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The American National System of Corporate Governance

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Abstract

Introduction Corporate governance (CG) has recently been extensively discussed, intensely debated and variously defined in the United States. For the purposes of this chapter, CG shall mean the internal arrangements within a corporation intended to provide reasonable assurances that corporate directors and officers make and implement decisions in accordance with their duties of care and loyalty to their corporations. CG in the United States is often associated with the recent initiatives taken in the wake of corporate scandals such as Enron and MCI. While the recent initiatives are undoubtedly important, their significance can best be understood in the context of the existing frameworks under corporate and securities law. The current initiatives in the United States (i.e. the recently adopted CG provisions in the listing requirements for the New York Stock Exchange (NYSE) – and the provisions of the Sarbanes–Oxley Act of 2002 – often called "Sarbanes– Oxley") in important ways simply add to the governance measures already in place pursuant to corporate law and securities regulation in the United States. Only after understanding foundations in corporate law and securities regulation in the United States is it possible to understand the significance, and the limitations, of the recently adopted NYSE listing requirements and of Sarbanes–Oxley. In general, the recent NYSE initiatives attempt to improve the degree of independence among directors of corporations listed there so that they are better able – and more likely – to meet the performance standards currently applicable to directors under corporate law (i.e. duties of care and loyalty), but the NYSE does not change those standards. Unfortunately, the NYSE listing requirements do not have the force of law. Sarbanes–Oxley, on the other hand, in general, attempts to improve the independence of external auditors and corporate directors so that they are better able – and more likely – to prepare public disclosures in form and substance required by US securities regulations. There are also provisions intended to enhance the care with which corporate officers prepare required public disclosures. Unfortunately, Sarbanes–Oxley applies only to disclosure requirements under US securities regulations. With limited exceptions, Sarbanes–Oxley is not specifically intended to apply to directors' or officers' broader obligations to their corporations or the standards applicable to their performance of those obligations.

Keywords: Corporate Governance, Corporate Law, NYSE

Corporate law in the United States Corporate law – at least in the United States – is often discussed but rarely understood, in part because corporate law is not federal law and in part because there is no government agency actively enforcing it. Securities law is better understood, in part because it is a federal law actively enforced by a government agency. The provisions of corporate law can be divided into three large topics: corporate formation, corporate constitutions and the potential personal liability of corporate directors and officers. First, corporate law in the United States contains provisions concerning the formation of corporations. In general, corporations are formed when one or more investors transfer assets into a separate account (i.e. the corporation) and, in exchange the investors are granted a divisible common interest (i.e. shares) in that account. The result of these two, simultaneous operations is the separation of share ownership from both corporate ownership of those assets and from corporate control of those assets. Second, corporate law contains provisions concerning corporate constitutions. Such provisions deal with each corporation's arrangements for the exercise of control over the corporation's accounts, i.e. arrangements for proposing, making and implementing decisions concerning the disposition of corporate assets. Within the scope of these provisions, corporate law is similar to the constitutional provisions of national governments and so can be referred to as corporate law's "constitutional provisions." Generally, corporate directors (the shareholders' elected representatives) delegate authority to corporate officers the obligation to manage corporate affairs in the ordinary course of business. Accordingly, corporate constitutional arrangements also include the obligation of corporate officers to report to corporate directors on the discharge of their management obligations. Third, corporate law contains provisions concerning directors' and officers' personal liability for actions taken in their corporation's name and for its account. These provisions of corporate law are taken largely from rules of agency law. Generally, corporate directors and officers can be personally liable for failing to act with due care and loyalty on the corporation's behalf.

Corporate formation In order to form a corporation in the United States, investors are required to contribute some form of capital – i.e. money or assets – to the corporation, a fictitious person with the legal right to own and dispose of assets. Corporations, in turn, own all of the assets contributed by the investors. As a condition to each shareholder's contribution, the corporation agrees to use the 76 B. L. Nelson contributed assets in the conduct of a legal business (or a more precisely specified business). In addition, the corporation – not its shareholders – owe all of the liabilities incurred in the corporation's conduct of the business. The investors' ownership in their corporations is usually divided into "shares," which are often, but not always, evidenced by share certificates. In the absence of classes of shares (i.e. shares with preferential rights), each share constitutes an equal undivided right to participate in distributions made by the corporation to its shareholders, either in the form of (a) dividends in the normal course of business, or (b) distributions in partial or total liquidation of the corporation. In the absence of classes of shares (i.e. shares with preferential rights), each share also has an equal vote in all decisions made by the shareholders in respect of the corporation. Finally, in the absence of an agreement between or among shareholders, shares are freely transferable and the corporation survives the transfer of shares, whether the transfer is by sale, testament or the laws of intestacy.

Corporate constitutions: separating share ownership and corporate ownership As explained above, there is a clear separation of shareholders' ownership of shares and the corporation's ownership of assets. Shareholders can directly exercise their ownership rights in shares, either personally or by delegation to others, but shareholders cannot personally exercise private property rights in corporate assets. Instead, corporations alone own the assets transferred to them by their shareholders and exercise private property rights in those transferred assets in the same manner and to the same extent as individuals, i.e. natural persons.

Corporate constitutions: separating share ownership and corporate control In general, in partnerships in the United States, each partner can act in the partnership's name and, therefore, for the account of all other partners in disposing of partnership assets. Unlike partnerships, corporations in the United States can exercise their private property rights only by delegation to one or more individuals. In other words, unlike partners, shareholders in corporations cannot act in the name and for the account of their corporations. Instead, all of the authority to act in the corporation's name and on its behalf is delegated to a single individual. This person is designated the "president" by corporate laws in the United States but is also, typically, given the title of "Chief Executive Officer" (CEO). The CEO typically delegates some of his or her power – in a manner allowed or required by the corporation's constitutional documents – to one or more subordinate individuals, all of whom are then authorized to act in the corporation's name within the scope of that delegation. The person or persons entrusted with the power to exercise the private property rights in corporate assets are called "corporate officers." CEOs have the authority and, in exchange for their compensation, the obligation to make and implement decisions in the ordinary course of business concerning the disposition of corporate assets. Corporate officers also have the obligation, pursuant to corporate law, to report on the results of operations to their corporations' directors, the shareholders' representatives. This reporting obligation under corporate law arises from the separation of corporate ownership and corporate control, as described above.

Corporate constitutions: shareholders' and directors' control

Shareholders' control of corporations under corporate law is limited to the election of directors and auditors – often nominated by CEOs. Relying on the following provision of corporate law, directors, in turn, typically limit their role to selecting CEOs (and, sometimes, other corporate officers) and to supervising their performance: "The business and affairs of every corporation ... shall be managed by or under the direction of a board of directors" (Delaware General Corporation Law, § 141 (a)). The only additional element of shareholders' and directors' control under corporate law is making decisions on matters outside the corporation's ordinary course of business, e.g. the payment of dividends, changes in the corporation's business, mergers, acquisitions, divestments and the liquidation or partial liquidation of the corporation. On such matters, shareholders and directors typically make decisions on the basis of proposals initiated by their corporation's CEO. In any event, shareholders and directors in the United States never have authority to take action in the corporation's dealings with third parties. All such corporate action – both in the ordinary course of business and extraordinary matters – are implemented by the CEO and other officers. Only the CEO and other corporate officers can sign documents and otherwise act in the corporation's name and for its account, i.e. only they can act as a corporation's "legal representative" (as such a term is understood in many civil law jurisdictions).

