Inside-Out Corporate Governance

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David A. Skeel, Jr. et al.*

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I. INTRODUCTION

In the past decade, two major corporate and financial crises have shaken the foundations of corporate governance in rapid succession. In 2001 and 2002, Enron, WorldCom, and several other major U.S. corporations collapsed after evidence of accounting fraud emerged at each company.1 By the time lawmakers and regulators had finished dealing with the fallout from these scandals and with the Sarbanes–Oxley Act of 20022 and other reforms, a new crisis emerged with the distressed sale of the largest subprime lender, Countrywide Financial, and the subsequent collapses of Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, and AIG.3

The earlier corporate scandals were widely viewed as a failure of corporate governance and were centered largely in the United States.4 The 2008 crisis, however, was far more global in its scope and was closely tied to governance and regulation in the financial services industry.5 The crisis raised grave concerns about the role of derivatives and other new financing techniques—the so-called shadow banking system—in 21st century governance.6 Much as with securities analysts and auditors in the earlier crisis,

1. The scandals of the early 21st century have been the subject of many helpful books and articles. Two of the best treatments from a corporate governance perspective are AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNIZING SECURITIES REGULATION IN EUROPE AND THE U.S. (John Armour & Joseph A. McCahery eds., 2006) [hereinafter AFTER ENRON] and JOHNN CORN, JR., GATEKEEPER: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006). For a particularly insightful analysis of the Parmalat collapse a few months later, see Guido Ferrarini & Paolo Giudici, Financial Scandals and the Role of Private Enforcement: The Parmalat Case, in AFTER ENRON, supra.


3. Accounts of these events are already legion. See, e.g., ANDREW R. SORKIN, TOO BIG TO FAIL: HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES (2010) (chronicling the collapses of, among others, Bear Stearns, Lehman Brothers, and AIG, based on extensive interviews with the participants).

4. For an extended analysis from this perspective, see COFFEE, supra note 1.

5. The emphasis on financial services is attested by the spate of recent books assessing the Bear Stearns and Lehman Brothers collapses and the crisis in the financial services industry more generally. See, e.g., WILLIAM COHAN, HOUSE OF CARDS (2009) (examining the collapse of Bear Stearns as an example of what went wrong on Wall Street during the 2008 financial crisis); SORKIN, supra note 3 (providing an inside look at the crisis in the financial services industry); DAVID WESSEL, IN FED WE TRUST (2009) (analyzing the crisis in the financial services industry from Federal Reserve Chairman Ben Bernanke’s point of view).

6. See, e.g., Andrew R. Sorkin, Paulson Backs Stronger Oversight of Markets, N.Y. TIMES DEALBOOK
the principal gatekeeper—in this case, the credit rating agencies that rated mortgage-related securitizations and other debt instruments—proved ineffectual.\(^7\)

Even more than its predecessor, the recent crisis spurred a pervasive restructuring of corporate regulation. Once fully implemented, Congress’s handiwork—the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank)\(^8\)—will dramatically rework three crucial areas: internal corporate decision making, third-party gatekeepers, and financial derivatives. With internal corporate governance, lawmakers focused on increasing minority shareholders’ ability to propose their own directorial candidates by authorizing the Securities and Exchange Commission (SEC) and other regulators to promulgate “proxy access” rules.\(^9\) The SEC quickly acted on this invitation—too quickly, it appears, as the SEC’s initial rule was struck down on procedural grounds.\(^10\) Dodd–Frank homed in on third-party gatekeepers by imposing new directorial independence requirements on credit rating agencies and instructing regulators to remove the provisions in banking regulation that give pride of place to the three dominant rating agencies: Standard & Poor’s, Moody’s, and Fitch.\(^11\) For financial derivatives—contracts whose value is based on changes in interest rates, currency values, stock prices, or nearly anything else, or the occurrence of a specified event, such as a default on a company’s debt—Dodd–Frank fills an almost complete regulatory vacuum. It does so by requiring that most derivatives be both cleared by a clearinghouse that guarantees the performance of both parties, and traded on an exchange, rather than negotiated privately by the two parties.\(^12\)

Although the three sets of reforms seem entirely unrelated—both as initially enacted and as regulators have fleshed out the new regime—we argue in this Article that the regulation in each area embraces, wrestles with, and attempts to shape a new corporate governance paradigm we call “inside-out” corporate governance. This new inside-out governance model has profound implications for corporate regulation, as well as the respective roles of federal and state legislation. Much as the principal regulatory challenge of the 1980s and 1990s was takeovers, the central question for the current era will be, we believe, how to effectively manage the new inside-out paradigm.

For much of the 20th century, corporate governance consisted of internal corporate governance—that is, decision making by the principal inside constituencies of the firm—together with outside oversight by regulators, auditors and credit rating agencies, and markets.\(^13\) With the advent of the takeover movement, most visibly in the 1980s,\(^14\) the

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\(^9\). Id. § 971.

\(^10\). These developments are the focus of Part II, infra. Dodd–Frank also institutes “say-on-pay,” requiring corporations to provide for non-binding votes on executive compensation at least once every three years. Dodd–Frank § 951.

\(^11\). See generally infra Part III (discussing third-party gatekeepers).

\(^12\). See generally infra Part IV (discussing derivatives regulation).

\(^13\). With “outside” factors, our particular concern is with oversight that is designed to enhance the
distinction between inside and outside governance began to erode. Although the “raiders” of the 1980s were outsiders, they relied on the internal mechanisms of corporate governance—such as proxy contests—when incumbent managers thwarted their bids with poison pills and other defenses. More recently, hedge funds and other “outside” investors have used the tools of corporate governance to seek representation on the board of directors or to influence corporate decision making in other ways. As a result of these developments, inside and outside governance are now intertwined in ways that echo the emergence of shadow banking in finance, and draw on many of the same innovations.

Throughout the Article, we pursue two main objectives. First, having identified the new inside-out governance paradigm, we show how it is reflected in the new regulatory landscape. Second, using inside-out governance as our lens, we assess its implications for proxy access, auditing and credit rating, and derivatives, and offer suggestions for further reform in each area.

At several key points in the Article, we draw on new developments in Italian and E.U. corporate governance. Italy may seem an odd place to look for revealing insights for the United States. The United Kingdom is usually viewed as a more logical choice, given the historical links between the United States and United Kingdom and the similarities in their approach to corporate governance. In both the United States and the United Kingdom, corporate stockholding is far more dispersed than elsewhere in the world, and both countries have a comparatively market-oriented stance toward corporate governance. Not only does Italy have far fewer publicly held corporations—roughly 300, as compared to 12,000 in the United States—but most large Italian corporations are

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14. There was an early takeover wave as well, dating back to the 1950s and early 1970s, but takeovers had their most dramatic effects in the 1980s. For a defense of the earlier takeovers, see Henry Manne, Mergers and the Market for Corporate Control, 73 J. POL. ECON. 110 (1965).


16. For evidence that this activism benefits investors, see Alon Brav et al., Hedge Fund Activism, Corporate Governance, and Firm Performance, 63 J. FIN. 1729 (2008).

17. One of the first articles to recognize the potential dangers of these developments was Raghuram G. Rajan, Has Financial Development Made the World Riskier?, 2005 FED. RES. BANK OF KANSAS CITY 313, available at http://www.kc.frb.org/publicat/sympo/2005/pdf/rajan2005.pdf (suggesting that financial innovations that were thought to reduce risk actually may increase the fragility of the financial system and magnify systemic risk). See also RAGHURAM G. RAJAN, FAULT LINES: HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY (2010) (further developing these arguments).

18. We do not claim that other scholars have not recognized the particular developments described in the text. Some, such as hedge fund activism, are well known. Our contribution is, we hope, showing they fit a larger pattern that now permeates corporate governance.

19. John Armour & David A. Skeel, Jr., Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation, 95 GEO. L.J. 1727 (2007). Indeed, one of us has analyzed the treatment of a key corporate governance issue—takeovers—in the United States and United Kingdom, albeit in an effort to show that the two nations’ regulation of corporate governance is more divergent than is commonly assumed. Id.

20. Id. at 1728.
controlled either by a family or by a corporate group. Unlike in the United States, where corporate governance experts worry primarily about the conflict of interest between managers and shareholders, the principal conflict in Italian corporations pits the control block against minority shareholders.

While the contrasts are indeed stark, they make the Italian comparison far more revealing for our purposes. With both minority shareholder representation and credit rating agencies, Italy has intervened in ways that echo proposals or actual reforms in the United States and which are designed to foster inside-out governance. By teasing out the reasons for the similarities and differences—do the divergences reflect a difference in the governance context, for instance, or might they offer insights of direct relevance for the United States?—we can offer new insights into these issues and inside-out governance more generally.

The Article begins, in Part II, with the issue of proxy access and minority shareholder representation on the board of directors. A central theme in this Part is the distinction between U.S. reform, which focuses on shareholder voting power, and the Italian emphasis on minority shareholder representation. U.S. regulators worry more about the process, or “means,” whereas Italy has been more concerned with the results, or “ends.” We argue that the distinction can be traced to the different shareholding patterns in the two countries, but that the two approaches also have very different implications for corporate governance and raise different concerns. We also show that the SEC has pursued an internally incoherent (though not politically incoherent) path on proxy access. Although proxy access is best seen as bringing outsiders such as hedge funds more fully into internal corporate governance—and thus as facilitating inside-out governance—the rule’s prerequisites—most importantly, a three year holding requirement—make it difficult for outsiders like hedge funds to use.

Part III shifts from internal governance to the third-party gatekeepers. With both of the key gatekeepers—auditors and credit rating agencies—inside-out governance is well-established. Although auditors and credit rating agencies provide outside oversight, both are hired by the corporation itself. In each case, this connection has created a serious conflict of interest, with concerns that the gatekeeper caters to the inside decision maker that is paying its bills. The proposed strategies for controlling this conflict tend to fall into two categories, which we refer to as ex ante and ex post approaches. By ex ante, we mean reforms that take effect at or before the time the gatekeeper is actually engaged to scrutinize a company. Examples include the requirement in the Sarbanes-Oxley Act that a company’s auditor be selected by an independent audit committee, and more elaborate proposals such as a new audit insurance scheme. The principal ex post strategy, on the

21. See, e.g., Marcello Bianchi et al., Pyramidal Groups and the Separation Between Ownership and Control in Italy, in THE CONTROL OF CORPORATE EUROPE (2001) (“The largest stake in listed and unlisted companies is held by other non-financial or holding companies.”).
22. Id.
23. With auditors, this pattern goes back many decades. See infra Part III.B.1 (providing a history of the auditing industry in the United States). Credit rating agencies originally used an outsider model, in which investors paid for access to credit ratings. See infra II.B.2 (providing a history of the credit rating industry in the United States). The shift to an issuer pays model came more recently and was one of the first hints of the shift to inside-out governance. See, e.g., Jeffrey Manns, Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability, 87 N.C. L. Rev. 1011, 1022–23 (2009).
24. See infra Part III.D (discussing the problems and solutions that auditors pose for corporate
other hand, is litigation and the possibility of legal liability if the gatekeeper fails to provide adequate oversight.

Several of the most interesting ex ante proposals would radically restructure the selection of these gatekeepers by, for instance, replacing the traditional auditing relationship with an insurance scheme. The proposals would retain the audit function’s inside-out quality, but would interpose an additional party, the insurance company. While we find these proposals alluring, we are skeptical of their efficacy, and argue for a different, though similarly market-oriented strategy: permitting an issuer and its auditor to contract over the scope of the auditor’s potential liability.25

With credit rating agencies, Dodd–Frank imposes a panoply of internal governance obligations (such as independent directors) that require increased disclosure and instruct regulators to remove the regulatory imprimatur for credit ratings.26 These changes would indirectly restructure the current inside-out framework by diminishing the pressure that pensions and other institutional investors have to buy securities that have been rated as investment grade by SEC-approved rating agencies (CRAs). While we favor the removal of the SEC-approved credit rating agencies’ regulatory advantage, we point out that these CRAs are now subject to burdens that will not apply to their competitors. We also advocate increased use of alternative mechanisms for assessing securities.27

Part IV focuses on derivatives regulation. With derivatives, the inside and outside dimensions of their use are quite separate in some respects. Internally, the directors of many corporations use derivatives to adjust their exposure to key risks. The directors of Southwest and other airlines, to provide a familiar example, use derivatives to hedge against increases in the price of oil.28 Derivatives also serve as an important and quite distinct form of outside governance. Changes in the price of a credit default swap—which insures against declines in the value of a company’s debt—provide crucial information about the company’s financial health, thus shaping investors’ willingness to invest in the company.

Dodd–Frank tries to distinguish the use of derivatives for hedging (inside governance) from more speculative dimensions of the derivatives markets (which are essential to their outside role).29 The legislation is designed to exempt the kinds of hedging transactions that are the principal corporate governance use of derivatives from the most intrusive of the new regulatory requirements.30 But burdening speculation also imposes costs on corporate use of derivatives for hedging, since hedging and speculation necessarily travel together. Moreover, and more importantly, Dodd–Frank requires that a

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25. This approach was suggested to us by CONSOB Commissioner Luca Enriques in a 2010 meeting at CONSOB. Meeting with CONSOB officials at CONSOB offices in Rome, Italy (Mar. 12, 2010).

26. See infra Part III.G (discussing the impact of Dodd–Frank).

27. See also Mark J. Flannery et al., Credit Default Swaps as Viable Substitutes for Credit Ratings, 158 U. PA. L. REV. 2085, 2085 (2010) (evaluating the “viability of credit default swap (CDS) spreads as a substitutes for credit ratings”).


30. See infra Part IV.E (discussing the exceptions for hedging transactions).
hedging firm’s directors explicitly opt out of margin requirements that would otherwise apply. The legislation itself formally integrates derivatives into inside corporate governance for these firms. After exploring each of these issues through the lens of inside-out corporate governance, we close the Article by speculating briefly about the future of inside-out governance for, among other things, state regulation of corporate law.

II. PROXY ACCESS AND MINORITY DIRECTORS

A. Introduction

The proxy process allows shareholders to vote without being present at the annual meeting, and thus enables modern corporations to satisfy quorum requirements despite their dispersed ownership structure.31 The SEC attempted to replicate the old-fashioned annual meeting when it adopted early proxy rules.32 The most fundamental right that shareholders are entitled to exercise at the annual meeting is nominating and electing directors.33 Rule 14a-8 of the Securities Exchange Act of 1934 (Exchange Act), however, allows management to exclude from its proxy materials a shareholder proposal that relates to nomination or election of the board of directors.34 This exclusion forced shareholders to conduct and to finance any directorial challenges by themselves.35 As a result, a shareholder’s ability to nominate and elect directors was impeded.36 This impediment, which had been debated for decades, was finally adjusted as a result of the new financial legislation, in ways that both acknowledge and stymie the new inside-out paradigm.37

35. Delaware law now allows shareholder to propose bylaws that require a company to reimburse shareholders who gain board representations for expenses relating to proxy contests. See infra text accompanying note 61 (discussing Delaware’s amendments to the Delaware Corporation Law).
36. See Fisch, supra note 31, at 1165 (arguing that, although the SEC rules do not prevent a shareholder from nominating a candidate or slate of candidates in opposition to management’s choices, they impede the ability of a shareholder to do so); see also John Pound, Proxy Contests and the Efficiency of Shareholder Oversight, 20 J. FIN. ECON. 237 (1988) (arguing that three problems, including the inefficiency in the system of proxy vote solicitation, may discourage the use of proxy contests to challenge management and transfer corporate control).
B. History

Shareholder access to the proxy process relating to the nomination or election of directors has undergone extensive change in the past 60 years. Because there have been no formal legislative developments, our historical review of the shareholder proxy access focuses mostly on regulatory actions taken by the SEC, along with a few influential judicial decisions that eventually prompted regulatory proposals. Due to the surge in regulatory attention in the past decade, we divide the evolution of shareholder proxy access into pre-2003 period and post-2003 period.

