HOW MUCH IS TOO MUCH? DIRECTOR EQUITY OWNERSHIP AND ITS ROLE IN THE INDEPENDENCE ASSESSMENT

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I. INTRODUCTION

The fallout of the Enron debacle spurred legislative and regulatory activity aimed at strengthening corporate governance and preventing another corporate implosion.[1] Confronting shattered investor confidence, Congress responded to these corporate governance fiascos by enacting the now infamous Sarbanes-Oxley Act of 2002.[2] The Securities and Exchange Commission (SEC), meanwhile, called on the self-regulatory organizations (SROs),[3] specifically the New York Stock Exchange (NYSE) and Nasdaq, to re-examine and strengthen their own listing and corporate governance standards, in particular those related to the qualifications of directors and officers.[4] In response, the SROs enacted comprehensive reforms to their corporate governance provisions, designed to "restore investor confidence by . . . ensuring the independence of directors and strengthening corporate-governance practices."[5]

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[1] Douglas M. Branson, *Enron—When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform*, 48 VILL. L. REV. 989, 989 (2003).

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

[3] The New York Stock Exchange (NYSE) and the Nasdaq Stock Market, Inc. are generally acknowledged as the nation's two largest stock markets. *See, e.g.*, Kate Kelly, *Big Board May Buy American Stock Exchange*, WALL ST. J., Mar. 7, 2002, at C1.

[4] Press Release, SEC, Pitt Seeks Review of Corporate Governance Conduct Codes (Feb. 13, 2002), *available at* http://www.sec.gov/news/press/2002-23.txt.

[5] Press Release, NYSE, Inc., NYSE Files Changes to Listing Standards with SEC: NYSE-Approved Measures Aim to Strengthen Corporate Accountability (Aug. 16, 2002), *available at* http://www.nyse.com/press/1044027444694.html; Press Release, NASDAQ, Inc., Nasdaq Proposes Improvements to Corporate Governance Standards to Benefit Investors (Apr. 12, 2002), *available at* http://www.nasdaq.com/Newsroom/news/pr2002/ne_section02_084.html.

Both Sarbanes-Oxley and the new SRO regulations prescribe an agenda of greater independence, although they take different approaches and focus on different areas. Sarbanes-Oxley focuses on the independence of company auditors and an audit committee of independent directors to oversee the independent auditors.[6] The SROs took a broader approach by creating independence criteria for a majority of the board and affirmatively requiring a compensation committee and a nominating/corporate governance committee ("nominating committee"), each comprised entirely of independent directors.[7] Both Sarbanes-Oxley and the SROs provide certain objective criteria to aid in the assessment of a director's independence. For example, both prohibit directors who are also executive officers from claiming independence.[8] The criteria they provide, however, are inconsistent in their approach to equity ownership by directors. Sarbanes-Oxley creates a safe harbor for non-employee directors holding ten percent of the company equity, but directors holding over that amount cannot claim the safe harbor.[9] The SROs, however, eschew thresholds in favor of conflicting guidance in their rule commentary that simultaneously highlights and downplays equity ownership as a factor affecting independence.[10] Consequently, the role that stock ownership should play in the independence assessment is unclear.[11]

This Comment considers the role of equity ownership from the perspective of the SROs' goals, and takes the position that equity ownership, if it should play any role in the independence assessment, should weigh solely in favor of finding independence. While many of the arguments made here may be equally applicable to assessing the

[6] 148 CONG. REC. H1540, 1540–41 (daily ed. Apr. 24, 2002) (statement of Rep. Sessions) (Sarbanes-Oxley sought to "ensure auditor independence . . . [and] increase corporate disclosure and responsibility"); Securities Exchange Act of 1934, § 10A(m) (codified as amended at 15 U.S.C. § 78j-1(m) (Supp. IV 2004)) (requiring board audit committees to be comprised entirely of independent directors).

[7] *See generally* NYSE, Inc., Listed Company Manual § 303A (2006), *available at* http://www.nyse.com/lcm/lcm_section.html (select "Section 3 Corporate Responsibility," then select "303A.00 Corporate Governance Standards") [hereinafter NYSE Manual] (setting out the Corporate Governance Standards); NASDAQ, Inc., Nasdaq Manual Online § 4350(c) (2006), *available at* http://nasdaq.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=1014 [hereinafter NASDAQ Manual] (setting out the Qualitative Listing Requirements for Nasdaq Issuers, provisions relating to independence of directors).

[8] 15 U.S.C. § 78j-1(m); NYSE Manual, *supra* note 7, § 303A; NASDAQ Manual, *supra* note 7, § 4200(a)(15).

[9] *See infra* Part II.A.

[10] *See infra* Part II.B.

[11] *See infra* Part III.

independence of audit committee members, the audit committee raises special concerns about fraud that cannot be completely resolved by an equity position alone.[12] For its part, the SEC should modify its taxonomy if it maintains its current posture toward audit committee equity ownership.[13]

Following this introduction, Part II will discuss the statutory and regulatory background defining director independence, now codified in the Securities and Exchange Act of 1934[14] ("Exchange Act") and SRO regulations.[15] Part III explores the interrelationships of these materials and the resulting confusion about what role equity positions play in the abstract definitions of "independence," and considers the effects that confusion can have on reporting companies and their investors. Part IV describes the benefits of director equity ownership. Finally, Part V proposes that, because significant equity ownership advances the SROs' corporate governance goals, a director's equity stake should not be considered when determining whether a director is independent. It also demonstrates how this approach would be consistent with the existing regulatory framework and furthers the SROs' purposes for demanding independence.

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[12] Insofar as the SEC is concerned with independence from management, as the SROs are, the position this Comment takes with respect to SRO rules may well be equally applicable to the SEC rules. It is a tenuous position to take, however, to argue that the largest shareholders (i.e., the owners) should be overseeing management as well as their own audit—an area that requires a level of detachment that an equity interest cannot provide. *See infra* Part IV. For an interesting perspective on the ineffectiveness of audit committee independence on financial statement quality, see Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1529–33 (2005).

[13] For example, the SEC could elect to replace "independent" with "outside" directors for the audit committee. "Outside" directors are defined as "nonemployee director[s] *with little or no direct interest in the corporation*." BLACK'S LAW DICTIONARY 493 (8th ed. 2004) (emphasis added). *Cf. id.* (an inside director is a "director who is also an employee, officer, *or major shareholder of the corporation*") (emphasis added). The concept of "outside directors" is not foreign to the SROs. NYSE Manual, *supra* note 7, § 303.01 ("Since 1956 the Exchange has required all domestic companies listing on the Exchange to have at least two outside directors on their boards."). The new § 303A provisions superseded the § 303 provisions that referenced outside directors, and they were removed on Sept. 9, 2005. Self-Regulatory Organizations; New York Stock Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to the Deletion of Superseded Corporate Governance Standards, Exchange Act Release No. 34-52396, 70 Fed. Reg. 54,430, 54,430 (Sept. 14, 2005).

[14] 15 U.S.C. § 78j-1(m) (Supp. IV 2004).

[15] NYSE Manual, *supra* note 7, § 303A; NASDAQ Manual, *supra* note 7, § 4200(a)(15).

II. STATUTORY AND REGULATORY DEFINITIONS OF DIRECTOR INDEPENDENCE

This Part provides a background on the differing approaches to director equity ownership taken by Sarbanes-Oxley, the SROs, and traditional court analyses. Consistent with the SEC's charge to prevent market fraud perpetrated through inaccurate corporate disclosures,[16] Sarbanes-Oxley directs the SEC to require audit committees to be composed solely of independent directors to oversee the audit of those disclosures.[17] In assuming their broader role in corporate governance,[18] the SROs require a majority of independent directors on the board and exclusively independent directors on the nominating and compensation committees.[19] Both Sarbanes-Oxley and the SROs prescribe minimum criteria to be met before a director may be considered "independent."[20] These objective definitions depart from traditional notions of independence insofar as they attempt to define independence in the abstract, rather than in context as a court would do.[21] While bright-line rules are favored for providing certainty for those who plan around them,[22] the differing standards prescribed by Sarbanes-Oxley and the SROs introduce their own ambiguity about what role equity ownership by directors, historically viewed as a positive incentive to monitor corporate activity, should play in the independence analysis under the new regulations.

To follow this Comment's use of "equity," it is important to recognize that stock is usually comprised of two features—an equity interest and a voting interest. Equity interest generally means a property (or financial) interest in a company that is typically associated

[16] *See infra* Part V; *see also* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) ("An Act [t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws . . . .").

[17] 15 U.S.C. § 78j-1(m).

[18] *See infra* Part V.

[19] NYSE Manual, *supra* note 7, §§ 303A.01, .04–.05.

[20] *Compare* 15 U.S.C. § 78j-1(m), *with* NYSE Manual, *supra* note 7, § 303A, *and* NASDAQ Manual, *supra* note 7, § 4200(a)(15).

[21] *See In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 941 (Del. Ch. 2003).

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

Id.

[22] Roell v. Withrow, 538 U.S. 580, 596 (2003) (Thomas, J., dissenting) ("A bright-line rule brings clarity and predictability . . . .").

with most benefits of stock ownership,[23] although the term "equity" can also be used as a synonym for a share of stock.[24] A voting interest generally attaches to an equity interest,[25] although voting and equity are severable concepts[26] that permit corporations to issue shares with non-proportional voting rights.[27] This Comment uses the term "equity" to mean stock comprised of an equity interest and a proportional voting right.[28]

A. Sarbanes-Oxley and the Rules Pursuant to It

Sarbanes-Oxley's impact on director independence has been limited to those directors who serve on a company audit committee that is responsible for overseeing the company auditors.[29] Those provisions are embodied in Section 10A of the Securities Exchange Act,[30] and direct the SEC to create rules that prohibit any company not in compliance with that section from being listed on a national exchange.[31] Pursuant to that directive, the SEC defined independence in Rule 10A-3.[32]

[23] *Cf.* Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. 971, 1016 (2004) (describing how the benefits derived by ensuring substantial *equity* ownerships could be advanced by requiring directors to retain *stock* received under compensation agreements).

