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CONGRESS, THE SEC AND PRIVATE LITIGATION: MENDING CORPORATE AMERICA

By Harvey Goldschmid
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Harvey Goldschmid is the Dwight Professor of Law at the Columbia University School of Law, where he has taught since 1970. From 2002 to 2005 he served as a Commissioner at the United States Securities and Exchange Commission. In 1998-99, he served as General Counsel (chief legal officer) of the SEC, and from January 1 to July 15, 2000, he was Special Senior Advisor to SEC Chairman Arthur Levitt. Commissioner Goldschmid is the author of numerous publications on corporate, securities, and antitrust law and a frequent lecturer at national and international legal programs and seminars. He received the 1999 Chairman's Award for Excellence from the SEC, as well as several teaching awards. Commissioner Goldschmid served in 1997-98 as a consultant to both the Federal Trade Commission and the SEC, and during this period, was a member of the Legal Advisory Committee (and Chair of its Subcommittee on Corporate Governance) of the New York Stock Exchange.

The date was July 31, 2002. The President had just signed the Sarbanes-Oxley Act into law the previous day. Financial markets were in turmoil. The corporate world was in disrepute. This is the date I was sworn in as a Commissioner of the Securities and Exchange Commission. Now things are still imperfect, but because of Sarbanes-Oxley, the SEC, and private litigation, things have significantly improved. A large element of public distrust has disappeared. I have been asked to provide you with a progress report on what the SEC did during the three years I served as Commissioner, and to address what I believe is the largest failure at the SEC, the failure to provide proxy access to shareholders.

Let me begin by stating my bottom line for the scandals of the late 1990s and early 2000s: there was systemic failure. The checks and balances expected from independent directors, independent accountants, securities analysts, commercial and investment bankers, lawyers and compliance personnel too often failed. During the past three years, serious SEC rule-making and enforcement efforts have taken place in each of these areas.

Independent directors are the most significant actors in the U.S. corporate governance system. But the most important insight to be gained from the recent scandals is that even active, demanding, independent directors cannot carry the load alone. The U.S. corporate governance system is heavily dependent on the effectiveness of various gatekeepers.

Harvey Goldschmid

In this issue of the Advocate*, we are pleased to publish an excerpt from Professor Goldschmid's speech at the October 20, 2005 Institutional Investor Forum in New York City.*

Strengthening of the Accounting Profession

Accountants are perhaps our most important gatekeepers. Two key issues were before Congress in creating Sarbanes-Oxley: one, how to strengthen the relationship between independent accountants and independent directors; and two, how to strengthen the accounting profession itself. The overriding concern on everyone's mind was that honest corporate numbers are fundamental to making the system work.

Perhaps the most important thing that the Commission did in the corporate governance area, and that Congress did in Sarbanes-Oxley, was to require the audit committee to take "direct responsibility" for the hiring, the evaluation, the compensation, and, where appropriate, the firing of the outside auditor. The words "direct responsibility" sent a powerful message, both from Congress and the SEC.

In addition, Sarbanes-Oxley added provisions for anonymous and confidential reporting and the hiring of outside experts to assist the audit committee. In conversations with both audit partners of major firms and audit committee members at major public corporations, it is clear that the "direct responsibility" mandate and the other audit committee reforms have had a dramatic effect. Now, there is more questioning, more interaction and an improved relationship between the independent directors and the outside auditor – this is an improvement in corporate governance of large consequence.

At the heart of Sarbanes-Oxley was the establishment of the Public Company Accounting Oversight Board. The PCAOB was established in large part due to a basic failure of self-regulation by the accounting profession. There was almost no internal discipline from the accounting profession itself. The rule-making process was suspect; the inspection process was questionable. The system was not working.

The PCAOB now has serious inspection, rule-making and disciplinary powers. It has grown from members of the Board answering their own telephones three years ago, to a staff of nearly 400 and a budget of roughly $137 million. The PCAOB has been a great success in terms of how well it has gotten off the ground.

