CRISIS AT THE AUDIT COMMITTEE: CHALLENGES OF A POST-PANDEMIC WORLD

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Abstract

*Company boards and their audit committees must constantly be aware of the developments impacting them.****** The last five decades*

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have witnessed a continuing growth and maturity in the recognition of the importance of the board's audit committee to the conduct of corporate governance. During the past two years alone, corporate audit committees have been faced with significant stressors: the global Covid-pandemic; resultant disruption to supply chains; wars in Europe and the Middle East; decline in economic growth combined with rampant inflation; increased global political instability; continued cyber-attacks, and increased regulatory disclosure demands resulting from threatening climate change and disruptive technological advances. In this paper, we focus on the audit committee and examine the hostile contemporary environment in which it must operate.

Our article proceeds in nine parts. First, we explore the law of the audit committee. Second, we discuss the history and operations of the audit committee; and the importance of the Foreign Corrupt Practices Act (FCPA) and the Sarbanes-Oxley Act. Third, we reflect on the impact of the regulatory responses and mandates resulting from rapid technological advances. Fourth, we focus on the importance of auditing cyber risk. Fifth, we cover and reflect upon the audit demands occasioned by the current global pandemic, including remote audits; logistical issues; accounting estimates; and going concern issues. Sixth, we discuss audit-related legal issues arising from the impact of climate change. Seventh, we cover the importance of—and challenges resulting from—the audit committee recruitment process. Eighth, we examine contemporary challenges and resources not mentioned previously. And last, we conclude. We believe this article makes a valuable contribution to the literature on this important topic by examining these challenges brought about by unique historical developments.

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Overview

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I. Role of the Audit Committee

> *Sarbanes-Oxley established requirements regarding corporate governance and accountability to help ensure that the incentives of executives, boards, accountants, and investors were better aligned . . .*
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> *Sarbanes-Oxley also added requirements for corporate boards and their audit committees. Specifically, boards need to disclose whether there is a financial expert on the audit committee. This audit committee is responsible for hiring and firing auditors, determining auditors' compensation, and approving any non-audit services provided by the firm. Public companies also are required to disclose the fees paid to, and services delivered by, their audit firms.*
>
> *Gary Gensler*
> *Chairman,*
> *U.S. Securities and*
> *Exchange Commission*
> *July 27, 2022*[1]

[1] Gary Gensler, Chairman, Sec. and Exch. Comm'n., Prepared Remarks at Center for Audit Quality "Sarbanes-Oxley at 20: The Work Ahead," (July 27, 2022), https://www.sec.gov/news/speech/gensler-remarks-center-audit-quality-072722 [https://perma.cc/LHQ9-PPNQ].

A. The Law of the Audit Committee

Although vitally important to the functioning of the modern corporate board, the legal roles and legal liability of the audit committee have remained rather opaque and amorphous. One court was so general in defining the contours of audit committee member liability that it held that audit committee members merely had a duty "to question the information being presented to them."[2] In that case, the court allowed the plaintiff's security law claim against the audit committee to proceed because the plaintiff had alleged that the "audit committee directors acted to cause and/or permit the issuance of false and misleading statements."[3] But that—like the other very limited case law concerning audit committees—sheds very little light on audit committee responsibilities, beyond the obvious fact that they—like all corporate directors—must follow the law.

The federal government and various federal agencies have provided more clarity in recent years, but the law regulating audit committees remains a patchwork of common law and statutory principles, mostly derived from state corporation law.[4] Whatever the source of the applicable law—whether it be from state common law, state statute, or federal regulatory law—the primary function of audit committee regulation is to ensure its independence and integrity in the corporate governance process.[5]

Not surprisingly, Delaware sets the framework for how an audit committee gets its power, which is, for the most part, derivative of the power of the company's board of directors.[6] The Delaware Code permits the board of directors to confer broad authority onto the audit committee, as long as doing so fits within the confines of the company's

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[2] Tischler v. Baltimore Bancorp, 801 F. Supp. 1493, 1501 (D. Md. 1992) (holding that the plaintiff sufficiently alleged that the audit committee directors acted to cause and/or permit the issuance of false or misleading statements).
[3] *Id.* (holding that the plaintiff sufficiently alleged culpable conduct as to the defendants as members of the audit committee).
[4] Lyman P. Q. Johnson, *The Audit Committee's Ethical and Legal Responsibilities: The State Law Perspective*, 47 S. TEX. L. REV. 27, 29 (2005) (explaining that states and not the federal government have traditionally regulated corporate governance).
[5] Zabihollah Rezaee, *Corporate Governance Role in Financial Reporting*, 17 RESEARCH IN ACCOUNTING REGULATION 107, 127 (2004).
[6] Del. Code Ann. tit. 8, § 141(c).

bylaws and internal structuring.[7] Specifically, the Code states that a committee created by the board "shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation."[8]

Florida law similarly provides that an audit committee "shall have and may exercise all the authority of the board of directors."[9] New York law also provides that an audit committee "shall have the authority of the board."[10]

While audit committees do appear to be an ever more necessary and widely accepted vehicle for ensuring effective corporate self-governance, state law does not require that they even exist.[11] But if a corporate board does choose to create one, then general common law and statutory duties are likely to attach to the committee and its individual members.[12] Most prominently among those responsibilities are the fiduciary duties of loyalty and care.[13]

The primary purpose of enforcing these responsibilities is to ensure that the committee functions independently and in the best interests of the company, without any conflict of interest.[14] To that end, Delaware courts—again serving as the leading model—impose a heavy burden on corporate directors to make decisions based on complete information.[15] For example, in one case, the Delaware Supreme Court

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[7] *See id.* (stating that a board of directors may bestow its own powers and authority to one or more designated committees, to the extent provided in the resolution of the board of directors).

[8] *Id.*

[9] Fla. Stat. § 617.0825(3) (2023).

[10] N.Y. Bus. Corp. Laws § 712(a).

[11] *Id.*; *see also* Del. Code Ann. tit. 8, § 141(c).

[12] *In re* Cheyenne Software, Inc. S'holders Litig., 1996 WL 652765, at *2 (Del. Ch. Nov. 7, 1996) ("directors are protected from a breach of the duty of due care when the directors reasonably believe the information upon which they rely has been presented by an expert "selected with reasonable care" and is within that person's "professional or expert competence.").

[13] *See id.*

[14] *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 54 BUS. LAW. 1067, 1084 (1999) [hereinafter *Blue Ribbon Committee Report*] ("[I]t is therefore imperative . . . that all parties recognize that the audit committee and full board . . . are the ultimate entities to which the auditors are accountable.")

[15] *In re* McDonald's Corp. S'holder Derivative Litig., 291 A.3d 652, 692 (Del. Ch. Mar. 1, 2023) ("[T]he criticism about an overly rapid investigation

concluded that corporate directors breached their fiduciary duties when they "fail[ed] to make true and correct disclosures of all information they had, or should have had, material to the transaction submitted for stockholder approval."[16] In another case, the Delaware Supreme Court held that corporate directors breached their fiduciary duties when they chose "to wall themselves off from material information which was reasonably available."[17]

One of the primary ways in which an audit committee can ensure that it does not breach these common law duties is by utilizing an expert.[18] If the committee uses "an expert 'selected with reasonable care'" who is operating "within that person's 'professional or expert competence,'"[19] then the audit committee can insulate itself—at least to some extent—from potential liability.

These basic common law concepts make up the core features and obligations of the audit committee, and an increased federal presence has further contributed to the development of the law of the audit committee.[20]

In the 1970s, the New York Stock Exchange (NYSE) began requiring that publicly traded U.S. companies have an independent audit committee.[21] Sarbanes-Oxley then defined, at least for purposes of federal law, that an audit committee is "[a] committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer."[22] Sarbanes-Oxley and the supporting rules promulgated by the Securities and Exchange Commission (SEC) have ushered in a new era of audit committee obligations, requiring numerous disclosures,

implicates the duty of care. '[I]n the world of business (as elsewhere), persons are often (or always) required to act on less than perfect or complete information.'")

[16] Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985).

[17] Paramount Communications Inc. v. QVC Network, Inc., 637 A.2d 34, 51 (Del. 1994)

[18] Cheyenne Software, Inc., *supra* note 12, at *2.

[19] *Id*.

[20] 15 U.S.C. § 7201(a)(3) (defining the "audit committee").

[21] *See* Order Approving Proposed Rule Change, 42 Fed. Reg. 14793, 14794 (Mar. 16, 1977). ("[A]n audit committee comprised solely of directors independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment as a committee member.").