[24] BLACK'S LAW DICTIONARY 580 (8th ed. 2004) (equity is "[a]n ownership interest in property, esp[ecially] in a business," but can also mean "[a] share in a publicly traded company").

[25] CHESTER ROHRLICH ET AL., ORGANIZING CORPORATE & OTHER BUSINESS ENTERPRISES § 3.02[2] (6th ed. 2007) ("When financing takes the form of classic 'equity,' the investor ordinarily obtains some control powers, including some voting power . . . .").

[26] *See* Kimble C. Cannon & Patrick J. Tangney, *Protection of Minority Shareholder Rights Under Delaware Law: Reinforcing Shareholders as Residual Claimants and Maximizing Long-Term Share Value by Restricting Directorial Discretion*, 1995 COLUM. BUS. L. REV. 725, 754 (1995) ("[Delaware] Code recognizes the difference between voting and equity interest by providing separate means of protection for the two interests . . . .").

[27] Frank Partnoy, *Robert Clark's Corporate Law: Twenty Years of Change: Financial Innovation in Corporate Law*, 31 IOWA J. CORP. L. 799, 811 (2006) ("[C]orporations issue multiple classes of equity, with different voting or dividend rights . . . .").

[28] United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975) (defining the five general characteristics of stock as embodying (1) the right to receive dividends, (2) negotiability, (3) ability to hypothecate, (4) "*voting rights in proportion to the number of shares owned*" and (5) the ability to appreciate in value (emphasis added)).

[29] 15 U.S.C. § 78j-1(m)(2)–(3) (Supp. IV 2004).

[30] *Id.* § 78j-1.

[31] *Id.* § 78j-1(m)(1).

[32] Listing Standards Relating to Audit Committees, 17 C.F.R. § 240.10A-3(b)(1)(ii) (2006). The following discussion is confined to non-investment compa-

Without affirmatively defining what an independent director is, the SEC has provided some objective criteria specifying what an independent director is not. Rule 10A-3 provides that to be considered independent, a director cannot accept any "consulting, advisory, or other compensatory" fees from the company other than in the director's capacity as a board or committee member.[33] Likewise, the director may not "be an affiliated person of" the company, other than in the director's capacity as a board or committee member.[34] Executive officers, employees, general partners, and managing members of affiliate entities are deemed "affiliates" based solely on their relationship with the affiliated entity.[35]

A director who owns substantial equity in the company he serves might be disqualified from being independent under Rule 10A-3 if his equity position gives him the status of "affiliate." The term "affiliate" itself is defined as a person who "controls, or is controlled by, or is under common control with," the company.[36] "Control" is defined as the power to direct management, "whether *through the ownership of voting securities*, by contract, or otherwise."[37] Thus by owning a substantial equity position in the company, a director might be disqualified from being independent because his equity position provides control of the company, earning him the status of "affiliate" in a capacity other than as a board or committee member.[38]

Recognizing the potential disqualifying effect of equity ownership,[39] the SEC provided a safe harbor threshold under which any person (other than an executive officer) who is a beneficial owner of ten percent or less of the voting equity securities of a company is

nies, although similar rules exist for investment companies. *See id.* § 240.10A-3(b)(1)(iii).

[33] *Id.* § 240.10A-3(b)(1)(ii).

[34] *Id.*

[35] *Id.* § 240.10A-3(e)(1)(iii).

[36] *Id.* § 240.10A-3(e)(1). When used elsewhere in the act, "affiliate" is given the meaning assigned under the Investment Company Act. 15 U.S.C. § 78c(a)(19) (2000); *see also id.* § 80a-2(a)(3)(A)) (defining "affiliated person" to include a person who holds five percent of the company's voting securities).

[37] Listing Standards Relating to Audit Committees, 17 C.F.R. § 240.10A-3(e)(4) (emphasis added).

[38] *See id.* "Equity position," as used in this Comment, means beneficial ownership of company equity. Note that additional criteria, not inconsistent with those under the SRO regulations, will presume affiliate status, such as employment by the company or employment by another affiliate of the company. *Id.* § 240.10A-3(e)(1)(iii).

[39] *See* Standards Relating to Listed Company Audit Committees, Exchange Act Release Nos. 33-8220, 34-47654, 68 Fed. Reg. 18,788, 18,793 (Apr. 9, 2003).

deemed *not* to be in control of the company.[40] This safe harbor provision expressly disavows any presumption of affiliate status for persons exceeding the threshold.[41] A director who exceeds this threshold, however, is not entitled to the safe harbor presumption.[42] For a director outside the threshold, the board will have to perform a facts and circumstances analysis to determine whether that director has "control" over the company.[43]

B. SRO Regulations

The SRO regulations require that the audit committee members also meet the SROs' independence tests,[44] but add additional requirements for the board and establish membership requirements for committees other than the audit committee.[45] For example, the NYSE requires that a majority of the board members be independent[46] and that the board has both a compensation and a nominating committee comprised entirely of independent directors.[47] Members of the compensation committee set the compensation levels for executives,[48] while the nominating committee members are charged with nominating new directors and recommending corporate governance guidelines to the board.[49]

[40] *Id.*; 17 C.F.R. § 240.10A-3(1)(ii)(A)(1). Beneficial ownership is determined under Regulation 13D. 17 C.F.R. § 240.13d-3. A beneficial owner is one who has voting or investment power over shares of the company, through any relationship. *Id.*

[41] 17 C.F.R. § 240.10A-3(e)(1)(ii)(B).

[42] *Id.* § 240.10A-3(e)(1)(ii)(A)(1).

[43] Standards Relating to Listed Company Audit Committees, Exchange Act Release Nos. 33-8220, 34-47654, 68 Fed. Reg. at 18,793.

[44] NYSE Manual, *supra* note 7, § 303A.07(b).

[45] *See id.* § 303A; *see also* NASDAQ Manual, *supra* note 7, § 4200(c). Although the NYSE and the Nasdaq rules are substantially similar, the NYSE rules are arguably more stringent in certain respects. *Compare* NYSE Manual, *supra* note 7, § 303A.05 (requiring companies to have a compensation committee), *with* NASDAQ Manual, *supra* note 7, § 4350(c)(3) (allowing compensation of officers to be determined by a compensation committee *or* by a majority of independent directors; a special committee is not required). For this reason, this Comment will focus on the NYSE rules, but will address the Nasdaq rules where they evince a departure that is material to the discussion. Note that the SRO regulations address audit committee independence insofar as they require, at a minimum, compliance with the SEC rules. NYSE Manual, *supra* note 7, § 303A.06 (requiring compliance with SEC Rule 10A-3); *accord* NASDAQ Manual, *supra* note 7, § 4350(d) (same); *see also* NYSE Manual, *supra* note 7, § 303A.07 (providing additional criteria such as a requirement of *three* independent directors on the audit committee) (emphasis added).

[46] NYSE Manual, *supra* note 7, § 303A.01.

[47] *Id.* §§ 303A.04–.05.

[48] *Id.* § 303A.05.

[49] *Id.* § 303A.04.

The NYSE regulations, like the SEC rules, do not define what an independent director is, but instead require the board to "affirmatively determine[] that the director has no material relationship with the listed company."[50] Once identified, independent directors and the criteria used to select them must be disclosed in the company proxy or Form 10-K.[51] The regulations set out some objective criteria that will defeat independence, for example, employment by the company within the last three years, payments to the director or a family member exceeding $100,000 over three years (other than payments for their capacity as a director), and certain relationships with the company auditor.[52] The regulations are primarily concerned with independence from management and maintain that ownership of even "a significant amount of stock, *by itself*," will not bar an independence finding.[53]

In their original version of proposed regulations, the SROs took the position that an absolute limit of twenty percent stock ownership would apply to audit committee members.[54] Under the proposed regulations, a person who held, or was associated with a person who held, twenty percent or more of the company's stock could not sit as a voting member of the audit committee.[55] No similar threshold was proposed for the other committees.[56] These proposed regulations were ultimately dropped, and the final regulations instead defer to the SEC audit committee requirements[57] and, in addition, require compliance with the general SRO independence requirements provided for the board and other committees.[58]

C. *Traditional Court Analysis*

Providing a much less complex framework, the independence inquiry under Delaware law has always been a contextual assessment. When determining whether a director was independent in a given situation, Delaware courts will review whether a director's decision was "based on the corporate merits of the subject before the board,"

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50 *Id.* § 303A.02.

51 *Id.* § 303A.02(a) cmt.

52 NYSE Manual, *supra* note 7, § 303A.02.

53 *Id.* § 303A.02(a) cmt. (emphasis added).

54 NYSE, Inc., REPORT OF THE NYSE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE 11 (June 6, 2002), *available at* http://www.nyse.com/pdfs/corp_govreport.pdf.

55 *Id.*

56 *Id.*

57 NYSE Manual, *supra* note 7, § 303A.06.

58 *Id.* § 303A.07(b).

or whether it was based on "extraneous considerations or influences."[59] This case-by-case approach is embodied in the "business judgment rule," a product of common law that affords directors a presumption that they acted in "the best interests of the company."[60]

The Delaware approach results in a far more open-ended inquiry. Rather than provide an abstract definition, the independence inquiry begins by determining from what or whom the director should be independent, and for what purpose, and then evaluates the director's relationship with that person or entity.[61] At the core of the inquiry, Delaware courts will consider a director as not independent if he is, "for any substantial reason, incapable of making a decision" solely in the best interests of the company.[62] For example, where a director must be independent from a director with a personal interest in a transaction, the director may not be independent if he is "beholden," or obliged, to the interested director.[63] "Beholden" encompasses more than financial obligations and can include personal and other relationships.[64] Close personal relationships that border on family ties,[65] colleagueship outside of the board, and even a prior professor-student relationship have come into the equation.[66] Naturally, such a review can only be transaction-dependent and contextual insofar as it is used to review specific relationships of a director in the context of reviewing specific actions of the board.

III. THE EFFECTS OF INCONGRUOUS INDEPENDENCE STANDARDS

This Part will discuss how the competing approaches of the SRO regulations and securities laws, despite providing some objective criteria, create ambiguity about how director equity ownership factors into an independence determination.[67] Indeed, "[t]he lack of any serious underlying theory of independent director motivation is star-

[59] Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984).

