Case Western Reserve Law Review

Volume 55 | Issue 3 Article 5

2005

Remarks of SEC Commissioner Roel C. Campos

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REMARKS OF SEC COMMISSIONER ROEL C. CAMPOS†

INTRODUCTION

I would like to thank Dean Gerald Korngold and George Dent for inviting me to this symposium. As an SEC Commissioner, appointed by the President in 2002, I came to the table with experiences that would allow me to have a balanced approach to regulation and enforcement. During my career, I have been a federal prosecutor, a corporate transactional attorney, an in-house general counsel, and an entrepreneur and business owner. In other words, I have lived on both sides of the regulatory table.

In this paper, I will give you my views on some of the more important corporate governance reforms resulting from Sarbanes-Oxley and changes in self-regulating organization (SRO) listing standards, with a focus on the need for independent boards and highly independent audit committees. I will also speak frankly about director liability and responsibility in today's corporate and regulatory environment. Finally, I will give you my view on shareholder access and end with a note on business and legal ethics.

I. SARBANES-OXLEY

As you know, the Commission has been extremely busy, as we have recently wrapped up implementing a number of the mandates of the Sarbanes-Oxley Act of 2002.[1] The Act was passed on the heels of the series of recent corporate failures including Enron, Andersen, WorldCom, and Tyco, just to mention a few, but also evident in the older cases of Waste Management, Sunbeam, and others. Sarbanes-Oxley is a landmark piece of legislation that was the first comprehen-

† Commissioner, United States Security and Exchange Comission (2002-present). J.D. Harvard Law School; M.B.A., University of California, Los Angeles; B.S., United States Air Force Academy. These remarks constitute the views of the author and are not necessarily the views of other S.E.C. Commissioners, the S.E.C., or its staff.

[1] Pub. L. No. 107-204, 116 Stat. 745 (2002).

sive overhaul of the U.S. federal securities laws since the laws were first adopted in 1933 and 1934. The legislation is particularly remarkable because it addresses virtually every participant in the capital markets, including independent auditors, public companies' officers, and boards of directors, audit committees, attorneys, broker-dealers, credit rating agencies, and investment advisers.

It creates a new era of accountability in that the law is designed to ensure that all participants in the capital markets are held accountable and ultimately act in the best interests of shareholders.

II. TODAY'S FOCUS

My focus today will be on issues for the corporate board and management, with a particular focus on issues the audit committee should be thinking about. I would like to start by discussing a few issues relating to Sarbanes-Oxley as well as the somewhat recent listing requirements that are now in place at the NYSE and NASDAQ. I do not need to tell this audience how the environment has dramatically changed since the bursting of the bubble of early 2000 and the corporate scandals that ultimately emerged. Certainly, from my perspective as an SEC Commissioner, it seems like there has been no letting up with respect to the amount of wrongdoing in our securities markets. Yet, I am an optimist, and I believe that recent legislative, regulatory, and SRO reforms have helped, and will continue to help, our securities markets maintain investor confidence.

I know that you appreciate the importance of investor confidence in the securities markets, which, of course, includes trust in financial statements of public issuers. In my view, financial statements and other financial information are among the key sources of market-moving information. Stock prices may go up or down the instant that a press release containing quarterly or annual earnings information is issued. It is the importance and integrity of this financial information that Sarbanes-Oxley seeks to address through different means, among other things, through:

- strengthening board and, specifically, audit committee independence;
- auditor independence;
- stiffer penalties for fraudulent disclosure;
- more disclosure with respect to non-GAAP financial measures and off-balance sheet transactions; and,

- of course, the establishment of the Public Company Accounting Oversight Board (PCAOB).

In addition to Sarbanes-Oxley, there have been significant developments at the NYSE and NASDAQ where listing standards have been strengthened through additional corporate governance requirements. These requirements, which I will discuss in more detail later, nicely complement those of Sarbanes-Oxley.

