

A NEW PRODUCT FOR THE STATE CORPORATION LAW MARKET:
AUDIT COMMITTEE CERTIFICATIONS

Lawrence A. Cunningham

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In the swirling corporate governance reforms led by SOX, the SEC, SROs and PCAOB, Delaware and other states are playing minor roles at best. State absence creates a missing arc in the evolving US corporate governance circle. The circle is drawn as follows: state corporation law charges boards of directors with managing corporations and authorizes board committees; SOX charges audit committees with tasks, including supervising external auditors; SROs require audit committee characteristics like independence and compel disclosure; PCAOB requires external auditors to evaluate audit committee effectiveness. This last step could close the circle except that auditors performing this evaluation generate conflicts with state corporation law, conflicts between auditors and audit committees and face other limitations. These conflicts and limitations can be neutralized in an audit committee evaluation exercise conducted by experts in state corporation law such as retired lawyers and judges. Newly-created state agencies so staffed could thus close the newly-forming corporate governance circle.

The paper considers this concept. It reviews the increasingly central role audit committees play in corporate governance; considers existing mechanisms available to promote effectiveness of that role—including state corporation law, SRO disclosure rules, and traditional auditing—and notes associated limits of each. It considers PCAOB's auditing standards requiring auditors to evaluate audit committee effectiveness, showing both the perceived need for such an evaluation and inherent limits on auditor capabilities to render this evaluation effectively. This review points directly to state agencies as possible providers of this evaluation and certification. Outlines for creation and administration of such state agencies are provided. The paper then assesses the odds of this concept being well-received by various constituents, finding likely support among users and producers of financial information as well as from the auditing and legal professions. It expresses doubt as to whether the SEC would support the concept given a new model of corporate-governance production in which the SEC uses various instrumentalities, including SROs and now PCAOB, to generate a functional federalization of corporate governance. Whether states will be receptive depends upon and is evaluated according to rival corporation law production models (races to the top or bottom; interest group; or state versus federal).

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INTRODUCTION

State corporation law is the foundation of corporate governance. It provides that corporations are managed by a board of directors.¹ It authorizes, but does not require, the board to act through committees.² In their stock exchange listing standards, self-regulatory organizations like the New York Stock Exchange and the Nasdaq Stock Market (the SROs) seize upon the committee device to require boards to create audit committees, populated by independent directors.³ These contemporary standards approach the concept of independence in excruciatingly specific terms, though at the core they are inspired by deep traditions embedded in state corporation law's fiduciary duty of loyalty.⁴

Numerous provisions of the Sarbanes-Oxley Act of 2002 (SOX) reflect the central role that audit committees play and prescribe greater utility. A key provision vests audit committees with the power to engage, supervise and compensate external auditors.⁵ While SOX specifies audit committee composition and function, it and implementing rules of the Securities and Exchange Commission (SEC) respect some federalism limits. They do not further specify how that committee's effectiveness is to be evaluated, though SROs require audit committees to adopt and disclose a governing charter and make periodic reports of their operations.⁶

For the audit committee effectiveness evaluation, the SOX-SEC apparatus implicitly delegates standard-setting to the Public Company Accounting Oversight Board (PCAOB), which SOX establishes. PCAOB adopted Auditing Standard No. 2 (AS No. 2) to require external auditors to evaluate the effectiveness of the audit committee's

¹ *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2003).

² *E.g.*, DEL. CODE ANN. tit. 8, § 141(c)(2) (2003).

³ *E.g.*, NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A.06-07 (Nov. 2003); NASD BY-LAWS, Art. 9, Sec. 5; NASD MARKETPLACE RULES, § 4350(d)(1)-(2) (2002).

⁴ William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State* 152 U. PA. L. REV. 953 (2003).

⁵ Sarbanes-Oxley Act of 2002, § 301, Pub. L. No. 107-204, 116 Stat. at 776-78; 15 U.S.C. 78c(a)58 & 7201(a)(3). SOX does not require boards of directors to form an audit committee. But without one, the entire board is deemed that committee and is subject to requisite laws and regulations.

⁶ *E.g.*, NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A.02 (Nov. 4, 2003); NASD MANUAL, MARKETPLACE RULES, § 4350 (2002).

oversight of a corporation's financial reporting and related internal control.⁷ This evaluation is to be part of the auditor's new task, under SOX, of attesting to managerial assertions concerning the effectiveness of internal control over financial reporting (ICOFR).

AS No. 2 raises numerous questions. These include how this task poses conflicts with the audit committee's new power over the auditor, how to reconcile it with state corporation law's mandate that boards of directors must conduct this oversight,⁸ auditor competence and the absence of objective auditing criteria to measure effectiveness. When AS No. 2 was released for public comment as a proposed standard (the Proposed Standard), the proposal appeared to require a separate and complete evaluation; when finalized, AS No. 2 cut back to clarify that the procedure is part of the auditor's overall evaluation of ICOFR. One reason for carving back was to address some of the numerous questions just mentioned.⁹

A significant consequence of the difference between the Proposed Standard's separate evaluation approach and AS No. 2's more curtailed approach concerns resulting transparency. As a separate evaluation, the task appeared designed to produce disclosure concerning an audit committee's effectiveness, to provide a form of positive assurance to users of financial statements. As merely a part of the auditor's overall evaluation of ICOFR, it becomes an opaque component not visible to financial statement users. It is a form of negative assurance: that the auditor did not find the audit committee ineffective.¹⁰

This difference appears necessary to minimize the difficulties associated with auditors performing this function, including conflicts, expertise and objectivity just mentioned. But it raises two additional questions. First, whether audit committee evaluation assignments that auditors are institutionally incapable of performing should be performed by them or by others. Second, whether it would be desirable to provide a vehicle offering affirmative public assurance of audit committee effectiveness rather than the negative assurance implicit in AS No. 2.

⁷ PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB), AUDITING STANDARD NO. 2: AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS (March 9, 2004), ¶¶ 55-59 [hereinafter AS No. 2]. [*Note: This is subject to SEC approval, expected easily given SEC's substantial role in the preparation process.*]

⁸ SRO listing "standards" specify in excruciating detail how boards of directors are obliged to supervise and evaluate audit committee performance, though the basic standard is at heart a principle of state corporation law.

⁹ Part II examines these issues.

¹⁰ AS No. 2 triggers public disclosure of ineffective audit committee oversight only when this amounts to a "material weakness" in ICOFR. AS No. 2, at ¶ 59.

AS No. 2's emphasis on audit committee effectiveness returns SOX's ambitions for audit committees to the foundation, to state corporation law from which directors get their power and duties. Incomplete in this arrangement, however, is that state law provides no mechanism for an audit committee evaluation, other than broad fiduciary duties applicable to all members of a board of directors. This missing link creates an opportunity for states to contribute to the ongoing discussions of corporate governance reform held in SOX's wake.

While Congress, the SEC, SROs and PCAOB—along with hundreds of assorted professionals—have developed a range of policies, proposals and ideas, Delaware and other states have been on the sidelines (apart from perceived revisions in their approach to the common law of fiduciary obligation).¹¹ States interested in retaining and attracting corporate chartering business, from Delaware to Nevada, have a golden opportunity here: provide in their laws some mechanism for a mandatory or optional formal audit committee evaluation and effectiveness certification.¹²

This Article considers a state-agency based approach to audit committee evaluation.¹³ A branch of state government could be vested with power to conduct a periodic evaluation and provide certification; this could be made mandatory or optional. If made optional, corporations could signal to investors a higher level of confidence in the integrity of their audit committees. This signal could be conveyed in how a state's corporations are denominated. In Delaware, for example, corporations opting out would continue to be called "Delaware corporations;" those opting in would enjoy the boosted designation "certified Delaware corporation."

The state-agency approach would avoid many of the thorny problems AS No. 2 raises and also address those matters that appeared in the Proposed Standard but which dropped from AS No. 2. It would eliminate conflicts of interest between auditors and audit committees and give responsibility to those possessing requisite expertise using objective criteria. It would also create a mechanism furnishing publicly-disclosed affirmative assurance, rather than the negative assurance enabled under AS No. 2.

¹¹ See Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. ____ (forthcoming 2004).

¹² Delaware is the country's leading state of incorporation for large companies. Some see Nevada as attempting to compete with Delaware. *E.g.*, Dave Berns, *Shareholders win ITT Decision: Will Judge Pro's Decision Help Nevada Become the "Delaware of the West"?*, 5 NEVADA LAWYER 22 (Dec. 1997).

¹³ Other approaches are possible. For example, state corporation law statutes could be amended to require boards of directors periodically to evaluate and certify their audit committees as effective; these amendments could make the exercise mandatory or optional (an opt-out based on a shareholder vote for example).