[22] *Id*.; 15 U.S.C. § 7201(a)(3).

including mandatory disclosures regarding financial experts retained by the committee.[23] Additionally, the NYSE and the National Association of Securities Dealers Automated Quotations (NASDAQ) have also imposed immense "financial literacy" requirements on audit committees, requiring, for example, that at least one member of the committee have expertise in accounting or financial management.[24]

These developments in the regulation of the audit committee reflect an understanding that the committee has evolved into a critically important element to the functioning of the modern corporation. The more powerful this committee becomes, the more likely it is that it will be subject to further regulation. In this article, we will explore how the audit committee has changed over time and how the legal landscape concerning the audit committee will continue to expand.

II. The SEC and the Audit Committee

> *Auditors are gatekeepers and therefore the importance of their responsibilities with respect to the identification of risks of material misstatement due to fraud . . . and the detection of material misstatements in the financial statements due to fraud should not be underestimated.*
>
> *This is particularly true because any changes to the macroeconomic and geopolitical environment in which companies operate may result in new pressures, opportunities, or rationalizations for fraud. Areas that have historically been a focus for auditors—the tone at the top of a company and the effectiveness of internal controls—appear to be key factors in either*

[23] 15 U.S.C. § 7265; *see also* Disclosure Required by Sections 406 & 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5109 (Jan. 23, 2003) (codified at 17 C.F.R. pts. 227, 228, 229, and 249) ("[A] company must disclose that its board of directors has determined that the company either: has at least one audit committee financial expert serving on its audit committee; or does not have an audit committee financial expert serving on its audit committee.").

[24] Order Approving NYSE Proposed Rule Changes Relating to Corporate Governance Practices of Listed Companies, 68 Fed. Reg. 64154, 64158 (Nov. 12, 2003) (requiring that each member of the audit committee be financially literate); Order Approving a Proposed Rule Change to Amend Certain Corporate Governance Disclosure Requirements for Listed Companies, 75 Fed Reg. 44829, 44830 (June 29, 2010) (requiring that at least 3 members of the committee be able to read and understand financial statements).

exacerbating or mitigating such pressures, opportunities, or rationalizations for fraud.

Paul Munter
SEC Acting Chief Accountant
October 11, 2022[25]

A. History of the Audit Committee

In 1978, then Chair of the Securities Exchange Committee (SEC) called audit committees "the most important development in corporate structure and governance in decades."[26] Audit committees initially had the objectives to "help the board of directors meet their responsibilities, provide better avenues of communication, enhance the outside auditor's independent position, increase the reliability and objectivity of financial reports, and to strengthen the role of outside directors."[27] They are the bridge between management, independent auditors, internal auditors, and the board of directors.[28] Prior to any audit committee regulatory requirements, some large companies had voluntarily created them.[29] Because of specific statutory audit requirements on financial institutions and insurance companies, they were among the first to establish audit committees.[30] Audit committees

[25] Paul Munter, Acting Chief Accountant, SEC, The Auditor's Responsibility for Fraud Detection (Oct. 11, 2022), https://www.sec.gov/news/statement/munter-statement-fraud-detection-101122 [https://perma.cc/S4D4-6XT3].
[26] Jillian M. Lutzy, *Analysis of the Proposed NYSE Corporate Governance and Audit Committee Listing Requirements,* 2 DEPAUL BUS. & COM. L.J. 99, 164 n.9 (2003) (quoting Institute of Internal Auditors, Inc., Proceedings, First Conference on Audit Committees October 17-19, 1977 Fort Lauderdale, Fla.) (noting SEC Chairman's opinion about the importance of the development of the audit committee in corporate structure).
[27] *Id.* at 102 (describing the initial objectives of establishing audit committees).
[28] *Id.* ("The audit committee has always stood at a crucial intersection between management, independent auditors, internal auditors, and the board of directors.").
[29] *Id.* at 100 ("Audit committees initially developed in large companies where the size of the board required specialized committees.").
[30] Bryan A. McGrane, *The Audit Committee: Director Liability in the Wake of the Sarbanes-Oxley Act and Tello v. Dean Witter Reynolds*, 18 CORNELL J. L. & PUB. POL'Y 575, 581 (2009) ("Early twentieth-century statutes placed specific audit requirements on banks, insurance companies, and similar financial institutions.").

were primarily adopted only by corporations where the size of their boards of directors created a need for specialized committees.[31] Because these committees predated regulation, there were no requirements to have them nor as to how they should operate.[32]

Regulatory importance was first given to audit committees in response to the SEC investigation of McKesson and Robbins.[33] In 1937, McKesson filed a fraudulent report with the SEC and the NYSE that was certified by Price Waterhouse & Co.[34] The company reported assets in excess of $87 million, of which $19 million was entirely fictitious.[35] The fraud was organized over several years by McKesson's president Frank Coster.[36] Frank Coster was a pseudonym used to conceal his real identity, Phillip Musica, who (as Musica) had previous convictions for commercial fraud.[37] The fraud was accomplished by creating fake invoices for merchandise from fictitious companies, which allowed an overstatement of inventory and accounts receivables, allowing McKesson to create false profits, much of which was paid to a shell company that Coster and other McKesson executives controlled.[38]

In response to McKesson, the NYSE issued the first report recommending companies adopt audit committees.[39] The report, entitled, *Independent Audits and Audit Procedures*, stated that "where practicable, the selection of the auditors by a special committee of the board of directors composed of directors who are not officers of the

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[31] Lutzy*, supra* note 26, at 100.
[32] *Id.* (noting the SEC's failure to require audit committees for all publicly held companies).
[33] In the Matter of McKesson & Robbins, Inc., Accounting Series Release No. 19, Exchange Act Release No. 2707, 1940 WL 977 at *1 (Dec. 5, 1940) [hereinafter McKesson & Robbins, *Accounting Release*].
[34] *Id.* at *3 (describing the certification of the report by Price Waterhouse & Co.).
[35] *Id.* (". . . total consolidated assets in excess of $87,000,000. Approximately $19,000,000 are known to be fictious.").
[36] *Id.* (describing Coster's involvement in engineering the fraud).
[37] *Id.*
[38] *Id*. at *3-4.
[39] Brenda S. Birkett, *The Recent History of Corporate Audit Committees*, 13 THE ACCT. HIST. J. 109, 115 (1986) ("The first major endorsement for the establishment of audit committees came from the New York Stock Exchange in 1939, also as a result of the McKesson and Robbins case.").

company appears desirable."[40] Also in response to the investigation of McKesson and Robbins, the SEC took a similar approach to the NYSE's recommendation of voluntarily creating audit committees.[41] In 1940, the SEC recommended that companies establish audit committees in Accounting Release No. 19, which was its summary report on its investigation of McKesson and Robbins.[42] The report found that the auditor, Price Waterhouse and Co., was appointed directly by Coster.[43] As for the board, except for "rare exceptions members of the board had no part in arranging for the audit and did not know the content either of the letters of engagement or of the long form report addressed to Coster, in which the character of the work was set forth."[44] While the audit itself was in accord with generally accepted audit practices, the lack of independence and Coster's involvement with the audit prevented the auditors from detecting the fraud.[45]

With a view toward ensuring auditor independence, the SEC recommended a program for publicly traded companies that included

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[40] *Id.* at 115, *quoting* New York Stock Exchange, *Independent Audits and Audit Procedures*, 102 ACCT. 383, 383 (April 6, 1940) (describing the report's statement about the selection of auditors); *see also* Lutzy, *supra* note 26, at 100 (recounting the NYSE's report's acknowledgment that a special committee of directors who are not officers is needed to ensure outside auditor independence).

[41] Peter Ferola, *The Role of Audit Committees in the Wake of Corporate Federalism: Sarbanes-Oxley's Creep into State Corporate Law*, 7 J. BUS. & SEC. L. 143, 144 (2007) ("The SEC first became concerned with the quality of public company audits in 1940 in conjunction with its investigation of McKesson and Robbins.").

[42] McKesson & Robbins, *Accounting Release*, supra note 33 at *4 ("Establishment of a committee to be selected from nonofficer members of the board of directors which shall make all company or management nominations of auditors and shall be charged with the duty of arranging the details of the engagement.").

[43] *Id*. at *5.

[44] *Id.* at *4 ("The testimony of the directors is that with rare exceptions members of the board had no part in arranging for the audit and did not know the content either of the letters of engagement or of the long form report addressed to Coster, in which the character of the work was set forth.").

