[76] Not surprisingly, the Commission backed off its initial position in the final rules.

The Act makes the lawyer, in a meaningful way, a coordinate constituent of the corporate governance process. The Commission follows this conception of the lawyer as a coordinate part of the corporate governance machinery rather explicitly: "Attorneys . . . play an important and expanding role in the internal processes and governance of issuers . . . ."[77]

Section 307 of the Act requires the Commission to issue rules setting forth the duties of lawyers in this regard, and the rules that it contemplates will create a whistle blowing role for lawyers or, to put the matter perhaps a bit more modestly, a monitoring role for lawyers that requires them to

74. *See id.* at 329 (holding no obligation for directors to disclose value of future options).

75. *See id.* at 330 n.5 (discussing possibility of misleading disclosures).

76. *See* Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 33,8150, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,802 (Jan 29, 2003). To characterize at least portions of the release as defensive in tone is likely a bit of an understatement.

77. *See id.* ¶ 86,824, at 87,113.

police corporate misconduct. This provision does so by requiring lawyers to report various kinds of malfeasance to the corporation's general counsel or CEO and, failing satisfactory action by the reportee, lawyers must report this evidence to the audit committee of the board or an independent board.[78] The Commission has also proposed the addition of lawyers' obligations to engage in "noisy withdrawals" in the event that an unsatisfactory response is forthcoming.[79] Thus, the Act brings within the governance structure an actor almost wholly ignored in corporate governance scholarship—the outside counsel.

But the way in which the Act does this is striking and has significant implications for the federalization of corporate law. Not only are lawyers required to "rat out" material violations of the securities laws by the corporation or its agents, they are also required to report "breaches of fiduciary duty or similar violation[s]," violations which the Supreme Court has told us in no uncertain terms are the exclusive province of state law and have no business in federal securities legislation.[80] Well, now they do. The Commission defines "breach of fiduciary duty" as "any breach of fiduciary or similar duty recognized under an applicable federal or state statute or at common law," including, but not limited to, misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions."[81] In creating this requirement, the Act not only makes the lawyer a central actor in the monitoring function of corporate governance with which we, as a profession, have been centrally concerned, but it also links that role directly to state substantive law. The potential either is for better corporate governance through an additional monitoring organ or, as I fear in my more cynical moments, a further watering-down of state law fiduciary duty to protect corporate lawyers, especially in their counseling role.

The implications are more significant than even these very significant effects might appear at first blush. For while lawyers have always counseled corporate clients with respect to fiduciary obligations, as instruments of the corporation's interest informed by boards and officers, the lawyer is frequently asked to counsel action and design transactions in ways that may come close to fiduciary breaches (and, sometimes, arguably are fiduciary breaches.)[82] This is likely to be changed by the Act, or at least the incentives for changed behavior and more finely conscientious counseling

78. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 307, 116 Stat. 745, 784 (2002) (discussing rules of professional responsibility).

79. *See* Securities Act Release No. 33,8186, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,824, at 87,114.

80. Santa Fe Indus. v. Green, 430 U.S. 462, 496 (1977).

81. Securities Act Release No. 33,8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 87,077.

82. It is of course the latitude of fiduciary law that creates the gray areas in which such counseling can occur. I do not by this statement mean to suggest that lawyers generally and knowingly counsel corporations or their boards or officers to violate their clear fiduciary obligations.

are clear.[83] For now the lawyer is obligated to report breaches of fiduciary obligation, and is subject to Commission sanctions for failing to do so. With their own liability and professional well-being on the line, it seems reasonable to expect that lawyers will be less aggressive in fiduciary counseling than they might have been—that is, less aggressive in counseling close to the line—and certainly more likely to see breaches of fiduciary obligation where they might have been overlooked before.[84]

