

Sarbanes–Oxley as Implemented by the SEC:

A Preliminary Evaluation of its Significance for U.S. and Foreign Firms (and their Advisors)*

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Introduction

As President Bush signed the Sarbanes–Oxley Act of 2002 (SOA), he called it one of the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt, an obvious reference to the adoption of the federal securities laws in 1933 and 1934. From one perspective, this reference seems rather overblown. As one reads the statute, it quickly becomes apparent that, in great contrast to the securities laws, SOA is not a comprehensive scheme of federal regulation; it is a grab bag of reforms with a rather random quality. Indeed, SOA clearly reflects the rushed and politically charged environment in which it was enacted. As former SEC commissioner Edward Fleischman notes, the legislation has all the hallmarks of politicians hastily and clumsily reacting to events. Yet the SOA does have far-reaching implications both literally (it applies to hundreds of foreign corporations whose securities are listed on U.S. stock exchanges) and figuratively (it sets several precedents which may shape the development of U.S. corporate law for decades to come). SOA, in short, is a peculiar law with some rather startling features.

In this paper, I wish to highlight three striking aspects of the SOA:

1. Significant federalization of the regulation of corporate governance In the U.S. federal system, internal corporate affairs have long been the province of state, rather than federal, law. Chancellors William Chandler and Leo Strine of the Delaware Chancery Court (the de facto Supreme Court for corporate governance in the United States), recently wrote that SOA represent[s] a marked increase in federal

government and [stock] exchange regulation of the corporate boardroom.?) They call the statute "a relatively aggressive move by the federal government and the exchanges into the area of corporate governance, an area where, traditionally, the states have been predominant.?)

2. Extraterritorial application of the federal regulation of corporate governance The SOA applies to all "issuers," which includes virtually all SEC-reporting companies, domestic or foreign. This is a departure from past policies of the SEC, the New York Stock Exchange (NYSE) and the Nasdaq to accommodate home country practices of foreign issuers, in order to attract foreign issuers to U.S. markets. These policies have had a notable measure of success, as 17% of the listings on the NYSE today are foreign issuers.⁵⁾

The extraterritorial approach of SOA put the Securities and Exchange Commission (SEC) in a difficult position: Under the U.S. federal system, it has rulemaking authority to shape the precise scope of SOA, so it has the ability to provide some accommodation to foreign issuers. Yet given the political storm in which the SOA was enacted, granting exemptions to foreign firms was difficult.

3. Federal regulation of the legal profession Attorney ethics and regulation of the legal profession have always been a matter of state law. Yet Section 307 of the SOA requires that the SEC issue rules "setting forth minimum standards of professional conduct for attorneys appearing and practicing before the [SEC] in any way in the representation of issuers." These rules even apply to foreign attorneys in some instances.

I. A Brief Overview of SOA's Corporate Governance Provisions

Before discussing these features of the SOA, we begin with a brief overview of the SOA as it relates to the regulation of corporate governance. It should be noted that the SOA has other important goals, such as enhanced financial disclosure and auditor independence, which are beyond the scope of this discussion.

Section 101: Creates the Public Company Accounting Oversight Board (PCAOB), whose duties include registering, inspecting and sanctioning accounting firms. Related provisions of SOA address conflicts of interest between the audit and consulting services provided by accountants.

Section 301: Mandates audit committees composed exclusively of directors meeting a statutory standard of independence. At least one member of the audit committee is expected to qualify as a "financial expert." Section 301 requires that the audit committee be "directly responsible for appointment, compensation, and oversight" of the work of the independent auditor. Section 301 also grants the audit committee

authority to engage independent legal counsel and other advisors at company expense.

Section 302: Requires certifications by the CEOs and CFOs of reporting companies that the financial information in the periodic SEC reports "fairly present[s] in all material respects the financial condition and results of operations of the issuer." SOA imposes substantial criminal penalties for certifications that are knowingly false.

Section 304: Requires forfeiture of incentive or equity compensation received, or stock trading profits made by the CEO or CFO, during the initial twelve month period covered by an earnings restatement resulting from "misconduct."

Section 306: Restricts the ability of directors and executive officers to trade company stock during certain "black out" periods when holders of individual account plans are prohibited from trading.

Section 307: Requires securities lawyers to report a material violation of securities law or breach of fiduciary duty or similar violation to the issuer's chief legal counsel, CEO, board, or an optional Qualified Legal Compliance Committee.

Section 402: Bars companies from directly or indirectly extending credit or arranging personal loans to its directors and officers.

Section 404: Requires disclosures pursuant to new SEC rules concerning the firm's internal control structure and management's assessment of the effectiveness of that structure.