Sarbanes-Oxley and the SEC have also eliminated the perverse conflict of interest created by excessive consulting fees paid to the auditing firm. Sitting as general counsel of the SEC in our confidential enforcement proceedings—and again, as a Commissioner for three years—I witnessed time and again situations where the amount of dollars involved in consulting appeared to have had a serious negative effect on the auditor's independence, on his or her willingness to bend and move in the wrong direction under financial pressure. When the consulting fees are two or three times the amount of auditing fees, the pressures that creates are understandable. Sarbanes-Oxley and the SEC have greatly diminished the adverse potential of this conflict of interest. There is still room for consulting, but it is in narrowed areas and must be approved by the independent members of the audit committee; a realistic limit has been placed on the overall weight of consulting dollars.

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Requiring Corporate Lawyers to do the Right Thing

Section 307 of Sarbanes-Oxley requires corporate lawyers to report potential wrongdoing and fiduciary breaches up the chain of command, and ultimately to the independent directors, if necessary. For present purposes, Section 307 has three basic concepts. One, reporting up would provide corporate lawyers, both inside and outside, the ability to ethically and legally report concerns and potential malfeasance up the chain of command. Two, it's going to prevent decisions that create material harm to corporations from being made at middle level corporate management. Finally—and there's legitimate debate about this, but I have no doubt about its wisdom—it moved the role of the corporate lawyer in the public corporation into a federal realm. Until now, reporting up or reporting out—which is a separate issue, an important one—was handled by state law and state disciplinary bodies. The general disciplinary groups in the various state bars simply did not focus on issues of securities law. Rather, they focused on lawyers' hands in the trust fund or other problems of that type.

We now have the SEC able to enforce this reporting-up, armed with the entire arsenal of SEC sanctions, from civil penalties to injunctive relief to prohibitions against appearing before the Commission. Again, this will make a system that was perfectly ineffective under state disciplinary rules far more effective.

Putting the Spotlight on Corporate Management

Sarbanes Oxley also increased the disclosure requirements, mandating a certification by CEOs and CFOs of corporate financial information. The reality, however, is that these certifications add almost nothing in terms of exposure to the law. The "almost" is because there are some criminal provisions that kick in at heavier penalties. But in the civil context, even prior to Sarbanes-Oxley, when the CFO and CEO signed a quarterly report, or a financial, they were legally taking responsibility for that document.

The certifications did, however, put a spotlight on the importance of the CEO's and CFO's signature and that had a dramatic effect. Now, CEOs and CFOs want to know where the numbers are coming from and about the quality of the information supporting those numbers. I have no doubt that disclosure today is considerably better, not because of increased legal exposure, but because people finally understand the importance of signing their names to the company's financial statements.

There has been a scream that grows louder in the business community relating to the cost of Sarbanes-Oxley. It ought to be made clear that Sarbanes-Oxley is not an expensive bill. The only significant cost item is the internal controls provisions of Section 404. The rest of the "great cost claims" are nonsense. Internal controls are always going to be a large ticket item, but they are a basic need of modern public corporations.

No one can seriously argue that internal controls are unnecessary. But the costs have been a problem. And there is little doubt that some wheels have been spinning that need not have been. Under the system, year two ought to be less expensive than year one, and year five should be considerably less expensive. But there are questions about how it has been implemented. Additionally, the SEC ought to look at whether the framework that applies to large public corporations like GE should be applied to smaller public corporations. But internal controls are an enormous public benefit, and the trick now is to hold down unnecessary costs.

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The Mutual Fund Industry

In an area where most Americans put their capital investment, the late trading and market timing activities that occurred in the mutual fund industry cannot be described in words less than "national disgrace." The willingness to take side payments and sticky assets was a venal breach of the public trust. The SEC responded by taking steps, and continues to take steps, to eliminate the use of market timing, late trading, directed brokerage, and other abusive practices. The SEC also focused on mutual fund governance, requiring an independent chair of the board, 75 percent independent directors, and a Chief Compliance Officer who is required, as are the lawyers and accountants, to report problems and potential scandals upward to the independent directors. Again, the SEC focused on reporting up, creating a mechanism to provide as much information as possible to the independent directors.

SEC Enforcement on the Rise

Good rules may be of little value unless they are enforced. There are two kinds of basic enforcement in the United States, one by the Commission itself, and the other by private law firms acting for investors. Both are absolutely critical. As the SEC has stated for 70 years, private enforcement is vital to making the system work.