At the same time that the Act and the Commission appear to have taken an aggressive position toward attorneys' whistle-blowing obligations, at least to the extent the Act includes breaches of fiduciary duty within its contemplation, the Commission has attempted to temper the potentially freezing effect the rules will have on client counseling.[85] In its release announcing the proposed rule on the matter, the Commission disavowed any attempt to destroy the "consultative process" between lawyer and client.[86] It stated that the reporting duty does not apply where the law is "unsettled" as to a particular course of action, which seems vaguely problematic if the Act is to be meaningful in this respect, since the outcome of fiduciary cases is highly fact dependent, and it is arguable that many fiduciary breaches occur under circumstances where the application of the law to the facts is "unsettled."[87] This language does not appear in the release adopting the final rule, creating some ambiguity as to its strength. The final rule adopts an objective standard, relying largely on the lawyer's judgment, as to when a violation must be reported "that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.") But the Commission backs off even further. It notes in the release announcing the proposed rule that even where the proposed course of action has been held illegal in other jurisdictions, no reporting duty arises unless it has been held illegal in the issuer's jurisdiction.[88] Even if the officer informs the lawyer that the officer intends to pursue a course of action held illegal in the issuer's jurisdiction, no reporting obligation

83. *See* Tuttle, *supra* note 22, at 937.

84. *See id.*

85. It would not be a huge surprise to see a substantial increase in legal fees by corporate firms to cover their increased risk of discipline by the Commission for violation of the new rules. In addition, while one would not expect to see it from this particular Supreme Court, one could imagine a future court implying a private right of action against attorneys under Section 307 of the Sarbanes-Oxley Act. *See* Lawrence E. Mitchell, *No Business Like No Business*, *in* THE REHNQUIST COURT 227-28 (Herman Schwartz ed., 2002).

86. *See* Securities Act Release No. 33,8150, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 86,532 (Nov. 21, 2002).

87. *Id.*

88. *See* Securities Act Release No. 33,8150, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,802, at 86,532 (Nov. 21, 2002).If we are dealing with fiduciary matters of a public corporation, the issuer's jurisdiction is more likely than not to be Delaware, in which precious little conduct is held illegal as a fiduciary matter.

arises until the officer *actually* engages in the action.[89] After all, as the Commission notes, the officer could always change its mind.[90] Thus, it appears, at least as to fiduciary reporting, that the Commission tried its best to back off the Act's clear requirement and diminish the role of the lawyer as an instrument of corporate governance, especially where fiduciary obligation is concerned. As one who is somewhat agnostic on the requirements of section 307, I do not find this particularly bothersome. However, the language is absent from the release adopting the final rule, creating some uncertainty as to how one interprets "material violation.".[91]

### C. *Analysts*

Finally we come to a group that has traditionally been completely beyond the Pale of corporate governance—securities analysts. Just as the credit rating agencies (as to which the Act demands an efficacy study) have served bondholders by providing supposedly objective advice on the investment quality of corporate bonds, the even less visible securities analysts fed their research to brokers and clients in what one might have hoped was an effort to provide an objective assessment of the financial condition and business prospects of the companies they followed. While we now know (if we had not already suspected) that their collective performance in this endeavor was deeply flawed, we have, as a profession, relied heavily upon analysts as a major mechanism in creating the efficient securities markets we assumed we had (and which to any observer, at least outside of Hyde Park, appear now to be far less efficient than on might have thought), permitting investors to rely upon the integrity of stock prices in general and rationally diversify their portfolios without a great deal of need to perform such research functions themselves. Clearly we were wrong, as recent studies as to analysts' behavior make clear that the "sell" recommendation was, until recently, a thing of the past, and that even the "hold" recommendation was vanishingly scarce. Research, influenced by perverse incentives created by the combination in single firms of the brokerage function and the investment banking function, has instead failed in that purpose and created a market in which information is far less reliable than might have previously been thought and, therefore, by definition less efficient.[92]

The Act works to correct this in two ways. Outside of the parameters of traditional corporate governance, it requires the Commission to adopt

89. *See id.*

90. *See id.*

91. While not an expert in legal ethics, I do think that Congress reached too far, and the Commission is trying to avoid destroying the very significant differences in professional obligations between public auditors and lawyers. Because the provision was rather ill-advised, the Commission's attempted retreat, through interpretation provided in the release, is entirely understandable.

92. There is a reason why Sanford J. Bernstein and Charles Schwab have been among the most respected research departments in the industry.

rules protecting analysts from any sort of penalty or retaliation from their employers because of their recommendations and requires, as a legal matter, separation of investment banking functions from brokerage and analyst functions.[93] It also requires analysts to publicly disclose conflicts of interest.[94] These protections and rules are clearly designed to increase the objectivity of analysts' reports and, therefore, the efficiency of the market.