Section 406: Requires disclosure concerning the firm's code of ethics for senior financial officers, or an explanation of why it has not adopted such a code. A code of ethics is defined to mean such standards as are reasonably necessary to promote honest and ethical conduct, full disclosure in the periodic reports required to be filed by the issuer, and compliance with applicable governmental rules and regulations.

Section 407: Requires disclosure pursuant to SEC rules concerning the audit committee's financial expert, or an explanation of why the audit committee does not have a financial expert.

Section 806: Protects whistleblowers who have provided information regarding possible securities law violations, by instructing reporting companies not to "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against" an employee who provides information to federal regulatory or law enforcement authorities or to a supervisor. A private right of action is created by which an employee may seek compensatory damages, including reinstatement, back pay with interest, litigation

costs and reasonable attorneys fees.

II. The New Federalism in Corporate Governance

In broad terms, until enactment of the SAO, there was a basic functional divide between federal and state law in the U.S. scheme of corporate governance. Federal law, generally implemented by the SEC, was principally concerned with financial disclosure. State law, through statutes and court cases, was concerned with internal corporate affairs (that is, the relative rights of shareholders and managers, and breaches of fiduciary duty on the part of directors). The rationale for this division is that corporations are creatures of state law, and thus the states should have primary authority to regulate their structure and governance.

This functional dichotomy is not as neat in practice as it is in theory, and it neglects the important role of the stock exchanges, which, through their listing standards, are also an important source of corporate governance regulation. In fact, both the NYSE and the Nasdaq have submitted to the SEC for approval new listing standards for public companies that extensively reshape the responsibilities and operating processes of the board of directors, committees of the board, and senior executives, as well as expanding the authority of shareholders.⁶⁾

The best illustration of the federal/state dichotomy in corporate governance is the U.S. Supreme Court's 1977 decision, *Santa Fe Industries v. Green*.⁷⁾ The case involved a short-form merger of a subsidiary into the parent corporation on allegedly unfair terms. The shareholder plaintiff, however, had not alleged or provided any evidence that the controlling shareholder had misled minority shareholders about the material terms of the transaction; the claim was essentially that the price offered was unfairly low. The Supreme Court held that absent nondisclosure or misrepresentation, breaches of fiduciary duty are not within the ambit of the federal securities laws. It found that Congress by Sec. 10(b) [the general anti-fraud provision of the U.S. securities laws] did not seek to regulate transactions which constitute no more than internal corporate mismanagement.⁸⁾ The Court speaks of policy considerations that weigh heavily against permitting a [federal] cause of action under Rule 10b-5 for the breach of fiduciary duty,⁹⁾ such as the possibility that extension of the federal securities laws to fiduciary duty breaches could overlap or interfere with state law.

However, the SOA generates considerable friction with this longstanding functional divide between federal and state law. In the words of SEC Commissioner Paul Atkins, "Sarbanes-Oxley contains many advances for corporate governance, although it also represents what formerly would have been an unimaginable incursion of the U.S. federal government into the corporate governance arena."¹⁰⁾

Here, I would like to highlight three areas of federal incursion into the state realm of

corporate governance in SOA:

1. Executive compensation Section 402 bans corporations from making loans to directors and officers, with certain limited exceptions. This is a direct federal limitation on the power of state-chartered corporations to engage in transactions specifically contemplated by state corporate laws. All state corporate laws permit conflicting interest transactions between the corporation and its officers and directors, provided they are authorized by disinterested directors or shareholders, or are substantively fair to the corporation.⁹)

In itself, the Section 402 ban is relatively trivial (though note that this provision throws into doubt the continued legality of the common practice of advancing legal expenses to officers and directors covered by state indemnification statutes), but its precedential significance may not be trivial. One could envision a slippery slope of federal regulation in this area. As Chancellors Chandler and Strine ask, "what next? A ban on going private transactions? Or options-based compensation of executives? Or a ban on interested transactions?"¹⁰)

Section 304 provides for a claw-back of certain compensation received by the CEO and CFO during an earnings restatement required because of misconduct. There are several possible objections to that provision: it preempts the board's power over executive compensation; it does not define "misconduct"; and it requires reimbursement even if other employees committed the misconduct. Some observers suggest that the effect of this provision may be to encourage CEOs and CFOs to resist restating financial statements, or to strategically time their compensation and stock transactions relative to any such restatements.¹¹)

The stock exchanges have also begun to regulate executive compensation in a manner that would more typically be accomplished by state corporate codes. The proposed NYSE and Nasdaq rules require stockholder approval for certain equity-based compensation plans, such as stock options. This is a particularly sensitive area for stock exchanges to alter the allocation of power between shareholders and managers, because of its relevance to a widely used anti-takeover defense, the poison pill. The poison pill (formally known as a shareholder rights plan) utilizes an option-like right to acquire stock, the issuance of which might also be subject to shareholder approval. Chancellors Chandler and Strine ask rhetorically whether the exchanges (with SEC approval) could preempt the state law debate on poison pills by adopting listing rules requiring stockholder assent to a board's adoption of a poison pill, and mandating a stockholder vote on a board's decision to block a bid through use of the pill.¹²)

