Washington University Law Review

Volume 79
Issue 2 *Corporate Accountability*

2001

The SEC, the Audit Committee Rules, and the Marketplaces: Corporate Governance and the Future

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THE SEC, THE AUDIT COMMITTEE RULES, AND THE MARKETPLACES: CORPORATE GOVERNANCE AND THE FUTURE

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I. INTRODUCTION

The "Audit Committee Rules" (the Audit Rules) comprise an integrated set of regulations issued by the Securities Exchange Commission (the SEC), the marketplaces, and the accounting profession.[1] The genesis of the Audit Rules was a determination by the SEC that the quality of the financial data reported by companies with publicly traded securities was susceptible to distortion (intentional or otherwise) in response to the pressures of the new, increasingly volatile and demanding marketplace.[2] The SEC further determined that altering the information flow and relationships within a company and between the company and its outside auditors could minimize this potential for distortion.[3] This change focused on the Audit Committee of the Board of Directors. Several different pieces of the overall puzzle, however, had to be changed to do this: the structure and function of the Audit Committee of the Board of Directors, the applicable independence standards or the company's outside financial auditors, the relationship between the Audit Committee and the auditors, and the public disclosure of this

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∗ Professor of Law, New York University School of Law; Co-Chair, Listing & Hearing Review Council of The Nasdaq Stock Market, Inc. (NASDAQ). I chaired the Council subcommittee charged with developing recommendations to the Board of Directors of NASDAQ regarding its response to the recommendations regarding audit committee listing standing. Those recommendations ultimately resulted in the adoption of the NASDAQ rules I discuss in this paper. I would like to thank Elazar Guttman for his valuable and diligent research assistance. I also gratefully acknowledge the boundless patience and considerable insight of Sara Bloom, Associate General Counsel, NASDAQ.

1. Securities Exchange Commission (SEC) Release No. 34-42266, Fed. Sec. L. Rep. (CCH) ¶ 86,230 (1999-2000 Transfer Binder) (Dec. 22, 1999) [hereinafter Final Audit Rules Releases]. *See also* SEC Codification of Statements on Auditing Standards, AU section 380 (SAS 61); Independence Standard Board Standard No. 1, *available at* http://www.cpaindependence.org (last visited Oct. 24, 2001) (Publications/ISB Final Pronouncements/Standard No. 1); New York Stock Exchange Listed Company Manual § 303.01, *available at* http://www.nyse.com/search/search.html (last visited Sept. 29, 2001) [hereinafter NYSE Manual]; The NASDAQ Stock Market, Inc., Marketplace Rules 4200, 4310, 4320, 4460, *available at* http://secure.nasdr.com/wbs/NETbos.dll?RefShow?ref=NASD4;&xinfo=/goodbye.htm (last visited Sept. 29, 2001) [hereinafter NASDAQ Rules].

2. Arthur Levitt, "The 'Numbers Game,'" Remarks at the New York University Center for Law and Business (Sept. 28, 1998), *available at* http://www.sec.gov/news/speech/speecharchive/1998 (last visited Sept. 29, 2001) [hereinafter Levitt Speech].

3. *Id*.

information flow and review of the company's financial statements.

Financial reporting defects are not new. Like many marketplace problems, financial reporting issues change in response to market conditions. In the recent past, the securities markets have seen some quite dramatic changes: the appearance of completely new industries, increasing numbers of actively participating investors, and enhanced technology. New industries can present our financial reporting system with challenges as new standards are developed or old standards are adapted to fit new transactions and new concepts.[4]

The presence of large numbers of active, technologically capable investors and the reduced costs of securities transactions has resulted in increased market volatility.[5] Investors are now able to buy and sell a stock in moments, if not seconds, accelerating the price movements that result from new information entering the marketplace. Many investors appear to feel that once a stock starts to move lower, the risk of staying in is not worth taking in light of the ease of entry and exit. It's better to get out and get back in later. With reduced transactions costs, this increased trading activity may even appear to be economically rational.[6]

In addition, there are multiple new sources of information about companies available to the investor.[7] This increase in available information has changed investor expectations as to a company's or a stock's performance and caused extremely rapid price changes from any variation from those expectations. This "democratization" of the research and analysis

4. *See, e.g.*, Letter from Lynn E. Turner, Chief Accountant, Office of Chief Accountant, Securities and Exchange Commission, to Ms. Arleen Thomas, Vice President, Professional Standards and Services, American Institute of Certified Public Accountants, re: 2000 Audit Risk Alert to the American Institute of Certified Public Accountants, *available at* http://www.sec.gov/info/accountants/staffletters/audrsk2k.htm (last visited Oct. 24, 2001).

5. *See, e.g.*, Datek homepage, *available at* http://www.datek.com (last visited Sept. 29, 2001); etrade homepage, *available at* http://www.etrade.com (last visited Sept. 29, 2001); National Discount Brokers, *available at* http://www.ndb.com/aboutNBD/tradingfeatures/commissionschedule (last visited Sept. 29, 2001) ("With NDB's TLC—Trade at Lower Commissions Program, you can make multiple trades of the same stock, on the same side of the market, on the same day, and pay full commission only once—on the initial trade. Each additional same side same day trade costs you just $3.95.").

6. *But see, e.g.*, Ronald L. Johnson, Day Trading: An Analysis of Public Day Trading at a Retail Day Trading Firm (Aug. 9, 1999) (North American Securities Administrators Association (NASAA) Report), *available at* http://www.nasaa.org/nasaa/scripts/fu_display_list.asp?ptid=16 (last visited Sept. 29, 2001). *See also* Do Day Traders Make Money, *available at* http://investorhome.com/daytrade/profits.htm (last visited Sept. 29, 2001) (citing other relevant sources therein).