A. Audit Committees

In speaking about independence, I want to focus first on audit committees. It goes without saying that there is an increased focus on audit committees and their roles in overseeing financial statements. Dating back as far as the early 1940s, the Commission has recognized the importance of audit committees and has sought to encourage effective and independent audit committees.

In this regard, Section 301 of Sarbanes-Oxley required the Commission to engage in rulemaking with respect to the independence of audit committees. In response, the Commission promulgated Rule 10A-3, which imposes, among other things, requirements on audit committee members that are in addition to the NYSE and NASDAQ listing requirements. Specifically, audit committee members: (1) cannot directly or indirectly accept any consulting, advisory, or other compensatory fees from the company or any subsidiary except for directors' fees and fixed compensation under a retirement plan (for prior service) and (2) cannot be "affiliated persons" of the company or any of its subsidiaries.

In my opinion, these stringent independence requirements were much needed. While there are certainly other problems that independence cannot fix, having strong and independent oversight by the board to keep management "in check" is a necessary framework. In fact, the 1998 Blue Ribbon Committee report, which was issued by a committee that was sponsored by the NYSE and NASDAQ, pointed to "recent studies" that showed a correlation between audit committee independence and a higher degree of active oversight and lower instances of financial statement fraud.

In addition to the independence requirements, Rule 10A-3 also requires the audit committee to directly appoint, retain, compensate, evaluate, and terminate the independent auditors; pre-approve non-audit services; resolve disagreements between management and the auditors; and oversee the auditors. There must also be the establishment of a procedure for handling employee complaints with respect to

accounting, internal control, or auditing matters. The function of the audit committee, as one of many gatekeepers, is evident from Section 301's emphasis on these responsibilities.

B. NYSE/NASDAQ Listing Standards

I would like to talk next about the SRO listing standard amendments that were approved by the Commission last year. In addition to Sarbanes-Oxley and the related Commission rulemaking, I believe that the NYSE and NASDAQ corporate governance reforms are vitally important. Following the emergence of the corporate scandals, but before the passage of Sarbanes-Oxley, then-Chairman Harvey Pitt requested that the NYSE and NASDAQ review their corporate governance and listing standards. In response, the NYSE and NASDAQ revised their listing standards. While there are a few differences between the NYSE and NASDAQ rules, these new listing standards impose more rigorous requirements on listed companies through the advancement of corporate governance.

Among the most significant of the new items is the requirement to have a *majority* of the board of directors comprised of independent directors with *affirmative* determinations by the board as to the lack of any direct or indirect material relationship between the company and the particular director. There are *per se* circumstances where directors are not "independent" such as a director who is an employee (or whose immediate family member is an executive officer) of the company until three years after the termination of such an employment relationship. Another bright-line situation where a director is not independent relates to a director (or an immediate family member) who receives greater than $100,000 per year in direct compensation from the listed company. Such a director would not be considered independent until three years after he or she ceases receiving more than $100,000 per year in such compensation.

In addition, NYSE and NASDAQ companies must have audit, compensation, and nominating/corporate governance committees, all of which must generally be comprised of independent directors. Each board committee must have a charter setting forth the committee's specific purposes, goals, and responsibilities and must conduct an annual performance evaluation of the committee. It is worth noting that, due to the importance placed on the integrity of financial statements, audit committees are specifically held to a higher standard with respect to independence *vis-à-vis* Section 301's requirements as compared to any other board committees, such as the compensation and nominating committees.

C. SOX Section 404 and the Relationship with the PCAOB

As I am sure many of you are aware (and financial executives and corporate counselors are undoubtedly painfully aware), Section 404(a) of Sarbanes-Oxley, and the Commission's related implementing rules, now require management of an issuer to assess the effectiveness of the company's internal control over financial reporting, as of the end of the company's most recent fiscal year. The Act also requires management to include in the company's annual report to shareholders management's conclusion, as a result of that assessment, as to whether the company's internal control is effective.