1. Pre-2003 Period

During the period from the enactment of the Exchange Act to 2003, the SEC, on several occasions, considered the issue whether shareholders can use management’s proxy materials for the purpose of director nominations and elections, without formally proposing to expand shareholders’ proxy access. In 1942, the SEC directed the staff to review then-effective proxy rules and submit proposed changes in order to address ballot access for shareholder proposals, including those in connection with director elections. One proposed rule would have revised the proxy rules to provide stockholders with an opportunity to “use the management’s proxy materials in support of their own nominees for directorship, as well as for the nominees of the management.” The SEC, however, did not adopt the proposed changes relating to proxy access and did not explain its decision.

In 1977, as part of a broad review of shareholder communication and participation in corporate governance, the SEC revisited the issue of shareholder proxy access. Without proposing rule changes, the SEC requested comments on “whether ... shareholders [should] have access to management’s proxy soliciting materials for the purpose of nominating persons of their choice to serve on the board of directors.” Meanwhile, the SEC asked questions about the eligibility of nominating shareholders, the disclosure requirements, the interplay with state law, and the distinction between control and non-control nominations. After holding a series of public hearings in 1997, the SEC proposed and adopted amendments to a number of proxy rules, none of which directly

38. It is worth noting that the Exchange Act did not include specific rules on these proxy solicitation issues when it was enacted. See Fisch, supra note 31, at 1137–38 (discussing implications of the changes’ deference to business owners’ judgment). To address shareholders’ complaints that management’s failure to include shareholder proposals in the company’s proxy materials made its proxy solicitation false and misleading, the SEC amended proxy rules and adopted Rule 14a-8 in 1942 to require management to include in its proxy statement any shareholder proposal that was “a proper subject for action by the security holders.” Id. at 1143–44.


42. Id.

43. Id.
addressed the issue of shareholder proxy access. Among these amendments, the SEC required companies to state whether they had a nominating committee, and if so, whether the nominating committee would consider shareholder recommendations. A staff report submitted to the Senate in 1980 concluded that due to the emerging concept of nominating committee, the SEC should not propose and adopt a shareholder access rule at that time. The staff report did, however, suggest the possibility of taking future actions with respect to shareholder nominations if the nominating committee did not serve as a satisfactory solution to shareholder nominations.

In 1992, the SEC reviewed the proxy access issue in connection with an amendment to Exchange Act Rule 14a-4, which provides that to establish a bona fide nominee, the nominee must consent to being named and to serve if elected. The amendment sought to decrease “the difficulty experienced by shareholders in gaining a voice in determining the composition of the board of directors.” In this setting, the SEC declined to require companies to include both management nominees and shareholder nominees for directorship in the same universal ballot. Rather, it revised the bona fide nominee rule to allow shareholders to fill out a “short slate” with management nominees, in which case shareholders seeking board representation would still need to file separate proxy statements and cards.

2. Post-2003 Period

Starting in 2003, at a time when the use of the proxy process by outsiders had become increasingly common, the SEC took a more active role on shareholder proxy access. This period also witnessed several seminal judicial decisions with respect to procedures for shareholder participation in board nomination. In April 2003, the SEC directed the Division of Corporate Finance to review the proxy rules and solicited public comments with regard to the Division’s review. The Division later recommended changes to enhance shareholder access to the proxy process relating to director


45. Id.

46. This conclusion is based on the work of a task force on Corporate Accountability. See DIVISION OF CORP. FIN., SEC, STAFF REPORT ON CORPORATE ACCOUNTABILITY A60–64 (Sept. 4, 1980) (printed for the use of Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess.) (recommending that the SEC not move forward on proxy access).

47. Id. at A60–65, A69.


50. The “short slate” rule allows shareholders who seek minority board representation to include some of the management’s proposed directors on their own slate. SEC Rule 14a-4(d), 17 C.F.R. § 240.14a-4. Under this rule, the shareholders can nominate board candidates of their choice and indicate which management candidate(s) they oppose, to make room for the new candidates. See also Governance Glossary, COUNCIL OF INST. INVESTORS, http://www.cii.org/governanceglossary#s (last visited Oct. 12, 2011) (defining the rule as allowing shareholders to nominate directors for a board and then indicate which nominees they will withhold their votes from to make room for new candidates).

nominations.\textsuperscript{52} In October 2003, the SEC proposed rules that would have required companies to include shareholder nominees in company proxy materials under certain circumstances, for the purpose of addressing perceived inadequacies of shareholder participation in the director nomination and elections.\textsuperscript{53} However, the SEC ultimately did not adopt the proposed rule.

In 2006, the Court of Appeals for the Second Circuit held in \textit{AFSCME v. AIG} that a shareholder proposal that sought to amend the corporate bylaws to establish a procedure by which shareholder-nominated candidates may be included on the corporate ballot did not relate to an election within the meaning of Rule 14a-8(i)(8) and therefore could not be excluded from corporate proxy materials under that regulation.\textsuperscript{54} In response to \textit{AFSCME v. AIG}, in 2007 the SEC proposed two alternative rules regarding the election exclusion set out in Rule 14a-8. The first would have allowed companies to exclude shareholder nomination bylaw proposals from the company’s proxy materials.\textsuperscript{55} The second proposal, on the other hand, would have required companies to include those shareholder proposals in company proxy materials upon certain conditions.\textsuperscript{56} The SEC adopted the first proposal, ostensibly to provide certainty to companies and shareholders.\textsuperscript{57}

Two years later, the Delaware Supreme Court weighed in with \textit{CA, Inc. v. AFSCME}.\textsuperscript{58} \textit{CA, Inc.} addressed a proposed shareholder bylaw that would have required the Board of Directors of CA, Inc. to reimburse the reasonable expenses incurred by stockholders in conducting successful proxy contests.\textsuperscript{59} The court held that while it was a proper subject for stockholder action under Delaware law, the proposed bylaw, if adopted, could have precluded directors from fully discharging their fiduciary duties.\textsuperscript{60}

After \textit{CA, Inc.}, Delaware amended the Delaware General Corporation Law to add Section 112, which explicitly permits Delaware corporations to provide shareholders with access to the corporation’s proxy solicitation materials in order to nominate directors. Delaware additionally added Section 113, allowing bylaws that require a corporation to reimburse expenses incurred by a stockholder in soliciting proxies to elect directors.\textsuperscript{61} Neither is automatic. Each requires that shareholders first propose a bylaw amendment.

\textsuperscript{52} \textsc{Division of Corp. Fin., SEC, Staff Report-Review of the Proxy Process Regarding the Nomination and Election of Directors (2003), available at} \url{http://www.sec.gov/news/studies/proxyreport.pdf}.

\textsuperscript{53} \textsc{Exchange Act Release No. 34-48,626, 68 Fed. Reg. 60,784, 60,794 (Oct. 23, 2003) (explaining that shareholders need to meet ownership threshold for two years as of the date of the nomination).}

\textsuperscript{54} \textit{AFSCME v. AIG, 462 F.3d 121, 125 (2d Cir. 2006). Rule 14a-8(i)(8) as then effective provided that management could exclude from the company’s proxy materials a shareholder proposal that “relates to an election for membership on the company’s board of directors or analogous governing body.” Id. The SEC later amended this rule to include nomination of directors as an additional ground for excluding shareholder proposals. Id.}

\textsuperscript{55} \textsc{Exchange Act Release No. 34-56,914, 72 Fed. Reg. 70,450 (Dec. 6, 2007).}

\textsuperscript{56} \textsc{CA, Inc. v. AFSCME, 953 A.2d 227 (Del. 2008).}

\textsuperscript{57} \textit{CA, Inc. v. AFSCME, 953 A.2d 227 (Del. 2008).}

\textsuperscript{58} \textit{Id. at 229.}

\textsuperscript{59} \textit{Id. at 240.}

\textsuperscript{60} \textsc{Del. Code Ann. tit. 8, §§ 112–13 (2010). Amended Section 112 is discussed in more detail in Part C.1, infra.}
authorizing the inclusion of shareholder proposals or reimbursement of expenses.

In May 2009, the SEC voted 3-2 to propose rules that would require companies to place shareholder nominees on company proxy materials and additionally to include shareholder proposals on proxy access in their proxy materials.62 In the face of substantial resistance, and as the new financial regulation was being debated, the SEC delayed implementation. After Dodd–Frank was enacted the SEC quickly issued new, final rules.63 The rules were immediately challenged and the D.C. Circuit struck them down as an impermissible exercise of the SEC’s rulemaking powers before the rules had been fully implemented.64

C. The State of Play on Proxy Access

1. The SEC’s Basis for Acting

Chairman Schapiro cited the 2008 financial crisis as a catalyst for the SEC’s push for proxy access:

The nation and the markets have recently experienced, and remain in the midst of, one of the most serious economic crises of the past century. This crisis has led many to raise serious questions and concerns about the accountability and responsiveness of some companies and boards of directors to the interests of shareholders. These concerns have included questions about whether Boards are exercising appropriate oversight of management, whether Boards are appropriately focused on shareholder interests and whether Boards need to be more accountable for their decisions regarding such issues as compensation structures and risk management.65

2. The Ill-Fated SEC Proxy Access Rule

Among other adjustments, the short-lived new SEC proxy access rule created a new Rule 14a-11 and modified Rule 14a-8(i)(8).66 Under the new Rule 14a-11, shareholders could include their own director nominees in a company’s proxy materials subject to certain limitations. Rule 14a-11 was limited with regard to: first, which shareholders could nominate directors on the proxy materials; and second, how many directors could be nominated by eligible shareholders.

As noted, Rule 14a-11 imposed minimum shareholding requirements and other restrictions on shareholders who wished to invoke proxy access. Shareholders wishing to

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66. Following convention, we will refer to the changes as the proxy access “rule” rather than rules from this point forward, although it involves changes to multiple rules and regulations. The new rule is explained in detail in Facilitating Director Nominations, Exchange Release Nos. 33-9136; 34-62,764, 75 Fed. Reg. 56,668 (Aug. 25, 2010) (codified at 17 C.F.R. pts. 200, 232, 240, 249).
gain access to Rule 14a-11 needed to hold at least three percent of the stock of the corporation, either individually or as part of a group. Shareholders also were required to represent that they have continuously beneficially owned the securities used for the purposes of determining the ownership threshold for at least three years as of the date of the shareholder notice; and that they would continue to own the qualifying securities through the date of the annual or special meeting. The shareholders must further represent that they did not intend to acquire or hold the securities for the purpose of or with the effect of changing control of the company or to gain more than a limited number of seats on the board, and that there was no relationship between the nominees and the nominating shareholder or group. As we shall see, the three year holding requirement would have had the effect of limiting which outsider investors could plausibly take advantage of the rule.

The second key parameter is the number of directors that shareholder proponents would have been entitled to nominate. Rule 14a-11 required a company to include on its proxy materials no more than the greater of: one shareholder director nominee, or the number of nominees that represented 25% of the company’s board of directors. This provision was designed to ensure that shareholders did not use this new rule to effect a change of control. If multiple shareholders or shareholder groups were eligible to nominate directors, the shareholder group with the highest percentage of stock would be able to include up to the maximum number of shareholder nominees allowable in the company’s proxy materials. If this shareholder or shareholder group did not use up the maximum number of nominations allowed, then the shareholder or group with the next largest stake could submit its nominations. This would continue until the maximum number of allotted nominations was used up.

3. Delaware’s Limited Addition to Proxy Access

On July 24, 2009, Delaware amended Section 112 to authorize shareholders to amend a company’s bylaws to require the company to include shareholder nominated directors on proxy materials:

The bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required, to the extent and subject to such procedures or conditions as may be provided in the bylaws, to include in its proxy solicitation materials (including any form of proxy it distributes), in addition to individuals nominated by the board of directors, one or more

68. Id. § 240.14a-11(b)(2).
69. Id.
70. Id. § 240.14(a)-11(b)(6).
71. Id.
72. See infra note 118 and accompanying text (discussing hedge funds’ use of the proxy process).
73. 17 C.F.R. § 240.14a-11(d)(1).
74. Id. § 240.14(d)(3). As we shall see, Italian corporate law offers a more sensible alternative that does not privilege the shareholders who file first. See infra notes 102–03 (providing information about Italian corporate law).
75. 17 C.F.R. § 240.14(e)(1).
76. Id.
individuals nominated by a stockholder.\textsuperscript{77} A key difference between Delaware’s new law and the SEC proxy access rule is that Delaware’s Section 112 requires a shareholder (except in the unlikely situation where the directors themselves amend the bylaws in this regard) to persuade fellow shareholders to adopt a bylaw amendment requiring that their board nominees be included on proxy materials, whereas the SEC rule requires inclusion in the first instance. Another way of looking at it is that Delaware has essentially established an “opt-in” shareholder nominee proxy access regime while the SEC has established an “opt-out” regime.

It is not clear what Delaware sought to do with the new Section 112. Even before the new Section 112, Delaware law probably allowed a corporation’s bylaws or charter to provide proxy access.\textsuperscript{78} If we assume that the new provision at least removes uncertainty about the legality of a bylaw proposal calling for proxy access, there remains the question of why Delaware would adopt such a limited reform—a reform that allows for the possibility of proxy access, but requires shareholders to first wage a full-blown proxy contest over the bylaw that would authorize it. The most likely explanation is that Delaware was sending a signal to Congress. Recent scholarship has pointed out that Delaware’s main competition as the leading source of corporate law is Congress, not the states.\textsuperscript{79} Particularly in recent years, a variety of developments in Delaware seemed designed to show that Delaware “gets it”—that Delaware is effectively regulating corporate law, and that Congress therefore does not need to step in.\textsuperscript{80} This suggests that Delaware may have enacted Section 112 in order to preempt SEC intervention on proxy access. If preemption was the motive, Delaware’s intervention was unsuccessful, given the SEC’s immediate re-occupation of the field. With the SEC rule at least temporarily invalidated, however, the Delaware changes have become significant once again.

\textbf{4. Delaware’s New Proxy Expense Rule}

Delaware’s new Section 113, which authorizes shareholder bylaws that require their company to reimburse proxy expenses in a directorial contest, effectively overrules the \textit{CA, Inc.} case and thus marks a genuine increase in shareholder power under Delaware law.\textsuperscript{81} With the corporation paying expenses, shareholders could more easily exercise power in director elections. One caveat is that like Section 112, Section 113 is an opt-in section,\textsuperscript{82} so shareholders must first amend the bylaws to obtain this grant of greater shareholder power.


\textsuperscript{81} \textit{DEL. CODE ANN. tit. 8, § 113} (2010).

\textsuperscript{82} Id.
D. Proxy Access: Current Scholarly Debate

For over 60 years, the SEC has been fluctuating between increasing shareholder rights and retreating from its role as shareholder advocate. When the SEC issued the proposal (Proposal) that led to the short-lived new rule, the Proposal received a massive amount of comments.83 A survey undertaken by Davis Polk & Wardwell LLP upon review of 41 of the comment letters submitted to the SEC summarizes the main concerns and issues raised by several constituencies.84 These comments closely track the academic debate on proxy access, and sharply frame the current views.

Public pension funds, institutional shareholders, and shareholder activists were among the principal proponents of the Proposal. The Council of Institutional Investors advocated “reasonable” access by long-term shareholders as well as groups of shareholders to company proxy materials to nominate directors.85 On the other hand, the Proposal was fiercely opposed by the Business Roundtable,86 the U.S. Chamber of Commerce,87 and many major corporate law firms.88 The U.S. Chamber of Commerce warned, for example, of the costs of the “unwise, unnecessary” Proposal, and the danger that it would weaken the functioning of the board and would favor some shareholders over others.89

The academic debate divided along similar lines. Supporters of the Proposal argued that proxy access should be the default rule, because it is easier for directors to propose that the company opt-out than for shareholders to successfully wage a campaign to pursue the company to opt-in.90 According to Lucian Bebchuk, the most prominent academic advocate for increased shareholder voting power,91 “the choice of default in corporate and securities law should depend on which selection would be more easily

85. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Elizabeth Murphy, Secretary, SEC 2 (Aug. 4, 2009), available at http://www.sec.gov/comments/s7-10-09/s71009-78.pdf.
86. “This is an unprecedented preemption of state corporate law—the bedrock of corporate governance—that will turn the boards of more than 15,000 publicly-traded companies into political bodies and threaten their ability to function.” John J. Castellani, President, Bus. Roundtable, Address at Business Roundtable on SEC Proxy Access Proposal (May 20, 2009), available at http://businessroundtable.org/news-center/business-roundtable-statement-on-sec-proxy-access-proposal/.
89. Letter from David T. Hirschman, supra note 87, at 2.
‘reversible’ by shareholders wishing to see it changed.”

