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S. Burcu Avci
Stephen M. Ross School of Business
University of Michigan

Cindy A. Schipani
Stephen M. Ross School of Business
University of Michigan

H. Nejat Seyhun
Stephen M. Ross School of Business
University of Michigan

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Do Independent Directors Curb Financial Fraud? The Evidence and Proposals for Further Reform[+]

By
S. Burcu Avci[*]
Cindy A. Schipani[**]
H. Nejat Seyhun[***]

Abstract

In this article, we argue that the U.S. corporate governance rules put too much faith in the independent board members and insufficient emphasis on the shareholders to control and monitor top management. Given the agency problem between the board of directors and the shareholders, outside directors can be captured by management, thereby leading to inadequate checks on management. The evidence presented in this paper shows that outside board members do not exercise sufficient controls on management even when management has gone awry. To solve this agency problem, we propose increasing the power of the principals: make shareholder resolutions binding on management, require a one share, one vote rule to increase the voting rights of shareholders, give the shareholders the ability to directly nominate and/or actively vote against board members and decrease shareholders' barriers to exercising these rights by creating corporate platforms for beneficial owners to register and vote their shares.

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[*] Post-Doc Research Scholar, Ross School of Business, University of Michigan, Ann Arbor, Michigan.
[**] Merwin H. Waterman Collegiate Professor of Business Administration and Professor of Business Law, University of Michigan, Ann Arbor, Michigan.
[***] Jerome B. & Eilene M. York Professor of Business Administration and Professor of Finance, University of Michigan, Ann Arbor, Michigan.

Introduction

Around the turn of the millennium, a slew of corporate scandals involving outright fraud, including those at Enron, WorldCom, Global Crossing, and Adelphia Communications, among others,[1] plagued capital markets and shook investor confidence to the core. Faced with this runaway corporate malfeasance by managers of large firms, Congress decided to discipline the managers by increasing the supervisory role of the board of directors. The Sarbanes-Oxley Act of 2002 ("SOX" or the "Act"),[2] was passed by Congress in an effort "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."[3]

This was not of course the only option for Congress. Congress could have also increased the direct supervisory role of the shareholders. This alternative, Congress decided not to pursue. We are now nearly fifteen years down the road from the corporate scandals of the early 2000s, and we are now in a position to observe how well Congress' choices have been working so far.

The actions Congress decided to take not only included increasing the potential criminal and civil fines and sentences for securities fraud, SOX also attempted to address concerns about corporate governance failures by adding a requirement that certain board members be independent[4] and rules regarding the composition of audit committees.[5] For example, SOX demanded that the audit committee be comprised of entirely independent directors[6] and include at least one financial expert.[7] In addition, SOX included rules requiring outside auditors be independent.[8]

One would have hoped these SOX-created independent watchdogs would reduce the incidents of securities fraud and result in better governance. Yet, our analysis of the number of class action settlements for claims of financial fraud for settlements greater than $10 million shows no significant decrease since the adoption of SOX. We presume that settlements of over $10 million indicate serious concern of the board evidencing the viability of the suit.[9] The dollar amount for analysis was chosen to reduce the incidence of strike suits in our data. Thus, the lack of a significant decrease in these claims seems to indicate that it may have been unreasonable to expect independent directors—who almost by definition are not privy to the day-to-day affairs of the firm – to have enough incentives or information to ferret out complex, and likely hidden, fraud.

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[1] *See* Scott Green, *A Look at the Causes, Impact and Future of the Sarbanes-Oxley Act*, 3 J. INT'L. BUS. & L. 33 (2004).

[2] The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

[3] *Id.* Preamble.

[4] *Id.* at 46.

[5] *Id.* at 38.

[6] *Id.* at 38.

[7] Sarbanes-Oxley Act of 2002, *supra* note 2, at § 407.

[8] *Id.* at § 404.

[9] To exclude strike suits, we require a minimum settlement amount of $10 million. The years 2001-2002 appear to be anomalous due to the recession and cratering stock market. We find that between 1996 and 2000; 42.4 lawsuits per year for an average annual total of $3.3 billion were settled for $10 million or more, while the corresponding numbers between 2003 and 2008 are 42.4 lawsuits per year and average annual total of $3.1 billion. While there are no on-going cases from the pre-SOX period, the post-SOX numbers exclude a total of 13 on-going cases.

Moreover, and perhaps even more troubling, our data also show that independent directors themselves are not necessarily immune from the temptations of financial fraud, particularly with the gains to be had from backdating stock options. SOX's reliance on them may simply have transferred oversight responsibilities from compromised executives to compromised and ill-informed board members.

An alternative approach to the SOX mandates would have been to empower the shareholders directly and enable them to exercise a greater degree of direct oversight over the managers. First, it does not make logical sense for the shareholders to cede some of their supervisory role to the managers, the very same people that they are trying to supervise. This is a nonstarter. But this is exactly what happens when the managers vote shareholders' proxy as they see fit. Second, the system of tracking the shareholders and registering all ownership of the security in the name of the shareholders is a long-ignored reform that puts the U.S. even behind most developing countries. It is now more than eight years following the Madoff scandal and the U.S still does not register securities directly in shareholders' names. This simple reform should put an end to all future Madoff-like scandals. Finally, the cost to shareholders from directly exercising their supervisory role and communicating with managers would be minimal in this electronic age. Companies could set up secure websites to allow the shareholders to review corporate issues and vote their choices.

We recommend that Congress take another look at this issue. Granted, although some shareholders are not privy to the day-to-day affairs and unless their holding is substantial, may rationally stay ignorant, there are also shareholders with substantial holdings who could be further empowered to provide an effective check on both the managers and the board of directors. To this extent, we thus propose that shareholder resolutions bind management (subject to minimum participation levels), one share to be required to have one vote, as well as for shareholders to have the ability to directly nominate and/or actively vote against board members.

We find that the outside directors have failed with everyone else on the board to monitor the management. In this regard, we investigate the timing and backdating of executive compensation options between 1996 and 2015. In this study, we find that outside directors manipulate their option grants like the top executives do. Similar to options given to the top managements, outside directors use dating and timing techniques to manipulate stock options granted. Our evidence shows that they employ backdating, spring-loading and bullet dodging games to increase the value of their options. Backdating among other techniques provides remarkable profits to outside directors. Application of these techniques for late reported grants increase outside directors' compensation by substantial amounts. Specifically, management received extra compensation amounts of 9.2%, 14.9% and 4.1% for the 1996-2002 period, 2003-2006 period; and the 2007-2014 period, respectively. For outside directors, the comparable numbers are 7.0%, 10.3%, and 7.5%, respectively. For large late reported option grants, abnormal returns increase even further.

Our evidence strongly suggests that outside directors are not fulfilling the monitoring responsibility placed on them by SOX. We recommend that the solution lies not in strengthening the board of directors, but by strengthening the power of the shareholders. We make three specific recommendations. First, we recommend that multi-class voting structures should be eliminated. The multi-class voting structures exacerbate the conflict between shareholders and the management and lead to inferior outcomes. Our second recommendation is to make the shareholder resolutions binding on the board of directors. Currently, management typically ignores the non-binding shareholder resolutions. Finally, we recommend that plurality voting be eliminated and replaced by majority voting for the board of directors. Majority voting shifts the relative power to elect the directors away from the management to the shareholders.

To address these issues this manuscript is organized as follows. Part I reviews some of the financial frauds giving rise to SOX followed in Part II by a discussion of the legislative response, focusing on the corporate governance provisions of the legislation. In Part III, we outline the role of directors and shareholders, and analyze impediments to the power of shareholders to oust board members. Our empirical study, demonstrating the ineffectiveness of SOX reforms for decreasing the number of viable class action suits for financial frauds as well as evidence of board complicity in the fraudulent backdating of stock options is presented in Part IV. Next, Part V offers proposals for reform to empower shareholders in the oversight role. Concluding remarks follow.

I. Prequel to SOX: Overview of the Financial Frauds of the Early 2000s

On July 25, 2002, Congress passed the Sarbanes-Oxley Act of 2002 (the "SOX Act" or "SOX").[10] Officially titled the Public Company Accounting Reform and Investor Protection Act, SOX was the federal government's response to the highly publicized corporate scandals that followed the tech boom of the late 1990s. The seven months before SOX's enactment saw four of the largest bankruptcies in U.S. history, most famously those of Enron and WorldCom. The reports that emerged in the aftermath attributed these bankruptcies to the fraudulent practices of top executives, with the help of corporate accounting firms, lawyers, and internal audit committees. These companies hid their debts and toxic assets from creditors and shareholders but they could not keep meeting financial obligations which in turn pushed them to finally reveal incredible losses after restating their earnings. Revelation of the frauds wreaked havoc on the stock market, resulting in Congress "hurriedly pass[ing] a measure that would toughen criminal fraud penalties to curb corporate wrongdoing."[11]

A. Enron

Before its collapse in 2001, Enron Corporation had been viewed by many as a poster child for American industry and innovation.[12] Once natural gas industry was deregulated in the 1980s, Enron, a traditional and asset-heavy gas-pipeline company, quickly saw an opportunity in trading

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[10] Sarbanes-Oxley Act of 2002, *supra* note 2.
[11] Richard W. Stevenson & Richard A. Oppel, Jr., *Fed Chief Blames Corporate Greed; House Revises Bill*, N.Y. TIMES, July 17, 2002, http://www.nytimes.com/2002/07/17/business/corporate-conduct-overview-fed-chief-blames-corporate-greed-house-revises-bill.html.
[12] *See, e.g.*, Marianne M. Jennings, *A Primer on Enron: Lessons from a Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures*, 39 CAL. WEST. L. REV. 163, 169 (2003).

business.[13] By the 1990s, transforming into a market-maker and trader in energy commodities and related derivatives,[14] Enron, at its peak, accounted for approximately 25% of all energy trading in the United States.[15] The markets Enron headed provided significantly lower transaction costs for utility companies requiring fuel sources. Development of technologies and the Internet allowed Enron to conduct most of its trading online. As a result, Enron became “the largest e-commerce company in the world, with a bubble-era stock price to match.”[16] In just fifteen years, Enron had reached the rank of the seventh largest American company by market capitalization.[17]

In October of 2001, because of accounting revisions, Enron took a $500 million after-tax charge against earnings and disclosed a $1.2 billion reduction of shareholders’ equity.[18] The market met this news with no immediate reaction: utility and energy companies were still willing to do business with Enron,[19] and investment rating agencies were reluctant to downgrade Enron’s bonds.[20] But investors— who had paid little attention to the impenetrability of Enron’s books during the corporation’s boom years— began to insist on explanations. Investors were particularly concern with complex, potentially self-dealing transactions with partnerships organized through Enron's chief financial officer, Andrew Fastow, which had not been apparent in the company’s financial accounting statements.[21] Wall Street was skeptical about Mr. Lay’s attempts to alleviate the troubling issues.[22] The SEC, after opening an informal investigation into Enron in August, launched a formal inquiry.[23]

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[13] William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1278 (2002); Wendy Zellner et al., *Enron’s Power Play*, BLOOMBERG, Feb. 11, 2002, http://www.bloomberg.com/news/articles/2001-02-11/enrons-power-play.

[14] *See* Peter Coy et al., *Enron: Running on Empty*, BLOOMBERG (Dec. 10, 2008), http://www.bloomberg.com/news/articles/2001-12-09/enron-running-on-empty (noting that some viewed Enron as the “Goldman, Sachs & Co. of the energy business”). Enron publicly acknowledged its change in direction via its securities filings: in 2001 Enron described its principal business as "security brokers, dealers and flotation,” whereas it had previously said it was in the business of "wholesale-petroleum and petroleum products.” *Id.*

[15] Kurt Eichenwald, *Enron’s Collapse; Audacious Climb to Success Ended in a Dizzying Plunge*, N.Y. TIMES, Jan. 13, 2002, http://www.nytimes.com/2002/01/13/us/enron-s-collapse-audacious-climb-to-success-ended-in-a-dizzying-plunge.html [hereinafter Eichenwald, Enron’s Collapse]; Jennings, *supra* note 12.

[16] *Id.*

[17] Eichenwald, Enron’s Collapse *supra* note 15; Coy et al., *supra* note 14.

[18] HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED, HOW TO FIX IT 5 (2006).

[19] Immediately after these disclosures, an executive of a major energy trader stated that it was not overly concerned about Enron’s financial health. Alex Berenson and Richard A. Oppel Jr., *Once-Mighty Enron Strains Under Scrutiny*, N.Y. TIMES, Oct. 28, 2001, http://www.nytimes.com/2001/10/28/business/28ENRO.html

[20] *See id.* Some have argued that large credit rating agencies are themselves conflicted because they take fees from the corporations whose debt they rate. *See* Jerry Hirsch & Thomas Mulligan, *Safeguards Failed to Detect Warnings in Enron Debacle*, L.A. TIMES, December 14, 2001, http://articles.latimes.com/2001/dec/14/news/mn-14906. The head of the team at Standard & Poor that handled Enron also acknowledged that the firm faced pressure not to downgrade Enron precipitously. *Id.* (“we take care not to overreact to any developing situation so that we don't cause a deterioration [in a company's finances] rather than just opine on it”).

[21] *Id.*

[22] *Id.*

[23] Alex Berenson, *S.E.C. Opens Investigation into Enron*, N.Y. TIMES, Nov. 1, 2001, http://www.nytimes.com/2001/11/01/business/sec-opens-investigation-into-enron.html.

Any hopes of Enron's survival were quickly quashed as further revelations about Enron's accounting and business practices came to light. The two limited partnerships that induced the $1.2 billion write-off were just the tip of the iceberg: according to Enron's 10-K filing, the company engaged in thousands of transactions using affiliates and separate special-purpose entities (SPEs) to insulate the company's earnings from short-term volatility resulting from its trading activities.[24] The accounting treatment afforded to SPEs allowed Enron to slough off its bad debts and toxic assets while simultaneously inflating profits,[25] provided that enough of the SPE's equity was held by an unrelated party.[26] In many of Enron's transactions with its SPEs, either Enron, an affiliate, or an Enron executive held the equity via a series of complex corporate structures and sham asset sales.[27] When some of these transactions came under scrutiny in the fall of 2001, their previous accounting treatments were disqualified and Enron was forced to consolidate the financial statements.[28]

Enron utilized many other accounting maneuvers to misrepresent its financial health. For example, the company reported artificial gains and reduced losses by characterizing the company's borrowings as sale-and-purchase transactions[29] and bootstrapping its own stocks. Enron also exploited mark-to-market accounting, requiring Enron to assign real-time fair market values to its derivative positions.[30] Playing this game, Enron would use excessively optimistic assumptions.[31] Enron's long-term energy trading contracts were also plagued by issues surrounding unclear valuation.[32]

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[24] ENRON CORP., 10-K (filed with the SEC on Apr. 2, 2001) (listing Enron's various subsidiaries). For a comprehensive account of Enron's accounting maneuvers, *see* Jennings, *supra* note 12, at 173-94.

[25] To summarize, the accounting treatment of SPEs would allow profits from transactions between Enron and its affiliate SPE to pass through to Enron's income statement. Provided that certain requirements were met, Enron could also move debt into its affiliate SPEs and preserve its credit rating. An investment-grade credit rating was crucial to Enron's trading and derivatives operations. Are Current Financial Accounting Standards Protecting Investors? Hearing Before the House Subcomm. on Commerce, Trade and Consumer Prot. of the Comm. on Energy and Commerce, 107th Cong. 21-22 (Feb. 14, 2002) (statement of Edmund L. Jenkins, Chairman, FASB), http://energycommerce.house.gov/107/action/107-84.pdf.

[26] For an SPE to obtain off-balance-sheet treatment, it must satisfy particular rules of consolidation accounting. SEC accounting rules required that a) a majority of the entity's equity be controlled by an unrelated party, and b) the debt-to-equity ratio of the SPE be capped at 33:1. *Id.* ; Steven L. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 CINN. L. REV. 1309, 1309 (2002); Neal Newman, *Enron and the Special Purpose Entities - Use or Abuse? - The Real Problem - The Real Focus*, 13 L. & BUS. REV. OF AM. 97, 97 (2007).William W. Bratton & Adam J. Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs*, 86 S. Cal. L. Rev. 783, 868 (2013).

[27] Bratton, *supra* note 13, at 1287.

[28] In the case of its infamous Chewco SPE, for example, "Enron's earnings for 1997 through mid-2001 were retroactively reduced by $405 million . . . . [and the] consolidation increased its total indebtedness by $628 million." William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1309 (2002).

[29] To expand on this accounting trick: "loans to Enron from outside sources were often accounted for as revenue, and then "churned" by transfers to and from SPEs and booked again as profits by both Enron and the SPEs." Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 Hous. L. Rev. 1, 10 (2003).

[30] "Under [mark-to-market] accounting, even though the position remains open and gain or loss has not yet been realized, the firm's income statement reflects the gain or loss implied by the contract's current value." *Id.* at 1294.

[31] A statement of the accounting rules then in force is set out in Statement of Financial Accounting Standards (SFAS) No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (June 1996).

[32] Bratton, *supra* note 13, at 1304.