[45] *Id.* at *3 ("Payments for goods purchased and collections from customers for goods sold were pretended to have been made by the Montreal banking firm of Manning & Company also for the account of McKesson. W.W. Smith & Company, Inc., Manning & Company, and the five Canadian vendors are now known to have been either entirely fictitious or merely blinds used by Coster for the purpose of supporting the fictitious transactions.").

the "[e]stablishment of a committee to be selected from nonofficer members of the board of directors which shall make all company or management nominations of auditors and shall be charged with the duty of arranging the details of the engagement."[46] Between the 1940s and the 1970s, the SEC continued promoting voluntary adoption of audit committees.[47] During this period, various Congressional committees and business industries urged the SEC to make audit committees mandatory for publicly traded companies.[48] While these pleas did not lead to further regulation of audit committees, the issue was again brought to the forefront because of business failures and scandals in the 1960s and 1970s.[49] These scandals brought distrust to the financial data produced by corporations.[50] In 1967, the executive committee of the American Institute of Certified Public Accountants (AICPA) recommended "that publicly owned corporations appoint committees composed of outside directors (those who are not officers or employees) to nominate the independent auditors of the corporations' financial statements and to discuss the auditors work with them."[51] In 1972, the

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[46] *Id.* at *5.

[47] Lutzy, *supra* note 26, at 100 ("Formal Securities and Exchange Commission ("SEC") endorsement of the audit committee can be traced to a 1940 investigation of McKesson & Robbins.").

[48] *Id.* ("However, despite the SEC's endorsement of such committees, between 1940 and the 1970s various committees of Congress and business industries criticized the SEC for its failure to require audit committees for all publicly held companies.").

[49] *Id.* ("A series of business failures and mistakes in the 1960-70s brought the audit committee back to the forefront of corporate governance proposals.").

[50] *See* Joseph W. Barr, 54 HARV. BUS. REV. 18, 24 (May/June 1976) (describing how accounting firms use "a forum of outsider directors to talk to in cases where fraud, illegal conduct, or sheer basic differences of opinion arise with management"); *see also* Albert Carr, *Is Business Bluffing Ethical?*, HARV. BUS. REV. (Jan. 1968), https://hbr.org/1968/01/is-business-bluffing-ethical [https://perma.cc/QGS8-5M9D] **("**And no one should think any the worse of the game of business because its standards of right and wrong differ from the prevailing traditions of morality in our society . . . This view of business is especially worrisome to people without much business experience.").

[51] AICPA Executive Committee Statement on Audit Committees of Boards of Directors, 124 J. ACCT. 10 (Sep. 1967) ("[T]hat publicly owned corporations appoint committees composed of outside directors (those who are not officers or employees) to nominate the independent auditors of the corporations' financial statements and to discuss the auditors work with them . . . .").

SEC continued its push for auditor independence with two Accounting Series Releases.[52] In them the SEC "endorse[d] the establishment by all publicly-held companies of audit committees composed of outside directors and urge[d] the business and financial communities and all shareholders of such publicly-held companies to lend their full and continuing support."[53] Further, the SEC noted that "the existence of an audit committee of the board of directors, particularly if composed of outside directors, should also strengthen [auditor] independence."[54] While still voluntary, in 1974 the SEC more strongly suggested the establishment of audit committees.[55] The SEC amended requirements to proxy rules in Schedule 14A to "include the existence and composition of the audit committee of the Board of Directors . . . If no audit or similar committee exists, the disclosure of that fact is expected to highlight its absence."[56]

The SEC's interest in companies having audit committees also became apparent in enforcement actions during the 1970s and beyond. Many enforcement actions during this time ended with consent decrees where companies accepted that they must create or continue to have voluntary audit committees.[57] Further, many of the consent decrees also

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[52] SEC Accounting Series Release No. 123 (Mar. 23, 1972).

[53] *Id.* ("We issued Accounting Series Release 123 recommending that corporations establish audit committees composed of outside directors to create a direct channel of communication between auditors and the Board to give greater objectivity to financial statements.").

[54] Independence of Accountants; Guidelines and Examples of Situations Involving the Independence of Accountants, SEC Accounting Series Release No. 126 (July 5, 1972).

[55] Notice of Amendments to Require Increased Disclosure of Relationships Between Registrants and Their Independent Public Accountants, SEC Accounting Series Release No. 165 (July 5, 1974) ("Disclosure is required of the existence and composition of the audit committee of the Board of Directors . . . If no audit or similar committee exists, the disclosure of that fact is expected to highlight its absence . . . .").

[56] *Id.*

[57] *See, e.g.*, SEC v. Lum's, Inc., No. 71 CIV. 5323, 1974 WL 386, at *3 (S.D.N.Y. Apr. 11, 1974) ("as long as [Caesars World] has securities registered under Section 12 of the Securities Exchange Act of 1934 [Caesars World] will continue to have a standing audit committee consisting of two or more members of the Board of Directors who are not officers or employees of [Caesars World]"); SEC v. Mattel, Inc., No. 74 CIV. 1185, 1974 WL 449, at *1 (D.D.C. Oct. 1, 1974) ("[The Court] ordered Mattel to appoint two additional unaffiliated directors and to establish a Financial Controls and

mandated the makeup and function of these audit committees.[58] While these were voluntary settlements binding only on the company involved in the enforcement action, they gave guidance to how the SEC viewed the audit committee's corporate governance function.[59] For example, in *SEC v. Lum's*, a consent decree agreed to by Caesar's World (a successor corporation of Lum's), ordered that:

> as long as [Caesars World] has securities registered under Section 12 of the Securities Exchange Act of 1934 [Caesars World] will continue to have a standing audit committee consisting of two or more members of the Board of Directors who are not officers or employees of [Caesars World] which committee shall … (a) have the functions set forth in the guidelines for such committees contained in SEC Accounting Release No. 123 or in such other guidelines as hereafter may be adopted by the Securities and Exchange Commission.[60]

Audit Committee and a Litigation and Claims Committee"); SEC v. Killearn Properties, Inc., No. TCA-75-67, 1977 WL 1065, at *1 (N.D. Fla. May 1, 1977) ("The Board of Directors shall continue to maintain an Audit Committee . . ."); SEC v. Mid Continent Sys., Inc., No. 83, 1983 WL 1319, at *2 (D.D.C. May 31, 1983) ("MCS has also undertaken, among other things to: (1) maintain an independent audit committee with a newly appointed independent director as chairman thereof . . . .").

[58] *See supra* note 57 (collecting cases).

[59] H. Lowell Brown, *Parent-Subsidiary Liability Under the Foreign Corrupt Practices Act*, 50 BAYLOR L. REV. 1, 58 (1998) ("[T]he SEC has provided some guidance as to its view of the audit committee's functions in corporate governance . . . selection and engagement of the independent auditors; review of the company's policies and procedures with respect to auditing, accounting and financial controls; review of the report of the independent auditors including the auditors' relationship with management, the quality of the company's auditing and financial personnel; all significant transactions and proposed adjustments, all proposed changes in accounting principles, and any suggestions for improvement of internal accounting controls or management systems . . . .").

[60] 1974 WL 386, at *3.

Some of the consent decrees were more specific as to the required functionality of the audit committees.[61] For example, in *SEC v. Killearn*, the consent decree had very specific requirements of the makeup and duties of Killearn's audit committee.[62] The consent decree ordered that Killearn's board of directors must maintain its audit committee and it must consist of at least three members who are outside directors of the board.[63] The audit committee was then tasked with certain responsibilities, including:

> i. It should review the engagement of the independent accountants, including the scope and . . . the compensation to be paid.
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> ii. It should review with the independent accountants, . . . the general policies and procedures utilized by the company with respect to internal auditing, accounting and financial controls. The members of the committee should have at least general familiarity with the accounting and reporting principles and practices applied by the company in preparing its financial statements.
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> iii. It should review with the independent accountants, upon completion of their audit, (a) any report or opinion . . . (b) the independent accountants' perceptions of the company's financial and accounting personnel; (c) the cooperation which the independent accountants received . . . (d) the extent to which the resources of the company were and should be utilized to minimize time spent by the outside auditors; (e) any significant transactions which are not a normal part of the company's business; (f) any change in accounting principles; (g) all significant adjustments proposed by the auditor; (h) any recommendations which the

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[61] SEC v. Killearn Properties, Inc., No. TCA-75-67, 1977 WL 1065, at *1 (N.D. Fla. May 1, 1977) ("The Board of Directors shall continue to maintain an Audit Committee ('Committee') of the Board consisting of at least three (3) persons who shall be members of the Board and outside directors of Killearn.").
[62] *See id.*
[63] *Id.* at *2.

independent accountants may have with respect to improving internal financial controls, choice of accounting principles, or management reporting systems.

iv. It should inquire of the appropriate company personnel and the independent auditors as to any instances of deviations from established codes of conduct of the company and periodically review such policies.

v. It should meet with the company's financial staff at least twice a year to review, and discuss with them the scope of internal accounting and auditing procedures then in effect . . .

vi. It should prepare and present to the company's board of directors a report summarizing its recommendation with respect to the retention (or discharge) of the independent accountants for the ensuing year.

vii. It should have the power to direct and supervise an investigation into any matter brought to its attention within the scope of its duties . . .

viii. [It should] . . . review all [press] releases and other information to be disseminated . . . which concern disclosure of financial conditions of and projections of financial conditions of Killearn and its subsidiaries;

ix. review of the activities of the officers and directors of Killearn as to their future dealing with the company . . .

x. approves any settlement or disposition of any claims or actions . . . which Killearn may have against any past or present officers, directors, employees or controlling persons.[64]

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[64] *Id*. at *2-*3.

