Improve Corporate Governance
Protecting Investors by Strengthening Gatekeeper Roles

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Summary

Recent corporate scandals from Enron to WorldCom have focused attention on *corporate governance*–the policies and practices that determine how a corporation is operated and governed. Pension plans and other investments have turned most American voters into shareholders, with a substantial interest in improving corporate governance to prevent future scandals and losses.

To promote accountability, transparency, and compliance, corporate governance systems rely heavily on "gatekeepers"—corporate directors, in-house and outside counsel, and internal and external auditors. Had the gatekeepers of Enron, WorldCom, and similar corporations been more effective, shareholders would not have suffered the huge losses they did.

In the wake of these scandals, Congress passed the Sarbanes-Oxley Act of 2002 (SOX). Direct corporate governance provisions of the Act, such as the mandating of extensive internal controls, may be more costly than beneficial. Meanwhile, and more importantly for purposes of this paper, the Act's gatekeeper-related provisions did not go far enough.

SOX gatekeeper provisions include: (1) requiring a company's board of directors to have an Audit Committee, composed solely of independent directors and responsible for overseeing the outside auditor and establishing a system to allow employees to submit confidential information about abuses; (2) creating the Public Company

Accounting Oversight Board to regulate outside auditors; and (3) requiring attorneys to report violations of securities laws to company officials.

The following measures would appropriately strengthen the roles of gatekeepers:

- As the *ultimate* gatekeeper for the interests of shareholders, board members should be required to participate in an initial orientation about their duties , responsibilities and best practices, as well as in periodic continuing education.
- The New York Stock Exchange should codify its listing requirement that a company's compensation committee be comprised of independent directors.
- The Board's compensation committee should be required to approve the compensation of all top-tier executives.
- Shareholders should be given a greater role in voting, through nominations, election of individual candidates instead of slates, and majority instead of plurality decisions.
- The Audit Committee should obtain control over the *internal* audit function as well as over the outside auditors, including the power to terminate personnel and to approve compensation.
- The Securities and Exchange Commission (SEC) should consider requiring attorneys to pass a competency examination before being permitted to appear before it.
- The board of directors should be involved in the decision to hire, retain and compensate the general counsel.

Regulatory controls also should be enhanced. The SEC should develop an inspection program to review corporations' financial statements and accounting practices. Such a program would familiarize examiners with a company's financial statements in order to identify variances or changes in accounting treatments. This, in turn, could result in identifying potential problems at an early stage.

Further, in cases involving corporate penalties, the SEC and Department of Justice should be required to prepare an analysis for the court as to why a proposed penalty is in the best interests of shareholders. Regulators should also sanction gatekeepers who

fail to protect shareholders. This would be a departure from the regulators' failure to bring a single action against any independent director of the companies involved in the recent major scandals.

Context

Although Presidential campaigns do not rise or fall on issues of corporate governance or financial regulation and enforcement, American voters today hold so many securities—mostly through 401(k) plans and other retirement vehicles—that candidates *must* address corporate scandals and the regulatory and enforcement weaknesses they reflect.

Large numbers of voters and opinion leaders would likely respond well to positive, productive proposals to improve corporate governance, enhance regulatory effectiveness, and prevent future scandals and fiscal collapses. Conversely, uninformed or demagogic criticisms would harm our capital markets, betray insensitivity to the complexity of American capitalism, and jeopardize the integrity of the very institutions that regulate market activity and protect investors.

Corporate Failures

Starting in December 2001, a string of major corporate scandals came to light that devastated many investors. The collapse of Enron was quickly followed by highly publicized scandals at Tyco, Adelphia, and Global Crossing. Then, in June 2002, WorldCom (later MCI and now Verizon Business) disclosed that it had discovered substantial accounting irregularities, which eventually would result in adjustments to its financial statements totaling more than $11 billion and the largest bankruptcy filing ever.

> While these scandals involved different facts, schemes, and circumstances, a common theme is the breakdown of corporate governance—that is, the policies and practices that determine how a corporation is operated and governed. By promoting accountability,

transparency, and compliance, corporate governance systems protect the interests of shareholders. Corporate directors, in-house and outside counsel, and internal and external auditors design and enforce a corporation's system. Collectively, these groups serve as "gatekeepers." Had the gatekeepers of Enron, WorldCom, and the other scandal-ridden corporations been more effective, massive harm to shareholders would have been prevented or at least reduced.