The auditor's attestation on management's assessment of the effectiveness of the company's internal control over financial reporting will be similar to an audit of financial statements. Internal controls are management's immediate responsibility. Management designs and operates the system of controls, including their processes for assessing the effectiveness of internal control. Once management concludes and asserts that the internal control system is effective or ineffective, the auditor attests to the probity of management's conclusion. Section 404(b) of Sarbanes-Oxley requires the auditor to provide this attestation pursuant to Rules established by the PCAOB.

The Commission recently approved the PCAOB standards. The Commission heard from some in the issuer community that an extension was needed. In response, the Commission extended the Section 404 compliance date for "accelerated filers" to the first fiscal year ending on or after November 15, 2004 and for non-accelerated filers to the first fiscal year ending on or after July 15, 2005.

These changes have led to much complaining about implementation costs. There is no doubt that Section 404 and the related rules have significant costs. I believe, however, that the benefits far outweigh these costs. In establishing internal control systems that meet these requirements, companies may discover inefficiencies that have existed for lengthy periods of time that, when corrected or improved, actually result in operational cost savings. More rigorous emphasis on internal controls may prevent the much-too-often scenario of "bad" financial statements that are the result of inadequate internal controls. Indeed, I believe that there is an added benefit of lower costs of capital when there is sufficient trust in the integrity of financial statements. A more rigorous internal control framework helps provide that.

Finally, the upfront costs in establishing this type of framework is without a doubt significant; however, there will most certainly be a

leveling off at some point after these initial expenditures, with costs hopefully becoming much less significant.

At the same time, I believe that valid concerns regarding the attestation rules expressed through comment letters to the PCAOB have generally been addressed in the final standard. As in most, if not all, rules, there is a careful balancing that must be done, and the Section 404(b) area is no exception. I welcome your additional commentary in this important area. One question that has been asked recently is what happens when companies do acquisitions late in the fiscal year. It is something that our staff is looking into. The Commission, in my view, does not want to interfere with acquisitions (e.g., imposing an assessment requirement for the target's internal controls may discourage acquisitions from occurring, at least acquisitions late into a fiscal year). Rest assured, we are considering this important issue.

With respect to auditing standards, Sarbanes-Oxley was revolutionary in that it created a new entity, the PCAOB, to set auditing and related professional practice standards for auditors of public companies. The PCAOB also is charged with conducting inspections of registered public accounting firms and also has the ability to bring enforcement actions. In the rulemaking area, the PCAOB is not technically subject to the Administrative Procedure Act; however, it has chosen to engage in a similar type of procedure whereby it solicits public comment to allow for interested parties to make their views known.

Pursuant to the Act, the Commission has direct oversight and approval authority over the PCAOB. This includes the need for Commission approval of PCAOB rulemaking and its budget. In addition, the Commission has the power to review and resolve disputes between the PCAOB and public accounting firms. There is currently, and I firmly believe should continue to be in the future, a constant dialogue between the PCAOB and the Commission, including on the staff level. Coordination between the Commission and the PCAOB is vitally important, as there are most certainly overlapping issues. While that coordination was essentially a necessity in the Section 404 context, the rulemaking in that area is a great example of that coordination. Moreover, as both have the authority to bring enforcement actions, there should be consideration of using both of our resources efficiently.

D. Financial Expert

An additional component of the Sarbanes-Oxley Act that may directly impact corporate governance is the new requirement that com-

panies disclose if they have a financial expert on their audit committees. It is not an enormous stretch to say that audit committees need to have the ability to truly understand and dig into the company's numbers. Someone on the audit committee should have enough familiarity in preparing or working with financial statements to be able to probe the financials prepared by management.

What does this mean for executives? First, executives may well, and should, get more attention from the audit committee. The audit committee should be asking the tough questions and digging into the financial statements. That is their job and, if executives are doing theirs, that shouldn't be intimidating. Another possible consequence of the new requirement is that financial executives may become stellar candidates for seats on audit committees. While you will not be able to sit on the audit committee of a company that you work for (because of our new audit committee independence requirements), you might be very well suited to sitting on other companies' audit committees due to your financial expertise.