Corporate constitutions: CEOs' and other officers' control

With the limited exceptions described above, in most US corporations all corporate decisions are made and implemented solely and exclusively by corporate officers. In fact, in the first instance, only one corporate officer, i.e. the corporation's CEO, is authorized to propose, make and implement all corporate decisions in the ordinary course of business. However, CEOs can delegate – and often are required by their corporations' charters to delegate – to other corporate officers the authority to make and implement certain decisions. In those instances where CEOs are required to delegate authority to certain officers (e.g. the chief financial officer (CFO), or the chief legal officer (CLO)), the CEOs tend to have the sole authority to appoint the individuals who fill those offices. Even in those instances where directors or shareholders make the final decisions, only officers often have the ability to make the initial proposals and to organize the decision-making process. For example, even though shareholders typically elect directors and external auditors, CEOs alone usually have the ability to select the sole nominee for directors and external auditors. In addition, presidents or CEOs organize and administer the election process. Finally, as previously noted, officers have the duty to report to their corporations' directors, the shareholders' representatives. This reporting obligation under corporate law arises from the separation of corporate ownership and corporate control. In other words, the officers' reporting requirements arise from the fact that they act in a corporation's name and for its account – not in their own name or for their own account.

Officers' personal liability to their corporations As evidenced by the foregoing discussion, some corporate law in the United States is dedicated to issues surrounding procedures for proposing, making, implementing and reporting on corporate decisions. Directors' and officers' personal liability to their corporations is another important topic under corporate law. The discussion in this section will focus on the potential personal liability of corporate officers. The potential personal liability of corporate directors will be discussed below under the heading of "special topics under corporate law." Within the scope of their authority, CEOs and other corporate officers have no liability to third parties, i.e. persons other than the corporations they serve. While corporations might incur liability to individuals and other corporations under the law of general obligation or contract law for their CEOs to act in their corporations' names and for their accounts, CEOs generally do not incur any liability to other individuals or corporations on the basis of those acts. Such is the risk for individuals and corporations in doing business with a corporation's CEO. On the other hand, CEOs and other corporate officers can be liable to their corporations under corporate law for their actions on behalf of their corporations. As regards possible personal liability to their corporations, corporate officers are similar to bailees, such as warehousemen and common carriers. Like bailees, managers take possession of corporate assets – not title to them – and only as a necessary incident to performing their personal services. Just as bailees, warehousemen or common carriers can be liable to the individuals who entrust assets to them if they fail to discharge their obligations, so corporate officers can be liable to their corporations for their failures in proposing, making, implementing and reporting on corporate decisions. Neither the recent NYSE listing requirements nor Sarbanes–Oxley increase CEOs' or other corporate officers' potential personal liability under corporate law. Finally, CEOs and other corporate officers can be held legally responsible by the United States government, and even subject to criminal sanctions, if the CEOs and other corporate officers violate a government regulation in the performance of their duties on behalf of their corporations. While the NYSE listing requirements have no effect on potential criminal sanctions, Sarbanes–Oxley increases the sanctions potentially applicable to CEOs and other corporate officers for violations of US securities regulations.

Officers' personal liability to their corporations: "fiduciary duties" are performance standards Corporate officers are required under corporate law to report to directors on the results of operations, but they are not required to inform or consult with directors or shareholders before making and implementing decisions in the ordinary course of business. In the absence of prior guidance from directors and shareholders, officers cannot be held accountable for failing to honor specific wishes of directors and officers. Corporate officers can, however, be held accountable for failing to meet the standards which all corporations can reasonably expect from their officers in making, implementing and reporting on corporate decisions. More precisely, corporate officers are subject to two specific performance standards, traditionally called "fiduciary duties." The two duties are the "duty of loyalty" and the "duty of care."

Officers' personal liability to their corporations: duty of loyalty By accepting appointment, all corporate officers are bound by corporate law to the "duty of loyalty" in all obligations they undertake on behalf of their corporations: i.e. the officers will avoid conflicts-of-interest between their corporations' interests and their own interests. There are three elements to corporate officers' duty of loyalty. First, corporate officers agree to make decisions in their corporation's best interest – without regard to their own best interests. Second, corporate officers agree not to acquire interests in conflict with their corporation's best interests. This element of the duty of loyalty prohibits corporate officers from maintaining or entering into competitive undertakings and from appropriating corporate opportunities for themselves. Third, in the event that officers' interests inevitably conflict with the best interests of their corporations, officers agree to disclose the conflict of interest to disinterested directors and to defer to them in making corporate decisions.

Officers' personal liability to their corporations: duty of care By accepting appointment, all corporate officers are bound by corporate law to the "duty of care," in respect of all acts they undertake on behalf of their corporations: i.e. the officers will pursue their corporations' goals as prudently as if they owned the corporations. The officers' duty of care has three elements. First, the officers must be acting "within the scope of their authority." This element of the duty of care relates to the corporation's by-laws, corporate resolutions and specific authorizations. If officers are not acting within the scope of these charter documents and authorizations, then the officers have breached their duty of care. Second, the officers must not be acting "negligently." This element of the duty of care relates to the diligence exercised by officers in collecting facts relevant to their decisions. In collecting facts, corporate officers breach their duty of care if they do not use the diligence of an ordinarily prudent corporate officer in similar circumstances. This element of the duty of care focuses on the facts available and known to officers at the time they make their decisions. Third, the officers must be acting "in good faith." This element of the duty of care relates to the diligence exercised by officers in reaching conclusions based on the facts known to them at the time they make their decisions. In reaching conclusions, corporate officers breach their duty of care if they do not exercise the judgment of an ordinarily prudent businessperson in similar circumstances. This element of the duty of care focuses upon the manner in which officers decisions are made. The application of the duty of care to officers' decisions is subject to the "business judgment rule." Pursuant to this rule, courts apply the duty of care on the basis of the facts reasonably available to corporate officers at the time that they are making and implementing their decisions – not on the basis of facts which the officers could not have known, even if they had been diligent. Moreover, pursuant to the "business judgment rule," courts apply the duty of care on the basis of results corporate officers can reasonably expect to achieve, not on the basis of results actually obtained. The business judgment rule does not apply to the duty of loyalty or compliance with government regulations, such as securities regulations.

Special issues under corporate law in the United States In addition to the foregoing general observations on corporate law in the United States, it is important to understand some special issues raised by the NYSE listing requirements, Sarbanes–Oxley and CG initiatives in general.