Sarbanes-Oxley Act

Prior to WorldCom's announcement of its accounting problems in June 2002, the House and the Senate Banking Committee had approved different versions of corporate and accounting legislation, with prospects for a final bill in doubt. The WorldCom announcement created enormous public pressure, and Congress reacted swiftly by passing the Sarbanes-Oxley Act of 2002 ("SOX").[1] President Bush signed the measure on July 30, 2002, amid great fanfare about how it was going to improve corporate governance and reduce fraud. Many of these expectations have not been met.

SOX contains wide-ranging provisions to strengthen the corporate governance practices of U.S. corporations. Several of these requirements—most notably Section 404, which requires a review of internal controls—have been the subject of strenuous debate.[2] At issue here, though, are the sufficiency and effectiveness of only those provisions that affect the role of gatekeepers.

SOX includes several gatekeeper provisions:

- requiring a company's board of directors to have an Audit Committee composed solely of independent directors
- making the Audit Committee responsible for the appointment, compensation, and oversight of the outside auditor and for establishing procedures for the

[1] Public Company Accounting Reform and Investor Protection Act, *P.L. 107-204 (2002)*.
[2] *See, e.g.*, Robert Charles Clark, "Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too," 22 *Ga. St. U. L. Rev.* 251, 295 (2005), stating that improved internal controls may not have caught problems at Enron and WorldCom because those scandals involved "extremely aggressive or irresponsible accounting judgments, estimates, and characterizations made by people at fairly high levels in the affected organizations," and Committee on Capital Markets Regulations, *Interim Report* (November 30, 2006).

confidential, anonymous submission by company employees of concerns about accounting or auditing practices

- creating a new agency, the Public Company Accounting Oversight Board (PCAOB), to strengthen the outside audit function. The PCAOB sets standards involving auditing, quality control, ethics, and audit reports and has authority to inspect, investigate, and discipline registered public accounting firms.
- requiring attorneys who practice before the Securities and Exchange Commission (SEC) to report material violations of the securities laws to a company's chief legal officer or chief executive officer. If those officers do not respond in an appropriate manner, the attorney is then required to report the violations to the Audit Committee of the board or to another committee composed solely of independent directors.

The Aftermath of SOX

Corporate governance practices are changing rapidly in response to legislative and judicial actions. The adequacy and effectiveness of SOX are being extensively studied and debated in Congress and other forums. While SOX may have increased investor confidence, at least in the short term, ongoing compliance with its direct corporate governance requirements has proved extremely expensive for some companies, and it is unclear whether the legislation's overall benefits have outweighed its total costs.

In addition to the legislative developments, the judiciary and other government entities have also altered the corporate governance landscape. For example, the recent Supreme Court term was extremely favorable for business interests.[3] Further, corporations are organized under state law, and many state attorneys general, including former Attorney General (now Governor) Eliot Spitzer of New York, have aggressively and publicly pursued corporate wrongdoing. Meanwhile, the primary corporate regulator is the Securities and Exchange Commission (SEC), which also has been active in redesigning the landscape.

[3] In the 2006-7 term of the U.S. Supreme Court, the U.S. Chamber of Commerce filed a friend of the court brief in 15 cases. The Court issued opinions that agreed with the Chamber's position in 13 of these cases, the highest success percentage for the Chamber in 30 years. *Business Week*, "The Supreme Court: Open for Business" (July 9, 2007).

Strengthen Gatekeeper Roles

While SOX sought to fortify the roles of gatekeepers, further reforms are necessary to improve the functions of boards of directors, auditors, and counsel.

Boards of Directors

Boards now have an expanded role and are subject to increased scrutiny, regulatory attention, and legal requirements. Serving on a corporate board has become more complex and demanding.

As the *ultimate* gatekeeper for the interests of shareholders, board members should be held to a very high standard. Other gatekeepers, such as lawyers and accountants, are licensed and subject to various continuing education requirements. Although we are far from requiring formal licensure of board members, they should be required to be educated about their fiduciary and oversight duties and responsibilities and trained to be effective. A mandated orientation session should include, at a minimum, a description of the relevant laws, significant court cases, ethical obligations, and best practices. In addition, board members should be required to receive annual continuing education.