In Bebchuk’s view, the “asymmetry between opt-outs favored and disfavored by the board strengthens the case for selecting proxy access as the default rule.”

Because shareholders cannot easily opt-in or opt-out of rules without the board’s support, it is therefore difficult for shareholders to adopt desirable rules that boards oppose.

Some supporters advocated proxy access but did not endorse all the details of the Proposal. A group of law professors argued in a letter to the SEC that the one percent threshold in the original Proposal was “too low” and could lead to “chaotic elections,” which would consequently distract the board. As a first step, they proposed to raise the threshold to a range of five to ten percent, which could be lowered and adjusted subsequently to the market’s response to the application of the Proposal.

Opponents called for private ordering and opposed the implementation of a uniform mandatory proxy access rule. They called for a more “incremental approach” that would simply amend Rule 14a-8 to preclude companies from excluding proposed proxy access bylaw changes from the company’s proxy materials. They characterized this approach as the traditional state law framework.

Perhaps the most remarkable attribute of the debate is that no one argued that proxy access should be prohibited altogether. Opponents argued only that shareholders should be required to demonstrate their support for it by affirmatively opting in, not that proxy access should be prohibited. It is impossible and impractical, they argued, to establish a mandatory federal proxy access regime that is applicable to 12,000 publicly traded companies in the United States.

Similarly, the Delaware State Bar Association criticized the proposal as “inconsistent with the overall philosophy of the Delaware General Corporation Law: to enable stockholders and boards to establish their own corporation’s internal rules in light of the wide variety of circumstances in which Delaware corporations function, rather than to limit their ability to do so.”

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92. Bebchuk & Hirst, supra note 90, at 10 (citing Lucian A. Bebchuk & Assaf Hamdani, Optimal Defaults for Corporate Law Evolution, 96 Nw. L. Rev. 489, 489 (2002)).

93. Id. at 11.

94. Similarly, Marco Ventoruzzo points out that only three out of hundreds of listed companies incorporated in Delaware have adopted proxy access under unique circumstances. Ventoruzzo, supra note 78, at 19. Unlike Bebchuk, Ventoruzzo argues that shareholders should be guaranteed representation on the board as under Italian law, a stance we discuss in Part E below. Id.


96. See Letter from Cravath, Swaine & Moore LLP et al., supra note 88, at 7. One of the SEC commissioners, Troy Paredes, took a similar stance. Troy A. Paredes, Commissioner of the SEC, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), available at www.sec.gov/news/speech/2009/spch052009ap.htm (recommending “amending Rule 14(a)-8(i)(8) to permit shareholders to include in the company’s jurisdiction of incorporation has adopted a provision explicitly authorizing a proxy access by law”).


98. See Joseph Grundfest, The SEC’s Proposed Proxy Access Rules: Politics, Economics, and the Law, 65 BUS. LAW. 361, 363 (2010) (arguing that it makes more sense to support a fully enabling approach to proxy access that allows all publicly traded corporations to determine the rules governing shareholder access to corporate proxy by majority vote).

99. Letter from the Delaware State Bar Association to Elizabeth M. Murphy, Secretary, SEC 5 (July 24,
E. An Italian Alternative

In Italy, unlike the United States, the principal agency problem is not between the shareholders and managers but rather between shareholders with a controlling interest and the minority shareholders.\textsuperscript{100} The most obvious responses to the conflict are either to reserve a seat on the board for minority shareholders or to limit the voting rights of the majority shareholders. Since the end of 2005, Italy has adopted the former approach, requiring that at least one position on the board of directors be reserved for minority shareholders.\textsuperscript{101} On the basis of the 2005 law, all listed corporations were required to amend their bylaws to give force to this provision and ensure that at least one director on their boards was elected by means of a so-called alternative list to represent the interests of minority shareholders.\textsuperscript{102} The law gave companies flexibility in determining the minimum amount of stock a minority shareholder or group needed to have to present its own “slate” of directorial nominees, but required that the percentage be not greater than 2.5%.\textsuperscript{103}

It is worth pausing to note how far the Italian approach to protecting minority shareholders diverges from U.S. corporate governance. In the United States, the watchword is shareholder power and proxy access is designed to make shareholder voting more meaningful. In Italy, by contrast, shareholder voting is secondary; the objective is to put minority representatives on the board. The most obvious explanation for the distinction is the prevalence of controlling shareholder blocks in Italy, as compared to the more fluid nature of shareholdings in the United States. But the distinction also seems to reflect different emphases in the two countries: voting is privileged in the United States, negotiation (with minority shareholders given a seat at the table) in Italy.

Prior to a March 2006 revision of the Italian Stock Exchange’s corporate governance code, election of directors was conducted by means of secret ballot. This caused a serious problem in ensuring that the minority shareholder chose the minority representative as it was impossible to ascertain which shareholders were voting for the different slates of directors. In March 2006, the Italian Stock Exchange revised its Corporate Governance Code to recommend that: “(a) Italian listed companies, while complying with the secret ballot requirement, still ‘ensure transparency in the selection and appointment process of directors’ and (b) qualified shareholders of Italian listed companies (including controlling shareholders and institutional investors) spontaneously declare their votes in the shareholders’ meetings for the appointment of the directors.”\textsuperscript{104}

\textsuperscript{100} See, e.g., Marcello Bianchi et al., Pyramidal Groups and the Separation between Ownership and Control in Italy, in THE CONTROL OF CORPORATE EUROPE 154 (Fabrizio Barca & Marco Becht eds., 2001) (analyzing the high concentration of direct ownership in the Italian corporate governance system).

\textsuperscript{101} Legge 28 dicembre 2005, n. 262 (It.).


\textsuperscript{103} Id. at 7. In addition, under Article 148, par. 2, of the TUIF, CONSOB, the Italian securities regulator, was required to mandate a procedure to be followed by listed companies for the election of a representative of the minority shareholders to represent them on the board of auditors, thus taking away the power of the companies to formulate their own election and nomination processes. Id. at 12.

\textsuperscript{104} Stefano Crosio & Gherardo Cadore, New Corporate Governance and Minority Shareholder Protection Rules for Italian Listed Companies, THE METRO CORP. COUNSEL, May 2006, at 36, available at
An issue that has generated widespread discussion in Italy, and may also have relevance for the United States, is the question whether minority shareholders will in fact place directors on the boards of most large Italian companies. The number of minority directors remains quite small; some observers suspect that the controlling shareholders of some companies have struck deals with the largest minority shareholders in return for the shareholders’ promise not to propose a slate of directors. This observation echoes concerns that proxy access in the United States will be used strategically, though the concerns are in sense mirror images: in Italy, the issue is hidden deals; in the United States it is, as discussed in the next Part, strategic use by outsiders of the “megaphone” of a public directorial election process.

F. Proposals

The scholarly debate on proxy access in general, and on the ill-fated SEC rules in particular, divides along much the same lines as the comment letters discussed earlier. In the discussion that follows, we briefly summarize the debate. Throughout the discussion, we highlight its implications for inside-out governance.

One problematic feature of the new rule was its inclusion of only the proposal made by the shareholder or group with the largest stake. This process runs directly counter to how a shareholder meeting would work. At an ordinary shareholder meeting, any shareholder—or any shareholder meeting a qualifying minimum stock ownership threshold—would be permitted to nominate a director, not just the shareholder with the highest percentage. The rule also limited access to shareholders who have held the stock for three years, which serves no evident purpose other than discouraging investors like hedge funds who buy stock in order to shake up the company’s governance from making use of proxy access.

There is no reason to believe that minority directors would routinely be elected, but this is not inherently problematic. In the United States, unlike in Italy, the empowerment of minority shareholders, with minority representation on the board, is less essential, given the relative paucity of American firms that are dominated by a controlling

[105] Evasion of the new governance rules was also a major concern after the major financial scandals broke out in the early 2000s. In spite of the existence of corporate governance rules in the form of the Preda Code, many Italian companies were either not following the code or circumventing its provisions. For example, if one looks at the board of directors of Parmalat Finanziaria it may be noted that the Board was composed of 13 members. Four of them, including the Chairman-CEO, were linked by family ties. With regard to the composition of the board, it is also interesting to observe that eight Parmalat Finanziaria directors also sat on the board of directors of Parmalat S.p.A., including all the members of the executive committee and one non-executive director. Thus, the company was not following the corporate governance requirements stipulated under the Preda Code. Andrea Melis, Corporate Governance Failures: to What Extent is Parmalat a Particularly Italian Case?, 13 CORP. GOVERNANCE 478, 484 (2005), available at www.csid.com.cn/upfile/vod/EU_SMEs/corporate%20governance.pdf.

[106] See supra note 74 and accompanying text (discussing U.S. and Italian approaches to nomination of directors by shareholder proponents).

[107] Delaware leaves the specific mechanics of elections to the corporation. DEL. CODE ANN. tit. 8, § 112 (2009).

[108] See note 68 and accompanying text (noting that Rule 14a-11 required shareholders seeking to invoke proxy access to hold the requisite amount of stock for three years).
shareholder. Moreover, it is not clear that new minority directors would often improve firm performance. While many support having a majority of independent directors, and some have called for a “devil’s advocate” or “chief naysayer” on the board, there is no strong correlation between board composition and firm performance. Several studies suggest that a board composed of a supermajority of independent directors may even perform worse than firms without such boards.

Much of the criticism of the new rule, both before and after its promulgation, focused on the possibility that unions and pension funds may use the new shareholder empowerment strategically. Joseph Grundfest argued, for instance, that the rule will create “megaphone externalities,” by enabling institutional shareholders, who have no knowledge of corporate governance or who might be motivated by political or not-for-profit goals, to place directors on the board who would be disruptive, and only interested in pushing an agenda which is not in the best interest of the corporation. This concern seems overstated, however. Union funds generally do not hold enough stock to meet the three percent threshold. In consequence, their frequent use of Rule 14a-8 to include proxy proposals in the company’s proxy materials, which requires only $2000 in stock holdings, does not mean they would be similarly active in invoking proxy access.

Michael Wachter and William Bratton have recently suggested a different argument against proxy access. Reform agendas that increase shareholder power, they claim, would undermine efficient corporate decision making by forcing managers to manage to the market. While this is a legitimate concern, access to nominating directors, unlike involvement in business decision-making that has long been reserved for directors and management, is a traditional shareholder right granted by state law. Moreover, their concern that managerial prerogatives be respected is in a sense a plea for traditional insider corporate governance in the face of an increasingly pervasive shift to inside-out governance.

In our view, if the SEC reintroduces the rule, it should alter the rule’s shareholding requirements in two ways to better maintain the historical continuity of shareholding while recognizing the interconnected, inside-out character of current corporate governance.

116. Id. at 659.
117. See, e.g., DEL. CODE ANN. tit. 8, § 216(3) (2009) (directors chosen by shareholder vote).
governance. The most important problem is the three-year holding requirement. Given that the outsiders most likely to use the proxy process are hedge funds, and hedge funds rarely hold stock for long periods, the holding requirement makes the new rule incoherent: it purports to facilitate outside governance, yet stymies the one constituency that is most likely to use it.\textsuperscript{118} In our view, sharply reducing the holding period is essential.

In contrast to the holding period, which should be reduced, the three percent shareholding requirement should be raised to at least five percent. Setting the threshold at five percent, and permitting every shareholder or group that qualified to nominate directors would further discourage the use of proxy access purely for megaphone reasons, as megaphone shareholders often own fairly low percentages of the company’s stock. Proxy access would be used more often by multiple shareholders working together, and it would more closely replicate the shareholder meetings of the pre-proxy era, where each shareholder or shareholder group would have represented a meaningful block of the company’s stock. At the same time, it would not destabilize inside governance because minority representation is limited and the access could not be used for a takeover.

III. THIRD-PARTY GATEKEEPERS: AUDITORS AND CREDIT RATING AGENCIES

A. Introduction

In the wake of the 2008 crisis, investors in the United States are once again cognizant of the reliance on third-party gatekeepers that was often the focus of concern following the collapse of Enron and WorldCom in the early 2000s. In this Part, we will evaluate two significant and analogous gatekeepers in the U.S. market: auditing firms and credit rating agencies. Both shape many investors’ investment decisions, with auditors providing the public’s primary “check” on corporate financial reporting and credit rating agencies serving, in many contexts, as the primary external evaluators of corporate debt. Both also are the earliest and most familiar exemplars of inside-out governance.

We begin by surveying the historical development of the two industries, as well as current proposals for reform—both in terms of ex ante regulation and ex post loss allocation through litigation. In the second Part, we examine the recent scholarly debate. We then draw on insights from Italy and the European Union in developing our own proposed treatment of auditors and credit rating agencies. In the final Part, we use the insights of the earlier discussion and analysis to assess the new Dodd–Frank reforms, some of which mirror our own analysis but others of which do not. Although inside-out governance creates a serious conflict of interest that cannot realistically be removed, we conclude that several simple reforms could limit its detrimental effects.

\textsuperscript{118} Marcel Kahan and Ed Rock make a similar point. They show that the constituency most likely to use the proxy process with large firms is hedge funds, yet hedge funds do not hold stock for long periods. Kahan & Rock, supra note 113. For smaller firms, the most active constituency is ex-insiders. \textit{Id}. 

B. History of Auditing and Credit Rating

1. History of the Auditing Industry in the United States

Efforts to set and enforce profession-wide standards in auditing date back to 1941, when the Institute of Internal Auditors (IIA) was formed to govern the practice of internal auditing. The next major advance came in 1947, when the American Institute of Certified Public Accountants' adopted the Generally Accepted Auditing Standards (GAAS). The standards seek to ensure that auditors have both the technical training required and an independent perspective on their work so that opinions on financial statements’ compliance with the Generally Accepted Accounting Principles (GAAP) will be meaningful.

The collapse of Enron, WorldCom, and Tyco in 2001 and 2002 brought major agency problems in the accounting industry to light. Because the auditors’ largest clients were so important to their bottom line (or in the case of Arthur Andersen, the bottom line of a segment of the firm), the auditors faced tremendous pressure to whitewash any problems discovered in the audit. Many commentators also believe that accounting firm’s desire to obtain lucrative consulting work from their audit clients also discouraged tough audits.

In 2002, Congress responded to the auditing fraud scandals by passing the Sarbanes–Oxley Act (SOX). SOX set forth standards for both the internal and external auditing functions in public companies. Significant requirements of SOX included provisions for increasing the independence of interests between external auditors and management (through mechanisms like the study of an auditor rotation requirement and a prohibition on auditors’ providing consulting or other services to clients), an expansion of the requirements for financial disclosures, and the creation of criminal liability for executives who fraudulently certify the accuracy of a firm’s financial statements. SOX also created the Public Company Accounting Oversight Board (PCAOB), an agency that evaluates auditing firms’ compliance with the Act. These reforms have been among the more successful of the SOX reforms, but problems remain, as we shall see.