2. Board structure and function SOA identifies the board, and particularly the audit

committee, as a focus of efforts to prevent future corporate wrongdoing. In so doing, however, it imposes a host of requirements on the audit committee that supplant state corporate law, which traditionally has given broad discretion to the board in matters of organization and delegation of responsibility. For example, Section 301 requires that national securities exchanges adopt listing standards mandating that listed companies have an audit committee and that the committee be comprised solely of independent directors. At least one member of the committee should qualify as a "financial expert" as defined in the statute. The audit committee is charged with being "directly responsible for the appointment, compensation, and oversight" of the corporation's independent auditor. The audit committee is given federal authority to retain independent legal and financial advisers whose fees are paid by the corporation. Finally, the audit committee must establish a system for employees to blow the whistle anonymously on questionable accounting matters. Each of these provisions preempts state law governing the board.

3. Regulation of attorneys "appearing and practicing" before the SEC The SEC, acting on the SOA mandate, has adopted rules governing securities attorneys' professional responsibility. As noted earlier, lawyers' ethics is traditionally a matter of state regulation, and the SEC's rules evoked federalism concerns on the part of the Conference of Chief Justices as well as the American Bar Association (ABA).¹³ Note that the statute and rules permit the SEC to sanction attorneys for failing to report breaches of fiduciary duty. Since there is no federal law of fiduciary duty governing the conduct of corporate directors and officers, SOA requires the SEC to make judgments about whether material evidence of a state corporate law breach existed.

III. The New Federalism and the Future of Corporate Law

The incursion of federal law into realms of corporate governance traditionally left to the states may strike many readers (particularly foreign observers or non-lawyers), as an abstraction of little practical significance. Yet this impression is mistaken, because this feature of SOA has substantial implications for the future of U.S. corporate law.

Recall the central point made at the outset: SOA overrides several corporate practices traditionally regulated by state law, but it does not, in itself, constitute a comprehensive federal body of corporate law. This means that SOA and the SEC's implementing rules will interact with and shape the development of state corporate law, rather than displace it per se. And this, in turn, means that the statute's impact will be felt most keenly in state courts, as they adjudicate disputes between shareholders and managers.¹⁴ To see how this will develop, consider that neither Congress nor the stock exchanges created mechanisms for stockholders to enforce the mandates of SOA. SOA contains no private right of action permitting shareholders to

sue for violation of the statute. And the stock exchanges' primary enforcement tool is the draconian penalty of delisting a company that does not comply with its rules. Thus, SOA contemplates enforcement exclusively by the SEC and the federal criminal authorities.

As Chancellors Chandler and Strine point out, however, this is not the end of the story. The United States has a large, well-financed and aggressive plaintiff bar. It is virtually certain that enterprising plaintiff attorneys will make creative use of SOA in state law shareholders litigation. For example, shareholders may claim that directors are breaching their fiduciary duties by not complying with SOA. The claim could be that the directors are exposing the corporation to sanctions, such as delisting, by not following the SOA and exchange rules. Another possible claim is that state law should incorporate features of SOA.

Another type of claim that is certain to be raised in the post-Enron environment is that directors failed to devote sufficient attention to their duties or to put in place adequate compliance programs, and thus failed to head off a problem that harmed the corporation. Directors in the pre-Enron world already faced such claims. In a well-known case called *Caremark*,¹⁵⁾ the Delaware Chancery Court recognized the validity of such a claim, but set the standard for director liability quite high. In that case, a shareholder filed a derivative suit claiming that the directors of Caremark, which provided health care services, breached their duty of care in failing to prevent violations by employees of various laws that prohibited referral payments to doctors. The court accepted the notion that a corporate board has a responsibility to establish a reporting and compliance system, and that failure to do so can be a breach of duty. But the court stated that "only a sustained and systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability" (emphasis added).

Given the disastrous consequences of board quiescence or complicity in the Enron and WorldCom accounting irregularities, and the fact that the SOA requires SEC reporting companies to implement internal control structures, it is likely that the *Caremark* case (despite the seemingly high threshold of board abdication required by the language in the opinion) will be used to find directors personally liable where compliance programs and procedures are flawed. Indeed, several federal courts applying Delaware corporate law have already done so.¹⁶⁾

The end result of such claims is that state courts may soon find themselves immersed in the implementation of the [SOA] reforms, even though their own state laws are not directly implicated.⁷⁾ As courts decide these cases, they may be tempted to align

their own state corporate law toward the dictates of SOA so as to avoid exposing directors to conflicting duties under federal and state law. The task will be to make use of this creative tension between federal and state law to motivate useful developments, while avoiding the confines of a uniform, rules-based procedural approach to corporate law. Commentators have already expressed concern that the NYSE's new listing requirements "trap all listed companies into a single model of corporate governance that disregards diversity and imposes a uniform vision of good corporate governance on all firms.¹⁸)