Special issues under corporate law in the United States: there is no national corporate law The most important special issue about corporate law in the United States is that there is no federal corporate law in the United States. Under the US constitution, the power to enact corporate laws is a power reserved for many states in the United States. The most important corporate law in the United States is in the law of the State of Delaware. Delaware first adopted its current corporate law in the early 1900s. Since that early date, Delaware has been by far the most popular state for corporate incorporations. (Corporations with operations any where in the United States are generally free to locate their legal domicile in any state in the United States. For example, a corporation with all or most of its operations in New York State is free to incorporate in Delaware.)

Special issues under corporate law in the United States: obligations of trust To the extent that corporate officers can make and implement decisions without first consulting with directors or shareholders, their relationship to their corporations is based on trust. Since corporate officers make and implement practically all decisions in the ordinary course of a corporation's business without consulting or even informing shareholders or directors beforehand, the trust placed in corporate officers is considerable. In fact, shareholders typically do not learn about their officers' individual decisions even after those decisions are made and implemented. On the contrary, shareholders typically know neither the individual decisions made by their corporations' officers, nor the results obtained from those individual decisions. This situation is not changed by officers' requirement to report to corporate directors under corporate law. Unless the directors impose an obligation on the CEO to inform or consult with them before making and implementing a decision, CEOs have no legal obligation under corporate law to report to directors on decisions they make and implement in the ordinary course of business. Similarly, this situation is not changed by US securities regulations. Pursuant to US securities regulations (as discussed below), shareholders know only the aggregate results of all decisions made by their corporations' officers – and shareholders know those results (not the individual decisions made) only after the decisions are implemented.

Pursuant to US securities regulations, shareholders know those aggregate results only on a periodic basis – typically once each three-month, six-month or one-year period.

Special issues under corporate law in the United States: directors' personal liability to their corporations The same performance standards applicable to officers, as outlined above, also apply to directors. In other words, in performing their obligations, directors are subject to the duty of loyalty and the duty of care, just as officers are subject to those duties. There is, however, an important difference. The standards applied to corporate officers are "professional" standards while the standards applicable to directors are lower, "unprofessional" standards. In other words, corporate officers are expected to demonstrate the care and loyalty of corporate officers. Corporate directors, on the contrary, are only expected to demonstrate the care and loyalty of a reasonable person.

There are even cases which suggest that the performance standards for corporate directors are subjective, "personal" standards. In other words, each corporate director is expected to demonstrate the care and loyalty which can be reasonably expected of him or her – having due regard for all relevant facts and circumstances, including his or her background, his or her previous tenure with the corporation and the amount of time he or she dedicates to the corporation. With one exception, neither the NYSE nor Sarbanes–Oxley sought to impose a professional standard on directors' performance as a part of their CG initiatives. The only exception is the requirement under Sarbanes–Oxley that one member of a corporation's audit committee should be a "financial expert."

Special issues under corporate law in the United States: delegations of authority Delegations of authority are fundamental to the creation of corporate organizations. The shareholders' delegation of all corporate management to directors is the initial delegation necessary for corporate formation. The next delegation of authority is the directors' delegation to the CEO of all corporate management in the ordinary course of business. Subsequent delegations are made by the CEO to other corporate officers, all in the manner previously described. Delegating directors and officers can be personally liable for acts and omissions of officers, employees or agents to whom they have delegated authority if the delegating directors or officers have not complied with their duties of care and loyalty in making and implementing the delegations. Most importantly, delegating directors and officers can be personally liable if they violate their duty of care in failing to supervise the subordinate individuals to whom they have delegated corporate authority. Director supervision of the CEO and other corporate officers is an important issue addressed by both the NYSE and the Security Exchange Commission (SEC) through their CG initiatives. Without changing the performance standards of directors under corporate law, both the NYSE and SEC attempt to rearrange corporate constitutions so that directors will in fact exercise more supervision of senior officers. They attempt to do so by requiring an increase in the independence of directors who serve on boards and important board committees, i.e. audit, compensation and nomination committees.

Special issues under corporate law in the United States: shareholder derivative actions Generally, there are no government agencies in the United States to enforce officers' personal liability to their corporations. Instead, in the United States the enforcement of such personal liability depends on legal action by corporations against their officers. Needless to say, such action presents significant difficulties.

First, corporations take such legal action, if at all, only after corporate officers' positions are terminated. At the same time, corporate officers typically negotiate waivers from further personal liability in the context of their termination agreements. Second, in the first instance such legal action needs to be authorized by the corporation's board of directors. At the same time, boards of directors often hesitate in bringing legal action against corporate officers, in part because of the morale issues such action raises for continuing corporate officers. Third, in the absence of legal action by boards of directors, shareholders are authorized to bring legal action against corporate officers for their personal liability to their corporations. At the same time, allowing individual or small numbers of shareholders to bring legal action against corporate officers can lead to confusion and wasting corporate assets. Such lawsuits are called "shareholder derivative action." In response to this third difficulty, shareholders who want to sue their corporate officers must follow procedures established under most corporate laws. Typically, shareholders are not allowed to sue in their own names; they are required to sue in the corporation's name. In addition, shareholders holding a relatively small percentage of outstanding shares are not allowed to sue; their lawsuits are subject to annulment by the corporation's independent directors; and they risk having to pay all expenses if they do not prevail in their claims against the corporate officers. The difficulties encountered by shareholders in bringing shareholder derivative action undermines the effectiveness of the performance standards (i.e. duty of loyalty and duty of care). In the absence of any government agency action enforcing those performance standards, they remain ineffective in too many cases. The initiatives from the NYSE and Sarbanes–Oxley do not eliminate any of the barriers to shareholder derivative action or create an agency responsible for enforcing corporate law in the United States.

United States securities regulations Just as it is important to understand corporate law in the United States in order to understand the recent CG initiatives there, so it is important to understand securities regulations in the United States. In fact, securities regulations take on added (arguably disproportionate) significance because (as noted above) there is no federal corporate law in the United States. In this context, "national" regulators necessarily (also sometimes called "federal" regulators in the United States) rely exclusively on securities regulations in order to introduce CG reforms.