The state-agency approach has its limits too. For example, a state level bureaucracy will not be in a position to examine all aspects of an audit committee to ensure its effectiveness. But no mechanism can do so. Likewise, certain tasks concerning audit committee evaluation may be better handled by auditors when conducting financial statement audits, as AS No. 2 requires.¹⁴ Given gaps, however, a combination of the two exercises may be optimal. Alternatively, a state agency could perform the evaluation and auditors rely on its conclusions, a reliance AS No. 2 authorizes.¹⁵

Despite likely appeal of the concept to users and preparers of financial statements documented in Part IV below, the concept is not likely to be adopted by many states (or any) absent substantial encouragement from those constituents. Regulators, including PCAOB and the SEC, may be less receptive than they should be to the concept. In AS No. 2, PCAOB effectively projects itself as an additional source of corporate governance. It will have territorial interests in commanding as large a section of that field as possible. The SEC, which oversees PCAOB, may wish to preserve maximal power in PCAOB as an additional means to exercise functional control over corporate governance, as it does using SROs, without direct encroachment on state corporation law.¹⁶

Apart from unlikely regulatory support, states may lack incentives to pursue the concept. Predictions of state inclinations regarding this concept depend on adopting one of several rival theories of state corporation law production: states compete with each other in a race to the top or bottom; they compete to benefit interest groups such as lawyers and investment bankers; they compete against the federal government; or they comprise one component of a multi-pronged model involving state, federal and SRO sources.¹⁷

If the race is to the bottom, states generally will reject the concept, but if to the top or to help interest groups, they will generally accept it. Under the more complex models, predictions are more difficult to make. However, it appears that the SEC is developing an elaborate method of creating corporate governance using arms such as SROs and PCAOB and may prefer using these arms over which it has direct statutory power, rather than states over which it holds only indirect power. States facing even this indirect SEC pressure may be reluctant to innovate corporate governance reforms the SEC would disfavor, even if they are in the best interests of corporations, investors and

¹⁴ See AS No. 2, ¶ 27 (“the auditor cannot audit internal control over financial reporting without also auditing the financial statements”).

¹⁵ See *id.*, ¶¶ 108-126 (expressly authorizing auditors to rely upon the work of others in conducting audit when such other work is competent and objective).

¹⁶ See Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 968-69 (2003).

¹⁷ See Part V, *infra*.

the public. This is one price of the increasing functional federalization of corporate governance.

This Article (I) assesses the need for any formal evaluation of audit committee effectiveness in light of existing alternatives providing assurance; (II) reviews AS No. 2 to show how its limits point directly to creating state mechanisms for this function; (III) suggests the outlines of such a program's design and administration; (IV) draws from comments made on the Proposed Standard to suggest that a state-agency approach would garner widespread support from investors and managers and from the auditing and legal professions; and (V) concludes by lamenting that despite virtues and probable field support, regulators and states may not support the concept.

I. NEED AND PARTIAL SOLUTIONS

SOX requires PCAOB to develop auditing standards concerning reports and attestations of managerial assertions of internal control effectiveness.¹⁸ The attestations relate to internal control over financial reporting (ICOFR). A key feature requires auditors to assess the effectiveness of audit committee oversight concerning ICOFR. The chief argument for this assessment is the central role that audit committees play in financial reporting. An assessment of its effectiveness is seen as critical.

The audit committee plays a central role in overseeing management, financial reporting and ICOFR, among other duties. Effective audit committees can be important components of corporate governance, including by aiding in deterring, detecting and preventing fraudulent financial reporting and thus protecting investors and other constituents. In addition, investors benefit from an understanding of audit committee roles in general and within particular organizations. The issue is how best to promote understanding and effectiveness. A combination of substantive rules, disclosure rules and independent assurance is desirable—much of which is in place.

A. Existing Substantive Duties

Audit committee members are, first and foremost, members of the board of directors. They are obliged to discharge state corporation law's fiduciary duties of loyalty and care, subject to deference under the business judgment rule. Duties include compliance with law. Breach of these duties exposes directors to liability to shareholders in private litigation, subject to state law provisions exculpating them from personal liability for money damages for breaches of the duty of care.¹⁹ These principles provide a measure of discipline on audit committee members in the performance of their duties.

¹⁸ Sarbanes-Oxley Act of 2002, §§ 404(b) & 103(a)(2)(A); Pub. L. No. 107-204, 116 Stat. at ____.

¹⁹ *E.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2003).

But given the business judgment rule and such exculpatory provisions, some regard this arrangement as insufficient.

B. Existing Disclosure Rules

SRO rules address the disclosure aspect. An audit committee must have a charter, disclose it publicly, evaluate itself, affirm charter compliance and report this to the full board of directors and to the SRO.²⁰ All these rules attempt to impose accountability and discipline on audit committees; the charter-and-disclosure components provide investors and gatekeepers with sources to understand audit committee operations. Whether these are sufficient to assure audit committee effectiveness is not entirely clear, however, leaving open whether an independent evaluation and certification would provide valuable assurance.

C. Existing Audit Practice

The issue becomes who will provide such assurance. The auditor is a logical choice, in part, because it also needs such an understanding to conduct its primary audit functions. Thus an existing solution is traditional audit practice. Auditors conducting traditional financial statement audits apply tests of internal controls to help plan the scope of their audits. This probing typically includes some dealing with the audit committee. Many financial calamities that brewed during the late 1990s are attributed to internal control failure, however, including within audit committees. These attributions cast doubt on the reliability of traditional audit practice to provide requisite assurance.

D. New Auditor Audits

AS No. 2 provides another arc to the evolving circle. Were it to include a full, formal, and publicly-disclosed evaluation of audit committee effectiveness, the circle might be complete. But it does not. In AS No. 2, PCAOB admits it cannot do so, in part, because of conflicts and limited competencies. Also auditors cannot do so because of other limitations, including inadequate measurement criteria and liability risks discussed next. These limitations indicate that it may be desirable to complete the circle by looking to parties with requisite independence, competence and criteria to provide a full, formal and publicly-disclosed evaluation.

II. INHERENT LIMITS OF THE AUDITOR EVALUATION

AS No. 2 requires auditors to evaluate audit committee effectiveness in overseeing external financial reporting and ICOFR. This raises questions concerning the relationship of this exercise to state corporation law's requirement that boards perform

²⁰ NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A.06-07 (Nov. 4, 2003); NASD By-Laws, Art. 9, § 5; NASD MARKETPLACE RULES, § 4350(d)(1)-(2).

this function (a duty SRO listing standards restate). It also creates conflicts between the auditor and the audit committee, which SOX anoints as the auditor's supervisor. The Proposed Standard elicited criticism along these lines;²¹ AS No. 2 responds by emphasizing that (1) it does not intend to supplant the board's responsibilities; (2) the auditor's evaluation is not separate or distinct but part of its control environment assessment; and (3) conflicts are inevitable. These responses leave open major issues concerning inherent limits of the auditor evaluation exercise and invite considering alternative providers of audit committee evaluation services.

AS No. 2 provides that auditors evaluating audit committees assess committee member independence. This raises questions concerning whether auditors possess requisite expertise to make what are essentially legal judgments. The Proposed Standard directed that auditors would also evaluate audit committee compliance with requirements of SOX, the SEC and SROs; AS No. 2 deleted these provisions in response to criticism that they are beyond an auditor's expertise. This raises questions concerning whether these elements are important for evaluating audit committee effectiveness and, if so, also indicates need to consider alternative service providers. AS No. 2 specifies a variety of other factors relevant to the evaluation, none of which lends itself to measurement by objective criteria usually used in auditing. This raises both sorts of questions: whether auditors possess requisite expertise and whether alternative providers of audit committee evaluations should be sought.

A. Conflicts

Two classes of conflicts arise from having auditors evaluate audit committee effectiveness: (1) legal conflicts between AS No. 2 and various laws and (2) structural conflicts between auditors and audit committees and between management and audit committees.

1. *Legal.* — AS No. 2's audit committee evaluation provisions can interfere with the allocation of responsibilities established under state corporation law and SOX. Under state law, boards of directors must manage the business and affairs of a corporation; under SOX, audit committees must discharge the board-oversight duty concerning the external auditor's qualifications and performance.

SOX's approach was designed to erase a conflict between auditors and managers that could be seen as a systemic weakness (auditors became beholden to management and softened their professional skepticism). The evaluation role AS No. 2 assigns to auditors puts them in the position of evaluating the audit committee, an organ of the board of directors. This can be seen to reintroduce the conflict in a different guise. It thus may be seen to conflict with the goals of those laws.

The nature of audit committee oversight adds to legal conflicts. Consider the nature of director obligations under state corporation law compared with professional

²¹ See Part IV, *infra*.

techniques auditors are trained to apply. Directors have fiduciary duties to their corporations and stockholders. They must act in their best interests when discharging statutory responsibilities to manage the business and affairs of a corporation. A well-developed body of common law applies. Doctrines include the duty of loyalty and the duty of care, along with the business judgment rule. These doctrines provide a judicial framework allowing directors leeway to exercise business judgment, while keeping behavior within acceptable boundaries.

In contrast to judicial approaches to supervising directors, auditors use professional skepticism in their tasks, second-guessing management decisions routinely. This approach, when applied to audit committee evaluations, threatens to alter audit committee behavior: from that contemplated under state corporation law with deference to business judgments into a more rule-oriented and constricting arrangement perhaps not in the best interest of a corporation or its shareholders. It could lead to highly disruptive and unnecessary disagreements. Hence AS No. 2 is somewhat at odds with state corporation law.

Consider also the different standards of legal obligation owed by directors compared to auditors. When acting through audit committees, these state corporation law fiduciary duties remain applicable to directors. Auditors are not fiduciaries for their clients or client stockholders. At best, law requires auditors to act professionally and not to commit negligence or fraud.²² They are contract parties, not fiduciaries. Having contract parties supervise fiduciaries turns a traditional legal hierarchy upside-down. It creates an incoherent corporate governance system.

AS No. 2 grapples with these challenges in limited ways. First, it implores auditors to recognize that boards are responsible for evaluating the performance and effectiveness of audit committees.²³ This is of course an obvious statement of law, fact, and authority that PCAOB cannot change. Second, AS No. 2 declares that it “does not suggest” that auditors are responsible for performing a “separate and distinct” audit committee evaluation.²⁴ Equally, however, it emphasizes that auditors assess committee

²² See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (discussing scienter standard and due diligence defense); *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983) (discussing preponderance of evidence standard versus clear and convincing standard); *SEC v. Arthur Young & Co.*, 590 F.2d 785 (9th Cir. 1979) (discussing negligence standard and requirements of pleading fraud with particularity).