Whether SOA will be a straightjacket or a springboard for the future of corporate law remains to be seen. But here it is interesting to note that one of the most influential lines of comparative corporate governance scholarship in recent years asserts (supported by a body of empirical evidence) that common law systems do a better job of protecting minority shareholders than civil law systems.¹⁹) Perhaps the essential difference between common law and civil law systems in the corporate field is the ex post application by common law judges of flexible fiduciary standards to police bad behavior by corporate insiders as opposed to more rigid, ex ante, rule-based procedural protections in civil law systems. If so, then there is a danger that SOA represents an "over-proceduralization" of U.S. corporate law that will diminish, rather than enhance, the protection of shareholders.

IV. Concerns for Corporate Managers and their Advisors

In the post-Enron environment, two of the most frequently asked questions are "is board service worth the risk?" and "why should I be on an audit committee?"

SOA does not explicitly change the liability standards for directors (though again, courts are likely to apply existing standards more aggressively in the wake of Enron and SOA). However, boards are definitely becoming more active, asking for more information and identifying issues before they become problems. This means that serving on a board has become more time consuming. Norman Veasey, Chief Justice of the Delaware Supreme Court, has said publicly that a director should spend 100 hours per year on routine matters. Many more hours are required of audit committee members. More time and attention devoted to the job is generally a good trend, but it is not without potential problems. For example, more time required for service on a single board means directors will serve on fewer boards. There is a possibility that companies may suffer by having less experienced board members with less diverse realms of experience. This possibility is exacerbated by the general difficulty of finding directors who meet the stringent new stock exchange definitions of "independence."

Another potential danger to corporate boardrooms posed by SOA is the gravitational pull toward hiring outside experts and advisors. Recall that SOA explicitly requires a financial expert on the audit committee, and authorizes the audit committee to hire outside legal and other advisors at corporate expense. There is nothing inherently

wrong with utilizing outside advisors, of course. But there is a danger that boards will become insulated from managers, and that committees will develop adversarial relationships with the board as a whole. The thinking of members of the audit committee may be, 'e have a right to outside advisors, so we should hire them.' Members of other committees may say, 'f the audit committee has outside advisors, we should too.' Eventually, board action may become too ponderous and unwieldy.

Finally, SOA places considerable new compliance burdens on public corporations.²⁰ For example, there is anecdotal evidence that some CEOs have responded to their certification requirements under Section 302 by imposing certification requirements down the corporate ladder on anyone involved in the preparation of the financial statements. In this sense, there is a multiplier effect on SOA's compliance burdens. Again, this is not inherently problematic, but one must ask, at what cost does compliance with the SOA come? Will senior executives spend less time on strategy? Will corporate boards and managers be tempted to adopt a mechanical, 'check the box' approach to corporate governance?

This concern is particularly acute given the new climate for corporate fraud enforcement in the United States in the wake of the Enron and other scandals. Corporate executives have moved high up on the list of enforcement targets over the past year, and SOA facilitates the white-collar criminal enforcement process in several ways.

Most notably, SOA expanded SEC powers. The statute allows the SEC to recoup executive compensation during periods covered by an earnings restatement, it lowers the standard for barring officers and directors from serving on public companies, ('substantial unfitness' was changed to 'nfitness', and it allows the SEC to freeze 'extraordinary payments' to executives if an SEC investigation is ongoing. Most importantly, however, SOA provided for a 40% increase in the SEC's budget. A bigger budget will mean more investigations and more cases, since law enforcement attorneys don't advance their careers through the cases they do not bring.

SOA may have other, more subtle, effects on the enforcement climate. The first prosecution under SOA, against HealthSouth for overstating profits by \$2.5 billion, suggests that the statute has increased the leverage of federal prosecutors. The Wall Street Journal called the new approach a 'federal shock and awe strategy against corporate fraud.'¹ At least according to the analysis in that news report, the draconian criminal penalties available under SOA are prompting mid-level executives to cooperate with prosecutors rather than resist and face long prison terms if found guilty at trial, and their cooperation makes possible the prosecution of more senior executives. The strategy for regional U.S. attorneys now is 'real time' prosecution of

white-collar crime and corporate fraud. That is, rather than waiting until a complete case is assembled with proof of every possible charge, prosecutors now proceed with a case once they have enough evidence to support a few good charges.