Summary of US securities regulations: corporate law and securities regulation are different Corporate law and securities regulation are usually considered to be closely related and indeed they are related in some ways. Most importantly, both include corporate reporting requirements. At the same time, the public disclosure requirements under securities regulation differ in important ways from the reporting obligations of corporate law. First, corporate law promotes the legal institution of corporations. Securities regulation promotes securities exchanges, another institution which could not exist without legal support. Second, corporate law is intended primarily for the benefit of shareholders, i.e. corporate investors for the periods of time that they hold their shares. Securities regulation is intended primarily for the benefit of share traders, i.e. corporate investors at the moment that they sell or buy their shares. Third, pursuant to corporate law, corporate officers report in privacy to corporate directors (the shareholders' representatives). Pursuant to securities regulations, corporate officers report directly to the entire public as the only feasible means of reporting to all potential share sellers and all potential share buyers. Fourth, the reporting requirements under corporate law exist separately – and in addition – to the public disclosure requirements under securities regulation. One of the duties for corporate officers of publicly traded companies is to prepare and release public disclosures under securities regulations. Those public disclosures under securities regulations are not a substitute for complying with officers' reporting duties under corporate law. In other words, if directors request information in addition to disclosures required under securities regulations, then the CEO and other corporate officers are required to provide that information pursuant to corporate law. Fifth, corporate law is based on trust while securities law is based on disclosures. Pursuant to corporate law, directors and officers are not required to disclose any material information to shareholders before the directors or officers make decisions on behalf of their corporations. Instead, shareholders trust their corporations' officers and directors. Share buyers do not trust share sellers in a similar fashion. Instead, pursuant to securities regulation, share sellers are required to disclose all material information before share buyers make their decisions. In publicly traded corporations, shareholders do not have direct access to the data required to provide the material information share buyers demand. As a result, publicly traded corporations are required under securities regulations to disclose all relevant information publicly, i.e. to all potential share sellers and potential share buyers. Accordingly, the most important element of trust in securities transactions is the trust placed both by potential share sellers (i.e. current shareholders) and by potential share buyers (i.e. the entire public) in the corporate officers who prepare the public disclosures required by securities regulations. Since 1976, breaching this element of trust (more precisely, breaching this "duty of care") has been subject to sanctions enforceable by the SEC under securities regulations since 1976. Summary of US Securities Regulations: securities regulation is like consumer protection law. In the absence of "consumer protection" statutes, sellers of goods are allowed to keep secrets – even important secrets – about the goods they offer for sale. Similarly, in the absence of securities regulations, sellers of corporate shares are allowed to keep secrets – even important secrets – about their shares and the corporations underlying those shares. Securities regulation is, in fact, intended as a type of consumer protection for buyers of shares in corporations. This principle is evidenced by the following famous question and answer during the public debates concerning adoption of the US securities regulations in 1933:

US CONGRESSMAN: You think, then, that when a corporation ... offers stock to the public ... the public has no right to know what [the corporation's] earning power is or [to] subject [the corporation] to any inspections...?

CEO OF AMERICAN SUGAR REFINING COMPANY: Yes, that is my theory. Let the buyer beware ... that is the way men are educated and cultivated. (1933 Congressional Testimony)

Securities regulations give buyers of company shares the "right to know" about their purchases just as consumer protection statutes give buyers of goods and services the right to know about their purchases. If the information supplied by sellers to buyers is complete in all material respects, then the market price for all items (goods, services and shares) is presumed to be fair. Unlike other forms of consumer protection – which focus exclusively on the buyers' "right to know" – securities regulation is intended to benefit both buyers and sellers of shares in publicly-traded corporations. Because of the separation of ownership and control in publicly-traded corporations, shareholders – i.e. potential share sellers – have no immediate information about corporate affairs. As a result, securities disclosures provide information to share sellers, as well as share buyers, concerning the value of shares purchased and sold on securities exchanges. In other words, disclosures under securities regulations are made on behalf of share sellers but for the benefit of both share sellers and share buyers.

Summary of US securities regulations: required securities disclosures are detailed

As with other consumer protection regulations, securities regulations seek to protect buyers by requiring sellers to give information to buyers. In the case of securities regulation, that information relates to the business of the company whose shares are being issued or traded. More concretely, public disclosures pursuant to US securities regulation (for our purposes, disclosures concerning shares in the company's equity) can be divided into two general categories: (i) disclosures by corporations and their initial investors concerning securities they are issuing, i.e. selling, securities to the general public – usually called an "initial public offering," and (ii) disclosures by corporations concerning their publicly-traded shares, i.e. shares resold and purchased on public exchanges. The Securities Act of 1933 (the "1933 Act") generally governs the issuance of securities by corporations, including disclosures issuing corporations are required to make in connection with the shares to be issued. The Securities Exchange Act of 1934 (the "1934 Act") governs the trading of corporate securities on public exchanges, including disclosures issuing corporations are required to make in connection with the already-issued shares available for sale to the public.

Summary of US securities regulations: securities disclosures must be made periodically The periodic disclosure requirements for companies whose shares are already issued and are being traded, i.e. the rules under the 1934 Act, are more important than the disclosure requirements for companies at the time of the initial public offering, issued by the SEC is the important element of securities regulation, i.e. the rules under the 1934 Act. The annual and quarterly reports to shareholders (in fact, disclosures to the entire public) are the most important periodic public disclosures required from corporations whose securities are traded on exchanges in the United States. The annual report is intended as a "state-of-the-company" report, providing financial data, results of continuing operations, market segment information, new product plans, subsidiary activities and research and development activities on future programs. The quarterly report provides regular updates of the annual report at three-month intervals. Between annual and quarterly reports, current reports and/or press releases are required whenever there is a material change in a corporation's business. In addition to the periodic reporting requirements, disclosures for publiclytraded shares include "proxy statements." Proxy materials differ from other public disclosures in that they are intended solely and exclusively for shareholders as opposed to share traders. Proxy statements contain disclosures needed by shareholders in those few instances when shareholder approval is required to take a corporate action. In the normal course of business, the only actions required by shareholders of corporations in the United States are the election of directors and external auditors. Accordingly, most proxy statements focus on providing information reasonably required for shareholders to make informed decisions concerning the election of directors and auditors.

Summary of US securities regulations: misstatements and omissions are not allowed As described above, the SEC has established an integrated system of public disclosures: (i) beginning with the prospectus, (ii) continuing with the annual, quarterly and current public disclosures, and (iii) including forms and procedures for proxy solicitation materials.

In general, the SEC requires the disclosure of all information it considers reasonably necessary to assure the "full and fair" disclosure of the character of the securities, publicly available for sale in the United States.1 At the same time, the specific disclosures mandated by the SEC in each instance are rather detailed. For example, the SEC requires disclosures on over twenty topics in a corporation's annual report to shareholders, including: general development of business, business by segments, financial information about segments and geographic areas, description of property, legal proceedings and changes in accounting methods. Having established specific disclosures requirements, the SEC mandates that corporations avoid misstatements and omissions in meeting those requirements. More precisely, the SEC requires that corporations avoid all "material" and all "intentional" misstatements and omissions. In other words, misstatements and omissions are acceptable only if they are both immaterial and unintentional.