Companies were responsive to the SEC's push to voluntarily create audit committees.[65] In 1970, approximately thirty-two percent of companies had audit committees, and by 1976 the number rose to eighty-seven percent.[66] In 1977, audit committees shifted from voluntary to required for certain companies.[67] Following the SEC's efforts to establish corporate governance standards, the agency put pressure on the NYSE to adopt a rule requiring companies listed on the exchange to have audit committees.[68] NYSE passed a rule, that was adopted by the SEC, requiring as a condition of being listed on the NYSE that a company "establish not later than June 30, 1978, and maintain thereafter, an audit committee comprised solely of directors independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment as a committee member."[69]

In 1978, the AICPA took the position that audit committees were necessary to maintain auditor independence and comply with generally accepted audit standards.[70] To avoid an appearance of intrusion into corporate governance, the AICPA recommended that the accounting profession encourage other bodies, such as stock exchanges,

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[65] Birkett, *supra* note 39, at 109 ("A 1970 survey by R. K. Mautz and F. L. Neuman showed that 32 percent of the corporations responding had audit committees, while a repeat of the survey in 1976 showed that 87 percent had audit committees . . . .").

[66] *Id*. ("A 1970 survey by R. K. Mautz and F. L. Neuman showed that 32 percent of the corporations responding had audit committees, while a repeat of the survey in 1976 showed that 87 percent had audit committees . . . .").

[67] *In re* New York Stock Exch., Inc., SEC Release No. 13346 (Mar. 9, 1977) ("The proposed rule change would require . . . to establish not later than June 30, 1978, and maintain thereafter, an audit committee comprised solely of directors independent of management . . . .").

[68] Roberta S. Karmel, *Realizing the Dream of William O. Douglas-The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 108 (2005) (noting that "the SEC used its leverage with the NYSE and other SROs to persuade them to require an audit committee with a majority of independent directors as a condition of listing on an exchange.").

[69] *In re* New York Stock Exch., Inc., *supra* note 67.

[70] Birkett, *supra* note 39, at 109 ("Where appropriate to the size and circumstances of the corporation, board members should include independent outsiders, and an audit committee should be formed.").

to require audit committees for publicly held companies.[71] Both the American Stock Exchange and the NASDAQ followed suit and also required listed companies to have audit committees in the late 1980s.[72] However, listing requirements are contractual terms only between listed corporations and the exchange on which they are listed.[73] Therefore, there was no legal requirements established requiring companies to have audit committees.[74]

In 1985, in response to a new wave of auditing failures, hearings were held on the SEC and Corporate Audits by the House Committee on Energy and Oversight.[75] Primary among the scandals were the savings and loans failures of the early 1980s.[76] This led the AICPA to establish the National Commission on Fraudulent Financial Practices, a private sector initiative.[77] James Treadway, a former SEC Chief, was the chair of the initiative, which became commonly known as the Treadway Commission.[78] The Treadway Commission studied the financial reporting system in the United States from October 1985 to September 1987 "to identify causal factors that can lead to fraudulent

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[71] *Id.* ("In addition, the committee stated that any Institute requirement would be viewed as an intrusion into the area of corporate governance and recommended that the accounting profession urge other bodies such as the stock exchanges and the National Association of Securities Dealers to encourage or require committees for publicly held companies.").
[72] McGrane, *supra* note 30, at 582 ("The National Association of Securities Dealers and the American Stock Exchange did not adopt similar listing requirements until the late 1980s.").
[73] *Id*. ("Listing requirements, moreover, only represent private contractual terms between corporations and the exchanges upon which their securities trade.").
[74] *Id*.
[75] Gary Klott, *Auditors Face U.S. Scrutiny*, N.Y. TIMES, Feb. 19, 1985, https://www.nytimes.com/1985/02/18/business/auditors-face-us-scrutiny.html?searchResultPositio n=1 ("The hearings . . . follow a succession of well-publicized incidents in the past few years in which auditors gave a client's financial statements a clean opinion shortly before the company met with financial disaster.").
[76] Jody K. Upham, *Audit Committees: The Policemen of Corporate Responsibility*, 39 TEX. J. BUS. L. 537, 540 (Winter 2004) ("The National Commission on Fraudulent Financial Reporting ('Treadway Commission'), chaired by former SEC Commissioner James C. Treadway, was formed in 1987 in response to the scandals of its day, including the savings and loan debacles of the early 1980s.").
[77] *Id.*
[78] *Id*.

financial reporting and steps to reduce its incidence."[79] Among other things, the Treadway Commission noted the importance of audit committees in reducing the risk of fraudulent financial reporting, and recommended that all public companies be required to have audit committees made up of at least three independent directors.[80] The Commission recommended that audit committees select the independent public accountant for the firm,[81] conduct post-audit reviews to obtain explanations from management regarding major variances in financial statements, and have the accountants explain changes in accounting standards that effect the financial statements.[82] To be effective, audit committees should exercise vigilant and informed oversight of the financial reporting process, including the company's internal controls and the quarterly reporting process.[83] The audit committee should meet on a regular basis and report its activities to the full board of directors.[84] The chairman of the audit committee should disclose the committee's activities and changes to the public accountant completing the audit in the annual report to shareholders.[85] No official action was taken because of the Treadway Commission.[86] However, the

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[79] NAT'L COMM'N ON FRAUDULENT FIN. REPORTING, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING, at 1 (1987).
[80] *Id*. at 12, 179 ("The independent public accountant's role, while secondary to that of management and the board of directors, is crucial in detecting and deterring fraudulent financial reporting . . . An audit committee normally should consist of not fewer than three independent directors.").
[81] *Id*. at 180-81.
[82] *Id*. at 181 ("The committee should obtain from management explanations for all significant variances in the financial statements between years . . . [t]he committee should request an explanation from financial management and the independent public accountant of changes in accounting standards or rules . . . that have an effect on the financial statements.").
[83] *Id*. at 12 ("To be effective, audit committees should exercise vigilant and informed oversight of the financial reporting process, including the company's internal controls . . . .").
[84] *Id.* at 180 ("The committee should meet on a regular basis and special meetings should be called as circumstances require . . . The committee should report its activities to the full board on a regular basis . . . .").
[85] *Id*. ("Finally, the chairman of the audit committee should write a letter describing the committee's activities and responsibilities for inclusion in the annual report to stockholders.").
[86] Ferola, *supra* note 41, at 146 ("The Treadway Commission specifically recognized the audit committee as a crucial gatekeeper in the deterrence and discovery of fraudulent activity . . . Surprisingly, no official action was taken with respect to the recommendation . . . .").

SEC continued to coax companies into creating audit committees of independent directors.[87]

In 1998, at the urging of the SEC, the heads of the NYSE and the National Association of Securities Dealers (NASD), the predecessor to the Financial Industry Regulatory Authority (FINRA), appointed a Blue Ribbon Committee to study the adequacy of audit committee oversight.[88] The Blue Ribbon Committee recommended that for companies with a market capitalization of over $200 million, the NYSE and the NASD require an audit committee of only independent directors and adopt a definition of independence of audit committee members.[89] By this definition, members of an audit committee are only independent "if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation."[90] The Blue Ribbon Committee Report also recommended that the audit committee be comprised of at least three members, each of whom is financially literate, and at least one of whom has accounting or related financial management expertise.[91] Further, it was recommended that a formal charter be issued and approved annually that specifies that the auditor is accountable to the audit committee.[92] The Blue Ribbon Committee Report also recommended that the SEC require the audit committee to confirm that the financial statements are properly

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[87] Karmel, *supra* note 68, at 108 ("In September 1998 the heads of the NYSE and the NASD appointed a Blue Ribbon Committee at the behest of the Chairman of the SEC to inquire into the adequacy of the audit oversight process by independent directors.").

[88] *Id*.

[89] Blue Ribbon Committee Report, *supra* note 14, at 1072.

[90] *Id*. at 1072-73; *see also infra* §§ VI and VIII (discussing independence) ("Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation.").