As revelations of these questionable accounting practices piled up, the public's attention turned to the cracks in Enron's corporate governance. Disclosures of self-dealing practices began with announcement that the CEO of Enron, Andrew Fastow, had been compensated $30 million for managing the limited partnerships that gave rise to the $1.2 billion writeoff.[33] In addition, Fastow and many members of Enron's board of directors, including members of its audit committee, benefited from accounting manipulations, receiveing consulting fees or cash donations to their favored charities. These "perks" were often funded by the same special-purpose entities that were being used to hide debt.[34]

The self-enriching practices of Enron's management did not stop there. Shortly before Enron filed for bankruptcy, the company generously gave its former CEO, Kenneth Lay, at least $67.4 million. Other senior directors and officers received more than $10 million each.[35] Enron also gave "retention bonuses" of over a million dollars to other members of top management to keep them in Enron.[36] Just before Enron filed for bankruptcy, about forty top employees received their entire deferred compensation in cash, an option not given to lower level employees.[37] The amount paid out to senior executives between restatement of earnings and filing of bankruptcy was a stunning $681 million.[38]

Enron's generosity stopped at the top management level as lower-level Enron employees' severance payments were capped at $13,500 per employee, the equivalent of two weeks' pay for some of them.[39] What made these favored-employee payments even more egregious was that Enron encouraged its employees to invest their 401(k) funds in Enron stock. However, Enron had prohibited its employees from selling company shares during the four weeks preceding the earnings restatement, so that lower-level employees who had invested 401(k) funds in Enron could do nothing as their retirement funds declined in value.[40] During this period, the media picked up on the pay disparity between top management and lower-level employees.[41] Lower-level employees accused executives of conducting $1.1 billion in insider stock sales during the blackout, dumping their shares in anticipation of negative news reaching the public.[42]

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[33] It should be noted that the two partnerships in question, and Fastow's role in them, were not completely hidden in the fall of 2001. They had been disclosed, albeit in extremely opaque terms, in a footnote to Enron's 2000 financials. *See* ENRON, 2000 ANNUAL REPORT 48 (2001); *see also* ENRON, 1999 ANNUAL REPORT 59 (2000).

[34] Hirsch & Mulligan, *supra* note 20.

[35] Kurt Eichenwald, *Even If Heads Roll, Mistrust Will Live On*, N.Y. TIMES, Oct. 6, 2002, http://www.nytimes.com/2002/10/06/business/even-if-heads-roll-mistrust-will-live-on.html [hereinafter Eichenwald, Even If].

[36] Kathryn Kranhold & Mitchell Pacelle, *Ex-Enron Workers Pursue Bonuses Given to Executives Before Collapse*, WALL ST. J., June 12, 2002, http://www.wsj.com/articles/SB1023819019250366920 [hereinafter Kranhold & Pacelle, Ex-Enron Workers].

[37] John D. McKinnon, *Senate Panel Will Vote on Executive-Pay Plan*, WALL ST. J., Sept. 19, 2002, http://www.wsj.com/articles/SB1032386849942589195; Hamilton, *supra* note 29, at 11.

[38] Kranhold & Pacelle, Enron Paid Managers, *supra* note 36.

[39] *See* David Barboza, *Enron Agrees to Increase Severance by $30 Million*, N.Y. TIMES, June 12, 2002, http://www.nytimes.com/2002/06/12/business/enron-agrees-to-increase-severance-by-30-million.html.

[40] *Id.*

[41] Joann S. Lublin, *Some CEOs Received Big Payouts as Companies They Led Faltered*, WALL ST. J., Feb. 26, 2002, http://www.wsj.com/articles/SB1014679757271725840.

[42] *See id.*

On December 2, 2001, Enron filed for Chapter 11 bankruptcy.[43] By that date Enron's share price had fallen to sixty cents per share, and approximately $3.5 billion of its bonds were trading at just a quarter of their face value.[44]

B. Global Crossing, Qwest, Adelphia, and WorldCom

The Enron scandal was the first in a wave of corporate debacles that filled news headlines and fueled public outrage. Many of the companies embroiled in scandal were household names such as AOL, Time Warner Inc., Rite Aid Corp. and Xerox Corp.[45] Misleading accounting practices were particularly widespread in the telecom industry: between January and June 2002, over 100 telecom companies restated earnings, most of which had passed public accounting muster.[46] The scandals involving Global Crossing, Qwest, Adelphia, and WorldCom exemplify some of the fraudulent accounting practices and self-dealing that paved the road to the enactment of SOX.

1. Global Crossing

Global Crossing was a main player in the telecom industry almost immediately after it came into existence but soon became bankrupt from accounting fraud: its trick of choice was liberal use of "pro forma accounting," a reporting technique that presents results on the basis that certain assumptions were made, allowing companies to stray significantly from GAAP.[47] Using pro forma accounting, Global Crossing left off its financial statements many items that would be considered expenses by GAAP.[48] The company dismissed concerns that certain cash amounts on Global Crossing's financial statements were inflated, noting that its auditor, "Arthur Andersen, had signed off on its annual reports that reflected the cash revenue."[49]

The SEC eventually launched an investigation into Global Crossing.[50] As Global Crossing later admitted, the company shredded documents even after the documents had been requested by the SEC as part of its investigation.[51] In April, Global Crossing filed for bankruptcy and then in August, they made a deal with their creditors to sell the business to a group of investors.[52] Like the executives at Enron, Global Crossing's executives profited from the inflated value of their company's stock. CEO Winnick received a total of $735 million from Global Crossing stock

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[43] Dan Ackman, *Enron Files Chap. 11*, FORBES, Dec. 3, 2001, https://www.forbes.com/2001/12/03/1203topnews.html.
[44] Coy et al., *supra* note 14.
[45] Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 925 (2003).
[46] Hamilton, *supra* note 29, at 17.
[47] *See* Richard J. Wayman, *Accounting Red Flags*, FORBES, Feb. 27, 2002, 8:00AM, http://www.forbes.com/2002/02/27/0227wayman.html.
[48] *See* Cunningham, *supra* note 45, at 931-32.
[49] *Id.*, at 931.
[50] Dennis K. Berman & Henny Sender, *Founder Winnick May Kick In Funds to Aid Global Crossing*, WALL ST. J., June 10, 2002, http://www.wsj.com/articles/SB1023657919482376440 [hereinafter Berman & Sender, Founder Winnick].
[51] Simon Romero, *Global Is Said to Admit Files Were Shredded*, N.Y. TIMES June 24, 2002, http://www.nytimes.com/2002/06/24/business/global-is-said-to-admit-files-were-shredded.html.
[52] Cunningham, *supra* note 45, at 928.

during the bankruptcy time period.[53] To maintain his stock share value in light of the impending collapse, Winnick purchased 'collars' which preserved a large portion of his shares' value.[54]

The Global Crossing board was filled with conflicts of interest. A number of the people on the audit committee were close to Winnick. Maria Logamasiano was Winnick's personal banker was on Global Crossing's audit committee and Winnick was on her company's Board of Advisors.[55] She, along with one other member of the Global Crossing audit committee eventually resigned due to conflicts.[56]

2. Qwest

On July 28, 2002, Qwest Communications International Inc. (Qwest) announced that it would restate earnings for 1999-2001, due to improper recognition of capital investments as profits.[57] This disclosure came on the heels of announcing about a $1 billion reduction in its revenue prediction for the next year and write-downs of $20 – 30 billion.[58] Moreover, Qwest revealed that it was close to violating covenants in its loan agreements that required it to maintain certain debt-to-EBITDA ratios. Following this succession of bombshells, Qwest entered into settlement negotiations with the SEC.[59]

Qwest came into being during the telecom boom in the 1990s and made the mistake of excessive investment in various resources.[60] To artificially inflate its financial statements, Qwest teamed up with other providers of domestic telephone services to create gimmick transactional accounting via "communications capacity swaps."[61] Quest announced that it planned to restate $950 million in revenue from mid-2000 and all of 2001 as part of swap transactions.[62] In these transactions Qwest sold capacity on its own network to another carrier and booked the revenue, while in parallel buying a nearly identical amount from the other company – deals that had little purpose other than boosting revenues while capitalizing costs.[63] These swaps became a mainstay of the industry, but – as the top executives at telecom companies realized—they were not sustainable.[64] Not long before collapse, Qwest noted that its executives collected close to $500

[53] *Id.*
[54] *Id.*
[55] Jennifer S. Recine, *Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act*, 39 AM. CRIM. L. REV. 1535, 1541 (2002).
[56] *Id.*
[57] *Qwest Says It Used Improper Accounting*, L.A. TIMES (July 29, 2002), http://articles.latimes.com/2002/jul/29/business/fi-qwest29 [hereinafter *Qwest Says*].
[58] Shawn Young, *Qwest Predicts Charge on Its Assets In 2002 of $20 Billion to $30 Billion*, WALL ST. J. Apr. 2, 2002, http://www.wsj.com/articles/SB1017702063924572320.
[59] *Qwest Says*, *supra* note 57.
[60] Cunningham, *supra* note 45, at 932.
[61] Shawn Young, *Qwest to Restate $950 Million In Revenue From 'Swap' Deals*, WALL ST. J., September 23, 2002, http://www.wsj.com/articles/SB1032735861697679593.
[62] *Id.*
[63] *Id.*
[64] *See id.*

million from 1999 to 2001.[65] But two people's earnings stood out—one former CEO earned close to $230 million, and another shareholder earned approximately $1.5 billion in 1999.[66]

3. Adelphia

In late March 2002, Adelphia, announced that it had failed to report $2.3 billion in debt.[67] The price of Adelphia stock crashed and the NASDAQ delisted the stock.[68] Later on that year during the month of May, Adelphia did not satisfy terms of more than one bank loan or bond agreements.[69] It was shortly after that when the company filed for bankruptcy.[70]

It came out in 2001 that several Rigas family members, who were on the company's board, had committed various frauds and misappropriated funds.[71] In May, all the Rigas family members resigned.[72] Then in June, more truth came out: the company admitted to overstating revenues and cash flow by yet an additional $500 million in the past two years; a couple more board remembers announced their resignation.[73] The next to go was the company's auditor.[74]

The collapse continued in July when the founder, John Rigas, was arrested along with his two sons for corporate looting, and bank, securities, and wire fraud for being involved in a scheme to defraud investors and creditors of multiple billions.[75] In an attempt to reduce company debt, the Rigas family had been purchasing additional stocks—but with money borrowed from the company.[76] They also took money from the company to fund a golf course and African safari vacations.[77]

4. WorldCom

WorldCom, which began as a local telecom outfit in 1983, had ballooned into the nation's second largest long-distance telecom carrier by 2000.[78] The company based its expansion model

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[65] Hamilton, *supra* note 29, at 18.
[66] *Id.*
[67] Geraldine Fabrikant & Andrew Ross Sorkin, *New Questions Are Turning Up in the Inquiry into Adelphia*, N.Y. TIMES, May 18, 2002, http://www.nytimes.com/2002/05/18/business/new-questions-are-turning-up-in-the-inquiry-into-adelphia.html.
[68] Deborah Solomon, *Adelphia Moves to Cover Further $1.9 Million in Loans*, WALL ST. J., June 17, 2002, http://www.wsj.com/articles/SB1024263905344759080.
[69] Recine, *supra* note 55, at 1542.
[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] Hamilton, *supra* note 29, at 23.
[74] *Id.*
[75] *Id.* at 24.
[76] *Id.*
[77] *Id.*
[78] Simon Romero, *WorldCom Decides to Take $79 Billion Write-Down*, N.Y. TIMES, Mar. 14, 2003, *available at* http://www.nytimes.com/2003/03/14/business/technology-worldcom-decides-to-take-79-billion-write-down.html [hereinafter Romero, WorldCom Decides].

on acquisitions of other telecom companies, often using its own stock.[79] At the same time, the company—with the help of senior employees and officers—employed a number of accounting schemes to artificially boost earnings. Under directions of the CFO, the company took $3.8 billion in costs and recorded them as capital expenses, intending to depreciate them over time.[80] In addition, by improperly characterizing those expenses, WorldCom misrepresented its EBITDA over $3.8 billion.[81] Another trick involved high-level accounting officials, who would aggregate batches of charge-off entries created by internal lower-level accountants, recording the lump sums as non-recurring events, using them to boost reported results during periods of poor performance.[82] A similar trick applied to properties WorldCom obtained through its acquisitions: the company would intentionally "write down" the value of acquired properties so it could use it to supplement future declines in earnings.[83]

By 2000, WorldCom was suffering from the same problems that plagued many other telecom companies.[84] It had overinvested in fiber optic cable, and the market excess undermined WorldCom's earnings by lowering the cost of its services.[85] WorldCom's first move to deal with expenses was to write down reserves on a balance sheet—which ended up saving the company over a $1 billion.[86] The company also counted as capital expenditures, instead of business expenses, so-called "line costs," disbursements made to other telecom players for the right to access their networks.[87] This ploy allowed WorldCom to spread costs out over longer time periods, reducing WorldCom's expenses in 2001 and the first quarter of 2002 by at least $2.6 billion.[88]

When John Sidgmore became WorldCom's new CEO in April 2001, he ordered an internal audit of the company's books.[89] Upon checking the company's capital expenditure records, an internal auditor discovered that several billion dollars' worth of line-costs were recorded in the capital expenditure accounts, rather than as expenses.[90] Not only that: apparently the line costs had properly been recorded as expenses initially, but had been transferred to asset

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[79] Kurt Eichenwald, *For WorldCom, Acquisitions Were behind Its Rise and Fall*, N.Y. TIMES, Aug. 8, 2002, *available at* http://www.nytimes.com/2002/08/08/business/for-worldcom-acquisitions-were-behind-its-rise-and-fall.html [hereinafter Eichenwald, For WorldCom].
[80] Daniel Gross, *The Accounting Trick That's Killing WorldCom*, SLATE, June 26, 2002, http://www.slate.com/articles/business/moneybox/2002/06/the_accounting_trick_thats_killing_worldcom.html.
[81] *Id.*
[82] Cunningham, *supra* note 45, at 936.
[83] *Id.*
[84] *See id.*.
[85] Simon Romero & Riva D. Atlas, *WorldCom's Collapse: The Overview*, N.Y. TIMES, July 22, 2002, *available at* http://www.nytimes.com/2002/07/22/us/worldcom-s-collapse-the-overview-worldcom-files-for-bankruptcy-largest-us-case.html.
[86] Cunningham, *supra* note 45, at 930.
[87] Peter Elstrom, *How to Hide $3.8 Billion in Expenses*, BLOOMBERG, July 8, 2002, *available at* http://www.bloomberg.com/news/articles/2002-07-07/how-to-hide-3-dot-8-billion-in-expenses.
[88] David Simons, *WorldCom's Convincing Lies*, FORBES, July 8, 2002, *available at* http://www.forbes.com/2002/07/08/0708simons.html; Eichenwald, For WorldCom, *supra* note 79.
[89] Elstrom, *supra* note 87.
[90] *Id.*

accounts during the account closing process.[91] Internal auditors reported all this to the chair of the audit committee—not long after, this committee chair, the CFO, and controller were all fired.[92]

Like Enron, WorldCom had employed Big Five accounting firm Arthur Andersen as an external auditor. Andersen, in February 2002, reported to the company's board audit committee that there had been no significant transactions or changes in accounting policies in the past year, and that the company had strict internal controls in place to detect false financial reporting.[93] These statements were untrue. In June of 2002, WorldCom admitted to overstating its earnings in earlier years by close to $4 billion from treating expense items like capital investments—which was the largest restatement of earnings an American corporation has ever been admitted.[94] The company's credit rating nosedived, and an additional $3 billion in expense item misuse was discovered, adding more to the already record high restatement of earnings.[95]

The consequences of WorldCom's fall were massive. WorldCom reduced their workforce by a staggering ten percent from 2001-2002—which equaled more than 20,000 employees.[96] A large number of the employees who were laid off were blue collar workers who had built WorldCom's massive fiber optic network.[97] From 1999 to 2002, WorldCom's stock fell from $60 to less than $1.[98] When lower-level employees were being let go in huge numbers, over $230 million was given to top executives from a two year bonus retention program.[99] Eventually, approximately $1.4 million originally promised to executives went to fund severance packages for lower-level employees, but the amount covered fewer than half of the employees who had been let go. [100]

II. The Congressional Response

A. Legislative History of SOX

Attempts at legislative reform were met with resistance by the Bush administration and conservative members of Congress.[101] Although mounting evidence of widespread corporate fraud fueled discussions between Congress and the Administration on potential reform measures,

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[91] *Id.*; *see also* Frank E. Ryerson, *Improper Capitalization and the Management of Earnings*, 16 Proceedings of ASBBS (February 2009).
[92] Cunningham, *supra* note 45, at 931.
[93] *See* Kurt Eichenwald, *Auditor Gave Assurances of Safeguards against Fraud*, N.Y. TIMES, July 9, 2002, *available at* http://www.nytimes.com/2002/07/09/business/corporate-conduct-bookkeeping-auditor-gave-assurances-safeguards-against-fraud.html [hereinafter Eichenwald: Auditor Gave Assurances].
[94] Hamilton, *supra* note 29, at 21.
[95] *Id.*
[96] Recine, *supra* note 55, at 1543.
[97] *Id.*
[98] *Id.*
[99] *Id.*
[100] *Id.*
[101] Frank O. Bowman III, Pour Encourager Les Autres?: *The Curious History and Distressing Implications of the Criminal Provisions of the Sarbanes-Oxley Act and the Sentencing Guidelines Amendments That Followed*, 1 OHIO ST. J. CRIM. L. 373, 393 (2004).

progress stalled due to disagreements over the measures' policy objectives.[102] President Bush's early reform proposal, a "ten-point plan" that focused on oversight.[103] The President's initial proposals were criticized as failing to provide "real teeth" that would hold corporate executives accountable.[104]

