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## Codes of Ethics and State Fiduciary Duties: Where is the Line?

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# CODES OF ETHICS AND STATE FIDUCIARY DUTIES: WHERE IS THE LINE?

BY Z. JILL BARCLIFT\*

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## I. INTRODUCTION

The important function of disclosure under federal securities laws and regulations, and the role of management in running the affairs of the corporation consistent with state fiduciary principles have a history of discord.<sup>1</sup> The recent mandates of the Sarbanes-Oxley Act (“SOX Act” or “SOX”), and the Security and Exchange Commission’s (“SEC”) implementing regulations continue to increase the disclosure obligations of public companies.<sup>2</sup> These disclosure obligations include more in-depth financial reports, certification of financial reports by senior executives, financial experts on the audit committee, and codes of ethics.<sup>3</sup>

The post SOX regulatory environment furthers the tension between federal securities, and state corporate law.<sup>4</sup> This article examines the implementation of code of ethics requirements under SOX. It examines the SEC’s regulations, which implement SOX requirements on the disclosure of codes of ethics, and self-regulatory agency (“SRO” or “listing agency”) rules on codes of ethics for public companies.<sup>5</sup> This article argues that code of ethics rules encroach into state law in

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<sup>1</sup> See, e.g., Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573 (2005); Richard A. Booth, *The Emerging Conflict between Federal Securities Law and State Corporation Law*, 12 J. CORP. L. 73 (1986); Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992); Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 107 COLUM. L. REV. 1793 (2006); William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619 (2006); Renee Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879, 880 (2006); see generally Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 BUS. LAW. 317 (2007); Mark J. Roe, *Delaware’s Politics*, 118 HARV. L. REV. 2491, 2521 (2005).

<sup>2</sup> See Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7261-66 (2002); see Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. ON REG. 313 (2007); Peter Ferola, *The Role of Audit Committee in the Wake of Corporate Federalism: Sarbanes-Oxley’s Creep into State Corporate Law*, 71 J. BUS. & SEC L. 143 (2007); Robert Ahdieh, *From Federalization to Mixed Governance in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFF. L. REV. 721 (2005); Thomas O. Gorman & Heather J. Stewart, *Is there a New Sheriff in Corporateville? The Obligations of Directors, Officers, Accountants, and Lawyers after Sarbanes-Oxley of 2002*, 56 ADMIN. L. REV. 135 (2004); E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441 (2003); David J. Schulte, *The Debatable Case for Securities Disclosure Regulation*, 13 J. CORP. L. 535 (1988).

<sup>3</sup> Sarbanes-Oxley Act of 2002, *supra* note 2.

<sup>4</sup> See Veasey, *supra* note 2, at 443; Regina F. Burch, *Director Oversight and Monitoring: The Standard of Care and the Standard of Liability Post-Enron*, 6 WYO. L. REV. 481, 483-84 (2006); Ramirez, *supra* note 2, at 321; Ferola, *supra* note 2, at 147-149; see Schulte, *supra* note 2, at 536-38, 547; see Gorman & Stewart, *supra* note 2 at 140 (arguing that corporate managers must currently adhere to a series of federal laws that were more typically found in state corporate law); see Ahdieh, *supra* note 2, at 721, 725-26, 728-729 (stating that the most universal criticism of the Sarbanes-Oxley Act is for its “federalization” of corporate law by delegation of rule-making authority to the SEC and the disconnect between the Act’s supposed ends and means).

<sup>5</sup> See, e.g., § 406; 15 U.S.C. § 7264; 17 CFR pt. 228-29, 249; 15 U.S.C. 78s(b)(1); 17 C.F.R. § 240; 19b-4; see also NYSE 303A.10, Code of Business Conduct and Ethics, [http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/listed/1101074746736.html&displayPage=/lcm/lcm\\_subsection.html](http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/listed/1101074746736.html&displayPage=/lcm/lcm_subsection.html) (last visited Sept. 19, 2007); Nasdaq Rules, <http://www.nasdaq.com/about/>

defining the fiduciary obligations of officers and directors.

Specifically, this article argues that the SEC's approval of New York Stock Exchange ("NYSE") and National Association of Securities Dealers ("NASD" or "Nasdaq") rules allow the SEC to do indirectly what it could not do directly.<sup>6</sup> The SEC has approved quasi-federal corporate governance rules that contravene the internal affairs doctrine, move closer to development of federal common law for corporate conduct, and supplant state corporate law by defining fiduciary duties of officers and directors.<sup>7</sup> The NYSE and Nasdaq rules require a listed public company develop a code of ethics that, among other things, prohibits the taking of corporate opportunities and conflicts of interest. These rules not only regulate the conduct of officers and directors in meeting their fiduciary obligations to the corporation and shareholders, but also redefine the meaning of fiduciary duties under state law, in particular Delaware.<sup>8</sup>

This article, therefore, calls for an amendment to the SEC's code of ethics

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CorpGovSummary.pdf (last visited Sept. 19, 2007).

<sup>6</sup> See [http://www.nasdaq.com/about/2008\\_Corporate\\_FS.pdf](http://www.nasdaq.com/about/2008_Corporate_FS.pdf) (Nasdaq is the listing agency and the operating subsidiary of the National Association of Securities Dealers "NASD"). The SEC's obligations under § 19(b) of the Securities and Exchange Act are to approve self-regulatory agency rules. Securities Exchange Act of 1934 §19(b), 15 USC §78 S(b)(2). For a history of SROs, including the New York Stock Exchange and Nasdaq see <http://www.sec.gov/rules/concept/34-50700.htm> (last visited Sept. 19, 2007) (17 CFR pt. 240, Release No. 34-50700, Concept Release Concerning Self-Regulation); see American Bar Association, Report, *Special Study On Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1497-1503, 1530-33 (discussing the history of NYSE and Nasdaq. In 1817, twenty-seven brokers organized themselves as the New York Stock Exchange Board, later renamed NYSE. The NYSE initially did not use listing standards to determine which stock to list. Prior to the twentieth century, each issuer and the NYSE negotiated flexible listing agreements. In the absence of uniform listing standards, the NYSE's Board of Governor's formed a Committee on Stock List to evaluate applications of issuers to list securities on the NYSE. Written corporate governance standards were not promulgated until thirty years later when the NYSE began securing agreements in writing and requiring disclosure of financial information. Then, through out the NYSE's development, the requirements in listing agreements became more numerous and stringent, such as, requiring companies to produce annual reports to stockholders, requiring annual stockholder's meetings, notifying NYSE of any change in the rights of stockholders or of "redemption of preferred stock," disclosure of semiannual income statement and balance sheets, quarterly income disclosures, etc. During the 1970s the NYSE was renowned as the most prestigious exchange, imposing the most stringent listing standards to attract some of the largest commercial and industrial companies in the United States. NYSE's trading volume was growing exponentially to about 16 million shares each day which was almost four times the volume in previous decades. In 2001, NYSE reported listing almost 3,000 companies and its daily volume exceeded a billion shares. The predecessor to Nasdaq was formed in 1971 by the NASD to improve the efficiency of OTC unlisted securities. Historically Nasdaq did not list securities but operated as a quotation service operated by a "registered securities association" rather than a registered "national securities exchange." Until the 1980s, Nasdaq unsuccessfully sought federal preemption of state blue sky laws in order to compete with NYSE and Amex who were dominating the U.S. securities market since the 1970s. One of the requirements of obtaining preemption was establishing listing requirements. In 1985, Nasdaq established its first corporate governance listing standards, such as requiring submission of annual and periodic reports to shareholders, appointment of directors, independent auditors, shareholder participation in some corporate transactions and execution of listing agreements. See American Bar Association, Report, *Special Study On Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1497-1503, 1530-33. See also Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards under the Securities Exchange Act*, 47 BUS. LAW. 1461, 1476-79 (1992).

<sup>7</sup> See generally American Bar Association, *supra* note 6, at 1525-28; see Bainbridge, *infra* note 66; see Bainbridge, *infra* note 88, at 591; see Thompson, *infra* note, at 1181-82.

<sup>8</sup> See Stephen M. Bainbridge, *Revisiting the One Share/One Vote Controversy: The Exchange's Uniform Voting Rights Policy*, 22 SEC. REG. L. J. 175 (1994) (discussing limits of listing agency rules).

implementing regulation to provide a safe-harbor for senior financial officers and principal executive officers. A safe-harbor provision should not only clarify that regulation 406 is for disclosure, but also that any substantive benchmarks for conduct required by listing agency rules do not supplant state fiduciary law.<sup>9</sup>

Part one of this article overviews SOX section 406, the SEC's regulation implementing section 406, and the NYSE and Nasdaq rules on codes of ethics. In particular, part one examines the legislative history of SOX section 406, and the interplay of SEC regulations and listing agency rules.

Part two briefly overviews the internal affairs doctrine. Part two also examines rulemaking boundaries of the SEC in approving amendments to SRO rules, and revisits the *Business Roundtable* decision.<sup>10</sup> Further, part two compares the legal environment leading to passage of SOX to the banking crisis of the 1980s, and examines the cases on federal common law.

Part three then focuses on the doctrine of corporate opportunity and conflicts of interest in Delaware. This part demonstrates that listing agency rules are inconsistent with Delaware's interpretation of conflicts of interest and corporate opportunity.