7. For example, with the effectiveness of Regulation Fair Disclosure in October 2000, see 17 C.F.R. Pts. 240, 243 and 249 (2000), *available at* http://www.sec.gov/rules/final/33-7881.htm, investors are now able to access company conference calls and webcasts previously available only to analysts and other market professionals.

function brings with it both good and bad news. Investors, on one hand, provided with access to information can and do make informed investment decisions without the need for the intervention of intermediaries and can do so almost instantaneously.

On the other hand, in this environment the pressure on public companies to conform to, if not exceed, market expectations with respect to financial performance has become intense. Marketplace punishment, if not reward, is quick and severe when a company fails to meet expectations.[8] The pressure on senior management is particularly intense, as both their personal wealth (in the form of stock performance-related compensation measures and the value of their stock options) and their jobs may be on the line.

In September 1998 Arthur Levitt, then Chairman of the SEC, gave a speech at New York University's Center for Law and Business, describing some of the financial reporting problems the SEC had been seeing as a result of the new marketplace environment, which he described generally as the "management of earnings."[9] Such management may undermine the integrity of the financial data on which the markets so heavily rely. And so the SEC decided to change the rules of the game, and the Audit Rules were the result.

II. BACKGROUND: THE SEC, THE MARKETPLACES, AND CORPORATE GOVERNANCE

The SEC has a long tradition of relying on marketplace listing standards to impose corporate governance requirements, including those involving audit committees:

> Since the early 1940s, the Commission, along with the auditing and corporate communities, has had a continuing interest in promoting effective and independent audit committees. It was, in large measure, with the Commission's encouragement, for instance, that the self-regulatory organizations first adopted audit committee requirements in the 1970s.[10]

8. Lawrence M. Fisher, Oracle Posts Earnings Growth of 31% for Latest Quarter, N.Y. TIMES, Sept. 16, 1999, at C1 ("Shares of the Oracle Corporation dropped sharply in after-hours trading this evening after the company reported first-quarter earnings that met the published consensus estimate of analysts but fell short of the whisper number.").

9. Levitt Speech, *supra* note 2. Examples of such earnings management cited by Chairman Levitt included creation of a future earnings cushion by deliberately overstating restructuring charges, the misuse of accounting techniques in connection with acquisitions, the establishment of "cookie jar reserves" to use for evening out future earnings, premature revenue recognition on a sale, improper deferral of expenses and misuse of the concept of materiality. *Id.*

10. SEC Release No. 34-41987 Fed. Sec. L. Rep. (CCH) ¶ 86,209 (1999-2000 Transfer Binder)

Indeed, Chairman Levitt invoked the informal, but powerful, influence the SEC exerts on the marketplaces in his September 1998 speech announcing the establishment of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.[11]

The SEC has utilized this technique to implement policies in fields where it either lacks direct statutory authority to regulate or where its authority is questionable.[12] This approach has sometimes been referred to as "regulation by raised eyebrow."[13] Because the SEC is not exerting its regulatory power in utilizing this approach, it does not violate limitations on its authority. However, this tactic has not been wholly free of debate.

Traditionally, the power to govern the internal affairs of corporations lies mainly with the states. Every state may enact general corporation laws that govern the formation and maintenance of an entity's corporate status. Those laws also include rules that govern the behavior of the corporate management and the rights of the shareholders. While the federal government probably has the power to create federal corporations law that would apply to corporations engaged in interstate commerce,[14] it has so far declined to do so. However, over the years, there has been substantial federal involvement in specific areas of corporate law. Although there is no federal law that deals directly with corporate governance in general, many federal statutes affect numerous aspects of corporate governance.[15]

The Securities Act of 1933 and the Securities Exchange Act of 1934, as sweeping as they were, did not federalize corporation law. The legislative history reveals that Congress had no such intent. The Conference Report to the Securities Exchange Act of 1934,[16] contains the following passage:

(Oct. 7, 1999) [hereinafter the Audit Rules Release].

11. "As part of this comprehensive effort to address earnings management, the New York Stock Exchange and the National Association of Securities Dealers have agreed to sponsor a "'blue-ribbon'" panel . . . Within the next 90 days, this distinguished group will develop a series of far-ranging recommendations intended to empower audit committees . . . ." Levitt Speech, *supra* note 2, at 7.

12. *See* Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545, 571 (1984). *See also* Patrick Moyer, *The Regulation of Corporate Law by Securities Regulators: A Comparison of Ontario and the United States*, 55 U. TORONTO FAC. L. REV. 43, 56 (1997).

13. *See* The Business Roundtable v. SEC, 905 F.2d 406, 410 (D.C. Cir. 1990) (quoting Schwartz, *supra* note 12, at 571).

14. *See* Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 801 (1994).

15. The National Bank Act, 12 U.S.C. §§ 21–216d (1988), the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (1982), and the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1982), all govern the election and make up of the board of directors in their respective industries, and stipulate other rules concerning corporate governance within those industries. While this list provides the more expansive examples, it is not conclusive.

16. H.R. REP. NO. 73-1838, at 35 (1934). *See also* S. REP. NO. 73-792, at 10 (1934) (denying that the Exchange Act authorizes SEC interference in corporate management).