In June 2002, the political dynamic finally shifted as a result of the WoldCom scandal.[105] By that point, the outcry had reached a fever-high pitch. Regulation of financial reporting and corporate governance were issues of peak salience and importance to the general American public. Consider, for example, as noted by Prentice and Spence, a June, 2002 article in the USA Today entitled *How Did Business Get So Darn Dity?*, which argued that greed was one of the main answers.[106] Prentice and Spence also pointed to a Gallup poll in 2002 showing that the percentage of people considering big business to be a major threat to the future of America had jumped by fourteen points from the previous two years.[107] Democrats jumped to make these scandals an issue in their election campaigns the following November.[108] In making his case for the necessity of comprehensive reform, Senator Leahy did not mince words:

> Enron has become a symbol for the torrent of corporate fraud scandals that have hit the front pages and battered our financial markets. Tyco, Xerox, WorldCom, Adelphia, Global Crossings, the list goes on. The things that happened at Enron did not happen by mistake. They were not the result of one or two "bad apples." Senior management at Enron, assisted by an army of accountants and lawyers spun an intricate web of deceit. They engaged in a systematic fraud that allowed them to secretly take hundreds of millions of dollars out of the company. This kind of fraud is not the work of a lone fraud artist. Rather, it is symptomatic of a corporate culture where greed has been inflated and honesty devalued. Unfortunately, as I have said and as the experts warned at our February 6 hearing, Enron does not appear to have been alone. Each week we read of corporation after corporation that has engaged in misconduct, and these are not small or marginal corporations. These are major mainstays of corporate America. The web of deceit woven by such publicly traded companies ensnares and victimizes the entire investing public who depend on the

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[102] Jacob M. Schlesinger & Michael Schroeder, *Bush Unveils Plan to Strengthen Rules For Corporations*, WALL ST. J. Mar. 8, 2002, *available at* http://www.wsj.com/articles/SB1015521463941827840.
[103] See President George W. Bush, State of the Union Address (Jan. 29, 2010), *in The President's Ten-Point Plan to Improve Corporate Responsibility and Protect America's Shareholders*, HOUS. CHRON. (Mar. 7, 2002, 6:30 AM), http://www.chron.com/business/enron/article/Full-text-of-Bush-s-shareholders-protections-2068211.php.
[104] David Greising, Bush `reforms' sound good but won't stop fury, (Mar. 8, 2002), http://articles.chicagotribune.com/2002-03-08/business/0203080344_1_president-bush-accountability-financial-statements.
[105] Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 Mich. L. Rev. 1817, 1821 (2007).
[106] Robert A. Prentice & David B. Spence, *Sarbanes-Oxley As Quack Corporate Governance: How Wise Is the Received Wisdom?*, 95 GEO. L.J. 1843, 1850 (2007).
[107] *Id.*
[108] Langevoort, *supra* note 105.

> transparency and integrity of our markets for everything from their retirement nest eggs to their children's college funds.[109]

The House of Representatives introduced H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002,[110] on February 14, 2002. The bill was sponsored by Republican House Representative Michael G. Oxley, Chair of the House Financial Services Committee. Like the reform proposals proposed by President Bush, the primary focus of H.R. 3763 was transparency in, and oversight of, corporate accounting practices.[111] Unlike the final rule, it contained no provision for increased criminal penalties—unsurprising, given that the House Financial Services Committee typically lacks jurisdiction over criminal matters.[112] Even though H.R. 3763 contained provisions similar to those shaping the Public Company Accounting Oversight Board ("PCAOB") in the Sarbanes proposal, the Oxley-sponsored bill was decidedly more friendly to corporate interests. The bill largely left the SEC to make key decisions about regulating auditors.[113] It contained fewer curbs on consulting by auditors and would have permitted private groups to form one or more oversight boards for the accounting industry.[114] House Democrats offered their own bill,[115] as well as a set of proposed amendments to Oxley's bill, both of which the House majority rejected.[116] On April 24, 2002, H.R. 3763 was passed by a Republican House 334 to 90.[117] The next day, it was referred to the

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[109] 148 CONG. REC. S6734-02 (daily ed. July 15, 2002) (statement of Sen. Leahy).

[110] Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, HR. 3763, 107th Cong. (2002).

[111] A key feature of the bill was the requirement that auditors of publicly traded corporations "be subject to a system of review by a public regulatory organization," which in turn would be subject to rules promulgated by the SEC. Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, H.R. 3763, 107th Cong. at § 2 (2002).

[112] *See generally* Public Company Accounting Reform and Investor Protection Act of 2002, S. 2673, 107th Cong. (2002) (pushing for important improvements to the current accounting system).

[113] Hilzenrath et al., *How Congress Rode a 'Storm' to Corporate Reform*, Wash. Post, July 28, 2002, *available at https://www.washingtonpost.com/archive/politics/2002/07/28/how-congress-rode-a-storm-to-corporate-reform/8b86dffc-430a-4434-8bda-1858d63d7d0f/?utm_term=.0c52b93bf675.*

[114] Bowman, *supra* note 101, at 396. Other features of Oxley's bill include:

> a prohibition against independent auditors of publicly traded companies offering certain kinds of non-audit services, a prohibition against exercising improper influence on the conduct of outside audits, a requirement of "real time" disclosure of financial information, a prohibition of insider trades during pension fund blackout periods, and a series of congressional mandates for "studies" of analyst conflicts of interest, corporate governance practices, SEC enforcement actions, and credit rating agencies.

Id.

[115] *See generally* Comprehensive Investor Protection Act of 2002, H.R. 3818, 107th Cong. (2002) (introduced on Feb. 28, 2002). The Act would have created

> a single national accounting oversight board under the SEC's direct supervision with specific legislative grants of authority, heightened independence requirements for members of the board from the large public accounting firms, a wider ban on non-audit services by auditing firms for corporations they audit, a ban on tying investment analyst compensation to the performance of their employer bank, criminal penalties for destruction of audit records, and a substantial increase in the SEC's enforcement budget.

Bowman, *supra* note 101, at 396.

[116] 148 Cong. Rec. H1540-92 (daily ed. Apr. 24, 2002).

[117] Ann Marie Tracey & Paul Fiorelli, *Nothing Concentrates the Mind Like the Prospect of A Hanging: The Criminalization of the Sarbanes-Oxley Act*, 25 N. ILL. U. L. REV. 125, 131 (2004).

Committee on Banking, Housing, and Urban Affairs in the Senate.[118] S. 2673, on the other hand, brought up in the Senate in June, dealt mostly with accounting reform and failed to significantly address criminal sanctions.[119] Neither committee, however, normally had jurisdiction over criminal penalties.[120]

Sarbanes's bill passed out of the Senate Banking Committee on a vote of 17-4 and reached the Senate floor in July,[121] where it was subject to numerous amendments. In general, the Republicans in Congress favored the relaxed oversight and governance standards in the Oxley bill, while the Democrats pushed for more aggressive regulation of the markets.[122] Both Democrats and Republicans eagerly embraced stronger criminal sanctions, however.[123]

In the end, the Senate decided to incorporate their bill with the Oxley Act.[124] On July 15, Representative F. James Sensenbrenner introduced "The Corporate Fraud Accountability Act of 2002," H.R. 5118, allowing even tougher criminal sanctions for accounting and auditing wrongdoings at public companies; the bill passed by a vote of 391-29 in the House the next day.[125] In conference, the bill's more severe penalties were incorporated into the Act.[126] Congress also grafted the criminal provisions from the Leahy bill (S. 2010) onto the accounting reforms and implemented the modified WCCPA.[127] All the text from the Senate's bill was included in the Sarbanes-Oxley Act, which was then signed into law by the president on July 29.[128]

B. SOX

In this Part, we focus on the corporate governance reforms required by SOX. These include the requirement that the boards of directors include a majority of outside directors and the mandate requiring an audit committee and the independence of all its members. In addition, the board must disclose whether the audit committee membership includes at least one financial expert – as further defined in the accompanying SEC regulations—and if not, why not. It also requires independence of the outside auditor. These provisions are discussed next.

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[118] *Id.*
[119] *Id.* at 132
[120] *Id.*
[121] Bowman, *supra* note 101, at 398.
[122] *Id.* at 400.
[123] *See Id*.
[124] Recine, *supra* note 55, at 1547.
[125] Lisa H. Nicholson, *The Culture of Under-Enforcement: Buried Treasure, Sarbanes-Oxley and the Corporate Pirate*, 5 DEPAUL BUS. & COM. L.J. 321, 337, n. 82 (2007).
[126] *Id. See* Conference Report to Accompany S. 3763, H. Rep. No. 107-610 (2002).
[127] Pub. L. No. 107-204, tit. IX, 116 Stat. 804 (codified in scattered sections of 15, 18, and 29 U.S.C.).
[128] Recine *supra* note 55, at 1547.

1. Audit Committees

The audit committee requirements of the Act were meant to enhance the ability of the board of directors to monitor management and outside auditors.[129] Most of these requirements, however, did not represent a significant departure from SEC and stock exchange requirements then in place. Despite its limited power to regulate the conduct of directors and officers,[130] the SEC has shaped the corporate governance standards embodied in the SOX Act in two main ways: by imposing disclosure requirements directly on companies, and by encouraging national stock exchanges to develop listing standards.

As early as the 1970s,[131] the SEC supported establishment of audit committees "to make management more accountable to the board and to emphasize the function of the board in monitoring the activities of the management."[132] The SEC required disclosure in the company's proxy materials whether the company had an audit, nomination and compensation committee, together with the membership, number of yearly meetings, and functions of such committee, if they existed.[133]

Around this same time period, national stock exchanges followed the SEC and began requiring certain corporate governance standards as a condition to being listed and for continued listing. For example, according to the Nasdaq Stock Market (Nasdaq) and the New York Stock Exchange (NYSE) rules, the two largest stock exchanges in the world by market capitalization,[134] a listed company must have an audit committee consisting of independent directors.[135] Early versions of Nasdaq and NYSE listing standards imposed few requirements on the audit committee, however, mostly resembling state law without any significant improvements.[136]

The revelation of major accounting fiascoes in 1998,[137] particularly the widespread practice of "earnings management,"[138] led the SEC to re-evaluate the role of audit committees.[139]

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[129] *See* Standards Relating to Listed Company Audit Committees, Release No. 33-8220 (Apr. 9, 2003), 17 C.F.R. §§ 228, 229, 240, 249, and 247 (2003) http://www.sec.gov/rules/final/33-8220.htm [hereinafter Audit Committee Release].

[130] The Supreme Court has held that the SEC's authority to regulate the conduct of officers and directors of public companies not involving "deception, misrepresentation, or nondisclosure" is limited. Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 475 (1977).

[131] *See* Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exch. Act Release No. 15,384 (Dec. 6, 1978), 1978 WL 14747.

[132] *See generally*, Philip A. Loomis, Jr., Commissioner, Securities and Exchange Commission, Speech to The Institute of Chartered Accountants in England and Wales, London, England (Nov. 3, 1978), http://www.sec.gov/news/speech/1978/110378loomis.pdf.

[133] Schedule 14A, Item 7(e). *See* HAROLD S. BLOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE § 4.11 (2002).

[134] World Federation of Exchanges, September 2016 Monthly Report, https://www.world-exchanges.org/home/index.php/statistics/monthly-reports.

[135] Sec. Act Release No. 6810 (Dec. 16, 1988), 53 FR 52550 (Dec. 28, 1988).

[136] BLOOMENTHAL, *supra* note 133, at § 4.1.

[137] *See id.*; Cunningham, *supra* note 45, at 925.

[138] *See* Gregory S. Rowland, Note, *Earnings Management, the SEC, and Corporate Governance: Director Liability Arising from the Audit Committee Report*, 102 COLUMBIA L. REV. 168, 168-70 (2002).

[139] Order Approving Proposed Rule Change by the NASD, Exchange Act Release No. 42231, File No. SR-NASD-99-48; Order Approving Proposed Rule Change by the NYSE, Exchange Act Release No. 42233, File No. SR-

Then Chairman Levitt, emphasizing "the crucial role of boards of directors as representatives of the shareholders" and noting the audit committee's responsibility "to ensure that shareholders receive relevant and reliable financial information," proposed that the audit committee play a more active oversight role by meeting more frequently and asking tough questions.[140] The audit committee could them become quite skeptical of the CEO and CFO.[141]

As part of a larger plan to improve financial reporting quality, Chairman Levitt tasked the NYSE and the National Association of Securities Dealers (NASD) with forming a "blue ribbon" panel to "improve audit committee performance."[142] In response to recommendations issued by the Blue Ribbon Committee (BRC) in 1999,[143] the NYSE and Nasdaq imposed substantial

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NYSE-99-39. "To strengthen the role of the auditor as an independent assurer of credible financial information and a major source of information for the audit committee and board, the accounting profession and the SEC agreed in 1997 to establish a new private sector body—the Independence Standards Board—to set independence rules and guidance for auditors of public companies." W. STEVE ALBRECHT, CHAD O. ALBRECHT, CONAN C. ALBRECHT, & MARK F. ZIMBELMAN, FRAUD EXAMINATION 657 (5th ed. 2016).

[140] *See* Remarks of Arthur Levitt, SEC Chairman, Corporate Governance in the Information Age, Tenth Annual Corporate Law Institute, Mar. 12, 1998, *available at* http://www.sec.gov/news/speeches/spch206.txt.

[141] Roberta S. Karmel, *Realizing the Dream of William O. Douglas – The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 110 (2005).

[142] *See* SEC Press Release 98-95, SEC Chairman Levitt Announces Action Plan to Improve Quality of Corporate Financial Reporting (Sept. 28, 1998), *available at* http://www.sec.gov/news/press98-95.txt; SEC Press Release 2000-23, Pitts Seeks Review of Corporate Governance, Code of Conduct (Feb. 13, 2002), *available at* http://www.sec.gov/news/press/2002-23.txt.

[143] BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES, REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES (1999). The BRC recommendations included the following:

> 1. That the NYSE and NASD adopt a new definition of independence for purposes of the audit committee;
> 2. That the NYSE and NASD require that the audit committee be composed solely of independent directors;
> 3. That the NYSE and NASD require that listed companies' audit committees have a minimum of three directors, each of whom is "financially literate," and that at least one member have accounting or related financial management experience;
> 4. That the NYSE and NASD require that listed companies' audit committees have a written charter, approved by the full board, that specifies the scope of the committee's duties, structure, processes and membership requirements;
> 5. That the SEC require audit committees make certain disclosures in the company's proxy statement relating to the audit committee's written charter.
> 6-7. That the NYSE and NASD require that listed companies' audit committee charter address the relationship between the outside auditor and audit committee;
> 8. That Generally Accepted Auditing Standards require that the outside auditor "discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles."
> 9. That the SEC require all reporting companies to include an audit committee letter in the Form 10-K containing certain disclosures;
> 10. That the outside auditor be required to discuss with the audit committee certain matters, including adjustments, management judgments and estimates, new accounting policies, and disagreements with management.

Id.

changes to their corporate governance and listing standards (the BRC revisions).[144] The changes included requiring that: the audit committee consist of at least three "independent directors;"[145] each member of the audit committee be financially literate,[146] at least one member have financial or accounting experience;[147] each audit committee have a written charter;[148] and a description of a number of relationships between the company and a director or her family member that would foreclose a finding of independence.[149]

To complement the BRC revisions, the SEC heightened its disclosure requirements with respect to audit committees. Each proxy statement must disclose whether the company had an audit committee.[150] Board audit committees are required to vouch for the accuracy of financial statements,[151] disclose whether they signed off on the financial statements, state whether an audit committee's written charter spells out the committee's duties, and submit any charter to the SEC every three years.[152]

Under Section 301,[153] SOX mandates that all public companies appoint an audit committee of the board of directors.[154] The power to hire, fire, and compensate[155] the external auditors must be held by the audit committee as opposed to the management or the board of directors as a whole; each audit committee is to be "directly responsible for the appointment, compensation, and oversight" of the external auditor, and the auditors are to report directly to the

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[144] *See* Order Approving Proposed Rule Change Amending the Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto, Exchange Act Release No. 34-42233 (December 14, 1999), *available at* https://www.sec.gov/rules/sro/ny9939o.htm; Order Approving Proposed Rule Change Amending the Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto, Exchange Act Release No. 34-42231 (December 14, 1999), *available at* https://www.sec.gov/rules/sro/nd9948o.htm.
[145] NYSE Manual 303.01(B)(2)(a) (1999) [1999 NYSE Manual].
[146] *Id.* 303.01(B)(2)(b).
[147] *Id.* 303.01(B)(2)(c).
[148] *Id.* 303.01(B)(1).
[149] *Id.* 303.01(B)(3). *See also* BLOOMENTHAL, *supra* note 133, at § 4.2.
[150] Audit Comm. Disclosure, Release No. 42266, 1999 WL 1244029, *9 (Dec. 22, 1999).
[151] "[E]ach audit committee was required, on the issuer's annual Form 10-K, to disclose whether its recommendation that the financial statements be included in the annual report was based on its discussions with management and the independent accountant." James D. Cox, *Reforming the Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurements*, 81 Wash. U. L.Q. 301, 306 (2003).
[152] Cunningham, *supra* note 45, at 932.
[153] See Exchange Act § 10A(m)(2). The section also directs the SEC to establish standards for audit committees; national securities associations are not to list any companies that fail to meet Section 301 requirements. *See* SOX Act § 301, 116 Stat. at 775 (codified at 15 U.S.C. § 78j-1) (adding § 10A(m) to the Exchange Act); Exchange Act § 10A(m)(1)(A)).
[154] SOX offers the following definition: "The term 'audit committee' means a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and 5 financial reporting processes of the issuer and audits of the financial statements of the issuer; and if no such committee exists with respect to an issuer, the entire board of directors of the issuer." The Sarbanes-Oxley Act adds a new section 3(a)(58) to the Securities Exchange Act of 1934. § 205, 116 Stat. at 773-74 (to be codified at 15 U.S.C. § 78c).
[155] SOX Act § 301, 116 Stat. at 776 (codified at 15 U.S.C. § 78j-1) (amending the Securities Exchange Act of 1934, § 10A(m)(5) and (6)).

audit committee.[156] According to this section, an audit committee must put an internal complaint system into place that deals with various complaints, including complaints about accounting matters or other related matters within the corporation.[157] To encourage financial reporting quality and independent external auditing, Section 301(3) imposes an independence requirement on each member of the audit committee.[158] To be independent, an audit committee member should not be an affiliated person with respect to the company, and should not accept any consulting, advisory, or other compensatory fee from the firm.[159]

Section 301 grew out of a sense that public company boards had failed their oversight responsibilities and had become beholden to the whims of the top executives – as the SEC Chairman William H. Donaldson pointed out, "[m]any boards have become gradually more deferential to the opinions, judgments and decisions of the CEO and senior management team [that] has been an obstacle to directors' ability to satisfy . . . [their] responsibility."[160] This was a massive change to general corporate law by the changes from this section, as well as some other sections, because corporate governance had typically been a state issue, not federal.[161]

The SEC, on April 25, 2003, did a couple of things. First, the SEC required, in compliance with section 301, each national securities exchange and national securities exchange association give it a list of amendments or proposed changes.[162] Second, the SEC required only audit committee members instead of the entire board, be independent.[163] Additionally, the SEC was supposed to, per SOX Section 407, put out rules that required companies to disclose if and if not, why not, the audit committee has at least one financial expert as a member, as the term is defined by the SEC.[164] In defining "financial expert," the Act considers a member's qualifications through her "education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer." An "understanding of GAAP, and experience in preparing or auditing of financial statements" can also be considered "financial expertise" according to the Act.