This article concludes arguing in support of a safe-harbor provision in the SEC's section 406 regulation. This final part explains the risks to state fiduciary law by using listing agency standards to define the obligations of officers and directors to shareholders, and the corporation. Additionally, this article points out the urgency to public companies, which may risk de-listing by NYSE and Nasdaq

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<sup>9</sup> See Veasey, *supra* note 2, at 443-44 (discussing the ways SRO and SOX intrude into Delaware law. Federal securities laws were initially promulgated to regulate the market in the area of disclosure. Delaware law has been a "default repository" for the development and depth of the law regarding fiduciary duties of directors and officers in the wake of emerging federal statutory duties and SEC Rules that may trump Delaware law. Although the SOX and SRO's reach into the internal affairs of Delaware corporations is substantial they have not entirely supplanted Delaware law. For example, SOX and SRO regulation have preempted or occupied internal affairs regarding the composition of board of directors, composition of audit, compensation, and governance committees, some activities and requirements of boards and committees, defining details regarding independence of directors, reporting and certification requirements of CEO's and the CFO, prohibitions, such as consulting fees and loans to officers); see American Bar Association, *supra* note 6, at 1493-96 (recommending nonbinding listing standard best practices "pertaining to the integrity of the securities markets and fairness to investors." Some of the best practice guidelines were to follow general principles. For example, best practices guidelines should be nonbinding and limited to issues of corporate governance necessary and "directly relevant" to maintenance of the integrity of the market and fairness to investors, allow for differences among issuers, where appropriate, considering size and other factors; joint action by NYSE and Nasdaq to create best practice guidelines to be updated and reviewed frequently through a protocol including publication, public comment; and active participation of the SEC, investors, issuers, firms, academics; joint establishment by NYSE and Nasdaq of processes to ensure uniform application and interpretation of best practice guidelines; written interpretations of guidelines, public availability of guidelines, issuance of rules and orders under section 11A of the Exchange Act authorizing a plan for joint action; requiring disclosure by each listed company in periodic reports, proxy materials, other public files regarding compliance with best practice guidelines; requiring explanation for noncompliance, and requiring disclosure of material changes to issuer's practices in an interim filing. American Bar Association, *supra* note 6, at 1493-96.).

<sup>10</sup> *Bus. Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (the Court of Appeals for the District of Columbia unanimously vacated Rule 19c-4, holding that the rule directly regulated the distribution of powers among classes of shareholders—a matter of internal corporate governance—and that the SEC overreached the scope of its statutory authority delegated by Congress in the Securities Exchange Act of 1934 Act).

in the event a company adopts a code of ethics that satisfies state fiduciary obligations for corporate opportunities or conflicts of interest, but does not comply with listing agency rules.

## II. CODE OF ETHICS REQUIREMENTS

### A. Codes of Ethics Pre - SOX Act

Company codes of ethics or conduct are not recent developments. Before the enactment of SOX, many companies had codes of ethics.<sup>11</sup> Companies adopted codes of ethics in order to satisfy certain requirements of the Federal Sentencing Guidelines and equal employment laws.<sup>12</sup> In addition, companies also adopted business ethics procedures to encourage an ethical work environment.<sup>13</sup> Often these codes of ethics ranged from values to compliance focused.<sup>14</sup> Such corporate codes covered a wide range of topics designed to promote employee honesty and integrity.<sup>15</sup> The SOX Act has required the disclosure of codes of ethics in ways not previously required by mandating disclosure of codes of ethics, if adopted, accountability procedures, and benchmarks for honest and ethical conduct.<sup>16</sup>

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<sup>11</sup> See Joshua A. Newberg, *Corporate Codes of Ethics, Mandatory Disclosure, and the Market for Ethical Conduct*, 29 VT. L. REV. 253, 254 (2005); see generally Kimberly D. Krawiec, *Organizational Misconduct: Beyond the Principal-Agent Model*, 32 FLA. ST. U. L. REV. 571, 591-93 (2005) (discussing types of corporate compliance codes).

<sup>12</sup> See Craig Ehrlich, *Is Business Ethics Necessary?*, 4 DEPAUL BUS. & COM. L. J. 55, 58 (2005); LINDA KLEBE TREVINO & GARY R. WEAVER, *MANAGING ETHICS IN BUSINESS ORGANIZATIONS: A SOCIAL SCIENTIFIC PERSPECTIVE ON BUSINESS ETHICS* 78 (Stanford University Press 2003).

<sup>13</sup> See Saul W. Gellerman, *Why "Good" Managers Make Bad Ethical Choices*, HARV. BUS. REV., Jul.-Aug. 1986, at 85 (arguing that more objective and more frequent control mechanisms are effective ways to avoid unethical management conduct and that there are four rationalizations used by managers to justify questionable conduct: first, there is a belief that the conduct is not "really" illegal or immoral; second, there is a belief that the conduct is in the best interest of the corporation or the individual; third, there is a belief that the conduct is "safe" and will not be exposed; and finally there is belief that since the conduct is beneficial to the company, the company will condone it).

<sup>14</sup> See Krawiec, *supra* note 11, at 591-98 (discussing types of corporate compliance codes); see generally TREVINO & WEAVER, *supra* note 12, at 91 (attempting to relate studies of ethics to larger normative questions of what ought to be valued. Values and ethics are communicated by the members of an organization similar to the way they conduct themselves, the manners in which they discuss matters regarding the organization and the manners in which they deal with outsiders. Perhaps, it is not surprising that organizational members tend to be less ethical in their decision-making if they perceive unfairness or injustice. From a subordinate's perspective, leaders carry out their agendas, incorporate their ethics into everyday operations of the company, and care about their employees will make more ethical decisions. TREVINO & WEAVER, *supra* note 12, at 91.); see STEVEN R. BARTH, *CORPORATE ETHICS: THE BUSINESS CODE OF CONDUCT FOR ETHICAL EMPLOYEES* 19-20 (Aspatore Books 2003).

<sup>15</sup> See TREVINO & WEAVER, *supra* note 12, at 91; LYNNE L. DALLAS, *ENRON AND ETHICAL CORPORATE CLIMATES, ENRON CORPORATE FIASCOS AND THEIR IMPLICATIONS* 187-207 (Nancy B. Rapoport & Bala G. Dharan, 2004) (discussing components of ethical decision-making).

<sup>16</sup> See STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., *FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE SECTOR WATCHDOGS* (Comm. Print 2002).

### B. *The SOX Act - Code of Ethics*

Section 406 of SOX requires the SEC promulgate regulations requiring a corporation to disclose whether it has a code of ethics for senior financial officers and if it does not the reasons for not adopting a code of ethics.<sup>17</sup> Section 406 of SOX does not require a company adopt a code of ethics; however, it does require the SEC to issue regulations requiring immediate disclosure of changes to or waivers of an adopted code of ethics.<sup>18</sup>

The SOX Act limited the applicability of the code of ethics to senior financial officers, principal financial officers, comptroller or principal accounting officers or those performing similar functions.<sup>19</sup> The SOX Act defines code of ethics to include standards promoting reasonable honest, ethical conduct and handling of conflicts of interest, timely and accurate filing of periodic reports, and compliance with laws.<sup>20</sup>

### C. *Legislative Background*

Congress passed the SOX Act amid turmoil and crisis in the public disclosure of financial fraud.<sup>21</sup> During many Congressional hearings, it became clear that transparency and independence would be the focus of legislation.<sup>22</sup> The legislative history of section 406 indicates the code of ethics provisions came at the recommendation of Senator Corzine.<sup>23</sup> Senator Corzine attributed a need for investors to know whether a public company held its officers to ethical standards to prevent corporate failures such as Enron and others.<sup>24</sup>

Other members of Congress recommended that the SEC develop rules to inform investors not only of corporate ethical standards, but also if the board waived any ethical requirements.<sup>25</sup> There is nothing in the legislative history on section 406 to suggest that Congress intended anything more than disclosure

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<sup>17</sup> Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7264(a) (2006).

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.* at § 406(C).

<sup>21</sup> See President Bush's comments on corporate governance,

<http://www.whitehouse.gov/infocus/corporateresponsibility/> (last visited Sept. 19, 2007); WILLIAM H. DONALDSON, SPEECH BY SEC CHAIRMAN: REMARKS AT THE 2003 WASHINGTON ECONOMIC CONFERENCE, <http://www.sec.gov/news/speech/spch032403whd.htm> (last visited September 19, 2007); see also The Business Roundtable statement, ENOUGH IS ENOUGH, <http://www.businessroundtable.org/taskForces/taskforce/document.aspx?qs=6AE5BF159F949514481138A6DF91851159169FEB5693FB5> (last visited Sept. 19, 2007).

<sup>22</sup> See also JOHN T. BOSTELMAN, THE SARBANES-OXLEY DESKBOOK, PRACTISING LAW INSTITUTE, §12:1.1, p.12-7 (Practising Law Institute 2004) (discussing legislatively history of SOX).

<sup>23</sup> See Senate Comm. on Banking, Housing, and Urban Affairs, Public Company Accounting Reform and Investor Protection Act of 2002, Report to Accompany S. 2673 Together with Additional Views, S. REP. NO. 107-205, at 32 (2002).

<sup>24</sup> *Id.*

<sup>25</sup> See H.R. 3763-The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002: Hearings on H.R. 3763 Before The Committee on H. R., 107th Cong., 131 (2002).

obligations for codes of ethics.<sup>26</sup>

Congress viewed a need for ethical accountability and disclosure as necessary in light of testimony revealing that the Enron board often waived its code of ethics requirements in order to engage in certain fraudulent financial transactions.<sup>27</sup> Many argued knowledge of such waivers would have allowed investors to see the broader financial picture and spot red flags.<sup>28</sup>

#### *D. SEC's Implementing Regulation and Corporate Governance Mandates*

Effective in March 2003, the SEC issued its final rule implementing SOX section 406 code of ethics disclosure requirements.<sup>29</sup> Later in 2003, the SEC also approved amendments to the NYSE and Nasdaq rules on corporate governance that included code of ethics requirements for listed companies.<sup>30</sup>

The rules, approved by the SEC, and adopted by the NYSE and Nasdaq, mandate listed companies adopt a code of ethics and disclose the code and any waivers.<sup>31</sup> The SEC's regulations do not require a company have a code of ethics, but disclose whether it has one or explain why it does not.<sup>32</sup> Optional versus mandatory adoption of a code of ethics is one of several ways that the regulations and rules differ.