Also demanding attention is compensation of senior management, an unusually high-profile and controversial issue.[4] In some of the more significant corporate frauds, senior officers' greed motivated much of the wrongdoing. In July 2006, the SEC issued new rules requiring additional disclosure about executive compensation. However, further steps should be taken to ensure that compensation is fair and appropriate:

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[4] Even President Bush has stated (in a major address to the financial community): "Government should not decide the compensation for America's corporate executives, but the salaries and bonuses of CEOs should be based on their success at improving their companies and bringing value to their shareholders. America's corporate boardrooms must step up to their responsibilities. You need to pay attention to the executive compensation packages that you approve. You need to show the world that American businesses are a model of transparency and good corporate governance." George W. Bush, *State of the Economy Report*, January 31, 2007, New York. Available at http://www.whitehouse.gov/news/releases/2007/01/20070131-1.

- First, the New York Stock Exchange should codify its listing requirement that a company's compensation committee comprise independent directors. This step would increase the integrity of executive compensation.
- Second, the compensation committee of the board should be required to review and confirm the compensation of all section 16 officers.[5] This step is not intended to replace the necessary judgment and input from senior management. However, it would provide additional independent oversight of the compensation process.

Election of directors is another topic subject to considerable current debate. Increased shareholders' rights in electing directors could provide shareholders with a greater voice in corporate governance. Many companies currently present a slate of management-chosen directors to the voting shareholders. Approval of these slates of directors is often measured by plurality voting. Allowing shareholders more flexibility in nominating candidates for directors, and in voting on individual directors and not slates, could increase shareholder influence in this process. Moreover, moving from plurality voting to majority voting could make management more sensitive to the interests of shareholders in nominating directors.[6]

Auditors

A company's web of audit accountability should encompass the Audit Committee of the board, outside auditors, and the internal audit department. While SOX took an important step forward by conferring on the Audit Committee control of the *outside* auditor relationship, further action is needed to increase the efficacy of the audit function in detecting corporate misbehavior.

Most important, the Audit Committee should obtain control over the *internal* audit as well, including the power to terminate personnel and to approve compensation. This step would reduce the likelihood that internal auditors would feel beholden to

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[5] Section 16 officers are essentially the executive officers of a company and are defined in Rule 16a-2 under the Securities Exchange Act of 1934.
[6] Committee on Capital Markets Regulation, *Interim Report*, at 105-106.

management. With both the outside and internal audit function under the control of an independent Audit Committee, the integrity and accuracy of financial statements would likely improve, as management would lose the power to interfere with the professional judgment of publicly regulated auditors and accountants.

Attorneys

The role of corporate counsel has changed dramatically in recent times. Historically, a general counsel's primary client was senior management and, to a lesser extent, the board. While general counsel must continue to serve these constituencies, they also now are viewed by regulators and potential litigants as a gatekeeper to the interests of a company's shareholders. For general counsel of today, serving several different interests can be rife with conflicts. As noted above, SOX created new reporting obligations for attorneys who learn of potential misbehavior. These obligations protect shareholders by ensuring that attorneys act in the best interest of the company and not certain individuals.

(Ideally, attorneys would have taken these steps even without the new statutory requirement. It is disturbing that a recent report of the New York City Bar advises against treating attorneys as gatekeepers because of the potential harm that this could have on attorney-client privilege.[7] Protecting the privilege is certainly a concern, but what would be far more troubling would be to give attorneys a pass on gatekeeper responsibilities when they occupy a unique position to prevent wrongdoing.)

An attorney's experience and training to serve as an effective corporate gatekeeper is a key issue. Rule 102(e) of the Securities Exchange Act of 1934 allows the SEC to bar an attorney from practicing before the Commission, but the SEC has no complementary procedure for *approving* attorneys as competent to practice before it. The SEC should consider requiring attorneys to pass a valid, reliable examination before being permitted to appear. Analogously, certain investment professionals face examination before being able to buy and sell securities on behalf of clients, and

[7] New York City Bar, *Report of the Task Force on the Lawyer's Role in Corporate Governance* (November 2006).

patent attorneys must submit to an examination required by the U.S. Patent and Trademark Office.

The complex role of in-house counsel in serving several interests is not reflected in the employment and compensation process, as these issues are usually determined only by the chief executive officer or other senior management. To eliminate the appearance of a conflict of interest, the board of directors, too, should be involved in the decision to hire the general counsel, as well as the final decision on attorney compensation.

Enhance Regulatory Protections

Federal and state securities regulators and self-regulatory organizations play an important and necessary role in corporate governance. They wield a broad and powerful array of sanctions, and their enforcement actions serve as a strong deterrent against wrongdoing. The SEC's enforcement priorities, reflected in public speeches by its Commissioners and staff, help shape corporate conduct.