The SEC implemented this mandated course of action later in March of 2003. The SEC released rules requiring all public companies to disclose any financial experts in their audit committees and explanations as to why they do not have one if that is the case.[165] The SEC attempted to make sure that these financial experts did not have greater liability than other

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[156]116 Stat. at 775 (codified at 15 U.S.C. § 78j-1) (amending the Securities Exchange Act of 1934, § 10A(m)(2)). See also Audit Committee Release, *supra* note 129129, at § II(B)(1).
[157] Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 Wm. Mitchell L. Rev. 1149, 1157 (2004).
[158] *See* Exchange Act § 10A(m)(3); Sarbanes-Oxley Act § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-1) (amending the Exchange Act, § 10A(m)(3)).
[159] *Id.*
[160] William H. Donaldson, Remarks at the 2003 Washington Economic Policy Conference, National Association for Business Economics, Washington, D.C. (Mar. 24, 2003).
[161] John C. Coates IV & Suraj Srinivasan, *SOX after Ten Years: A Multidisciplinary Review*, ACCOUNTING HORIZONS, Sept. 2014, at 627.
[162] Johnson & Sides, *supra* note 157, at 1158.
[163] *Id.*
[164] *Id.*
[165] *Id.*

members by stating that the financial experts would not have greater duties or obligations under any securities laws, and limited the term ‘expert’ so certain provisions in securities laws would not apply.[166] Whether someone is a financial experts is determined by the board of directors.[167]

2. Auditor-Client Relationships

Under Section 201 of SOX, which adds § 10A(g) to the Exchange Act of 1934,[168] external auditors are prohibited from providing certain kinds of nonaudit services to their auditing clients. For example, they may not provide financial information systems design and implementation, bookkeeping services, appraisal or valuation services, actuarial services, internal audit outsourcing services, management functions or human resources, investment banking services, legal services, and other services that might be determined by regulation to be impermissible.[169] Further, public companies are required to disclose the dollar value of audit and audit-related services versus permitted non-audit services.[170]

In addition, Section 203[171] includes both term limits and restrictions on the external auditor. Although the original idea of having a mandatory periodic rotation of audit firms was dropped, SOX § 203 as enacted requires that audit engagement partners and audit reviewing partners—i.e., the highest-ranked auditing firm employees who deal with the executives of an auditing client—be rotated off the engagement after five years.[172] In addition, audit firm employees who have worked on an audit of a client company may not switch over and become employees of that client until a certain “cooling off” period has run.[173]

Section 202 requires, with an exception for some de minimis services, that all services provided from an auditor and to an issuer must have pre-approval from the audit committee.[174] These pre-approvals must be disclosed, pursuant to the Exchange Act, in a company’s periodic reports.[175]

C. Other Relevant Provisions

[166] *Id.*
[167] *Id.*
[168] Securities Exchange Act of 1934 § 10A(g), 15 U.S.C. §78j-1 (2010).
[169] *Id*.
[170] According to Coates & Srinivasan, *infra* note 161:

> While SOX prohibited audit firms from providing many (but not all) types of consulting services to their audit clients, just before SOX, four of the (then) Big 5 audit firms spun off their consulting arms into separate entities in 2000 and 2001. . . . Despite this drastic change in business models arising from the spin-offs, consulting services still account for a large share of revenues for the big audit firms. Non-audit fees to audit clients as a proportion of total fees fell from almost 51 percent of fees in 2002 to about 21 percent in 2005 and have remained steady at that level since then till recently and were around 22 percent in 2012.But these services are now largely provided to companies that are not audit clients.

[171] Securities Exchange Act § 10A(j).
[172] 15 U.S.C. § 78j-1 (2010).
[173] SOX § 206, adding Exchange Act § 10A(l).
[174] Johnson & Sides, *supra* note 157, at 1177.
[175] *Id.*

There are several other relevant provisions in SOX aimed at improving the governance of corporations. These are described briefly below.

1. Loans to Officers

Section 402 generally prohibits public companies to directly or indirectly make loans to their directors and officers.[176] This section also disrupted and interfered with standard arrangements at many public companies, such as travel advances, personal use of a company car, and others.[177]

2. Code of Ethics Disclosure

Section 406 mandates that public companies take action in several ways when it comes to a code of ethics disclosure, including disclosing whether the company has any adopted code of ethics for senior financial officers, disclosing to the public any changes that are made and if the company granted any waivers from the code.[178] Later, the SEC issued rules requiring public companies to disclose whether a code of ethics has been adopted and to file the code with the SEC.[179] A code of ethics must require:

> 1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
> 2) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;
> (3) Compliance with applicable governmental laws, rules and regulations;
> (4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and
> (5) Accountability for adherence to the code.[180]

The SEC promulgated rules to implement Sections 406 and 407 in March of 2003—the Section 407 release from the SEC expanded Section 406 mandates to cover disclosure of any code of ethics that applies to a company's CEO.[181]

3. Forfeiture of Certain Bonuses and Profits

Under Section 304, any public company that must:

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[176] *Id.* at 787 (amending Securities Exchange Act §13(k)).
[177] Karmel, *supra* note 141, at 105.
[178] Lyman Johnson, *Having the Fiduciary Duty Talk: Model Advice for Corporate Officers (and Other Senior Agents)*, 63 Bus. Law. 147, 161 (2007).
[179] Item 406 of Regulation S-K, 17 C.F.R. § 229.406 (2004). *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177, 68 Fed. Reg. 5110 (Jan. 31, 2003).
[180] 17 C.F.R. § 229.406(b) (2004).
[181] Johnson & Sides, *supra* note 157, at 1185.

prepare an accounting restatement due to material non-compliance with any financial reporting requirement under the securities laws, as a result of misconduct, then the principal executive officer and the principal financial officer(s) must reimburse the corporation for (i) any bonus or other incentive-based or equity-based compensation received by such person during the twelve-month period following the first public issuance of the defective report and (ii) any profits realized from the sale of securities of the corporation during that twelve-month period. This Section was intended to force the principal officers of the company to pay more attention to the company's financial reporting and to dissuade management from focusing on short-term gain.[182]

III. The Roles of the Board and the Shareholders

A. The Board of Directors

Boards of directors have been a traditional element of American corporate governance. In the early days, boards were responsible for managing day-to-day businesses of corporations—typically ranging from controlled to family-owned companies.[183] Lately, in the era of highly-dispersed ownership of corporations, directors usually perform their duties on a part-time basis.[184] Recognizing this trend, modern corporate laws call for management of the corporation to fulfill boards' duties.[185] Traditionally, it is said that "the board sets corporate policy, makes the major decisions, and delegates to management the task of carrying out policy and those decisions."[186] As an independent governing body, the board is supposed to be separate from senior management.[187] An independent board, in theory, does not have substantial ties to top management and thus will be comfortable objecting them, as needed.[188] The reality draws quite a different picture.

The absence of a controller increased the role of CEO, reducing the board's actions to "advisory rather than supervisory"[189] in nature. The Gordon and Mace studies even found that contemporary management, setting a corporation's policies and making certain major decisions, limited boards' role to providing "formal approval (almost never disapproval) of those policies and decisions."[190] Boards, being inferior to management, slipped into rubberstamping role in such corporations. Supervision is also undermined by another factor: management often participates in handpicking of directors before elections; directors now often owe their positions to the officers

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[182] *Id.*, at 1181.
[183] *See* Kelli A. Alces, *Beyond the Board of Directors*, 46 Wake Forest L. Rev. 783, 788 (2011).
[184] Lucian A. Bebchuk, *The Myth of the Shareholder's Franchise*, 93 Va. L. Rev. 675, 679 (2007).
[185] Franklin A. Gevurtz, *The Function of "Dysfunctional" Boards*, 77 U. Cin. L. Rev. 391, 395 (2008).
[186] *Id.*
[187] Alces, *supra* note 183, at 789.
[188] *Id.*
[189] *See Id.*
[190] Gevurtz, *supra* note 185, at 395-96, citing ROBERT AARON GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION 143 (1966); Myles L. Mace, DIRECTORS: MYTHS AND REALITY 107 (1971); Myles L. Mace, *Directors: Myth and Reality-- Ten Years Later*, 32 RUT. L. REV.293 (1979); Bayless Manning, *The Business Judgment Rule and the Director's Duly of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1483 84 (1984).

"they are supposed to supervise, and they rely upon those same officers for the information they use in supervising them."[191]

Monitoring is another function of boards in the corporate governance. The board is responsible for discovering bad faith or incompetence,[192] and hiring and firing of senior management, particularly the CEO.[193] In practice, however, boards face a challenging task of detecting managerial malfeasance directly, typically acting on a part-time, irregular basis. As Professor Adams and colleagues note, a board would rely "on the actions of outside auditors, regulators, and, in some instances, the news media,"[194] or on the information, provided by a CEO.[195] The explanation is simple: directors do not have time to pay close attention to monitoring tasks. Monitoring of management is often collegial, where directors learn from management "why the officers recommend a particular course of action and officers are not perceived as inferior to directors when the board makes most of its business decisions."[196]

In addition, directors serve in a counseling or advisory role. A board may provide expertise for matters about which one or more board members are expert.[197] Boards may also give advice or opinions to top management about general business matters.[198] Occasionally, a corporate board may also act as a mediator among shareholders and managers, other employees, creditors, and perhaps even the community at large.[199]

Performing a managerial function, the board ultimately decides major corporate issues, such as bringing certain lawsuits on the company's behalf, selling the corporation, buying or merging with another companies, dividend distributions to shareholders, the corporation's capital structure.[200]

As evidence of the board's influence over corporate governance practices, a study of 1500 S&P firms from 1998 to 2004 linked weak corporate governance and backdating.[201] The study found that the more inside and gray directors on the board, independent directors appointed by the incumbent CEO, director compensation in options and CEOs serving as the chair of the board the higher levels of backdating.[202] Another study found correlations between measures of CEO

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[191] Alces, *supra* note 183, at 789.
[192] *Id.*
[193] Gevurtz, *supra* note 185, at 396.
[194] Renee B. Adams et al, *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. OF ECON. LITERATURE 58, 65 (2010). http://u.osu.edu/weisbach.2/files/2015/01/AdamsHWJEL2010-2ff7jzc.pdf.
[195] *Id.*
[196] Alces, *supra* note 183, at 795.
[197] Renee B. Adams et al, supra note 12, at 65.
[198] Alces, *supra* note 183, at 798.
[199] Gevurtz, *supra* note 185, at 396.
[200] Alces, *supra* note 183, at 798.
[201] Daniel W. Collins et al., *Corporate Governance and Backdating of Executive Stock Options*, 26 CONTEMP. ACCT. RES. 403, 405 (2009).
[202] *Id.* at 406.

influence, such as lower numbers of independent directors and longer CEO tenure, and opportunistically timed grants.[203]

B. Shareholders

In contrast, the shareholders' role in corporate governance has traditionally been limited.[204] Corporate law relies on the principle of separation of ownership and control:[205] shareholders own the corporation and boards manage the business. Shareholders who oppose the business decisions of the board or management cannot affect change directly: they can only exit,[206] sue,[207] or vote.[208] Thus, shareholder rights can be divided into four groups: economical, litigation, control and informational. Shareholders vote at annual meetings which, at least in theory, should provide "a channel for communication between shareholders, the board, and management."[209] On time-sensitive matters, votes may be held at special shareholder meetings called in the middle of a year. [210]

1. Shareholder Voting: An Overview

A fundamental right of the shareholder is the election of directors.[211] Delaware Chancellor William Allen has described shareholder voting as "the ideological underpinning that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own."[212] A fully informed shareholder vote ratifies board action, even it is in favor of a "voidable" transaction.[213]

Yet, shareholder voting power has frequently proved to be ineffective way to control management in highly dispersed corporations. Individual shareholders are unlikely interested in

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[203] Lucian A. Bebchuk et al., *Lucky CEOS and Lucky Directors*, 65 J. FIN. 2363, 2365 (2010) [hereinafter Bebchuk, et al, *Lucky CEOS*]. The Bebchuk et al. study covered the time period 1996-2005. In this paper, we extend the analysis to 2015 to show that these practices are still on-going.

[204] *See, e.g.*, Joshua R. Mourning, *The Majority-Voting Movement: Curtailing Shareholder Disenfranchisement in Corporate Director Elections,* 85 WASH. U. L. REV. 1143, 1147 (2007).

[205] Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 416 (2006).

[206] Recent studies have increasingly focused on the impact of "exit" with respect to large, institutional investors. For a review of the literature, *see* Alex Edmans, *Blockholders and Corporate Governance*, 6 ANN. REV. FIN. ECON. 23, 24 (2014).

[207] See Paul H. Edelman et al., *Shareholder Voting in an Age if Intermediary Capitalism*, 87 USC L. REV. 1359, 1376 (2014) for a discussion of factors limiting the efficacy of shareholder suit. *Id. See also* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions,* 57 VAND. L. REV. 133 (2004).

[208] Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARVARD L. REV. 833, 835 (2005) [hereinafter Bebchuk, *The Case*].

[209] David Yermack, *Shareholder Voting and Corporate Governance*, 2 ANNU. REV. FINANC. ECON. 2.1, 2.3 (2010).

[210] *Id.*

[211] Velasco, *supra* note 205, at 416.

[212] Blasius Indus. Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988). Similarly, Professor Lucian Bebchuk, one of the foremost proponents of increasing shareholder power, describes the U.S. corporation as "a representative democracy in which the members of the polity can act only through their representatives and never directly." Bebchuk, *The Case*, *supra* note 208, at 836.