[60] Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927 (Del. 2003) (citing Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995)).

[61] *See* Beam v. Stewart, 845 A.2d 1040, 1050 (Del. 2004).

[62] *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2002).

[63] *Id.* at 938–39.

[64] *Id.*

[65] *Beam*, 845 A.2d at 1050.

[66] *In re* Oracle Corp., 824 A.2d at 942.

[67] Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 157 (2006) ("While 'independence' has generally proven fairly easy to conceptualize, if more difficult to define in precise legislative language, one area in which substantial disagreement exists even in principle is that of the significance to be given to stock ownership by the putatively independent director.").

tlingly manifest."[68] This uncertainty can have the effect of dissuading venture capitalists, mutual fund managers, and other investors with substantial equity stakes from confidently asserting their independence and serving crucial roles on the board.[69] Depriving young companies of the management expertise of venture capitalists in an era where initial public offerings are increasingly backed by venture capital, and indeed some industries are predominantly financed by such capital,[70] can inhibit growth and ultimately shareholder value.[71] Moreover, venture capitalists, mutual and pension fund managers, and other institutional representatives constitute a substantial pool of managerial talent that could contribute independent directors to corporate boards and improve corporate governance.[72] Yet these corporate backers are left to operate in an uncertain framework,[73] an

[68] *Id.* at 160.

[69] *See* Letter from Mark G. Heesen, President, National Venture Capital Association, to Jonathan G. Katz, Secretary, SEC (May 8, 2003), *available at* http://sec.gov/rules/sro/nyse200233/nationalven050803.htm (Commenting on the proposed SRO regulations, Mr. Heesen stated that the National Venture Capital Association "is particularly sensitive to the risk that new definitions of director independence in the Proposed Rules could have the unfortunate effect of limiting the ability of venture capitalists to serve on audit and compensation committees.").

[70] Malcolm Baker & Paul A. Gompers, *The Determinants of Board Structure at the Initial Public Offering*, 46 J.L. & ECON. 569, 572–73 (2003).

[71] *See* James Edward Harris, *Level Five Philanthropy: Designing a Plan for Strategic, Effective, Efficient Giving*, 26 U. ARK. LITTLE ROCK L. REV. 19, 34 (2003) (Venture capitalists "add value through the depth of their engagement by bringing expertise to the board, making valuable connections, recruiting and mentoring management talent." They condition additional investments "upon demonstrating progress toward performance measures that will lead to long-term growth.").

[72] William B. Chandler III & Leo E. Strine, Jr., *Views from the Bench: The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 992–96 (2003); Heesen, *supra* note 69 ("[A] recognition of the independence of directors who represent large venture capital shareholdings is critical to the effectiveness of these Proposed Rules in populating boards and committees with experienced, financially savvy, independent directors.").

[73] MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP 7–8, 77 (2007), *available at* http://www.nyc.gov/html/om/pdf/ny_report_final.pdf. In a report commissioned by Mayor Michael Bloomberg and U.S. Senator Charles Schumer, McKinsey & Company interviewed financial services industry executives and investor groups, and worked with experts on financial regulations to assess their views on maintaining U.S. financial services leadership. *Id.* A strong concern arising out of this research is the perceived legal unpredictability caused by the "inherent complexity" of the U.S. regulatory framework. *Id.* "[T]he *system's inherent complexity has the unfortunate side effect of making it harder to manage legal risk* in the US than in many other jurisdictions. . . . Legal experts indicated that this is a major reason why many corporations now choose English law to govern their international commercial contracts." *Id.* (emphasis added). New York's legislature encourages businesses to select New York as their forum. *See* N.Y. GEN. OBLIG. LAW §§ 5-1401 to -1402 (Consol. 2006) (permitting

undesirable consequence in view of the positive role director equity ownership plays in corporate governance.[74]

What dissuades these various actors is threefold. First, the most generous consequences of a failure to comply with SRO listing requirements are suspension and removal from the exchange.[75] Second, in contrast to Delaware's contextual assessment, companies must disclose which directors are independent and how the determination of their independence status was made in the company's annual proxy statement or Form 10-K filed with the SEC.[76] Such disclosures, in advance of any alleged wrongdoing, could subject the company to SEC scrutiny and liability (and, some would argue, vexatious lawsuits[77]) under the anti-fraud provisions of the Exchange Act.[78] Third, the SRO independence status of a director, determined in a transaction-independent context, may be unfairly extended to assessments of independence in judicial review of a director's decisions,[79] where the courts have historically eschewed categorization before considering why a director should be independent and from whom the director should be independent.[80]

The cause of this uncertainty comes from the interrelationship of SEC and SRO regulations and how they address director equity ownership. The ambiguity begins with the audit committee requirements and the ten percent voting stock threshold created by the non-affiliate safe harbor under the SEC rules,[81] and the uncertain import of failing to be within the threshold. Delaware jurists William Chan-

choice of New York law or choice of New York forum for transactions unrelated to New York but "covering, in the aggregate," $250,000 for choice of law or $1,000,000 for forum selection).

[74] *See generally infra* Part IV.

[75] NYSE Manual, *supra* note 7, § 801.00.

[76] *Id.* § 303A.02(a) cmt.

[77] BLOOMBERG & SCHUMER, *supra* note 73, at 100–01, 104 (discussing the prevalence of "meritless" lawsuits and the pressure it puts on companies to settle and avoid the high costs of litigation). Former New York Governor Eliot Spitzer, whose widely recognized work fighting Wall Street firms as New York's attorney general helped earn him his position as governor, threw his support behind the report. Aaron Lucchetti, *Why Spitzer Is Backing Study That Endorses Less Regulation*, WALL ST. J., Jan. 23, 2007, at C3.

[78] *See, e.g.*, Exchange Act Rule 10b-5, 17 C.F.R. 240.10b-5 (2006) (providing liability for false or misleading statements of material fact in corporate disclosures).

[79] Chandler & Strine, *supra* note 72, at 998 (asserting that, where traditional independence inquiries are transaction specific, courts must be cautious not to rest their independence inquiry on the status assigned by the regulations).

[80] Beam v. Stewart, 845 A.2d 1040, 1050 (Del. 2004).

[81] Listing Standards Relating to Audit Committees, 17 C.F.R. § 240.10A-3(e)(1)(ii)(B) (2006).

dler and Leo Strine posited that that the ten percent threshold acts as a per se bar to qualification of a director whose beneficial ownership exceeds that level from serving on the audit committee[82] because of the negative implication of not being able to claim the safe harbor. Indeed, many commentators to the proposed rule were also concerned that a fixed level would raise a presumption of non-independence.[83] In response to these concerns, the SEC now expressly disavows such a presumption in the Rule itself,[84] but it cannot be denied that as a result of this threshold, a director with a large equity position has a "taint that, at best, can be explained away," even if only for audit committee purposes.[85] The possibility remains that a director who might otherwise be independent will be disqualified from serving on the audit committee solely because of his equity position. This possibility suggests that at some point, a director is no longer independent for audit committee purposes when he or she exceeds some indeterminate threshold of beneficial ownership.[86]

This "taint" might affect the independence analysis under the SRO regulations where a director would also assert his or her independence. Key corporate functions are performed by nomination and compensation committees that must be comprised of entirely independent directors,[87] and indeed the board itself must be comprised of a majority of independent directors.[88] If this taint carries over to the analyses under the SRO regulations, board membership itself may be foreclosed to beneficial owners of large equity positions.

In applying the same independence requirements to the board as they do to the audit committee, the SROs further blur the lines between these two regimes,[89] making it difficult to disentangle the meaning of independence in one context from its meaning in the other. The SROs, of course, require that audit committees comply

[82] Chandler & Strine, *supra* note 72, at 990–91. William Chandler and Leo Strine are Chancellor and Vice-Chancellor, respectively, of the Delaware Court of Chancery. *Id.* at 953.

[83] Standards Relating to Listed Company Audit Committees, Exchange Act Release Nos. 33-8220, 34-47654, 68 Fed. Reg. 18,788, 18,793 (Apr. 9, 2003).

[84] 17 C.F.R. § 240.10A-3(e)(1)(ii)(B).

[85] Chandler & Strine, *supra* note 72, at 989–90.

[86] *See* Clarke, *supra* note 67, at 158 ("Congress . . . could be seen as viewing substantial ownership of securities as undesirable in independent directors.").

[87] NYSE Manual, *supra* note 7, §§ 303A.04–.05 (2006).

[88] *Id.* § 303A.01.

[89] *Id.* § 303A.07(b) ("In addition to any requirement of Rule 10A-3(b)(1), all audit committee members must satisfy the requirements for independence set out in Section 303A.02.").

with the Sarbanes-Oxley independence requirements.[90] The dilemma is that the SROs also require the audit committee members to be independent under the SRO regulations.[91] Thus a director on the audit committee must be independent under both Sarbanes-Oxley and the SRO regulations.[92] A director on the compensation committee, however, need only qualify under the SRO regulations—and may so qualify even though, under Sarbanes-Oxley, he may be disqualified from sitting on the audit committee because of a large equity stake.[93] The result is a system in which a director on the audit committee is independent under the same SRO regulations as a director who is not independent for audit committee purposes, yet the SROs would label both directors "independent" and both must pass the same SRO independence tests. While not purporting to place emphasis on stock ownership, the NYSE regulations do suggest that stock ownership is at least a factor that adversely affects an independence determination by stating that stock ownership will not *by itself* preclude independence.[94] Adding to the uncertainty is the SROs' hostility toward significant equity ownership in their initial recommendation of a twenty percent threshold for audit committee membership.[95] Yet all these indications of similarity between the seemingly firm Sarbanes-Oxley approach and the SRO approach are at odds with the NYSE's claim that it "does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding."[96] In addition, although the SRO independence requirements also apply to the audit committee, the fact that the SRO requirements are "in addition" to the SEC requirements suggests that they supply some difference.[97] What results is simply an unclear position on equity ownership.

[90] *Id.* § 303A.02(a).