> The House bill does not contain a provision corresponding to that contained in subsection (d) of section 13 of the Senate amendment providing that "nothing in this title shall be construed as authorizing the Commission to interfere with the management of the affairs of an issuer." This provision is omitted from the substitute as unnecessary, since it is not believed that the bill is open to misconstruction in that respect.[17]

However, the SEC has never read this as an absolute bar on its ability to implement policies that might affect corporate governance. The SEC long behaved as if rules promulgated in furtherance of some declared purpose of the Act were within its authority, regardless of the effect the rules had on corporate governance. While this belief went unchallenged for a long time, it was more a result of the SEC's prudential reluctance to promulgate rules that directly implicated internal corporate governance than any judicial acceptance of the position. That practice lasted until 1988, when the SEC adopted Rule 19c-4[18] which was rebuffed by the Court of Appeals for the District of Columbia.[19]

In *The Business Roundtable v. SEC*,[20] the court denied the SEC authority to prohibit the listing of classes of common stock with a reduced per share vote of common shareholders compared to a different, less widely held class. Although the reduction would have required the affected shareholders' approval, the SEC sought to discourage such actions as contrary to the welfare and best interest of public shareholders generally.[21] The SEC grounded its authority in the Exchange Act's grant of power to regulate the proxy process,[22] and in the Act's purpose of protecting investors and the public interest.[23] The court, while agreeing with the SEC's reading of the purposes of the Exchange Act, held that Rule 19c-4 went beyond the SEC's delegated authority under the Act.[24] Relying on legislative intent[25] and

17. *Id.*
18. 17 C.F.R. § 240-19c-4 (1991).
19. 905 F.2d 406 (D.C. Cir. 1990).
20. *Id.*
21. *Id*. at 411.
22. Securities Exchange Act § 14(a), 15 U.S.C. § 78n(a) (1988), which provides in pertinent part: "It shall be unlawful for any person, . . . in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit . . . any proxy." *Id.*
23. Securities Exchange Act §§ 6(b)(5), 15A(b)(6), 15 U.S.C. §§ 78f(b)(5) (1988), 78o-3(b)(6) (Supp. II 1990).
24. *Business Roundtable*, 905 F.2d at 410-12.
25. *See supra* note 4 and accompanying text.

Supreme Court precedent,[26] the court reasoned that the Act never intended to interfere with internal corporate management and that it only authorized the SEC to regulate the procedural aspects of shareholder voting.[27] Therefore, the court invalidated the Rule because it sought to regulate substantive corporate behavior by limiting what shareholders can agree on.[28]

The decision made it clear that any SEC rule must steer clear of "corporate governance as a whole."[29] However, in dictum the decision acknowledged the possibility that the marketplaces could effect such policies by creating listing requirements that directly affect corporate governance.[30]

Although listing requirements are subject to SEC review and approval, the SEC's power to disapprove them is quite limited. Individual exchanges are not considered to be functioning as regulatory bodies when dealing with issuers who request to be listed.[31] Rather, they are functioning as private entities. Individual exchanges only exert regulatory power when regulating their members, such as traders and brokers. Under those circumstances, the SEC must review and may approve such actions only if they "are related to the purposes of the Act."[32] However, in the area of listing standards, the marketplaces function as private entities, and the SEC standard of review is limited to ensuring that such actions do not interfere with the purposes of the Act.[33] This difference in the legislative standards allowed the SEC to implement its corporate governance policies by convincing the individual marketplaces to adopt them as listing requirements.[34]

Some commentators have questioned the wisdom and effectiveness of delegating implementation and enforcement of the SEC's corporate governance agenda to the marketplaces.[35] Ultimately, the only action a marketplace can take against a violator is to de-list its stock. De-listing

26. Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).

27. *Business Roundtable*, 905 F.2d at 413-14.

28. *Id.* at 415.

29. 905 F.2d at 413.

30. *Id.* at 414.

31. *Id.*

32. *Id.*

33. *Id.*

34. At least one commentator has criticized the court's adoption of a limited standard of review for listing requirements proposed by the individual exchanges. *See* Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461 (1992). The criticism stems from the court's interpretation of the statutory language and the legislative history. The court understood them as implying differing standards of review depending on whom the rule is regulating. The article argues that the legislative intent was to reign in the power of individual exchanges to regulate issuers by subjecting it to SEC approval. Once this premise is accepted the variability of the Acts terminology is insignificant. *Id.* at 1462-63.

35. *See generally* John F. Olson, *How to Really Make Audit Committee More Effective*, 54 BUS. LAW. 1097 (1999).

decreases the liquidity of the stock, by decreasing its trading volume and limiting the number of market professionals, particularly member firms of the marketplaces, who trade in it. While this hurts the issuer, the marketplaces themselves, their members, and the holders of the de-listed stock also suffer. The marketplaces compete directly and fiercely for new listings. This could create a disincentive in the marketplaces to de-list for violation of a qualitative listing standard.

The SEC's oversight responsibilities act as a brake on the marketplaces' ability to attempt to gain advantages in attracting listings by using corporate governance standards as competitive tools. In connection with the Audit Rules, the SEC made it quite clear that it expected all major markets[36] to adopt similar schemes and that these rules do not give rise to any competitive edges.[37]

The marketplaces have complex and multilayered relationships with the SEC. Even in areas where the SEC has no direct authority, like the promulgation of corporate governance rules, it is risky for a marketplace to resist strong SEC suggestions.[38] The marketplaces usually have several issues pending for the SEC at any one time, including a variety of listing proposals, trading rule changes, and disciplinary matters. While there is no overt "linking" of issues by the SEC, a marketplace is not likely to take a strong position in opposition to the SEC's "raised eyebrow," particularly when the SEC is exerting similar pressure on all the marketplaces.

The Audit Rules involved a well-orchestrated series of events. First, the SEC announced the formation of The Blue Ribbon Committee on the Effectiveness of Audit Committees (the BRC),[39] to be funded by the

36. At the time the Audit Rules were adopted, the American Stock Exchange had been acquired by the NASD and was run in conjunction with NASDAQ. The functions and governance of those markets has since been severed.