Special issues under US securities regulations: the SEC has no power to adopt corporate law In keeping with the arrangements of many other regulatory schemes in the United States and around the world, the statutes governing the issuance and trading of corporate securities in the United States (the 1933 Act and the 1934 Act) are very broad, "To provide full and fair disclosure of the character of the securities sold in interstate commerce and through the mails, and to prevent fraud in the sale thereof" (Preamble to the 1933 Act). Those powers do not, however, include corporate law. Under the Constitution of the United States, the power to adopt corporate law is reserved for several States of the United States. As a result, the SEC's recent initiatives have been limited to requirements related to public disclosure requirements for corporation's whose shares are publicly traded in the United States. As a result, the CG reforms initiated by the SEC do not apply to US corporations whose shares are not traded on stock exchanges in the United States, even if those corporations are very large. In addition, the SEC does not have the power to adopt regulations concerning corporate constitutions or concerning performance standards for corporate directors or officers unless those regulations are reasonably necessary in order to regulate public disclosures. In the absence of such a connection, the SEC must rely on reforms made to the NYSE and other stock exchanges in the United States.

Special issues under US securities regulations: the NYSE is a private association This chapter contains several references to securities exchanges. Securities exchanges in the United States, including the NYSE, are private associations, not government agencies. Securities exchanges in the United States – as well as other participants in US securities transactions, such as brokers, dealers and mutual funds – are regulated by US securities laws, primarily in the 1934 Act and regulations adopted pursuant to the 1934 Act. In SEC parlance, securities exchanges are called “Self-Regulatory Organizations” (SROs). The various governmental regulations applicable to securities exchanges are not immediately important to corporate executives. It is important to corporate executives that, in the first instance, securities exchanges regulate themselves. In other words, securities exchanges such as the NYSE adopt their own governing regulations – in much the same way that corporations adopt their own charter documents. In fact, securities exchanges such as the NYSE are required to create rules that “allow for disciplining members for improper conduct and for establishing measures to ensure market integrity and investor protection.” The NYSE and other exchanges are subject to SEC regulation and can include their listing requirements (i.e. their requirements for companies to be listed on the exchanges) requirements which affect corporate constitutions and the performance standards of corporate directors and officers. At the same time, listing requirements adopted by the NYSE and other exchanges do not have the force of law. The only sanctions available to exchanges against those corporations and individuals who violate their listing requirements are delisting of the corporation whose directors and officers violate its rules and the disqualification of such persons from serving in such a capacity in the future.

Special issues under US securities regulations: the SEC does not approve contents of disclosures All public disclosures made pursuant to the US securities regulation – other than press releases – must first be filed with the SEC as a preliminary or tentative disclosure, but the SEC does not approve any public disclosures. The SEC is given an opportunity to review and comment on the filings but the SEC’s failure to make objections or take exceptions with filings does not mean that the SEC approves. In fact, the SEC requires that all prospectuses contain the following disclaimer:

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. (See e.g. 17 CFR 229.501. Item 501(b) (7))

Rather than having the SEC approve required public disclosures, securities regulations mandate that corporations engage a firm of external public accountants to audit and issue a report on its required periodic public disclosures. If a corporation’s external auditors detect a material or intentional misstatement or omission, then they report the misstatement or omission to the corporation. If the misstatement or omission is not corrected in the normal course of the audit, then the external auditors are obligated to call it to senior management’s attention (i.e. the CEO or CFO). If senior management does not correct the consequential misstatement or omission, then the auditor is required to call it to the directors’ attention (typically through the board’s audit committee) and, in addition, within one day, thereafter, to disclose the misstatement or omission to the SEC. The auditor is also required to qualify its audit report concerning any uncorrected misstatement or omission and is authorized to resign as the company’s external auditors. The SEC’s reliance on the auditing professional to provide reasonable assurances that public disclosures comply with securities regulations places a great importance on the competence and, of equal importance, the independence of certified public accountants in their discharge of auditing functions for publicly traded corporations.

Recent CG initiatives The remainder of this chapter focuses on recently adopted CG initiatives in the United States to provide reasonable assurances that boards are loyal and diligent in their supervision of corporate business and affairs. The NYSE, through its listing requirements, and the US Congress, with the adoption of Sarbanes– Oxley, have both recently adopted authoritative measures in respect of supervising a corporation’s most senior management. These two organizations, one a private association and the other a governmental body, have acted in concert but separately, so that the recent initiatives in the United States preserve an important characteristic of the US system for CG: it is not a unified system. Two separate organizations have acted in part because there is no federal corporate law in the United States (only the various laws of the various states, with Delaware remaining the most important); in part because there is no government agency within the United States (not even at state level) actively enforcing corporate law in the United States (not even state corporate law); and in part because there is no corporate law in the United States specifically intended for publicly-traded corporations (not even at the level of the various states). As you will see, the NYSE has attempted to improve the degree of independence among directors of corporations listed there so that they are better able – and more likely – to meet the performance standards currently applicable to directors under corporate law (i.e. duties of care and loyalty), but the NYSE does not change those standards. More precisely, the NYSE initiatives are intended to improve directors' independence without increasing requirements for directors' competence or diligence. Unfortunately, the NYSE listing requirements do not have the force of law. In general, with the adoption of Sarbanes–Oxley, the US Congress attempts to improve the independence of external auditors and the diligence of corporate officers and directors so that they are better able – and more likely – to prepare public disclosures with the form and substance required pursuant to securities regulations. With limited exceptions, Sarbanes–Oxley does not augment the substance of the disclosure requirements. Sarbanes–Oxley also does not significantly modify the performance standards applicable to the preparation of those disclosures. Corporate law gives those with the power to manage a corporation's business (senior corporate officers) wide latitude to make and implement decisions in their corporations' names. The decisions they make and implement are subject to legal challenge by the corporation – usually at a shareholder's initiative – only to the extent that senior corporate officers violate their duty of care and duty of loyalty in making and implementing their decisions. Senior corporate officers can generally satisfy their "duty of loyalty" with confidence by following the simple procedure in making full disclosure of conflicts-of-interest to independent directors and negotiating directly with them – or their designee. In the absence of violation of law including federal securities regulations, senior corporate officers are rarely found to have breached their "duty of care." Such findings are rare because courts' review of senior officers' decisions is subject to the "business judgment rule," i.e. senior corporate officers' decisions are not reviewed on the basis of facts unavailable to them at the time of the decision or on the basis of the results obtained. Their decisions are reviewed only on the basis of the facts available to them or which, through due diligence, could have been available to them at the time that they made their decisions – and without regard to the results obtained. Within the context of the broad authority directors delegate to senior corporate officers pursuant to corporate constitutions, typically only three powers are reserved for directors: the power to appoint senior corporate officers, the power to regulate compensation and the power to dismiss them. For practical and sometimes contractual reasons, directors frequently have limited discretion in reducing senior corporate officers' remuneration. Accordingly, once senior corporate officers are appointed, directors' ability to supervise them is effectively limited to the power to dismiss them.