[91] *Id.* Not without good reason—much of the additional objective criteria under SRO regulations are well reasoned, e.g., transaction-based prohibitions, *id.* § 303A.02(b)(v), and not as clearly delineated in the SEC regulations. *See* Listing Standards Relating to Audit Committees, 17 C.F.R. § 240.10A-3(b)(1)(ii) (2006).

[92] NYSE Manual, *supra* note 7, § 303A.07(b).

[93] *See supra* notes 81–86 and accompanying text.

[94] NYSE Manual, *supra* note 7, § 303A.02(a) cmt. ("[T]he Exchange does not view ownership of even a significant amount of stock, *by itself*, as a bar to an independence finding.") (emphasis added).

[95] NYSE, INC., REPORT OF THE NYSE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE 11 (June 6, 2002), *available at* http://www.nyse.com/pdfs/corp_govreport.pdf.

[96] NYSE Manual, *supra* note 7, § 303A.02(a) cmt.

[97] *Id.* § 303A.07(b).

This uncertainty about the role of equity ownership might discourage venture capitalists, who often seek board representation,[98] from participating in corporate governance because their equity stake makes them uncertain candidates for "independent" roles under the regulatory framework. A poignant example can be found in a recent proxy statement filed with the SEC, in which the company indicated that three directors would not be independent under NYSE standards, based solely on their affiliate status under SEC Regulations, because their employment with a private equity fund gave them a large beneficial ownership in the company.[99]

The confusion is not simply a product of the regulatory language, but is also fueled by advocacy groups that simultaneously promote and condemn director share ownership. In a less than clear position on equity ownership, Institutional Shareholder Services (ISS), a leading proxy advisement firm that provides guidance to institutional holders on how to vote their proxies,[100] internally classifies a director who beneficially owns ten percent or more *voting or equity* stock as a "Non-Independent Non-Executive Director" in its international voting guidelines;[101] yet, in its U.S. voting guidelines, ISS sets the threshold at fifty percent beneficial ownership of the companies *voting* shares before being considered an "Inside Director."[102] While these conflicting guidelines make ISS's position on a safe level of director equity ownership uncertain, ISS nonetheless maintains that directors should hold some equity in the companies they serve.[103] Yet

[98] Bruce Taragin, *Venture Capital 101*, at 4 (Nov. 14, 2002), *available at* http://www.blumbergcapital.com/white_papers/files/VC101.pdf, *reprinted in* JAY B. ABRAMS, HOW TO VALUE YOUR BUSINESS AND INCREASE ITS POTENTIAL 223–41 (2004) ("VCs are price sensitive, active investors who seek Board representation . . . .").

[99] Sterling Chemicals, Inc., Definitive Proxy Statement (Form DEF14A), at 16 (Mar. 16, 2006), *available at* http://www.sec.gov/Archives/edgar/data/1014669/000095012906002747/h33413ddef14a.htm. The private equity fund Resurgence Asset Management was the beneficial owner of a "substantial majority" of Sterling Chemicals' securities. *Id.*

[100] Alan Murray, *Frustrated "Greens" Turn to Boardrooms*, WALL ST. J., Jun. 7, 2006, at A2 (explaining that ISS "advises pension funds and other institutions on how to vote their corporate proxies"); Lingling Wei, *Corporate Governance (A Special Report)—How Am I Doing? Peer-based Evaluations Are Moving Slowly into the Boardroom*, WALL ST. J., Oct. 9, 2006, at R5 (stating that ISS is the nation's largest proxy-advisory firm).

[101] INSTITUTIONAL S'HOLDER SVCS., ISS 2007 INTERNATIONAL PROXY VOTING GUIDELINES SUMMARY 6 (Dec. 15, 2006), *available at* http://www.issproxy.com/pdf/2007InternationalSummaryGuidelines.pdf (international director classification, effective Feb. 1, 2007).

[102] INSTITUTIONAL S'HOLDER SVCS., ISS 2007 US PROXY VOTING GUIDELINES SUMMARY 10 (Dec. 15, 2006) (U.S. director classification, effective Feb. 1, 2007), *available at* http://www.issproxy.com/pdf/2007USSummaryGuidelines.pdf.

[103] *Id.* at 15 ("[S]tock ownership on the part of directors is desired . . . .").

just as under the audit committee requirements, at some point a director's beneficial ownership disqualifies her from being considered independent, although exactly where that threshold is drawn in ISS's view is not well defined.[104] Considering the influence that ISS has over shareholder votes and management decisions,[105] a more concrete position is certainly warranted.

ISS is not alone in maintaining a confusing stance on director equity ownership. Although taking a seemingly adamant position on relationships with significant shareholders, International Corporate Governance Network's (ICGN) inconsistent position on share ownership contributes to the uncertainty about what role equity should have. ICGN, an international organization focused on promoting good corporate governance,[106] disapproves of directors with relationships to significant shareholders,[107] while simultaneously encouraging director equity ownership. ICGN promotes a board of directors who exercise independent judgment in the best interests of the corporation and presumes that directors who have relationships with large shareholders might be subject to influences extraneous to those of the corporation.[108] In ICGN's view, then, a director with a relationship to a significant shareholder is never independent.[109] Not unlike ISS, however, ICGN encourages director equity ownership and demands that every corporation have a policy of director share ownership for the purpose of aligning the interests of directors with those of the shareholders "in a meaningful way."[110]

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[104] *See supra* notes 101–02 and accompanying text.

[105] Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1439 (2002) ("A recent study found that voting recommendations by the ISS against management proposals are usually decisive, and the firm's stated views on a voting issue will often be critical as to whether management pursues the issue.").

[106] Sara Calian, *Global Panel Targets Executive Pay*, WALL ST. J., Sept. 20, 2002, at C16 (explaining that ICGN's membership "includes asset managers from the United Kingdom, other European nations, Japan, South Korea, Australia and Brazil—as well as large U.S. groups such as the California Public Employees' Retirement System" and represents approximately $10 trillion in assets); ICGN.org, About the Network, http://www.icgn.org/organisation/mission.php (last visited Feb. 9, 2006).

[107] INT'L CORP. GOVERNANCE NETWORK, STATEMENT ON GLOBAL CORPORATE GOVERNANCE PRINCIPLES § 5.5 (Jul. 8, 2005), *available at* http://www.icgn.org/organisation/documents/cgp/revised_principles_jul2005.php [hereinafter ICGN, GOVERNANCE PRINCIPLES] (setting out factors affecting independence, including relationships with large shareholders).

[108] *Id.* §§ 5.4–.5.

[109] Note that "relationship" encompasses beneficial owners. Determination of Beneficial Owner, 17 C.F.R. § 240.13d-3 (2006).

[110] ICGN, GOVERNANCE PRINCIPLES, *supra* note 107, § 5.18.

The SROs' "controlled company" exemptions create a paradox that further complicates the analysis. A "controlled company" is a listed company in which an individual, group, or other company holds more than fifty percent of the voting power.[111] Companies that qualify for the exemption are excluded from the independent director requirements related to board and committee composition under the SRO rules.[112] These exemptions recognize the right of majority shareholders to select directors and have control over key decisions.[113] The SROs added the exemptions in response to concerns that requiring a majority of independent directors would have adverse consequences such as depriving rights of majority shareholders, foreclosing family-owned companies' owners from board membership, and discouraging venture capitalists from making a public offering.[114] The exemptions have drawn sharp criticism, however, because they undermine the safeguards the regulations otherwise provide.[115] Indeed, a controlled company is largely exempt from compliance with the SROs' independence rules.[116] Whatever the merits of the exemption, its basis *solely* on beneficial ownership of voting shares seems to imply that a person holding fifty percent of the company could never qualify as independent.[117] Yet this implication is at odds with the position taken elsewhere in the SRO rules that stock ownership does not *by itself* bar an assertion of independence.[118] Moreover,

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[111] NASDAQ Manual, *supra* note 7, § 4350(c)(5) (setting out the exemption under Qualitative Listing Requirements for Nasdaq Issuers Except for Limited Partnerships); NYSE Manual, *supra* note 7, § 303A.00 (setting out the exemption in the introduction).

[112] NYSE Manual, *supra* note 7, § 303A.00.

[113] NASDAQ, Inc., IM-4350-4 Board Independence and Independent Committees (Jan. 13, 2006), *available at* http://nasdaq.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=1019. Clearly this exemption is also important for parent companies. *Id.*

[114] NYSE, Inc., Amendment No. 1 to the NYSE's Corporate Governance Rule Proposals 24 (2003), *available at* http://www.nyse.com/pdfs/amend1-04-09-03.pdf (setting out the various concerns raised by commentators).

[115] Deborah Solomon, *Loophole Limits Independence—Dozens of Firms Use Exemption That Allows Them to Avoid Rules Mandating Board Structure*, WALL ST. J., Apr. 28, 2004, at C1 ("They also raise troubling issues at companies where a controlling shareholder may have substantial voting interest but a small economic stake, the critics say.").

[116] Even under the exemption, the SROs retain the requirement that independent directors must meet in regularly scheduled "executive sessions," exclusive of non-independent directors. NASDAQ Manual, *supra* note 7, § 4350(c)(5); *accord* NYSE, Manual, *supra* note 7, § 303A.00 (does not obviate section 303A.03 on executive session).

[117] *See* NYSE Manual, *supra* note 7, § 303A.00.

[118] *Id.* § 303A.02(a) cmt.

it suspends whatever protection might otherwise have been afforded by the independence regulations.[119]

Uncertainty comes at a cost.[120] While the SEC and the SROs should be applauded for providing objective criteria to evaluate director independence, the obfuscated role of equity ownership in these abstract definitions of independence is in need of some clarification. In restructuring their posture, the SROs should acknowledge the positive effects of director equity ownership.

IV. THE CASE FOR INDEPENDENCE WITH EQUITY OWNERSHIP

Director equity ownership, if it plays any role in the independence analysis, should be a heavy thumb on the scale in favor of independence. Independence is, of course, relative.[121] Complete independence can be achieved only through complete disinterest, that is, absence of a positive incentive to engage in the company—an undesirable attribute for a director.[122]

The SROs, however, want to ensure that the directors maintain independence from executive management.[123] Managerial oversight is a pervasive theme of the SRO regulations that runs through the obligations of each of the required committees.[124] Independence from management is best promoted by aligning the directors' interests with those of the shareholders to ensure effective managerial oversight. This section will discuss how that alignment has both historically and currently been achieved though director equity ownership.