37. Arthur Levitt, Remarks Before the Conference on the Rise and Effectiveness of New Corporate Governance Standards, Federal Reserve Bank of New York, New York, N.Y. (Dec. 12, 2000) [hereinafter Levitt Governance Speech], *available at* http://www.sec.gov/news/speech/speecharchive/2000speech.shtml (last visited Sept. 29, 2001) ("The management of the New York Stock Exchange has committed that they will push hard to reinstate the time-honored, common sense rule that requires shareholder approval for plans that grant options or award stock to officers and directors, if NASDAQ does likewise. Last week NASDAQ sought input from its issuers regarding the advisability of this approach.").

38. The NYSE was more resistant to the adoption of the Audit Rules, as is reflected in the format of the listing standard they ultimately adopted. *See infra* text accompanying notes 75, 83. Several influential members of the Legal Advisory Committee to the NYSE strongly questioned the need for the Audit Rules. *See* Memorandum from Martin Lipton on Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees: Some Questions and Suggestions (Mar. 10, 1999) (on file with author); Memorandum from John F. Olson, *supra* note 37.

39. BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES, REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING

marketplaces. The BRC then issued its report, containing a series of recommendations. Most were addressed to the marketplaces and recommended changes in listing standards.[40] Some were addressed to the accounting profession. And some were addressed to the SEC itself, recommending disclosure regulations that complemented or implemented the other recommendations. Finally, the national securities markets implemented these recommendations through their listing standards.

A company that wants to have its securities traded on a national securities market must apply for listing on that market. Federal regulations require each of those markets[41] to establish standards which companies must meet in order to qualify for trading. Noncompliance with the listing standards is grounds for the delisting of securities from the relevant market.[42] For the purpose of this paper, I will limit my discussion to the New York Stock Exchange (NYSE) and The Nasdaq Stock Market, Inc. (NASDAQ).[43]

There are two general types of listing standards: quantitative and qualitative. Quantitative standards include the size and financial condition of the company, the number of shareholders of the class to be traded, the market value of the public float, and the minimum bid price of the security.[44] Qualitative standards relate largely to matters of corporate governance.[45]

The securities marketplaces have an unusual status among the regulatory institutions of this country. They are "Self-Regulatory Organizations" (SROs). This designation, included in the Securities Act of 1933,[46] elevates the marketplaces above merely private enterprises, entitled to determine their own rules and membership requirements, but includes legislative and adjudicative authority subject to SEC oversight. This quasipublic,

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THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES (1999), *available at* http://www.nasd.com/docs/textapp.pdf (last visited Sept. 29, 2001) [hereinafter BRC Report].

40. *See generally id.*

41. SEC Release No. 33-7422 Fed. Sec. L. Rep. (CCH) ¶ 85,945, ¶ 89,709 (1997 Transfer Binder) (June 10, 1977).

42. The marketplaces have established delisting processes, involving notice periods, the availability of hearings, and appellate review. *See* NASDAQ Rules, *supra* note 1, at Rules 4800-4890; NYSE Manual, *supra* note 1, § 8.

43. At the time of the Audit Rules, the American Stock Exchange (AMEX) was administered jointly with NASDAQ including the development and administration of listing standards. With respect to the other exchanges registered under the 1934 Act, no significant company's securities are listed on such exchanges that are not also listed on the NYSE, NASDAQ, or the AMEX.

44. These standards are available on http://www.nyse.com and http://www.nasd.com.

45. The qualitative rules cover the distribution of annual and interim reports, the presence of independent directors, the audit committee rules, rules regarding the holding of annual shareholders' meetings, requirements for shareholder approval of certain issuances of stock or adoption of certain stock option plans, and shareholder voting rights. *See* NASDAQ Rules, *supra* note 1, §§ 4350-51; NYSE Manual, *supra* note 1, Rule 203 & § 3.

46. 15 U.S.C. § 78d-1 (1988).

quasiprivate status has enabled the marketplaces to move where the SEC can no longer tread in the area of corporate governance.

Indeed, the marketplaces may be the only entities in this country which are able effectively to impose nationwide standards of corporate governance.[47] The SEC has been ruled out of the business, Congress has never seen fit to try, and no single state has the requisite reach.[48] This authority has never been successfully attacked.[49]

III. THE AUDIT RULES

The Audit Rules represent an essentially procedural solution to a substantive problem. This procedural solution is not a new way to approach issues of corporate governance. In the area of directors' duties of care and loyalty, the legal requirements involve the process of decisionmaking. The directors have to be informed as fully as circumstances permit, be as deliberative as circumstances permit, seek outside advice as prudently feasible, and be free of any disabling conflict of interest which would taint their objectivity. The decision must be made in good faith, in the best interests of the corporation as a whole.[50] Legal rules are poor vehicles for mandating outcomes in complex factual situations like the running of a corporation, nor are legal review mechanisms particularly suited to a substantive review of the outcome of the decisions made in that situation.

Similarly, the Audit Rules require that certain steps be taken and that certain activities systematically occur, including, for example, the annual discussion between the outside auditors and the Audit Committee regarding the company's accounting policies.[51] However, the Audit Rules add two unusual elements: setting out qualifications for directors who serve on Audit Committees, and involving the outside auditors in specific interactions with the Audit Committee through the regulation of the auditors, not the company.

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47. NYSE Manual, *supra* note 1, at Rule 312.03(c) and NASDAQ Rule, *supra* note 1, at Rule 4350(i)(1). For example, both marketplaces require an issuer to secure shareholder approval for certain stock issuances (for example, twenty percent of the outstanding shares) under circumstances where a shareholder vote is required neither as a matter of securities law nor as a matter of state corporate law.

48. Even the General Corporation Law of the State of Delaware, reaches only to corporations incorporated in that state. *See generally* DEL. CODE ANN. tit.8.