121. COFFEE, supra note 1.
122. Enron filed for bankruptcy on November 30, 2001 and WorldCom on July 21, 2002. Along with the collapse of the companies, several executives of Enron and WorldCom were criminally convicted. Arthur Andersen LLP forfeited its CPA license after being convicted of obstruction of justice in 2002. The conviction was later vacated in Arthur Andersen LLP v. United States, 544 U.S. 696 (2005), but Arthur Andersen LLP is no longer a viable participant in the auditing industry. These developments are discussed in some detail in id.
126. Id. § 301 (codified at 15 U.S.C. § 7241); id. § 906(a) (codified at 18 U.S.C. § 1350).
128. One irony of SOX is that some of its other provisions—most importantly, the requirement in Section
2. History of the Credit Rating Industry in the United States

Despite the significant impact of credit rating agencies’ evaluations on the investor community, the industry has been largely unregulated. In 1973, the SEC promulgated Rule 15c3-1, which incorporated the ratings of “Nationally Recognized Statistical Rating Organizations” (NRSROs) into broker-dealers’ permitted calculation of capital requirements. The new rule greatly expanded the significance of credit ratings. After the fall of Enron and WorldCom, potential regulation of credit rating agencies was once again at the forefront of financial regulation concerns. Tentative strides toward greater regulation in the industry came with the passage of SOX in 2002. Under Section 702 (b), the SEC was required to prepare a report evaluating the performance of credit rating agencies. In January 2003, the SEC issued its report, discussing conflicts of interest and the lack of transparency in the industry. In its report, the SEC highlighted the most troublesome practices in the credit-rating industry, including the conflict inherent in the standard “issuer pays” model (in which the issuer pays a credit-rating agency to rate its securities), conflicts arising from credit-rating agencies’ offering of consulting services to firms that they rate, and the inadequacy of agencies’ disclosure of the rationale behind ratings. The report was opened for public comments in June 2003.

As a result, Congress passed the Credit Rating Agency Reform Act of 2006. The Act requires the SEC to precisely define the requirements for NRSRO registration. It also gives the SEC authority to regulate matters of internal control in credit-rating agencies. In 2007, the SEC promulgated rules to implement the Act.

C. Recent Developments in the Regulation of Auditors and CRAs

1. Developments in the Auditing Industry

Since the passage of SOX in 2002, the auditing industry has seen little regulatory development. The most important controversy has involved a constitutional challenge to the PCAOB. The Supreme Court upheld the Board in summer 2010, ending the uncertainty over its status.

404 that companies establish internal controls—created a huge increase in demand for auditors’ services, despite the fact that auditors had performed so poorly in their gatekeeping role before the scandals. Id. § 404 (codified at 15 U.S.C. § 7262).

129. SEC Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (2009).
130. Sarbanes–Oxley Act § 702(b).
132. Id.
134. Id.
136. Id.
2. Current Developments in the Credit Rating Industry

Concerns about credit-rating agencies figured much more prominently in the legislative debate around financial regulation, than in the legislation that passed. The most important change, which mirrors the approach we advocate below, is to delete the references to credit ratings in a variety of laws and regulations.\footnote{Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 939, 939A, 124 Stat. 1370, 1885–88 (2010); SEC, REPORT ON REVIEW OF RELIANCE ON CREDIT RATINGS (2011), available at http://sec.gov/news/studies/2011/939astudy.pdf; FED. RESERVE BD. OF GOVERNORS, REPORT TO THE CONGRESS ON CREDIT RATINGS (2011), available at http://www.federalreserve.gov/publications/other-reports/files/credit-ratings-report-201107.pdf.} The practical effect, if the instructions are fully implemented, will be to remove pressure on insurance companies, pension funds, and others to invest in securities that have been given a credit-rating agency’s seal of approval. The new legislation also makes it somewhat easier to sue a credit agency by stating that the Exchange Act of 1934 applies to credit-rating agencies to the same extent as to accounting firms and securities analysts.\footnote{Dodd–Frank § 933.} If this provision is implemented, it will mark a major expansion of potential liability, and it will figure prominently in our discussion below (as an after-the-fact, or ex post, mechanism for policing these gatekeepers).

Finally, Dodd–Frank imposes other requirements on credit rating agencies, to be implemented primarily through the SEC’s authority over Nationally Recognized Statistical Rating Organizations (NRSROs).\footnote{Id. §§ 933(a), 934, 935 (codified at 15 U.S.C. § 78o-7 (2009)). Note that, under the Act, an agency would be permitted to withdraw from registration with the SEC upon a showing that it receives less than $250 million in annual revenue from credit rating services, H.R. 4173, 111th Cong. § 6002(a)(5) (2009).} Under Dodd–Frank, the Commission will review the process and performance of credit rating agencies to evaluate the agencies’ internal controls.\footnote{Dodd–Frank § 932.} It will also require agencies to disclose (to a limited extent) the methodologies by which they establish credit ratings for structured securities.\footnote{Id.} Dodd–Frank further mandates certain corporate governance mechanisms in NRSROs, including requirements that one-half of an agency’s Board of Directors be independent directors and that some must be “ratings users.”\footnote{Id.} It also empowers the Commission to promulgate rules for the disclosure of conflicts of interest, and for prohibitions on rating agencies’ providing certain other advising services to the firms whose securities they are rating.\footnote{Id.}

D. Auditing: Problems and Solutions from the Current Debate

1. The Agency Problem

In the absence of correctives, the managers of publicly-held corporations lack strong incentives to act efficiently due to the separation of management and risk-bearing; that is, managers do not bear the costs or reap the benefits of their actions.\footnote{Frank H. Easterbrook & Daniel R. Fischel, Close Corporations and Agency Costs, 38 STAN. L. REV.} Auditors help to
police this conflict of interests by providing objective outside oversight of the corporation’s financial statements. However, an agency problem is inherent in the system: because management pays the auditor’s salary, the auditor will be tempted to please the managers, rather than providing tough scrutiny. The conflict stemming from this inside-out dynamic may be exacerbated if the auditor also performs consulting services for the company, or wishes to do so, because the auditor may fear that the company will withhold consulting opportunities if it is dissatisfied with the audit.

Gatekeeper failure was a central theme of the corporate scandals in the early 2000s. During the Enron-era financial scandals, auditors seemed to submit to management’s authority in order to reap the rewards from managers. Auditors “acquiesced in managerial fraud,” behavior that was the result of trends that were long in development.

2. Scholars’ Solutions and Skepticism

Some scholars have argued that auditors’ conflict of interest was magnified in the 1990s by accounting firms’ desire to secure consulting work from their audit clients. But it is not clear whether this actually exacerbated the existing conflict. In a survey of the existing empirical literature, Roberta Romano did not find any evidence that an auditor’s performance of consulting functions impaired the quality of its audit. Romano characterizes SOX’s restrictions on auditing firms’ performance of non-audit services as an unsubstantiated leap.

3. The Limits of SOX

SOX partially addressed the agency problem of auditors by transferring the hiring and supervision of the auditor to a firm’s internal audit committee, which is supposed to be independent. But the company itself, rather than shareholders or a third party, still makes the decision about which auditor to use. SOX did not attempt to eliminate the longstanding inside-out dimension of the audit function.

While SOX focused on ex ante correctives, the prospect of ex post liability also is an important factor in auditor performance. SOX did little to reverse a pattern of restrictions

271, 277 (1986).
146. Id.
149. Id.
150. Coffee, supra note 147, at 304.
151. Id. at 322.
154. Coffee, supra note 147, at 336.
155. Roberta Romano’s survey of empirical studies raises appreciable doubt as to whether requiring that the directors on the audit committee be independent improves auditors performance. Romano, supra note 152, at 1530.
on auditor liability dating back to the 1990s. Auditors faced a higher chance of litigation before the 1990s brought the Public Securities Litigation Reform Act\textsuperscript{156} and the Supreme Court’s 1994 \textit{Central Bank of Denver} case, which held that Rule 10b-5 did not reach those “aiding and abetting” securities fraud.\textsuperscript{157} These two events sharply reduced the likelihood of auditor liability. Even after the Enron and WorldCom scandals, litigation against auditing firms is uncommon,\textsuperscript{158} although several judicial decisions have reinvigorated aiding and abetting liability.\textsuperscript{159}

4. Scholars’ Proposals for Auditing Reform

Auditors’ effectiveness as monitors can be increased by either ex ante or ex post mechanisms, as we have seen. A vibrant literature has developed on both. Because the leading ex ante proposals call for major structural changes to the audit relationship—a complete reworking of the inside-out relationship between auditors and the corporation—we begin with the debate over ex post liability rules. We then turn to the proposed ex ante correctives.

a. Ex Post Litigation

Under current law, a shareholder plaintiff must show that the auditor acted recklessly or knowingly—that is, with scienter.\textsuperscript{160} Some scholars, such as Frank Partnoy, believe that strict liability is the best way to prevent auditor misconduct.\textsuperscript{161} Even critics of strict liability recognize three benefits: (1) auditors would have greater incentive to act cautiously and exercise due diligence; (2) auditors would limit their level of activity by rejecting overly risky clients; and (3) courts and regulators would be saved immense costs and time.\textsuperscript{162} Opponents of strict liability fear, however, that it could have the unwanted consequence of excluding law-abiding yet riskier clients from accessing the markets, or could even lead to failure in the market for auditors.\textsuperscript{163}

Strict liability also would exacerbate the weakening of legal privilege that has characterized the post-Enron era. Spooken by the collapse of Arthur Andersen, external

\begin{footnotes}
\item[158] See John C. Coffee, Jr., \textit{Reforming the Securities Class Action: An Essay on Deterrence and its Implementation}, 106 Columbia L. Rev. 1534, 1550 (2006) (noting auditors were named as defendants in only eight cases during 2004 and 2005).
\item[159] Most importantly, in a case involving Enron, the court ruled that primary liability can extend to any person who contributes materially false or misleading information in the creation of an SEC document. Coffee, \textit{supra} note 147, at 337–38.
\item[160] \textit{See generally} Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (requiring scienter in cases brought under Section 10(b) and Rule 10b-5).
\item[162] Coffee, \textit{supra} note 147, at 347.
\end{footnotes}
Auditors have become much more aggressive in collecting information. Corporations increasingly are pressured to disclose documents that would legally be “protected by the attorney-client privilege and/or the attorney work product doctrine” as auditing firms emulate the government and demand these documents. Auditors have also insisted on costly investigations whenever circumstances seem even mildly suspicious, resulting in further danger to the legal protection some documents rightly enjoy.

Although unlimited strict liability could make auditors’ job too costly to perform, Partnoy’s modified system, which would limit the maximum permissible damages, might reduce the burden while avoiding many of the costs of other approaches. Several scholars contend that even a modified strict liability regime would be too harsh. Assaf Hamdani argues, for instance, that forcing all auditors to internalize the cost of fraudulent activity from the outset of employment with a client could potentially force law-abiding clients and auditors out of the market. A lawsuit against one branch of an international network could bring down the entire network. John Coffee also questions the potential harshness of Partnoy’s proposal. With strict liability, auditors might charge clients higher fees. A client that an auditor considers a higher risk of fraud could be charged especially high costs. Although the deterrent effect could be beneficial, there is no real guide to distinguishing honest clients from fraudulent ones at the outset of a business relationship. As Coffee notes, “some clients within each category will pay too little and others too much.”

Coffee himself proposes “stricter”—not strict or modified strict—liability. The auditor would have a certification backed by an insurance policy, which would be capped at a realistic level. As with strict liability, the gatekeeper would not need to be charged with any showing of fault, but his liability would be limited to the amount that achieves adequate deterrence. Under the proposal, if a client were found liable, the auditor would contribute to that liability up to the amount of his insurance.

Rather than pick one of strict liability approaches, or reject them altogether, we believe the most sensible approach is to allow auditors and firms to establish their

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165. Id.
166. See id. at 22–24 (noting that investigations can lead to disclosure to external audit or waiving privilege).
167. See, e.g., Kraakman, supra note 163, at 77 (noting that if costs of performance were too high, clients may seek “pliable gatekeepers”).
168. See Partnoy, supra note 161, at 545 (arguing that modified system reduces insurance costs by eliminating defense litigation costs).
169. Hamdani, supra note 163, at 63.
170. Coffee, supra note 147.
171. See id. at 347 (describing attractions of higher auditor fees).
172. Id.
173. Id. at 349.
174. Id.
liability framework by contract, subject to a statutory minimum. We are not the first to advocate this approach. Peter Wyman, former partner at PricewaterhouseCoopers, has sought for some time to convince the SEC to embrace a contractual approach. Wyman’s principal concern is that litigation could destroy one of the four remaining big accounting firms, and he envisions that firms and their auditors would sharply restrict liability. We think this is possible, but we also suspect that many of the contracts would provide for meaningful, though likely capped, liability. The contractual approach would not eliminate inside-out governance, but it would invigorate the ex post oversight of auditors.

b. Ex Ante Reform: Restructuring the Audit Relationship

Rather than seeking to improve the existing ex post liability structure, other scholars have called for a restructuring of the auditor–client relationship. Joshua Ronen and Lawrence Cunningham both propose an ex ante insurance structure. According to Ronen, the threat of liability is not strong enough to balance the potential rewards to auditors of doing management’s bidding. He argues that no outside force—legislation, regulation, or litigation—can cure the conflict of interest between management as principal and auditors as agents. Only complete removal of the agency relationship—in our terms, pure outside governance—can adequately address the conflict. The auditor should be connected to a principal whose economic interests reflect the investors’ interests. Under the reforms proposed by Ronen and Cunningham, corporations would not hire and pay auditors; rather, corporations would buy financial statement insurance, providing coverage for any misrepresentations in the financial reports of auditors. The insurance carriers would hire and pay the auditors.

According to Ronen, financial statement insurance would realign the incentives of auditors and management with shareholders and all other players. As it stands currently, auditors will likely give managers the benefit of the doubt when faced with questionable information, due to fear of losing future revenues. If the auditor’s client is an insurance company, on the other hand, it has an incentive to be much more searching. In addition to shifting to an insurance model, Ronen calls for GAAP reforms that redefine what parts of a financial statement can and should be audited. Specifically, financial statement elements that inherently are not verifiable would not be

176. This approach was suggested to us by CONSOB Commissioner and corporate law scholar Luca Enriques. Interview with Luca Enriques, CONSOB Commissioner, in CONSOB, Rome, Italy (Mar. 12, 2010).
179. Ronen, supra note 178, at 47.
180. Id. at 48.
181. Id.; Cunningham, supra note 178, at 1742.
182. Ronen, supra note 178, at 41.
183. Id.
184. See id. at 55.
185. Id. at 42.
As we discuss further below, we are skeptical about several aspects of the proposals, including the assumption that GAAP rules could effectively distinguish between verifiable and non-verifiable information and the likelihood that the market for financial statement insurance would function efficiently. We also are not optimistic that inside-out governance can be avoided.

E. Credit Rating Agencies: Problems and Solutions from the Current Debate

1. Introduction

In the literature on credit rating agencies (CRAs) and their role in the current financial crisis, three dominant problems are cited as causing the failure of CRAs to effectively perform their gatekeeping functions. First, the “issuer pays” system, whereby issuers of securities pay fees to CRAs to rate their bonds, creates a classic conflict of interest that has led to ratings shopping and arguably affected ratings quality. Second, there is little to no oversight of CRAs, their methodologies, their symbology (that is, the labels they give to their ratings), or their effectiveness. Third, there are presently no effective means to hold CRAs accountable for their actions through either public or private enforcement mechanisms. The first and third concerns closely track the problems we have just seen with the audit function. The second is unique to CRAs.

In this Part, we begin by discussing the perverse effects that competition among CRAs had in the 2000s. We then discuss the proposal—adopted by Dodd–Frank—that CRAs disclose more about their ratings process. Finally, we explore the mix of additional ex ante and ex post reforms that would be needed to more fully address the problems with credit ratings and use the insights of this analysis to assess the new legislation.

2. Ratings Shopping and the Debate Whether to End “Issuer Pays”

Prior to the scandals of the early 2000s and the 2008 financial crisis, the dependence of CRAs and other gatekeepers on maintaining a pristine reputation was thought to make collusion or miscalculation unlikely. Almost no one now holds remotely as optimistic a view of the benefits of regulation. As Partnoy notes in his assessment of the current debacle, CRAs gave high investment grade ratings to 11 big financial institutions that later faltered or failed.