At the same time, however, albeit less directly than in the case of auditors and lawyers, the effect of the Act is to improve the quality of monitoring by creating legal incentives and penalties encouraging analysts to more thoroughly and carefully examine the corporations they follow, thus providing an important adjunct to boards, auditors and lawyers in corporate monitoring. While less direct and more modest in scope than the ways in which the Act interjects auditors and lawyers into the corporate governance structure, and while not providing substantive standards of reporting or performance as it does in the case of auditors, CEOs, CFOs and audit committees, the Act nonetheless imports another measure of federal law into the corporate governance structure.

What should be clear from the preceding discussion is the extent to which the Act expands, or potentially expands, the scope of corporate governance rather dramatically by directly assigning governance responsibilities to actors who previously had stood aloof from matters of governance (although their actions clearly played a role in corporate governance). At least as important, these roles are part of a new federal scheme, largely detailed and enforced by the Commission, which significantly intrudes upon, if it does not necessarily supplant (or at least not supplant completely) the role of state corporate governance law.

Thus, the Act potentially serves as a declaration that our monitoring model of corporate governance, in which we principally relied upon a weak system of monitoring by the board (governed by laws that allowed it to abrogate much of its responsibility) and the market is a failure, as demonstrated by the events of 2002. It serves, to some extent, as an assertion that the corrective lies in the federal takeover of substantive aspects of state corporate law, as well as the mandated inclusion within the governance machinery, the responsibilities of which are directed toward ensuring the integrity of the monitoring and disclosure necessary to ensure that our corporate system works effectively. While not quite the federal corporate law envisioned by Bill Cary, it has the potential to rock the preeminence of Delaware as the font of all things corporate and ensure some degree of uniformity in standards of care and loyalty in public corporations.

93. *See* Sarbanes-Oxley Act § 501(a)(1), (3).

94. *See id.* § 501(b).

## III. GETTING BACK TO BUSINESS

If all the Act had the potential to accomplish was that which I have thus far described, it would be technically interesting, principally to lawyers, and disturbing to those who idealize or at least prefer the current balkanized state of our corporate law. It might improve the integrity of the system, but it is not at all clear to me that the same result could not have been accomplished by appropriately funding the Commission and the vigorous enforcement of our existing securities laws. After all, much of the really bad conduct that led to the crisis violated already existing laws, and the Act doesn't do much to address some of the conduct that was legal. Perhaps part of the problem was the environment in which those laws existed. For in a funny way, one of the things that made the Act an important tool in stemming the market's freefall in the summer of 2002 is the thirty-year deregulation of our securities markets, starting with the 1975 *Blue Chip Stamps v. Manor Drug Stores*[95] and, most dramatically if not most recently, capped-off with the so-called Private Securities Litigation Reform Act of 1995.[96]

But environment is important in another way too, and it is in this respect that the Act has the potential to accomplish its greatest good, albeit a good at which it does not appear directly to aim. The purpose of the Act, as articulated, is to restore investor confidence by shoring up the integrity of corporate governance, financial reporting and market mechanisms—an add-on, if you will, to existing securities laws. But, taken as a whole, the Act has the potential to redress, at least to some important extent, the real cause of the corporate collapse of 2002.

Short-termism in individual investing may or may not be a good thing. After all, specialists, market makers and day traders make significant profits by short-term trading, and in so doing they may help to move market prices in the "right" direction. But much—if not all—of the information these traders rely on is information about stock price movements, not information about the assets, liabilities, profits and cash flows of the corporations in whose stock they trade. The right direction for these short-term traders is determined by the simple laws of supply and demand (and therefore market psychology) rather than by corporate fundamentals. It may be that these traders move the market in the right direction, but so much depends upon how you define right direction. In any event, and regardless of how one feels about the subject, specialists and market makers at least stabilize the market by matching supply and demand. The question of value, and how it affects corporate management, is not importantly on the table.

Short-termism in individual investing may or may not be a good thing. Short-termism as the driving force of investing is, however, highly destruc-

95. 421 U.S. 723 (1975).