[213] Stroud v. Grace, 606 A.2d 75, 83 (Del. 1992).

investing their time and energy in costly monitoring activities, owning a small percentage of stock. Empirical evidence shows that successful challenges of management a by a rival team seeking to run the company better are quite rare.[214] In addition to costs, shareholders are likely uncertain about a rival team and their future capabilities. Shareholders often stay conservative, giving preference to current management, even having substantial dissatisfactions. The case is different in corporations with a high institutional ownership. "Institutions are more likely than other shareholders to vote at all, more likely to vote against manager proposals, and more likely to vote for proposals by other shareholders."[215] Skeptics, on the other hand, view activist institutional investors as extracting short-term profit at the expense of long-term growth.[216]

2. Shareholder Voting Rights

Under Delaware General Corporations Law (DGCL), each stockholder is entitled to vote at a meeting of stockholders or by proxy.[217] In addition, each stockholder has one vote for each share, unless the corporate charter provides otherwise.[218] There are several circumstances that require shareholder vote. Under Delaware law, shareholders elect board of directors.[219] Charter[220] and by-laws[221] amendments also require shareholder approval. Professor Bebchuk, refers to such amendments as "rule-of-the-game" decisions.[222] Certain major corporate decisions also require a shareholder vote, such as mergers[223] or a sale of all or substantially all the assets,[224] commonly referred as "game-ending" decisions.[225] Under NYSE rules, shareholder approval is required for equity compensation plans; in certain self-dealing transactions; or if the issuance of stock increases the number of outstanding shares or voting power by 20% or more.[226]

The Dodd-Frank Act provides shareholders of public companies with an advisory vote on compensation paid to executives ("Say on Pay")[227] as well as golden parachute payments in case of merger or acquisition.[228] The Act produced immediate favorable results. During the 2011 proxy season, for example, management in some public companies "either changed the company's pay practices in response to the possibility of an unfavorable shareholder vote, or

[214] Lucian A. Bebchuk, *The Myth of the Shareholder's Franchise*, 93 Va. L. Rev 675, 688 (2007). [hereinafter Bebchuk, *The Myth*].
[215] Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1382 (Del. 1995) (citing Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 925 (1992).
[216] John C. Coffee & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 549 (2016).
[217] Del. Code Ann. tit. 8, § 212 (West 2012).
[218] *Id.*
[219] *Id*. § 211.
[220] *Id.* § 242(b). The company's state of incorporation can also be changed subject to shareholder vote, but also requires initiation by management. *Id.*
[221] *Id.* § 109 (West).
[222] Bebchuk, *The Case*, *supra* note 208, at 836–37.
[223] *Id.* § 251(c) (West)
[224] *Id.* § 271
[225] Bebchuk, *The Case*, *supra* note 208, at 836–37.
[226] NYSE, Inc., Listed Company Manual § 312.03(c) (2015).
[227] 15 U.S.C.A. § 78n-1 (West)
[228] 15 U.S.C.A. § 78n-1 (West)

offered additional disclosure explaining pay practices that had come onto the shareholder radar screens."[229]

It is well-settled, however, that board of directors initiates all major corporate decisions; shareholders may not initiate any such decisions.[230] Thus shareholders have only a veto power.[231] A veto power on important business matters presumably gives shareholders some form of control over the corporation, or at least, preserves an important mechanism. Yet, as Professor Thomson and Edelman note, "[v]oting plays a limited role in corporate decision-making, much more limited than in the public sphere."[232]

3. Director Elections

Under Delaware law, shareholders elect the board of directors,[233] with the board acting as "a surrogate for and in the interests of the shareholders." [234] As Professor Velasco noted, "[i]n theory, this should give shareholders ultimate control over the business. In practice, however, it does not."[235] Some scholars have commonly recognized, that "the reality is that management, and not shareholders, generally selects the directors."[236] Because of highly-dispersed nature of corporate ownership, "the CEO was able to run the daily operations of the firm and could handpick nominees to the board,"[237] placing boards effectively in inferior position to the CEO.[238] In addition, shareholders often prefer to sell their shares if they disagree with management, rather than voting or contesting elections[239]—a less costly choice.

Typically, only one slate of nominees is presented to shareholders and directors can be elected by a simple plurality.[240] It should be noted that many corporations have recently changed the procedure, requiring the vote of a majority of the shares cast.[241] Under the former system, if only one shareholder voted, the nominees would still be elected.[242] Any shareholder may nominate a candidate for elections, but first, such proposal must be submitted to the board's committee. If the board rejects the proposal, the shareholder may choose to engage in "proxy contest" to include the candidate into elections,[243] or give up the idea. Such an expensive and time consuming endeavor would require the shareholder "to file Schedule 14A with the SEC, hire

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[229] Randall S. Thomas et al., *Dodd-Frank's Say on Pay: Will it Lead to a Greater Role for Shareholders in Corporate Governance*, 97 CORNELL L. REV. 1213, 1265 (2012).
[230] Bebchuk, *The Case*, *supra* note 208, at 836
[231] *Id.* at 846–47.
[232] Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 130 (2009).
[233] DEL. CODE. ANN. tit. 8, §211(b).
[234] John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 Minn. L. Rev. 1313, 1328 (1992).
[235] Velasco, *supra* note 205, at 416–17.
[236] Gevurtz, *supra* note 185, at 396.
[237] Alces, *supra* note 183, at 789.
[238] *Id.*
[239] Thompson & Edelman, *supra* note 232, at 130.
[240] *Id.*
[241] Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1230 (2008).
[242] Thompson & Edelman, *supra* note 232, at 138.
[243] Bo Becker & Guhan Subramanian, *Improving Director Elections*, 3 HARV. BUS. L. REV. 1, 2 (2013).

a proxy solicitor, and often engage in an expensive public campaign to support their nominee or nominees,"[244] with reimbursement by the corporation only if nominee is elected.

4. Factors Undermining Democratic Shareholder Voting

Even if shareholders are dissatisfied with the current board and choose to challenge the incumbents, the rate of their success is highly discouraging. The entrenchment of incumbent boards is reflected in the empirical data: a 2011 survey of Russell 3000 companies reported that of 16,822 candidates nominated for board seats, only 26 candidates were proposed by shareholders; the success rate for incumbent candidates was 99.9%, compared to 46% for the candidates proposed by shareholders.[245] Professors Becker and Subramanian calculated that only 69 director seats, or 0.4% of total director elections, presented a choice for shareholders of U.S. companies in 2011.[246]

a. Financial Costs to Challenging an Incumbent Board

It is very typical for a publicly traded corporation to have only one candidate for board positions; this candidate almost always nominated by management. According to the federal proxy rules, only current management can utilize corporate funds to solicit proxy votes for its slate of director candidates. The expenses of the challenging party are solely borne by that party.[247]

Unsurprisingly, bearing the full cost of challenging management candidates represents a significant impediment to shareholder power. If a shareholder wants to place candidates on the corporate ballot, the shareholder "must absorb the printing costs, postage costs, and legal costs of mounting a full-blown proxy solicitation, and these costs can amount to millions of dollars."[248] This asymmetry ultimately leads to lessened accountability by the incumbent board and management to shareholders.[249] As Professor Bebchuk notes, "while potential challengers have insufficient incentive to invest in mounting a proxy contest, incumbents have excessive incentive to invest in opposing a challenge: they have an incentive to spend more than is optimal from the shareholders' collective perspective."[250]

In addition, there is an issue of sharing the benefits of winning a contest. If the challenging party wins the election, the shareholder waging the proxy contest will be reimbursed for proxy solicitation expenses. And yet, on the benefit side, the shareholder will receive only pro rata interest of the increased price of his or her share.[251] Thus, there is an obvious discouraging

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[244] *Id.*
[245] *Id.*
[246] *Id.*
[247] *Charles M. Elson*, *Shareholder Election Reform and Delaware Corporate Regulation*, DEL. LAW., Spring 2008, at 18.
[248] Steven A. Ramirez, *The Special Interest Race to CEO, Primacy and the End of Corporate Governance Law*, 32 DEL. J. CORP. L. 345, 362–63 (2007).
[249] Elson, *supra* note 247, at 18.
[250] Bebchuk, *The Myth*, *supra* note 214, at 690.
[251] Mourning, *supra* note 204, at 1153.

factor to engage in proxy contest: the benefit will be shared among all shareholders, while the risk of loss (the costs) is borne solely by the challenging party.[252]

Charles Elson presents an interesting solution to this problem: to provide reimbursement of reasonable expenses to challengers who lose by only a small percentage.[253] Presumably, a challenger with low chances to win will not engage in the contest, otherwise, there is a great risk of losing with substantial vote margin, depriving the challenger of the right for reimbursement.

b. Shareholder Uncertainty and Costs

Convincing shareholders that a rival team will bring a superior performance is not an easy task. Incumbent candidates would have a better track record for the performance in particular company, thus making their plans less hypothetical. A rival team would have a difficult time presenting as complete of a picture of their plans as the incumbents,[254] with incumbents relying on their experience from past years. In addition, rival teams may not be able to specify their CEO pick well in advance, as such candidates may not be willing to engage in conversations with rival team members, whereas shareholders generally know the name of CEO nominated by the incumbents at the time of elections.[255] Thus, the incumbents are more predictable in future, making them less-risky for individual shareholders.

Another challenge a rival team may face is shareholder passiveness and lack of interest in election: many shareholders fail to vote.[256] This failure to vote accords with rational choice theory: with minimal mathematical likelihood that one vote will alter the election, the individual's tangible benefit of the outcome of an election is modest at best, if there is one at all.[257] The collective action/free-riding problem comes into play here as well. Institutional investors, in turn, having no collective action issue, may still be reluctant to support a rival team. Banks, for example, are looking for a new business from companies, and thus, voting for a challenger may prevent them from obtaining ne business from the incumbents.[258]

In the current U.S. system, shares are commonly held in "street name," where the broker with whom the stocks were purchased, or another intermediary entity, is listed as the legal owner on a corporation's records but the shareholder still receives the financial benefits as the "beneficial owner" of the stock.[259] If a shareholder desires, she can register her shares with the Direct Registration System, which allows a shareholder to move her shares from street name to directly registered in her name and back to street name.[260] Unfortunately, this system, created in

[252] *Id.*
[253] Elson, *supra* note 247, at 18.
[254] Bebchuk, *The Myth*, *supra* note 214, at 692.
[255] *Id.*, at 692-93.
[256] Paul H. Edelman et al., *Shareholder Voting in an Age if Intermediary Capitalism*, 87 USC L. REV. 1359, 1384 (2014).
[257] *Id.*
[258] Bebchuk, *The Myth*, *supra* note 214, at 693.
[259] U.S. Securities and Exchange Commission, *Holding Your Securities; Get the Facts*, March 4, 2003, *available at* https://www.sec.gov/reportspubs/investor-publications/investorpubsholdsechtm.html.
[260] *Id.*

1996, can take up to thirty days to prepare a shareholder's directly held stock for sale, although two to five days is more common.[261]

c. Administrative Issues

Generally, the basic rules of shareholder voting follow about the same structure, most shareholders vote by proxy.[262] The election administration is not flawless, however. Weaknesses and inconsistencies include inaccurate shareholder lists,[263] delays and omissions in ballot distribution,[264] and incomplete vote tabulation by the subcontractor firms that run elections on behalf of public companies.[265]

Inaccuracies may lead to doubt among shareholders as to whether the election results are legitimate. It is especially troubling in cases of contested elections—archaic administration may create additional impediments and a rival team may incur significant expenses if it loses the election. Furthermore, "even if an election's outcome is not in doubt, managers and shareholders pay attention to not only the identity of the victor, but also to the vote totals on both sides."[266] In addition, '[i]f votes are not counted accurately, then voting totals become noisier signals of shareholders' preferences, undermining the value of corporate elections as a form of communication."[267]

5. Recent Changes Facilitating Shareholder Voice

a. The Decline of Staggered Boards

One of the attributes of corporate governance, commonly criticized by the proponents of shareholder power, is staggered boards. The staggered board has primarily served as an antitakeover mechanism. Typically, in a staggered board, directors are divided into three separate classes serving staggered terms,[268] and shareholders elect only a third of directors in any given year. [269] It therefore takes two years to replace a majority of the board and gain control by a rival. The alternative is a unitary board. In a unitary board structure, all directors are elected at each annual meeting.[270]

Professor Bebchuk found two ways in which staggered boards obstruct challenges against incumbent directors. First, it increases costs, because rivals need to run a slate of directors at least

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[261] *See* Interactive Brokers, *Funding Reference: Position Transfers*, (last visited April 9, 2017), *https://www.interactivebrokers.com/en/index.php?f=funding&p=transfer.*
[262] Yermack, supra note 209, at 2.3-2.4.
[263] *See* Kahan & Rock, *Hanging Chads, supra* note 241 at 1253-55.
[264] *Id.* at 1249-53.
[265] *Id.* at 1251-53.
[266] Yermack, *supra* note 209, at 108.
[267] *Id.* at 106.
[268] Alma Cohen & Charles C.Y. Wang, *How Do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment*, Harvard Business School, at 6 (Working Paper 13-068, May 17, 2013).
[269] Steven Davidoff Solomon, *The Case against Staggered Boards*, N.Y. TIMES, Mar. 20, 2012, https://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards/.
[270] Cohen & Wang, *supra* note 267, at 6.

twice, campaigning for more than a year. [271] Second, shareholders are reluctant to vote for a rival, even with a better agenda, in a company with staggered board structure.[272] After a rival wins the first round of elections, the board will be internally divided for at least one year.[273] This instable transition discourages shareholders.

Staggered boards may also lead to "lower value, a greater likelihood of making acquisitions that are value-destroying, and a greater propensity to compensate executives without regard to whether they actually do a good job."[274] These factors and pressure from public led to a decline of staggered board in American corporate practice: 302 S&P 500 companies had staggered boards in 2002;[275] in 2016, only 84 boards held staggered elections.[276] Of 900 other companies outside the S&P 500, the same rates have declined by about 25 percent since 2002.[277] Many institutional investors and proxy advisers favoring de-staggering boards as well.[278]

b. Majority Voting

Large companies have been recently adopting majority voting.[279] Under this system, uncontested board nominees must receive majority of the "for" votes than "against" or "withheld" votes to win elections.[280] Plurality voting represents an alternative way—the nominees receiving the most "for" votes are elected or re-elected.[281] Thus, a director would need to receive a plurality of the votes cast.[282] The main concern with the plurality voting rule arises in an uncontested election, there a director may win elections upon receiving just one "for" vote[283] (assuming all other votes were "withheld").[284] It follows that if only one candidate is on the ballot, she wins.

The majority vote rule challenges incumbent directors, making them more accountable, "because every election, in effect, becomes a contest between the candidate and not the candidate."[285] It also makes the challenging process cheaper—unsatisfied shareholders do not need to run their own candidates—shareholders may campaign for withholding of votes. The opponents of majority voting rule, on the other hand, are concerned that "shareholders could

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271 Bebchuk, *The Myth*, *supra* note 214, at 694.
272 *Id.*
273 *Id.*
274 Davidoff Solomon, *supra* note 269.
275 *Id.*
276 Carol Bowie, ISS 2016 BOARD PRACTICES STUDY (2016), available at https://corpgov.law.harvard.edu/2016/06/01/iss-2016-board-practices-study/.
277 Davidoff Solomon, *supra* note 269.
278 Cohen & Wang, *supra* note 268, at 6.
279 *See Majority Voting for Directors*, COUNCIL OF INSTITUTIONAL INVESTORS, *available at* www.cii.org/majority_voting_directors.
280 *See id.*
281 *Id.*
282 Becker & Subramanian, *supra* note 243, at 9.
283 *Majority Voting for Directors*, *supra* note 278.
284 Becker & Subramanian, *supra* note 243, at 9.
285 *Id.*

withhold (or threaten to withhold) votes for reasons unrelated to shareholder value maximization."[286] This is especially relevant for companies with institutional shareholders.

Major movement of establishing the majority voting system began in 2006 proxy season, when some institutional shareholders submitted more than 140 shareholder proposals calling for the adoption of this voting rule.[287] It received substantial support—in 2007, for example, the rate of success of these proposals was more than 50%.[288] Professors Choi and colleagues found that in 2005, only nine of the S&P 100 companies used majority voting in director elections; as of January 2014, almost 90% of S&P 500 companies have adopted some form of majority voting.[289] Studies have shown that majority voting led to positive abnormal returns, but that this effect diminished over time.[290] Another study found that firms that adopted majority voting were more likely to implement shareholder proposals that, in turn, positively impacted stock price.[291]

Adoption of the majority voting rule may be explained by several factors. One possibility is self-selection—companies with "good" and proactive corporate governance self-select into adopting majority voting.[292] Another is that majority voting makes directors more responsive to shareholder interests. A third possibility is that companies that have adopted majority voting may engage in more campaigning ("electioneering") in close elections, whether by lobbying Institutional Shareholder Services not to issue a "withhold" or "against" recommendation or by targeting shareholders directly, because the implications of receiving a majority withhold votes are more severe. Finally, shareholders may be more reluctant to cast a negative vote when a failure to get a majority of "for" votes could result in the ouster of the nominee.[293] Shareholders may perceive that a failed election at a company with a majority voting rule may interfere with board functioning or impact stock price and therefore be reluctant to cast a "no" vote.

c. SEC Proxy Rules

For many years, the restrictive SEC proxy rules imposed significant costs on potential insurgents and chilled shareholder speech.[294] Since 1992, however, the SEC has been gradually relaxing its proxy requirements. In 2007, the SEC promulgated its "eProxy" rules, which were designed to further reduce costs by eliminating the mailing costs of proxy statement to shareholders.[295]

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286 Yonca Ertimur et al., *Does the Director Election System Matter? Evidence from Majority Voting*, at 3, available at https://www0.gsb.columbia.edu/mygsb/faculty/research/pubfiles/5856/DirectorElection.pdf.
287 Mourning, *supra* note 204, at 1163.
288 *Id.* at 1164-65.
289 Stephen Choi et al., *Does Majority Voting Improve Board Accountability?*, Faculty Scholarship. Paper 1589, at 1121 (2016), *available at* http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2590&context=faculty_scholarship.
290 *Id.*
291 *Id.* (citing Yonca Ertimur et al., *Does the Director Election System Matter?: Evidence from Majority Voting*, 20 REV. ACCT. STUD. 1 (2015)).
292 *Id.*
293 *Id.*
294 *See* Coffee & Palia, *supra* note 216, at 559.
295 *Id.*

Under the new Rule 14a-16, public companies mail shareholders only a Notice of Internet Availability of Proxy Materials, at least 40 days prior to the shareholder meeting.[296] All proxy materials now must be publicly accessible, free of charge, at the website, specified in the notice and must remain there through the conclusion of shareholder meeting.[297] A shareholder may solicit proxies pursuant to the new rule as well.[298] Online posting of proxy materials reduces at least distribution costs, as only a single page—the notice—needs to be mailed (the cost of printing and mailing was estimated $5–$6 per set of proxy materials.[299] The SEC Commissioner noted, that these savings "help level the playing field between management and dissenting shareholders."[300] The practice shows, however, that eProxy has not often been employed.[301]

d. Changes in Broker Rules

The majority of shares are held in "street name" by custodians, such as banks and brokerage firms, on behalf of their clients, the "beneficial owners" of the shares.[302] Issuers of proxy materials do not know the identity of the beneficial owner, which in turn creates a barrier to shareholder communications.[303] Brokers are required to forward proxy materials to the actual beneficial owners for a fee, paid by the issuer.[304] In some circumstances, typically in case of a routine and uncontested matters, brokers were permitted to vote shares on behalf of beneficial owners.[305] There is no practical reason for brokers not to support management on these matters because they did not have an economic interest in the corporation.