Many point to the inherent conflict in the inside-out “issuer-pays” model as encouraging formalistic compliance with ratings standards rather than serious

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186. Id.
188. Infra Part III.E.3.
191. Id.
investigation of risk. Pressure to issue a higher-grade rating to a paying customer may cause the CRA to willfully ignore the real underlying risks or encourage laxity in performing their auditing function. Competition among a small number of repeat participants in complex markets like structured finance appears to have made things worse, encouraging “competitive laxity” in the principal rating agencies. Because the issuer can always solicit another rating from a different CRA, the CRA has an incentive to overrate to retain the customer and prevent ratings shopping. Because CRAs only disclose final ratings actions, the issuer receives no informational penalty on the market that might be caused by publicity of the lower rating.

Despite the significant problems with the issuer-pays model and wide acknowledgment of potential ratings inflation and agency costs it generates, there are relatively few calls to completely eliminate it or replace it with an alternative system. This may reflect either a lack of imagination in the scholarship or the fact that a purely outside approach such as an “investor pays” model, the most obvious alternative, suffers from equally serious limitations.

The most interesting and well-reasoned argument for a new, purely outside “user fee” or “investor pays” model has been made by Jeffrey Manns. Under Manns’ approach, the SEC would regulate the CRA process through a competitive bidding process that would simultaneously mediate potential conflicts of interest arising from the investor–CRA relationship and increase competition among CRAs. Marco Pagano also makes a forceful argument for a return to a user fee model, but he does not sketch out a model for doing so.

Interestingly, Senator Al Franken proposed during the Senate debates in spring 2010 that the SEC rather than the issuer arrange for credit ratings. The Franken amendment was adopted by the Senate, but essentially dropped from the final

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193. See id. at 4 (stating that the issuer pay model creates a conflict of interest); John Patrick Hunt, Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal For Improvement, 2009 COLUM. BUS. L. REV. 109 (2009) (providing a comprehensive analysis of why reputation costs are unlikely to be sufficient to guarantee high-quality or accurate ratings).

194. See PARTNOY, supra note 192, at 4 (stating that the issuer pays model creates a conflict of interest that gives CRAs an incentive to provide generous ratings); Hunt, supra note 193, at 136–37 (stating that regulators engage in competitive laxity, granting organizations the high ratings they want).

195. Hunt, supra note 193, at 121–23, 132–34 (citing studies indicating that competition between NRSROs to rate structured-finance products may actually lead to “competitive laxity” because of the small number of investment banks and institutions managing these transactions and their ability to put pressure on NRSROs to rate their products favorably to maintain their lucrative business relationship).

196. For a theoretical model demonstrating that oversight is likely to deteriorate under these conditions, see Patrick Bolton et al., The Credit Ratings Game (Feb. 14, 2010) (unpublished manuscript), available at http://ssrn.com/abstract=1342986.


198. Manns, supra note 190.

199. Id. at 1031–33.


As we argue at the end of this part, the Franken proposal would have solved the agency problem but would have imposed an impossible burden on an agency ill-suited to handle it. In our view, there is no silver bullet solution to the conflicts of interest in the ratings process. Rather than abandoning the issuer pay model, a more promising solution is to remove the regulatory imprimatur given the credit ratings and to require more disclosure. As we shall see, Dodd–Frank includes new rules on each of these topics, although their implementation has proven tumultuous.

3. Ex Ante Approaches (1): Removing the Regulatory Imprimatur

Partnoy and other scholars have focused—rightly, in our view—on the regulatory imprimatur that SEC regulation gives to Nationally Recognized Statistical Ratings Organization (NRSRO) ratings. Starting in the 1970s, regulators increasingly keyed broker dealers’ and other financial institutions’ capital requirements to ratings given by NRSROs—treating investment grade securities more favorably. Regulations requiring investments to meet certain ratings grades subsequently expanded into many other areas and now apply to many pension funds and other large institutional investors. These regulations have led to institutionalized reliance on the very small subset of CRAs designated as NRSROs: Moody’s, Standard and Poor’s, and Fitch’s bond rating services occupy the lion’s share of the market. Many critics argue that pressure from both issuers of securities, who need their bonds to meet rating requirements, and investors, who depend on their current investments achieving high ratings to comply with regulations, have a powerful effect in inflating the ratings NRSROs issue. Regulatory dependence on credit ratings has led to what Partnoy calls the “Paradox of Credit Ratings”: though the quality of credit ratings declined as the NRSROs’ institutional capacities were stretched by understaffing, lack of analyst expertise, and increasingly complex conflicts of interest, NRSROs experienced phenomenal growth in profitability and size.

4. Ex Ante Approaches (2): Enhancing Transparency and Oversight

Most (although not all) scholars favor increased disclosure from the black box of the credit rating agencies’ ratings process, as do we. But general discussion is often vague about just what this should entail—as is Dodd–Frank itself. We therefore treat the
disclosure issue in some detail, describing the key elements of an effective disclosure regimen.

a. Mandating Disclosure of Rating Agency Actions

Partnoy argues that CRAs should be forced to disclose to the public all rating agency actions, including all initial ratings proposals, downgrades, upgrades, placements on watch, and removal of ratings, in addition to unsolicited ratings and subscriber-paid ratings. Partnoy believes—rightly in our view—that giving this information to the market would not only curb ratings shopping, but also allow valuable oversight of potential conflicts of interest and outweigh any costs it might impose on the business model of CRAs. Full disclosure might also save limited CRA resources that might otherwise be wasted on ratings shopping. In effect, it would create a “pay upfront” system whereby it would be difficult for an issuer to solicit a rating and then decide to go with another agency’s proposal after shopping around. Patrick Bolton, Xavier Freixas, and Joel Shapiro also argue for a mandatory pay upfront system. Though Marco Pagano and others worry that mandatory disclosure of all actions would undermine the business model of ratings agencies, the potential benefits of disclosure in significantly reshaping the issuer–CRA relationship seem too great to forgo.

b. Clarifying Methodology and Symbology

The seemingly simple letter rating system that most CRAs use conveys little to no substantive information about the characteristics of the debt product it is attached to. The reasons for this are two-fold. Firstly, CRAs do not publish the information that grounds their rating of the company (although it is questionable whether investors would independently evaluate this information). Secondly, the method of analysis used to arrive at the letter rating is withheld as proprietary information by the CRAs, which argue that disclosing their methodology would undermine their business model. But without this information, it is nearly impossible for the market to evaluate the level of due diligence, professional competence, and analytical rigor underlying the risk rating given by the CRA.

Furthermore, because there are no substantive minimum standards of analysis and little to no explanation of the methods used to arrive at a rating, there is no way to judge which CRAs’ models are more accurate or precise than others. In fact, many CRAs have been accused of employing outdated methodologies that have failed to adapt to the

209. Id. at 9–10.
210. Id.
211. Bolton et al., supra note 196.
212. Id. at 2–3.
213. Interview with Marco Pagano, Einaudi Institute for Economics, in Rome, Italy (Mar. 10, 2010).
214. PARTNOY, supra note 192, at 10.
215. Id.
216. See Carol A. Frost, Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies, 22 J. ACCR. AUDITING & FIN. 486 (2007) (examining criticisms that there are serious problems with the level of diligence and competence of CRAs).
constantly evolving debt instruments that have been created over the past decade. Critics further assail the professional competence of the analysts and the CRAs, which are chronically understaffed and lack important quality controls. It may be inferred that one of the reasons NRSROs vehemently oppose increased disclosure requirements regarding methodologies is exposure of the flimsy and analytically flawed methodologies for evaluating these instruments that have contributed to the present recession.

During the 2008 crisis, lack of transparency in methodologies and symbology served to further obfuscate the meaning of the same rating across diverse debt products. This was especially important. For example, the risks behind a CDO, a municipal bond, and an ordinary corporate debt offering are very different, with widely varying levels of complexity that might be very hard for investors to appreciate and even harder to evaluate independently. Yet each of these instruments is rated on the same scale. The temptation to take them at face value is clear, and the proportion of credulous investors is likely to increase during a boom period while the reputational costs of understating credit risk are lowered.

c. Removing the Disclosure Exemption

Lastly, CRAs are not required to disclose the information underlying a ratings decision under an exception to the normal requirement of “Regulation Full Disclosure” that is imposed on issuers. Thus, inside information can be concealed from the market though the CRA is aware of it and may use it to evaluate a rating. This invariably creates confusion and speculation in the market, which is forced to act without full access to the insider information. A more disturbing potential effect of this exemption is that it increases the incentive for CRAs to conceal information from the public and artificially inflate ratings. As we shall see, our analysis strongly supports the decision by the drafters of Dodd–Frank to remove the exemption.

5. Ex Post Enforcement Proposals and Comprehensive Reform

The previous discussion has focused on what may be done ex ante to ameliorate CRA conflicts of interest, ratings shopping, and the general lack of disclosure and transparency. Many of these problems could also be mitigated if, ex post, CRAs were held accountable through public enforcement, a private litigation mechanism, or even sanctions built into the structure of the issuer–CRA relationship. The leading proposals offer a mix of ex ante and ex post approaches to these problems and range from

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218. Id.
219. Rosner, supra note 197, at 8.
220. PARTNOY, supra note 192, at 10.
221. Id. at 11.
222. Bolton et al., supra note 196, at 1–3.
224. PARTNOY, supra note 192, at 14.
gradualist regulatory reform to complete restructuring of the ratings market. We assess several of the most important below.

Jeff LaFrance proposes subverting the special NRSRO status and regulatory system by creating a competition for NRSRO designation.\footnote{LaFrance, supra note 206, at 8.} Under his system, NRSRO designation, and the oligopolistic benefits attached to it, would be based on the performance and ratings accuracy of the agency.\footnote{Id.} If NRSRO statuses were put up for grabs every three years, LaFrance argues, the incredible profit potential of being a NRSRO versus the costs of losing that status would encourage a race to the top.\footnote{Id.} LaFrance’s proposal would preserve the pre-Dodd–Frank regulatory reliance on credit ratings.\footnote{Id.} Although the proposal is intriguing, removing the regulatory imprimatur and enhancing disclosure as Dodd–Frank instructs, seems simpler, less disruptive, and at least as likely to function effectively.

At the other end of the reform spectrum, Manns suggests a complete restructuring of the model under which CRAs operate. Under his approach, discussed above, the issuer pays model would be supplanted by a user fee system financed by a flat transaction tax on all debt offerings.\footnote{Manns, supra note 190, at 1062–63.} The SEC would play a coordinating role and would require CRAs to bid for the right to rate a particular debt issue, thus creating competition among CRAs and hopefully breaking up the oligopoly the three largest NRSROs currently maintain and increasing quality.\footnote{Id. at 1062.} Manns would also end the relative immunity from liability CRAs currently enjoy by allowing creditors who pay the transaction fee to sue for gross negligence.\footnote{Id. at 1062.} Importantly, enforcement of the right would be initiated by the agency and awards would be capped at an undetermined multiple of the fee paid to the rating agency.

While Manns’ model, with its mixture of ex ante and ex post reform, is appealing, it also has the potential to become an unwieldy, costly, and politically-charged bureaucracy.\footnote{White, supra note 205, at 7.} A new regulatory authority, especially one with enforcement duties, should be as insulated from political pressures as possible, and be able to attract highly specialized experts, which are qualities that are not current features of the SEC.\footnote{Partnoy, supra note 192, at 9.} Additionally, Manns’ model does not link the competition for user fees to accuracy, but instead offers them to the lowest bidder. While increasing competition, this could also lead to a race to the bottom, especially if enforcement were not vigorous.

A final proposal, by Yair Listokin and Benjamin Taibleson, advocates an innovative mechanism that would avoid many of the regulatory costs inherent in other models, but
also change both the ex ante and ex post incentives of CRAs. Listokin and Taibleson would maintain the issuer pays system that is currently in place. But they would replace the current cash compensation system with an incentive compensation system whereby CRAs would be paid in the debt they rate.\textsuperscript{235}

The obvious concerns with this approach are that the CRA might game the system by overrating or underrating the debt in question. Listokin and Taibleson argue that underrating is unlikely to be a problem, because CRAs that consistently underrated so that they would be in effect overpaid would probably not find a lot of issuers to accept their ratings proposals.\textsuperscript{236} In theory, overrating also should not be a problem, since the CRA would be penalized because the debt they received would be worth less than the cash it replaced.\textsuperscript{237} But it is possible that a CRA might overrate, despite the lower fee, in order to attract repeat business from issuers.

An additional problem with the Listokin and Taibleson proposal, and also with LaFrance’s proposal, is the lack of a private liability regime and the potential incompatibility of private liability with their proposals. Their proposals depend on the economic punishment being sufficiently strong to discourage malfeasance or negligence, but there may be many cases at the margins where this would not be true. A robust public or private enforcement mechanism might be necessary in a model where ex ante incentives are not overpoweredly strong. Nevertheless, the proposal is intriguing, and has the virtue of recognizing the inevitability of inside-out governance while counteracting the conflict at its heart.

\textbf{F. Insights from Italy and the European Union}

In Europe, auditors and credit rating agencies are regulated by two different, though coordinated legislators—the single Member States and the European Union. While auditing is a competence of each Member State, credit rating agencies are regulated primarily at the EU level. In the discussion that follows, we therefore begin at the Member State level, with Italy, and then turn to the European Union.

\textbf{1. Auditing in Italy}

For decades, the most prominent features of Italian corporate governance were, on one hand, the absence of \textit{external} auditing of corporate financial reporting and, on the other, the existence of an internal \textit{board of statutory auditors} (collegio sindacale\textsuperscript{238}) in charge of overseeing “the overall administration of the corporation.”\textsuperscript{239} Recent reforms have placed much more emphasis on the external auditor. We consider each in turn.

The “traditional” model provides for a “triple-check” system in corporations’ process for choosing external auditors.\textsuperscript{240} That is, in order to choose an external auditor,
the auditing firm must be approved not only by the Board of Directors and the Board of Auditors, but also by the shareholders. However, this “triple-check” system is ineffective in practice. First, the lack of competition in the audit market is such that the significance of which auditor a corporation initially chooses does not realistically affect the auditing firm’s later work. Moreover, most Italian firms have ownership structures with controlling shareholders. Therefore, the fact that shareholders must approve the choice of external auditor serves little purpose beyond the board’s approval of the auditing firm.

Italian law strictly regulates both the term and the removal of auditing firms: an auditing firm may not be engaged for more than nine years (and cannot be renewed for three years after that period), cannot perform the audit for more than six years (regardless of whether the individual works for the same auditor), and the corporation must justify any removal of an auditor to the securities regulator (CONSOB). Additionally, this justification may not result from a difference of opinion about the audit process or result. This regulatory system may be deemed a compromise between CONSOB and the market, as the system allows for CONSOB’s supervision of the auditing process without requiring that CONSOB itself appoint the external auditors.

The obvious lesson for the United States from the Italian experience is that there are limited options for further audit reform in a world with only four major accounting firms. Restrictions such as additional auditor rotation requirements might significantly diminish conflicts of interest in a world with numerous auditors. In a world with only four, they will be ineffectual.

2. Credit Rating Agencies in the European Union and Italy

Like the United States, the European Union has recognized the pivotal role CRAs play in allowing investors to make investment and financing decisions. European Union efforts to address the CRAs’ role in capital markets date back to less than ten years ago—that is, in the aftermath of the corporate scandals of the early 2000s. In 2002, the European Commission instructed the Economic and Financial Affairs Council (ECOFIN), composed of the Economics and Finance Ministers of the 27 Member States, to analyze the credit rating industry. In late 2003, the European Parliament adopted a resolution concerning the role and methods of rating agencies, following an initial report from its Committee on Economic and Monetary Affairs addressing the potential need for legislative action on CRAs.