I have heard the complaint many times that our new requirement that audit committees consist solely of independent directors will make it very difficult to find qualified persons to serve on companies' audit committees. Similarly, I have heard complaints that companies will have difficulty finding financial experts to sit on their audit committees. Whenever I hear this, I say "hogwash." There are many excellent, qualified candidates who are ready, willing, and able to serve on listed companies' audit committees. Public companies need to stop confining the search to the same old places. Companies need to expand their horizons beyond the traditional small circle around the CEO. I imagine that some of you in this room would be excellent audit committee members. If you would not have been considered in the past, perhaps you will be considered now.

Whether you ultimately sit on listed companies' audit committees, serve as a CFO or in another corporate financial capacity, or serve as legal counsel to the board or one of its committees, the message you can derive from Sarbanes-Oxley is that you must be responsible and you will be held accountable. Clearly, independent directors and audit committees must be awake, aware, well prepared, and vigilant; CFOs, controllers and treasurers similarly will also be held accountable to the audit committee and ultimately to the shareholders; and corporate counselors must be at the top of their game.

E. Director Liability

I would like to focus on Director liability for a moment. Boards of Directors have maintained an unhealthy distance from business decisions of their public companies. Boards, and particularly outside directors, were conceived of as the shareholders' representative; yet, too often, they are dominated by associates and friends of senior management. Moreover, board membership too frequently has been viewed by outsiders as an honor or a perk instead of a substantive job. Many outside directors have lacked expertise in the relevant industry and in accounting and financial reporting issues. Thus, Boards were too rarely equipped to uncover and derail the determined efforts of management to cook a company's books.

In addition, directors too often took the approach of keeping themselves distanced from things they "did not want to be aware of." This approach is not acceptable. Directors must ask the tough questions and get involved. And most importantly, when something that should raise an eyebrow comes to the attention of a director, that director must follow up and investigate. The director cannot ignore red flags, or even pink ones.

I would like to discuss some recent actions against directors to help you understand my state of mind here. In *SEC v. O'Shaughnessy*[2] the Commission charged the Chairman of the Candie's shoe company's board and two other directors with securities fraud for participating in and/or ignoring red flags while the company was engaged in fraudulent accounting practices. The Commission alleged that Candies' senior management employed three fraudulent accounting practices to hit the estimated earnings target:

- "bill and hold" transactions;
- illusory sales transactions with a barter company controlled by a company officer;
- unsupported journal entries recognize millions in "sales credits."

What did the directors do? Our action alleged that the Chairman of the company ignored red flags evidenced by the following conduct. Evidence showed that an accounting officer made him aware that the company was engaged in "bill and hold" transactions that *may* not be

[2] Litigation Release No. 18120, Civil Action No. 03 CV 3022, 2003 SEC LEXIS 1041 (April 30, 2003).

in accordance with GAAP. He did not investigate. He did not follow up. He authorized the issuance of a press release that preannounced fiscal year earnings after he had reason to know that some of the revenue may be a result of the "bill and hold" transactions without investigating whether Candies' projected income and revenue figures were accurate. He also authorized an earnings release notwithstanding knowledge that the company's auditors had not yet signed off on Candie's financial statements because of a variety of questions they had about the barter transactions and sales credits. The Chairman had essentially emphasized hitting earnings targets and then took the approach of "not wanting to know how it was done," and in fact ignoring facts brought to his attention that should have caused him to investigate the accounting practices. The Commission alleged that this was reckless. He was hit with a fraud cease and desist order and penalty.

The Commission alleged that the other directors had actual knowledge of and encouraged the use of improper transactions and encouraged false confirmations to be provided to auditors regarding the shipment of goods to cover up improper transactions. These directors were hit with fraud injunctions, penalties, and officer and director bars. These guys are in their forties and their careers are over.