²³ AS No. 2, ¶ 56; see also AS No. 2, App. E ¶ E69 (explaining PCAOB’s conclusion that the standard should explicitly acknowledge that the board of directors is responsible for evaluating the effectiveness of the audit committee and that the auditor’s evaluation of the control environment is not intended to supplant those evaluations).

²⁴ AS No. 2, ¶ 56; see also PCAOB RELEASE ACCOMPANYING AS NO. 2, at 20-21 (explaining the same point).

effectiveness because of the central role audit committees play in a corporation's control environment.²⁵

These provisions are helpful in minimizing conflicts between AS No. 2 and state corporation law; they do not eliminate them. Suppose a board makes a business judgment not to appoint a financial expert to the audit committee (optional under SOX and SRO listing standards and permitted by state corporation law), and makes a legal judgment concerning how and when to disclose this (required by SOX). But suppose the auditor disagrees with both conclusions. What happens?

In a traditional audit of financial statements, similar disagreements are resolved simply: the board's judgments control. The auditor uses its opinion when planning the scope of its audit—typically one of broader scope than if it concurred in the board's judgments. In an audit of ICOFR, however, additional processes follow.

The auditor must come to an opinion on ICOFR. If it concludes that these judgments amount to an ineffective audit committee, AS No. 2 instructs it to consider this, at minimum, a significant deficiency and perhaps a material weakness.²⁶ These requirements can constrain an auditor to issue an adverse opinion on ICOFR. In this circumstance, directors will feel pressure to knuckle under to the auditor's opinion rather than exercise their own judgment.

That is a clear conflict between AS No. 2 and state corporation law. It is not enough for AS No. 2 to tell auditors that boards are responsible for audit committee performance and evaluation. Accordingly, auditor assessment of audit committee effectiveness is inherently limited; other mechanisms to provide requisite assurance may need to be sought.

2. *Structural.* — Under SOX § 301 and implementing measures of the SEC and the SROs, listed company audit committees are directly responsible for appointing, compensating, and overseeing the work of the company's external auditors. This investment of power in the audit committee presents a structural conflict with AS No. 2's mandate that auditors evaluate audit committee effectiveness.

The body directly responsible for appointing and determining compensation of the auditors, and overseeing their work, is subject, in turn, to that auditors' scrutiny as part of its audit of ICOFR. A committee so supervising an auditor, charged with evaluating the committee, can be impaired in performing its duties; an auditor charged with evaluating the committee's effectiveness, in its supervisory and other tasks, can be impaired in performing this evaluation and its other work.

²⁵ AS No. 2, ¶ 56.

²⁶ *Id.*, ¶¶ 59 & 140.

The circular approach can violate the independence concept at the foundation of auditing. Auditors are not independent if they act in a managerial capacity. A formal assessment of audit committee effectiveness is a management role, a board responsibility. Even when the evaluation is described as part of the auditor's overall assessment of a corporation's control environment, this raises issues of independence impairment in fact and in appearance.

Whether the conflicts are merely arguable, potential and possible, or real and inevitable, the arrangement creates the appearance of conflict. This violates longstanding principles of federal law expressed by the Supreme Court, specific SEC rules, and voluminous professional auditing literature defining generally accepted auditing standards.²⁷

Not all such "360-degree" reviews are inherently suspect, of course. Many managerial review exercises at major corporations are conducted in precisely this manner. But given the central function of auditors and audit committees in the financial reporting process, any structures that may deter frank assessments should be resisted.

Moreover, devices that may tend to weaken an audit committee should be resisted. When auditors are vested with implicit directive power over board audit committees, this dilutes a board's similar power, which may have the effect of diminishing an audit committee's effectiveness.

If an auditor's evaluation of audit committee effectiveness is memorialized in audit opinions, moreover, consideration would be necessary concerning whether management would also have to formally evaluate the audit committee. This multiplies conflicts.

A technical case can be made that when audit committees are part of an auditors' formal scope of review, they would likewise be within management's formal scope of review.²⁸ If so, managers would become obligated to evaluate audit committees. But

²⁷ See SECURITIES AND EXCHANGE COMMISSION, RULE 2-01 OF REGULATION S-X, § 210.2-01 ("Rule 2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact *and in appearance*") (emphasis added); see also SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: REVISION OF THE COMMISSION'S AUDITOR INDEPENDENCE RULES, RELEASE NOS. 33-7919 & 34-43602, at notes 38-39 (citing numerous sources that emphasize requirement of the *appearance* of auditor independence, including professional auditing literature and legal precedent such as the Supreme Court case of *United States v. Arthur Young & Co.*, 465 U.S. 805, 819 n.15 (1984)).

²⁸ The technical case would run as follows. Under AS No. 2, an ineffective audit committee is a significant deficiency. This in turn is a strong indicator of a material weakness in ICFR. In such cases, management must review and address the issue to make its own internal control assessment adequate. This would imply that management

audit committees are typically charged with evaluating management. So an additional conflict arises where management is reviewing the audit committee and *vice versa*.

A more severe problem arises. If managers must evaluate the audit committee, auditors will seek to rely on management's evaluation in preparing their own evaluation or reevaluation. This adds yet another circularity problem where auditors rely on management. The result is a series of tangled circles studded with conflicts that risk undermining the systemic utility of both auditors and audit committees.

PCAOB addresses these concerns obliquely. Its key structural response is to emphasize that the auditor's evaluation of the audit committee is "not a separate evaluation" but part of evaluating the control environment and monitoring components of ICOFR.²⁹ It opined that this would partially address the structural conflict and that the part unaddressed is simply inherent in professional auditing.³⁰

PCAOB's release accompanying AS No. 2 sought to minimize conflict concerns. It opined that "Normally, the auditor's interest and the audit committee's interests will be aligned" in pursuing fair financial statements and effective control and auditing.³¹ It characterized the conflict between SOX § 301 and AS No. 2 as "theoretical."³² PCAOB appealed to auditing custom and investor knowledge, saying "experienced auditors are accustomed to bearing" such conflicts and "that investors expect an auditor to address" them.³³

Accordingly, PCAOB does not ultimately resolve the conflict, but says instead that it is inevitable, auditors are used to operating with such conflicts, and investors are okay with this. This result creates deep tension with fundamental concepts of auditor independence and the heavy stress SEC regulations and SOX place on auditor independence. Try as it did, PCAOB does not adequately respond to these concerns. An additional or alternative mechanism that avoids these fundamental problems thus remains appealing.

would have to review the audit committee in order for the auditor to furnish an unqualified control audit opinion.

²⁹ AS No. 2, App. E, ¶ E66.

³⁰ *Id.* (explaining that emphasizing the context of the auditor's evaluation would "address, to some extent, the conflict-of-interest concerns" but that the conflict "is, to some extent, inherent in the duties that society expects of auditors.").

³¹ PCAOB RELEASE ACCOMPANYING AS NO. 2, at 21.

³² *Id.*

³³ *Id.*

B. Expertise

Two additional concerns relate to whether auditors possess requisite expertise to comply with AS No. 2's requirement that they evaluate audit committee effectiveness as part of assessing the control environment. The first is whether auditors possess necessary knowledge concerning the legal concept of independence, which AS No. 2 states auditors assess in this evaluation. The second involves audit committee compliance with SOX, SEC and SRO requirements, which the Proposed Standard required auditors to assess but which AS No. 2 deletes. The deletion solves one question and raises another: auditors are not directed to reach legal conclusions concerning compliance, but are these conclusions in fact necessary to form opinions concerning audit committee effectiveness?

1. *Independence.* — The Proposed Standard stated that auditors should evaluate committee member independence, along with evaluating the independence of their nomination, selection and action.³⁴ AS No. 2 retains provision concerning evaluating member independence, but deletes the latter more detailed provisions without explanation. It likewise dropped without explanation a statement to the effect that the more independent the nominating process, the more independent a committee is likely to be.³⁵

Identifying PCAOB's reasons for the deletions requires speculation. Reasons may include concerns that assessing the independence of a nomination or selection process or of director action involves judgments concerning corporate governance and law beyond an auditor's expertise.³⁶ SRO listing standards require boards to determine the independence of each outside director, using specific criteria under those standards supplemented by general principles rooted in state corporation law.³⁷ Establishing links between the independence of the nomination and selection process and member independence is difficult. It is likewise a matter of corporate governance and legal judgment. Determinations are made with reference to state corporation law, SOX § 301, SEC regulations, and SRO listing standards, all likely beyond an auditor's expertise.³⁸

³⁴ Proposed Standard, ¶ 58.

³⁵ *Id.*

³⁶ Supporting this guess are some comment letters on PCAOB's Proposed Standard, including those provided by some auditing firms, as discussed in Part IV, *infra*.

³⁷ NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A.02 (Nov. 4, 2003); NASD MANUAL, MARKETPLACE RULES, § 4350 (2002).

³⁸ Another possible reason for the deletion is that SEC rules also require corporations to disclose nominating committee processes. *See* SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: DISCLOSURE REGARDING NOMINATING COMMITTEE FUNCTIONS AND COMMUNICATIONS BETWEEN SECURITY HOLDERS AND BOARDS OF DIRECTORS, RELEASE NOS. 33-8340 & 34-48825 (Nov. 24, 2003). However, if this justifies deleting nomination-selection process independence from an auditing standard, it suggests

If the reason PCAOB deleted the supplemental requirements concerned expertise and matters of law, it is difficult to justify retaining the factor calling for auditors to evaluate the “independence of the audit committee members from management.”³⁹ This is likewise a question of law and corporate governance, not auditing.