V. Extraterritorial Application of the SOA:

Concerns for Foreign Issuers

As noted above, SOA applies to all issuers, domestic and foreign. That means virtually every company with shares or ADRs traded on U.S. securities exchanges is covered by the statute. This is a large universe of firms. For example, 470 non-U.S. firms from 51 countries are listed on the NYSE.²²⁾ The extraterritorial application of U.S. corporate governance standards to foreign private issuers (FPIs) conflicts with the traditional approach of SEC to accommodate foreign issuers. For example, FPIs can file annual reports under Form 20-F rather than Form 10 and 10-K, securities registered by a FPI are exempt from the proxy rules of Section 14 and the short-swing profit provisions of Section 16, and until the enactment of the SOA, FPIs have been exempt from domestic listing requirements relating to corporate governance. For example, provisions applicable to domestic firms relating to voting rights and independent audit committees have not applied to them.

The change in approach met with universal condemnation from overseas commentators. Representative is the criticism of Don Cruikshank, Chairman of London Stock Exchange: "We are particularly critical of the legislature now, let the SEC pick up the pieces later approach of the act, especially the imposition of extra-territorial rule in a global market without prior consultation."³⁾ These criticisms had both general and specific animus. At a general level, SOA identifies the board and the audit committee as the locus of corporate governance and oversight responsibility. This is consistent with past U.S. corporate governance practices, but it is new and troubling for foreign issuers. In many countries, such as Korea, controlling shareholders are prominent. In other countries, such as Japan, boards have traditionally been very large, so real decision-making was done by a small subset of senior executives. Yet the corporate law prohibited delegation of important matters, so committees of the board had no formal authority. Most countries lack the highly developed case law on the duties of directors that the U.S. has, so directors have a much weaker sense of their responsibilities to shareholders and a much lower probability of being held liable for their actions or inaction. At a more academic level (but a point that has been championed by those in foreign countries who oppose board reform), the emphasis on independence as an overriding virtue of board members is not supported by existing statistical studies. In fact, there is little statistically significant evidence that board composition is related to firm performance.²⁴⁾

At a more specific level, several provisions of SOA raised concerns for FPIs:

1. Section 301 The audit committee requirements of SOA Section 301 were particularly troubling for FPIs. For example, they are incompatible with the structure of the German GmbH, which has a lower-tier insider board and an upper-tier supervisory board 50% composed of employees. They are also problematic for large Japanese firms, which have an inside board of corporate audit [kansayaku] composed principally of company employees who are not members of the board (currently, one member of the audit board must be independent; as of 2005, a majority must be independent).²⁵⁾ Also, under the corporate laws of many countries, the shareholders appoint and dismiss the outside auditing firm at the annual shareholders' meeting, a process that is inconsistent with Section 301's mandate that the audit committee be directly responsible for appointment of the auditor.

In the end, in reaction to what the SEC diplomatically called "any thoughtful comments from dozens of FPIs and their representatives from around the world," the final rules carved out exceptions to accommodate different audit committee structures mandated by foreign law. As adopted, the SEC rules permit non-management employees to serve as audit committee members, consistent with co-determination and similar arrangements in other countries. Shareholders may select or ratify auditors, consistent with the requirements of many countries. Alternative structures such as boards of auditors are permitted to perform auditor oversight where such structures are provided for under local law, as in Japan. Foreign government shareholder and controlling shareholder representation on audit committees is permitted under certain conditions. FPIs have until July 2005 to comply with audit committee rules.

2. U.S. federal oversight of foreign auditors In creating the Public Company Oversight Accounting Board, SOA makes no exceptions for foreign accounting firms that audit SEC reporting companies. Thus, they are subject to PCBOA registration, inspections, investigations and disciplinary proceedings. This can overlap or conflict with home country governmental oversight.²⁶⁾ SOA also requires the production of audit workpapers. This can conflict with local law on disclosure of confidential information to foreign authorities. For example, it appears to conflict with EU data protection laws that forbid transferring personal data outside the EU.²⁷⁾ This prompted a backlash from the European Union, which has warned of reciprocal requirements for U.S. accounting firms.²⁸⁾ European auditors working for companies listed in the U.S. are already subject to equivalent laws that have been in place in the EU since the 1980s. Indonesia's largest telecom firm may be de-listed from the NYSE because the SEC has rejected its financial reports, since its auditor is not registered with the PCAOB.