Insofar as independence has historically been a contextual assessment,[125] Delaware case law assessing independence is instructive. Delaware is considered to be "the most important state of incorporation in the United States,"[126] and is the state of incorporation for a

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[119] *Id.* § 303A.00.

[120] *See* BLOOMBERG & SCHUMER, *supra* note 73, at ii.

[121] Beam v. Stewart, 845 A.2d 1040, 1050 (Del. 2004).

[122] *See* Clarke, *supra* note 67, at 159–60 (stating that the purpose of having directors seems obscure if, in removing their ties to managerial interests, the regulatory framework neglects "to substitute a tie to the interests of any other constituency"). This result would leave no incentive to act in any predictable way, other than to avoid liability. *Id.*

[123] NYSE Manual, *supra* note 7, § 303A.02(a) cmt.

[124] *Id.* §§ 303A.04–.05, .07.

[125] *See supra* Part II.C.

[126] Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 396 (2003); *see also* Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1782 (2002) ("Delaware [is] by far the most successful state in the incorporation marketplace . . . .").

majority of public companies.[127] Moreover, most states look to Delaware for corporate law precedents.[128]

Recent Delaware case law continues to affirm the positive role that equity ownership plays in keeping directors independent from management by aligning their interests instead with the shareholders. For example, in *In re Oracle Corp. Derivative Litigation*,[129] when Oracle failed to make its quarterly projections, the Delaware Court of Chancery refused strict disgorgement liability for an officer who traded while in possession of information that cast doubt on Oracle's ability to make those projections.[130] The refusal, the court said, was based in part on a concern that strict liability would "raise the barriers that already dissuade large, but not controlling, stockholders from serving on company boards"[131] because it would make it more difficult for a director to trade in the company stock. The court emphasized that having "as Ross Perot would say, 'skin in the game'"[132] by owning company stock aligns insiders' interests with those of the shareholders, a result that Delaware courts encourage.[133]

The *Oracle* court surveyed a number of other Delaware decisions where equity ownership lent credence to a director's judgment because it aligned his interests with those of the shareholders.[134] For example, in *Unitrin v. American General Corp.*,[135] the Supreme Court of Delaware reasoned that outside directors who were substantial stockholders could not be presumed to value their board positions greater than their economic interests as stockholders when voting in a proxy contest.[136] In such a contest, said the court, the stockholder-directors have the same interests as the general stockholders: maximizing the

[127] Lucian Arye Bebchuk et al., *Management and Control of the Modern Business Corporation: Executive Compensation and Takeovers: Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 780 n.74 (2002); Richard A. Mann et al., *Starting from Scratch: A Lawyer's Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773, 806 (2004).

[128] Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 IOWA J. CORP. L. 625, 663 n.200 (2004); *see* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 903 (2002).

[129] 867 A.2d 904 (Del. Ch. 2004), *aff'd*, No. 561, 2005 Del. LEXIS 150 (Del. Apr. 14, 2005).

[130] *Id.* at 929–30.

[131] *Id.* at 931.

[132] *Id.* at 930.

[133] *Id.*

[134] *Id.* at 930 n.116.

[135] 651 A.2d 1361 (Del. 1995).

[136] *Id.* at 1380–81.

value of their investment.[137] Similarly, in *In re Pennaco Holdings, Inc.*,[138] the Delaware Court of Chancery held that, despite the prospect of a substantial severance package for a change in control of the company, the corporate officers, who were also some of the largest shareholders, were unlikely to favor a sub-par takeover offer just to cash in on their severance packages.[139] Implicitly, the court reached this result because the officers' interests as equity holders were bound to be greater than their personal interests in their severances.[140] Moreover, in response to a separate challenge of the board's stock option grant to itself, the court explicitly stated that such a grant served the permissible purpose of aligning the interests of the board with those of the shareholders.[141]

In the merger context, while assessing an alleged breach of the board's duty of loyalty in entering into a preferential transaction with a pension trust in order to secure the pension trust's support of the merger, the court in *IXC Communications Inc. v. Cincinnati Bell, Inc.*[142] found that the interests of directors with substantial stock ownership would likely be aligned with all of the company shareholders.[143] This lent credibility to the board's decision to enter the agreement where, absent some other showing of self-interest, the challenged transaction was not shown to be inconsistent with the interests of all the shareholders.[144]

In addition to the courts, Congress has acknowledged the important role that equity plays in ensuring that the interests of shareholders are paramount. Congress recently passed the Private Securities Litigation Reform Act of 1995[145] (PSLRA), which creates a presumption in Exchange Act class action suits that the most adequate lead plaintiff is the person with the largest financial interest in the action.[146] This presumption can be rebutted only by showing that

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[137] *Id.* at 1380.
[138] 787 A.2d 691 (Del. Ch. 2001).
[139] *Id.* at 709.
[140] *See id.*
[141] *Id.*
[142] No. 17324, 1999 Del. Ch. LEXIS 210 (Del. Ch. Oct. 27, 1999).
[143] *Id.* at *17–*18.
[144] *Id.*
[145] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).
[146] 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I) (2000).

> [T]he court shall adopt a presumption that the most adequate plaintiff in any private action . . . is the person or group of persons that[, in addition to filing requirements and otherwise being eligible under Fed-

the person would not fairly protect the interests of the class, or that the person is subject to unique defenses that might detract from his ability to serve the class adequately.[147]

PSLRA presents a situation analogous to the role of directors in their oversight of corporate management. PSLRA was enacted to provide oversight of lawyers in securities class actions, where lawyers were perceived as managing the litigation unchecked and serving their own interests.[148] Much like the previously extant corporate governance regulatory framework was perceived as failing to constrain self-interested management,[149] the rules of professional conduct were seen as ineffective in constraining plaintiffs' attorneys in securities class actions.[150] Congress touted the PSLRA for putting investors with significant financial interests in charge of their cases,[151] acknowledging that shareholders with more to gain or lose will best serve the interests of shareholder classes in exercising oversight.[152]

Financial theory also provides sound support for the aligning effects of equity interest. Agency costs are a widely accepted theory on the result of differing interests between management and shareholders.[153] Agency costs in the corporate context are the sum of (1) the

> eral Rule of Civil Procedure 23] . . . in the determination of the court, has the largest financial interest in the relief sought by the class . . . .

Id.

[147] *Id.* § 78u-4(a)(3)(B)(iii)(II). This is akin to the "no material relationship with" the company portion of the SRO independence test. NYSE Manual, *supra* note 7, § 303A.02(a).

[148] *See* 141 CONG. REC. S9199, S9212 (daily ed. June 28, 1995) (statement of Sen. Domenici) ("[U]nder this reform lawyers are going to represent a class of people, not a select plaintiff that they choose as pet plaintiffs. Lawyers are going to be more responsible to the courts . . . .").

[149] Kathleen F. Brickey, *White Collar Criminal Law in Comparative Perspective: The Sarbanes-Oxley Act of 2002: Enron's Legacy*, 8 BUFF. CRIM. L. REV. 221, 246 (2004).

[150] Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2065 (1995); *see also* Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 COLUM. L. REV. 650, 724 (2002) (discussing the potential for excess lawyer control, inability of shareholders to monitor class counsel, and inability of courts to handle potential abuse through settlement review).

[151] 141 CONG. REC. S9199, S9212 (statement of Sen. Domenici) ("First, it puts investors with real financial interests, not lawyers[,] in charge of the case. It puts investors with real financial interests, not professional plaintiffs with one or two shares of stock[,] in charge of the case.").

[152] 141 CONG. REC. S8885, S8893 (daily ed. June 22, 1995) (statement of Sen. D'Amato) ("This bill says the institutional investors, the people who have billions in pension funds, the retirees, those managers will have a greater stake in the case.").

[153] *See, e.g.*, Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV., 323–29 (1986), *available at* http://www.business.ecu.edu.au/users/dallen/corporatefinance3/jensenfreecashflow.pdf (discussing con-

costs of monitoring management, (2) the costs incurred by the company in instituting its own compliance control and ascertaining the desires of the shareholders, and (3) the costs of a loss in value for the shareholders for inevitable deviations from the ideal course of action.[154] Agency costs arise from a divergence in interests between stockholders and management where there is a "separation of ownership and control,"[155] with stockholders retaining ownership but management retaining control. To acknowledge the existence of agency costs is to acknowledge that without the common interest created by equity ownership, divergent interests can impede shareholders' interests and value.[156] Introducing equity ownership at the managerial oversight level (the board of directors) provides the incentive to ensure shareholders' interests are served. Said another way, "non-management directors are there to help shareholders solve the agency problem."[157] Indeed, many respected commentators agree that an equity interest can mitigate agency costs by "inducing management to care about shareholder interests."[158] The NYSE itself states that the "governance rules implemented in 2003 and 2004 empower independent directors *as representatives of shareholders*."[159]

The aligning effects of equity ownership raise unique theoretical concerns that are inconsequential when viewed with the purpose of independence under the SRO regulations, to wit, keeping the directors separate from management.[160] One concern with finding large equity holders independent is the fear that a rift will form between

flicts of interest between shareholders and managers over free cash-flow payment policies and how such conflicts can create agency costs).

[154] *See id.*

[155] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976).

[156] *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 850 (2005) ("In publicly traded companies with dispersed ownership, the interests of management do not fully overlap with those of shareholders, and management thus cannot be automatically counted on to take actions that would serve shareholder interests. As a result, agency costs that reduce shareholder value might arise.").

[157] Clarke, *supra* note 67, at 154.

[158] *E.g.*, Bebchuk, *supra* note 156, at 850. Lucian Bebchuk is the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance at Harvard Law School. Prof. Lucian A. Bebchuk, http://www.law.harvard.edu/faculty/bebchuk (last visited Feb. 28, 2007). He is a frequent commentator on corporate governance issues and an advocate for increased shareholder power in corporate governance. *See id.*

[159] NYSE, Inc., Investor Protection, http://www.nyse.com/regulation/about/1045516499685.html (follow "Listed-Company Compliance" hyperlink) (last visited Jan. 24, 2007) (emphasis added).