In fact, the appearance and use of this factor in AS No. 2 are driven entirely by legal rules. This is clear from the following note contained in AS No. 2, stating that companies whose securities are not listed:

may not be required to have independent directors for their audit committees [and that] the auditor should not consider the lack of independent directors at these companies indicative, by itself, of a control deficiency.⁴⁰

The purpose of the note is clear and accurate: when not required by listing standards, absence of independent directors is not alone a control deficiency. The negative implication is less clear and possibly wrong: when required by listing standards, absence of directors is alone a control deficiency. Whether this negative implication is correct is a legal question. The issue is whether an audit committee’s role and relative effectiveness varies with exchange listings and related requirements. That, in turn, depends on the purpose and meaning of the relevant requirements, including in this context the independence concept. The purpose and meaning of legal concepts, including the concept of director independence, are questions requiring legal analysis and interpretation.

Relative to auditing, moreover, why should lack of independent directors indicate a control deficiency? The foregoing note implies that the presence or absence of independent directors is not relevant to internal control, much less to an auditor’s assessment of audit committee effectiveness. Rather, for listed companies, the issue is whether they are in compliance with listing standards, not whether that compliance promotes committee effectiveness. The directive that auditors evaluate audit committee member independence is therefore also fundamentally a matter of complying with those listing standards imposing the requirement.

PCAOB serves as more than an auditing standard-setter. It is a component of an SEC-directed regulatory regime combining various instruments including disclosure. *See Part V, infra.*

³⁹ AS No. 2, ¶ 57.

⁴⁰ *Id.*

It is not possible to escape the fact that auditor evaluations of these characteristics are therefore legal judgments, not auditing judgments.⁴¹ In any event, these challenges indicate, again, that a search may be warranted to find alternative or additional providers of audit committee evaluation and certification services.⁴²

2. *Compliance.* — Independent audit committee members is a requirement of SRO listing standards. While AS No. 2 retains provisions directing auditors to assess this factor, it deleted two other provisions expressly requiring auditors to evaluate compliance with law and regulation, including SRO listing standards. The deleted provisions directed auditors to assess audit committee compliance with the excruciatingly detailed SRO listing standards under SOX § 301 and whether an audit committee included a financial expert (called an audit committee financial expert or ACFE) as contemplated under SOX § 407.⁴³ Materials accompanying AS No. 2 indicated three reasons for these deletions, as follows:

The factors that addressed compliance with listing standards and sections of [SOX] were deleted, because those factors were specifically criticized in comment letters as being either [1] outside the scope of the auditor’s expertise or [2] outside the scope of ICOFR [and PCAOB believed] that

⁴¹ This view strengthens the suggestion noted above (in note 38) that PCAOB is operating as a component in a complex web of federal regulation being directed by the SEC rather than as an independent auditing standard setter. *See Part V, infra.*

⁴² Another inherent limit appears. When auditors render opinions concerning audit committee effectiveness that involve legal expertise, they risk violating state laws prohibiting the unauthorized practice of law. *Cf. Letter to PCAOB from BDO Seidman, LLP* (PCAOB Letter No. 136) (advising that when financial statement preparers lack guidance for SOX § 404 compliance they turn to auditors and “It is possible that auditors providing this guidance might be misconstrued as providing legal advice . . .”). Auditors doing so pursuant to AS No. 2 generate an additional bundle of clashes. Issues include the relationship between state law governing the legal profession and prohibiting the unauthorized practice of law on the one hand and the exact juridical status of PCAOB on the other. *Compare* AS No. 2, ¶ 2 (noting that the standard summarizes legal requirements to provide context and understanding, not to interpret them).

⁴³ Proposed Standard, ¶ 57. SOX § 301 directed the SEC to direct the SROs to adopt various corporate governance standards as listing requirements, which the SROs have done. Resulting listing standards, including for example the New York Stock Exchange’s Section 303.A.00, specify such minutia as audit committees must have at least three members and such procedures as audit committees having charters containing specified details. SROs traditionally described their listed company manuals as containing “listing standards,” accurate in the pre-federalization era and a misnomer now that these manuals are laden with dense, excruciatingly-detailed provisions bearing no resemblance to the concept of “standards.”

[3] those factors were not significant to the type of evaluation the auditor was expected to make of the audit committee.⁴⁴

Explanation [1] is easy to accept; the other two raise additional issues.

Concerning the first explanation, consider that audit committees must comply with various SRO listing standards and judge applicable best practice guidelines established by SROs, the SEC and other engines of corporate governance. Whether a committee complies with SRO listing standards is a legal judgment and whether a board of directors opts to have its audit committee adhere to formally-articulated best practices is a business judgment.

Consider SOX's provision concerning including an ACFE. Rules permit, but do not require, this feature and provide that a board opting not to include an ACFE disclose reasons. Whether to include an ACFE is essentially a matter of business judgment. Issues include whether that expertise is necessary and whether relevant SEC standards are appropriate for the corporation. Auditors are not in a position to assess this business judgment.

Rules requiring disclosing whether audit committees include an ACFE are essentially legal rules. The remedy for failure to comply is delisting, and possibly other sanctions. These are legal results posing business consequences. They are not elements within the auditor's purview, which is concerned ultimately with fair financial reporting and indirectly with effectiveness of ICOFR.

PCAOB's second and third justifications for deleting compliance assessment factors are more difficult to understand and interpret. If these are "outside the scope of ICOFR" and "not significant" to the auditor's evaluation, why were they included in the Proposed Standard? A possible reason is that the Proposed Standard envisioned an auditor evaluation that was "separate and distinct" and encompassed review beyond effectiveness concerning ICOFR. The review contemplated by AS No. 2 is narrower. This explanation may be satisfactory in terms of understanding and applying AS No. 2 as an auditing standard.

But PCAOB's explanation is unclear. It bases its conclusion in part on comment letters critical of the concept as *either* beyond an auditor's expertise *or* outside the scope of ICOFR; it separately states its opinion that these are not significant to the auditor's expected evaluation. It leaves unclear whether PCAOB believes they are outside the scope of ICOFR and leaves unexplained why they are not significant.⁴⁵

⁴⁴ AS No. 2, App. E, ¶ E68.

⁴⁵ Opacity in PCAOB's explanation suggests another possible account of its decision to delete these items, echoing points noted above (in notes 38 and 41): that PCAOB is a component of a broader federalized corporate governance regime managed by the SEC. See Part V, *infra*.

Whatever weight one assigns to the relative significance of compliance as a measure of audit committee effectiveness regarding ICOFR, what is clear is that PCAOB is directing auditors not to treat this as a factor. Whether auditors will do so or not is another question, since AS No. 2's list of factors is not exhaustive. More importantly, if compliance is significant to audit committee effectiveness, in terms of ICOFR or more generally, this again suggests reasons to consider searching to identify additional or alternative providers of audit committee evaluations.

C. Objective Criteria

AS No. 2 mentions numerous other factors bearing on auditor assessment of audit committee effectiveness in overseeing external financial reporting and ICOFR. Most of these factors, as well as most audit committee activities, are not measurable using objective criteria, a foundation of traditional auditing standards. Hence, many are quite subjective. AS No. 2 hints at this when introducing its factors: "The aspects of the audit committee's effectiveness that are important may vary considerably with the circumstances."⁴⁶

One factor AS No. 2 mentions is the clarity boards use in articulating the audit committee's responsibilities and how well managers and committee members understand them.⁴⁷ Measuring linguistic clarity is not easy; teachers measure reading comprehension routinely and assign grades based on examinations. It is unclear whether auditors possess objective tools such as examinations—and whether audit committee members and managers would sit for them.⁴⁸

⁴⁶ AS No. 2, ¶ 57.

⁴⁷ *Id.* ["the clarity with which the audit committee's responsibilities are articulated (for example, in the audit committee's charter) and how well the audit committee and management understand those responsibilities."].

⁴⁸ No doubt many auditors excel in linguistic clarity and most of AS No. 2 is written clearly, but consider the definition it provides for "significant deficiency," the most critical concept in auditing:

A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

AS No. 2, ¶ 9.

AS No. 2 states that auditors assess the audit committee's involvement and interaction with the external auditor. Apart from this metric's circularity and conflict-creation, measuring involvement and interaction is highly subjective. The Proposed Standard spoke of the "level" of these factors, language AS No.2 drops. Though "level" may be no more objectively measurable, at least it hinted at some standard. AS No. 2 also deletes illustrations appearing in the Proposed Standard concerning involvement relating to the auditor's retention, appointment and compensation. No reason for the deletion is provided.

AS No. 2 also states that auditors assess the audit committee's involvement and interaction with the internal audit team. The same criticism applies. AS No. 2 also dropped the Proposed Standard's use of the word "level" in this context. Similarly, it deletes illustrations appearing in the Proposed Standard concerning involvement relating to the audit committee's line of authority and role in appointing and compensating internal auditors, also without explanation.

AS No. 2 deleted a catch-all evaluation metric appearing in the Proposed Standard: the amount of time a committee devotes to internal control issues and the amount of time members "are able" to devote to committee activity. It likewise does not explain why, perhaps because the metric so obviously ignores quality of time. By definition, efficient committees spend little time with greater effectiveness and inefficient committees spend more time with lesser effectiveness.

AS No. 2 also adds factors not contained in the Proposed Standard: (1) committee interaction with key members of financial management, including the chief officers of finance and accounting; (2) the degree to which difficult questions are raised and pursued with management and the auditor, including as to critical accounting policies and judgmental accounting estimates; and (3) the committee's responsiveness to issues that an auditor raises. While likely probative of audit committee effectiveness, none of these is measurable using objective criteria that are staples of traditional auditing practice and assurance.