SEC Inspections

The SEC's inspection program requires reevaluation. Very few, if any, of the issues that caused the major recent corporate scandals were uncovered by the SEC. For example, the problems at WorldCom were discovered by the company's internal audit department, which was acting on a tip from an employee that certain allegations in a newspaper article regarding company practices warranted investigation. Similarly, improper accounting practices at Enron were uncovered by an internal review that resulted in an October 2001 restatement.

The SEC (and other regulators) does have a formalized inspection program for broker-dealers and investment advisers. The SEC staff visits securities firms on a regular schedule, reviews numerous documents, conducts interviews, and issues a report with findings. The program routinely identifies issues of regulatory concerns and has prevented serious problems. In addition, the intensity of the program leads regulated

financial entities to conduct mock inspections and other self-assessments to prepare for SEC inspections.

However, the SEC does not have a similar inspection program to review the financial statements and accounting practices of public companies. Such a program could have immense benefits, including familiarizing examiners with a company's financial statements in order to identify variances or changes in accounting treatments. This, in turn, could result in identifying potential problems at an early stage.

Penalties

Sanctions are another area where regulators could enhance their corporate governance oversight. The recent corporate scandals led the SEC to ratchet up penalties significantly. SEC-imposed fines and disgorgement (repayment of ill-gotten gains) jumped five-fold in one year:

SEC TOTAL FINES AND DISGORGEMENT AMOUNTS, FY 2003-2006.

Year	Amount $
2003	350 million
2004	1.7 billion
2005	1.9 billion
2006	1.2 billion

Fines against individual companies also increased dramatically. Before SOX, the largest civil penalty levied by the SEC against a single company was $10 million (against Xerox in 2002). By contrast, the fine imposed against WorldCom was $750 million.

Although large fines against corporations are sometimes appropriate and necessary, they may not always serve as an effective deterrent. Moreover, in some cases, fines are assessed against a company long after the wrongdoers have left and new management has taken its place. In this type of situations, a large fine may harm only

uninvolved management and shareholders.[8] Due to the complicated nature of assessing penalties, regulators—including the SEC and the Department of Justice—should be required to explain why the proposed fine is in the best interests of shareholders. This analysis should be scrutinized closely by the courts when they are asked, as the final decision-maker, to impose the fine.

Regulators also should focus their attention on gatekeepers who fail to protect shareholders. Even though independent investigations identified failings by board members in some of the more notorious corporate scandals,[9] the regulators did not bring a single action against any independent director of these companies.[10] Regulators should closely examine every corporate fraud to determine whether gatekeepers met their responsibilities to investors.

Concluding Observations

The strength of U.S. capital markets is in large part due to effective corporate governance. Hastily enacted—when speed was important in signaling Washington's intention to protect shareholders from future breakdowns in corporate integrity—SOX may have added burdens and significant costs to corporate governance practices without providing a full measure of corresponding benefits.

Gatekeepers are critical in protecting the interests of shareholders. As most voters are also shareholders, Presidential candidates have ample reason to support carefully

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[8] The SEC considers two principal factors in determining penalties: the direct benefit to the corporation as a result of the violation, and the degree to which a penalty will further harm the injured shareholders. In addition to these factors, the SEC also considers the need for deterrence, the level of intent of the violator, the degree of difficulty in detecting the violation, the extent of the injury to the innocent parties, whether complicity in the violation is widespread at the corporation, remedial steps taken by the corporation, and cooperation by the company. U.S., Securities and Exchange Commission, "Statement Concerning Financial Penalties," news release, January 4, 2006. Available at http://www.sec.gov/news/press/2006-4.

[9] For example, WorldCom's Compensation Committee played a critical role in the Company's decision to lend Bernard Ebbers, the former CEO, more than $400 million. FIRST INTERIM REPORT OF DICK THORNBURGH, BANKRUPTCY COURT EXAMINER 71-81 (November 4, 2002). As these loans were collateralized with WorldCom stock, they put the Company's shareholders at risk and placed Mr. Ebbers under immense pressure to support the stock price. *Id.* at 78. Enron's internal investigation also identified failings by the Board. In particular, the Board approved and oversaw some of the problematic related-party transactions entered into by the Company. SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP., REPORT OF INVESTIGATION 148-165 (February 1, 2002).

[10] Directors did not escape without any accountability, as they were named as defendants in the numerous class and derivative actions that were filed as a result of the corporate scandals.

designed proposals to strengthen our corporate governance systems by enhancing gatekeeper roles.

About the Author and the Project

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