#### *E. SEC's Section 406*

Unlike other SEC SOX regulations, which mandate additional substantive compliance with securities laws, section 406 requires only disclosure or waiver of a code of ethics.<sup>33</sup> Consistent with SOX, the SEC did not require a company to have a code of ethics, but to disclose whether it has one or explain why it does not.<sup>34</sup> If a company has a code of ethics, the regulations set forth broad parameters for what should be included in a code of ethics and does not require specific

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<sup>26</sup> See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearings Before the Committee on Banking, Housing, and Urban Affairs*, 107<sup>th</sup> Cong. (2002) (statement of Honorable David S. Ruder, former Chairman, U.S. Sec. and Exch. Comm'n) (stating the internal affairs of the corporation are not subject to SEC direct intervention); see also Joshua A. Newberg, *Corporate Codes of Ethics, Mandatory Disclosure, and the Market For Ethical Conduct*, 29 VT. L. REV. 253, 272-76 (2005) (discussing legislative history of SOX section 406).

<sup>27</sup> See Newberg, *supra* note 26, at 272.

<sup>28</sup> See Senate Comm. on Banking, Housing, and Urban Affairs, *Public Company Accounting Reform and Investor Protection Act of 2002*, *supra* note 23.

<sup>29</sup> See Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 17 C.F.R. § 228, 229, 249 (2006).

<sup>30</sup> See Self-Regulatory Organizations, 60 Fed. Reg. 64,154 (Sec. and Exch. Comm'n Nov. 12, 2003) (order approving proposed rule changes); see also Commissioner Pitt's Press Release, <http://www.sec.gov/news/press/2002-23.txt> (last visited Sept. 19, 2007).

<sup>31</sup> *Id.*

<sup>32</sup> Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, *supra* note 29.

<sup>33</sup> *Id.* at 5110; see also Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7264(a) (2006).

<sup>34</sup> Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, *supra* note 29, at 5110, 5118.



language, compliance procedures or disciplinary measures.<sup>35</sup> The SEC expanded its final rule to include not only senior financial officers, but also the principal executive officer even though SOX limited its scope to certain senior financial officers.<sup>36</sup>

Although the SEC's section 406 regulation permits companies to define their own code of ethics standards, procedures for internal reporting, and accountability for code compliance, the SEC recommends that a code of ethics include written standards "reasonably designed to deter wrong doing."<sup>37</sup> The regulation requires the code of ethics cover parameters consistent with SOX. These are honest and ethical behavior, including handling of conflicts of interest; fair, accurate, and timely filing of disclosure reports; compliance with applicable laws, rules and regulations; internal procedures for reporting and accountability for violations of the code ethics.<sup>38</sup> The SEC did not require the code of ethics include specific language that officers avoid conflicts of interest.<sup>39</sup>

Companies may select from several alternatives to disclose the code of ethics including website postings, and must disclose any waivers from compliance with its code of ethics immediately.<sup>40</sup> Companies may also have separate codes of ethics for different officers.<sup>41</sup> The SEC defines a waiver or implicit waiver as a material departure or failure to prevent a material departure from a provision of the code of ethics.<sup>42</sup> Also implicit in this requirement is that the board must approve any waivers to the code of ethics.<sup>43</sup>

#### F. NYSE and Nasdaq Requirements

Unlike the SEC's regulation that did not require adoption of a code of ethics, the SEC approved NYSE and Nasdaq rule changes that require listed companies to adopt a code of ethics.<sup>44</sup> The SEC commented that requiring companies listed on the NYSE or Nasdaq adopt code of ethics encouraged ethical conduct and, therefore, provided investors with information to evaluate and assess compliance

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<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 5118 (Code of Ethics final rule B(1)(a)). Although the SEC received comments suggesting it not extend the requirement to the principal executive officer, the SEC ultimately decided that it was proper to extend the requirements to the principal executive officer because it was appropriate to expect financial officers reporting to the chief executive to hold the principal executive officer to the same standards. *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at 5118, n. 43.

<sup>39</sup> Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, *supra*, note 29, at 5118.

<sup>40</sup> *Id.* at 5119, n. 53. The SEC requires that only "only amendments or waivers relating to the specified elements of the code of ethics and the specified officers must be disclosed." *Id.*

<sup>41</sup> *Id.* at 5118, n. 46, 5126, 5130-31.

<sup>42</sup> *Id.* at 5119, 5131; *see also* BOSTELMAN, *supra* note 22, at Chapter 12.

<sup>43</sup> Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, *supra*, note 29, at 5119; *see also* BOSTELMAN, *supra* note 22, at Chapter 12

<sup>44</sup> *See* Self-Regulatory Organizations, 60 Fed. Reg. 64, 154 (Sec. and Exch. Comm'n Nov. 12, 2003) (order approving proposed rule changes).

with the code of ethics.<sup>45</sup>

### G. NYSE Rules

The NYSE rules require a company listed on its exchange adopt and disclose its code of ethics, and any waivers of the code of ethics.<sup>46</sup> The NYSE requires the code of ethics apply to directors, officers, and employees and is not only broader in application than the SEC's regulation, but also the SOX Act.<sup>47</sup>

The NYSE listing company rules further differs from the SEC regulations and requires the code of ethics address the following: conflicts of interest, corporate opportunities, confidentiality, fair dealing, protection and proper use of company assets, compliance with laws, rules and regulations, encouraging the reporting of any illegal or unethical behavior.<sup>48</sup> While a listed company may define its own policies, the more significant of these requirements are conflicts of interest and corporate opportunities.

The NYSE rules define a conflict of interest as a personal interest that interferes with the interests of the company.<sup>49</sup> Companies must have policies to prohibit conflicts of interest and provide a means to report such conflicts of interest.<sup>50</sup> Prompt disclosure of waivers by the board is required.<sup>51</sup> The NYSE rules define a corporate opportunity as taking for personal benefit opportunities available resulting from a company position or privy to information, using company property for personal gain, and competing with the company.<sup>52</sup> The code of ethics is to prohibit employees from taking such corporate opportunities.<sup>53</sup>

### H. NASDAQ Rules

Similar to the NYSE listing rules, the Nasdaq listing rules require a company listed on its exchange adopt, disclose a code of ethics and any waivers.<sup>54</sup> It also applies to directors, officers, and employees.<sup>55</sup> However, unlike the NYSE rules, the Nasdaq rules require the code of ethics satisfy the requirements of the SEC's section 406 regulation, and provide enforcement procedures.<sup>56</sup> The Nasdaq rules

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<sup>45</sup> *Id.* at 64,175.

<sup>46</sup> NYSE Listed Company Manual § 303A.10, Code of Business Conduct and Ethics, <http://www.nyse.com/lcm/1078416930909.html?enable=subsection&number=3&&sssnum> (last visited Sept. 22, 2007).

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> NYSE Listed Company Manual § 303A.10, Code of Business Conduct and Ethics, <http://www.nyse.com/lcm/1078416930909.html?enable=subsection&number=3&&sssnum> (last visited Sept. 22, 2007).

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> Nasdaq Corporate Governance Summary of Rule Changes, Nov. 2003, <http://www.nasdaq.com/about/CorpGovSummary.pdf> (last visited September 22, 2007).

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

require the codes of conduct cover conflicts of interest and enforcement provisions although it does not define the meaning of conflicts of interest and does not include a prohibition against the taking of corporate opportunities.<sup>57</sup> It requires that only the board or a committee may waive the requirements of a companies' code of conduct and any such waiver promptly disclosed to shareholders.<sup>58</sup>

### I. The SEC's Role in Regulating SROs

The SEC's regulatory authority over listing agencies such as NYSE and Nasdaq derives from section 19 of the Exchange Act.<sup>59</sup> Section 19(b)(1) gives the SEC authority to approve proposed rules or amendments to rules by the NYSE and Nasdaq.<sup>60</sup> The listing agencies must explain the purpose of and reasons for a proposed rule change.<sup>61</sup>

The SEC must hold rulemaking proceedings on SRO proposed rule changes.<sup>62</sup> The SRO may not implement rule changes unless approved by the SEC.<sup>63</sup> The SEC must then either approve the rule change or begin proceedings to disapprove a rule change.<sup>64</sup> The SEC must either approve or disapprove an SRO proposed rule amendment based on its findings that the proposed rule changes meet applicable laws and regulations for SROs.<sup>65</sup>

There is nothing in the statute that limits the scope of SRO rulemaking on corporate governance.<sup>66</sup> Nonetheless, the SEC, in addition to its rulemaking

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<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> Securities and Exchange Act of 1934, § 19(a)(2), 15 U.S.C. § 78s(a)(2), (c) (2000); see Report, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1517-23 (2002); see also *Bus. Roundtable v. SEC*, 905 F.2d 406, 408-09 (D.C. Cir. 1990); see also S. Rep. No. 94-75, at 7 (1975); see also Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 969-72 (2003) (discussing history of listing standards); see Douglas C. Michael, *The Untenable Status of Corporate Governance Listing Standards under the Securities Exchange Act*, 47 BUS. LAW. 1461, 1477, 1479 (1992); F. Hodge O'Neal, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 618-20 (1991) (discussing rulemaking authority of SEC over SROs); Robert B. Thompson, *Corporate Federalism in the Administrative State: The SEC's Discretion to Move the Line Between the State and Federal Realms of Corporate Governance*, 82 NOTRE DAME L. REV. 1143, 1151 (2007) (discussing role of listing standards in corporate governance).

<sup>60</sup> Securities and Exchange Act of 1934, § 19(b)(1), 15 U.S.C. § 78s(b)(1)(2), (c) (2000); see American Bar Association, Report, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1496-1503 (2002) (discussing history of listing standards).

<sup>61</sup> Securities and Exchange Act of 1934, § 19(b), 15 U.S.C. § 78s (b)(2), (c); Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards under The Securities Exchange Act*, 47 BUS. LAW. 1461, 1463 (1992).

<sup>62</sup> Securities and Exchange Act of 1934, § 19(a)(1)(B), 15 U.S.C. § 78s (a)(1)(B) (2000).

<sup>63</sup> Securities and Exchange Act of 1934, § 19(b)(1), 15 U.S.C. § 78s (b)(1) (2000).