49. It has, of course, been criticized. *See, e.g.*, Michael, *supra* note 34.

50. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

51. Such review is mandated by the Audit Committee charter for the Audit Committee and by SAS 61 for the accountants.

A. The BRC Recommendations

The BRC Report contained ten recommendations. Six were recommendations for changes in the marketplace listing standards, three were directed at new SEC disclosure requirements,[52] and one recommended a change to Generally Accepted Auditing Principles.[53]

The listing standard recommendations were divided by goal. The first two were "aimed at strengthening the independent of the audit committee."[54] Recommendation One was made to the marketplaces and proposed a new definition of director "independence" for purposes of audit committee membership.[55] Recommendation Two recommended that the listing

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52. Recommendation Nine urged the SEC to require disclosure of the adoption of a charter by an audit committee, whether the committee "satisfied its responsibilities" under the charter during the previous year, a triennial disclosure of the charter itself and the adoption of a "safe harbor" from liability for these disclosures. BRC Report, *supra* note 39, at K-16. Recommendation Nine urged the SEC to require an annual letter to shareholders in the annual report and Form 10-K Annual Report from the audit committee disclosing whether or not, with respect to the prior fiscal year:

> (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments referenced in (i) above under the circumstances; (iii) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (i) and (ii) above; and (iv) the audit committee, in reliance on the review and discussions conducted with management and the outsidet auditors pursuant to (i) and (ii) above, believes that the company's financial statements are fairly presented in conformity with General Accepted Accounting Principles (GAAP) in all material respects.

Id. The BRC further recommended a "safe harbor" for these disclosures as well. *See id.* Recommendation Ten suggested that the SEC requires the review by a company's outside auditor of the quarterly reports pursuant to SAS 71 (Interim Financial Review) before the filing of Forms 10-Q and that the outside auditor be required to discuss the results of this review with the audit committee. BRC Report, *supra* note 39, at 16.

53. Recommendation Ten urged that General Accepted Auditing Principles (GAAP) require a discussion between the outside auditor and the audit committee regarding the auditor's view of the quality of the accounting principles applied by the company including a discussion of clarity and degree of aggressiveness or conservatism reflected. *Id*.

54. *Id.* at 10.

55. The Committee also recommended the following:

> [B]oth the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) adopt the following definition of the independence for purposes of service on the audit committee for listed companies . . . .
>
> Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relationships include:
>
> - A director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
> - A director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;

standards include a requirement for an audit committee composed entirely of independent directors.[56] Recommendations Three, Four, Six, and Seven were aimed at "making the audit committee more effective" by requiring an audit committee composed of at least three directors, each of whom is "'financially literate'" and at least one of whom has "accounting or related financial management expertise."[57] The recommendations further required the audit committee to adopt a charter specifying "the scope of the committee's responsibilities, and how it carries out those responsibilities" and to review the charter annually.[58] Recommendation Six urged that, as a requisite to listing, the charter specify that the authority of the audit committee derives from the board's ultimate authority as representative of the shareholders for the selection and replacement of the outside auditor.[59] The final recommendation directed to the marketplaces was to ensure, by requiring it in the charter, that the audit committee receive from the auditors a written statement of all its audit and non-audit relationships with the company. The committee would also be required to discuss these relationships with the auditors in order to assure the auditors' continuing independence and objectivity.[60]

- A director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;
- A director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments that are or have been significant to the corporation or business organization in any of the past five years;
- A director being employed as an executive of another company where any of the corporation's executives serves on that company's compensation committee.
- A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporations and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

BRC Report, *supra* note 39, at 10-11, 24.

56. *Id.* at 11-12, 25.

57. Recommendation Three, *id.* at 12.

58. Recommendation Four, *id.* at 13.

59. The charter would have to specify the following:

> [T]he outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

Recommendation Six, BRC Report, *supra* note 39, at 14.

60. Recommendation Seven, *see id*. The statement is that described in Independence Standards Board Standard 1. *See supra* note 1.

B. Scope of the Rules

The BRC Report suggested an exemption from all of its listing standard recommendations for companies with a market capitalization of less than $200 million.[61] It is difficult to understand this exemption, both in its substance and in its definition, except as a wave of the hand towards small business, in the same sense that the SEC has had to include a Small Business Impact Statement in its rules since the passage of the Small Business Regulatory Flexibility Act.

Much of the systematic data cited in the BRC report to support the need for the Rules is based on the increasing likelihood of financial fraud in small companies.[62] Despite the instances of earnings management, in large companies that Chairman Levitt discussed in his speech announcing the formation of the BRC, the structural impediments to the independence of the Audit Committee are much more prevalent in small concerns. The Committee of the Sponsoring Organizations of the Treadway Commission (COSO) Report,[63] one of the bases for these recommendations for reform, found that small companies were much more likely to have a strong, indeed overbearing, Chief Executive Officer (CEO) who dominated the outside directors.

The market capitalization cutoff was thus unrelated in any meaningful way to the problem the BRC identified in its Report. In addition, market capitalization is a variable thing. The $250 million threshold would have been at best difficult and at worst impossible to police, with companies on the edge of that number sliding into and out of the rule's coverage, at whatever interval measured. Finally, the number took no account of any existing market structure such as the quantitative listing qualifications NASDAQ had established to differentiate between its National Market and Small Cap markets or between Small Cap and the Over-The-Counter (OTC)

61. BRC Report, *supra* note 39, at 23 ("The Committee also recognizes, however, that smaller companies may have greater difficulties meeting any enhanced standard regarding independence; companies with smaller market capitalizations—so-called "small cap" companies—may have relationships with large investors that may require greater flexibility as to board and audit committee membership and composition."). In furtherance of that policy, Recommendations 1 (definition of director independence), 2 (audit committee to consist solely of independent directors) and 3 (financial literacy requirement for audit committee members) were written to apply to "listed companies with a market capitalization above $200 million." *Id.*

62. *Id.* at 2 (letter from the Chairmen).