Despite many comment letters on the Proposed Standard criticizing the absence of objective measurement criteria,⁴⁹ AS No. 2 does not come to grips with the reality that these factors elude measurement by objective criteria. This does not mean the factors or even subjective testing of them are unimportant or useless. It suggests that traditional auditing tools are not well suited to conducting the evaluation.

D. Liability Risks

Finally, two issues arise concerning the liability effects of auditor evaluation of audit committees. First, auditors evaluating audit committee effectiveness may expose themselves to liability for violation of professional standards. Suppose an auditor evaluates a corporation's audit committee as effective. Subsequently a major financial

⁴⁹ See Part IV, *infra*.

fraud is uncovered within the company. Auditors are likely defendants in lawsuits by shareholders now armed with an additional liability theory. This auditor liability risk may unduly raise the requirements auditors insist that audit committees meet before drawing a favorable assessment. This bias would accentuate conflicts of interest.

Second, auditors evaluating audit committee effectiveness may expose audit committee members to liability for violation of fiduciary obligations. Suppose an auditor evaluates a corporation's audit committee as ineffective. Whether or not fraud exists within the corporation, shareholders are now armed with a theory of liability against those directors. This audit committee liability risk may unduly lower the requirements auditors insist that audit committees meet before drawing a favorable assessment. This bias cannot be counted on to offset the bias created by auditor liability risk. Taken together, the conflicts again compound.

E. Summary of Limits and Gaps

To summarize the limits of auditor evaluation of audit committee effectiveness shown by AS No. 2:

- reports are not disclosed unless ineffectiveness constitutes a material weakness;
- evaluations are part of an overall control environment review related to ICOFR, not a full-scale effectiveness evaluation;
- even this partial and non-public method poses conflicts with state corporation law;
- it creates conflicts between auditors and audit committees;
- auditors must assess legal issues such as independence and cannot assess legal issues such as compliance;
- auditors lack objectively measurable criteria; and
- liability risks of auditors and audit committees can impair optimal evaluation, compounding conflicts.

Within these limits, auditors must nevertheless gain some level of assurance as to audit committee effectiveness. Auditors attesting to the veracity of managerial assertions concerning internal control over financial reporting, and to financial statement assertions, require an understanding of audit committee effectiveness.

The issues are (1) whether the gap between what auditors can do and the ideal can be filled using additional providers of audit committee effectiveness evaluations and/or (2) whether alternative providers should be sought for the entire exercise, both to provide assurance to financial statement users and for auditors to rely upon.⁵⁰ Accordingly, it remains potentially fruitful to consider other parties to supplement or substitute in this exercise to overcome these inherent limits of auditor evaluations of audit committee effectiveness.

⁵⁰ See AS No. 2, ¶¶ 108-126 (expressly authorizing auditors to rely upon the work of others in conducting audit when such other work is competent and objective).

III. STATE AGENCIES

To recapitulate the framework of the evolving corporate governance regime: state law provides that boards, including through audit committees, manage corporations; SOX directs that audit committees oversee auditors, but otherwise imposes no substantive duties on or regulatory oversight of audit committees; SROs provide disclosure rules related to audit committee responsibilities and performance;⁵¹ PCAOB provides a partial, limited and not-always-public auditor evaluation of audit committee effectiveness in overseeing financial reporting and ICOFR.

In this evolving circle of corporate governance, one arc remains to be included: a mechanism for a full, public audit committee evaluation other than by the board of directors. While not obviously necessary,⁵² the arc is missing from the circle chiefly due to federalism concerns: SOX and the other federal engines (SEC, SROs, PCAOB) have not filled it. Congress could. For example, it could direct that audit committees be evaluated and certified, perhaps by the SEC, PCAOB, or the United States General Accounting Office (GAO).⁵³

This is neither likely nor wise. It is unlikely because when Congress enacted SOX, it expended its firepower, acted under the heated light of public fury, and through the combination bought all related political rewards. It is unwise because though SOX itself essentially merely codifies best practices, those charged with implementing its provisions have so heavily extended the tentacles of corporate governance that more federal hands on the scale would throw the system even further out of balance than the gales following SOX so far have done.

Private suppliers could be tapped. A corporation could engage a different auditing firm for this function. This would ameliorate conflicts, but not expertise problems. Or a corporation could retain an outside law firm. This would solve expertise problems. But lawyers' interest in other work would pose conflict issues. Specialty firms are unlikely to emerge as major sophisticated providers, given that the service would likely produce low profit margins. Higher-quality providers measured by higher opportunity costs would likely not participate. For all three such alternative providers, moreover, liability risks would be significant. Unless they priced their services at premiums equivalent to

⁵¹ SRO listing "standards" specify in excruciating detail how boards of directors are obliged to supervise and evaluate audit committee performance, though the basic standard is at heart a principle of state corporation law.

⁵² See Part I, *supra*.

⁵³ A historical parallel supports both identifying and rejecting this alternative: early drafts of the federal securities laws from the 1930s provided that public company audits would be performed by the GAO.

functional insurers, this market would unlikely become vibrant or useful to the public capital markets.⁵⁴ States can fill the gap.

A. *Inherent Appeal, and Some Limits*

This section outlines how a state agency would overcome or neutralize all of the inherent limits associated with an auditor evaluation of audit committee effectiveness. Highlights include: it would be public in terms of disclosure, complete, conflict-free, assess legal and compliance issues, be performed using criteria with which relevant experts are familiar and eliminate liability risks posed by auditor evaluations. The following explains each point.

The first two advantages are nearly self-evident. First, state agencies could provide public evaluations of audit committee effectiveness. Corporations could disclose the certifications as part of their public securities filings. Second, the service could examine overall committee effectiveness, not just concerning areas related to external financial reporting and ICOFR.

States may be superior to auditors and other private actors because they are free of conflicts these face. Avoiding conflicts is inherent in the concept of a state-chartered agency conducting the certification exercise. Both conflicts AS No. 2 poses are neutralized: there is no conflict between the state and its corporation law and no conflict between a state agency and boards of directors, audit committees, corporate management or auditors. This would diminish the circumstances in which disagreements arise, limiting them to situations in which major concerns about effectiveness exist, not quarrels over business or legal judgments.⁵⁵

An equally significant advantage is that states have at their disposal the expertise and requisite criteria to apply. Experts in state corporation law would draw on the reservoir of fiduciary concepts. These require independence (a duty of loyalty concept) and competence, including a measure of financial expertise (duty of care concepts). They encompass the particulars specified in SEC and SRO rules emanating from these bedrock concepts, as well as compliance with law.

This expertise offers another virtue. State corporation law's fiduciary obligations, including independence and competence (loyalty and care), are standards-based. Their fabric is the thickly textured doctrine of the common law. This provides an attractive alternative to the dense rule-bound approach that invariably emanates from federal

⁵⁴ For the case supporting using insurance markets to address financial fraud risks, see Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance and GAAP Revisited*, 8 STAN. J. L. & BUS. 1 (2002).

⁵⁵ Conflicts could arise depending on how the state agency were funded, a point discussed in the next section.

sources, including SROs, as well as from accounting and auditing standard setters, including PCAOB.⁵⁶

A possible drawback appears: underlying state law concepts may be seen as lax. State agency affirmations of audit committee effectiveness based on adherence to weak state law principles would not mean very much. This drawback can be turned into an advantage by encouraging states to compete in this area. State agencies reviewing the relationship of their laws to audit committee effectiveness could facilitate development of state law more congruent with standards necessary to make audit committees effective.⁵⁷

A major upside to a state agency approach to audit committee evaluation is liability risk limitation. State agencies attesting to audit committee effectiveness can be designed to enjoy the benefits of sovereign immunity, for both the agency and its employees. An agency's certification would not expose it to liability in the event of subsequent financial frauds at the corporation. The result is to eliminate liability risks from the tasks of the agency and the audit committee.

Nor should agency certifications carry any legal significance in subsequent litigation concerning a company, its board of directors, audit committee or shareholders. Positive certifications should not be available to insulate boards or committees from liability and negative certifications should not provide a basis to support shareholder claims of director breach of fiduciary duty or other liability. In each case, however, courts could admit related evidence when deemed appropriate under judicial notice concepts. These provisions would likewise eliminate liability risks from the tasks of the agency and the audit committee.

A final advantage to the state agency approach is that the agency could also experiment with a variety of designations. These can include a pass-fail assessment to more refined gradations. A refined scale would offer more valuable information to the user community and provide superior feedback to audit committees on their effectiveness.⁵⁸

The advantage of a graded scale, on the other hand, implicates complex measurement challenges. State agencies interested in providing graded evaluations would need to develop adequate criteria by which to provide them. This raises a related

⁵⁶ See Chandler & Strine, *The New Federalism of the American Corporate Governance System*, *supra* note 4; *see also supra* note 42.

⁵⁷ Probabilities here depend on which of several rival theories of corporation law production one holds, discussed in Part V, *infra*.

⁵⁸ PCAOB expresses a more modest goal, necessary by virtue of inherent limits on what auditors can do in the exercise. See AS No. 2, App. E, ¶ E67 (the goal is not to “grade the effectiveness of the audit committee along a scale” but to detect any audit committee ineffectiveness for purposes of the auditor’s overall control evaluation).

and broader question they would need to answer: what constitutes audit committee effectiveness. This can vary with contexts, corporations and committees. Officials would need to recognize this informed by an appreciation of fiduciary law principles embracing this reality. Officials would also need to understand that the audit committee is an element of the overall corporate governance system of which board-effectiveness is likewise a key element. Evaluating and certifying this broad functionality may be difficult.