[91] Blue Ribbon Committee Report, *supra* note 14, at 1073 ("The Committee recommends that the NYSE and the NASD require listed companies with a market capitalization above $200 million . . . to have an audit committee comprised of a minimum of three directors, each of whom is financially literate . . . .").

[92] *Id*. at 1073-74 ("The Committee recommends that the NYSE and the NASD require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.").

prepared and in compliance with Generally Accepted Accounting Principles.[93] Instead of SEC rule proposals, in 1999 the NYSE, NASDAQ, and the American Stock Exchange all filed amended listing standards adopting most of the recommendations in the Blue Ribbon Committee Report.[94]

In 2002, after financial fraud was found at major companies such as Enron, Adelphia Communication, and WorldCom, Congress enacted the Sarbanes-Oxley Act (Sarbanes-Oxley).[95] Sarbanes-Oxley shifted the voluntary nature of audit committees and their functions to a necessary one by codifying many of the recommendations of the Blue Ribbon Committee Report, as well as previous recommendations by the SEC, the stock exchanges, the AICPA and other entities.[96]

Sarbanes-Oxley strengthened the audit committee membership requirements of director independence and heightened qualifications.[97] Elsewhere, Trautman quotes professors Geoffrey C. Hazard and Edward B. Rock who wrote that "Sarbanes-Oxley . . . is important not because it invents the role of independent director, but, rather, because it makes a variety of corporate functions mandatory and vastly increases their legal complexity, and consequently enhances the requirements of

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[93] *Id*. at 1074-75. ("The Committee recommends that the SEC require all reporting companies to include a letter . . . disclosing whether or not, with respect to the prior fiscal year . . . the audit committee . . . believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP). . . .").

[94] Karmel, *supra* note 68 at 109.

[95] Lawrence J. Trautman, *Who Qualifies As an Audit Committee Financial Expert Under SEC Regulations and NYSE Rules?,* 11 DEPAUL BUS. & COM. L. J. 205, 212 (2013) [hereinafter Trautman, *Audit Committee Financial Experts*] ("It was the corporate financial fraud found in the cases of Enron, Adelphia Communication, WorldCom, 27 and the like that led to 'not only a tightening of NYSE and NASDAQ listing requirements with respect to independent directors, but also with the recent enactment of SOX, which is the first step toward the federalization of corporate governance norms for outside directors.'").

[96] *Id.* at 214 ("SOX 'may require the audit committee to be in regular, sometimes continuous, communication with the outside auditors, and members may expect the committee to be at times as a practical matter in continuous session.'").

[97] *Id.* at 216 (citing Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189, 1198-99 (2003)) ("The Act defines 'independent' as a director who may not 'accept any consulting, advisory, or other compensatory fee from the issuer; or be an affiliated person of the issuer or any subsidiary thereof.'").

corporate judgment that can withstand question or challenge."[98] Therefore, as professors Hazard and Rock state, under Sarbanes-Oxley, it is the Audit Committee which is subject to the most significant change.[99] These changes, they explain, are:

- The Audit Committee of a corporation subject to the new regime will be comprised solely of independent directors.[100] Moreover, the company must disclose whether at least one of the members of the Audit Committee is a "financial expert" and if not, why not.[101]

- The Audit Committee statutorily will be "directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee."[102]

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[98] *Id.* at 213 (citing Geoffrey C. Hazard & Edward B. Rock, *A New Player in the Boardroom: The Emergence of the Independent Directors' Counsel,* U. PA. INST. FOR L. & ECON. 5 (Paper No. 04-07, 2004) [hereinafter Hazard & Rock, *Independent Directors' Counsel*], http://ssrn.com/abstract=519242) ("Sarbanes-Oxley ("SOX") is important not because it invents the role of independent director, but, rather, because it makes a variety of corporate functions mandatory and vastly increases their legal complexity, and consequently enhances the requirements of corporate judgment that can withstand question or challenge. This complexity, we assert, will lead to an expansion of lawyers' roles.").

[99] *Id.*; *see also* Gopal V. Krishnan & Gnanakumar Visvanathan, *Reporting Internal Control Deficiencies in the Post-Sarbanes-Oxley Era: The Role of Auditors and Corporate Governance*, Oct. 2005, at 5. http://www.ssrn.com/abstract=646925.

[100] Sarbanes-Oxley §301, Securities Exchange Act §10A(m)(3), 15 U.S.C.A. §78j-1).

[101] Sarbanes-Oxley §407, 15 U.S.C.A. §7265).

[102] Sarbanes-Oxley §301 (2), Exchange Act §10A(m)(2), 15 U.S.C.A. §78j-1)).

- The Audit Committee will have to "establish procedures for – (A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."[103]

- The Audit Committee will have to pre-approve audit and permissible non-audit services.[104]

- The Audit Committee must have a "charter that addresses a list of specified duties, responsibilities and purposes, one of which must be to 'assist board oversight of (1) the integrity of the company's financial statements . . . [and] (2) the company's compliance with legal and regulatory requirements."[105]

- Part of the Audit Committee's responsibility is to monitor and ensure that the audit engagement team not overstay its permissible term. (The term limit is five years on, five years off for the audit partner, and no member of the audit team may accept a financial reporting job with the issuer without first observing a one year cooling off period.)[106]

- The Audit Committee must also monitor audit partner compensation to ensure that the audit partner does not get paid based on non-audit services provided to the issuer.

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[103] Sarbanes-Oxley §301(4), Exchange Act §10A(m)(4), 15 U.S.C.A. §78j-1).
[104] Sarbanes-Oxley §202, Exchange Act §10A(i), 15 U.S.C.A. §78j-1).
[105] New York Stock Exchange (NYSE) Listed Company Manual §303A(7)(b)(i)(A), http://www.nyse.com); Bart Schwartz and Jonathan Freedman, *Corporate Counsel: Accounting Scandals, The New Rules, And Board Culture*, 228 NYLJ 5 (Oct. 10, 2002).
[106] Exchange Act §10A(j) and (l), 15 U.S.C.A. §78j-1.

- The Audit Committee will have the authority to engage independent counsel and other advisers it deems necessary, at company expense.[107][108]

Moreover, Sarbanes-Oxley "may require the audit committee to be in regular, sometimes continuous, communication with the outside auditors, and members may expect the committee to be at times as a practical matter in continuous session."[109]

B. How the Audit Committee Works

With the benefit of over 25 years of audit committee experience, veteran corporate director and audit committee chair Michele Hooper observes that the role and "responsibility for audit committees falls into a couple of buckets, the most important of which is responsibility for ensuring that the organization is appropriately addressing the issue of financial reporting and that the committee has reviewed the alignment of the company's audit and audit-financial reporting structure."[110] Director Hooper warns:

Compliance with complex and constantly-changing regulations and rules as to what the audit committee should be doing and the audit itself requires both time, expertise and experience to ensure management's responsibility for accurate and complete financial numbers. While the external auditors are providing assurance, responsibility begins and ends with company management.[111]

In all types of enterprise (nonprofit, for-profit, educational, and governmental), the primary focus of an audit committee is risk.[112] Particularly in large and complex organizations, it is always a challenge for audit committee members to grasp the details of enterprise risk. Michele Hooper states:

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[107] Sarbanes-Oxley §301(5) and (6), Exchange Act §10A(m)(5) and (6), 15 U.S.C.A. §78j-1.
[108] Hazard & Rock, *Independent Directors' Counsel*, *supra* note 98, at 6-7.
[109] *Id.*; Peter M. Collins, *Outside Counsel: Sarbanes-Oxley Act Creates a New Role for the Audit Committee,* 228 NYLJ 22 (Oct. 17, 2002).
[110] Lawrence J. Trautman, Seletha Butler, Frederick R. Chang, Michele Hooper, Ron McCray & Ruth Simmons, *Corporate Directors: Who They Are, What They Do, Cyber Risk and Other Challenges,* 70 BUFF. L. REV. 459, 472 (2022) [hereinafter Trautman, *Corporate Directors*].
[111] *Id.*
[112] *Id.* at 473.