<sup>64</sup> Securities and Exchange Act of 1934, § 19(a)(1)(B), 15 U.S.C. § 78s (a)(1)(B) (2000).

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* See also Stephen M. Bainbridge, "A Critique of the NYSE's Director Independence Listing Standards," UCLA School of Law, Research Paper No. 02-15, June 2002, <http://ssrn.com/abstract=317121> (last visited Sept. 23, 2007) (explaining that nothing prohibits SROs from making rules on corporate governance); see American Bar Association, *supra* note 60, at 1519-21 (discussing the role of listing standards in corporate governance); see also U.S. Securities and Exchange Commission, Concept Release Concerning Self-Regulation, <http://www.sec.gov/rules/concept/34->

approval, maintains significant influence over SROs, and often uses this influence to further its regulatory goals.<sup>67</sup>

The SEC may also implement a proposed rule change if it believes such action protects investors or otherwise maintains market integrity.<sup>68</sup> Once approved the SRO may enforce its rules provided such rules comply with applicable rules, regulations or federal and state law.<sup>69</sup>

In the rulemaking record for the NYSE and Nasdaq standards on codes of ethics, the SEC stated its belief that mandating adoption of a code of ethics would not only encourage ethical behavior by directors, officers and employees, but also encourage the knowledge and understanding of standards of conduct expected in carrying out corporate duties.<sup>70</sup> It also stated its belief that the codes of ethic requirements are consistent with Congressional intent to provide information to shareholders on waivers, and otherwise consistent with requirements in furtherance of the securities laws and regulations.<sup>71</sup> The rulemaking record does not suggest the SEC commented that the NYSE or the Nasdaq rules intruded into the corporate governance domain reserved for state law.<sup>72</sup>

#### J. *The Interplay of SEC's section 406, NYSE, and Nasdaq Rules*

Notwithstanding that the SEC's section 406 implementing regulation does not require an issuer to adopt a code of ethics, any issuer that is also a registered listed company with either the NYSE or Nasdaq must adopt a code of ethics.<sup>73</sup> Any NYSE or Nasdaq listed company risks de-listing for failing to comply with listing agency rules.<sup>74</sup> The result is that many public companies must develop

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50700.htm (last visited Sept. 23, 2007) (codified at 17 C.F.R. pt. 240). Section I Introduction and Section II Foundations of Self-Regulation describe the ability of SROs to go beyond SEC standards and prescribe "business conduct." *Id.*

<sup>67</sup> See Bainbridge, *supra* note 66, at n. 15; see American Bar Association, *supra* note 60, at 1503 (discussing the influence of the SEC on listing standards); Robert B. Thompson, *Corporate Federalism in the Administrative State: The SEC's Discretion to Move the Line Between the State and Federal Realms of Corporate Governance*, 82 NOTRE DAME L. REV. 1143, 1178-79 (2007).

<sup>68</sup> Securities and Exchange Act of 1934, § 19(b)(1), (2), 15 U.S.C. § 78s b(1), (2) (2000).

<sup>69</sup> *Id.*; see American Bar Association, *supra* note 60, at 1517-23 (discussing regulatory authority of SEC over listing agencies); see Michael, *supra* note 61, at 1496.

<sup>70</sup> Self-Regulatory Organizations, 60 Fed. Reg. 64,154, 64,175 (Sec. and Exch. Comm'n Nov. 12, 2003) (order approving proposed rule changes).

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* Commentators did not raise the issue of SRO rules intruding into state corporate law. *Id.* See also American Bar Association, *supra* note 60, at 1517-24.

<sup>73</sup> See also JOHN T. BOSTELMAN, THE SARBANES-OXLEY DESKBOOK, PRACTISING LAW INSTITUTE Chapter 12, § 12:1.4 (Practising Law Institute 2004) (discussing interplay between section 406 of the Sarbanes-Oxley Act and NYSE/Nasdaq rules); see also Thomas O. Gorman & Heather J. Stewart, *Is There a New Sheriff in Corporateville? The Obligations of Directors, Officers, Accountants, and Lawyers after Sarbanes-Oxley of 2002*, 56 ADMIN. L. REV. 135, 148 (2004) (discussing the impact of not adopting a code of ethics); see generally Michael, *supra* note 61, at 1462-63, 1466-67.

<sup>74</sup> NYSE Listed Company Manual, § 802.01 Continued Listing Criteria, [http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/listed/1182508124422.html&displayPage=/lcm/lcm\\_section.html](http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/listed/1182508124422.html&displayPage=/lcm/lcm_section.html) (last visited Sept. 23, 2007); Nasdaq Listing Requirements for Nasdaq Securities 4300, [http://www.complinet.com/nasdaq/display/display.html?rbid=1705&element\\_id=13](http://www.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=13) (last visited Sept. 23, 2007); see also BOSTELMAN, *supra* note 73, at § 12:1.4; Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State*

codes of ethics to satisfy SEC and listing agency rules or design varied codes of ethics for different officers, directors, and employees.<sup>75</sup> Thus, the SEC has required implicitly what it did not require directly.<sup>76</sup>

*K. Safe-Harbor and Liability under Section 406*

The SEC issued disclosure regulations for sections 406 and 407 under a single release.<sup>77</sup> Section 407 regulations require the disclosure of whether a company has a financial expert on its audit committee.<sup>78</sup> After receiving several comments on the increased liability risks to directors designated as the financial expert, the SEC concluded that it was not its intent to increase the obligations or liabilities of the financial expert director because the purpose of the regulation was disclosure.<sup>79</sup> Therefore, the SEC included a safe harbor from liability for the audit committee financial expert resulting from the financial expert designation pursuant to the regulation.<sup>80</sup> The safe-harbor protects the audit committee financial expert from increased duties, obligations, or liabilities under federal or state law.<sup>81</sup>

The SEC did not include a similar safe harbor provision in section 406's code of ethics requirements, notwithstanding that both provisions are disclosure and not substantive requirements.<sup>82</sup> Further, there is nothing to suggest from the SEC's rulemaking record that the SEC intended to alter the liability risks of senior officers.<sup>83</sup> Because the SEC did not address liability issues, or see the need to add a safe-harbor to its section 406 regulation, the reasonable inference is that the SEC views the code of ethics as disclosure obligations only.<sup>84</sup> This view is consistent with the legislative history of SOX 406.

Though the SEC's implementation regulation does not directly address liability issues, presumably, the SEC could prosecute for failure to disclose a code of ethics (if adopted) or any waivers.<sup>85</sup> What is not clear is whether the SEC could

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*Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 977-78 (2003).

<sup>75</sup> See BOSTELMAN, *supra* note 73, at § 12:1.4.

<sup>76</sup> See Thompson, *supra* note 67, at 1180-84 (2007); see A. C. Pritchard, *Markets As Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 976, 1017 (1999); see *Bus. Roundtable v. SEC*, 905 F.2d 406, 412 (D.C. Cir. 1990); see also Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, UCLA School of Law, Research Paper No. 02-15, <http://ssrn.com/abstract=317121> (last visited Sept. 17, 2007).

<sup>77</sup> Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5110, 5110 (Jan. 31, 2003) (to be codified at 17 CFR pt. 228, 229, and 249).

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at 5117.

<sup>80</sup> *Id.* at 5116-17.

<sup>81</sup> *Id.*

<sup>82</sup> See Disclosure Required By Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5110, 5118-19 (Jan. 31, 2003); see Joshua A. Newberg, *Corporate Codes of Ethics, Mandatory Disclosure, and the Market for Ethical Conduct*, 29 VT. L. REV. 253, 280-281 (2005).

<sup>83</sup> See Newberg, *supra* note 82, at 278-79.

<sup>84</sup> See *id.*

<sup>85</sup> See Paul Vizcarrondo, Jr. & Andrew C. Houston, *Liabilities Under Sections 11, 12, 15 and 17 of the Securities Act of 1933 and Sections 10, 18 and 20 of the Securities Exchange Act of 1934*, 1556 PLI/Corp 537, 542 (2006). "Sarbanes-Oxley provides that any violation of the Act is considered a violation of the 1934 Act, thus availing the SEC of its full range of powers, remedies and penalties

prosecute an improper waiver of the code of ethics by the board under federal securities laws or whether a board could claim compliance with state fiduciary duties as its defense for a code of ethics waiver.<sup>86</sup> Therefore, it is likely state fiduciary laws continue to govern liability of officers and directors subject to the code of ethics, and that any underlying behavior not in compliance with a code of ethics are not subject to federal securities law violations.<sup>87</sup>

If, as Congress suggests, investors must decide the value and meaning of codes of ethics, then, shareholders can use knowledge on waivers of codes of ethics to demand greater accountability by boards. However, if the triad of codes of ethics laws, regulations, and rules further the encroachment into state corporate law in areas clearly reserved for the state; then the codes of ethics requirements true value may be to continue federalization of state corporate law.<sup>88</sup> Whether it is a race to the top or a race to the bottom, shareholders benefit from a balanced symbiotic relationship between federal securities laws, listing standards, and state corporate law.<sup>89</sup> Defining the fiduciary duties of officers and directors in state corporate law is a fundamental principle of the internal affairs doctrine worthy of preservation.<sup>90</sup>

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under the 1934 Act. It also expands the 1934 Act remedies by providing that, in civil enforcement actions brought by the SEC, courts may grant any equitable relief that is appropriate for protection of investors, which could suggest broader and more intrusive court oversight of (and monetary remedies against) violators of the Act. Except with respect to recovery of profits from prohibited sales during a blackout period and suits by "whistleblowers," the Act does not expressly create new private rights of action for civil liability for violations of Sarbanes-Oxley itself. However, the Act potentially impacts existing private rights of action under the 1934 Act by (1) lengthening the general statute of limitations applicable to private securities fraud actions to the earlier of two years after discovery of the facts constituting the violation or five years after the violation . . . and (2) expanding reporting and disclosure requirements, which could potentially expand the range of actions that can be alleged to give rise to private suits under Sections 10(b) and 18 of the 1934 Act and SEC Rule 10b-5." *Id.* (internal citation omitted).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1577-78, 1617 (2005); Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. ON REG. 313, 326-27 (2007); see Pritchard, *supra* note 76, at 927-30, 976-81 (1999); see Michael, *supra* note 61, at 1478 (1992); Robert B. Thompson, *supra* note 67, at 1181-82 (2007); Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 591 (1991).