Just a few weeks ago, the Commission filed an enforcement action against Bristol-Myers Squibb Company.[3] The complaint alleges that Bristol-Myers engaged in a fraudulent scheme to inflate its sales and earnings in order to create the false appearance that the company had met or exceeded its internal sales and earnings targets and Wall Street analysts' earnings estimates. To "beat the numbers" Bristol-Myers perpetrated a fraudulent earnings management scheme by, among other things, selling excessive amounts of pharmaceutical products to its wholesalers ahead of demand, improperly recognizing revenue from $1.5 billion of such sales to its two largest wholesalers, and using "cookie jar" reserves to meet its internal sales and earnings targets and analysts' earnings estimates. In settling the Commission's action, Bristol-Myers agreed to an order finding securities fraud and requiring the company to pay $150 million and perform numerous remedial undertakings, including the appointment of an independent adviser to review and monitor its accounting practices, financial reporting, and internal controls.

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[3] *See* Press Release, U.S. Sec. & Exch. Comm'n, *Bristol-Myers Squibb Company Agrees to Pay $150 Million to Settle fraud Charges* (Aug. 4, 2004), *available at* http://www.sec.gov/news/press/2004-105.htm.

Specifically, the complaint alleged that Bristol-Myers inflated its results by:

- stuffing its distribution channels with excess inventory near the end of every quarter in amounts sufficient to meet its targets by making pharmaceutical sales to its wholesalers ahead of demand; and

- improperly recognizing $1.5 billion in revenue from such pharmaceutical sales to its two biggest wholesalers. In connection with the $1.5 billion in revenue, Bristol-Myers covered these wholesalers' carrying costs and guaranteed them a return on investment until they sold the products. When Bristol-Myers recognized the $1.5 billion in revenue upon shipment, it did so contrary to GAAP.

- When Bristol-Myers' results still fell short of Wall Street's earnings estimates, the company tapped improperly created divestiture reserves and reversed portions of those reserves into income to further inflate its earnings.

- In addition, as a result of its channel-stuffing, Bristol-Myers materially understated its accruals for rebates due to Medicaid and certain of its prime vendors, customers of its wholesalers that purchased large quantities of pharmaceutical products from those wholesalers.

The Commission obtained the following relief against Bristol-Myers:

- a permanent injunction against future violations of the antifraud, reporting, books and records and internal controls provisions of the federal securities laws;

- disgorgement;

- a civil penalty of $100 million;

- an additional $50 million payment into a fund for the benefit of shareholders; and

- various remedial undertakings, including the appointment of an independent adviser to review, assess, and monitor

> Bristol-Myers' accounting practices, financial reporting, and disclosure processes and internal control systems.

Bristol-Myers' earnings management scheme distorted the true performance of the company and its medicines business on a massive scale and caused significant harm to the company's shareholders. The company's conduct warrants a stiff civil sanction. As our investigation continues, we will be focusing on, among other things, every individual responsible for the company's failures.

When I learn of these situations, I ask myself: "Where was the audit committee during the two years this was going on?"

F. It's Time For Audit Committees To Go on Offense!

Audit committees and independent directors must take more affirmative roles in rooting out accounting and internal control issues. Audit committees must engage in a fundamental business concept—"Systematic Risk Management." I am certainly not the first person to suggest this. The authors of countless business school textbooks and pamphlets handed out at financial executive retreats have covered the concept, but audit committees need to take the concept seriously.

There are five steps to implementing systematic risk management:

1) Identify potential risks;

2) Evaluate the risks and prioritize concerns;

3) Create and implement an action plan;

4) Train employees;

5) Evaluate the plan and improve on it when necessary.

These are simple concepts that anyone trained in business, particularly audit committees, should already be doing. Audit committees should implement such a system to find early warnings of accounting and internal control issues in their companies. Football legend Vince Lombardi preached: "The best defense is a good offense." A Lombardi-run audit committee would proactively seek out potential risks.