> This challenge is further complicated because individual audit committee members are only on company premises maybe half a dozen times a year. By not being there every day, audit committee members don't see everything. However, these skilled and experienced professionals are able to look at risk areas—and then are able to build assurance structures around these areas of risk. This is how the audit committee structures its efforts to understand what needs to be done. As is the case in all the standing committees, audit committees have an annual agenda that is aligned to charter responsibilities and the committee's annual calendar. With these structures in place, the committee helps to ensure that all of the responsibilities required by law are addressed. Audit committees typically have a structure consisting of perhaps three or four board members that are assigned to audit. Audit committee members must deal with the complexity of information flow from key members of the management team.[113]

Much has been written during recent years about the importance of having at least one financial expert on the audit committee of every public board.[114] Director Michele Hooper recalls that "[b]efore going into board service myself, I used to run businesses—and therefore, routinely dealt with the management of financial reporting—and so, along with other relevant experiences, qualify to be considered an audit committee 'financial expert.'"[115] This accounts for "how I got selected to serve on a number of audit committees, and also as an audit committee chair. My preference is to have other audit-experienced directors on my audit committee as well," she recalls.[116] Director Hooper states:

> Domain expertise is particular [*sic*] important in audit. For example, when I chaired the audit committee of a major pharmaceutical company, we had a former chair of the U.S. Food & Drug Administration (FDA) as an

[113] *Id.*
[114] *See* Trautman, *Audit Committee Financial Experts, supra* note 96, at 213.
[115] Trautman, *Corporate Directors*, *supra* note 111, at 475.
[116] *Id.*

> audit committee member, because she brought a valuable and different perspective, including detailed understanding of the drug regulation and approval process. By understanding the audit structure and the underlying numbers, audit committee members are informed about what the committee should be doing. There are many ways in which a board begins to approach this issue of audit and risk assessment. These are very important parts of the board's responsibilities.[117]

C. Foreign Corrupt Practices Act (FCPA)

Professor Trautman states, "[a] constant problem area for those doing business around the world is the Foreign Corrupt Practices Act (FCPA), and the issues of bribery and corruption."[118] FCPA violations can be an enterprise-ending event for smaller companies.[119] Although

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[117] *Id.*

[118] *Id.* at 477; *see also* Neal Newman & Lawrence J. Trautman, *Securities Law: Overview and Contemporary Issues*, 16 OH. ST. BUS. L.J. 149 (2021); Lawrence J. Trautman, *Rapid Technological Change and U.S. Entrepreneurial Risk in International Markets: Focus on Data Security, Information Privacy, Bribery and Corruption*, 49 CAP. U. L. REV. 67 (2021); Lawrence J. Trautman & Joanna Kimbell, *Bribery and Corruption: The COSO Framework, FCPA, and U.K. Bribery Act*, 30 FLA. J. INT'L L. 191, 193–94 (2018); Lawrence J. Trautman, *Following the Money: Lessons from the "Panama Papers," Part 1: Tip of the Iceberg*, 121 PENN ST. L. REV. 807, 809–10 (2017); Lawrence J. Trautman & George P. Michaely, Jr., *The SEC & The Internet: Regulating the Web of Deceit*, 68 CONSUMER FIN. L. Q. REP. 262 (2014); Lawrence J. Trautman & Kara Altenbaumer-Price, *Lawyers, Guns, and Money: The Bribery Problem and U.K. Bribery Act*, 47 INT'L LAW. 481, 483–85 (2013); Lawrence J. Trautman & Kara Altenbaumer-Price, *Foreign Corrupt Practices Act: An Update on Enforcement and SEC and DOJ Guidance*, 41 SEC. REGUL. L.J. 241, 241–44 (2013); Lawrence J. Trautman & Kara Altenbaumer-Price, *The Foreign Corrupt Practices Act: Minefield for Directors*, 6 VA. L. & BUS. REV. 145 (2011).

[119] Rebecca L. Perlman, *The Political Economy of the Foreign Corrupt Practices Act: An Exploratory Analysis*, 9 J. OF LEGAL ANALYSIS 153, 156 (2017) ("These costs can entail significant fixed components, making them lower on a per unit basis for larger companies, giving these companies a competitive advantage over their smaller counter- parts. Similarly, larger companies may have in-house specialists who can absorb FCPA-related

many "of the prosecutions are of larger companies like Siemens, which resulted in about a $1.8 billion fine[,] Professor Trautman states, 'You've got to be selling a lot of products to pay $1.8 billion and still have something left over.'"[120] FCPA-experienced director Ron McCray observes:

> Aside from the egregious cases which by definition, oftentimes are easy, the Foreign Corrupt Practices Act can offer traps for the unwary. When I was an operating and staff executive for FCPA matters, I thought it very important for companies in my jurisdiction to have a code of conduct which speaks to the FCPA. Also important is to have someone from compliance or the legal department regularly provide instructions to executives who have exposure to FCPA risk. These regular sessions give employees a grounding and confidence about how they should think about doing their jobs and know whom to consult for advice. And if you do that, you have a chance of somebody not falling into one of these traps for the unwary.[121]

Likewise, Director Hooper states:

> I would also add that from the board standpoint, one of the things that I found very important when I chaired audit committees of global companies, was getting up out of my chair and going to some of these locations, particularly high-risk international locations. I found actually being on location to be important, because people need to see you. They need to hear from you. They need to hear you reinforcing the ethics and integrity and expectations of the corporation and quite frankly, have them know that somebody cares and is watching. And sometimes, just to know that somebody

compliance tasks into their existing work. The distinct possibility arises that larger companies may gain a competitive edge over small and medium-sized competitors as a result of FCPA obligations. Likewise, incumbent firms may find that FCPA enforcement creates entry barriers for potential new competitors").

[120] Trautman*, Corporate Directors, supra* note 111, at 479.

[121] *Id.*

> is watching covers a whole lot of ground. For many corporations, it's not so much a focus on the $1.8 billion that a Siemens might pay, but it is reputational risk from these areas involving bribery and corruption. So, it's really important and very, very substantive for board members to be engaged.[122]

D. Bribery and Corruption Runs Rampant

A casual visit to the SEC website will reveal many examples of enforcement actions brought against issuers for FCPA violations.[123] Just one example, that of global steel pipe manufacturer Tenaris, is presented in Exhibit 1.

Exhibit 1.
SEC Charges Global Steel Pipe Manufacturer with
Violating Foreign Corrupt Practices Act

Press Release

SEC Charges Global Steel Pipe Manufacturer with Violating Foreign Corrupt Practices Act Tenaris to pay $78 million to settle charges related to Brazilian bribery scheme

FOR IMMEDIATE RELEASE

2022-98

Washington D.C., June 2, 2022 —

The Securities and Exchange Commission today announced that Tenaris, a Luxembourg-based global manufacturer and supplier of steel pipe products, will pay more than $78 million to resolve charges that it violated the Foreign Corrupt Practices

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[122] *Id.* at 479-80.

[123] *SEC Enforcement Actions: FCPA Cases*, SEC, https://www.sec.Gov/enforce/sec-enforcement-actions-fcpa cases#:~:text=2022,schemes%20i n%20Brazil%20and%20Algeria [https://perma.cc/L8CC-SRQP].

Act (FCPA) in connection with a bribery scheme involving its Brazilian subsidiary.

According to the SEC's order, the resolution with Tenaris is the result of an alleged bribe scheme involving agents and employees of its Brazilian subsidiary to obtain and retain business from the Brazil state-owned entity Petrobras. Specifically, the order finds that between 2008 and 2013, approximately $10.4 million in bribes was paid to a Brazilian government official in connection with the bidding process at Petrobras. The bribes were funded on behalf of Tenaris' Brazilian subsidiary by companies affiliated with Tenaris' controlling shareholder.

"Tenaris failed for many years to implement sufficient internal accounting controls throughout its business operations despite known corruptions risks," said Charles Cain, Chief of the SEC Enforcement Division's FCPA Unit. "This failure created the environment in which bribes were facilitated through a constellation of companies associated with its controlling shareholder."

This is not the first time Tenaris has been involved in a corruption scheme. In 2011, the company entered into a Non-Prosecution Agreement with the Department of Justice and a Deferred Prosecution Agreement with the SEC as a result of alleged bribes the company paid to obtain business from a state-owned entity in Uzbekistan.

Tenaris consented to the SEC's order without admitting or denying the findings that it violated the anti-bribery, books and records, and internal accounting controls provisions of the Securities Exchange Act of 1934 and agreed to pay more than $78 million in combined disgorgement, prejudgment interest, and civil penalties. The company also agreed to comply with undertakings for a two-year period related to its ongoing remedial efforts . . .[124124]

[124] John C. Coffee Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1036 (2022) ("With the Enron and WorldCom insolvencies and

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III. Impact of Rapid Technological Advances

> *[R]apid technological change poses new challenges for policymaking. It can outpace the capacity of Governments and society to adapt to the changes that new technologies bring about, as they can affect labor markets, perpetuate inequalities and raise ethical questions . . . Therefore, harnessing frontier technologies could be transformative in achieving the Sustainable Development Goals and creating more prosperous, sustainable, healthy and inclusive societies.*
>
> *Recent decades have seen a dramatically accelerating pace in the development and adoption of new technologies… This rapid technological change is affecting almost every area of the economy, society and culture.*
>
> *United Nations Conference on Trade and Development, Geneva 2019*[125]

During recent years it appears that, "auditors, company managers, regulators, and academics agree that data analytics is fundamentally changing the financial reporting and auditing processes."[126] During the 2020-22 global pandemic, quarantines, travel restrictions, and other

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the evidence of financial impropriety manifest to all, Levitt and others-most notably, Senator Paul Sarbanes-convinced Congress to replace auditor self-regulation with a new body: the Public Company Accounting Oversight Board (PCAOB).The PCAOB was the centerpiece of SOX, but it was hardly an "off-the-shelf' proposal. But for the crisis, auditor self-regulation would have persisted. Depending on one's preferred perspective, Levitt and Sarbanes are either the heroes or villains of this story").