<sup>89</sup> Kahan & Rock, *supra* note 88, at 1619-22; see Ramirez, *supra* note 88, at 313, 329, 339; Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 963 (2003); see American Bar Association, *supra* note 60, at 1487, 1522-23 (2002).

<sup>90</sup> See *supra* note 89; William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 633-39 (2006); see Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1484, 1499-1507 (1992); Bainbridge, *supra* note 88, at 565, 619 (discussing history of SEC's role in federalizing corporate law); see generally Paul Rose, *The Corporate Governance Industry*, 32 J.CORP. L. 887 (2007).

### III. WHERE IS THE LINE?

#### A. *Internal Affairs Doctrine*

The settled accord between federal and state regulation of corporate law is that federal securities law regulates disclosure and state law regulates conduct.<sup>91</sup> Although Congress is free to create federal law that overrides state corporate law, absent direct Congressional action or legislative intent, courts will not usurp the role of state law in decipherment of those matters reserved for it.<sup>92</sup> Thus, the internal affairs doctrine simply provides that state law govern the internal affairs of the state created corporation.<sup>93</sup> The Delaware Supreme Court has succinctly stated that under the doctrine of internal affairs state law governs those matters “that pertain to the relationships among or between the corporation and its officers, directors, and shareholders.”<sup>94</sup>

Notwithstanding the federal and state law demarcation, the separation is not always a bright line.<sup>95</sup> Federal securities laws have encroached state law in areas other than disclosure such as voting rights and insider trading.<sup>96</sup> Specifically, insider trader laws, which regulate conduct is an appropriate intrusion into state law justified by the need to ensure the integrity of the trading markets.<sup>97</sup> Although

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<sup>91</sup> *CTS Corp. v. Dynamics Corp. of Amer.*, 481 U.S. 69, 85-87 (1987), *rev'd in part*, 481 U.S. 69 (1987) (addressing constitutional challenges to Indiana's Control Share Acquisitions statute. Six days after the Indiana Act took effect, the Dynamics Corporation of America announced a tender offer for greater than a million shares of CTS stock. The Court considered whether the Williams Act had preempted the Indiana Act and whether the Indiana Act violated the Commerce Clause. The Court found no preemption and stated that “if Congress had intended to pre-empt all state laws that delay the acquisition of voting control following a tender offer, it would have said so explicitly.”); *see also* E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 443-44 (2003).

<sup>92</sup> *See* Kahan & Rock, *supra* note 88, at 1577-78, 1617; Richard A. Booth, *The Emerging Conflict between Federal Securities Law and State Corporation Law*, 12 J. CORP. L. 73 (1986); Lucian A. Bebchuk, *supra* note 90, at 1437; Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 107 COLUM. L. REV. 1793 (2006); *see generally* William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619 (2006); Renee Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879, 880 (2006); *see generally* Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 BUS. LAW. 317 (2007); Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2521 (2005).

<sup>93</sup> *See* *Vantage Vent. Partners v. Examen, Inc.*, 871 A.2d 1108 (Del. 2005); *see also* *CTS Corp.*, 481 U.S. at 69; Alan R. Palmiter, *The CTS Gambit: Stanching the Federalization of Corporate Law*, 69 WASH. U. L.Q. 445, 451 (1991).

<sup>94</sup> *Vantage Vent. Partners*, 871 A.2d at 1113; *see also* *CTS Corp.*, 481 U.S. at 69; *see* Palmiter, *supra* note 93, at 451; William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L. J. 663, 665-66 (1974).

<sup>95</sup> *See* Jones, *supra* note 92 at 879, 883 (discussing the circularity of the internal affairs doctrine); *see* Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 619 (1991) (discussing the role of federal and state law in regulation of corporations).

<sup>96</sup> *See* Jones, *supra* note 92, at 882.

<sup>97</sup> *See* *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977). The internal affairs doctrine states that state law governs those matters concerning the internal workings of the corporation. *Id.* In a case involving violations of federal securities laws for insider trading, the Supreme Court concluded that breach of a fiduciary duty under state law is not a breach of securities laws. *Id.* at 476. The Supreme Court stated that the purpose of securities laws was disclosure and that issues of fairness were not

a debate continues over the scope of state law in the regulation of securities, the regulation of the conduct, including the fiduciary duties, of directors and officers remains a state matter.<sup>98</sup>

### B. Internal Affairs and the SEC

In cases where the SEC implemented rules that encroached into states' rights to regulate corporate governance matters, courts have intervened to vacate such rules.<sup>99</sup> In *Business Roundtable v. SEC*, the D.C. circuit struck down a SEC regulation barring national listing associations from listing stock of a corporation restricting or reducing its per share voting rights.<sup>100</sup> The court described the SEC's regulation as crossing the line "beyond disclosure."<sup>101</sup> The court concluded that the regulatory review of the SEC over SROs does not give it the authority to create federal corporate laws using "access to . . . capital markets as its enforcement mechanism."<sup>102</sup> The court concluded that unless SRO rules further the exercise of federal regulatory power, they could not preempt state law.<sup>103</sup>

### C. Federal Common Law and The Banking Crisis

During the banking crisis of the 1980's, tensions arose between the role of

matters of direct concern to the securities laws. *Id.* at 477. The Supreme Court affirmed prior decisions that a state's interest in developing consistent rules for directors, officers, and shareholders is fundamental to the commerce clause. *Id.* "[T]he 'fundamental purpose' of the Act [the securities act] as implementing a 'philosophy of full disclosure'; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute." *Id.* at 478.

<sup>98</sup> See generally Steven A. Ramirez, *supra* note 88, at 303; see generally Peter Ferola, *The Role of Audit Committee in the Wake of Corporate Federalism: Sarbanes-Oxley's Creep into State Corporate Law*, 71 J. BUS. & SEC L. 143 (2007); David J. Schulte, 13 J. CORP. L. 535 (1988); see Gorman & Stewart, *supra* note 73, at 140-41, 149-50, 173-74; see generally Veasey, *supra* note 91, at 441; see generally Robert Ahdieh, *From Federalization to Mixed Governance in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFF. L. REV. 721, 722, 731 (2005) (arguing that modern public corporations face dual pressures from privatization on one hand and nationalization on the other but that these pressures may open opportunities to develop and reform corporate law. It is not disputed that federal law has a "traditional orientation" to regulate securities issuances, disclosure, and secondary trading while state law has been traditionally oriented to corporate governance, but tradition alone is insufficient to challenge the Act's corporate governance mandates. A doctrinal segregation opens up two perspectives. One is to characterize corporate law as private and securities law as public and the other is to characterize corporate law as the "regulation of substance" while securities law is the regulation of process).

<sup>99</sup> *Bus. Roundtable v. SEC.*, 905 F.2d 406, 417 (D.C. Cir. 1990) (quoting the court in *C.T.S. Corp.*, a case involving control shares, the Williams Act, and the Commerce Clause). On review of an order by the SEC, the Court stated that "[n]o principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders." 481 U.S. at 89. "A State has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs." *Id.* at 91; see Michael, *supra* note 88, at 1480-85 (analyzing the *Business Roundtable* opinion).

<sup>100</sup> *Bus. Roundtable*, 905 F.2d at 407; American Bar Association, Report, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1525 (2002).

<sup>101</sup> *Bus. Roundtable*, 905 F.2d at 412.

<sup>102</sup> *Id.*

<sup>103</sup> *Id.* at 413-417; see Bainbridge, *supra* note 95, at 618-20 (discussing rulemaking authority of SEC over SROs); see American Bar Association, *supra* note 100, 1523-24.



federal and state law in regulating the conduct of officers.<sup>104</sup> In a series of cases, the Supreme Court resolved several key issues on the role of federal and state law in determining the liability of banking officers.<sup>105</sup>

In an environment much like the crisis that led to the passage of the SOX Act, Congress passed in response to the scandals involving financial institutions, a series of laws to protect the banking industry from fraud and abuse, and to reign in conduct of banking officers.<sup>106</sup> The majority of the scandals involved senior officers and directors of failed financial institutions accused of fraud, improper conduct, and breach of various fiduciary duties.<sup>107</sup>

Many of the failed financial institutions were state-chartered financial institutions; however, state-chartered financial institutions insured by the Federal Depository Insurance Corporation (“FDIC”) are subject to federal regulatory requirements.<sup>108</sup> The more significant of these regulatory requirements is the ability of the FDIC (or appropriate regulatory receiver) to sue officers and directors of failed state chartered institutions for breach of duties.<sup>109</sup>

In 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (“FIRREA”).<sup>110</sup> The purpose of FIRREA was to allow the FDIC to recover depositors’ losses from a failed state-chartered financial institution above a certain threshold.<sup>111</sup> As a result, FIRREA governed the liability of directors and officers of FDIC insured financial institutions.<sup>112</sup>

Specifically, section 1821(k) of FIRREA required that “a director and officer of insured depository institutions may be personally liable . . . for gross negligence, including . . . conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined under applicable State law.”<sup>113</sup> Before passage of FIRREA, case law on the liability of financial institution’s officers and directors was not clear.<sup>114</sup> The purpose of section 1821(k) was to clarify the liability of directors and officers of state-chartered financial institutions.<sup>115</sup>

During the course of financial institutions bankruptcy litigation, confusion

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<sup>104</sup> See Steven A. Ramirez, *The Chaos of 12 U.S.C. Section 1821(K): Congressional Subsidizing of Negligent Bank Directors and Officers?*, 65 *FORDHAM L. REV.* 625 (1996).