In identifying risks and prioritizing concerns, with the framework of 404 in mind, I believe it would be prudent for independent directors, and particularly audit committee members, to become knowledgeable about accounting shenanigans that have become pervasive

in their company's industry, as highlighted through SEC enforcement actions.

For example, in the software technology industry, accounting problems have been pervasive where revenues are prematurely and improperly recognized for long-term services tied to sales, in violation of SOP 97-2.[4] In the Internet advertising industry and telecom industry, illegal "round-tripping" has been a pervasive accounting problem.[5]

In many industries, including the biotech and software technology industries, channel stuffing has become the illegal accounting trick of choice to help "meet the numbers."[6]

In creating and implementing an action plan, as audit committees are working with their outside accountants in their review of internal controls, it would be prudent for the audit committee to fully comprehend accounting issues that have become prevalent in their industry, and requisition "spot checks" by their auditor in the course of the financial and 404 audits to take a hard look and satisfy themselves that no transaction accounting shows signs of channel stuffing, round-tripping, or other accounting shenanigans pervasive in their industry.

G. *Reaction to a Recent Article in* Director's Monthly *Entitled:* The Heat Is Still On: Director Liability Warnings from Delaware[7]

This article has an undertone addressing the concern of board members that Sarbanes-Oxley and the new NYSE rules have eroded the "business judgment rule." The general concern is that this will make it very difficult for companies to take calculated business risks that will advance the bottom line. I would like to put this in context for you and highlight some important points.

Courts, in looking at the "business judgment rule," have long held that "in making business decisions, directors must consider all material information reasonably available" and must "act in good faith." Some have questioned whether a "new set of expectations on direc-

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[4] *See, e.g.*, SEC v. i2 Technologies, Inc., Litigation Release No. 18741, Civil Action No. 3:04 CV 1250, 2004 SEC LEXIS 1187 (June 9, 2004); *In re* Axeda Systems Inc., Release No. 48783, Administrative Proceeding No. 3-11334, 2003 SEC LEXIS 2710 (Nov. 14, 2003); *In re* Critical Path, Inc., Securities Litigation, 156 F. Supp. 1102 (N.D. Cal. 2001).

[5] *See, e.g.*, In re Homestore.com, Inc. Securities Litigation, 347 F. Supp. 2d 769 (C.D. Cal. 2004); SEC v. Gemstar-TV Guide Int'l, Inc., Litigation Release No. 18760, Case No. CV-04-04-4506 RGk, 2004 SEC LEXIS 1289 (June 23, 2004).

[6] *See, e.g.*, SEC v. Symbol Technologies, Inc., Litigation Release No. 18734, Case No. CV 04 2276, 2004 SEC LEXIS 1120 (June 3, 2004).

[7] Ira M. Millstein, *The Heat Is Still On: Director Liability Warnings from Delaware*, DIRECTOR'S MONTHLY (January 14, 2003), *available at* http://www.nacdonline.org/dm/NACD-Jan-14-2003-DMX.pdf.

tors" will play a role in a court's assessment of what information was "reasonably available" and whether the directors have "acted in good faith."

Sarbanes-Oxley and SRO rules have not eroded the "business judgment rule." The bottom line is if directors act reasonably and in good faith, they will be protected from liability. From the perspective of SEC actions, let me be very clear, participating in, overlooking, or ignoring red flags indicating possible fraudulent accounting *is not a business decision.* As the SEC action against Candies directors illustrates, the situations where directors have to be worried about an SEC action against them is where they act very unreasonably and in bad faith. Where you see SEC actions against directors is where information regarding *possible* improper accounting practices or indicia of possible improper recognition of revenue comes to the attention of a director and a reasonable director, acting in good faith, would investigate. If the directors do not conduct an independent investigation, they are not acting reasonably or in good faith and should not be protected by the "business judgment rule." It is that simple and it is not a different analysis after Sarbanes-Oxley.