Finally, there may be areas where auditors are in a better position than state agency officials to evaluate aspects of audit committee effectiveness. These may relate to technical aspects concerning ICOFR. State agency officials would need to develop an understanding of these areas or themselves rely upon auditors for assistance in their evaluation. Whether one or the other of such evaluations is adequate would require investigation; if each contributes unique expertise both may be necessary and each would rely upon the other to complete respective assignments.⁵⁹ Advantages to the state agency approach remain in affording this additional assurance auditors cannot provide.

B. Implementation

From the states' viewpoint, a key attraction of a state-agency audit committee evaluation program is to create and/or leverage a brand name. States command legal expertise, especially as to concepts of independence, loyalty, competence and governance. Delaware has a brand name that attracts corporate chartering business to the state; Nevada appears interested in creating one; the larger states with more in-state corporations and a rich corporate law tradition also boast a brand name in the corporate world, including California and New York.

States adopting the concept would signal interest in developing the gold standard in corporate governance. Exploiting this opportunity by creating a state agency to provide audit committee evaluations and certifications entails facing design and administration issues, the outlines of which are sketched as follows.

Organization and Authorization. The agency could be created as part of an existing arm of state government or a newly-created agency.⁶⁰ It could be part of the executive or legislative branches of state government, but should be separate from the judicial branches (to protect against the use of agency certifications in subsequent litigation). To enjoy sovereign immunity, the agency should be created as part of the state, rather than any political sub-division. The agency could be created either by act of

⁵⁹ Cf. AS No. 2, §§ 108-126 (expressly authorizing auditors to rely upon the work of others in conducting audit when such other work is competent and objective).

⁶⁰ In Delaware, this task could be assigned to the existing Division of Corporations within the Department of State, or a newly-created corporations auditing office.

the governor or through particular legislation.⁶¹ Ideally, the agency would be designed to maximize insulation from political pressures.

Staffing and Training. Relevant experts within a state include active and retired lawyers and judges. These experts could be appointed to the agency in the same manner as other state officials or judges. Or alternative appointment mechanisms could be devised, such as the governor appointing officials directly with or without approval of the state legislature. Some experts may opt for this role rather than going on the bench. Limited additional training would be necessary (as to ICOFR perhaps), though members would undoubtedly continue to maintain their expertise through formal and informal educational pursuits such as reading relevant literature and attending relevant conferences.

Certifications and Designations. Corporation codes could be amended to require or make optional a periodic audit committee evaluation and public certification. A range of certifications could result depending on the scope of the related evaluation, from simple compliance to overall effectiveness. Corporations could disclose the certifications in any forum they wished, including as part of their public securities filings.

Optional Approach Suggested. Whether to make it optional or mandatory requires deliberation. While this choice should be left to individual states, there is a strong case for the optional approach given absence of a compelling systemic need for the certification.⁶² If optional, corporations would decide on frequency; if mandatory, states would specify whether it should be done annually, bi-annually, tri-annually, or perhaps at different frequencies for corporations of different size, complexity and track financial reporting track records. If made optional, two categories of domestic corporations could be designated, one for those opting in and one for those opting out. In Delaware, for example, corporations could describe themselves as a “Delaware corporation” for those opting out; and a “certified Delaware corporation” for those opting in.

Extending to Out-of-State Corporations. States could offer this service for locally-chartered corporations and could even offer it for corporations chartered elsewhere. So extending the service offers the advantage of enhancing competition among states, with the partial disadvantage of requiring experts in one state’s corporation law to become expert in another (there is sufficiently limited variation across states that this should be of limited significance). If offering the service to out-of-state corporations, these could be authorized to use the designation in a similar way to in-state corporations. A California corporation opting for the Delaware certification, for example, could describe itself as a “Delaware-certified California corporation.”

⁶¹ In Delaware, the process of amending the state corporation law is straightforward, managed virtually entirely by the Corporation Law Section of the Delaware State Bar Association. See Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885 (1990).

⁶² See Part I, *supra*.

Self-Funding. The agency could generate funds from those corporations using its certification service. Pricing of services could be proportional to SOX's public company accounting support fee, given work required and information being generated and conveyed. It would certainly be a small fraction of those fees and likewise a small fraction of ongoing audit costs (especially now that they have risen significantly).⁶³ Pricing could be in part a function of the agency's expenses. The largest agency expenses would likely be for salaries and office space. Travel expenses could be charged to corporations using the service.

Supplemental Budgets. The agency need not be self-sustaining from service fees it generates. A portion of the state budget funded by corporation franchise fees could be allocated to underwrite the agency's budget. This would be a prudent budgetary measure to the extent the certification becomes a signal of a states' interest in the most effective audit committees and corporate governance generally. States offering the service to domestic and foreign corporations could offer a discount for domestic corporations, a device to lure additional chartering business to the state and offset such supplemental budgeting.

Funding Conflicts. A potential conflict arises when corporations pay a state to provide this service, however, on grounds of regulatory capture. There is no complete way around such conflicts. A way to minimize it in this context is to provide shareholders a voice in making the decision whether to use the service. After all, the service would be primarily for their benefit. Alternative tools to facilitate shareholder voice on the subject include state law voting mechanisms such as charter opt-ins or opt-outs and/or federal proxy mechanisms providing for more pro-active shareholder proposals on the subject.

Other Factors. This is not an exhaustive catalogue of relevant features of a state agency audit committee evaluation function. It outlines key features. States would be entitled and encouraged to experiment with variations on these and other features. The possibility of variations on these themes and particular models would induce competition among the states. Corporations, acting through their boards of directors and audit committees, would consider which programs, if any, offer the best product in terms of signaling credibility to the market and towards minimizing the corporation's cost of capital.

⁶³ See FINANCIAL EXECUTIVES INSTITUTE SURVEY ON SARBANES-OXLEY SECTION 404 IMPLEMENTATION (Jan. 2004) [survey of 321 companies of various sizes shows that under SOX (a) on average annual costs rise \$1,322,200 (\$590,100 for internal control audits and \$732,100 for new systems) and (b) for companies with revenues exceeding \$5 billion, average annual costs rise \$6.2 million (\$4.7 million for new internal control audits, \$1.5 million for new systems)].

IV. ANTICIPATING SUPPORTING CONSENSUS FROM THE FIELD

Comments offered publicly on PCAOB's Proposed Standard provide a strong basis for inferring that the state-agency approach would garner substantial support from a wide variety of constituencies, including users, producers and professionals.

A. Users and Producers

Several comments on behalf of investors and other financial statement users supported PCAOB's Proposed Standard in concept, though recognizing the difficulty auditors face in discharging the assignment.⁶⁴ They emphasized the need for an *independent* review, which excludes auditors. Suggestions included that boards of directors hire specialists from another CPA firm or from a non-CPA firm.⁶⁵

Not all investor groups supported PCAOB's Proposed Standard.⁶⁶ The California State Teachers' Retirement System emphasized conflicts, limited auditor competencies and existing sources of supervision and information. Even it, however, concluded by suggesting that "PCAOB may want to review the charters and opine on the audit committee's diligence in mitigating risks to the public."⁶⁷

A residual user concern focused on the importance of auditors understanding audit committee effectiveness. Absent such testing, one said, it would be "wrong and misleading to investors" for an auditor to report that it has assessed effectiveness of ICOFR without assessing the audit committee.⁶⁸ This can be solved, however, by providing an independent and competent review upon which auditors can rely.

Issuer comment letters nearly unanimously recognized the need for effective audit committees, while generally opposing having auditors perform the evaluation.⁶⁹ Only a

⁶⁴ These included the Commonwealth of Virginia; CalPERS; the AFL-CIO; Ohio Retirement Systems and Glass, Lewis & Co.

⁶⁵ Despite these qualifications, PCAOB asserted in explanations accompanying AS No. 2 that "investors supported the provision." AS No. 2, App. E, ¶ E63.

⁶⁶ This is contrary to PCAOB's assertion in explanations accompanying AS No. 2 that "investors supported the provision." *Id.*

⁶⁷ *Comment Letter to PCAOB from California State Teachers' Retirement System* (PCAOB Letter No. 58).

⁶⁸ *Comment Letter to PCAOB from Glass, Lewis & Co., LLC* (PCAOB Letter No. 184). Glass Lewis is an independent proxy and financial research firm that provides research to institutional investors. *Id.*

⁶⁹ Collective expressions of corporate America's opinions sounded themes similar to those particular corporations offered and summarized here. *E.g., Comment Letter to*

few issuer comment letters supported using the auditor to perform this task, noting conflicts.⁷⁰ Another hinted at the state agency possibility: that the evaluation be done “on a periodic basis by a party other than the external auditor.”⁷¹

The vast majority of issuers opposing the Proposed Standard’s auditor evaluation of the audit committee cited SOX § 301 as conflicting with AS No. 2⁷² (some of these also cited conflicts with SRO rules requiring boards to conduct audit committee evaluations).⁷³ Many emphasized that audit committee effectiveness is a board of directors’ responsibility,⁷⁴ questioned whether auditors possess requisite expertise, and noted that SROs are addressing the subject. Issuer comment letters that suggested tying the need to the board of directors returns the question to state doorsteps. On balance,

PCAOB from Business Roundtable (PCAOB Letter No. 181) (concept is “particularly inappropriate” given SOX § 301 and SRO listing standards). Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million US employees and \$3.7 trillion in annual revenues. *Id.*

⁷⁰ *Comment Letters to PCAOB from United Technologies Corporation* (PCAOB Letter No. 46); *Chittendon Corp.* (PCAOB Letter No. 34); *Kimball International* (PCAOB Letter Nos. 2 & 38); and *Crowe Chizek and Company, LLC* (PCAOB Letter No. 168).