<sup>105</sup> See *id.* at 625-26.

<sup>106</sup> *Id.* at 626-36.

<sup>107</sup> See generally *id.*

<sup>108</sup> See *id.*

<sup>109</sup> Ramirez, *supra* note 104, at 661, 665-66.

<sup>110</sup> *Id.* at 626.

<sup>111</sup> 12 U.S.C. § 1821(k) (2000).

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> See Ramirez, *supra* note 104, at 631. See, e.g. *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942) (applying federal common law to a state-chartered bank but distinguishing *Erie R.R. v. Tompkins*, 304 U.S. 64, *cert. denied*, 305 U.S. 637 (1938)); see *FDIC v. Bierman*, 2 F.3d 1424 (7th Cir. 1993) (applying federal common law to state-chartered bank); but see *RTC v. Gregor*, 872 F. Supp. 1140, 1144-45 (E.D.N.Y. 1994) (holding that state law governs claims against directors and officers of federally-chartered banks and that federal common law does not even apply to federally-chartered banks).

<sup>115</sup> *Id.*

arose primarily from several circuit court opinions reaching opposite results as to whether directors and officers owed federal common law duties or state common law duties.<sup>116</sup> The two issues developed from a lack of clarity in lower court opinions on whether state or federal law governed officer's knowledge of fraud and whether there is a federal common law providing standard of care for officers and directors.<sup>117</sup> The Supreme Court addressed these and other issues in two key cases: *O'Melveny & Myers v. FDIC* and *Atherton v. FDIC*.<sup>118</sup>

Relying on established principles, the Supreme Court in *O'Melveny* held that state law governs the status of a corporate officer's knowledge on state law claims for a state chartered bank.<sup>119</sup> Answering the questions of whether federal or state law governed, the Supreme Court held absent an explicit federal statutory provision, issues not addressed in federal regulations are presumably subject to state law.<sup>120</sup>

Subsequently, in *Atherton*, relying in part on *O'Melveny*, the Court, interpreting section 1821(k) of FIRREA, concluded that the senior officers of a failed state chartered financial institution are subject to state law.<sup>121</sup> It further

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<sup>116</sup> *Id.* at 631, 635.

<sup>117</sup> *Id.* at 625.

<sup>118</sup> *O'Melveny & Meyers v. Fed. Deposit. Ins. Corp.*, 512 U.S. 79 (1994). FDIC sued the former counsel of a failed state chartered financial institution. *Id.* at 82. The issue was whether state law or federal law governed the tort liability of the attorneys who provided legal counsel to the failed financial institution, but who were not officers of the financial institution. *Id.* at 85. Relying on the principles of *Erie Railroad Co. v. Tompkins*, the Court held that state law governed the conduct of the attorneys and concluded that there was no federal common law. *Id.* at 83-84. The court went on to suggest that unless there is an explicit federal statutory provision or regulation that is comprehensive and detailed, state law would govern matters not otherwise addressed by a federal regulatory scheme. *Id.* at 85. The Court reiterates that there are limited circumstances where it is likely to find a federal common law and these exist when there is a "conflict between some federal policy or interest and the use of state law." *Id.* at 87 (quoting *Wheeldin v. Wheeler*, 373 U.S. 647, 651 (1963) and *Wallis v. Pan Am. Petroleum Corp.*, 384 U.S. 63, 68 (1966)). Indeed, finding a conflict between federal and state law is essential in finding a federal common law. *O'Melveny*, 512 U.S. at 87-88. In assessing whether there is a conflicting policy that court looks to interest in uniformity of laws, a direct right of the government tied to an identifiable federal policy. *Id.* at 88-89; *see also Atherton v. Fed. Deposit Ins. Corp.*, 519 U.S. 213 (1997).

<sup>119</sup> *O'Melveny*, 512 U.S. at 89 (concluding that officers of a federally insured state-chartered financial institution accused of fraud and breaches of fiduciary duties under California law were subject to state law).

<sup>120</sup> *Id.* at 85 (the Court "would not contradict an explicit federal statutory provision. Nor . . . adopt a court-made rule to supplement federal statutory regulation that is comprehensive and detailed; matters left unaddressed in such a scheme are presumably left subject to the disposition provided by state law.").

<sup>121</sup> *Atherton*, 519 U.S. at 216. The FDIC (successor to the RTC) sued officers and directors of a failed federally chartered financial institution. *Id.* The issues in the case were whether the standard of care for the officers' conduct was governed by state law, federal common law or a special federal statute. *Id.* at 215-16. The Court held that "state law sets the standard of conduct as long as the state standard (such as simple negligence) is stricter than that of the federal statute. The federal statute nonetheless sets a 'gross negligence' floor, which applies as a substitute for state standards that are more relaxed." *Id.* at 216. Where Congress speaks, the intent must follow. *Id.* The Court, again relying on *Erie*, confirmed that there is no federal common law and the justification for federal common law is for limited circumstances. *Id.* at 218. In deciding whether the application of state law standards of care conflict with a federal policy or interest, the Court concluded that uniformity was not a persuasive argument because banks were permitted to follow the corporate governance of states and that state-chartered banks were indeed governed by state law. *Atherton v. Fed. Deposit Ins. Corp.*, 519 U.S. 213, 218 (1997). In deciding whether federal statutory law supplanted state law, the court

concluded that there is no federal common law absent a “specific showing that the use of state law will create a significant conflict with, or threat to, some federal policy or interest.”<sup>122</sup>

#### D. SOX and Federal Interest

The legislative history of SOX section 406 suggests that federal interests are in the disclosure of ethical standards and waivers.<sup>123</sup> The SEC’s regulatory implementation of section 406 also focuses on knowledge of ethical standards and disclosure.<sup>124</sup> The SEC’s failure to use its rulemaking authority or political influence to limit the NYSE and Nasdaq corporate governance rules so that they were consistent with the internal affairs doctrine contravenes the legislative intent regarding code of ethics disclosures and the SEC’s regulatory authority.<sup>125</sup>

Further, the SEC did not demonstrate a threat to a federal policy or interest to warrant the supplanting of state fiduciary principles governing officer and director conduct in its rulemaking approval of NYSE and Nasdaq rule amendments.<sup>126</sup> The court in *Business Roundtable* rejected the SEC’s argument that integrity of the markets was a sufficient justification to intrude into a state’s right to regulate internal corporate matters.<sup>127</sup> Such an intrusion into state corporate law is difficult to justify under SRO rulemaking when compliance with state law is also a standard for listing agency rules.<sup>128</sup>

### IV. DELAWARE STATE LAW

#### A. Corporate Opportunity and Conflicts of Interest

Corporate opportunity and conflicts of interest are common law principles that describe the fiduciary duty of loyalty owed by corporate agents to

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interpreted that FIRREA supplanted lower standards. *Id.*

<sup>122</sup> *Id.* at 214; see also *Cort v. Ash*, 422 U.S. 66, 78 (1975); see Joshua A. Newberg, *Corporate Code of Ethics, Mandatory Disclosure, and the Market for Ethical Conduct*, 29 VT. L. REV. 253, 279-81 (finding no federal common law on the standard of care under FIRREA).

<sup>123</sup> See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearings Before the Committee on Banking, Housing, and Urban Affairs*, 107<sup>th</sup> Cong. (2002) (statement of Honorable David S. Ruder, former Chairman, U.S. Sec. and Exch. Comm’n) (stating the internal affairs of the corporation are not subject to SEC direct intervention); see also Joshua A. Newberg, *Corporate Codes of Ethics, Mandatory Disclosure, and the Market For Ethical Conduct*, 29 VT. L. REV. 253, 272-76 (2005) (discussing legislative history of SOX section 406).

<sup>124</sup> See *supra* notes 2, 18, 29, 31.

<sup>125</sup> See Bainbridge, *supra* note 95, at 595-98 (discussing SEC oversight over SROs).

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*; see Michael, *supra* note 61, at 1462-63, 1483-84; see also *Bus. Roundtable*, at 408-09; see also S. REP. NO. 94-75, at 7 (1975); see American Bar Association, *supra* note 100, at 1491-92, 1525-26.

<sup>128</sup> See Bainbridge, *supra* note 95, at 595-98; see Michael, *supra* note 61, at 1493-94; see also *Bus. Roundtable*, 905 F.2d at 408-09; see also S. REP. NO. 94-75, at 7 (1975); see American Bar Association, *supra* note 100, at 1518-19.

shareholders.<sup>129</sup> Directors and officers owe duties of loyalty that prohibit putting personal interests above those of the corporation and shareholders.<sup>130</sup> Corporate opportunity doctrine issues occur when the corporate officer or director takes an opportunity that results in a conflict between the officers or directors fiduciary obligations to the corporation and personal interests.<sup>131</sup>

### B. Conflicts of Interest in Delaware

Delaware has codified parts of its conflict of interest rules in its interested director statute.<sup>132</sup> The statute does not void transactions deemed conflicts of interest, but allows for disclosure of material information and voting by disinterested directors.<sup>133</sup> The statute relies on fairness and good faith as standards for assessing the validity of an interested director or officer's transaction with the corporation.<sup>134</sup>

### C. Corporate Opportunity in Delaware

Unlike conflict of interest rules, Delaware's corporate opportunity doctrine derives from common law principles expounded in *Guth v. Loft, Inc.*<sup>135</sup> In *Guth*, the court stated corporate opportunity derives from basic fiduciary duties owed by corporate officers and directors, and requires protection of corporate interests above personal.<sup>136</sup> Broadly defined, the corporate opportunity doctrine prohibits an officer or director from taking advantage of a business opportunity if the corporation is financially able to take the opportunity.<sup>137</sup> However, the business opportunity must be consistent with the corporation's business, the corporation must have an "interest or expectancy" in the business opportunity, and if taken, the opportunity puts the officer or director in conflict with the duties owed to the corporation.<sup>138</sup>

Notwithstanding this test, an officer or director may take a corporate opportunity if the business opportunity does not become available due to the officer's or director's corporate role, the opportunity is not "essential" to the corporation, the corporation does not have an "interest or expectancy," and the opportunity did not result from wrongfully using corporate resources.<sup>139</sup>

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<sup>129</sup> *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361-62 (Del. 1993).