A few additional considerations related to the extraterritorial application of the SOA:

1. Ban on corporate loans to officers and directors It is common practice for international companies to make loans to senior management in connection with reassignments. Does SOA make this practice illegal?
2. Individual CEO and CFO certifications For FPIs, these are done on Form 20F, an annual report. U.S. executives must certify financial statements quarterly basis.
3. Director liability As noted above, SOA has ushered in an era of more vigorous enforcement of managerial liability for failure to monitor. Legal advisors to FPIs should examine corporate indemnification and insurance policies to ensure adequate coverage for executives, and take an active role in ensuring compliance with applicable law.
4. Compliance costs SOA increases the legal fees and related costs associated with cross listing their securities in the United States. Although passage of the SOA caused Porsche not to list on the NYSE, SOA is unlikely to lead to a large-scale decline in foreign listings on U.S. securities exchanges, because the benefits of such cross-listings in most cases still outweigh the costs.²⁹⁾

VI. Federal Regulation of Attorney Conduct

There is a widespread sense that lawyers were part of the Enron problem. Senator Jon Corzine (D-NJ), former chief executive of Goldman Sachs, put it most bluntly:

In fact, in our corporate world today—and I can verify this by my own experience—executives and accountants work day to day with lawyers. They gave advice on almost each and every transaction. That means when executives and accountants have engaged in wrongdoing, there have been some folks at the scene of the crime—and generally they are lawyers.³⁰⁾

Indeed, as with the accountants, stock analysts, and governmental regulators, the lawyers stumbled badly in Enron. Section 307 of the SOA is the Congressional response to the sense that lawyers are partly to blame. It requires that the SEC issue rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to senior legal or executive officers within the company and, in the absence of an appropriate response to that report, to the audit committee or the board of directors.

Section 307 came as an unwelcome surprise to the bar. It was introduced as a floor amendment very late in the passage of the SOA by Senators John Edwards, Michael Enzi and Jon Corzine. In the prior year, the American Bar Association had rejected revisions to its Model Rules of Professional Conduct that were less stringent than Section 307.

On November 21, 2002, in response to this directive of the SOA, the SEC published for comment proposed rules, which, among other things, required attorneys who do not receive an appropriate response to their report of a material violation to effect a so-called noisy withdrawal by notifying the SEC that they have withdrawn from the representation of the issuer or professional considerations, and to disaffirm specific documents filed with the SEC. The ABA strongly objected to many features of the SEC's proposed rules.³¹) But it was particularly critical of the noisy withdrawal provisions: We believe [the provisions] risk destroying the trust and confidence many issuers have up to now placed in their legal counsel, creating divided loyalties and driving a wedge into the attorney-client relationship. The ABA expressed concern that some issuers would not consult counsel; or that premature or erroneous withdrawal would harm the issuer and its shareholders. The ABA comments even suggest that the noisy withdrawal rules are an undesirable, costly and unnecessary supplement to reporting up-the-ladder as specifically required by Section 307 of the Act. Other commentators have suggested that by effectively turning lawyers into whistleblowers for the SEC, the proposed rules undermine the lawyers' independence and ability to serve as a bulwark against the government.³²)

The final rules, adopted in January and effective on August 5, 2003, were significantly modified in light of the public comments received. The SEC extended the comment period on noisy withdrawal, and solicited comment on an alternative procedure to the noisy withdrawal provisions. Under this proposed alternative, in the event that an attorney withdraws from representation of an issuer after failing to receive an appropriate response to reported evidence of a material violation, the issuer would be required to disclose its counsel's withdrawal to the SEC as a material event. Some commentators believe that this alternative is more conducive to preservation of confidentiality in the attorney-client relationship. A final rule is expected late this summer.

The SEC standards cover attorneys appearing and practicing before the SEC. This is defined broadly, to mean providing advice in respect of the US securities laws or SEC regulations thereunder regarding any document that the attorney has notice will be filed with or incorporated into any document that will be filed with the SEC.

The operative provision is Section 205.3 (b), which provides that a lawyer must report forthwith evidence of a material violation of the securities laws or breach of

fiduciary duty by the issuer or any of its agents to the issuer? chief legal officer or its chief executive officer forthwith. Alternatively, the lawyer can report to the company? ?qualified legal compliance committee,?if one has been established in advance. If the lawyer reports to a QLCC his or her responsibility ends; there is no duty to monitor the company? response to the report.

What must be reported is ?vidence of material violation,?but the definition of this key term is convoluted. Part 205.2(e) defines it as ?redible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, in ongoing, or is about to occur.? One commentator has argued that this definition is so murky that it amounts to a requirement that the lawyer report only if he knows of a violation—a rare occurrence.³³)

If the reporting lawyer does not receive an ?ppropriate response,?the lawyer must report the evidence to the audit committee or to the full board of directors. Appropriate response means a response as a result of which the attorney reasonably believes (1) that no material violation has occurred, is ongoing, or is about to occur; (2) that the issuer has adopted appropriate remedial measures; or (3) that the issuer, with the consent of the board, an independent committee, or a QLCC, has retained an attorney to review the reported evidence and either substantially implemented any remedial recommendation or has been advised that a ?olorable defense?is available to the issuer. The SEC? final rule on ?oisy withdrawal?will determine the required action of a lawyer who does not receive an appropriate response to his report.