The *Director's Monthly* article raises two questions that are worth focusing on because they highlight that directors need to be involved in order to act in good faith. First, the article asks: can directors have a good faith belief that an audit committee of a multi-billion dollar multi-national corporation that meets for an hour quarterly (with some participating by phone) devoted enough time and attention to oversight? *No!* Not even close! Second, should the audit committee and board have their own independent advisors, investigators, and lawyers? *Yes.* As guided by Sarbanes-Oxley, the board and its committees should "engage independent counsel and other advisors, as it determines necessary to carry out its duties" and should not rely exclusively on the corporation's advisors and lawyers.

As a final point, directors who are supposed to be independent should have the guts to be a pain in the neck and act independently.

H. Director Independence Under State Law

While this is certainly not an area that is directly within the Commission's jurisdiction, I wanted to briefly mention director independence in the context of state law and discuss a case that I personally believe is an important one.

1. In re Oracle Corp *Derivative Litigation*[8]

In *In re Oracle*, a shareholder derivative suit was filed against Larry Ellison, CEO of Oracle, and several directors accusing them of breaching their fiduciary duties by engaging in insider trading. After the filing of the complaint, Oracle established a special litigation committee ("SLC") composed of two "independent" directors to evaluate the insider trading claim, which ultimately concluded that the CEO and directors did not have material nonpublic information and that Oracle should thus not pursue the insider trading claim. The SLC moved for termination of the derivative action. The SLC had the burden of persuading the court that: (1) the members of the SLC were independent; (2) the SLC members acted in good faith; and (3) the SLC had reasonable bases for the recommendations.

The Delaware chancery court denied the SLC's motion on the basis that the SLC had failed to show that no material factual question existed as to the independence of the SLC. Specifically, the existence of Stanford University connections among the SLC members (both were Stanford professors), as well as the fact that the CEO had considered giving $170 million to Stanford, led the court to indicate that there was "a social atmosphere painted in too much vivid Stanford Cardinal red for the SLC members to have reasonably ignored it."[9] Vice-Chancellor Strine concluded that the SLC has not met its burden to show the absence of a material factual question about its independence due to the "substantial" relationships among the SLC, the Trading Defendants, and Stanford. These ties were so significant that they caused reasonable doubt about the SLC's ability to impartially consider whether the Trading Defendants should face the lawsuit.

In describing the independence of the SLC, Vice-Chancellor Strine indicated that he was measuring independence "contextually" and that this

> contextual approach is a strength of [Delaware] law, as even the best minds have yet to devise across-the-board definitions that capture all the circumstances in which the independence of directors might reasonably be questioned. By taking into account all circumstances, the Delaware approach undoubtedly results in some level of indeterminacy, but with the compensating benefit that independence determinations are tailored to the precise situation at issue.[10]

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[8] *In re Oracle Derivative Litigation*, 824 A.2d 917 (Del Ch. 2003).

[9] *Id.* at 947.

[10] *Id.* at 941.

Vice-Chancellor Strine noted the recent reforms through Congressional action and the SROs. In this regard, Strine indicated that these actions were narrower in scope as to who constituted "independent directors" but that there was recognition by, for example, the New York Stock Exchange listing standards that it was not possible to capture all circumstances involving potential conflicts of interest or that might relate to the materiality of a director's relationship with a listed company.

In thinking about director independence, in my opinion, it is important not to look only at the specific requirements that exist (for example, through the NYSE and NASDAQ listing standards) but also to carefully consider *any* sort of relationships that *could* be deemed to impair independence. From a regulatory perspective, it is not possible to implement standards that capture every possible situation, primarily because independence determinations relate to a fact-specific inquiry. In my view, I believe that this case sends an important message that boards must carefully consider all factors that could lead to possible non-independence.