63. Committee of Sponsoring Organizations of the Treadway Commission (COSO), Financial Fraudulent Reporting: 1987-1997, An Analysis of U.S. Public Companies (Mar. 1999) (on file with author).

Bulletin Board.[64] The enforcement problems such a line presented would have been formidable at best.

NASDAQ[65] based its threshold on the line the SEC drew when it adopted the Small Business (SB) filing system. Only those companies which file their forms as SB filers[66] can obtain any relief from the new Audit Rules. However, those companies are not completely exempt, but are instead subject only to a somewhat less burdensome set of requirements.[67]

C. The Content of the Rules and the Controversies

The Audit Rules govern the function of the Audit Committee, its composition and the qualification of its members. The function of the Audit Committee was perhaps the least controversial aspect of the recommendations. While there was objection to the requirement that each Audit Committee adopt and disclose a charter setting forth its various duties, those objections were comparatively muted. Objectors were concerned that a charter would lock the Audit Committee into taking only certain steps in a certain order, and prevent it from responding flexibly to urgent or unusual circumstances that might arise on the ground that deviation from the charter might itself expose directors to liability.[68] In its strong form, objectors saw the charter as a road map for filing a complaint against the members of the audit committee for failing to comply with the requirements it had itself established for its functioning.[69] However, the Rule did not mandate the content of the charter and various model charters addressing these concerns very quickly appeared.

The basic composition concept, that the Committee be composed solely of at least three independent directors,[70] was also by itself uncontroversial.

64. NASDAQ Rules, *supra* note 1, at Rules 4310(c), 4420 (Small Cap Market and National Market System).

65. The NYSE did not object to the BRC recommended threshold, but it is a decision in which the NYSE has no stake, because it does not list companies with that low level of market capitalization.

66. The term "Small Business Issuer" is defined in rule 405 under the Securities Act of 1933, 15 U.S.C. § 77 (2000), to include U.S. or Canadian companies (not including investment companies) with both revenues and market value of the public float of $25,000,000 or less. Only Small Business Issuers may avail themselves of the less burdensome registration and filing requirements of the SB forms. *See, e.g.*, General Instruction A to Form 10-KSB under the Securities Exchange Act of 1934.

67. NASDAQ Rules, *supra* note 1, at Rule 4350(d)(2)(C).

68. *See* Memorandum from Martin Lipton, *supra* note 38.

69. It remains to be seen whether these or any of the other liability-related fears regarding the Audit Rules will be borne out. To date, there appears to have been no complaints filed in which these Rules are named or are the source of any pleaded causes of action.

70. SB filers may have fewer than three independent directors on their audit committees as long as the committee has at least two members, a majority of which are independent under the new definitions. NASDAQ Rules, *supra* note 1, Rule 4310(c)(26)(B)(iii).

Both major marketplaces had already required companies to have independent directors on their boards, to have audit committees, and to have some independent director presence on that committee. However, the BRC's recommended redefinition of the term "independence" gave rise to some issues, not all of which are yet resolved.

The definition of director "independence" has never been firmly established in regulatory law. The Audit Rules presented the opportunity and the risk of more clearly setting out the parameters of independence for public companies. The two primary markets chose two very different kinds of defining principles.[71]

The NYSE adopted a very general concept of independence, using the same criterion it used prior to the adoption of the audit rule: independent directors are those with "no relationship to the company that may interfere with the exercise of their independence from management and the company."[72] In addition, employees (or their immediate family members) of the company or its affiliates, or members of interlocking compensation committees do not qualify as independent.[73] Finally, there is a catchall exclusion of directors with business relationships with the company.[74] However, "if the company's Board of Directors determines in its business judgment that the relationship does not interfere with the director's exercise of independent judgment," then the director qualifies as independent for audit committee membership.[75]

The NASDAQ rule takes a much different approach to the definition of "independent", listing with some specificity disqualifying relationships. The NASDAQ approach might reflect the difference between the companies it lists and those that the NYSE lists. Many NASDAQ companies are smaller in size, less mature in history (even if very large in market capitalization), and often have less sophisticated advisors. Boards of directors of such companies may benefit significantly from increased guidance on the content of terms like "independence". To the extent that there are liability concerns that arise from board determinations of such matters, a bright line standard embodied in the rules of the company's marketplace gives the directors a

71. There is, of course, overlap between the marketplaces. For example, both markets reduced the length of time a relationship with the company is disqualifying—from the five years recommended by the BRC to three years.

72. NYSE Manual, *supra* note 1, § 303.01(B)(2)(a).

73. A director who is employed as an executive of another corporation where any of the company's executives serves on that corporation's compensation committee may not serve on the audit committee. *Id.* § 303.01(B)(2)(c).

74. *Id.* § 303.01(B)(2)(b).

75. *Id.*

strong claim of reasonableness when they act in conformity with those rules.

The NASDAQ rule drew upon benchmarks already developed in related contexts. For example, the BRC recommended disqualification of directors who accept compensation from the company other than for board service or retirement benefits. The NASDAQ rule adopted a $60,000 floor before this disqualification applies, based on other SEC disclosure requirements applicable to executive compensation matters.[76] Because companies must already compile data for this purpose, the new rule would involve no additional compliance burden. With respect to "significant" payments made to or from a director's business, the NASDAQ rule adopted the definition of "significant" in the American Law Institute's Principles of Corporate Governance.[77] The NASDAQ rules also contain an escape valve in the event that there is one director who might not otherwise qualify as independent, but whose presence on the audit committee is determined (by the independent directors) to be so important that it is in the best interests of the company.[78]

Both marketplace rules bar a director who is an employee of an "affiliate" of the company from serving on the audit committee. However, the definition of "affiliate" is far from crisp. The definition that the SEC has traditionally used in various of its regulations defines an affiliate as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with [the company]."[79] For audit committee purposes, the issue of affiliate is raised most acutely with respect to venture capitalists.