In 2010, the NYSE rules and the Dodd-Frank Act prohibited brokers from voting shares on behalf of the owners in non-routine matters, without shareholder instructions in most circumstances.[306] Under amended Rule 452 of the NYSE, director elections, regardless of whether they are contested, are considered non-routine and brokers may not vote the shares without instructions.[307] Similarly, Section 957 of the Dodd-Frank Act bars brokers from voting shares held in their names without shareholder instructions in board elections, executive compensation, or any other significant matter.[308]

These amendments are meant to protect shareholders by preventing uninstructed broker voting and to prevent voting distortions. This is especially significant in the context of majority voting—"broker votes can no longer be counted for this purpose, thus

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[296] 17 C.F.R. § 240.14a-16.
[297] *Id.*
[298] *Id.*
[299] Becker & Subramanian, *supra* note 243, at 14.
[300] *See* Coffee & Palia, *supra* note 216, at 559.
[301] See Becker & Subramanian, *supra* note 243, at 15.
[302] Kahan & Rock, *Hanging Chads*, *supra* note 241, at 1234-35.
[303] § 13:13.Transfer agents—Street name securities and proxies, 23A Broker-Dealer Operations Sec. & Comm. Law § 13:13.
[304] *Id.*
[305] *See* Coffee & Palia, *supra* note 216, at 27.
[306] *Id.*
[307] Order Approving Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08, 74 Fed. Reg. 33,293 (July 10, 2009).
[308] 15 U.S.C.A. § 78f (West).

increasing the insurgents' chances to unseat an incumbent in a 'withhold the vote' campaign."[309] It also leads, however, to potential unintended negative consequences. For example, the inability of brokers to vote uninstructed shares means that corporations with high supermajority requirements for amending their charters, may be unable to reach these thresholds without uninstructed broker vote, even with strong support from shareholders and directors.[310] This phenomena is referred as "frozen charter."[311]

e. Proxy Access

The advocates of increasing shareholder's power have persistently demanded implementation of the "proxy access" rule. The idea is fairly straight-forward—under the rule, long-term significant shareholders may choose to place their board candidates on the company's proxy statement.[312] Proponents argue that proxy access empowers shareholders with more active role in monitoring managers and board by the threat of replacement.[313] The Dodd-Frank Act provided the SEC with the express authority to regulate shareholders access to the corporate proxy.[314]

In turn, the SEC adopted Rule 14a-11, the proxy access rule, in 2010, but the D.C. Circuit struck it down in 2011, holding that the SEC acted failed to adequately to assess the economic effects of a new rule.[315] Rule 14a-11 required public companies to include in their proxy materials nominations for director from qualified shareholders who own at least 3% of a company's outstanding shares for a minimum of three years.[316] Yet, in 2015, at least 116 companies received a shareholder proposal seeking a proxy access to be included into corporate documents in accordance with the vacated SEC rule: requiring ownership of 3% for three years to gain access to the company's proxy statement for nominees for up to 25 percent of the number of directors.[317] Companies' responses varied—from rejecting the idea on principle, to expressing openness to adopting or agreeing to adopt the rule, sometimes requiring a 5% ownership threshold, instead of 3%.[318] As a result, 125 companies had a proxy access bylaw by the end of 2015; it is likely that a majority of S&P 500 companies will follow the trend in the near future.[319]

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309 *See* Coffee & Palia, *supra* note 216, at 28.
310 Scott Hirst, *Frozen Charters*, 34 YALE J. ON REG. 91, 94 (2017) ("In the three years after the broker voting change took effect, in 54 of the 63 companies where charter amendments failed despite receiving overwhelming shareholder support, the company would have had their amendments pass had the broker voting change not been implemented.").
311 *Id.*
312 Becker & Subramanian, *supra* note 243, at 20; *See also* Bo Becker & Guhan Subramanian, Improving Director Elections, 3 HARV. BUS. L. REV. 1 (2013); Coffee & Palia, *supra* note 216, at 43.
313 J.W. Verret, *Defending Against Shareholder Proxy Access: Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank*, 36 J. CORP. L. 391, 393 (2011)
314 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971(b), 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o)
315 Bus. Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011).
316 Facilitating Shareholder Director Nominations, 75 FR 56668-01.
317 Marc S. Gerber, *US Corporate Governance: Have We Crossed the Rubicon?*, 2016 WL 1399452.
318 *Id.*
319 *Id.*

Recent practice indicates that 3%/3-year ownership thresholds have become a typical unofficial standard of proxy access threshold provisions.[320]

Proponents' arguments in favor of proxy access may be summarized as follows: it promotes greater director accountability to shareholders; makes it significantly easier and less costly to nominate board candidates; it fosters competition leading to election of better qualified and more independent directors; and it makes it easier for boards to replace underperforming directors.[321] There is, however, disagreement among advocates for proxy access regarding the proper way to implement the rule. On one hand, the regime, denoted as "private ordering," allows shareholders to initiate adoption of proxy access. On the other hand, a "default" regime, imposes the proxy access rule. Professor Bebchuk argues that because of the difference in power between management and shareholders, private ordering will fail to increase shareholder involvement in director nominations.[322] Thus, Bebchuk favors the default rule with the minimum thresholds requirements,[323] as vacated Rule 14a-11 provided. Professor Grundfest, however, advocates for a private ordering regime because it allows shareholders to choose among different structures of the rule, finding the best fit for a company's needs.[324]

In response to the financial crisis, Delaware enacted Section 112 of the DGCL. It states that "bylaws may provide that if the corporation solicits proxies with respect to an election of directors…it may be required to include in its proxy solicitation materials (including any form of proxy it distributes), in addition to individuals nominated by the board of directors, 1 or more individuals nominated by a stockholder."[325] Thus, Section 112 provides for private ordering of proxy access, in line with Grundfest's proposal. In addition, the SEC did not appeal the D.C. Circuit case, and instead amended Rule 14a-8 on September 14, 2011, to prohibit companies from excluding shareholder proposals that would amend a company's governing documents regarding director nomination procedures.[326] It resulted in what Bernard Sharfman referred to as shareholder-initiated proxy access in addition to board-initiated proxy access.[327]

Companies have started using "substantially implemented" or "directly conflicts" exemptions to exclude shareholder proxy access proposals. Yet, consistent with 2016 season, in 2017, the SEC has continued to affirm that shareholder proposals asking for a proxy access rule are considered to be substantially implemented if companies provide terms permitting shareholders that own 3% or more for at least three years to nominate the greater of two directors,

[320] Kobi Kastiel, PROXY ACCESS, SEC UNCERTAINTY AND RELATED ISSUES IN 2015, available at https://corpgov.law.harvard.edu/2015/02/24/proxy-access-sec-uncertainty-and-related-issues-in-2015/.
[321] *Id.*
[322] Lucian A. Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 492 (2002).
[323] *See Id.*
[324] Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW. 361, 366 (2009).
[325] Del. Code Ann. tit. 8, § 112 (West)
[326] 17 C.F.R. § 240.14a-8
[327] Bernard S. Sharfman, *What Theory and the Empirical Evidence Tell Us about Proxy Access*, 13 J.L. Econ. & Pol'y 1, 6–7 (2017).

or 20%, of the board.[328] In addition, the SEC's Division of Corporation Finance stated that the staff will not view a shareholder proposal to be directly conflicting with a management proposal if a reasonable shareholder could logically vote for both.[329] It eliminated a major way companies addressed proxy access proposals.[330]

IV. Empirical Evidence

This section presents our hypotheses, data, methodology and empirical evidence regarding the role of outside shareholders in preventing stock option manipulation. Our evidence shows that the presence of outside directors did not reduce the either corporate fraud or malfeasance by the board itself during our sample period extending from 1996 to 2015.

A. Securities Class Action Lawsuits

We start by examining the number of securities class action lawsuits that were either settled, dismissed or are on-going. We obtain this evidence from the Stanford Class Action Clearing House (SCAC). A securities class action contains allegations of violations of federal or state securities laws.

[Please insert Table 1 here]

SCAC keeps track of about 4,000 class action lawsuits since the Private Securities Litigation Reform Act of 1995 has been passed. The total number of cases filed, settled, dismissed or on-going is shown in Table 1. The total number of lawsuits filed is 1,407 for the 1996-2000 time period, while the number of cases settled is 588 or 64.1% of the total. The number of cases settled for $10 million or more equals 212 or 23.1% of the total.

Looking at the post-SOX period between 2002 and 2008,[331] we see that the total number of lawsuits decided is 1,116, and the number of cases settled is 580 or 52.0% of the total cases decided. The number of cases settled for $10 million or more equals 254 or 22.8% of the total cases decided, which is very similar to the pre-SOX period. The dollar volume of settlements shows similar patterns. All settlements average $3.6 billion per year pre-SOX and $3.3 billion post-SOX period. For large settlements (more than $10 million), the corresponding figures are $3.3 billion per year in the pre-SOX period and $3.1billion in the post-SOX period. Hence, there is no sign of abatement in the number or dollar amount of settled cases during the post-SOX period. Consequently, SOX does not appear to be leading to better corporate governance.

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[328] Ning Chiu, *Status of SEC Staff Decisions on Proxy Access Shareholder Proposals and Aggregation Limits on Nominating Shareholder Groups*, DAVIS POLK, Feb. 21, 2017, *available at* https://www.briefinggovernance.com/2017/02/status-of-sec-staff-decisions-on-proxy-access-shareholder-proposals-and-aggregation-limits-on-nominating-shareholder-groups/.
[329] Michael Greene, *SEC Rule to Play Major Role in Proxy Access: Attorneys*, BLOOMBERG, Jan. 28, 2016, available at https://www.bna.com/sec-rule-play-n57982066686/.
[330] *Id.*
[331] We restrict our post-SOX time period to 2003-2008 to abstract from the large number of on-going cases during the post-SOX period.

B. Malfeasance of the Board

Next, we investigate whether malfeasance by the board itself has declined following SOX.[332] To explore this issue, we revisit the options backdating scandal of 2006 and extend our time period to 2015. We explore whether executives manipulate the timing of option grants or timing of information flows to benefit themselves during the post-SOX period. If executives have positive information around their option grants, they can delay the public announcement of news until after executive options are granted in order to benefit their compensation. This activity is called spring-loading. If executives possess negative information around their option grant time, they can expedite the release of negative information to a date earlier than information release in order to benefit their compensation. The early release of negative information reduces the stock price and thus the exercise price of the options. This activity is called bullet-dodging.

The dating hypothesis is linked to backdating and forward-dating of stock options. Backdating suggests that executives change the date of options grants to an earlier date when stock price was at minimum. It is straightforward to test this hypothesis, because if there is a change in the grant date, grant date will be reported with delays. There is a positive relationship between the length of delays and the amount of stock price bounce since the grant date. Forward-dating suggests that if the stock price has been falling since grant date, executives may the incentives to wait to see if the price will fall further. Forward dating is more difficult to test, since there is automatic bounce in price between the grant date and the reporting date. Nevertheless, forward dating hypothesis also predicts a stock price decline prior to option grant date.

To test these hypotheses, we obtain option grant data from Thompson Reuters insider reporting database, which contains all option grants to executives and directors including inside and outside directors in all publicly listed firms in the United States. Other studies have also used the insider trading database to analyze corporate governance and internal control mechanisms.[333] The database contains identifying information of firms, identifying information of executives, number of shares granted, underlying security of the option, grant date and reporting date. Since the Thompson Reuters Table 2 database starts at 1996, we limit analysis period to January 1, 1996 to December 31, 2015. We collect daily returns of underlying company stocks and value weighted market index from CRSP.

332 See, M. P. Narayanan & H. Nejat Seyhun, *The Dating Game: Do Managers Designate Option Grant Dates to Increase Their Compensation?* 21 REV. OF FIN. STUD. 21, 1907 (2008). *See also* S. Burcu Avci, Cindy A. Schipani & H. Nejat Seyhun, *Ending Executive Manipulations of Incentive Compensation*, 42 J. CORP. L. 277 (2017).

333 Taylan Mavruk & H. Nejat Seyhun, *Do SEC's 10B5-1 Safe Harbor Rules Need to Be Rewritten?*, 2016 Colum. Bus. L. Rev. 133, 154 (2016); Cindy A. Schipani & H. Nejat Seyhun, *Defining "Material, Nonpublic": What Should Constitute Illegal Insider Information?*, 21 FORDHAM J. CORP. & FIN. L. 327 (2016); S. Burcu Avci, Cindy A. Schipani & H. Nejat Seyhun, *Ending Executive Manipulations of Incentive Compensation*, 42 J. CORP. L. 277 (2016); S. Burcu Avci, Cindy A. Schipani & H. Nejat Seyhun, *Manipulative Games of Gifts by Corporate Executives*, 18 U. PA. J. BUS. L. 1131 (2016); Hollis A. Skaife et al., *Internal Control over Financial Reporting and Managerial Rent Extraction: Evidence from the Profitability of Insider Trading*, 55 J. ACCT. & ECON. 91, 107 (2013); Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 68 J. L. & ECON. 371, 403 (2005); Scott L. Summers & John T. Sweeney, *Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis*, 73 ACCT. REV. 131, 144 (1998); Enrichetta Ravina & Paola Sapienza, *What Do Independent Directors Know? Evidence from Their Trading*, 23 REV. FIN. STUD. 962, 1001 (2010).

We analyze three sub-periods that represent different eras in executive compensation literature. The first sub-period is the pre- SOX period, between January 1, 1996 to August 31, 2002. There is no regulation about stock option backdating in this period. The second period, scandal-period, is between September 1, 2002 to December 31, 2006. The feature of this period is the high number of backdating scandals. The last period is January 1, 2007 to December 31, 2015 period, which is named as post- scandals period.[334]

Table 2 shows number of grants, number of firms and number of options granted for top executives and inside and outside directors. We report these numbers separately for promptly reporting and delayed reporting for each group. Total number of options granted for inside directors and top executives is 40,914.5 million, and for outside directors is 8,460.4 million for the whole sample period. Of these totals, 21,697.3 million options were granted in the pre- SOX period; 9,713.5 million options were granted in the backdating scandals period; and 17,964.10 million options were granted in the post-scandal period. Also, 29,885.8 million options were reported promptly, while 19,489.10 million options were reported late during the whole sample period.

[Please insert Table 2 here]

In the pre-SOX period, delayed reported number of grants, number of firms and number of options are much higher than those for promptly reporting option grants. Only one fifth of top executives and inside directors report their options promptly while this ratio is one third for outside directors. This relationship reverses after SOX. The number of promptly reported grants, firms and options inflates while number of delayed grants, firms and options mitigates in post-SOX period. Prompt reporting increased up to 90% of all option grants for both insiders and outsiders. This trend continues in the post-scandal period. Nevertheless, even in the post-scandal period, about 3% of all option grants are late reported.

We use event methodology to measure the abnormal returns around event dates. Event dates are option grant dates. We measure 90 days of cumulative market-adjusted abnormal daily stock returns (CAR) before the event date and 90 days of CAR after the event date. For all summary statistics, the unit of observation is the individual grant.

We define abnormal returns as the difference between the daily returns for firms with the option awards to executives and the value weighted index of NYSE, AMEX, NASDAQ, and ARCA. This approach controls for market movements and implicitly assumes the average beta or risk- exposure is one. Our sample contains more than 6,000 firms; therefore, we can safely claim that this assumption is satisfied. Abnormal return AR_{it} for stock i and day t is computed by a market adjusted model as:

$$AR_{it} = (R_{it} - R_{mt})$$

For each firm i and day t, where R_{it} is the simple daily return on the stock option i awarded to insiders on day t. R_{mt} is the daily return on the value weighted index of stock market.

[334] Avci, Schipani & Seyhun, *supra* note 333332.

For each event date t, these returns are first averaged across all option granting firms i to compute average abnormal returns:

$$AAR_t = \frac{1}{n_t}\sum_{i=1}^{n_t} AR_{it} \ ,$$

The average abnormal returns are the cumulated across the event dates as follows:

$$\text{CARt} = \sum_{t=1}^{T} AAR_t$$

These cumulative abnormal returns are then graphed to examine the behavior of abnormal returns around option granting dates. In Figures 1 through 6, abnormal returns are computed using market adjusted model. Day 0 refers to grant day. Day 90 refers to the ninetieth trading day after the grant date, while day -90 refers to the ninetieth trading day before the grant date.

We group insiders into two groups: Executives and inside-directors; and outside-directors. Inside-directors are those who combine the title of director with the title of office. An example is OD (officer-director). The title of outside directors is directors is simply given as D.[335] To highlight the emphasis by SOX, on outside directors, we combine executives and inside-directors in one group called executives and contrast this group with non-executive outside-directors.