⁷¹ *Comment Letter to PCAOB from Texas Instruments Incorporated* (PCAOB Letter No. 114).

⁷² *E.g., Comment Letters to PCAOB from BP plc* (PCAOB Letter No. 47); *Pfizer Inc.* (PCAOB Letter No. 69); *Eli Lilly and Company* (PCAOB Letter No. 75); *Boise Cascade Corporation* (PCAOB Letter No. 81); *Commercial Federal Corporation* (PCAOB Letter No. 87); *Empire District* (PCAOB Letter No. 97); *Southern Union Company* (PCAOB Letter No. 98); *EnCana Corporation* (PCAOB Letter No. 111); *Texas Instruments Incorporated* (PCAOB Letter No. 114); *E. I. duPont de Nemours and Company* (PCAOB Letter No. 115); *Edison Electric Institute* (PCAOB Letter No. 117); *Cummins Inc.* (PCAOB Letter No. 123); *Irwin Financial Corporation* (PCAOB Letter No. 125); *EMS companies (Solecdrtron, Flextronics, Celestica and Sanmina-SCI)* (PCAOB Letter No. 130); *Sun Life Financial Inc.* (PCAOB Letter No. 134); *Jefferson Wells International* (PCAOB Letter No. 135); *Bank of America* (PCAOB Letter No. 145); *Computer Sciences Corporation* (PCAOB Letter No. 151); *Motorola, Inc.* (PCAOB Letter No. 154); and *BellSouth Corporation* (PCAOB Letter No. 162).

⁷³ *E.g., Comment Letters to PCAOB from Commercial Federal Corporation* (PCAOB Letter No. 87); *E. I. duPont de Nemours and Company* (PCAOB Letter No. 115); and *Bank of America* (PCAOB Letter No. 145).

⁷⁴ *E.g., Comment Letters to PCAOB from GlaxoSmithKline Services Unlimited* (PCAOB Letter No. 62); *EnCana Corporation* (PCAOB Letter No. 111); *Yellow Corporation* (PCAOB Letter No. 146).

therefore, the issuer community would likely support the state agency concept. If made optional, some would likely opt for it.

Few directors offered comments on PCAOB's Proposed Standard; those commenting said little concerning specifics of auditor evaluation of audit committee effectiveness. In general, however, one could expect directors to prefer a state agency approach rooted in common law principles. There is nothing new in these concepts. They are also standards-based and include the business judgment rule. This contrasts with the auditor's professional skepticism that would lead to second-guessing and PCAOB's heavily rule-based approach that suffocates business judgment.⁷⁵ While not possible to predict every director's opinion, it seems reasonable to expect that a critical mass would support it.⁷⁶

B. The Auditing Profession

The Big Four⁷⁷ generally opposed PCAOB's Proposed Standard requiring auditor evaluations of audit committees, but not because it lacks a certain appeal.⁷⁸ Deloitte and PWC sympathized, in principle, but held deep reservations as to implementation; KPMG

⁷⁵ Numerous comment letters criticized PCAOB proposal as exceedingly dense and rule-bound. *E.g.*, *Comment Letters to PCAOB from Association of the Bar of the City of New York* (PCAOB Letter No. 68) ("overly rigid, technical rules," and encouraging "more principles-based and less rigid" approach); *Institute of Chartered Accountants in England and Wales* (PCAOB Letter No. 102) ("gives the impression of trying to achieve, and having an overall expectation of, 'perfection'", and evincing a "stifling bureaucracy"); *Irwin Financial Corporation* (PCAOB Letter No. 125) ("overly prescriptive and rigid"); ATT (PCAOB Letter No. 85) ("overly prescriptive"); *Boise Cascade Corporation* (PCAOB Letter No. 81) ("too prescriptive and detailed"); *Manufacturers' Alliance/MAPI* (PCAOB Letter No. 99) ("Unnecessarily prescriptive"); *Prof. Dennis R. Beresford* (PCAOB Letter No. 21) ("overkill").

⁷⁶ Comments from consultants to boards furnish support. One proposed to overcome inherent limitations of auditor evaluations by suggesting that audit committee evaluation be done by a "third party approved by shareholders, in a separate evaluation. *Comment Letter to PCAOB from Value Alliance and Corporate Governance Alliance* (PCAOB Letter No. 127).

⁷⁷ The firms and the number of their letters in PCAOB's comment-letter registry are Deloitte & Touche LLP (71); Ernst & Young LLP (E&Y) (144); KPMG LLP (91); and PriceWaterhouseCoopers LLP (PWC) (82).

⁷⁸ This view is contrary to PCAOB's assertion in explanations accompanying AS No. 2 that auditors "were generally supportive" although they sought clarity that the evaluation was "not a separate and distinct evaluation" but "one element" of the auditor's overall understanding and that auditors would have difficulty given lack of total access. AS No. 2, App. E, ¶ E64.

and E&Y made the practical objections more explicit. All accepted that audit committee effectiveness is an important component of the control environment, but only a component and therefore not warranting separate auditor evaluation. PWC emphasized that the board of directors is responsible for audit committee effectiveness; E&Y observed that internal control should function without audit committee involvement; and Deloitte recognized that many see the audit committee as outside the scope of internal control over financial reporting (ICOFR).

Deloitte and KPMG both expressed concern about evaluation capabilities given that auditors lack full, complete, unfettered access to audit committee members, meetings and information. E&Y identified the following areas where it believes auditors are capable of evaluation using objective criteria: clarity of responsibility articulation; assessing the committee's management approach to designing, implementing, and monitoring ICOFR; and whether it reacts to management's failure to respond to deficiencies. KPMG disagreed concerning whether auditors have these and other capabilities, noting in particular that it is not clear how auditors would assess member understanding of duties or the significance of time devoted.

All the Big Four singled out areas clearly beyond their capabilities or competence. Leading this list are those involving legal determinations like independence and listing standard compliance. Deloitte characterized testing compliance with listing standards under SOX § 301 as testing for compliance with laws/regulations, outside the scope of ICOFR. It also indicated the lack of auditor capability in evaluating whether the audit committee nominating process was independent. KPMG opined that compliance with listing standards under SOX § 301 or concerning ACFE under SOX § 407 are legal interpretations and regulatory compliance outside the scope of reliable financial reporting.⁷⁹

The Middle Three⁸⁰ offered opinions similar to the Big Four. BDO Seidman also emphasized that because corporate governance—not just the audit committee—is a critical component of the control environment board effectiveness is critical. It also cautioned against having auditors provide implicit assurance on audit committee effectiveness.⁸¹ Grant Thornton added that effective audit committees are not necessary

⁷⁹ Deloitte and KPMG both suggested that if the concept is retained, then management's report would also need to assess audit committee effectiveness. Deloitte cited for support SOX § 407's requirement that boards determine whether to have an ACFE and listing standards that require boards to perform annual audit committee assessments. KPMG concurred (as did the mid-sized auditing firm, McGladrey & Pullen, LLP), adding that auditors should be permitted to rely upon management's assessment in preparing their own evaluation. The Big Four also all agreed that the listed factors need refinement.

⁸⁰ The firms and the number of their letters in PCAOB's comment-letter registry are BDO Seidman, LLP (136); Grant Thornton LLP (101); and McGladrey & Pullen, LLP (142).

to effective ICFR and effective oversight is not sufficient for effective ICFR. McGladrey & Pullen expressed greater optimism, opining that legal compliance matters aside, auditors possess objectivity and technical competence to judge audit committee effectiveness, but wanted the duty limited to “consideration of observable information and behavior.”

The AICPA substantially replicated comments of the Big Four.⁸² An Illinois group was divided, though even supporters noted that auditors face a “difficult task” in evaluation, including as to legal and regulatory compliance.⁸³ A Texas group favored it, admitting that the audit committee’s power over the auditor may deter objective assessment, but noting that ineffective audit committees can cause significant problems.⁸⁴ A New York group noted conflicts and competency issues, but again paving the way toward a state approach concluded that this task should be performed by the board of directors, the SEC or “some other body that is not in the employ of the audit committee.”⁸⁵ One professional auditors’ group believed the proposal is appropriate, but required more guidance;⁸⁶ another took the opposite position, urging its deletion.⁸⁷ The latter cited the litany of factors posing inherent limits, all of which would be neutralized by the state agency concept.

International associations of accountants expressed reservations, drawing on learning that likewise points towards a state solution. The largest group of international accountants observed that it is a difficult question: in theory, auditors cannot perform this task; in practice, someone must perform it; and on balance, the optimal solution is to

⁸¹ BDO Seidman was the only major accounting firm to cite SOX § 301’s directive as driving a conflict between the audit committee and the auditor and hindering communication, the dominant points offered by nearly every issuer comment letter and many others. *See supra* note 71 and accompanying text.

⁸² *Comment Letter to PCAOB from American Institute of Certified Public Accountants* (PCAOB Letter No. 105).

⁸³ *Comment Letter to PCAOB from Audit and Assurance Services Committee of the Illinois CPA Society* (PCAOB Letter No. 103).

⁸⁴ *Comment Letter to PCAOB from Texas Society of Certified Public Accountants* (PCAOB Letter No. 78).

⁸⁵ *Comment Letter to PCAOB from New York State Society of Certified Public Accountants* (PCAOB Letter No. 140).

⁸⁶ *Comment Letter to PCAOB from National State Auditors Association* (PCAOB Letter No. 113).