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76. Regulation S-K, Item 404(a); 17 C.F.R. § 229.404(a) (1999).

77. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 1.34(a)(4) (1992). Payments that "exceed 5% of the corporation's or business organization's consolidated gross revenues for that year, or $200,000, whichever is more" is how the term "significant" is written in the NASDAQ rules. NASDAQ Rules, *supra* note 1, Rule 4200(a)(15)(d).

78. For example, a person who is no longer an employee of the company but whose employment ended less than three years ago, thereby disqualifying him or her under Rule 4200(a)(15)(a), *supra* note 1, may be appointed by the Board under this provision. Rule 4310(c)(26)(B)(ii), *supra* note 1. This provision might be used as well for the appointment to the audit committee of a representative of a venture capital firm. *See* discussion of affiliates *infra* notes 72-80 and accompanying text. Chairman Levitt strongly advocated this view as well:

> *Quality* will hone the competitive edge for all markets. Those who consider lowering their standards to attract more business, or who do not fully embrace transparency, should think long and hard before they start a race to the bottom. In an era when investors are increasingly able to shift their capital in and out of markets cheaply and easily, it serves us well to remember that no market has a divine right to investors' capital.

Levitt Governance Speech, *supra* note 37.

79. *See, e.g.*, Securities Act of 1933, Rule 144 (a)(1), 17 C.F.R. § 229.144(a)(1) (1999); Securities Exchange Act of 1934, Rule 12b-2, 17 C.F.R. § 240.12b-2 (1999). "Control" is also a poorly defined term under the securities acts. Control "means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." Rule 12b-2, 17 C.F.R. § 240.12b-2 (1999).

Venture capitalists are usually the initial source of outside capital for a small, privately held enterprise. Venture capitalist are usually, the initial source of outside capital for a small, privately held enterprise. There are arguments both in favor of and against representatives of venture capitalist firms sitting on audit committees. Venture capitalists are often the most financially sophisticated members of the Board of a new, public company. They often retain a large ownership stake in the company. Those factors weigh in favor of including such directors on the audit committee, on the grounds that they are knowledgeable, sophisticated, and have interests aligned with those of the public shareholders. However, there may also be a serious conflict of interest between venture capitalists and public shareholders.

More often than not, venture capitalists will be looking to liquidate all or most of their stock position in the company,[80] which gives them a strong interest in taking actions to keep the stock price high at the times when, and for the period that, they (and often founding management) are able to liquidate their positions or make distributions to their limited partners. Such an interest may align them more with management than with the public shareholders. Similarly, the larger the venture capitalists' stock positions, the more significant the control they may exercise, again aligning them more with management than with the public and limiting the objectivity with which they would fulfill the audit committee's functions.

The most controversial aspect of the BRC Recommendations regarding the composition of the Audit Committee had to do with qualifications for Committee members. The BRC suggested that Audit Committee members each be "financially literate"[81] and that at least one member have such background or training in financial matters that he or she is "financially sophisticated".[82] On its face, these requirements seem quite reasonable and

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80. If the firm is organized as a limited partnership with a finite duration, they may also distribute the shares out to the partners no later than the termination date of the partnership.

81. The BRC Recommendation does allow for a director who is not financially literate to remain eligible for audit committee membership if he or she "becomes financially literate within a reasonable period of time after his or her appointment to the audit committee." BRC Report, *supra* note 39, at 12, 26. Both marketplaces adopted this transitional concept in their financial literacy requirements. How a director becomes financially literate and when that magic moment occurs remains to be determined. Since the marketplaces engage in many educational functions for their listed companies, perhaps they can develop a vehicle for this purpose.

82. *Id.* at 25.

> Because of the audit committee's responsibility for overseeing the corporate accounting and financial controls and reporting . . . this committee clearly has a more recognizable need for members with accounting and/or related financial expertise [such that it] results in the individual's financial sophistication.

sensible for a committee that is primarily responsible for reviewing financial results and conversing intelligently with both internal financial management and outside auditors. However, this recommendation raised a considerable storm of negative response.

Commenters principally objected that any stated level of expertise required for committee members would simply increase the liability exposure of those directors. First, the qualifications requirement itself would result in litigation by aggrieved shareholders to determine whether a committee member was "financially literate" or "financially sophisticated." Second, the standard of behavior for directors under both state corporate law and federal securities law would be substantially raised as a result of their stated expertise.

The marketplaces responded to these concerns with the same differing approach they used with respect to the other recommendations. Both marketplaces adopted these requirements for audit committee members. However, the NYSE placed the determination of "financial literacy" and "financial sophistication" in the business judgment of the board of directors.[83] The NASDAQ rule attempted to specify the content of these concepts by using the language of the BRC Report itself, which explains "financial literacy" as "the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement and cash flow statement."[84] With respect to "financial sophistication," the BRC Report describes the expertise it requires to reflect the following criteria:

> past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.[85]

Id.

83. NYSE Listed Company Manual § 303.01(B)(2)(b) provides that "[e]ach member of the audit committee shall be financially literate, as such qualification is interpreted by the company's Board of Directors in its business judgment . . . ." *See supra* note 1. Section and Rule 303.01(b)(2)(c) provides that "[a]t least one member of the audit committee must have accounting or related financial management expertise, as the Board of Directors interprets such qualification in its business judgment." *See supra* note 1.