NYSE listing requirements Recent corporate scandals suggest that directors may have abused their right to regulate compensation and, in appropriate cases, neglected their obligation to dismiss senior corporate officers. Compensation of senior corporate officers at some US corporations – already very high by international standards – has increased geometrically in recent years, even without a corresponding increase in corporate results. Too frequently, it even appears that directors have not dismissed senior corporate officers even though, on the basis of facts eventually disclosed to the public, at least a few senior corporate officers may well have egregiously breached their duties of care and loyalty over long periods of time. It even appears that, too often, directors have not obtained fair results for their corporations in those instances where senior corporate officers have disclosed conflicts-of-interest and negotiated corporate contracts directly with directors. In the absence of US corporate law applicable to publicly traded companies, the NYSE has – at the prompting of the US SEC – taken some initiatives in an attempt to correct directors' recent apparent abuses and neglect. More specifically, the new "CG" guidelines require that companies traded on the NYSE have committees of independent directors for the purpose of (i) determining executive compensation, (ii) nominating senior corporate officers and directors and (iii) auditing information provided by senior corporate officers to boards of directors. By addressing the corporate constitutional issues of (i) who should be corporate directors and (ii) how they should make their decisions, the NYSE is attempting to ensure that directors exercise their rights in respect of senior corporate officers discharge of their supervisory obligations in a manner consistent with their duties of loyalty and care.

NYSE listing requirements: brief background The NYSE is a private association subject to regulation by the US SEC. The SEC imposes many requirements for corporate securities listed on the NYSE, most of which relate to the size of the issuer and the nature of the securities. Traditionally, the NYSE has deferred to the General Corporation Law of the State of Delaware for determining CG requirements and to the SEC for determining disclosure requirements for companies listed on the NYSE. On February 13, 2002, the SEC asked the NYSE to review its CG requirements for companies listed on the NYSE. After receiving extensive public comment, on August 16, 2002, the NYSE filed its Corporate Governance Proposals with the SEC. After making the original August 16 filing, the NYSE filed separately with the SEC proposals requiring approval by beneficial shareholders of equity-compensation plans. The NYSE's CG listing requirements are set forth in the new section 303A of the NYSE's "Listed Company Manual." All of them are outlined below. Prior rules are briefly summarized for the purpose of highlighting changes.

Independent directors should supervise senior officers: "independent directors" As evidenced by the following specific requirements, it is most important for the NYSE listing requirements that directors be independent. For a director to be deemed independent, the board must affirmatively determine that the director has "no material relationship with the listed company." In the past, independence was defined as having no "relationship with the company that may interfere with the exercise of the director's independence from management and the company." It appears that the acceptance of "immaterial" fees from the listed company – in addition to directors' fees – will not jeopardize the "independence" of directors. Neither former employees of a listed company nor any employees or partners of its independent auditors – including the immediate families of any such employees or partners – may be classified as "independent" directors for a period of five years after the end of their engagement with the listed company. In the past, the applicable period of time, called a "cooling-off" period, was three years.

Independent directors should supervise senior officers: a majority of all directors must be independent Unless a listed company has a controlling shareholder, corporate boards must have a majority of independent directors. This is a new requirement. Independent directors should supervise senior officers: compensation and nomination committees: entirely independent. Listed companies must have compensation and nomination committees and those committees must be composed entirely of independent directors. This is a completely new requirement. In the past, neither separate compensation nor nomination committees were required.

Independent directors should supervise senior officers: audit committee: entirely independent In the past, listed companies were required to have an audit committee and the audit committee was to be composed of at least three independent directors. Now, audit committees must be composed entirely of independent directors, as defined above. In addition to the rules for "independence" applicable to all directors, audit committee members must limit their compensation from the company to the fees they receive as directors.

Directors should supervise with clear policies and procedures: board committees must have and disclose charters In the past, there was no obligation for listed companies to have nomination or compensation committees or for audit committees to adopt charters, i.e. rules for procedures and decisions. Now, the boards of listed companies must adopt charters for each of their nomination, compensation and audit committees and the charters must be published.

Directors should supervise with clear policies and procedures: companies must have and disclose codes of conduct Listed companies must adopt and disclose governance guidelines and codes of business conduct applicable to the senior corporate officers, including the CEO and the CFO. This is an entirely new requirement which follows an identical new requirement from the SEC.

Directors should supervise with clear policies and procedures: non-management directors must regularly hold separate meetings The independent directors of listed companies, now sometimes called the "executive committee" or "executive session" are required to meet regularly without members of senior management for the purpose of reviewing corporate business and affairs. This is a completely new requirement.

Directors should supervise with clear policies and procedures: shareholders must approve most stock option plans In the past, shareholder approval was not required for many stock-option plans. Now, shareholder approval is required for all such plans, other than employment-inducement options, option plans acquired through mergers, and tax-qualified plans such as 401(k)s.

Directors should supervise with clear policies and procedures: internal auditors are required In the past, listed companies were not required to have an internal audit function. In other words, audit committees received all information from senior corporate officers or external auditors. Now, all listed companies must have an internal audit function, available to the audit committee for investigations and other information.

NYSE listing requirements: penalties include reprimand and de-listing Under the new CG listing requirements, the NYSE is allowed to issue a publicreprimand letter to listed companies who violate requirements and, as in the past, to terminate the listing of violating companies. While self-regulation through the NYSE listing requirements has certain advantages over government regulation, the only sanctions available to the NYSE are, in effect, punishment for corporations and their shareholders – not for corporate directors and officers.

NYSE listing requirements: application to foreign companies The NYSE has determined that it will not apply any particular CG listing requirement to a foreign company with securities listed on the NYSE (a "foreign issuer") if the foreign issuer provides a written certification from legal counsel in its country of incorporation that the foreign issuer complies with the CG rules (i) of that country, and (ii) of any security exchange in that country on which the issuer's securities are listed.

US securities regulations Sarbanes–Oxley has received much attention as the most important US CG initiative in the wake of the recent corporate scandals in the US. As indicated above, the NYSE's CG requirements are probably more comprehensive because they are intended to provide reasonable assurances that directors diligently and loyally supervise their delegations of authority to CEOs and other corporate officers. In contrast, the authority of the SEC – and, therefore, the scope of Sarbanes–Oxley – is limited to adopting measures reasonably necessary for reliable corporate financial reporting and the prevention of fraud in corporate securities trading. Sarbanes–Oxley addresses three broad issues related to public disclosures pursuant by corporations to securities regulations: (i) the substance of those disclosures, (ii) the independence of auditors of periodic financial reports and (iii) the procedures whereby corporations prepare and present those periodic reports. The Sarbanes–Oxley also imposes (iv) increases in the potential personal criminal penalties for violations of securities regulations by corporate officers. As with the NYSE listing requirements, each summary summarizes the state of the law prior to adoption of Sarbanes–Oxley. The term "issuers" in the following summary refers to corporations with securities publicly traded on US exchanges.

The substance of securities disclosures: material changes must be disclosed rapidly and clearly Issuers are required to disclose "on a rapid and current basis ... material changes to the financial condition or operation if the issuer, in plain English" (Sarbanes– Oxley, § 409 (a)). Since 1934, issuers have been obligated to report on Form 8-K and in press releases, the occurrence of any material events or corporate changes of importance to investors. It will not be clear what § 409 adds to previous regulations until the SEC issues regulations pursuant to this new statute.