<sup>130</sup> *Id.*

<sup>131</sup> *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 157 (Del. 1996); *Cede*, 634 A.2d at 361-62.

<sup>132</sup> See DEL. CODE ANN. tit. 8, § 144 (West 2007); see *Fliegler v. Lawrence*, 361 A.2d 218, 221-22 (Del. 1976).

<sup>133</sup> DEL. CODE ANN. tit. 8, § 144(a)(1) (West 2007); see *Cede*, 634 A.2d at 365-66, n. 33, 34.

<sup>134</sup> DEL. CODE ANN. tit. 8, § 144(a)(1) (West 2007); see *Marciano v. Nakash*, 535 A.2d 400, 404 (Del. 1987).

<sup>135</sup> See *Broz*, 673 A.2d at 154-55 (stating that the corporate opportunity doctrine is derived from *Guth*); *Guth v. Loft, Inc.*, 5 A.2d 503, 510-11 (Del. Ch. 1939).

<sup>136</sup> *Guth*, 5 A.2d at 510-11; see *Johnston v. Greene*, 121 A.2d 919, 923 (Del. 1956).

<sup>137</sup> *Broz*, 673 A.2d at 157.

<sup>138</sup> *Id.* at 155.

<sup>139</sup> See *id.*

In determining whether the corporation has an “interest or expectancy” in the business opportunity, the courts have stated there must be reasonable basis to find a connection between the opportunity and the corporation’s business.<sup>140</sup> Assessing the meaning of “interest or expectancy” includes a determination of whether a company’s financial position allows it the reasonable opportunity consistent with its overall “aspirations” for the business.<sup>141</sup> No single factor determines when a corporate opportunity exists, and issues of fairness are central to the analysis.<sup>142</sup>

If there is a business opportunity, in which the corporation does not have an “interest or expectancy,” the officer or director may take the opportunity for him or herself.<sup>143</sup> Under Delaware law, the officer, or director, is not obligated to ask the board for formal permission to take the business opportunity provided there is a reasonable basis to believe the corporation does not have an interest in the opportunity.<sup>144</sup>

*D. Listing Agency Rules and Delaware’s Corporate Opportunity Doctrine/Conflict of Interest*

The Nasdaq rules on code of ethics require only that the code of ethics covers conflicts of interest and otherwise complies with SEC’s section 406 requirements.<sup>145</sup> The rule does not include a prohibition on corporate opportunity.<sup>146</sup> As a result, Nasdaq’s code of ethics rules does not include a detailed definition of code conduct that differs from state fiduciary duties.

The corporate opportunity doctrine in Delaware law and the NYSE’s definition of corporate opportunity differ in significant ways. Under the NYSE rules, a company’s code of ethics must prohibit employees, officers, and directors from taking corporate opportunities.<sup>147</sup> Under Delaware law, officers and directors may take a corporate opportunity, even without formal approval by the board, if there is reasonable determination that the corporation is unable to take the

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<sup>140</sup> See *id.* at 156 (citing *Johnston v. Greene* 121 A.2d 919 (Del. 1956)). See also DEL. CORP. LAWS tit. 8, § 122(17) (allowing a corporation to renounce in its certificate of incorporation or by board action any interest or expectancy of the corporation in a business opportunity).

<sup>141</sup> See *id.* at 157.

<sup>142</sup> *Broz*, 673 A.2d at 155; See also *Hollinger Int’l v. Black*, 844 A.2d 1022, 1061-62 (Del. Ch. 2004).

<sup>143</sup> *Broz*, 673 A.2d at 155; *Hollinger*, 844 A.2d at 1061-62.

<sup>144</sup> *Broz*, 673 A.2d at 157 (stating “[i]t is not the law of Delaware that presentation to the board is a necessary prerequisite to a finding that a corporate opportunity has not been usurped.”). See also *id.* at 158 (distinguishing *Yiannatsis v. Stephanis*, 653 A.2d 275, 278-79, 282 (Del. 1995) relied on by lower court). In *Yiannatsis*, a shareholder brought suit against other shareholders and the corporation for acquiring shares from the estate of a deceased shareholder in breach of the shareholder’s agreement. *Id.* The Delaware Court of Chancery found that the defendant shareholder breached the fiduciary duty of loyalty by taking a corporate opportunity in its own self-interest without properly presenting the opportunity to the plaintiff. *Id.* On appeal, the Supreme Court of Delaware affirmed the decision on the same grounds, failure to present the opportunity to purchase the shares to the plaintiff. *Id.*; see also MBCA §8.70.

<sup>145</sup> See NYSE Listed Company Manual, *supra* note 51 and accompanying text.

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*; see also Self-Regulatory Organizations, 60 Fed. Reg. 64, 154 (Nov. 12, 2003) (order approving proposed rule changes).

opportunity.<sup>148</sup> The board need not formally review the opportunity and decide to reject it before the officer or director takes the opportunity.<sup>149</sup>

The NYSE rules differ significantly from Delaware's fiduciary duty obligations of the officer or director.<sup>150</sup> The result is that Delaware-incorporated NYSE-listed companies must prohibit the taking of corporate opportunities in its code of ethics, formally obtain board approval for any waivers, and disclose such waivers to investors. Such companies must develop codes of ethics that satisfy listing agency rules, which require compliance otherwise not required under Delaware's fiduciary laws.

## V. IN SUPPORT OF A SAFE-HARBOR

### A. Corporate Governance and SRO rules

The court in *Business Roundtable* defined boundaries for the SEC.<sup>151</sup> The SEC could not compel SRO rulemaking that was outside of its statutory authority.<sup>152</sup> The SEC did not compel standards for SRO code of ethics rulemaking; rather they approved standards that crossed into corporate governance area reserved for state corporate law.<sup>153</sup> The SEC has tacitly done what the court in *Business Roundtable* suggested it could not do— create a federal law using the capital markets as its enforcement arm.<sup>154</sup>

Although section 19 of the Exchange Act does not exclude corporate governance from the scope of SRO rulemaking standards, the *Business Roundtable* decision certainly suggests that SEC review of SRO rules must be consistent with the purposes of the Exchange Act.<sup>155</sup> Thus, if the SEC cannot mandate SRO rules to create federal corporate law, then it should be able to approve self-generated SRO rules to accomplish the same goal.<sup>156</sup> Even if this is what the SEC has accomplished through its approval of SRO code of ethics requirements, the SEC

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<sup>148</sup> *Broz*, 673 A.2d at 157-58; *Yiannatsis*, 653 A.2d at 278-79, 282.

<sup>149</sup> *Broz*, 673 A.2d at 157-58; *Yiannatsis*, 653 A.2d at 278-79, 282.

<sup>150</sup> See E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 448-49 (2003) (discussing the ways SRO and SOX intrude into or supplant state internal affairs doctrine).

<sup>151</sup> *Bus. Roundtable v. SEC.*, 905 F.2d 406, 417 (D.C. Cir. 1990); see generally Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565 (1991); Robert B. Thompson, *Corporate Federalism in the Administrative State: The SEC's Discretion to Move the Line Between the State and Federal Realms of Corporate Governance*, 82 NOTRE DAME L. REV. 1143, 1181-82 (2007) Securities Exchange Act of 1934 §§ 19(b)(c), 15 USC §78s(b)(2),(c).

<sup>152</sup> See Thompson, *supra* note 151, at 1182-83.

<sup>153</sup> *Id.*

<sup>154</sup> *Bus. Roundtable*, 905 F.2d at 412; see also Bainbridge, *supra* note 151, at 619-20 (discussing the risk of creating federal law to regulate corporate governance).

<sup>155</sup> *Bus. Roundtable*, 905 F.2d at 412; see also Bainbridge, *supra* note 151, at 619-20; American Bar Association, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1521-22 (2002); Securities Exchange Act of 1934, §§ 19(b)(c), 15 USC §78s(b)(2),(c).

<sup>156</sup> See American Bar Association, *supra* note 154, at 1526; see Thompson, *supra* note 151, at 1181.

has not established a conflict with federal law warranting an intrusion into state law matters.<sup>157</sup>

Other intrusions into state corporate law by listing agency rules, such as independent director requirements or shareholder voting, are less intrusive than a direct redefining of state fiduciary obligations.<sup>158</sup> The NYSE rules on corporate opportunity and conflicts of interest are the “proverbial camel’s nose” moving into state corporate governance – defining fiduciary duties – in a way that not only further federalizes corporate law.<sup>159</sup> As companies face litigation challenges on their compliance with the SEC’s 406 regulation, issues surrounding the appropriateness of waivers are likely to arise.<sup>160</sup>

### *B. Reasons for a Safe-Harbor*

A safe-harbor provision in the SEC’s 406 regulation would serve several important functions. It would directly acknowledge that 406 is primarily a disclosure requirement as suggested by rulemaking record of SOX and the SEC. It would also give the SEC a way out of its dilemma of approving SRO rules not only inconsistent with the legislative history, but that tacitly intrude into state corporate governance.<sup>161</sup>

Because it is unknown how SRO rules that intrude into state corporate law may be enforced, a safe-harbor provision would also minimize the securities litigation risks to companies.<sup>162</sup> For example, NYSE and Nasdaq rules go beyond the scope of SOX and SEC regulations in several ways.<sup>163</sup> SOX limited its application to principal senior financial officers.<sup>164</sup> Although the SEC expanded its application to include the principal executive officer, it did not include directors. Both NYSE and Nasdaq include directors within its rules for code of ethics.<sup>165</sup>

<sup>157</sup> See *Atherton v. Fed. Deposit Ins. Corp.*, 519 U.S. 213, 214 (1997); see also *Cort v. Ash*, 422 U.S. 66, 78 (1975); see *Newberg*, *supra* note 122, at 279-81; see *Thompson*, *supra* note 151, at 1183.