Figure 1 shows the mean CARs from 90 trading days prior to the grant date (date 0) to 90 days after the grant date for executives and inside directors (insiders) versus outside directors during the pre-SOX period (January 1996- August 2002). As can be seen from Figure 1, stock prices form a V-pattern for all insiders' option grants, either prompt or late reported. The presence of the V-pattern indicates that option timing games were prevalent during the pre-SOX period.

Furthermore, Figure 1 indicates that the late reported options have higher post-grant returns than promptly reported options. This pattern holds for both executives and outside directors. This finding indicates that backdating was also prevalent prior to SOX.

Finally, Figure 1 shows that the post-grant returns are much smaller for outside directors than for insiders. This pattern holds true to both prompt and late reported option grants. This finding indicates that outside directors are involved with manipulative compensation games to a lesser extent than the executives during the pre-SOX period.

The specific numbers are as follows: Executives enjoy a post-grant bounce of 7.8% and 9.2% abnormal returns following the grant date for promptly-reported and late-reported option

[335] The remaining titles include the chairman of the board (CB), vice chairman (VC), assistant vice president (AV), chief executive officer (CEO), chief financial officer (CFO), chief investment officer (CI), chief operating officer (CO), chief technology officer (CT), executive vice president (EVP), officer (O), officer and treasurer (OT), divisional officer (OX), president (P), senior vice president (SVP), vice president (VP), secretary (S), controller (C), controlling person (CP), indirect shareholder (DS), founder (F), former (FO), general manager (GM), general partner (GP), limited partner (LP), managing partner (M), managing director (MD), other executive (OE), treasurer (TR), and members of the various board members.

grants, respectively. The difference between these two groups, or 1.4% can be attributed to option-timing games, while 7.8% can be attributed to information timing games.

The comparable figures for the outside-directors are as follows: Outside-directors enjoy a post-grant bounce of 3.7% and 7.0% abnormal returns following the grant date for promptly-reported and late-reported option grants, respectively. The difference between these two groups, or 3.3% can be attributed to option-timing games, while 3.7% can be attributed to information timing games. Overall, this evidence is consistent with the hypothesis that outside directors were involved in compensation manipulation games albeit to a slightly lesser degree than executives themselves. =Furthermore, more of the compensation games involved manipulating information flows than blatant backdating of option grant dates.

[Please insert Figure 1 here]

Figure 2 shows the abnormal profits of insiders and outsider-directors for during the post-SOX, options option-dating scandal period of September 2002 to December 2006. We notice that the post-grant stock price bounce is much higher here for all groups: Executives enjoy a post-grant bounce of 4.6% and 14.9% abnormal returns following the grant date for promptly-reported and late-reported option grants, respectively. The difference between these two groups, or 10.3% can be attributed to option-timing games, while 4.6% can be attributed to information timing games. Thus, option timing games appear to be much more prevalent during this time period.

The comparable figures for the outside-directors are as follows: Outside-directors enjoy a post-grant bounce of 4.6% and 10.3% abnormal returns following the grant date for promptly-reported and late-reported option grants, respectively. The difference between these two groups, or 5.7% can be attributed to option-timing games, while 4.6% can be attributed to information timing games. Overall, this evidence is consistent with the hypothesis that outside directors were involved albeit to a slightly lesser degree than executives in compensation manipulation games.

[Please insert Figure 2 here]

This evidence flies in the face of the intended purpose of SOX, which designated the outside directors as the gatekeepers to serve as a check on the top management. The outside directors clearly do not appear to fulfill this purpose. Instead of acting as a check on the top management, outside directors appear to benefit from both information-flow as well as option grant timing games almost as much as the top executives themselves.

We now turn to the post-scandal period of 2007 to 2015. Figure 3 shows abnormal profits of insiders and outsiders for the post-scandal period.[336] Figure 3 shows the compensation games continue during the most recent, post-scandal period. Executives still enjoy a post-grant bounce of 3.8% and 4.1% abnormal returns following the grant date for promptly-reported and late-reported option grants, respectively. The difference between these two groups, or 0.3% can be attributed to option-timing games, while 3.8% can be attributed to information timing games.

[336] We call this period as post-scandal period because the scandals were revealed in 2006.

Thus, once-again, information-timing games appear to be much more prevalent during this time period.

The comparable figures for the outside-directors are as follows: Outside-directors enjoy a post-grant bounce of 3.8% and 7.5% abnormal returns following the grant date for promptly-reported and late-reported option grants, respectively. The difference between these two groups, or 3.7% can be attributed to option-timing games, while 3.8% can be attributed to information timing games. Overall, this evidence is consistent with the hypothesis that outside directors were involved as much if not more so than the executives in compensation manipulation games.

[Please insert Figure 3 here]

Once again, the significant post-grant returns that are captured by the outside-directors indicate that SOX has not worked as intended. Outside-directors are not providing sufficient checks and balances on the top management to prevent option timing games even in the post-scandal period. To investigate the extent of these games, we now restrict our attention to very large option grants involving more than 100,000 shares. The evidence for large grants are shown in figures 4, 5 and 6.

[Please insert Figures 4, 5 and 6 here]

Our evidence for the large grants shows similar but higher abnormal returns. The fact that the post-grant date abnormal returns increase even more for larger grants further corroborates the conclusion that these stock return patterns are not random, but rather they are deliberate and planned. On net, our evidence does not corroborate outside-directors as providing checks and balances on the top management either before or after SOX.

V. Proposals for Reform

Our evidence shows that SOX has not been effective in improving corporate governance. It has not reduced the overall fraudulent activity. The number of class action lawsuits has not decreased significantly since SOX was passed. Furthermore, the large volume of large settlements has not declined. Our evidence also shows that SOX has not reduced manipulative activity by the board itself. Overall, our evidence indicates that the responsibilities placed by SOX on the outside directors do not appear to work as intended.

Our recommendation is placing more emphasis and power on the shareholders themselves. Instead of placing almost exclusive emphasis on the board of directors as the gatekeepers for the top management, we need to strengthen corporate governance by strengthening the monitoring role of the shareholders. While not all shareholders will be interested in providing a monitoring role, all shareholders will certainly benefit from enhanced shareholder rights.

We suggest a number of reforms that can enhance shareholder rights. First, the recent trend towards multi-class control structures with unequal voting rights should be checked. Some recent IPOs have involved giving zero shares to outside shareholders. Firms that have recently adopted multi-class shareholder structure with unequal voting rights include Berkshire Hathaway, Google, LinkedIn, Zynga, Groupon and Facebook. There is also evidence that the shareholder returns suffer in controlled firms.[337]

Second, shareholder voting rights can be strengthened by making shareholder by-law resolutions binding on the board of directors. Currently, SEC requires that public companies include shareholder proposals in its proxy statements.[338] However, these proposals are non-binding recommendations to the board of directors. Furthermore, corporations typically exclude these proposals under any one of 12 specific reasons, such as "improper under state law."[339] Even if passed by the shareholders, these resolutions may not be adopted by the board of directors for any number of reasons. Binding by-law resolutions would give direct control to the shareholders to assert their interests over the board of directors and top management.

Another important recommendation is majority-vote requirement for the election of the board, instead of the current plurality rule. The current rule does not permit shareholders to vote against a nominee. They can only withhold their vote if they are unhappy with the candidate. Theoretically, if there is no competing nominee, a person can be elected to the board with a single vote. Majority voting can be further strengthened by requiring that if any director does not receive majority of the votes, that the director must resign immediately and a new proxy must be held to determine the replacement director. Having an effective majority requirement however would eliminate these outcomes and increase shareholder power over the election of the board.

Finally, we suggest a revamping of the Direct Registration System to decrease costs and barriers to shareholders' decisions to exercise their voting right. Specifically, the system should not only allow for shareholders to automatically register and unregister their shares to the corporation's books through a secure online portal, but also educate themselves on corporate issues and vote their shares through this portal instead of through the archaic means currently employed.

Conclusion

In this study we examine the monitoring role of outside directors. SOX has placed special emphasis on independent board members to control and monitor the top management. Our evidence presented in this article has shown that outside directors are not fulfilling this requirement as SOX intended.

First, we investigate the number of class action lawsuits and the dollar value of settlements from 1996 to 2015. We find no sign of abatement in either the number settled cases or the dollar amount of settlements during the post-SOX period as compared to the pre-SOX period. Consequently, the specific provisions of SOX do not appear to be leading to better corporate governance—by reducing lawsuits against the corporations.

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[337] *See* Edward Kamonjoh, *Controlled Companies in the Standard & Poor's 150*, IRRC INSTITUTE, March 2016, *available at* http://irrcinstitute.org/wp-content/uploads/2016/03/Controlled-Companies-IRRCI-2015-FINAL-3-16-16.pdf
[338] *See* SEC Rule 14a-8.
[339] *See* Doron Levit & Nadya Malenko, *Nonbinding Voting for Shareholder Proposals*, 66 J. FIN. 1579 (2011).

Second, we examine direct malfeasance by the board itself. In this regard, we investigate the timing and backdating of executive compensation options between 1996 and 2015. In this study, we find that outside directors receive manipulated their option grants like the top executives do. Similar to options given to the top managements, outside directors use dating and timing techniques to manipulate stock options granted. Our evidence shows that they employ back-dating, spring-loading and bullet dodging games to increase the value of their options. Back-dating among other techniques provides remarkable profits to outside directors. Application of these techniques for late reported grants increase outside directors' compensation by substantial amounts. Specifically, management received extra compensation amounts of 9.2%, 14.9% and 4.1% for the 1996-2002 period, 2003-2006 period; and the 2007-2014 period, respectively. For outside directors, the comparable numbers are7.0%, 10.3%, and 7.5%, respectively. For large late reported option grants, abnormal returns increase even further.

Our evidence strongly suggests that outside directors are not fulfilling the monitoring responsibility placed on the by SOX. We recommend that the solution lies not in strengthening the board of directors, but by strengthening the power of the shareholders. We make three specific recommendations: First, we recommend that multi-class voting structures should be eliminated. The multi-class voting structures exacerbate the conflict between shareholders and the management and lead to inferior outcomes. Our second recommendation is to make the shareholder resolutions binding on the board of directors. Currently, management typically ignores the non-binding shareholder resolutions. We also recommend that plurality voting be eliminated and replaced by majority voting for the board of directors. Majority voting shifts the relative power to elect the directors away from the management to the shareholders themselves. Finally, we propose the Direct Registration System currently employed be replaced with a mode modern system of both registration and voting.

Table 1: Security Class Action Lawsuits from SLCA

Year	Number of Cases Settled	Number of Cases Settled for $10M or more	Number of Dismissed Cases	Number of On-going Cases	Total Number of Cases Filed
1996	63	20	33	0	96
1997	121	40	44	0	165
1998	151	52	81	0	232
1999	120	43	83	0	203
2000	133	57	72	0	205
2001	419	51	68	0	487
2002	164	78	93	1	258
2003	117	47	100	1	218
2004	121	44	106	0	227
2005	91	34	86	1	178
2006	69	34	46	1	116
2007	92	45	72	5	169
2008	90	50	105	5	200
2009	57	35	77	12	146
2010	53	16	89	14	156
2011	57	16	110	21	188
2012	34	11	72	45	151
2013	13	4	47	106	166
2014	5	0	22	143	170
2015	189	0	12	131	332
Totals	2,159	677	1,418	486	4,063

Table 2: Sample Characteristics of Insider Trading by Periods								
		Top Executives and Directors			Outside Directors		
		Number of Grants	Number of Firms	Number of Total Options Granted (in millions)	Number of Grants	Number of Firms	Number of Total Options Granted (in millions)
Pre-SOX Period 1/1996 - 8/2002	**Promptly Reporting**	103,639	4,976	3,612.80	36,816	3,765	1,358.20
	Delayed Reporting	406,928	7,857	13,861.80	132,532	6,608	2,864.50
Backdating Scandal 9/2002 - 12/2006	**Promptly Reporting**	460,543	4,812	6,722.60	128,130	4,096	1,373.20
	Delayed Reporting	52,556	2,487	1,336.40	18,411	1,745	281.30
Post-Scandal Period 1/2007 - 12/2015	**Promptly Reporting**	746,567	4,917	14,401.00	172,716	3,359	2,418.00
	Delayed Reporting	26,902	1,576	979.90	10,371	905	165.20

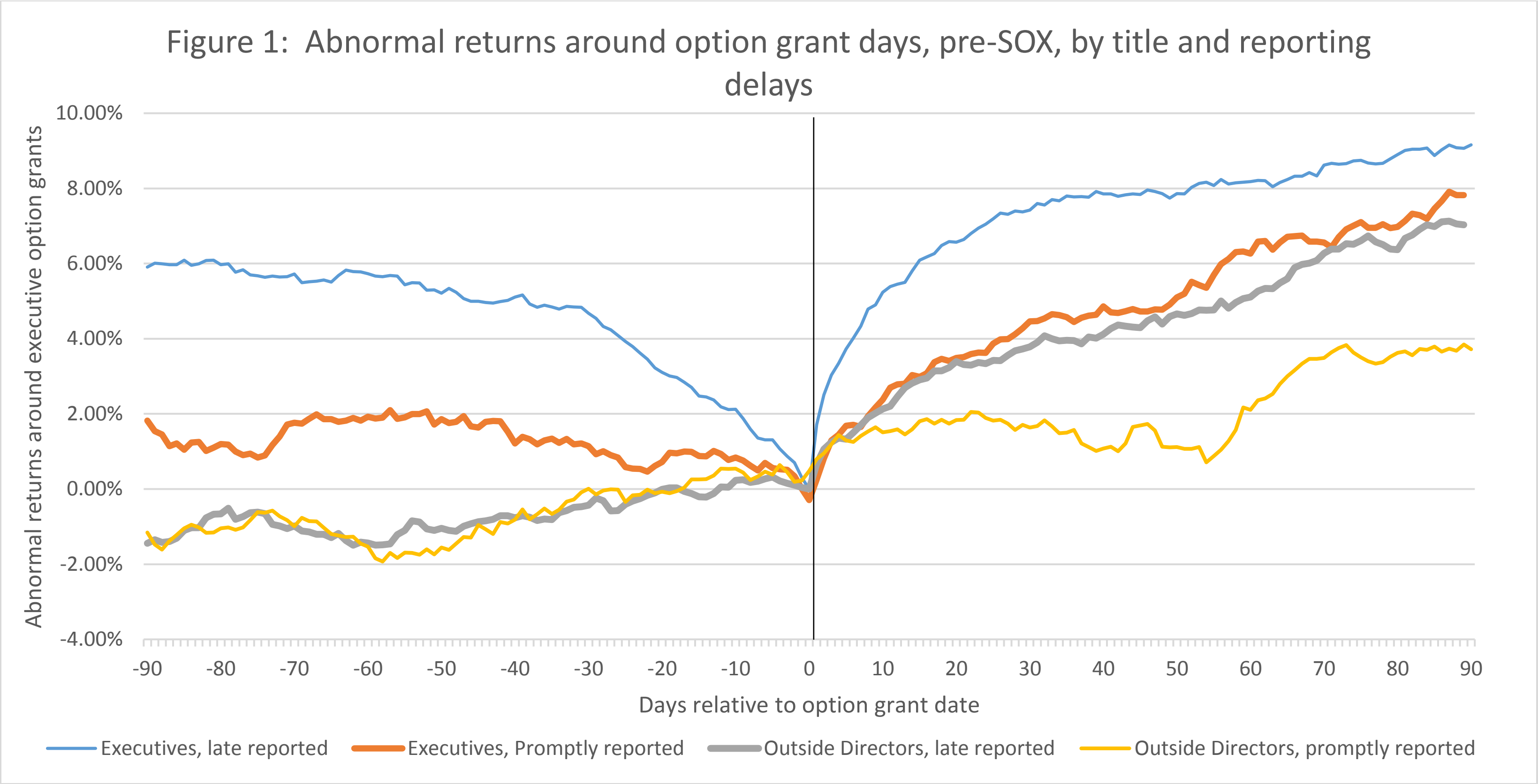
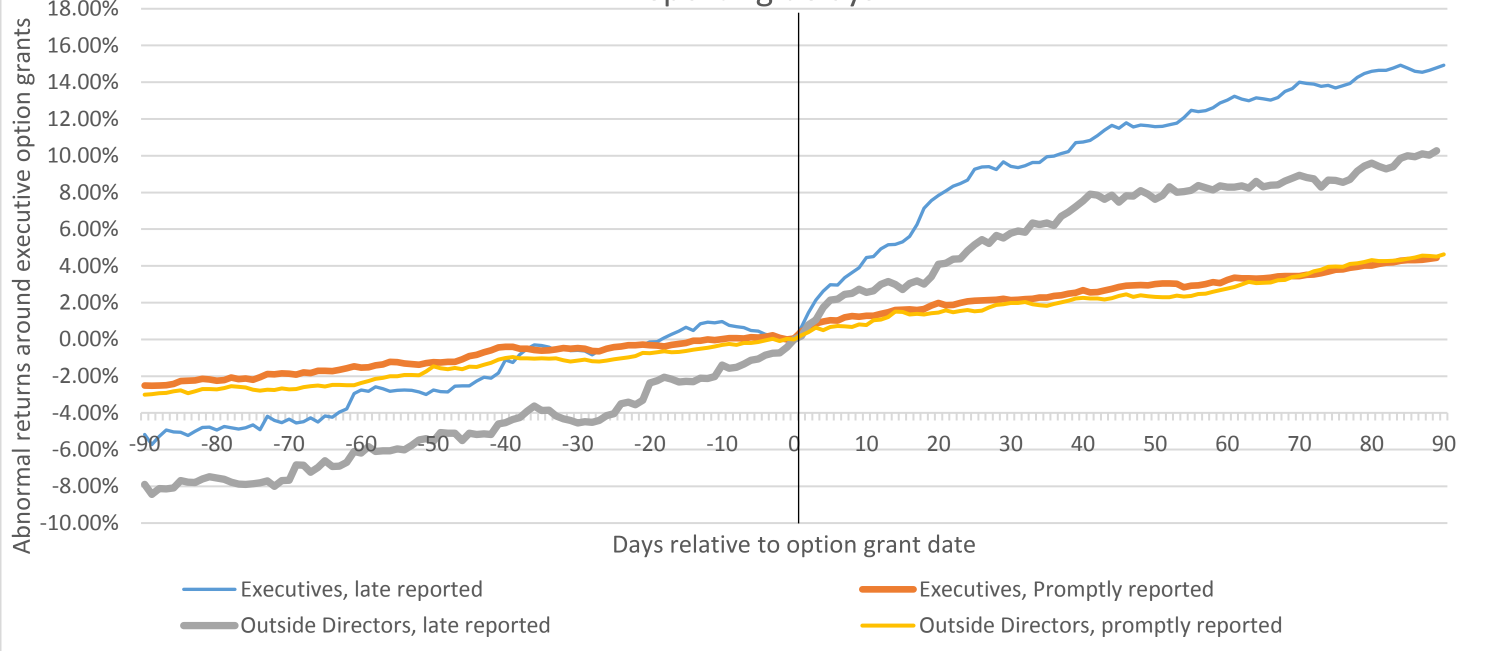