[160] NYSE Manual, *supra* note 7, § 303A.02(a) cmt.

long-term and short-term interests of different shareholders.[161] Of particular concern is the short-term view of corporate prospects that a director associated with a venture capital fund might hold.[162] This concern is echoed in positions such as that taken by ICGN, evident in its fear of extraneous influences on directors' decisions by large shareholders.[163] While intellectually appealing, the argument misses its mark in the SRO context because, even were such a rift to form, it would not detract from keeping directors separate from management.

Financial theory demonstrates that a long- versus short-term shareholder rift is unlikely because there is no opportunity for short-term gains in valid corporate decision making. At the outset, it is not at all clear—as a general proposition—that corporate actions favored by short-term shareholders will necessarily conflict with those favored by long-term shareholders.[164] A fundamental principal of financial theory is that projects with a positive net present value (those with long-term value regardless of their duration) increase the current value of the firm to the benefit of both long-term and short-term shareholders.[165] The obvious corollary is that projects with a poor or negative net present value (those which will cause a net loss or a poor return regardless of duration) reduce the current value of the entity.[166] With all projects—regardless of duration—priced into the pre-

[161] *See* Robert D. Kraus, *Inevitable Conflicts?: When a Venture Capitalist Is a Director*, BUS. L. TODAY, Jan.–Feb. 2004, at 49–50, *available at* http://www.abanet.org/buslaw/blt/2004-01-02/kraus.shtml.

[162] *Id.*

[163] *See supra* note 107 and accompanying text.

[164] *See* Bebchuk, *supra* note 156, at 884.

> [C]onsider[ing] the potential costs that might be caused by shareholders with short horizons, such as institutional investors and traders that follow high-turnover strategies . . . [, i]t is far from clear that the governance provisions favored by such shareholders would commonly deviate from those favored by long-term shareholders. If a governance arrangement is widely viewed as detrimental to long-term share value, its long-run effect will likely be reflected in the company's stock price when the arrangement is adopted, and thus the short-run effect of its adoption will likely be negative as well.

Id.

[165] *See* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 23–24 (8th ed. 2006). Net present value is a formula for determining the present value of a prospect of a known duration. *See id.* Because the net present value of undertaken projects are reflected in the current market value, regardless of the project's timeframe, having a short-term interest in holding an equity position does not diminish the need for taking a long-term view of corporate prospects. *See id.*

[166] *See id.*

sent value of the entity, rational directors should not take a short-term view, even if their motives are purely financial and short-term, because capital markets will discount the present market value of a firm based on a project's long-term effect on the value of the company.[167] Therefore, short-term decisions will be discounted in the present stock price, thwarting the ability to make quick changes and "cut and run" with a short-term gain.

A more troublesome situation might arise when a director who is a venture capitalist, pension fund manager, or other significant investor faces an opportunity to sell the entity at a low price while under pressure to exit the investment by the fund he manages.[168] The director may favor voting for the transaction, although longer-term shareholders may prefer to remain as an independent entity.[169]

While by no means an impossible scenario, the obvious rejoinder is that all shareholders have varying investment objectives which might affect their decision to sell or remain; their only consensus will be on their ultimate return on investment.[170] It is equally likely that venture capitalists, pension fund managers, or other significant investors might be more interested in the long-term prospects of the firms for which they serve as directors. Does their interest in the long term prospects, fueling their desire to vote against such a transaction, render their actions inappropriate? A completely disinterested director

[167] *See id.* at 350 ("[M]arket prices . . . impound all available information about the value of each security . . . .").

[168] Kraus, *supra* note 161, at 50.

[169] *Id.* Kraus discusses other hypothetical scenarios wherein the shareholder directors may have a "difference in viewpoint" with the common shareholders, particularly where the directors hold preferred shares, and provides the thoughtful admonition to venture capitalists to be wary of these potential conflicts when seeking board positions, because of the risk of litigation that might challenge their decisions. *Id.* at 51. This Comment takes no position on the advisability of seeking board representation given the potential liability for any decisions a director makes, but offers the response that, as a practical matter, articulable conflicts can be made for seemingly any given set of facts. *See, e.g.*, Beam v. Stewart, 845 A.2d 1040, 1051 (Del. 2004) ("[D]oubt might arise either because of financial ties, familial affinity, a particularly close or intimate personal or business affinity or because of evidence that in the past the relationship caused the director to act non-independently vis à vis an interested director."). Kraus does generally acknowledge, however, that a venture capitalist's main objective is to maximize his return, a "principle [that] should resonate with the company itself as well as its other shareholders." Kraus, *supra* note 161, at 50.

[170] Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1386 (Del. 1995). *See generally* Harvey L. Pitt, *On the Precipice: A Reexamination of Directors' Fiduciary Duties in the Context of Hostile Acquisitions,* 15 DEL. J. CORP. L. 811, 825–34 (1990) (discussing the complexity that is introduced during a takeover bid because shareholders have different investment objectives and considering whether it is appropriate to distinguish among these objectives).

would have to make the same decision, but without the incentive that an equity position provides to ensure the best deal possible for all shareholders.[171] Moreover, such a director would have only his personal interest in retaining his professional fees or other benefits of directorship,[172] providing an incentive to remain entrenched that is at odds with shareholders who would support a fairly priced sale.[173] Simply put, there is no way to guarantee that every investor's subjective desires will be met in every transaction; the best approximation of that end is to have the director's interests aligned with the stockholders' in the most meaningful way possible—an interest in securing a return on their investment.

There is no argument that the "short-sighted venture capitalist" situation would be "pronounced" when the transaction proceeds might accrue solely to those investors, as preferred shareholders, and leave little or nothing for the common shareholders.[174] Moreover, the possibility does not warrant an exclusion from directorship before the transaction occurs. A significant body of law condemns such financial self-interest,[175] and this exact scenario is ably handled by the

[171] *Cf.* Clarke, *supra* note 67, at 159–60.

[172] Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 870 (2003).

> For example, in many large public corporations, outside directors do have a nominal equity stake in the company, but receive far more substantial compensation in the form of annual fees, which often exceed $90,000, in exchange for attendance at a few board meetings per annum. Such a compensation system, of course, is wholly inadequate to promote the kind of personal incentive necessary to create an active board.

Id.

[173] *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 953–54 (Del. 1985) (explaining that when a corporation deals in its own stock, it may deal selectively with its shareholders, "provided the directors have not acted out of a sole or primary purpose to entrench themselves in office"); *see also* Am. Gen. Corp. v. Unitrin, Inc., No. 13656, 1994 Del. Ch. LEXIS 187, at *31–*32 (Del. Ch. Oct. 13, 1994) (finding that the "prestige and perquisites" of directorship, even absent a salary, could cause directors to "reject an excellent offer unless it includes this value in its 'price parameter'"), *rev'd*, 651 A.2d 1361, 1380–81 (Del. 1995) (reversing on appeal because the directors, *who were also substantial shareholders*, could not be presumed to value their interest in their directorship over their own economic interest as shareholders).

[174] Kraus, *supra* note 161, at 50.

[175] *See, e.g.*, Orman v. Cullman, 794 A.2d 5, 25 (Del. Ch. 2002). An interest precluding application of the business judgment rule exists when (1) a director receives a benefit, (2) from the transaction, (3) "which is not generally shared with . . . the other shareholders of his corporation," and (4) that benefit is materially significant to that director. *Id.*

courts.[176] It is difficult to imagine a situation in which a director would be more likely to be accused of having a financial self-interest. Where a personal conflict of interest exists, directors must demonstrate the "entire fairness" of the transaction, or face severe personal liability for their actions.[177]

The short-term view concern might have more force in the context of the audit committee, a situation which raises special concerns about short-sighted interests held by those charged with monitoring the adequacy of audit controls.[178] In the audit committee situation, concerns about short-term interest may not be completely dissipated by an equity position, no matter how well aligned shareholder and director interests may be. Without proper oversight by parties with no personal stake in the firm's financial performance, creative accounting could escape review and temporarily inflate market value.[179] As Enron investors lament, these types of fraudulent accounting prac-

[176] *E.g.*, *In re* Tele-Comms., Inc. S'holders Litig., No. 16470, 2005 Del. Ch. LEXIS 206, at *30 (Del. Ch. Dec. 21, 2005) ("Because a clear and significant benefit . . . accrued primarily . . . to such directors controlling such a large vote of the corporation, *at the expense of another class of shareholders to whom was owed a fiduciary duty*, then a standard of entire fairness applies." (emphasis added)); *see also* Blue Chip Capital Fund II L.P. v. Tubergen, 906 A.2d 827, 830, 834 (Del. Ch. 2006) (where plaintiffs alleged that defendant directors with preferred shares approved an asset valuation in an attempt to maximize the preferred shareholder profits, dismissed fiduciary claim without prejudice because a remedy lied in contract, but would permit the fiduciary claim if the contractual remedy were inadequate).

[177] Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)) ("[D]irectors are required to demonstrate both their utmost good faith and the most scrupulous inherent fairness of transactions in which they possess a financial, business or other personal interest which does not devolve upon the corporation or all stockholders generally."). In such a situation the directors would be required to prove the "entire fairness" of the transaction, both as to price and as to procedure. *Id.*

[178] *See generally* Standards Relating to Listed Company Audit Committees, Exchange Act Release Nos. 33-8220, 34-47654, 68 Fed. Reg. 18,788, 18,815 (Apr. 9, 2003) (providing standards that relate to "the audit committee's responsibility to select and oversee the issuer's independent accountant; procedures for handling complaints regarding the issuer's accounting practices; the authority of the audit committee to engage advisors; and funding for the independent auditor and any outside advisors engaged by the audit committee").