I. New Nominating Committee Disclosure Requirements

As part of the Commission's ongoing examination of the director nomination area, the Commission adopted new disclosure rules relating to enhanced disclosure of the director nomination process. Companies must now disclose, among other things, the minimum qualifications and standards that they seek in director candidates and whether the nominating committee will consider director candidates submitted by shareholders, and if so, the process for consideration of such candidates. With respect to suggestions of director candidates by greater than five percent shareholders who have held their shares for at least one year, the company must disclose whether it has rejected such director candidates and, if both have consented, the identities of the five percent shareholder and its director candidate.

While not a part of the NYSE and NASDAQ listing standards, I believe that this disclosure requirement will provide for more meaningful information relating to nominating committees and the director nomination process generally. Investors, including significant institutional investors, have indicated that this type of transparency is important to them.

J. Shareholder Access

Because others will be commenting extensively on shareholder access, I will just briefly give you my views. In regard to shareholder

nominations of directors, many have advocated for independent nominating committees, full disclosure of nominating committee procedures, and *consideration* of shareholder-named candidates, over *mandated* nominations based on numerical "triggering events."

I want to be frank about where I come down on this. We pored over literally thousands of comment letters, and our proposal, requiring two triggering events, is out there now. We will set a date for finalizing the rule, I hope before the end of the year, if not sooner. I am on the record in favor of the proposal, and I believe that the facts clearly support me on this. The proposal is very modest. Shareholders will never be permitted to seek a majority of the board; as proposed, they will only be allowed to nominate one candidate out of a board of eight directors, two for boards with between nine and nineteen directors, and at most, three for boards with twenty or more directors. And—and it's a big "and"—the nominee has to be independent of the shareholders, so they cannot put their own person on there. I don't see the threat to the day-to-day business that many in the corporate community have indicated to us. If there are facts that I am not taking into account, then I certainly want to understand them, because I do not want to create a business obstruction. But I just don't see it. So far all I have heard is supposition. In fact, all the evidence that I see points to the contrary.

In many other developed countries, shareholders have much greater access to the proxy. In fact, in Canada, if you have five percent of votes, you can put forward a whole slate of directors. But even under that regime, the rule is almost never used.

I believe if we do not adopt this moderate proposal, the shareholder activists will come roaring back with a vengeance and will want much more access and create a much more onerous situation for business. I don't think that's necessary. The proposal allows for negotiation and it gives companies time to react. I don't believe it gives shareholders undue influence. Remember that all of the shareholders have a vote and no overly narrow interest will carry the day. Under the proposal, a narrow interest group will never be able to persuade fifty percent of the shareholders to support an item that hurts shareholder value. Ultimately, such groups will not gain leverage in discussion with the company unless there is a potential for success.

K. Business Ethics

We all know that having rules in life is not enough. Indeed, if it were enough, the existence of the laws and rules would ensure proper conduct among human beings. For this reason, I urge all of you—the

current and future board members, and corporate executives, and counselors for public companies—to live and practice on a daily basis good ethics and principles.

My colleagues and I at the SEC have encouraged corporate directors and senior management to make it clear to employees through their words and conduct that *ethics matter*. Senior management and boards of directors should establish practices that acknowledge and commend acts of honesty and ethical behavior.

Just as good deeds in life create unforeseen blessings, I believe it is fundamental that honesty and integrity will ultimately create business success. Creating an ethical business culture should not be viewed as a sacrifice. Indeed, it is *good business* to be open and honest with your shareholders. It is *good business* to have fair dealings with your business partners. It is *good business* to reward employees for being honest and ethical. It is *good business* to be known as a company that deals fairly in its business transactions. It is *good business* for shareholders to know that a company not only has a code of ethics but that the code is followed every day. It is also *good business* to select leaders largely based on their integrity and commitment to ethical behavior.

In conclusion, I believe that we have come a long way in implementing some long-needed reforms. Independence of directors, stricter guidelines with respect to independent auditors and audit committees, and other regulations, while not a panacea, will, in my opinion, result in companies being held more accountable. It is my hope that the great concern that we have seen today by companies, their management and their boards will continue in the future, through the next bull market and beyond.