In late 2008, the Commission announced a proposal for a regulation of the European

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241. This limitation was emphasized to us by officials at CONSOB. Meeting with CONSOB Officials at CONSOB offices, Rome, Italy (Mar. 12, 2010).
242. See, e.g., Bianchi et al., supra note 21 (describing this feature of Italian firms).
Parliament and of the Council on Credit Rating Agencies, which both the Council and the Parliament approved in April 2009. The regulation set forth four main goals: an improvement of rating methodologies, an increase in transparency, proper management of conflict of interests between the CRA and the issuer, and creation of an effective registration and surveillance framework.\textsuperscript{248} The industry’s high level of concentration also caused the European Parliament to have antitrust concerns.\textsuperscript{249} Marla Costanza Barducci and Timo Fest note that the purposes in the Commission’s proposal correspond to the U.S. CRA Reform Act goals: (i) to establish competition among the credit rating agencies; (ii) to increase transparency; and (iii) to prevent and/or address conflicts of interest between the issuer and the CRAs.\textsuperscript{250}

The E.C. Regulations’ second goal, transparency in both methodology and performance, is of particular note. The main benefit of transparency is the opportunity to compare ratings issued by different agencies. Articles 7(1) and 9(1) of the E.C. Regulation mandate that CRAs disclose to the public the methodologies, models, and key rating assumptions that they used, and also every material change made thereto.\textsuperscript{251} Moreover—this feature differentiates the E.C. Regulation from the pre-Dodd–Frank U.S. legal framework—Article 8 addresses unsolicited ratings.\textsuperscript{252} Its goal is to enable investors to sort out solicited ratings from unsolicited ones.\textsuperscript{253} Thus, Article 8 requires that CRAs not only identify such ratings and disclose all procedures regarding them, but also highlight that the rated entity did not participate in the rating process and, therefore, that the CRA did not have access to its documents. This action causes issuers to lose their incentive to ask for a “clarifying” rating, which means that investors will demand a solicited rating from their chosen agencies.\textsuperscript{254} Banning unsolicited ratings will implicitly cause an increase in competition within the CRA industry—the third goal of the E.C. Regulation.

These developments in the European Union, which pre-dated Dodd–Frank, suggest a convergence in the general strategies for regulating credit rating agencies. Both in the United States and in Europe, increased disclosure is the principal mechanism for discouraging the race to the bottom that infected credit ratings during the real estate boom. Rather than an abandonment of the inside-out model, increased disclosure along with adoption in the United States of the European tendency to place much less reliance on credit rating agencies will become the principal approaches for regulating credit rating agencies on both sides of the Atlantic.

\begin{itemize}
\item \textsuperscript{249} Communication CRA, supra note 245.
\item \textsuperscript{250} Barducci & Fest, supra note 244.
\item \textsuperscript{252} Id. art 8.
\item \textsuperscript{253} Id.
\item \textsuperscript{254} Id.
\end{itemize}
G. Where Are We After Dodd–Frank?

1. Directions for Further Audit Reform?

The current regulatory climate is not a hospitable one for innovations such as contractual adjustments to the liability of auditors, at least in the United States. Interestingly, some of the more radical reform proposals might merit serious consideration in a country like Italy which lacks effective ex post enforcement due to a weak court system and the absence of a robust derivative litigation device. In the Italian context, for instance, the costs of implementing a system similar to those proposed by Ronen and Cunningham may be cost justified.

2. Credit Rating Reform

Unlike with auditing, credit rating agencies and the breakdown of the credit rating process feature prominently in Dodd–Frank. According to an initial list of “congressional findings,” credit rating agencies “play a critical ‘gatekeeper’ role in the debt market that is functionally similar to that of securities analysts . . . and auditors;” they performed badly prior to the crisis, and their conflicts of interest need to be policed. To better watch these watchers, the legislation instructs the SEC to establish a new Office of Credit Ratings, and alters their regulation in four ways, several of which parallel the proposals we have made.

Most importantly, Dodd–Frank removes many of the statutory provisions that steer financial institutions and institutional investors towards rated securities, and also instructs the financial regulators to remove any references in their rules to reliance on rating agencies. In place of references to investment grade securities, Dodd–Frank substitutes language requiring that a security “meet standards of credit-worthiness” established by the relevant regulator. If regulators fully comply with these instructions, it will bring a significant and beneficial shift, given that pressure from the “buy-side” was at least as important a factor in the breakdown of credit ratings as the inherent conflict of interest when the issuer pays for its securities to be rated.

Second, as noted earlier, the new legislation revamps the internal governance of credit rating agencies, requiring that more than one-half of the directors be independent and that some of the directors be “ratings users.” The new regulations also prohibit credit rating agencies from basing the compensation of their executives on the performance or profitability of the CRA. These changes are more problematic. Not only do they micromanage CRA governance, but they impose burdens on SEC-approved

255. See generally Ferrarini & Giudici, supra note 1, at 202-04 (describing recent enactment of a derivative suit device and its limitations).
257. Id. § 932. The SEC is also instructed to review each rating agency’s code of ethics and conflicts policy each year, and to do an annual inspection. Id.
258. Id. §§ 939, 939A.
259. See, e.g., id. § 939.
260. Dodd–Frank § 932.
261. Id.
CRAs that non-approved agencies are not forced to bear.

Third, the legislation seeks to increase the efficacy of ex post litigation by explicitly subjecting the CRAs to the same treatment under the securities fraud provisions of the Securities and Exchange Act of 1934 as securities analysts and auditors. It is not altogether clear how much effect these provisions will have, since a principal defense the CRAs have used in litigation is that their ratings are entitled to First Amendment protection. The adjustments to the securities laws at least open the possibility of more serious scrutiny, although a brouhaha that developed almost as soon as Dodd–Frank was enacted suggests that the CRAs will staunchly resist any increase in exposure. In response to a provision in Dodd–Frank that created the possibility that CRAs will be deemed experts and exposed to potential liability under the Securities Act of 1933 if they are listed in a registration statement, the leading CRAs refused to allow issuers to include them as experts in connection with offerings of asset-backed securities (ABS). ABSs theoretically cannot be issued without the CRA rating. Faced with this impasse, the SEC quickly blinked, temporarily permitting ABS issuers to omit the expert from their SEC registration statement. This assures that CRAs are once again insulated from liability unless the SEC shifts course.

An additional question mark in the new provisions is their treatment of the crucial question of disclosure. As we have pointed out, robust disclosure—including disclosure of CRAs’ contacts with issuers seeking ratings and of the CRAs’ rating methodologies—would prevent the competitive race to the bottom that plagued the credit rating agency process during the real estate bubble. Dodd–Frank explicitly removes the CRAs’ exemption from Regulation FD, and it creates the possibility of much more extensive disclosure by instructing the SEC to promulgate regulations for increased disclosure and inviting the SEC to develop a form for disclosing the CRAs’ methodologies. If the SEC does indeed require much more extensive disclosure, the new legislation could significantly improve the efficacy of CRAs. The key question is whether the SEC will indeed mandate adequate disclosure. It is quite possible that the CRAs will fend off meaningful disclosure in the rulemaking process, based on the kinds of arguments we saw earlier. They will predictably claim, for instance, that disclosing their methodology would compromise their ability to compete with other CRAs. As with many dimensions of Dodd–Frank, the regulation will only be as good as the regulators charged with implementing it.

Overall, however, the measured Dodd–Frank approach is more compelling than the kind of dramatic shift from the issuer pays model that many scholars have advocated. While the conflicts of interest in issuer pays are severe, the alternatives flounder when it

262. Id. § 933.
263. The CRAs’ First Amendment defense is analyzed at length in Caleb Deats, Note, Talk that Isn’t Cheap: Does the First Amendment Protect Credit Rating Agencies’ Faulty Methodologies from Regulation?, 110 COLUM. L. REV. 1818 (2010).
264. See, e.g., Stacey-Marie Ishmael, Rating Agencies to Debt Issuers: Don’t Cite Us, FT ALPHAVILLE (July 19, 2010), available at http://ftalphaville.ft.com/blog/2010/07/19/290701/fitch-to-debt-issuers-dont-cite-us-thank-you-very-much/ (discussing the reaction of Fitch to the repeal by Dodd–Frank Section 939G of Rule 439(g) promulgated under the Securities Act of 1933).
266. Dodd–Frank § 939B.
comes to implementation. The thought of the SEC trying to assign credit rating agencies for every debt issuance that needs one, is not a comforting one. Focusing on the buy-side pressures in buying rated securities and preventing ratings shopping through disclosure are more plausible and cost effective strategies. Each acknowledges the inevitability of inside-out governance, but also addresses the pressures that have exacerbated the inherent conflict in an issuer pays approach.

IV. DERIVATIVES REGULATION

A. Introduction

As nearly everyone now agrees, derivatives magnified the 2008 financial crisis by, among other things, making it easier to speculate on the real estate market and increasing the financial fragility of investment banks and other financial institutions. Dodd–Frank focuses heavily on systemic risk concerns such as the danger that the failure of a major participant in the derivatives markets will create turmoil in the financial markets. At the same time, lawmakers sought to exempt corporations’ use of derivatives for hedging purposes. In the terms we use in this Article, this suggests, at first glance, that the outside dimension of derivatives will be heavily regulated, their use inside the corporation less so. But Dodd–Frank requires firms that rely on derivatives for hedging to affirmatively opt out of the margin requirements that would otherwise apply, based on a determination made by “an appropriate committee” of the board of directors.267 Dodd–Frank has thus placed the subject of derivatives on the agenda of boards of directors, intruding into internal procedures of corporate governance in order to regulate external market systems. As we shall see, this could transform the inside use of derivatives, imposing fiduciary obligations that previously had been, at most, confined to a small number of cases.268 As with shareholder voting and third party gatekeepers, outside governance is now making its way into the corporate board. Before exploring this and other dimensions of the new derivatives regulation, we first put derivatives in historical context and critically assess the scholarly literature.

B. History of Derivatives Regulation

While a detailed historical account of derivatives is not necessary, a brief overview will show the nature of derivatives, their role in corporate governance, and the often accidental fashion in which regulation has developed. The history is essential to understanding the odd regulatory framework that has emerged.

A “derivative” is a financial contract whose value derives from that of another asset or event. Derivatives can be designed or structured in a myriad of different forms to meet a wide range of risk-hedging and speculative goals. The most traditional is perhaps the forward contract, used for commodities as well as stocks and other underlying assets, in which the owner must buy a specific asset on an agreed upon date at a price agreed upon at the formation of the contract.269 Futures contracts are similar to forward contracts, but

267. Id. §§ 723(b), 763(a).
268. See infra note 314 and accompanying text (discussing Brune v. Roth, the principal case).
are often standardized and do not expire upon delivery, making them transferable and tradable on public exchanges. An option contract gives the owner the right to either buy or sell an asset at a future date for a specified premium. Futures options are a type of option contract in which the underlying asset is a futures contract. Finally, in a swap contract, two counterparties agree to exchange specific cash flows at specified intervals, trading one kind of risk for another—for example, a fixed interest rate for a variable rate. In recent years, the most well-known type of swap has been the Credit Default Swap (CDS), an instrument that allows counterparties to hedge against or bet on a debt issuer’s bankruptcy, default, or restructuring.

1. The Development of Derivatives

Derivatives date back to at least ancient Sumeria, and they were common in the Roman Empire. In medieval Holland, forward and options contracts were used to hedge against speculative pressures on commodities as occurred with tulips in 1637. As commodities futures trading became more pervasive, exchanges were established to facilitate their use, first in northern Europe and then in Chicago in 1848, with the Chicago Board of Trade. More than a century later, in the 1970s, the collapse of the gold standard of the Bretton Woods System and shocks in commodities prices following the Yom Kippur War created new risks in the global financial system. Swaps, beginning with foreign-exchange (forex) swaps and currency swaps, were invented to allow market participants to hedge against these new risks. Swaps saw particularly rapid growth in the 1990s and 2000s, especially relatively new types of derivatives based on credit instruments. It is this most recent growth that made derivatives a central feature of contemporary corporate governance.

2. Derivatives and Regulation in the United States

Derivatives have a long history in the United States because of its abundance of natural commodities. Futures exchanges emerged throughout the country, with New York initially possessing the greatest number and variety of exchanges. However, Chicago increased in importance as America expanded westward in the mid-nineteenth century

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270. Id. at 419.
271. Id. at 421.
272. Id. at 422.
273. Id. at 420.
277. Id. at 29–30.
278. Id. at 50.
279. Id.
281. Swan, supra note 275, at 215.
and eventually overtook New York as the center of American commodities trading. American derivatives contracts were at first limited to those who actually intended to deliver the underlying goods. Courts determined the validity of a contract using the so-called “intent test,” articulated first by the English Court of Common Pleas in *Grizewood v. Blane*, which sought to bar speculation as a form of illegal gaming. At the turn of the twentieth century, there was widespread popular support for federal regulation to check speculation on commodities futures prices. Despite this, Congress failed to pass any bills that sought to regulate derivatives, and in 1905, the Supreme Court adopted a more permissive approach toward derivatives. Under the “serious purpose” test announced in *Board of Trade of Chicago v. Christie Grain & Stock Co.*, futures contract participants were required only to demonstrate a serious business purpose for entering the contract, rather than actual intent to deliver. 

In response to the agricultural recession following World War I, and public perceptions of derivatives trading as a “gambling hell,” the government took a more restrictive approach to derivative contracts. First, the Supreme Court returned to the view that some futures contracts were forms of wagering activity. Second, Congress sought to end the trade in options contracts through the Grain Futures Act of 1922 (Grain Futures Act). The Grain Futures Act had two goals: to protect consumers against so-called “bucket shop” operations that fleeced unsuspecting investors, and to provide regulatory controls to halt the manipulation of commodity prices.

The 1930s brought the beginning of modern American securities regulation and a new layer of derivatives oversight. In 1936, Congress passed the Commodity Exchange Act (CEA) with the hope of curbing commodities speculation—denounced by President Roosevelt as a major contributor to the Great Depression. The CEA created the Commodity Exchange Commission (CEC) and began active federal policing of the market with the twin motives of protecting traders and preventing the systemic risk from speculation. Its particular target was speculators who had, in the two years since the passage of the Exchange Act, transferred their activities from stock markets to grain exchanges to escape regulations. However, competition between the agricultural and banking committees in Congress prevented the creation of a comprehensive, unified regulator for commodities and securities.

282. *Id.* at 218.
283. *Id.* at 219; *Grizewood v. Blaine*, 11 C.B. 526 (1851).
286. *Id.*
287. The best historical account of the rhetoric and emerging regulation of “bucket shops” and “gambling hells” is *Ann Fabian, Card Sharps And Bucket Shops: Gambling In Nineteenth Century America* (1998).
288. See *Dickson v. Uhlmann Grain Co.*, 288 U.S. 188 (1933) (finding that grain futures contracts executed on organized exchanges were unenforceable and illegal as gambling).
291. *Id.* at 341–42.
292. *Id.* at 340.
293. *Id.* at 341.
After a disruption due to World War II, futures trading resumed under the 1936 framework (although the CEA was subsequently amended in 1968 to provide increased power to the CEC).\textsuperscript{295} America’s withdrawal from the gold standard and the volatility of commodity (especially oil) prices after the Yom Kippur War sparked the creation of new types of derivatives, and in response Congress passed the Commodity Futures Trading Commission Act.\textsuperscript{296} The Commodities Futures Trading Commission Act consolidated powers previously shared among state, federal, and industry regulators into a new commission, the Commodity Futures Trading Commission (CFTC), that had the power to regulate all goods, articles, services, rights, and interests in which there was a contract for future delivery (except onions).\textsuperscript{297}

In the years that followed, the growing importance of derivative contracts to the financial services industry led the SEC to demand an increasing role in derivatives regulation.\textsuperscript{298} In 1982, the CFTC granted the SEC jurisdiction over options on stocks and stock indices, while retaining jurisdiction over futures and options on futures.\textsuperscript{299} Despite this surrender of authority, the CFTC found itself quite busy throughout the 1980s as the emergence of new derivative instruments, such as swaps and off-exchange futures contracts, demanded a federal regulatory response.\textsuperscript{300} The CFTC took a laissez-faire approach to these new so-called hybrid instruments, issuing “no action” letters on a wide array of new derivatives contracts and creating a safe harbor for qualified swap transactions that put such transactions beyond the requirements of the CEA.\textsuperscript{301}

In 1992, Congress attempted to tackle the growing internationalization of derivatives contracts, which left many outside of the scope of American regulatory power, with the Futures Trading Practices Act.\textsuperscript{302} The Futures Trading Practices Act\textsuperscript{303} further amended the CEA, permitting exemptions for transactions that met a list of vague and permissive criteria.\textsuperscript{304}

The Commodity Futures Modernization Act of 2000 (CFMA) was the final attempt to rethink the regulation of derivatives prior to Dodd–Frank.\textsuperscript{305} The CFMA excluded a broad range of derivative transactions, including swap agreements, mortgages, hybrid instruments, and over-the-counter derivatives from the jurisdiction of both the CFTC and the SEC, leaving them unregulated by the federal government.\textsuperscript{306} Under the CFMA, certain classes of trading facilities were also excluded from CFTC regulation.\textsuperscript{307} The rationale for this deregulation was that markets would regulate themselves; proponents believed that exchange facilities and industry self-regulation would take the place of

\textsuperscript{295} Id. at 256.
\textsuperscript{296} Markham, supra note 290, at 341.
\textsuperscript{297} SWAN, supra note 275, at 257.
\textsuperscript{298} Id. at 260.
\textsuperscript{299} Id.
\textsuperscript{300} Id. at 265.
\textsuperscript{301} Id. at 266.
\textsuperscript{302} SWAN, supra note 275, at 269.
\textsuperscript{304} Id.
\textsuperscript{307} Id.
government regulators, who had, in any event, steadily receded from their role. The placing of credit derivatives outside of the scope of regulation was followed by the loosening of net capital rules for large investment banks in 2004, providing increased liquidity that was partially funneled into the growing market for credit derivatives.