96. *See* MITCHELL, *supra* note 7, at 135-46; *see also* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

tive.[97] Short-term investing breeds excessive volatility and damages investor confidence in the markets. Short-term investing pressures managers to engage in short-term management, damaging the future prospects of the corporation with promiscuous layoffs, inadequate funding for research and development, environmental pollution and substandard production quality. Short-term investing drives managers to manage earnings, not business. Only by managing earnings can most corporations consistently satisfy a short-term market's demand for constantly increasing stock prices. Also, managing earnings instead of businesses in response to the short-term pressures of the market (as well as other factors like the dominance of executive stock options as a major form of compensation—sufficiently so that it now comprises approximately 15 percent of market capitalization) leads managers to mislead investors, sometimes, as we have recently seen, crossing over the line into gross illegality.[98]

The Act does not address this problem, or at least not directly. But in certain provisions of the Act, and even more apparently in the regulations, one can see the tools necessary—if not sufficient—to reverse the short-term managerial ethic.[99] For in the statute and rules are the seeds of the destruction of the utility of managing earnings. If managing earnings can no longer serve the purpose of misleading investors, then the incentive to manage earnings will disappear. As a result, we could well see managers return to the economically and socially important task of managing businesses rather than stock prices.

There are a number of places where these tools are introduced. These include the Commission's rules requiring the clear explanation of non-GAAP financial information (which means pro forma financial statements which means earnings projections),[100] rules governing the clear explanation, disclosure, tabular presentation and discussion in the issuer's MD&A of off-balance sheet financing,[101] CEO and CFO certification of financial statements, with the Commission's added emphasis on cash flows as well as their additional requirement that these officers certify as to the general fairness of the corporation's financial presentation, and not simply the GAAP presentation.[102] Taken together, these provisions and regu-

97. *See* MITCHELL, *supra* note 7, at 4-11 (developing this argument in detail); *see also* Lawrence E. Mitchell, *A Critical Look at Corporate Governance,* 45 VAND. L. REV. 1263, 1283-1301 (1992) (beginning exploration of these ideas).

98. *See* MITCHELL, *supra* note 7, at 45-48, 52 (addressing some causes of development of short-term investing ethic).

99. *See id.* (describing my own solutions).

100. *See* Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 33,8176, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,816, at 86,846 (Jan. 22, 2003).

101. *See* Securities Act Release No. 33,8182, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,821, at 86,980 (Jan. 28, 2003). I am tempted to refer to this as the "Enron" release since it addresses issues raised almost exclusively among the corporate scandals in the Enron case.

102. *See* Securities Act Release No. 33,8124, [2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,720, at 86,128 (Aug. 28, 2002).

lations effectively demand that any attempt to manage earnings be clearly disclosed and that the absence of an attempt to do so be certified by the CEO and CFO. The incentive to manage earnings is destroyed—it cannot be hidden any longer. Any attempt to circumvent this incentive change exposes the corporation's CEO and CFO to liability. Without the opportunity to manage earnings, increases in stock prices can only come from real earnings, real cash. The Act and its regulations have the potential to return managers to managing businesses, rather than managing financial statements.

### A. *Pro Formas*

Earnings statements and other extra-filing communications are dealt with by Section 401 of the Act and Regulation G.[103] Typically reported using "pro forma" financial information, the Commission requires instead the term "non-GAAP financial measures" to describe these reports in order to avoid confusion with the use of the term "pro forma" in Regulation S-X.[104] "Non-GAAP financial measure" is defined to mean a "numerical measure of a registrant's historical or future financial performance, financial position or cash flows" that either includes or excludes amounts that would be included or excluded in financials complying with GAAP.[105] The rule is intended to be broad enough so that compliance is required whether or not the non-GAAP financial presentation would be subject to the antifraud laws. The Regulation requires issuers using non-GAAP financial measures not only to disclose at the same time the most "comparable [financial] measure calculated and presented in accordance with GAAP," but also to present a reconciliation that is clearly understandable to investors of the differences between the GAAP measures and the non-GAAP measures.[106]

The Commission is quite clear that it is aiming directly at the practice of excluding non-recurring expenses or revenues as well as presentation of earnings in the form of earnings before interest, taxes, depreciation and amortization ("EBITDA"), which are two of the most common techniques of presenting earnings information in a way that makes earnings look better than they would be if presented in accordance with GAAP.[107] In other words, they are two of the most common ways of managing earnings. In announcing this requirement, the Commission is clearly focused on cash flows as well as earnings, an important observation because cash flows are far more difficult to obscure or misstate.[108] They are also the essence of

103. *See* Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 33,8176, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,816, at 86,831-32 (Jan. 22, 2003).