⁸⁷ *Comment Letter to PCAOB from Institute of Internal Auditors* (PCAOB Letter No. 112).

require auditors to perform an evaluation linked narrowly to their assessment of the overall control environment.⁸⁸ A UK accountancy group noted that the UK Combined Code on Corporate Governance requires boards to conduct performance evaluations of audit committees.⁸⁹ A European group emphasized the need to address the conflict, not shrink from it, suggesting using a threats-safeguards approach similar to that of the IFAC Ethics Code which would involve requesting an “independent colleague (review partner) to assist.”⁹⁰

Among accounting academics, the leading group, the American Accounting Association (AAA), opined: “one radical and perhaps cost-prohibitive suggestion is to require a second audit firm to perform the audit committee assessment on a less frequent basis (e.g., every 3-5 years).” As noted at the beginning of this Part, this would solve the problem of independence, but not of expertise. It indicates, however, a willingness that should lead the AAA to support the state agency approach—a willingness likewise strongly indicated by substantially all the other comment letters the auditing profession provided to the PCAOB on its Proposed Standard, as summarized above.

C. The Legal Profession

The American Bar Association (ABA) concluded that PCAOB’s Proposed Standard was “not consistent with” SOX § 301⁹¹ and “appear[ed] flawed and circular.” Beyond these general fatal flaws, the ABA identified three more negotiable flaws: many requirements are beyond an auditor’s expertise or are better handled by others; are not measurable by objective criteria; or require legal judgments.

The Association of the Bar of the City New York reported similar objections to the Proposed Standard, and also objected on the grounds that the listed evaluation factors “would require a much greater degree of involvement by the auditors in the internal operation of the audit committee” and observation requiring skills beyond auditor expertise, including knowledge of listing standards and interpretations.⁹² The New York

⁸⁸ *Comment Letter to PCAOB from Association of Chartered Certified Accountants* (PCAOB Letter No. 88). The Association of Chartered Certified Accountants is the world’s largest professional association of accountants. *Id.*

⁸⁹ *Comment Letter to PCAOB from Institute of Chartered Accountants in England and Wales* (PCAOB Letter No. 102).

⁹⁰ *Comment Letter to PCAOB from Fédération des Experts Comptables Européens* (PCAOB Letter No. 79).

⁹¹ *Comment Letter to PCAOB from American Bar Association, Section of Business Law* (PCAOB Letter No. 185).

⁹² *Comment Letter to PCAOB from Association of the Bar of the City of New York, Committee on Financial Reporting* (PCAOB Letter No. 68).

State Bar Association expressed similar concerns, citing both independence-impairment when auditors perform this essentially managerial function and questioned whether auditors are in a good position to carry out the duties.⁹³

No other bar association commented on the Proposed Standard, though an informed guess suggests that most would concur with the views expressed by the ABA and the two New York associations. On the other hand, certain bar associations might have more specific concerns, including for example the Delaware State Bar Association, whose expertise in corporation law and corporate governance may equip and incline it to provide more detailed insights. In any event, if the comments these bar associations provided are representative, it is reasonable to infer that the legal profession as a body would support the state agency concept.

V. ANTICIPATING REGULATORY OPPOSITION

Despite predicting likely support for the state agency concept from users and preparers of financial statements and from the auditing and legal professions, it remains uncertain whether regulators or states would support it. These predictions can be informed by evaluating the overall prevailing framework of corporate governance and alternative models of how its components are produced. The current array is dominantly federal, with states residing in the background, a relationship that tends to support predicting federal regulatory opposition and state opposition, reluctance or indifference.

A. Federal

Generations of corporate law scholars have debated whether state corporation law is a product of horizontal competition among the states and, if so, whether the competitive output showed a race to the top, to the bottom or to somewhere else.⁹⁴ As

⁹³ *Comment Letter to PCAOB from New York State Bar Association, Business Law Section, Committee on Securities Regulation* (PCAOB Letter No. 180). The American Society of Corporate Secretaries echoed the points, also emphasizing how the SROs are addressing the questions. *Comment Letter to PCAOB from American Society of Corporate Secretaries, PCAOB Sub-Committee of the ASCS Securities Law Committee* (PCAOB Letter No. 106).

⁹⁴ Debate dates to the 1930s, led by Justice Brandeis and Professors Berle and Means, continued through the 1970s in a noted exchange between SEC Chairman Cary and Judge Winter, and endured through the 1990s and today with scores of articles devoted to numerous aspects of the subject. For representative positions, see ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATION LAW* (1993) (top); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992) (bottom); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65

the intellectual and empirical debate stalemates on this horizontal competition among states, an alternative sees a vertical competition between federal securities regulation and state corporate law, with the federal hand dominant but still limited.⁹⁵ In this story, SROs either (a) fill a gap between federal and state corporate governance sources or (b) operate as an extension of the federal regulatory hand into territory better reached through superficially-private means or where federal courts would not allow federal administrative agencies to venture.⁹⁶

Recent debates concerning SROs resemble the hoary corporate law debate in asking whether competition among SROs, plus foreign securities exchanges, are running a horizontal race of their own, and whether this is to the top or bottom.⁹⁷ Similar debate concerns competition among other regulatory bodies, such as accounting standard-setters like the Financial Accounting Standards Board (FASB) versus the International Accounting Standards Board (IASB).

With PCAOB's creation a similar conversation is likely concerning its obvious competitors such as the International Auditing Standards Board. To the extent PCAOB also engages in standard-setting that affects corporate governance, however, a new conception of horizontal competition emerges: PCAOB can compete with states and SROs. PCAOB's product market is less clear than Delaware's (charters for franchise fees) or the SROs (listings for listing fees). But power to set the agenda and to control the processes of standard-setting may be intrinsically valuable, and despite SOX's effort to insulate PCAOB from the auditing profession, rents may remain available that PCAOB could have a major role in allocating.

In the case of evaluating audit committees, which body should set the agenda and specify required elements: the SEC, SRO, PCAOB or states? The SEC may fear direct efforts to do this would extend beyond the power Congress granted it in SOX (or, more precisely, that a federal court might accept this argument); it may recognize that using SROs would be impracticable given their distance from the operational activities of audit committees; by default or design, PCAOB fills the bill. Some evidence from the evolution of the Proposed Standard into AS No. 2 suggests that PCAOB is operating as a

TEX. L. REV. 469 (1987) (lawyer and investment banker interest groups); William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L. REV. 401 (1994).

⁹⁵ E.g., Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 488 (2003).

⁹⁶ See Thompson, *Collaborative Corporate Governance* *supra* note 16.

⁹⁷ E.g., John C. Coffee, Jr., *Racing Toward the Top? The Impact of Cross-Listings and Stock Market Competition on Corporate Governance*, 102 COLUM. L. REV. 1757 (2002).

component of a more general federal-based corporate governance system.⁹⁸ Whether the SEC would want the states to do this is unclear. Some evidence suggests that federal regulators disfavor competition among SROs;⁹⁹ if so, they may likewise object to horizontal competition by states against these SEC instrumentalities.

Indulging a naïve perspective, however, if regulators were acting in the best interests of the nation, they would welcome the state agency approach to audit committee certification as well. Congress, the SEC and the SROs exhibited some federalism restraint in their provisions concerning audit committees. All reposed substantial power in boards to review effectiveness and imposed disclosure requirements. PCAOB offers enhanced review by auditors, but is clearly aware of inherent limitations. None of these groups offers the solution best suited to the task.

Returning to regulators' self-interest, assigning this function to the states would relieve these regulators of the particular associated burdens, while leaving them in a position to monitor the concept's operation. This would furnish them with an additional lever, laboratory and knowledge in discharging their own regulatory and oversight functions. Even so, regulators are essentially foes of regulatory competition, much as capitalists are foes of market competition.

B. States

As for states, their likely support varies depending on the theory of state corporation law production one embraces. The traditional models—race to the bottom or top or an interest group model—offer ready predictions. If a race to the bottom best explains state corporation law production, states are unlikely to support the proposal to the extent it imposes discipline and transparency on management. If a race to the top or an interest group model, then states are likely to embrace the proposal. They would embrace the proposal under the race to the top to the extent it lowers the cost of capital by reducing agency costs and serves the interests of capital markets and investors. They would embrace it under the interest group theory to the extent it produces additional revenue for states and their lawyers, keeping services in the legal profession and out of the auditing and accounting professions.

Predictions of state inclination are more difficult if one embraces the two variations on the model, which appear increasingly more capacious and accurate descriptions of the observed federalization of corporate governance production. Under the vertical competition model, states only act when pressured and the federal machinery can nearly always directly or indirectly preempt them. The only way to preempt this is to fall into line; this proposal would constitute an innovation rather than a capitulation.

⁹⁸ See *supra* notes 38, 41 and 45 (discussing AS No. 2's deletion of factors appearing in PCAOB's Proposed Standard concerning independence of audit committee nomination and selection process and compliance while retaining factor of member independence).

⁹⁹ See Thompson, *Collaborative Corporate Governance*, *supra* note 16.

Under the disguised-federalization model, states may have a role, but may lack incentives to play it.

What emerges is a tentative hypothesis concerning the degree to which the newest model of corporate governance production may become even more complex. There is an emerging horizontal competition among different types of competitors. What unites competitors in traditional horizontal competition models is the particular product and revenue stream: charters and franchise fees for states or listings and listing fees for SROs. What unites competitors in the modified horizontal model is the broader product and public choice stream: corporate governance and standard-setting power.

How this competition plays out will significantly influence the shape of corporate governance in the years to come. What happens with the state agency audit committee certification concept might provide road maps. A good bet is the road ahead will be flooded with federal regulations, pumped from the large spigot SOX offered the SEC and its instrumentalities including SROs and PCAOB.

CONCLUSION

[to come]