The substance of securities disclosures: off-balance sheet accounting and contractual obligations Issuers must explain its off-balance sheet arrangements in a separately captioned subsection of "Management's Discussion and Analysis" (MD&A) in the annual report to shareholders. Issuers must also provide an overview of certain known contractual obligations in a tabular format (Sarbanes–Oxley, § 401 (a) and January 27, 2003 SEC Release, No. 33–8182). These provisions change the presentation but not the substance of certain financial disclosures. Material off-balance sheet arrangements are already disclosed in footnotes to the financial statements. Material contracts must be described and provided as exhibits.

The substance of securities disclosures: use of non-general accounting agreed on principal (GAAP) financial measures Issuers that disclose or release non-GAAP financial measures must include, in that disclosure or release, a presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure. (Sarbanes– Oxley, § 401 (b) and January 22, 2003 SEC Release, No. 33–8177.) This provision is new. It responds to issuers' recent practice of disclosing pro-forma accounting statements in press releases. Pro-forma financial statements have not been permitted as part of the regular periodic disclosures (quarterly and annual reports to shareholders), except in certain circumstances – such as acquisitions during the accounting period covered by the report – and only as an addition to mandated financial statements prepared and presented in accordance with generally accepted accounting principles (GAAP).

The substance of securities disclosures: companies must disclose codes of ethics Issuers shall disclose whether it has adopted a code of ethics that applies to the company's principal executive officer and principal financial officer. A company without such a code must disclose this fact and explain why it has not done so. A company also will be required to promptly disclose amendments to, and waivers from, the code of ethics relating to any of those officers. A code of ethics shall require: honest and ethical conduct, reliable financial disclosures and compliance with applicable regulations, including "the ethical handling of actual or apparent conflicts of interests between personal and professional relationships" (Sarbanes–Oxley, § 407 and January 27, 2003 SEC Release, No. 33–8177.) At least some issuers have had codes of ethics, but the SEC apparently suspects that – either in principle or in practice – too many of such codes have not been applicable to a corporation's most senior officers. The new rules require disclosure of a code of ethics applicable at least in principle to senior officers and, importantly, whether any waivers from the code have been granted for any senior corporate officers. As previously noted, US securities regulations are concerned exclusively with reliable financial reporting and the prevention of fraud in the sale of securities on US exchanges. At the same time, as evidenced by the SEC's provisions on internal accounting controls (Securities Exchange Act of 1934, § 13 (b-2), the SEC cannot overlook issues of corporate due diligence to the extent that due diligence is required in order for corporations to prepare and present required financial statements and other public disclosures. Similarly, in Sarbanes–Oxley, the SEC has prescribed that publicly traded corporations must adopt and publish a code of ethics specifically applicable to its CEO and CFO.

Auditor independence: create a "public accounting oversight board" (PACOB) The SEC shall establish an independent board for the purpose of regulating accountants who audit public companies and establishing auditing standards. The board will consist of five members, only two of which shall have been certified public accountants. The board will be funded by companies with securities publicly traded on US exchanges (Sarbanes–Oxley, §§ 101–109). There already is – and since 1933 – has been an independent board for the purpose of regulating accountants who audit public companies and establish auditing standards. It is the American Institute of Certified Public Accountants (AICPA). In addition, there already is – and since 1933 – an independent board for the purpose of developing generally accepted accounting principles, the Financial Accounting Standards Board (FASB).

Auditor independence: limitation of auditors' non-audit services Issuers are prohibited from engaging their auditors for non-audit services except with (i) pre-approval from the audit committee, and (ii) public disclosure related to services provided. An accountant would not be "independent" from an audit client if an audit partner received compensation based on selling engagements to that client for services other than audit, review and attest services (Sarbanes– Oxley, § 208 (a) and January 28, 2003 SEC Release, Nos 33–8183, 34–47265). There has been a wide-reaching SEC rule concerning Auditor Independence. Consistent with existing rules, independence would be impaired if the accountant or any covered person has a direct or material indirect business relationship with the audit client, other than providing professional services since February 5, 2001.

Corporate procedures for periodic disclosures: "internal controls over financial reporting" In each annual report to shareholders, issuers shall state management's responsibility for establishing and maintaining internal controls over financial reporting, together with an assessment of the effectiveness of those controls. "Internal controls over financial reporting" is defined as a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (Sarbanes–Oxley, § 404 and Rules 13(a)–15(f). Since 1976, "issuers" have had the obligation to maintain internal accounting controls, pursuant to § 13 (b) of the 1934 Act. Since 1976, management has voluntarily confirmed its responsibility for internal accounting controls in each annual report to shareholders. This provision is virtually identical to the 1976 requirement and the practices evolving out of the 1976 requirements except that (i) senior management must review internal controls for changes and effectiveness on a quarterly basis and (ii) that senior officers and directors must be involved in design and implementation as follows: the controls must be "designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel" (1934 Act, Rules 13(a)–15(f)).

Corporate procedures for periodic disclosures: "disclosure controls and procedures" Publicly traded corporations must implement controls and other procedures of an issuer that are designed to ensure that information required for public disclosure pursuant to securities regulations is recorded, processed, summarized and reported, within the time periods specified for such disclosures (1934 Act, Rules 13(a)–15(f)). The difference between "internal controls on financial reporting" and "disclosure controls and procedures" is that regarding disclosure controls and procedures, the public disclosures and related filings with the SEC must be timely. It is clear from the regulations that internal controls on financial reporting are a part of the disclosure controls and procedures. Senior management must review each for changes and effectiveness on a quarterly basis.

Corporate procedures for periodic disclosures: CEO and CFO certification of quarterly and annual reports CEOs and CFOs of issuers must personally certify their companies' annual and quarterly financial reports, subject to civil and criminal penalties. Civil and criminal penalties already exist for intentional material misstatements and omissions in financial statements. Since 1976, CEOs and CFOs have voluntarily made statements confirming their responsibility for financial statements and internal controls.

Corporate responsibility for periodic disclosures: audit committee: all independent directors Issuers must have an audit committee composed entirely of independent directors and disclose the name of at least one financial expert together with whether the expert is independent of management. An issuer that does not have an audit committee financial expert must disclose this fact and explain why it has no such expert (Sarbanes–Oxley, § 406 and January 27, 2003 SEC Release, No. 33–8177). Under NYSE listing requirements, it is already required for at least three members of the audit committee to be independent. Since January 31, 2000, issuers have had to disclose certain matters concerning their audit committees in the proxy statement incorporated by reference with each annual report to shareholders, including whether the audit committee has: (i) reviewed and discussed the audited financial statements with management and independent auditors; (ii) received from the auditors disclosures regarding their independence; and (iii) based on the review and discussions with management and auditors, recommended to the board of directors that the audited financial statements be included in the annual report to shareholders. Issuers have been required to disclose whether their board of directors has adopted a written charter for the audit committee, and if so, include a copy of the charter as an appendix to the company's proxy statements at least once every three years (December 22, 1999 SEC Release, No. 34–42266).