Another controversial provision of the new rules is 205.3(d) (2), which permits (but does not require) an attorney to reveal to the SEC, without the client? consent, confidential information to the extent the attorney reasonably believes necessary to prevent the client from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors. This goes beyond the scope of ABA Model Rule 1.6, which only permits outside disclosure if a client? criminal act threatens imminent death or substantial bodily harm. Attorneys who violate the SEC standards are subject to civil penalties and administrative disciplinary proceedings.

It should be noted that non-U.S. attorneys providing securities advice to clients whose shares are listed on U.S. markets are subject to these rules. In response to criticism from foreign attorneys, however, the SEC excluded ?onappearing foreign attorneys.?These are non-U.S. attorneys who do not hold themselves out as practicing U.S. law, who provide securities advice only incidentally and in consultation with U.S. counsel. Therefore, non-U.S. attorneys who believe that the requirements of the SEC

rules conflict with law or professional standards in their home jurisdiction may avoid being subject to the rule by consulting with U.S. counsel whenever they provide securities advice. Also 205.6 (d) provides that attorneys who practice outside the U.S. are not required to comply with the SEC rules to the extent such compliance is prohibited by foreign law. Note that this applies not only to non-U.S. attorneys but to U.S. attorneys who practice in foreign countries.

As with many other provisions of SOA, the greatest implication of Section 307 and the SEC's new rules may lie in their precedential effect rather than the rules themselves. Obviously, we must await the SEC's final rules on "discovery withdrawal" before we can reach any firm conclusions about the impact of the rules. But the "colorable defense" escape hatch, the permissive rather than mandatory nature of reporting of evidence to the SEC, and the garbled definition of "material evidence" which serves as the triggering standard for the reporting obligation, all serve to water down the new federal oversight regime for securities lawyers.

Yet as a precedent, it is hard to ignore the significance of this new federal scheme to regulate attorney conduct. The rules have opened up a vigorous debate about the creation of specialized ethics rules for different practices specialties, the role of "gatekeepers" in the U.S. system of corporate governance, and the specter of comprehensive federal oversight of the legal profession. Given developments in the accounting profession, this latter scenario is not as farfetched as it seemed a short time ago. Judge Stanley Sporkin, for example, has commented, "If lawyers are not careful, there will be a public oversight board for attorneys." At a less dramatic level, an ABA Task Force on Corporate Responsibility has recommended changes to the Model Rules to make them more consistent with the SEC rules and to enhance the role of the lawyer in corporate governance and legal compliance.³⁴)

Putting aside the substance of the new rules, this debate seems quite healthy for the American legal profession. And the debate suggests that more thinking needs to be done about the role and regulation of the legal profession in the process of economic globalization. To date, discussions of the globalization of capital, product and managerial markets have largely ignored the role of lawyers in this process. Yet legal representation arguably has become more critical as cross-border transactions and global financial markets require that participants play by a common set of ground rules. These developments, in turn, suggest the importance of discussing harmonization of ethical rules for lawyers around the world.

Conclusion

Whether SOA targeted the core problems that gave rise to Enron and the other highly publicized scandals depends on the root cause of those scandals. The SOA focuses primarily on secondary actors, and adopts a fairly mechanical approach to improving

corporate governance. If, as some believe, Enron was a result of the collapse of gatekeeper regime—the accountants, lawyers and stock analysts who serve as crucial certifiers and reputational intermediaries in the public capital markets³⁵)—then SOA addresses the root cause of the problem. If, however, Enron and the other scandals were fundamentally caused by flaws in the U.S. system of executive compensation compounded by perverse accounting and tax rules, then Congress missed the mark, since very little in the statute addresses the incentive scheme for corporate managers. And if market forces and the existing state law regime of corporate governance, however imperfect, are the appropriate way to prevent scandals and discipline management, then additional regulation at the federal level was not only unnecessary but counterproductive.

Regardless of one's conclusion on this score, it is fair to say, at least preliminarily, that SOA ushered in a new era in U.S. corporate governance, with serious consequences for corporate boards, executive officers, and their advisors. Due to the structure of SOA, the implications of SOA extend around the world. It is exciting, if uncharted, territory for corporate governance and the legal profession.

* Based on a Speech Delivered to The Korean Securities Law Association, Seoul, May 28, 2003.

1) Elisabeth Bumiller, Bush Signs Bill Aimed at Fraud in Corporations, NY Times, July 31, 2002, at A1.

2) Cited in presentation by Paul T. Schnell, The Impact of Sarbanes–Oxley on Global Capital Markets, April 22, 2003.

3) William B. Chandler and Leo E. Strine, Jr., The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State, unpublished manuscript, Feb. 26, 2003, at 7.

4) *Id.* at 9.

5) John C. Coffee, Jr., Racing Towards the Top: The Impact of Cross–Listings and Stock Market Competition on International Corporate Governance, 102 Colum. L. Rev. 1757, 1771 (2002).