84. BRC Report, *supra* note 39, at 26. This language appears in NASDAQ Rule 4310(c)(26)(B)(i), *supra* note 1.

85. *Id.*

This language also appears in the NASDAQ rule.[86]

The SEC coordinated its actions in response to the BRC Report closely in time with those of the marketplaces,[87] adopting most of the recommendations that the BRC Report addressed to it.[88] Significantly, the SEC did not adopt the proposal that the audit committee include in its letter to shareholders a statement of its belief, based on its review of the financial statements and its discussions with management and the outside auditors that the financial statements are fairly presented in conformity with Generally Accepted Auditing Principals (GAAP).[89] The BRC recommendation regarding a GAAP compliance disclosure generated enormous opposition.[90] The comments that the SEC received convinced it that the BRC recommended disclosure could effectively amount to a certification by the audit committee, which would require an extremely sophisticated and extensive knowledge of GAAP by all its members. Such a high level of accounting expertise was not within the contemplation of the financial literacy and financial sophistication requirements for audit committee members.[91]

Instead of the BRC proposal, the SEC adopted a more common securities law disclosure formulation. The audit committee must state, based on its review and conversations with management and the auditors, whether "anything has come to the attention of the members of the audit committee" that would make them believe that the audited financial statements "contain an untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading."[92]

IV. THE FUTURE OF CORPORATE GOVERNANCE

The development of corporate governance rules by the principal U.S. marketplaces under the watchful eye, if not the aegis, of the SEC, is now firmly established as a feature of U.S. securities regulation. Indeed, listing

86. NASDAQ Rules, *supra* note 1, Rule 4310(c)(26)(b)(i).

87. The Audit Rules Release, *supra* note 10, was dated October 7, 1999; the original NASD proposal was submitted to the SEC on September 20, 1999 and published for comment on October 6, 1999. Securities Exchange Act Release No. 41982 70 SEC Docket (CCH) 16, ¶ 1747 (Oct. 6, 1999).

88. *See* discussion of BRC Report recommendations, *supra* notes 39-60 and accompanying text.

89. *See* Recommendation Nine, BRC Report, *supra* note 39, at 15-16. The NYSE proposal was published for comment at the same time. *See* Securities Exchange Act Release No. 41980 70 SEC Docket 16 (Oct. 6, 1999).

90. Final Audit Rules Release, *supra* note 1, ¶¶ 82,886-87.

91. The Audit Rules Release proposals were adopted in Release No. 34-42266, *supra* note 1.

92. This familiar disclosure standard echoes the obligations of outside directors reviewing the portions of a registration made under the authority of an expert, most commonly the audited financial statements, under section 11(b)(3)(C) of the Securities Act of 1933.

standards may be the only currently-existing vehicle by which any kind of uniform concepts of corporate governance can be implemented nationally. The same reasons underlying this aspect of listing standards domestically also apply internationally. Marketplaces can have transnational reach. They may, depending on local law, retain some or all of their status as private entities, thereby avoiding the imposition of political or bureaucratic hurdles. The marketplaces also have a strong competitive interest in maintaining sound corporate governance practices as part of their identities in the global arena.

There has been a great deal of recent interest in the development of global corporate governance standards.[93] Ministers of the twenty-nine Organization for Economic Co-operation and Development (OECD) participating nations recently endorsed a report of the AD Hoc Task Force on Corporate Governance of the OECD, adopting a set of these principles.[94] Various other groups, including the World Bank and International Corporate Governance Network, are also active in the area.[95]

Investors rely on the existence of these standards. The extent to which investors value principles of corporate governance has not been exhaustively measured, but the studies performed to date suggest that investors will—and perhaps do—pay more for good corporate governance. A McKinsey & Company study[96] done in cooperation with the World Bank found that the vast majority of institutional investors surveyed[97] reported that they would pay more for shares of stock in companies with good corporate governance practices than companies with comparable financials without such practices. Much work remains to be done on just which types of corporate governance rules are most important to investors and are most transportable, but Board composition and improved financial reporting rank highly in these recent statements and studies.[98]

Marketplaces can and should play a key role in these developments. They

93. *See, e.g.*, Symposium, *The Changing Structure of Securities Regulation*, 78 WASH. U. L.Q. 397 (2000).

94. Organization for Economic Co-operation and Development, Directorate for Financial, Fiscal and Enterprise Affairs, Ad Hoc Task Force on corporate Governance, OECD Principles of Corporate Governance.

95. *See, e.g.*, International Corporate Governance Network, Corporate Governance and Globalization: The International Corporate Governance Network 2000 Meeting, *available at* http://www.icgn.org/documents/NYC_2000_agenda_4-19-00.htm (last visited Oct. 24, 2001).

96. *See, e.g.*, MCKINSEY & COMPANY, INVESTOR OPINION SURVEY (2000) (on file with author).

97. Over 200 institutional investors were surveyed worldwide, of which forty percent were based in the United States. *Id.*

98. *See also* Corporate Governance, TIAA-CREF Policy Statement on Corporate Governance, *at* http://www.tiaa-cref.org/libra/governance/index.html (last visited Sept. 29, 2001); Governance, Issue No. 80 (2000) (on file with author).

have considerable expertise in developing, implementing, and enforcing corporate governance standards. Marketplaces also have a strong interest in bringing at least some of their basic corporate governance concepts with them as they expand across borders. When investors buy a share of stock traded on the NYSE or on the NASDAQ National Market, there are implicit assurances in the brand that the marketplaces should be anxious to protect. Brand recognition will attract investors, enhancing liquidity, and enhanced liquidity will attract additional listings. The marketplaces promote this brand recognition in their moves to open new markets, but like any other brand, they must be vigilant to maintain its quality.

Corporate governance is an important part of that picture. The Audit Rules cannot be directly translated into non-U.S. markets. However, the principles the Audit Rules are meant to further—greater accountability and transparency in financial disclosure and oversight of the process by qualified and independent directors—are likely to be significant to every securities market.