[125] U.N. CONFERENCE ON TRADE AND DEVELOPMENT, THE IMPACT OF RAPID AND TECHNOLOGICAL CHANGE ON SUSTAINABLE DEVELOPMENT (Feb. 17, 2020), https://unctad.org/system/files/official-document/dtlstict2019d10_en.pdf [https://perma.cc/N5AR-UF9Z].

[126] *Id.*

business interruptions altered the way business and audits are conducted, perhaps for many years to come.[127] While additional focus on this topic is beyond the scope of this single law review article, ample resources are provided in our footnotes for those desiring more on this topic.[128]

A. Crisis in the Crypto Markets

During November 2022, *The New York Times* reported that "[i]n less than a week, the cryptocurrency billionaire Samuel Bankman-Fried went from industry leader to industry villain, lost most of his fortune, saw his $32 billion company plunge into bankruptcy and became the target of investigations by the Securities and Exchange Commission

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[127] Sarah Ovaska & Maria Murphy, *A needed push into remote auditing*, J. OF ACCT., May 26, 2022 [hereinafter Ovaska & Murphy, *Remote Auditing*], https://www.journalofaccountancy.com/news/2022/may/needed-push-into-remote-auditing.html [https://perma.cc/JPB8-93BT] ("Wilson's consulting firm . . . found 61% of the 223 CPA firms surveyed plan to conduct more than half of their audit work remotely in the future. That same question, when asked pre-pandemic, only had 17% of firms indicating they'd conduct the majority of their audit work away from client locations.").

[128] Dereck Barr-Pulliam, Helen L. Brown-Liburd & Kerri Ann Sanderson, *The Effects of the Internal Control Opinion and Use of Audit Data Analytics on Perceptions of Audit Quality, Assurance, and Auditor Negligence*, 41 AUDITING: A J. OF PRACTICE & THEORY 25 (2022), https://ssrn.com/abstract=3021493 ("Advanced audit data analytics tools allow auditors to analyze the entire population of accessible client transactions."); Jeremy Bertomeu, Edwige Cheynel, Eric Floyd & Wenqiang Pan, *Using Machine Learning to Detect Misstatements*, REV. ACCT. STUD. (Forthcoming), https://ssrn.com/abstract=3496297 ("Machine learning offers empirical methods to sift through accounting data sets with a large number of variables and limited a priori knowledge about functional forms."); Brandon Garrett & Gregory Mitchell, *Testing Compliance*, 83 L. & CONTEMPORARY PROBLEMS 47 (2020), https://ssrn.com/abstract=3777948 ("The guidance does not address what risk assessment tools or data gathering or methods are effective in any given type of industry; it merely highlights the need for a data-driven analysis to ensure that compliance is working."); Kimberly Houser & Debra Sanders, *The Use of Big Data Analytics by the IRS: What Tax Practitioners Need to Know*, 128 J. TAXATION (2018), https://ssrn.com/abstract=3120741 ("The Former Commissioner of the IRS, John Koskinen, indicated that their data analytics program is the key to increasing efficiency in the audit process and reducing unnecessary audits for compliant taxpayers.").

and the Justice Department."[129] The failure of FTX and its many related crypto entities was responsible for contagion and collateral damage for many cryptocurrency investors and counter-parties engaged in the cryptocurrency community.[130] With FTX entities scattered across many jurisdictions worldwide, it may take years for the U.S. bankruptcy proceedings to conclude.[131] Following the Chapter 11 filing, post-bankruptcy FTX CEO John J. Ray III attributed the collapse of FTX to "the absolute of concentration of control in the hands of a very small group of grossly inexperienced and unsophisticated individuals who failed to implement virtually any of the systems or controls that are necessary for a company that is entrusted with other people's money."[132] In *SEC v. Samuel Bankman-Fried*, the complaint filed on December 13, 2022 states:

> From at least May 2019 through November 2022, Bankman-Fried engaged in a scheme to defraud equity investors in FTX Trading Ltd. ("FTX"), the crypto asset trading platform of which he was CEO and co-founder, at the same time that he was also defrauding the platform's customers. Bankman-Fried raised more than $1.8 billion from investors, including U.S. investors, who bought an equity stake in FTX believing

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[129] Lawrence J. Trautman & Larry D. Foster II, *The FTX Crypto Debacle: Largest Fraud Since Madoff?*, U. MEMPHIS L. REV. (forthcoming), http://ssrn.com/abstract=4290093 (citing David Yaffe-Bellany, *How Sam Bankman-Fried's Crypto Empire Collapsed,* N.Y. TIMES, Nov. 15, 2022 at A1, https://www.nytimes.com/2022/11/14/technology/ftx-sam-bankman-fried-crypto-bankruptcy.html).

[130] *Id.* at 1 ("The demise of FTX and its' many related crypto entities created contagion and collateral damage for other participants and investors in the cryptocurrency community.").

[131] *See id.* ("The U.S. bankruptcy proceedings of many FTX related entities, scattered across many jurisdictions worldwide, will likely take years to sort out.").

[132] *Id.* (citing *Investigating the Collapse of FTX, Part I: Hearing Before the H. Comm. On Fin. Services,* 117th Cong. (2022) (statement of John J. Ray III, CEO FTC Debtors), [https://perma.cc/552L-ZN34]) ("FTX new CEO John J. Ray III characterizes the collapse of FTX as the result of 'the absolute of concentration of control in the hands of a very small group of grossly inexperienced and unsophisticated individuals who failed to implement virtually any of the systems or controls that are necessary for a company that is entrusted with other people's money.'").

> that FTX had appropriate controls and risk management measures. Unbeknownst to those investors (and to FTX's trading customers), Bankman-Fried was orchestrating a massive, years-long fraud, diverting billions of dollars of the trading platform's customer funds for his own personal benefit and to help grow his crypto empire.[133]

At the close of 2022 it is reported that "[c]rypto fund asset managers saw investors withdraw almost $20 billion in November, or nearly 15% of total assets under management."[134] At this point in time it had become evident that investor losses were pervasive as evidenced by "[t]he share of U.S. households that have ever transferred funds into a crypto-related account jumped to 13% as of June 2022, up from 3% before 2020, according to data from the JPMorgan Chase Institute."[135]

B. The Future of Technological Threats

How new technologies will emerge and evolve to create novel and unimaginable challenges for audit committees, corporate governance and global national security interests is the basis of worry for those in positions of corporate responsibility.[136] With continued business and nation state disruption from cybersecurity threats, businesses need to prepare for potential threats from technological advances now emerging from advances and growing availability stemming from quantum computing technology.[137]

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133 Complaint at 1, SEC v. Samuel Bankman-Fried, No. 22-cv-10501 (S.D.N.Y. Dec. 13, 2022).
134 Gunjan Banerji, *Crypto's Onetime Fans Are Calling It Quits After FTX Collapse,* WALL ST. J., Dec. 19, 2022, at B3.
135 *Id.*
136 Lawrence J. Trautman, Scott Shackelford, Brian Elzweig, & Peter C. Ormerod, Understanding Cyber Risk: Unpacking and Responding to Cyber Threats Facing the Public and Private Sectors, 70 U. MIAMI L. REV. (forthcoming), https://ssrn.com/abstract=4262971 ("We have shown how cyber-attacks, particularly ransomware campaigns, continue to pose major threats to businesses, sovereigns, state and local government, health and educational institutions, and individuals worldwide.").
137 *Id.*; Michael J. Conklin, Brian Elzweig, & Lawrence J. Trautman, *Legal Recourse for Victims of Blockchain and Cyber Breach Attacks*, 23 U.C. DAVIS BUS. L. J. 135, 135 (2023), http://ssrn.com/abstract=4251666

IV. Auditing Cyber Risk

> *Beginning in 1974, auditors were required to consider the effects of information technology on financial statements. This evolved into the development of attestation engagements dealing with controls at a service organization, as well as other permissible information security consulting services offered to the market . . .*
>
> *We are supportive of the transparency that will result through enhancing disclosure by registrants around cybersecurity risk management, strategy, governance, and incident disclosure. As domestic and foreign cybersecurity threats evolve, particularly in the remote and hybrid work environments, timely cybersecurity disclosures are becoming increasingly more relevant and useful to investors and other stakeholders in the financial reporting ecosystem . . .*
>
> *Center for Audit Quality*
> *May 9, 2022*[138]

Cyber risk is quickly becoming "mission critical" for *all* large companies.[139] One prominent commentator on directors' and officers' ("D&O") insurance listed cybersecurity as one of the top ten D&O issues for 2020, 2021, and 2022.[140] As such, it is demanding board-level

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("Complicating the cybersecurity technical and regulatory challenges is the rapid pace of technological change, which brings novel threats with the relatively recent explosion of blockchain enabled and artificial intelligence applications.").