6) But even here, the functional divide between federal and state law is apparent. The courts have held that the SEC—which must approve stock exchange rules—does not have authority to regulate substantive relations between shareholders and managers in the guise of approving listing standards. *Business Roundtable v. Securities and Exchange Commission*, 905 F.2d 406 (D.C. Cir. 1990) (SEC exceeded its authority in prohibiting exchanges from listing firms that departed from a one–share/one–vote principle)

7) 430 U.S. 462 (1977).

8) Paul Atkins, The Sarbanes–Oxley Act of 2002: Goals, Content, and Status of Implementation, March 25, 2003.

9) See, e.g., Delaware General Corporation Law, Section 144.

- 10) Chandler and Strine, *supra*, at 37.
- 11) Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, Regulation, Spring 2003, at 26, 28.
- 12) Chandler and Strine, *supra*, at 32.
- 13) Letter from Conference of Chief Justices to Jonathan G. Katz, SEC, December 13, 2002; Letter from American Bar Association to Jonathan G. Katz, SEC, December 18, 2002.
- 14) This point is developed at length by two commentators with a keen interest in the matter: Chancellors Chandler and Strine of the Delaware Chancery Court, where many of these disputes are heard in the first instance. See Chandler and Strine, *supra*. This section of the paper draws heavily on their analysis.
- 15) *In re Caremark International Inc. Derivative Litigation*, 698 A. 2d 959 (1996).
- 16) See *In re Abbott Laboratories Derivative Litigation*, 325 F.3d 795 (7th Cir. 2003); 2003 U.S. Dist. LEXIS 7818 (S.D.N.Y. May 12, 2003).
- 17) Chandler and Strine, *supra*, at 47.
- 18) Bainbridge, *supra*, at 29.
- 19) See, e.g., Raphael LaPorta, et al., *Legal Determinants of External Finance*, 52 J. Fin. 1131 (1997).
- 20) One study estimates that the cost of being a public company increased by 90%, from \$1.3 million to about \$2.5 million, as a result of SOA. See the *Increased Financial and Non-Financial Costs of Staying Public (2003)*, available at <http://pdfserver.amlaw.com/nlj/051203costs-study.pdf>.
- 21) Ann Carrns et al., *HealthSouth Case Unveils a Stock Strategy*, Wall St. J. April 4, 2003, at C1.
- 22) <http://www.nyse.com/listed/>.
- 23) Cited in Paul T. Schnell, *The Impact of Sarbanes-Oxley on Global Capital Markets*, April 22, 2003.
- 24) See, e.g., Sanjai Baghat and Bernard Black, *The Non-Correlation between Board Independence and Long-Term Firm Performance*, 27 J. Corp. L. 231 (2002).
- 25) As of April 2003, Japanese firms have the option of establishing audit, nomination and compensation committees composed of a majority of independent directors in lieu of the board of corporate audit. Ironically, however, exceptions for foreign systems made in the SEC rules (discussed in text immediately below) provide incentives for Japanese firms to retain the board of corporate audit, because a company switching to the committee system would meet the requirement of SOA only if it had an entirely independent audit committee. On the other hand, a company retaining the corporate auditor system would qualify if it had only a majority of independent members of the audit board.
- 26) In its preliminary rules, which must be approved by the SEC, the Oversight Board has created modest accommodations for foreign accounting firms. The most important is that they are not required to provide registration information that would violate

home country laws. One SEC commissioner has stated that the Oversight Board's failure to recognize foreign supervisory regimes is "troubling." Paul Atkins, Recent Experience with Corporate Governance in the USA, June 26, 2003.

27) Note, however, that registration with the PCAOB does not subject foreign audit firms to U.S. courts except with respect to disputes with the PCAOB.

28) See Europe Asks Compromise on Auditors, New York Times, April 15, 2003, at W1.

29) For a detailed analysis supporting this conclusion, see Michael A. Perino, American Corporate Reform Abroad: Sarbanes-Oxley and the Foreign Private Issuer.

30) 148 Cong. Rec. S6556 (July 10, 2002) (Statement of Jon Corzine).

31) See American Bar Association comments on SEC Release Nos. 33-8150; 34-46868; IC-25829, dated December 18, 2002.

32) See Evan A. Davis, The Meaning of Professional Independence, 103 Colum. L. Rev. 1281 (2003).

33) Susan P. Koniak, When the Hurlyburly's Done: The Bar's Struggle with the SEC, 103 Colum. L. Rev. 1236, 1275-76 (2003).

34) Report of the American Bar Association Task Force on Corporate Responsibility, March 31, 2003.

35) See John C. Coffee, Jr., Understanding Enron: It's About the Gatekeepers, Stupid, 57 Bus. Law. 1403 (2002).