Figure 1: Abnormal returns around option grant days, pre-SOX, by title and reporting delays
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
-2.00%
-4.00%
Abnormal returns around executive option grants
-90
-80
-70
-60
-50
-40
-30
-20
-10
0
10
20
30
40
50
60
70
80
90
Days relative to option grant date
Executives, late reported
Executives, Promptly reported
Outside Directors, late reported
Outside Directors, promptly reported

Figure 2: Abnormal returns around option grant days, 2002-2006, by title and reporting delays



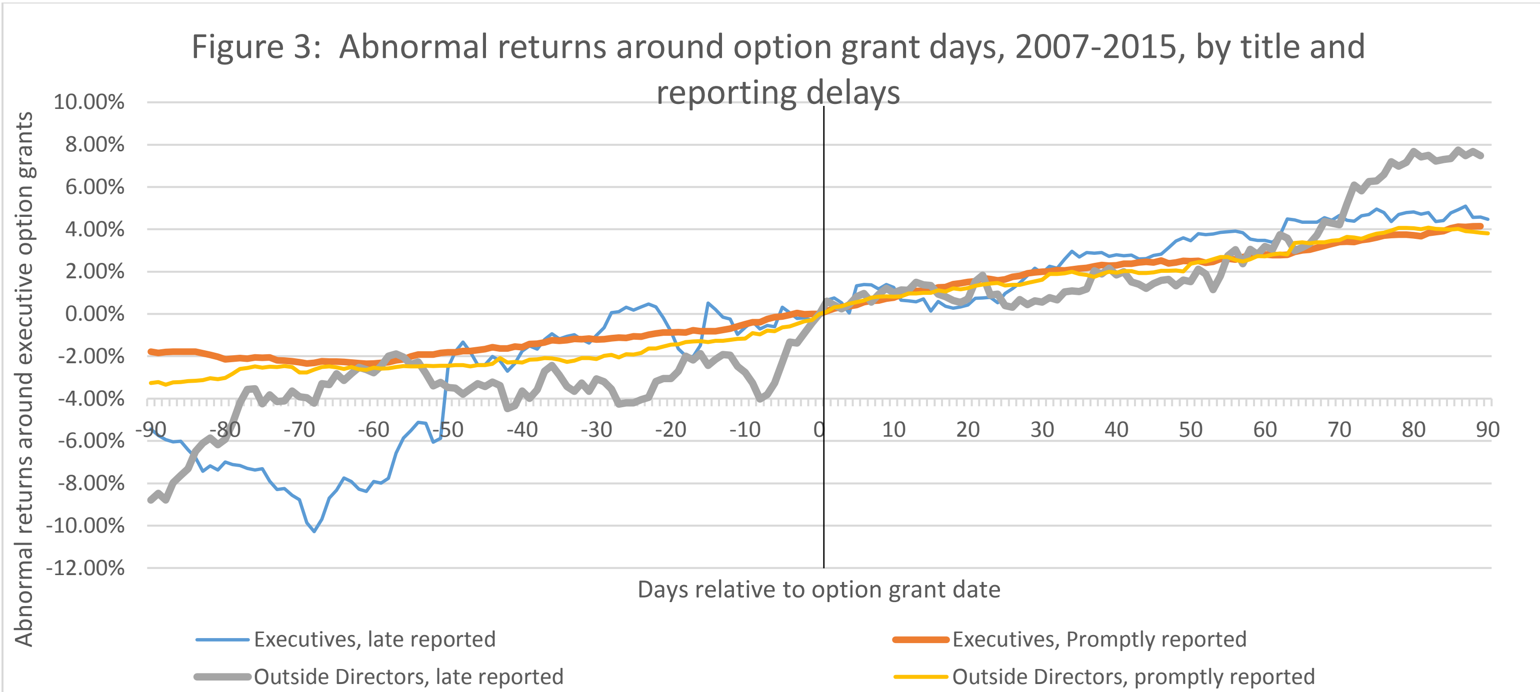


Figure 3: Abnormal returns around option grant days, 2007-2015, by title and reporting delays
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
-2.00%
-4.00%
-6.00%
-8.00%
-10.00%
-12.00%
Abnormal returns around executive option grants
-90
-80
-70
-60
-50
-40
-30
-20
-10
0
10
20
30
40
50
60
70
80
90
Days relative to option grant date
Executives, late reported
Executives, Promptly reported
Outside Directors, late reported
Outside Directors, promptly reported

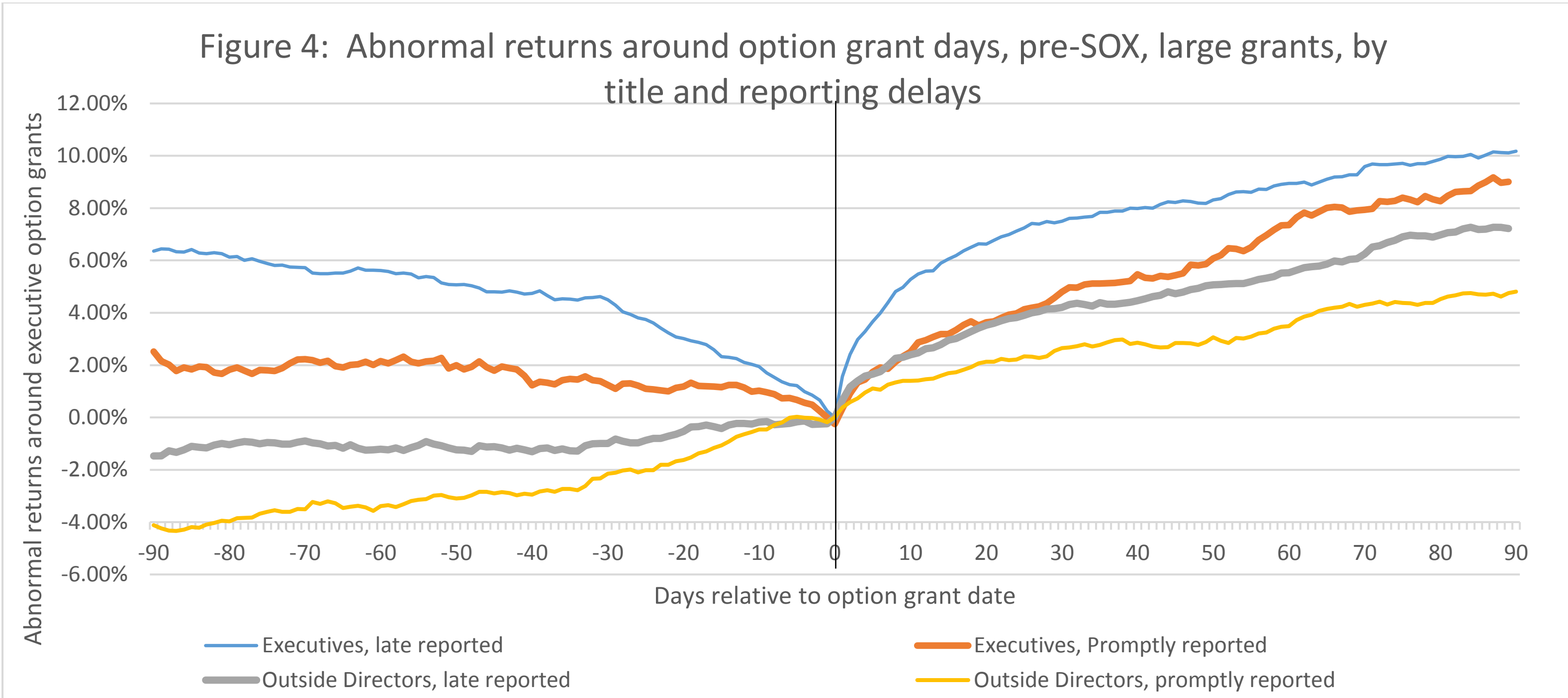
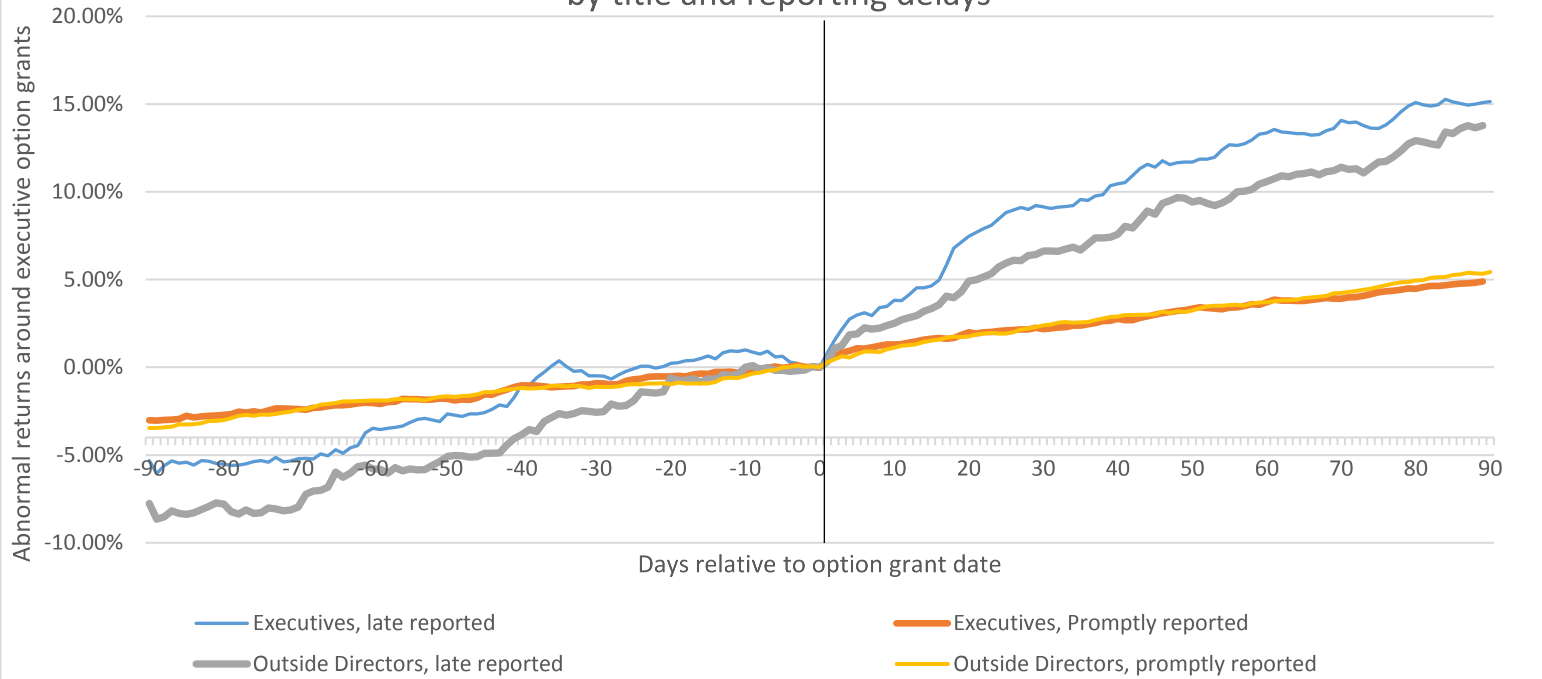


Figure 4: Abnormal returns around option grant days, pre-SOX, large grants, by title and reporting delays
Abnormal returns around executive option grants
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
-2.00%
-4.00%
-6.00%
-90
-80
-70
-60
-50
-40
-30
-20
-10
0
10
20
30
40
50
60
70
80
90
Days relative to option grant date
Executives, late reported
Executives, Promptly reported
Outside Directors, late reported
Outside Directors, promptly reported

Figure 5: Abnormal returns around option grant days, 2002-2006, large grants, by title and reporting delays



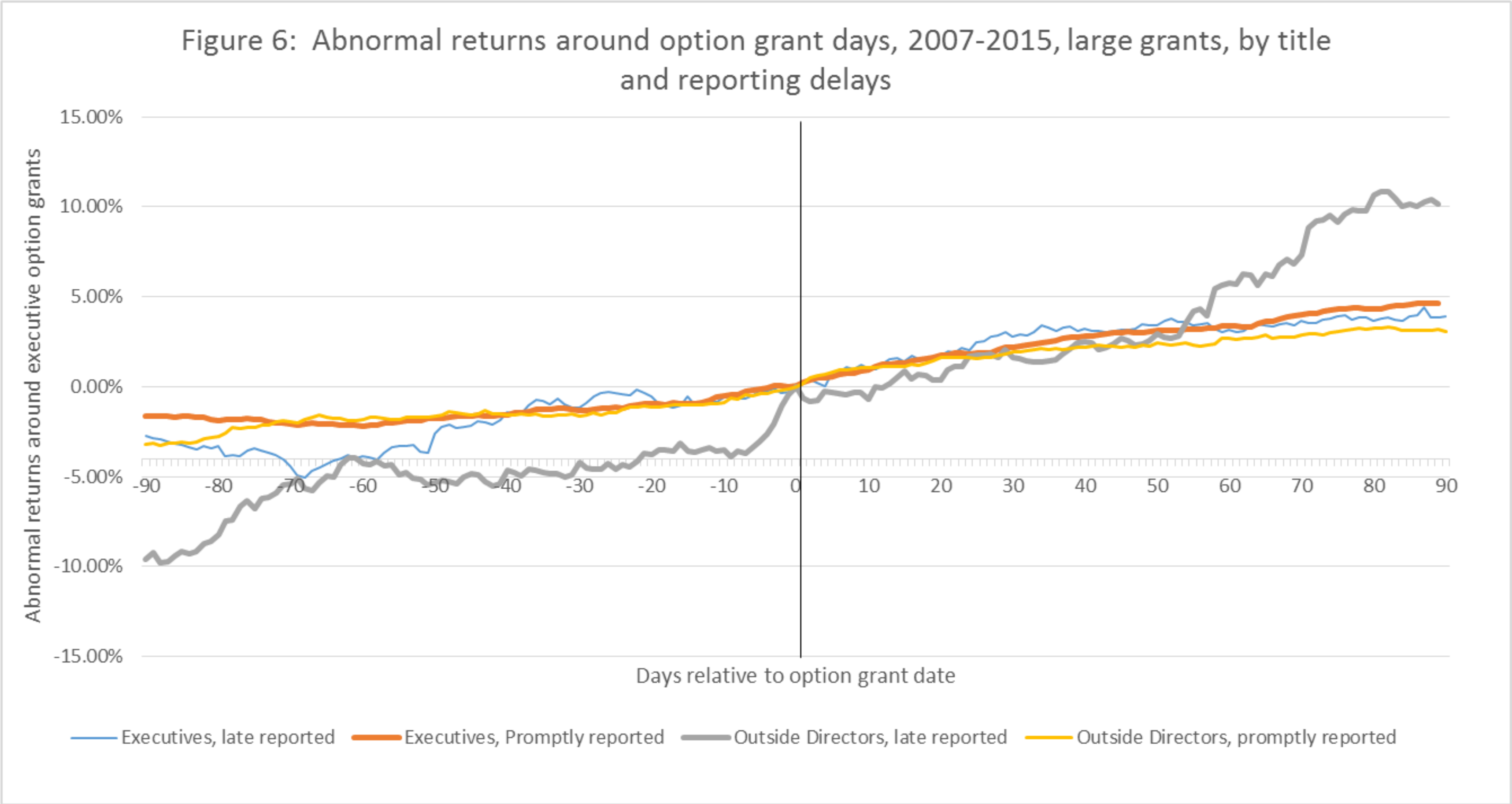


Figure 6: Abnormal returns around option grant days, 2007-2015, large grants, by title and reporting delays
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
Abnormal returns around executive option grants
-90
-80
-70
-60
-50
-40
-30
-20
-10
0
10
20
30
40
50
60
70
80
90
Days relative to option grant date
Executives, late reported
Executives, Promptly reported
Outside Directors, late reported
Outside Directors, promptly reported