3. Inside-Out Corporate Governance and Derivatives

As financial derivatives have grown in importance, they have become an increasingly important feature of internal corporate governance. To the extent that firms rely on derivatives as part of an overall risk-management strategy, that choice is tantamount to allowing the market to serve a risk-control function traditionally delegated to corporate governance mechanisms. As Frank Easterbrook pointed out nearly a decade ago, proper use of financial derivatives can replace some of the functions of corporate governance. Derivatives also now feature prominently in outside governance. Investors can use derivatives to customize their investments, for instance, as Easterbrook also pointed out, and try to control for risks that they believe firm management will not adequately address. They also play an important role in outside governance (particularly with swaps) by providing market signals concerning the financial condition of a corporation or its securities.

Some commentators have suggested that the use of derivatives will be incorporated into directors’ core fiduciary duties. Although a few courts have suggested that directors may indeed have an affirmative duty to hedge the company’s risks in some contexts, it seems unlikely that courts will actively police directors’ use of derivatives, given their deferential stance toward ordinary directorial decision making under the business judgment rule. Even absent serious judicial scrutiny, however, oversight of a firm’s use of derivatives for hedging, and in some cases speculative purposes, has become an important directorial function (a function that Dodd–Frank has strongly reinforced, as discussed below). Indeed, several scholars have recently suggested that

309. Morrissey, supra note 280, at 663.
311. Id.
312. Through the use of financial derivatives, the shareholder can customize equity and debt investments in a company, theoretically changing the relationship between the shareholder and the firm. Easterbrook argues that customized derivatives contracts offer every conceivable risk-return combination so that investors will unanimously favor the maximization of expected value within each firm even if that means the firm must engage in high-risk strategies to achieve those gains. Id. at 738–39. The correct use of derivatives, he argues, should make shareholders risk neutral. Id.
313. See, e.g., Flannery et al., supra note 27, at 2085.
314. See Brane v. Roth, 590 N.E.2d 587, 589 (Ind. Ct. App. 1992) (holding that the directors of a grain elevator cooperative were responsible for losses due to a failure to hedge).
315. Id.
316. Easterbrook argues that hedging at the firm level to protect investors makes little sense because investors are diversified and effectively risk-neutral. Easterbrook, supra note 310, at 744–45. In his view, hedging suggests firm failures in curtiling risk-aversion although he acknowledges there is scarce data to support this assertion. Id.
derivatives expertise is an important benefit of private equity fund control or influence over a company’s board of directors.\textsuperscript{317}

Both Dodd–Frank and regulators have attempted to carve out a space for the inside governance functions of derivatives. Non-financial entities that are hedging only commercial risk are exempt from mandatory clearing.\textsuperscript{318} However, a corporation that is subject to the reporting requirements of Section 15(d) of the Exchange Act must elect to use the exemption. The election must be made by an “appropriate committee” of the board of directors and only after reviewing and approving the decision. The SEC and CFTC have proposed rules, Rule 3Cg-1 and Sec. 39.6 respectively, suggesting compliance with the election requirement through a specific corporate governance procedure:

For example, a board resolution or an amendment to a board committee’s charter could expressly authorize such committee to review and approve decisions of the electing person not to clear the swap being reported. In turn, such board committee could adopt policies and procedures to review and approve decisions not to clear swaps, on a periodic basis or subject to other conditions determined to be satisfactory to the board committee.\textsuperscript{319}

The election is valid, though, only if the corporation is using the non-cleared derivatives to hedge or mitigate commercial risk. This potentially creates legal uncertainty for the approved transactions. If the board’s belief in its compliance turns out to be incorrect, are the non-cleared contracts entered into illegal? If so, have the directors possibly failed their “Caremark” duty to provide adequate oversight of firm compliance?\textsuperscript{320} Distinguishing hedging commercial risk from market speculation is a difficult issue,\textsuperscript{321} as discussed below. Thus Dodd–Frank has linked, more tightly than ever before, the outside and inside dimensions of derivatives use.

\textbf{C. Derivatives Regulation in the Legal Literature}

Financial derivatives catapulted from obscurity into the public consciousness due to a series of scandals involving rogue traders and spectacular losses at Procter & Gamble and in Orange County in the early to mid-1990s.\textsuperscript{322} Because of their perceived complexity, the youth of the market, and the scale of misfortunes being reported in the financial press, “derivatives” quickly took on a negative connotation in the popular press,

\begin{itemize}
  \item \textsuperscript{318} Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 723(a), 763(a), 124 Stat. 1376, 1675–81, 1762 (2010).
  \item \textsuperscript{319} End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80,747, 80,750 n.18 (Dec. 23, 2010) (to be codified at 17 C.F.R. pt. 39).
  \item \textsuperscript{321} The SEC and CFTC have attempted to define commercial risk by proposing Rule 3a67-4 and Sec. 151.5.
  \item \textsuperscript{322} The scandals are chronicled in \textit{FRANK PARTNOY, INFECTIOUS GREED: HOW DEFICIT AND RISK CORRUPTED THE FINANCIAL MARKETS} (2003); Kimberly D. Krawiec, \textit{Accounting for Greed: Unraveling the Rogue Trader Mystery}, 79 OR. L. REV. 301, 302–05 (2000).
\end{itemize}
akin to speculation or even gambling. Capturing the ethos, *60 Minutes* referred to derivatives as “the riskiest securities ever devised.”

Congress seemed poised to make a legislative response to the widely publicized derivatives losses, but many scholars were skeptical of regulation. Roberta Romano warned against “poor policy choices” and “regulatory changes [implemented] in crisis mode.” Others concluded that “additional federal regulation of derivative securities would be expensive and counterproductive” or unnecessary. Although regulators and the press raised concerns that the newfound popularity of derivatives, particularly OTC derivatives, posed systemic risk, most scholars believed that overall systemic risk was actually reduced by derivatives’ ability to shift risks to the parties best able to bear them. In fact, at least one scholar argued that the best way to achieve an efficient, “level playing field” regulatory system for derivatives would be to reduce the regulation of exchange-traded derivatives rather than increase the regulation of their OTC counterparts.

Although this sanguine attitude toward the nascent (yet enormous and quickly growing) derivatives market was the norm, it was not universal. Even before several

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323. See Roberta Romano, *A Thumbnail Sketch of Derivatives Securities and Their Regulation*, 55 Md. L. REV. 1, 2–5 (1996) (describing the media and legislative response to the multi-million dollar losses sustained through derivative transactions by entities as diverse as hedge fund investor David Askin, Procter & Gamble, Barings PLC, Odessa College, and Orange County, California between 1994 and 1995). See also Eric D. Roiter, *Investment Companies’ Use of OTC Derivatives: Does the Existing Regulatory Regime Work?*, 1 STAN. J.L. BUS. & FIN. 271, 273 (1995) (“The headlines dominating the financial pages of the past year may have lead their readers to conclude that the use of OTC derivatives seriously threatens the stability of the mutual fund industry.”).


325. See Romano, supra note 323, at 3–4 (reporting that between April and October 1994, Congress held ten hearings on derivatives, numerous bills proposing expanded regulation of derivatives were introduced in the 103rd Congress, and the GAO reported a need for greater regulation in May 1994).

326. *Id.* at 5–6.


328. See, e.g., Jonathan R. Macey, *Derivative Instruments: Lessons for the Regulatory State*, 21 J. CORP. L. 69, 89 (1995) (“[D]erivatives are not really as new or as threatening as is commonly supposed . . . . [D]erivatives should not be regulated.”); Roiter, supra note 323, at 285 (concluding that within the framework of the Investment Companies Act (ICA), “proponents of drastic legislation or regulation to curb investment companies’ use of OTC derivatives have not demonstrated a pressing need for such action”).


330. *Id.* at 22 (“Furthermore, the growing size of the market has led to the development of new risk management techniques and skills in dealer financial institutions which have had the effect of reducing their overall riskiness by managing risks which were previously not actively faced and managed. This general reduction of risk in the system has on balance contributed to the overall reduction of systemic risk.”).


332. See Darby, supra note 329, at 6 (describing how “OTC derivatives [had] largely survived skeptical scrutiny” and the existence of an “impasse between some regulators’ concerns and the analyses of academics
high profile derivatives disasters, Henry T.C. Hu warned of cognitive biases and informational deficiencies that “when applied to the OTC derivatives context, [could] lead to excessive risk-taking and overinvestment.”\textsuperscript{333} However, because the same informational deficiencies applied equally to regulators, even he favored only incremental changes in regulation (a position he maintained after the major losses of 1994).\textsuperscript{334} Thomas Hazen and Lynn Stout took more contrarian positions. Hazen supported executive and legislative efforts to place responsibility for derivatives regulation within a single agency.\textsuperscript{335} He also advocated an “economic purpose” test to separate impermissibly speculative derivatives transactions from those legitimately designed to reallocate risk or facilitate price discovery,\textsuperscript{336} as well as a suitability requirement.\textsuperscript{337} Stout argued that derivatives trading may inherently lower net social welfare, even absent a systemic crisis, and proposed (based on precedent in the history of gambling regulation) that derivatives contracts be treated as unenforceable.\textsuperscript{338}
Three areas generated much of the discussion prior to the recent crisis: proposals for margin requirements/capital adequacy, discussions of the application of insurance regulation to derivatives, and more recently, the effect of derivatives-enabled hedging on corporate votes. We consider each in turn.

The first issue was the use of margin and capital requirements to curb the risk of derivatives. OTC derivatives by definition were not traded on any exchange, and were not subject to the margin rules imposed by the Federal Reserve Board. Although the CFMA restricted OTC derivatives to “eligible contract participants,” including institutions and high net worth individuals, there were no further restrictions based on risk exposure. Exchange-traded derivatives, such as security futures, were subject to margin requirements, though the precise level at which they should be set was contested. The weakness of these requirements was the focus of some commentators before the crisis. This is the one scholarly concern that became a dominant theme of the new regulatory framework.

Second, derivatives’ role in hedging and redistributing risk led some scholars to compare the regulatory environment surrounding them to insurance. Hazen questioned the disparity between the relatively heavy regulation of insurance products and providers and the light or nonexistent regulation of derivatives, which often serve a similar purpose. Perhaps the most important regulatory distinction between insurance contracts and derivatives is that entering into an insurance contract requires the insured to have an “insurable interest” in the subject of the contract whereas no such


339. See Thomas Lee Hazen, Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling and Insurance, 24 ANN. REV. BANKING & FIN. L. 375, 429 (2005) (“[T]he over-the-counter derivatives markets do not impose margin requirements.”). Note, however, that private mechanisms for collateral roughly equivalent to margin are not unusual in the OTC derivatives world, in addition to the Master Agreement used by most OTC derivatives market participants. PARTNOY, supra note 322, at 217. ISDA has also created a standard-form Credit Support Annex. See Norman Menachem Feder, Deconstructing Over-the-Counter Derivatives, 2002 COLUM. BUS. L. REV. 677, 745–46 (2002) (explaining the standard-form created by the ISDA).


341. See Hazen, supra note 339, at 429 (explaining that there are no further requirements).

342. Many commentators put their faith in clearinghouses as the solution. See, e.g., Aaron Unterman, Innovative Destruction—Structured Finance and Credit Market Reform in the Bubble Era, 5 HASTINGS BUS. L.J. 53, 94–95 (2009) (reporting on recent efforts to reduce risk through the use of clearinghouses). We discuss clearinghouses below.

343. Partnoy proposed that the margin framework be replaced with “generalized standards” for three broad categories of transactions and portfolios, with some categories requiring substantially more than the 20% margins proposed by the SEC and CFTC, and other categories requiring less. PARTNOY, supra note 322, at 230–35.

344. See Hazen, supra note 339, at 430–34 (questioning the disparity between heavy regulations of insurance products and the light regulation of derivatives).

requirement presently exists for derivatives such as credit default swaps. A few scholars have advocated reforms that would require an “economic purpose” (the equivalent of an insurable interest) in derivatives transactions. Although media coverage often supported this perspective—calling for bans on “naked CDSs,” for instance—the new framework does not take any of these steps.

Finally, scholars such as Henry Hu and Bernard Black directed attention to the effects that derivatives-based hedging can have on corporate voting. The features of equity-based derivatives that make them so useful for sophisticated risk management have the simultaneous effect of “decoupling” a shareholder’s voting stake from their economic interest in the welfare of the corporation. Hu and Black dubbed this “empty voting.” Although most scholars proposedremedy empty voting through enhanced disclosure alone, Sean Martin and Frank Partnoy argued that what they termed “encumbered shares” should have much reduced voting power. In a subsequent analysis, Hu and Black argued for a variety of specific structural changes that would mitigate the impact of encumbered shares. While empty voting surfaced in several dramatic cases that made the rounds of the literature—most prominently, its use by the hedge fund Perry Corp in a takeover battle—it does not appear to be a pervasive problem. As we shall see, Dodd–Frank focused much more on managing the systemic

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346. See Brian J.M. Quinn, The Failure of Private Ordering and the Financial Crisis of 2008, 5 N.Y.U. J.L. & BUS. 549, 609–11 (2009) (noting that while so-called “naked swaps” are a form of “naked shorting” of equity shares, naked shorting is illegal but naked swaps were big business).

347. Id. at 610–11 n.210; see also Hazen, supra note 345, at 133–34 (“Policymakers should consider whether the failure of the CDS markets has signaled a need to revitalize the commodities laws’ economic purpose requirement.”).

348. See, e.g., FT Reporters, Call for Ban on CDS Speculation, FIN. TIMES, Mar. 10, 2010, http://www.ft.com/intl/cms/s/0/63a554b0-2be5-11df-8033-00144feabdc0.html#axzz1h55ahCkN.


350. See Decoupling II, supra note 349, at 633–40 (describing the effects of “decoupling” voting rights from economic interests).

351. Id.

352. See Decoupling I, supra note 349, at 875–86 (outlining proposed remedies for disclosure rules); Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. PA. L. REV. 1021, 1077 (2007) (“For now, we agree with Henry Hu and Bernie Black that not enough is known about the extent of empty voting to prescribe anything more than an increase in disclosure of schemes generating empty votes.”).


356. A new article by Holger Spamann reaches a similar conclusion. Spamann argues that the one context where problematic manipulation may occur is in the restructuring of debt in an effort to avoid bankruptcy. See Holger Spamann, Derivatives and Corporate Governance: Over-Hedging, Negative Voting, and Counterparty Incentives (Jan. 3, 2011) (unpublished manuscript) (on file with author) (proposing regulatory correctives).
risk created by derivatives trading, while protecting its corporate governance uses.