Corporate responsibility for periodic disclosures: no improper influence on auditors Issuers' directors and officers shall not "fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant ... for the purpose of rendering ... financial statements misleading." (Sarbanes–Oxley, § 303 (a) and 1934 Act, Rule 13 (b2–2))

Since 1933 and 1934, it has been illegal, subject to potential personal criminal penalties, to engage in fraudulent or manipulative practices in connection with the issuance or trading of corporate securities in the United States. Since 1976, it has been expressly illegal, subject to potential personal criminal penalties, to make, or cause to be made, a materially misleading statement or omission to an accountant in connection with the preparation of public disclosures pursuant to securities regulations.

Corporate responsibility for periodic disclosures: standards of conduct for securities lawyers An attorney must report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the issuer up-the-ladder within the company to the CLO or the CEO. If the CLO and CEO do not respond appropriately to the evidence, requiring the attorney to report the evidence to the audit committee, another committee of independent directors or the full board of directors. The SEC is still considering the "noisy withdrawal" provisions whereby a securities lawyer must "report-out" if the board does not respond appropriately to the evidence (Sarbanes–Oxley, § 307 and January 29, 2003 SEC Release, No. 33–81851). This provision is substantially identical to the responsibilities and procedures of external auditors in respect of consequential violations of law discovered by them in the course of their audit activities pursuant to securities regulations (1934 Act, § 10A and Rule 10(A-1)). Noisy-withdrawal applies to accountants and involves a notification to the SEC.

Penalties for corporate officers and directors: increased criminal penalties for destroying or falsifying audit records Officers, directors and employees will be subject to enhanced criminal penalties – up to 20 years – for destroying audit records or falsifying documents and for knowing other violations of the securities regulations (Sarbanes–Oxley, § 1102 and the Federal Sentencing Guidelines). In addition, CEOs and CFOs are required to forfeit bonuses, incentive compensation or gains from the sale of company securities during the 12-month period after the initial publication of financial statements that have to be reinstated as a result of misconduct. There is already the possibility of criminal penalties for (a) obstruction of justice and (b) for "knowingly circumvent[ing] or knowingly fail[ing] to implement a system of internal accounting controls or knowingly falsify[ing] any book, record, or account required [as part of the system of internal accounting controls]" (1934 Act, § 13(b) 4 & 5).

Acts and omissions constituting violations of securities regulations can, of course, also be violations of duties of care and loyalty under corporate law. On the other hand, it is possible to violate securities regulations without having breached the duties of care and loyalty. It is worth noting that violations of securities regulations, like violations of at least some other laws, are not subject to the business judgment rule.

Special issues under CG: nominating and electing directors The focus on the independence of directors, both in the NYSE listing requirements and in Sarbanes–Oxley, is prompted at least in part by the current arrangement in publicly-traded US corporations, whereby senior corporate officers nominate candidates for their boards of directors. In effect, senior corporate officers select their own supervisors and, in addition to paying directors fees for director services, also commonly pay them investment banking and consulting fees. The selection of directors by senior management, together with the payments to directors from senior management, is widely perceived to compromise directors as supervisors of senior management. Corporate law does not dictate that senior corporate officers nominate candidates for their boards of directors. On the contrary, corporate law simply provides the flexibility whereby senior officers can take the initiative in nominating candidates. Whether candidates are nominated by senior officers, other directors (e.g. the nominating committee) or by shareholders themselves, corporate law stipulates that shareholders must elect candidates as directors. Senior officers are able to nominate practically all candidates for the boards of directors of publicly traded US corporations largely because senior officers are responsible for preparing the proxy solicitation materials pursuant to which directors are elected. At the same time, there is no routine process for soliciting nominations from shareholders. In this context, the candidates nominated by senior officers are typically the only candidates on the ballot for election as directors. On July 15, 2003, a SEC report recommended the following actions (i) improved disclosure to shareholders concerning the procedures whereby directors are nominated and (ii) improved shareholder access to the director nomination process. Among other things, the July 15 report recommends that corporations (a) establish and disclose specific procedures by which shareholders can communicate with the directors of the corporations in which they invest, and (b) require that major, long-term shareholders (or groups of long-term shareholders) be provided access to company proxy materials to nominate directors, at least where there are objective criteria that indicate that shareholders may not have had adequate access to an effective proxy process.

Conclusion on CG in the United States Experience with political organizations indicates that a good method for avoiding abuses of power is their separation and balance. Some elements of recent CG initiatives separate some powers at the level of corporate boards of directors (e.g. creation of separate committees for nominating officers and auditing financial statements) and at the level of corporate officers (e.g. both the CEO and CFO signing certificates concerning the annual report to shareholders). Yet, it seems that little consideration has been given expressly and directly to introducing a “separation and balance of powers” as a fundamental principle for CG. No modification to securities regulation, for example, can possibly constitute a fundamental “separation and balance of power” within a corporation because the entire financial reporting function (i.e. the object of securities regulation) comes into play only in respect of operations which are complete on, and as of, the date that the financial statements are issued, to the extent that CG has as its goal avoiding the abuse of power by corporate directors and officers (i.e. in the form of either a breach of their duty of care or their duty of loyalty), then a modification in securities regulation can act only to deter such abuses – not to prevent them. Moreover, modifications in securities regulation avoid such abuses only to the extent that public disclosures deter them. In too many cases, it seems that the possibility of disclosure is not an effective deterrent. In order to avoid abuses of power by corporate directors and officers, it seems better to prevent those abuses than to attempt to deter them through possible disclosure. In order to prevent abuses of corporate power, it seems that separating and balancing those powers is an obvious alternative. One alternative would be to establish a chief corporate officer for each area of fundamental corporate concern (e.g. operations, legal compliance and financial reporting) with the "constitutional" arrangement that corporations would not make or implement decisions unless all three agreed on that action.[2]

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Notes

[1]The SEC expressly provides that registrants must provide such other information as is necessary to make the mandated statements "full and fair." The best known formulation of this is Rule 10 (b–5) of the 1934 Act: "It shall be unlawful, in connection with the purchase or sale of any security, for any person, directly or indirectly ... to make any untrue statement of a material fact or to omit to state a material fact." 2 The "Internal Control – [2]Integrated Framework" – first released by the Committee of Sponsoring Organizations of the Treadway Commission in September 1992 – suggests that operations, legal compliance and reliable financial reporting are the three fundamental objectives for all corporations. In September 2004, COSO expanded its framework to include strategic considerations, with the specific intention and effect that, according to COSO: in addition to operating concerns, legal compliance and reliable financial reporting should be incorporated into a corporation's strategic direction ("Enterprise Risk Management – Integrated Framework" (September 2004) by the Committee of Sponsoring Organizations of the Treadway Commission, AICPA, Jersey City, New Jersey 07311–3881, USA).