[179] *E.g.*, McClendon, *supra* note 23, at 974–75 (describing how Enron executives created an "illusion of exploding cash flow" and "capitalized on this manipulation" by acquiring stock under compensation plans and "disposing of those shares prior to the issuance of financial restatements that caused a dramatic decline in stock price"); Nathan Wilda, *David Pays for Goliath's Mistakes: The Costly Effect Sarbanes-Oxley Has on Small Companies*, 38 J. MARSHALL L. REV. 671, 674 (2004) (Enron undertook "extensive fraudulent accounting practices and business partnerships that inflated its stock price dramatically. When Enron was forced to restate its earnings and account for the hidden liabilities, it reported enormous losses resulting in a free-falling stock price.").

tices are not without their practitioners.[180] Thus, the SEC's hostility toward equity ownership by audit committee members may be justified.

The concern echoed in the SRO amendments, however, is independence from management.[181] Independence from management is readily accomplished through ensuring director equity ownership and alignment with the shareholders' interests. From this perspective, the SROs should encourage directors to take a substantial equity stake in the corporations they serve. Yet the ambiguity introduced by Sarbanes-Oxley and the recent amendments to the SRO regulations obfuscate the role that equity ownership plays.[182] Thus, the SROs need to take a more firm position in favor of equity ownership in their independence criteria.

V. EQUITY OWNERSHIP SHOULD HAVE NO ADVERSE EFFECT ON AN INDEPENDENCE ASSESSMENT

The SROs should amend their objective criteria to affirm that equity ownership will not affect the independence assessment—no matter what ownership interest a director may have—and take a position in the commentary that favors director equity ownership. This change is supported by the SROs' purposes in demanding director independence. It could also improve corporate governance in general by eliminating the need for the controlled company exemption, while retaining the general notion of independence embodied in the remainder of the requirements.[183] Moreover, legislative history seems to suggest that the ambiguity the SROs created was not their original intention.

This Part will discuss the general purposes of independence under the SRO rules and demonstrate that this proposal is not only consistent with the current regulatory scheme, but could also improve corporate governance generally by furthering the SROs' stated goals.

[180] *See supra* note 179; *see also* John R. Emshwiller, *Skilling Gets 24 Years in Prison—Enron Ex-CEO Faced Longer Term for Fraud, Conspiracy Conviction; Victims Fund to Get $45 Million*, WALL ST. J., Oct. 24, 2006, at C1 (describing the recent sentencing of Jeffrey Skilling, the former Enron CEO, for his involvement in Enron's frauds).

[181] NYSE Manual, *supra* note 7, § 303A.02(a) cmt. (2006).

[182] *See supra* Part III.

[183] *E.g.*, NYSE Manual, *supra* note 7, § 303A.02 (requiring an affirmative finding of independence by the board, prohibiting recent employment by the company, and other requirements).

A. Unintended Consequences

Legislative history of the new regulations suggests that the SROs did not intend to give equity ownership a scarlet letter.[184] The NYSE added commentary indicating that stock ownership alone was not a bar to independence in response to concerned venture capitalists and commentators who sought "clarification of the interaction between share ownership and independence."[185] In the SEC Release approving the proposed SRO regulations, the SEC took notice of a commentator who "expressed its strong support for the position taken by both the NYSE and Nasdaq not to disqualify independent directors for ownership of even a significant amount of stock."[186] Thus, the drafters acknowledged the issue and, standing alone, seemed to have addressed it.

It is the SROs' regulatory interplay with the SEC, even in the initial approval process, that cast a sinister shadow on equity ownership. In paraphrasing the SRO position that the NYSE "does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding,"[187] the SEC release restates the position as "not *necessarily* a bar to an independence finding."[188] The SROs' position toward director equity ownership may not have been so unclear had their regulations never been juxtaposed with the Sarbanes-Oxley regulations.

A simple change in SEC taxonomy might remedy some of the angst. The SEC and SROs' concurrent use of the term "independence" with different meanings under either scheme is a part of the problem.[189] The statutory authority to create the audit committee rules does not require use of the term "independent."[190] As the new-

[184] Indeed, the NYSE acknowledges the value of equity ownership by directors and officers. *Id.* § 309.00.

[185] Self-Regulatory Organizations: Notice of Filing of Proposed Rule Change, 68 Fed. Reg. 19,051, 19,061 (Apr. 17, 2003).

[186] Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes, Exchange Act Release No. 34-48745, 68 Fed. Reg. 64,154, 64,169 (Nov. 12, 2003).

[187] Self-Regulatory Organizations: Notice of Filing of Proposed Rule Change, 68 Fed. Reg. at 19,053.

[188] *Id.* at 19,061 (emphasis added).

[189] *See supra* note 89 and accompanying text.

[190] *See* 15 U.S.C. § 78j-1(m) (Supp. IV 2004). Audit committee members must be members of the board of directors and "otherwise be independent." *Id.* § 78j-1(m)(3)(A). "Independent" is only defined for purposes of the paragraph it is in. *Id.* § 78j-1(m)(3)(B). The SEC already provided for a different usage of the term "affiliate" in the new rule. Listing Standards Relating to Audit Committees, 17 C.F.R. § 240.10A-3(b)(1)(ii) (2006). "Affiliate" would otherwise have the meaning Congress

comer to the corporate governance regulatory field,[191] the SEC should consider replacing "independent" with a term that more clearly differentiates the two regimes.[192]

Moreover, a change in the taxonomy would serve the preeminent Sarbanes-Oxley goal: protecting investors by improving the accuracy of corporate disclosures.[193] Each director's independence status and how that status was determined must be disclosed in a company's proxy statement or Form 10-K.[194] If the differing standards are not made clear to investors then the confusion this Comment takes issue with will ultimately devolve to the public.[195]

B. *The SRO Policies Favor Director Equity Ownership*

Although the SEC and the SROs share similar roles in the marketplace, the goals of the SROs' new regulations address important areas other than those addressed by the SEC. Like the SEC's market oversight role,[196] the SROs are charged with designing rules "to prevent fraudulent and manipulative acts and practices, [and] to promote just and equitable principles of trade."[197] To that end, the SEC and the SROs share a common stance on audit committee membership,[198] which includes an apparent hostility toward those members

gave it under the Investment Company Act. 15 U.S.C. § 78c(a)(19). "Independent" was not previously defined and should therefore be less constrained in its use. *See id.* § 78c(a).

[191] Sarbanes-Oxley is an unprecedented shift into direct federal regulation of corporate governance. Jill E. Fisch, *The New Federal Regulation of Corporate Governance*, 28 HARV. J.L. & PUB. POL'Y 39, 42 (2004); Lyman P.Q. Johnson & Mark A. Sides, *Corporate Governance and the Sarbanes-Oxley Act: The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1150 (2004); *cf.* Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFFALO L. REV. 721, 744 (2005).

[192] *See supra* note 13 (suggesting "outside" director as a suitable replacement based on the accepted definition of that term).

[193] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) ("An Act [t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws . . . .").

[194] NYSE Manual, *supra* note 7, § 303A.02(a) cmt.

[195] *See supra* Part III. Note that the SEC's and SROs' respective positions on equity ownership are not their only inconsistent position. *Id.* While some overlap exists, there are some criteria under the SRO regulations that do not exist under SEC rules. *Id.*

[196] *See generally* SEC, THE INVESTOR'S ADVOCATE: HOW THE SEC PROTECTS INVESTORS, MAINTAINS MARKET INTEGRITY, AND FACILITATES CAPITAL FORMATION (Sept. 11, 2007), http://www.sec.gov/about/whatwedo.shtml.

[197] 15 U.S.C. § 78f(b)(5) (2000).

[198] NYSE Manual, *supra* note 7, § 303A.06 (requiring compliance with Exchange Act Rule 10A-3, as mandated by 15 U.S.C. § 78j-1(m)(1)(A)).

with large equity stakes.[199] Their common goal is to improve independent review and to provide a check on a company's financial controls.[200] However, the additional SRO regulations seem geared more toward their broader decree to perfect a "free and open market . . . and, in general, to protect investors and the public interest."[201] The reasoning underlying the SROs' criteria for additional committees—and the board itself—supports taking an approach favoring equity ownership.

First, the SROs' initial requirement mandates a board comprised of a majority of independent directors.[202] The goal of this requirement is to increase the "quality of board oversight" and reduce conflicts of interest.[203] The SROs serve each of these purposes by encouraging director equity ownership.

Improved board oversight results from an active board, and equity ownership ensures an active board. Like the SROs, commentators have criticized the boards of public companies for their "failure to engage in the kind of active management oversight that results in more effective corporate performance."[204] Commentators praise active board involvement as a means of improving corporate performance and management accountability,[205] leading companies to innovate ways to stimulate a more active board.[206] In empirical studies examining key indicators of board performance, equity ownership correlates with better management oversight and more effective

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199 *See supra* Part IV.

200 Standards Relating to Listed Company Audit Committees, Exchange Act Release Nos. 33-8220, 34-47654, 68 Fed. Reg. 18788, 18789 (Apr. 9, 2003).

201 15 U.S.C. § 78f(b)(5) (2000); *see also* NYSE Manual, *supra* note 7, § 301.00 ("[C]onsistent with the Exchange's long-standing commitment to encourage high standards of corporate democracy, every listed company is expected to follow certain practices aimed at maintaining appropriate standards of corporate responsibility, integrity and accountability to shareholders.").

202 NYSE Manual, *supra* note 7, § 303A.01.

203 *Id.* § 303A.01 cmt.

204 *E.g.*, Sanjai Bhagat et al., *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885, 891 (1999).

205 Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1298, 1317–18 (demonstrating a significant correlation between improved corporate performance and an "active, independent board" through observation of board activism). *See generally* Kaja Whitehouse, *Move Over, CEO: Here Come the Directors*, WALL ST. J., Oct. 9, 2006, at R1.

206 *See* Gaston Ceron, *Musical Board Chairs: Some Companies Hope That by Rotating Lead Directors, They'll Bring a Greater Array of Ideas to the Table; But This Approach Comes with a Price*, WALL ST. J., Jun. 21, 2004, at R5 (describing recent corporate practice of rotating key board positions among directors to increase director participation, despite concerns about continuity in leadership).

boards.[207] But to have such a desirable effect on director behavior, their equity ownership must be substantial.[208] Thus, improvement of the "quality of board oversight" is achieved through encouraging substantial equity ownership.