D. Derivatives Regulation in the Finance Literature

Although the finance literature overlaps with the legal scholarship in many respects, it has focused more extensively on the reasons that derivatives have proven to create so much risk. The literature tends to attribute derivatives’ contribution to the recent crisis to one of three causes: 1) the products themselves, 2) pressures created by regulation, or 3) cognitive bias and human error. We take up each in turn.

1. Product-Centric View

In one view, the foray into exotic derivatives—instruments that were poorly understood by traders and investors alike—triggered the financial collapse. Futures, options, and swaps have at least one thing in common: a small original position could lead to significantly greater risks. As it is inherently difficult to assess the risk of a position, for many years, regulators’ efforts were aimed only at improving market structure and ensuring that transactions and their settlement were properly documented. The two most prominent proposals for addressing these problems were moving OTC trading onto exchanges and requiring that derivatives be cleared through clearinghouses. Both are central pillars of the new regulatory landscape.

2. Legislatively Driven Collapse

Scholars who attribute the crisis in the derivatives sector to legislation trace detrimental regulatory change to the Gramm–Leach–Bliley Act (GLBA), which (in addition to largely abolishing the Glass–Steagall Act) failed to regulate and in some cases precluded regulation of the hybrid products that newly-formed entities could now create, own, package, and sell. Products like black box collateralized debt obligations (CDOs) and CDSs fell between the cracks of functional regulation. The GLBA explicitly exempted security-based swap agreements from regulation by the SEC by Section 2A of the Securities Act of 1933 and similarly Section 3A of the Securities Exchange Act of 1934.

359. The GLBA repealed portions of the Glass–Steagall Act, allowing banks, brokerages, and insurance companies to merge. Thereafter, “financial institutions” were defined as “companies that offer financial products or services to individuals like loans, financial or investment advice or insurance.” See Don Pitti, New Regulation Will Drive Trends in the Financial Services Industry—Again, 29 REV. BUS. 2, 4–7 (2009).
1. The definition of “security” in § 77b(a)(1) of this title does not include any security-based swap agreement (as defined in Section 206B of the Gramm-Leach-Bliley Act [15 USCS § 78c note]).
2. The Commission is prohibited from registering, or requiring, recommending, or suggesting, the registration under this sub-chapter of any security-based swap agreement . . .
3. The Commission is prohibited from—
(A) promulgating, interpreting, or enforcing rules; or—
A number of regulatory anomalies spurred the growth of derivative products, notably capital requirements that favored excessive risk-taking. Some pundits wish to blame the financial crisis on a general atmosphere of deregulation and free-market ideology, but they usually avoid citing specific policies. The most powerful regulatory impetus—the anomaly in risk-based capital standards—was subtle and cannot be attributed to any particular regulatory ideology. As early as 2001, the Securities Industry Association (SIA) suggested, in comments on the then proposed amendments to the risk-based capital standards of the Board of Governors Federal Reserve System, that OTC derivatives dealers should be treated like traditional broker-dealers for risk weighting purposes, which would relax standards to a 20% risk weight. The result of the back-and-forth between regulators and the industry was continued commitment to refining risk-capital standards to better access risk while relaxing valuation standards attached to credit derivatives guarantees and other instruments with risk-reducing effects.

3. Human Error and the Role of Secondary Actors

Scholars who focus on human error emphasize that the realization of risk management benefits depends on how market participants use these instruments. They argue that a key cause of the crisis and its propagation was the misuse of credit derivatives, rather than instrument-inherent features.

One possible failure exists in the basic financial model prototype. On this view, firm managers’ misuse of derivatives contributed to the current financial meltdown. In the instance of credit derivatives, most experts believe that a portfolio of simple CDS contracts held by a solid insurance company would have survived the recession on an equity basis, as the actuaries and statisticians had predicted. What the actuaries failed to account for—the risk of a broad market decline and the risk of a bond-rating hit to the insurer from rating companies—caused risk to balloon unnoticed. This created the equivalent of a “run” on the insurers’ reserves, as would happen if suddenly an epidemic

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361. Letter from Cheryl M. Kallem, Chair of Capital Committee, SIA, to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve (Jan. 29, 2001), available at http://www.sifma.org/issues/item.aspx?id=1183. OTC derivative dealers are subject to special requirements and regulatory treatment under the rules of the SEC. OTC derivatives are subject to many heightened regulatory requirements. They are subject to special limitations on the scope of their activities (Exchange Rule 15a-1), specified internal risk management control systems (Rule 15c3-3), recordkeeping obligations (Rule 17a-3(a)(10)), reporting responsibilities (Rule 17a-12), and net capital treatment (Rule 15c3-(a)(5)). In light of these enhanced regulatory requirements, the SIA presumed that OTC derivatives dealers should receive a 20% risk weight.


365. Id.

366. Id.
struck a life insurance company’s insured population.\textsuperscript{367} Scholars admonish banks and brokerages for assuming that the current conditions would continue without major disruption.\textsuperscript{368}

E. The Dodd–Frank Reforms

The primary focus of the new legislation is reducing the sort of systemic risk now considered to lie at the root of the current financial crisis. The reform uses several mechanisms to accomplish this goal. First, Dodd–Frank will require many market participants to clear their OTC transactions through a Central Clearing Party (CCP, or clearinghouse).\textsuperscript{369} Second, many derivatives will be directed to exchanges for exchange-trading.\textsuperscript{370} “Major Swap Participants” dealing in OTC instruments that are too complex to be cleared must report to a third-party “swap repository.”\textsuperscript{371}

Finally, the legislation empowered regulators to place limits on the derivatives positions any individual market participant held.\textsuperscript{372} By pushing derivatives to exchanges and clearinghouses, Dodd–Frank aims to reduce systemic risk through greater standardization of contracts, more active oversight of collateral requirements, and access to more trading information.\textsuperscript{373}

Congress did not regulate derivatives directly. Instead, Dodd–Frank granted authority to various existing regulators—primarily the SEC and CFTC—to introduce rules through the notice and comment process that will govern the derivatives markets. In addition to the SEC and CFTC, banking regulators (including the Federal Reserve) are required to coordinate, draft and adopt uniform rules.\textsuperscript{374} This process is now well underway, although regulators immediately fell behind the schedule that Congress set for many of the rules.

1. Exchange-Traded Derivatives

The drafters of the legislation believed that more transactions should occur on exchanges.\textsuperscript{375} One of the primary assumptions behind this policy was that reducing the complexity of the market will reduce systemic risk. Accordingly, Dodd–Frank will

\textsuperscript{367} Id.
\textsuperscript{368} Id.
\textsuperscript{370} Id.
\textsuperscript{371} Id. § 728.
\textsuperscript{372} See, e.g., id. § 737 (establishing the power of the Commission to regulate derivative holdings).
\textsuperscript{374} The principal derivatives regulations can be found in Title VII of Dodd–Frank.
\textsuperscript{375} See, e.g., Dodd–Frank § 723 (authorizing regulators to require that swaps be cleared and traded on an exchange).
require all financial entities to trade all cleared swaps on an exchange or swap execution facility unless they are not listed for trading. 376 Non-eligible participants must execute all swaps on an exchange. 377 Regulators expected that the higher cost of customized, non-exchange-traded derivatives will lead derivative counterparties to meet their risk-sharing needs through standardized instruments available on exchanges.

The exchange trading requirement is unlikely to dramatically affect either the inside or outside governance uses of derivatives. Pricing of exchange traded derivatives may be more accurate, which will enhance its use as a mechanism of outside governance. The effects for inside governance may be negative, if the requirement makes idiosyncratic hedging more costly. On the other hand, more standardized derivatives are likely to be cheaper once the regulation is fully in place, because derivatives dealers will no longer be able to charge the premium prices they earn for more tailored derivatives.

2. Clearinghouses

The legislation assumes that clearing derivatives transactions through a central party will limit the riskiness of the derivatives markets—especially the risk of loss from the collapse of a major derivatives dealer. Clearinghouses are intended to enforce capital and margin requirements, and to compile and provide information on trading to the regulators. 378 Because the clearinghouses are responsible for the performance of either party in the event they default, they will, regulators hope, have strong incentives to verify solvency and to enforce margin maintenance requirements throughout the life of the contract.

How well clearinghouses actually protect the market from escalating insolvency during a crisis depends on how much collateral they require. Therefore, Dodd–Frank requires that clearinghouses have adequate capitalization of their own, with agency rulemaking determining the final amount. 379 For similar reasons, Dodd–Frank allows a party to a derivatives contract to request that the clearinghouse segregate all collateral. 380 Clearinghouses must also meet ethical requirements such as avoiding conflicts of interest and obeying antitrust requirements. 381

The corporate governance implications of the clearinghouses will be similar to the impact of exchange trading. The principal difference is that the clearinghouses are more likely to increase the cost of derivatives for both inside and outside governance, because they will increase costs for dealer banks. If the clearinghouses do indeed reduce counterparty risk, they will simplify pricing of the derivatives that feature most prominently in outside governance.

376. Id.
377. Id.
378. See, e.g., id. § 725 (requiring the clearing houses have adequate resources and require adequate margin).
379. Id.
380. Dodd–Frank § 724.
381. Id. § 726.
3. Collateral Requirements

Dodd–Frank does not provide any specific guidelines as to how much collateral will be necessary to enter into and maintain a derivatives contract—once again, the task of setting those figures will be delegated to the regulatory agencies. Presumably, the clearinghouses will develop dynamic formulas for determining minimum amounts of collateral for each derivative product. The formulas will likely take into consideration the type of party entering into the transaction. For example, a swap dealer might be required to provide a different amount or type of collateral than a business whose primary industry is not financial services.

Dodd–Frank explicitly exempts hedging from the enhanced margin requirements by excluding firms that use derivatives solely for hedging from designation as a Major Swap Participant. The rationale for the exemption is that end users—that is, corporations that use derivatives for the purposes of inside governance—do not pose the same systemic risk in their use of derivatives as large financial institutions. Regulators have already hinted that at least some of these corporations may not be exempt from the capital requirements, however. And the costs borne by dealer banks will invariably affect the price of derivatives used for hedging.

4. Position Limits

The financial regulators are authorized to set absolute limits on the positions that a derivatives counterparty can take. Regulators also are instructed to set limits on the overall use of particular derivatives contracts. The latter limits will presumably consist of a ceiling on the total number of contracts outstanding for the same underlying asset. Lawmakers may have envisioned this as a tool for limiting trading during times of abnormally high market volatility.

5. Disclosure

Dodd–Frank requires considerably more disclosure from derivative parties, but the information will be delivered to the public only in the aggregate. Clearinghouses, repositories, and Major Swap Participants must register with the appropriate agencies, so

382.  *Id.* § 725.

383.  This would echo the commercial end-user exemption that provides carve outs from the clearing and exchange requirements for any counterparty that 1) is not a financial entity, 2) is using the swap to hedge commercial risk, and 3) notifies the Commission of how it fulfills its financial obligations for non-cleared swap transactions. *Id.* § 723.

384.  *See, e.g.*, *id.* § 721 (excluding hedging from definition of Major Swap Participant).

385.  In 2011 congressional testimony, Federal Reserve Governor Daniel Tarullo refused to rule out the possibility that some large “end users”—that is companies that use derivatives for hedging—may be subject to capital requirements with respect to the derivatives they purchase. *See, e.g.*, Ben Protess, Republicans Push for Exemptions to Derivatives Rules, N.Y. TIMES DEALBOOK (Feb. 15, 2011), http://dealbook.nytimes.com/2011/02/15/republicans-push-for-exemptions-to-derivatives-rules/.

386.  *See, e.g.*, Dodd–Frank § 737 (granting the CFTC authority to set limits “on the number of positions that may be held by any person for the spot month, each other month, and the aggregate number of positions that may be held by any person for all months”).

387.  *Id.* (amending further the Commodity Exchange Act to “establish limits . . . on the aggregate number or amount of positions in contracts based upon the same underlying commodity”).
that regulators can keep track of their reporting of key data.\textsuperscript{388} Clearinghouses are instructed to provide data on swaps, prices, fees, and the size of the market when seeking approval to clear a contract.\textsuperscript{389} The application must include information on the counterparty’s ability to manage risks, as well as data on its financial resources.\textsuperscript{390}

6. Implications for Corporate Governance: A Concluding Note

There was discussion throughout the legislative debate about seriously punishing the speculative use of derivatives, and Dodd–Frank’s much stricter regulatory oversight is designed to achieve this indirectly by dampening risk-taking. The problem from the perspective of firms that use derivatives for governance purposes is that their access to liquid markets for hedges depends on the active participation of speculators in the market. Even if firms that use derivatives solely for hedging are exempt from the most intrusive regulation, as Dodd–Frank attempts to do,\textsuperscript{391} their costs will rise as speculation becomes more expensive. In terms of the broader perspective of this Article, the point is simply that the inside and outside functions of derivatives in corporate governance cannot be separated. Here, as with proxy voting and third party gatekeepers, inside and outside functions are inextricably linked—a link that is further reinforced by the requirement that directors approve a hedging firm’s invocation of the exemption from margin requirements. The interconnections cannot realistically be removed; they must be managed. With derivatives, this means recognizing and taking into account the fact that tightening restrictions on one use of derivatives (speculation) will have immediate and potentially detrimental effects on another (hedging by an end user).

V. CONCLUSION

Until recently, the inside and outside dimensions of corporate governance could be clearly and meaningfully distinguished. Inside governance consisted of the relationship among shareholders, directors, and officers within the corporation, while outside governance included regulation and the role of markets in disciplining the firm’s decision makers. This is no longer the case. Corporate governance is now best seen as inside-out in nature, with formerly “outside” gatekeepers and decision makers regularly exercising, or being included among, the mechanisms of inside governance.

The implications of the new inside-out governance are not the same for every dimension of corporate governance. With the proxy process, inside-out governance became increasingly important after the 1980s, when the managers of target corporations began using poison pills and other defenses to thwart outside bidders, and bidders responded by using the proxy process. The recent legislative reforms attempt to further facilitate inside-out governance, although they favor traditional institutional investors over hedge and equity funds. The inside-out dimension of auditing and credit rating creates an intractable conflict of interest, because each is paid by the corporation it scrutinizes. Although Congress toyed with the possibility of removing conflicts by

\textsuperscript{388} See id. § 731 (explaining the registration requirements for Major Swap Participants).

\textsuperscript{389} Id. § 725.

\textsuperscript{390} Id.

\textsuperscript{391} Dodd–Frank § 721(a)(33).
instructing the SEC to assign credit rating responsibilities, the new legislation leaves the conflict in place but seeks to alleviate it by reducing the importance of credit ratings. The inside and outside governance functions are more distinct with derivatives. Lawmakers focused primarily on regulating the outside features of derivatives much more aggressively, but they also reinforced the inside-out dimension. With each of these issues, we have suggested reforms that would better coordinate the inside and outside functions; or, as in the case of auditing and credit rating, further counteract the conflicts.

In addition to its reshaping of every aspect of corporate governance, inside-out governance also has important implications for the allocation of lawmaking authority between Congress and the states—Delaware in particular. It has often been noted—with alarm by Delaware, and with glee by Delaware’s critics—that the last decade has brought an increasing federalization of corporate governance.392 Inside-out governance has played an unappreciated part in this trend. Nearly all of the features of outside governance have long been regulated by Congress rather than the states—through the securities laws, federal regulation of investment advisors, and other legislation. To the extent the shift to inside-out governance is permanent—and we believe it is—this suggests that Congress will not recede from corporate governance in the coming years. The traditional perception that corporate governance is regulated entirely, or even largely, by the states, may soon be a thing of the past.

392. One of the first to sound the alarm was Stephen Bainbridge. Stephen M. Bainbridge, The Creeping Federalization of Corporate Law, REGULATION, Spring 2003, at 26.