104. *See id.* ¶ 86,816, at 86,833-34.

105. *See id.* ¶ 86,816, at 86,833.

106. *Id.*

107. *See id.* ¶ 86,816, at 86,834.

108. *See id.* ¶ 86,816, at 86,835.

the value of a share of stock, that value being the cash an investor anticipates receiving from the investment.

The Commission also requires these presentations to be included in filings with the Commission, and requires the presentation, with "greater or equal" prominence, of the most comparable GAAP measure as well as statements explaining management's purpose in using non-GAAP financial statements and noting why management believes them to be useful.[109] In this respect, the regulations effectively require management to admit that it is managing earnings if that indeed is what it is trying to do.

While the rules also include changes in Form 8K and other interesting details, for purposes of this discussion the foregoing should make it clear that the Act has the potential to destroy the practice (or at least the utility of the practice) of managing earnings.

### B. *Off-Balance Sheet Financing; The Enron Rule*

As is certainly well-known by now, one of the principal ways in which Enron, Act 1 of the corporate follies of 2002, was able to deceive investors as to its fundamental value was by engaging in extensive off-balance sheet financing transactions which had the effect of both understating liabilities and overstating earnings.[110] Section 401 of the Act requires issuers to disclose off-balance sheet financing transactions as well as other arrangements, obligations and contingent obligations "that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses."[111] One would have thought the accounting rules already required such disclosure (indeed, the MD&A rules already require such disclosure), but Enron's financial statements were, if nothing else, the perfection of (perhaps) technical but hardly substantive compliance with these rules.

The Commission, in passing regulations to deal with this problem, goes beyond financial statement disclosure and directs issuers to discuss such financing techniques in detail in the MD&A section of their Commission filings.[112] The rules define off-balance sheet financing (arguably a bit more narrowly than does the Act) and determine that disclosure is necessary only when the issuer is subject to a binding agreement.[113] In another respect, the rules track regulations in terms of materiality. The rules require MD&A discussion as long as the possibility of loss is "reasonably

109. *See id.* ¶ 86,816, at 86,837.

110. Of course the fact that Enron failed properly to disclose these transactions was critical to its ability to maintain the house of cards.

111. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 406(a)(j), 116 Stat. 745, 789-90 (2002).

112. *See* Securities Act Release No. 33,8182, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,821, at 86,983 (Jan. 28, 2003).

113. *Id.* ¶ 86,821, at 86,979.

likely", the same standard as is currently required in the MD&A.[114] In this respect, the Commission backed off a more aggressive interpretation of the Act than it took in the proposed rule which would have required disclosure if the possibility of loss was "not remote".

Most important is the substance of disclosure itself. The issuer is required to discuss "the nature and business purpose of the off-balance sheet arrangements," as well as their significant terms and conditions, as long as the issuer has a direct or contingent obligation even though it may not be a party to the agreement.[115] The issuer has to disclose not only the overall magnitude of the issuer's off-balance sheet arrangements, but also specifically has to disclose revenues, expenses, cash flows, retained interests, issued securities, indebtedness and the nature and amount of any other contingent or non-contingent obligations or liabilities.[116] Here, the Commission is again expressly concerned with adequate disclosure of effects of the arrangements on a corporation's liquidity and cash flows and demands that management present a big-picture analysis of such arrangements and their effects as well as the details to the point where tabular disclosure might be required and the entire discussion is placed in a separate section of the MD&A. One could again get lost in the details of the regulations, but the details discussed so far make it perfectly clear that to the extent such rules are seriously enforced (rather than allowing the development of meaningless boilerplate as to, for example, management's reasons for using such arrangements), the utility of off-balance sheets and other similar arrangements for misleading investors as to the corporation's actual financial position (again, importantly including its cash flows) is dramatically diminished if not destroyed.