Sarbanes-Oxley provided the government with substantial new powers in terms of civil money penalties and other remedies. Congress recognized that mutual funds, corporations, directors, officers, and the various gatekeepers must be held accountable for wrongdoing. Effective deterrence requires a strong and credible threat. It is that threat that creates powerful incentives to avoid wrongful acts, and to bring about the cultural and procedural changes that will keep the corporation on the right track.

Quantitatively, SEC enforcement has increased dramatically. Today, the cases are larger and more complex than ever. In fiscal 2002, the SEC took its first $10 million civil penalty from a public corporation. There were 20 such penalties in 2003, and 40 in 2004. In both 2003 and 2004, the SEC collected more in civil penalties than had been collected in the prior 15 years combined. It was not just the civil penalties. To be an effective deterrent, the entity or individual must pay that penalty and feel the pain. Now, unlike before, payment of an SEC civil penalty may not be reimbursed, insured, or used for tax deductions.

Effective deterrence requires a strong and credible threat. It is that threat that creates powerful incentives to avoid wrongful acts, and to bring about the cultural and procedural changes that will keep the corporation on the right track.

I hasten to add, this system will not work unless qualified individuals continue to serve as officers and directors of public corporations. We must not unfairly frighten them away from serving. The SEC does not want to diminish or interfere with risk taking, corporate entrepreneurial activity, or with appropriate corporate autonomy. Corporate risk can create new product, innovation, efficiency, and healthy change. The SEC simply asks: if the business decision goes right, disclose it; and if it goes badly, disclose that too.

Shareholder Rights and Proxy Access

Shareholders, who put up the investment capital, have precisely the right instincts in our economic system. Shareholders who understand the game are concerned about efficiency, productivity, honesty, and, of course, share price and profitability. Strengthening shareholder power is the most dramatic and effective way to improve corporate governance in the United States today.

In an ideal system, the shareholders are well represented by the board of directors.

But what happens when the board does not adequately represent their interests? When the company is struggling and nothing is happening to bring about change? What can shareholders do? Unfortunately, under our current system, the answer is not enough. Shareholders can certainly sell out, the so-called "Wall Street walk." But from a corporate governance standpoint, that is not enough. Something needs to be done to remedy the problems, to create mid-course corrections, to prevent the company from falling into bankruptcy.

The "Wall Street walk" has some effect, but not enough in the governance context. This is where proxy fights could dramatically improve the system. Under the current system, management and incumbents can spend freely on proxy fights. Phone banks, advertisements, letters, and everything else in a modern campaign are automatically reimbursed by the corporation. Insurgents, on the other hand, are reimbursed only if they win. Thus, it is too costly and risky to run a proxy fight, and the numbers bear that out. Cured for special situations and small cap companies, there are only one or two proxy fights a year in the United States among all of our public corporations. That is economically irrational.

Now the SEC put out proposals in October of 2003, which were fiercely opposed by the Business Roundtable and the CEO community, who argued that the proposals were too complex and could put "radicals" on the board. What they didn't note was that the proposals were complex because they were meant to protect against inappropriate pressures or wild-eyed types getting on a board. The proposals were aimed at stimulating "dead" companies that desperately need help.

Hopefully, proxy access is not dead. The SEC proposals can be streamlined. Other proposals can be explored. The bottom line is that the proxy process needs to be improved one way or the other. There has to be a mechanism to get shareholders further into this game. Right now, the election process is unfairly and unwisely a closed system. Ultimately, proxy access could have at least as much effect in the governance area as the lead plaintiff provisions have had in cleaning up a lot of the problems in the litigation area.

The Long View

Let me close on an optimistic note. Over the last three years, serious SEC rule-making and enforcement efforts have occurred. Officers and directors, accountants, lawyers, mutual funds, hedge funds and others in the financial community have been dealt with sensibly and with balance. The scandals of the 1990s and early 2000s made us face serious systemic imperfections. They also made it possible to bring about reform. I believe that Sarbanes-Oxley, along with the efforts of the SEC and private litigation, will permit the United States to maintain and strengthen its position as a world leader in corporate accountability and financial disclosure.

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