The SROs are also concerned about conflicts of interest.[209] Equity ownership aligns a director's interest with that of the shareholders,[210] and reduces the director's personal interest in her position.[211] The basic tenets of independence and equity ownership can be viewed as intertwined notions, each fueling the other. Independence from management—as well as freedom from other personal or financial interests—ensure objectivity in oversight, while an equity stake ensures that the objectivity is exercised effectively.[212] Absent equity ownership, directors' motives are to collect their personal compensation and avoid liability—a virtual invitation to shirk performance and a conflict of interest in its own right.[213] In stark contrast to equity ownership, having only personal compensation at stake might lead a director to value his position as director more than the performance of the company,[214] a result at odds with the desire to reduce conflicts of interest. In this view, "[i]ndependence and equity ownership, acting in tandem, are the keys to effective corporate governance."[215] Thus a board with a majority of directors having a substantial equity stake will achieve the SROs' objectives in requiring a majority of independent directors by reducing the potential for conflicts of interest, and increasing the quality of management oversight and corporate performance.

Second, the SROs require listed companies to have a compensation committee comprised entirely of independent directors.[216] The

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[207] *E.g.*, Bhagat et al., *supra* note 204, at 921. The authors use firm financial performance and likelihood of CEO turnover during times of poor performance as indications of effective board oversight. *Id.* 885–90. Based on a survey of 449 U.S. companies, the authors conclude that "better management monitoring and substantial board equity ownership are correlated." *Id.* at 921.

[208] Charles M. Elson et al., *Corporate Governance Reform and Reemergence from Bankruptcy: Putting the Structure Back in Restructuring*, 55 VAND. L. REV. 1917, 1923 (2002); *see* Bhagat et al., *supra* note 204, at 919.

[209] NYSE Manual, *supra* note 7, § 303A.01 cmt.

[210] *See supra* Part IV.

[211] *See* Unitrin v. Am. Gen. Corp., 651 A.2d 1361, 1380–81 (Del. 1995).

[212] *See* Charles M. Elson, *Enron and the Necessity of the Objective Proximate Monitor*, 89 CORNELL L. REV. 496, 498 (2004).

[213] *See id.*

[214] *See Unitrin*, 651 A.2d at 1380–81.

[215] Elson, *supra* note 212, at 499.

[216] NYSE Manual, *supra* note 7, § 303A.05.

compensation committee is responsible for reviewing corporate goals related to CEO compensation, reviewing the CEO's performance, and determining the CEO's compensation based on its evaluation, as well as recommending executive and other compensation plans and producing reports on executive compensation for inclusion in the company's proxy statement.[217] These duties require directors with interests adverse to the executives to ensure that these decisions are based on merit rather than comity. An equity position would ensure that directors' interests are adverse to management's on compensation issues.[218] By increasing their ownership stake, directors will have every incentive to seek performance for the executives' compensation, where directors with a minimal interest would be more yielding.[219] Making equity ownership synonymous with independence would further the SROs' purpose in requiring an independent compensation committee.

Third, as they do for the compensation committee, the SRO regulations require a nominating committee comprised entirely of independent directors.[220] The responsibilities of the nominating committee are to identify qualified persons to nominate for board membership, develop corporate governance guidelines, and oversee the evaluation of management and the board.[221] As in other areas, those directors whose interests are aligned with the shareholders' through equity ownership are more likely to act consistent with shareholders' desires.[222]

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[217] *Id.* § 303A.05(b)(i)(A)–(C).

[218] Charles M. Elson, *Executive Overcompensation: A Board-Based Solution*, 34 B.C. L. REV. 937, 982–83 (1993).

> Nowhere would the positive effect of a personally-motivated outside directorship be more evident than in the area of executive compensation. Overcompensation is the result of ineffective bargaining. People without great incentive to press for position rarely do. Equity ownership would align the position of the outside director with that of the group most disadvantaged by unreasonable compensation, the shareholders.

Id.

[219] *See* Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 74 (2003) (stating that directors typically have only a nominal equity interest in the firm and thus have little incentive to fight the CEO on compensation issues); *see also* Chandler & Strine, *supra* note 72, at 991 (stating that venture capitalists with substantial equity positions have a strong incentive to monitor "managerial rent-seeking").

[220] NYSE Manual, *supra* note 7, § 303A.04.

[221] *Id.* § 303A.04(b)(i).

[222] *See supra* Part IV.

Moreover, proposed corporate governance reforms evince a more general policy that encourages stock owners to be involved in the tasks performed by the nominating committee, in contrast to a policy of financially disinterested directors. In recent years, commentators have called for shareholder ability to directly initiate corporate governance reform in order to increase director accountability to shareholders.[223] In fact, the SEC has considered a "direct access" rule that would permit shareholders owning five percent or more of the company to nominate directors, in certain circumstances.[224] Such reforms, if enacted, would be difficult to square with a policy of denying nominating committee membership to large shareholders, who would presumably be able to nominate directors and initiate governance policy under those reforms.

C. Advancing SRO Policy by Closing the Gaps

If the SROs left equity ownership out of the independence determination it would eliminate the need to suspend otherwise valid corporate governance reforms for companies falling under the controlled company exemption. "Controlled companies" are those companies in which more than half of the voting power is concentrated in a person, group, or parent company.[225] A company fitting this classification is exempt from compliance with the requirement of a majority of independent directors as well as all of those related to the compensation and nominating committees.[226] By suspending these requirements for controlled companies the SROs defeat the sound policy goals served by the regulations' enactment.

The "controlled company" exemption introduces several issues. First, the exemption permits board and committee membership by any person, regardless of his or her ties to management or insider positions.[227] This is contrary to the audit committee requirements which make no exemption for company size.[228] Second, the threshold at

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[223] Bebchuk, *supra* note 156, at 884.

[224] Security Holder Director Nominations, Exchange Act Release No. 34-48626, 68 Fed. Reg. 60784, 60789-90 (Oct. 23, 2003) (discussing proposed Rule 14a-11 which would enable persons that have a five percent beneficial ownership to nominate a director when either a company nominee has received thirty-five percent "withhold" votes, or a prior proxy proposal for a "direct access" procedure received more than fifty percent support in a prior vote).

[225] NYSE Manual, *supra* note 7, § 303A.00.

[226] *Id.*

[227] Subject only to the audit committee requirements under Sarbanes-Oxley. *See* NYSE Manual, *supra* note 7, § 303A.00.

[228] Standards Relating to Listed Company Audit Committees, Exchange Act Release Nos. 33-8220, 34-47654, 68 Fed. Reg. 18,788, 18,804 (Apr. 9, 2003).

fifty percent ownership seems in effect to be an arbitrary concession, as shareholders holding smaller fractions of ownership have similar rights, but no comparable protections exist for them. Third, for persons close to the threshold, it creates a perverse incentive simply to acquire or retain a voting position that exceeds the threshold to claim the exemption.

The exemption also invites the potential for abuse, such as achieving the exemption through a firm capitalization that creates substantial voting interest in classes of shares held by the exemption-seekers, where those persons have in fact only a minimal equity stake in the company.[229] This structure provides complete voting control without the positive incentives attendant to equity ownership. This is possible because the exemption applies to persons beneficially owning *voting* shares, as opposed to simply "stock" or "equity."[230]

Finally, other less flagrant means of circumventing the SRO regulations may have similar counterproductive results. A basic example is board stacking. A director with a substantial equity stake who is dissuaded from asserting his independence might seek to increase the board size to add an offsetting independent director, and not run afoul of the rule requiring a majority of independent directors.[231] While within the confines of the regulations,[232] board stacking is a problem in its own right; empirical evidence demonstrates that larger boards tend to harm firm performance.[233] Leaving the SRO regulatory framework intact for all listed companies and acknowledg-

> Section 10A(m) of the Exchange Act makes no distinction based on an issuer's size. As discussed in the Proposing Release, we think that *improvements in the financial reporting process for companies of all sizes are important for promoting investor confidence in our markets.* In this regard, because there have been instances of financial fraud at small companies as well as at large companies, we think that improving the effectiveness of audit committees of small and large companies is important.

Id. (emphasis added).

[229] *See* Solomon, *supra* note 115, at C1. ("They also raise troubling issues at companies where a controlling shareholder may have substantial voting interest but a small economic stake, the critics say.").

[230] NYSE Manual, *supra* note 7, § 303A.00.

[231] *Cf.* Harry G. Hutchison, *Director Primacy and Corporate Governance: Shareholder Voting Rights Captured by the Accountability/Authority Paradigm*, 36 LOY. U. CHI. L.J. 1111, 1112 (2005) (discussing board stacking in the context of takeover defenses and shareholder voting rights manipulation).

[232] The regulations address classified boards, NYSE Manual, *supra* note 7, § 304.00, but do not set a limit on the total number of directors.

[233] *See, e.g.*, Jennifer G. Hill, *Deconstructing Sunbeam—Contemporary Issues in Corporate Governance*, 67 U. CIN. L. REV. 1099, 1104–05 (1999); Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 293 (2004).

ing the positive effect that equity ownership has in ensuring independence and performance eliminates these issues by permitting uniform application of SRO policy to all listed companies.

VI. CONCLUSION

The current regulatory framework supplied by Sarbanes-Oxley and the SROs has introduced ambiguity into the definition of independence for directors who own substantial blocks of company stock. In defining the contours of independence, the SEC and the SROs have taken inconsistent positions, placing an uncertain taint on director equity ownership that runs counter to the traditional legal understanding of its role.[234] While a change in SEC taxonomy could alleviate some confusion, the SRO regulations need a shift in posture.

Because equity ownership furthers their corporate governance objectives, the SROs should encourage equity ownership by all directors.[235] Taking the strong position that equity ownership will not adversely affect any finding of "independent" status under the SRO regulations would clarify the uncertain regulatory framework. Moreover, this position would reduce or possibly eliminate the need for a controlled company exemption and other regulatory evasions, thereby ensuring that the rest of the regulations' well reasoned criteria are intact for those companies that would otherwise rely on the exemptions. As a result, the SROs would more equitably further their regulatory objectives and restore equity ownership to its rightful position as a positive incentive to ensure good corporate performance.

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[234] *See* Chandler & Strine, *supra* note 72, at 992.

[235] *See supra* Parts IV–V.