### C. *Cash, Cash, Cash*

As a final example of the ways in which the Act and regulations potentially destroy the ability of managers to mislead investors as to a corporation's fundamental values is the final rules governing CEO and CFO certification of the financial statements discussed above[117] and the accompanying disclosures required in Commission filings.[118] Two things about this certification and disclosure are particularly notable—both added by the Commission in its belief that doing so best furthers the purposes of the Act. The first is an emphasis on cash flows. This is particularly important because, as I noted earlier, cash is the only reliable measure of a corporation's worth. The 1990's bubble market should have taught all but the most evangelistic market-efficiency gurus not to rely upon market prices as

114. *Id.*

115. *See id.* ¶ 86,821, at 86,980.

116. *See id.*

117. *See* Securities Act Release No. 33,8124, [2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,720, at 86,130 (Aug. 28, 2002).

118. *See* Securities Act Release No. 33,8177, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,818, at 86,885-86 (Jan. 23, 2003).

a correct measure of value (while it remains true that at any particular moment that price is what you will get for your stock if you then sell it or what you must pay if you then buy it.) Moreover, earnings and other accounting measures are subject to accounting conventions and manipulation, although if the rules I have previously discussed are enforced, and with the (hopefully) looming presence of the new Public Oversight Board, accounting measures will become more reliable. But it is as true now as it was in 1938, when John Burr Williams penned a bit of doggerel (as well as a serious book), that the real value of stock is the cash you expect to receive from investing in it.[119]

The second is the fact that the rules require that the CEO and CFO certify that the corporation's financial statements "fairly present" its financial condition, not only in GAAP terms but in terms of common sense.[120] This latter requirement is striking, for it precludes these officers from hiding behind the financial statements, no matter how GAAP-compliant they are, and forces them to assert that the financials are meaningful (that is, in terms of the kinds of things one cares about in assessing returns to investors, like cash flows, results of operations, and the like). In effect, this certification has the effect of calling on the CEO and CFO to publicly proclaim their own belief in the "hard numbers," as it were. Again this creates a strong disincentive to manage earnings, hide liabilities, emphasize non-GAAP financial measures and generally engage in the kind of financial trickery that characterized the crises of the past year. At the same time, while their certification is conditioned by their "knowledge," there is a presumed level of due diligence expected from these officers, not only in the Commission's rules, but also in the additional fact that they are to be responsible for and must certify not only internal controls, but also disclosure controls and procedures—all of which presuppose the need to make the disclosures I have already discussed in subsections A and B above. Incentives for meaningful—not technical—integrity are thus created.

### D. *A New World of Investors*

The Commission and the Act have created an environment in which there will be little profit in managing earnings and other sorts of financial chicanery that might help to bloat stock prices in the short-term but leave the corporation wanting in the long-term. To the extent this becomes the case, we will ideally see management turn again to the management of their businesses rather than their finances. MBA students might again major in marketing, management, human resources and the like, instead of flocking to finance, and a talent pool of good old-fashioned business man-

119. *See generally* JOHN BURR WILLIAMS, THE THEORY OF INVESTMENT VALUE (1938).

120. *See* Securities Act Release No. 33,8124, [2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,720, at 86,144 (Aug. 28, 2002).

agers might grow. From the investor's standpoint, there will no longer be any excuse to say that the investor was deceived by a corporation's numbers, and, more to the point and socially beneficial, there will be relatively little profit in promiscuous short-term trading. For the way to make money from a corporation that is managed for its business rather than its finance is "the old fashioned way"—to earn it. One could dare hope for the eventual development of a new investment culture in which stockholders buy and hold for the long-term, investigating their companies and reading financial information and other disclosures prior to investing. One can hope. Whether the regulations are vigorously enforced, or whether the SEC is lax, whether institutional investors continue to exert short-term pressure on management, and whether the market's recent need for instant gratification continues, remain to be seen.[121]

121. For the effect of this pressure on short-termism, see MITCHELL, *supra* note 7, at 170-74.