<sup>158</sup> See *Thompson*, *supra* note 151, at 1163-68 (discussing other SRO rules impacting state corporate law).

<sup>159</sup> *Bainbridge*, *supra* note 151, at 620 (describing rule 19c-4 as the “proverbial camel’s nose”).

<sup>160</sup> *Thompson*, *supra* note 151, at 1185-87 (discussing litigation risks); see NYSE Listed Company Manual § 303A.29, Code of Business Conduct and Ethics, <http://www.nyse.com/lcm/1078416930909.html?enable=subsection&number=3&&sssnum> (last visited Sept. 22, 2007).

<sup>161</sup> *Bainbridge*, *supra* note 151, at 620 (describing the creeping federalization of SRO rules); see NYSE Listed Company Manual § 303A.26,34, Code of Business Conduct and Ethics, <http://www.nyse.com/lcm/1078416930909.html?enable=subsection&number=3&&sssnum> (last visited Sept. 22, 2007).

<sup>162</sup> See *Thompson*, *supra* note 151, at 1187 (discussing enforcement issues).

<sup>163</sup> See NYSE Listed Company Manual § 303A.44, Code of Business Conduct and Ethics, <http://www.nyse.com/lcm/1078416930909.html?enable=subsection&number=3&&sssnum> (last visited Sept. 22, 2007).

<sup>164</sup> See NYSE Listed Company Manual § 303A.17, Code of Business Conduct and Ethics, <http://www.nyse.com/lcm/1078416930909.html?enable=subsection&number=3&&sssnum> (last visited Sept. 22, 2007).

<sup>165</sup> However, SEC’s 406 regulation does not apply to directors, but it implicitly requires director approval of waivers to codes of ethics, *supra* note 33; see NYSE Listed Company Manual § 303A.46, Code of Business Conduct and Ethics, <http://www.nyse.com/lcm/1078416930909.html?enable=subsection&number=3&&sssnum> (last visited

SEC regulations contemplate that companies may have several codes of ethics for different officers.<sup>166</sup> Section 19 does not limit SROs to a scope of coverage in circumstances where it differs from the SEC.<sup>167</sup> Litigation issues of enforcement, and liability and how listing agencies rules impact compliance issues are unknowns.<sup>168</sup>

More critically, the NYSE rule in particular, by requiring codes of ethics to prohibit corporate opportunities and conflicts of interest has developed rules contrary to at least the state law of Delaware.<sup>169</sup> What are the litigation risks to companies? The impact on interpretation of state fiduciary duties is likely to result in considerable confusion as companies attempt to comply with listing agency rules that regulate officer conduct and, as one commentator argues, *de facto* federal preemption of state law.<sup>170</sup>

### C. *A New Federalism*

The establishment of listing agency rules as a new federalism of corporate law is a particularly dangerous slippery slope.<sup>171</sup> As previously indicated, the legislative history of section 406 of the SOX Act does not suggest that Congress intended the code of ethics disclosure to be anything more than a disclosure of whether a company had a code of ethics, if not why not, and any waivers.<sup>172</sup> Although inclusion of a code of ethics requirement seems to be Congress' response to the public outcry over corporate misconduct, the SOX Act requires only disclosure and leaves the decision of whether such conduct requires further investigation to investors.<sup>173</sup> The SEC's authority to approve listing agency rules

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Sept. 22, 2007), *see* Nasdaq Corporate Governance Summary of Rule Changes, Nov. 2003, <http://www.nasdaq.com/about/CorpGovSummary.pdf> (last visited September 22, 2007)

<sup>166</sup> *See* NYSE Listed Company Manual § 303A.29, Code of Business Conduct and Ethics, <http://www.nyse.com/lcm/1078416930909.html?enable=subsection&number=3&ssnum> (last visited Sept. 22, 2007).

<sup>167</sup> *See* Bainbridge, *supra* note 66 (explaining that nothing prohibits SROs from making rules on corporate governance); *see also* American Bar Association, *supra* note 60, at 1519-21 (discussing the role of listing standards in corporate governance); *see also* U.S. Securities and Exchange Commission, Concept Release Concerning Self-Regulation, <http://www.sec.gov/rules/concept/34-50700.htm> (last visited September 23, 2007) (codified at 17 C.F.R. pt. 240). Sections I and II of the Concept Release Concerning Self Regulation describe the ability of SROs to go beyond SEC standards and prescribe "business conduct." *Id.*

<sup>168</sup> *See* Thompson, *supra* note 151, at 1185-86.

<sup>169</sup> Given the vast number of public corporations incorporated in Delaware the impact is significant.

<sup>170</sup> *See* Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, UCLA School of Law, Research Paper No. 02-15, 29, available at <http://ssrn.com/abstract=317121> (last visited Sept. 17, 2007).

<sup>171</sup> *See* Thompson, *supra* note 151, at 1185-86; *see* Bainbridge, *supra* note 151, at 619-20; Lyman P. Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1216-17 (2004) (describing SOX and SRO imposition of responsibilities on directors and implications on fiduciary duties).

<sup>172</sup> *See* Ruder, *supra* note 124 (stating that the internal affairs of the corporation are not subject to SEC direct intervention); *see also* Newberg, *supra* note 123, at 272-76 (discussing legislative history of SOX section 406); *Id.* at 26..

<sup>173</sup> *See* James H. Check, et. al., Report of the American Bar Association Task Force on Corporate Responsibility, March 31, 2003, p.69, for a discussion on the way a committee can comply with state fiduciary rules, [http://www.abanet.org/buslaw/corporateresponsibility/final\\_report.pdf](http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf) (last visited Sept.



does not include the authority to intrude into those matters left to state law.<sup>174</sup> Nor does it include the ability to create federal corporate law without demonstrating a threat to federal policy in state law.<sup>175</sup>

Quasi-federal rules, which use capital markets as enforcement mechanisms also put public companies in a difficult compliance situation. Thus, there is the need to clarify what rules govern senior officers' conduct in meeting the standards under the corporate opportunity doctrine as defined under the NYSE rules and state fiduciary duties. The SEC acknowledged the risks to directors under section 407 and included a safe-harbor provision to minimize the risks to the audit committee financial expert.<sup>176</sup> It should also do the same for principal financial and executive officers under section 406.

The SEC has stated that because of the listing agency requirements to adopt a code of ethics, public companies whose stock lists on the NYSE or Nasdaq must develop codes of ethics or risk de-listing.<sup>177</sup> Without a safe harbor, companies risk defining senior officer conduct for compliance with codes of ethics in ways that are not consistent with state law.<sup>178</sup>

The safe harbor provision is necessary to further the disclosure function of section 406 and not conduct.<sup>179</sup> The disclosure versus conduct accord serves as the appropriate boundary for demarcating between federal securities laws and state law in defining the duties of senior officers of the public corporation.<sup>180</sup> Additionally, a safe harbor clarifies that state law governs fiduciary duties of officers including the meaning of conflicts of interest and corporate opportunities.

## VI. CONCLUSION

SRO rules should not replace state law, the SEC or private attorneys in enforcing the obligations of directors and officers.<sup>181</sup> Many debate the efficacy of code of ethics laws and regulations. It is unlikely company adoption of codes of

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29, 2007).

<sup>174</sup> Bus. Roundtable v. SEC, 905 F.2d 406, 412 (D.C. Cir. 1990).

<sup>175</sup> See Thompson, *supra* note 151, at 619-20.

<sup>176</sup> Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7264(a) (2006).

<sup>177</sup> NYSE Listed Company Manual, § 802.01 Continued Listing Criteria, available at: [http://www.nyse.com/frameset.html?nyseref=http%3A//www.nyse.com/regulation/listed/1182508124422.html&displayPage=/lcm/lcm\\_section.html](http://www.nyse.com/frameset.html?nyseref=http%3A//www.nyse.com/regulation/listed/1182508124422.html&displayPage=/lcm/lcm_section.html) (last visited Sept. 23, 2007); Nasdaq Listing Requirements for Nasdaq Securities 4300, available at [http://www.complinet.com/nasdaq/display/display.html?rbid=1705&element\\_id=13](http://www.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=13) (last visited Sept. 23, 2007); see also BOSTELMAN, *supra* note 73, at § 12:1.4; Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 977-78 (2003).

<sup>178</sup> The regulations do not define the meaning of "honest and ethical conduct" nor does it define the basis of liability for satisfying the requirements of the code of ethics. *Supra*, note 33 Further, there is nothing in the legislative history to suggest the purpose of the code of ethics provisions was to define standards of conduct of principal financial officers. *Supra* note 33.

<sup>179</sup> See Veasey, *supra* note 2, at 443-44; see also American Bar Association, *supra* note 6, at 1493-96.

<sup>180</sup> Bratton et al, *supra* note 90 at 633-39.

<sup>181</sup> See A. C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 980 (1999).

ethics will result in less corporate malfeasance; however, the use of corporate codes of ethics to set benchmarks for minimal corporate conduct can have positive benefits. Nonetheless, corporate law has reserved for the states the responsibility for defining the boundary for officers and directors' behavior.<sup>182</sup> Until such time Congress dictates a need to define corporate conduct, the SEC must not use its authority over listing agencies to embolden federal law. There is nothing to suggest it was the inadequacy of state law in defining fiduciary duties, which caused the recent round of corporate malfeasance.

The proposal in this article recommends the SEC protect investors by adding a safe-harbor provision that clarifies the purpose of section 406, because SRO rules not only go beyond the legislative intent, but also re-define the state fiduciary duties of officers (and directors) in a way inconsistent with minimally Delaware's law. It also calls for the SEC to comply with the spirit and intent of *Business Roundtable* by not using listing agency rules to do indirectly what it cannot do directly – intrude into those matters that relate to the relationships among and between the corporation and its officers, directors and shareholders.

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<sup>182</sup> See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521, 1597-1600 (2005).