[138] *See* Comment letter from Denis McGowan, Center for Audit Quality Vice President, Professional Practice, to Office of the Secretary, SEC (May 9, 2022) (on file with author), *reprinted at* https://thecaqprod.wpenginepowered.com/wpcontent/uploads/2022/05/caq_SEC_cybersecurity_comment_05_2022_final.pdf [https://perma.cc/SV9F-NQPD].

[139] H. Justin Pace & Lawrence J. Trautman, *Mission Critical*: Caremark, *Blue Bell, and Director Responsibility for Cybersecurity Governance*, 2022 WISCONSIN L. REV. 887, 891-92 (2022) [hereinafter, Pace & Trautman, *Mission Critical*].

[140] Kevin LaCroix, *The Top Ten D&O Stories of 2022*, D&O DIARY (Jan. 3, 2023), https://www.dandodiary.com/2023/01/articles/director-and-officer-lia

attention.[141] This has led many companies to "assign cyber risk oversight to the audit committee."[142] Assigning cyber risk oversight to the audit committee is risky because audit committees already have "a substantial portfolio unrelated to cybersecurity."[143] At a time when their "core responsibilities in accounting and financial compliance, prudence, and integrity have grown even more challenging, complex, and time consuming," it is dangerous to expand audit committee duties beyond those core responsibilities.[144] Cyber risk involves understanding technical areas that require a different skillset and expertise than traditional audit committee core responsibilities.[145]

Just as cyber incidents and public attention to cyber issues are increasing, so too is the regulatory burden on companies increasing in

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bility/the-top-ten-do-stories-of-2022/ **[**https://perma.cc/B7Q7-ES8N**]** **("**Over the past several years, cybersecurity has been a consistent D&O claims concern."); Kevin LaCroix, *The Top Ten D&O Stories of 2021*, D&O DIARY (Jan. 3, 2022), https://www.dandodiary.com/2022/01/articles/director-and-officerliability/the-top-ten-do-stories-of-2021 **[**https://perma.cc/8VPK-YN5H**]** ("A recurring theme in recent years has been the risk of D&O claims following in the wake of cybersecurity incidents . . . ."); Kevin LaCroix, *The Top Ten D&O Stories of 2020*, D&O DIARY (Jan. 4, 2021), https://www.dandodiary.com/2021/01/articles/director-and-officer-liability/the-top-ten-do-stories-of-2020 **[**https://perma.cc/8V6J-T8RC**]** **("**cybersecurity remains a critical operational concern for organizations of every type . . . .").

[141] *See* Firemen's Ret. Sys. of St. Louis v. Sorenson, No. 2019-0965-LWW, 2021 WL 4593777, at *1 (Del. Ch. Oct. 5, 2021) ("Cybersecurity has increasingly become a central compliance risk deserving of board level monitoring at companies across sectors.").

[142] Pace & Trautman, *Mission Critical*, *supra* note 158, at 937 (citing Lawrence J. Trautman, *Who Qualifies as an Audit Committee Financial Expert Under SEC Regulations and NYSE Rules?,* 11 DEPAUL BUS. & COM. L.J. 205, 233 (2013)); Lawrence J. Trautman, *Who Sits on Texas Corporate Boards? Texas Corporate Directors: Who They Are and What They Do,* 16 HOUS. BUS. & TAX L.J. 44, 76–77 (2016)).

[143] Pace & Trautman, *Mission Critical*, *supra* note 157, at 939 (citing Hughes v. Hu, No. 2019-0112-JTL, 2020 WL 1987029, at *5 (Del. Ch. Apr. 27, 2020)).

[144] Leo E. Strine, Jr., Kirby M. Smith & Reilly S. Steel, *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective* Caremark *and EESG Strategy*, 106 IOWA L. REV. 1885, 1915 (2021) [hereinafter Strine et al., *Caremark and ESG*].

[145] Pace & Trautman, *Mission Critical*, *supra* note 158, at 944.

this area.[146] SEC guidelines require issuers to disclose the board's role in cyber oversight if cyber risks are material.[147] Marriott faced securities claims after a major cyber incident.[148] The SolarWinds Corporation (SolarWinds) faced multiple class actions and investigations by the SEC, DOJ, and multiple states Attorneys General after a major cybersecurity breach.[149] It is noted that "[r]egulated industries frequently have their own cybersecurity requirements."[150] These requirements increase the risk that ransomware payments may be unlawful.[151] Further, a comprehensive understanding of data breach disclosure obligations under the laws of all relevant states is required.[152]

Audit committee failures bring a risk of personal liability for the committee members under the *Caremark* doctrine, which applies to failures of oversight.[153] *Caremark* claims are a species of claim for breach of fiduciary duty located in the duty of good faith, itself a subset of the duty of loyalty.[154] Because *Caremark* claims fall under the duty

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[146] *Id.* at 949.

[147] *Id.* (citing Vivek Mohan, David Simon & Richard Rosenfeld, *SEC Increasingly Turns Focus Toward Strength of Cyber Risk Disclosures*, HARV. L. SCH. F. CORP. GOVERNANCE (July 25, 2021), https://corpgov.law.harvard.edu/2021/07/25/sec-increasingly-turns-focus-toward-strength-of-cyber-risk-disclosures [https://perma.cc/JW2L-PD29]); Commission Statement and Guidance on Public Company Cybersecurity Disclosures, 83 Fed. Reg. at 8, 166). *See also* Neal F. Newman, Lawrence J. Trautman & Brian Elzweig, *The SEC Proposed Cybersecurity Infrastructure Rules and New Disclosure Requirements*, https://ssrn.com/abstract=4536669.

[148] *See* Firemen's Ret. Sys. of St. Louis, 2021 WL 4593777, *supra* note 160, at *12-16 (stating Marriott was charged with a breach of fiduciary duties for not conducting adequate due diligence of the company's cybersecurity technology).

[149] Pace & Trautman, *Mission Critical*, *supra* note 158, at 935 (citing Verified Shareholder Derivative Complaint at ¶ 109, *Constr. Indus. Laborers Pension Fund v. Bingle*, No. 2021-0940-SG, 2022 WL 4102492 (Del. Ch. Sept. 6, 2022)).

[150] *Id*. at 950.

[151] *Id*.

[152] *Id*.

[153] *Id.* at 888 ("[I]f the potential for Caremark liability for failures of oversight hangs like the sword of Damocles over corporate directors of Delaware corporations, then that sword has been considerably more secure than that of the original myth.").

[154] H. Justin Pace & Lawrence J. Trautman, *Climate Change and* Caremark *Doctrine, Imperfect Together*, 25 U. PENN. J. BUS. L. 777 (2023) [hereinafter, Pace & Trautman, *Imperfect Together*].

of loyalty rather than the duty of care, the business judgment rule does not apply, and *Caremark* claims cannot be exculpated under Section 102(b)(7) of the Delaware Corporate Code.[155] "Successful oversight claims are invariably tied to some unlawful corporate conduct that the plaintiffs alleged would have been avoided had the directors met their fiduciary duties."[156] There are two categories of *Caremark* claims.[157] In a failure to implement claim, the plaintiff alleges that "the directors utterly failed to implement any reporting or information system or controls."[158] In a failure to monitor claim, the plaintiff alleges that, while there are controls in place, the board "*consciously* failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[159]

Courts are willing to infer that an audit committee that meets rarely and for a limited period of time cannot have fulfilled all of a long list of responsibilities under its charter.[160] "A plaintiff can state a *Caremark* claim by alleging that 'the company had an audit committee that met only sporadically and devoted patently inadequate time to its work.'"[161] But even an audit committee that discusses cyber issues only sporadically can avoid an inference that it is "a nominal, sham committee."[162]

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[155] *Id*. (citing Pace & Trautman, *Mission Critical*, *supra* note 158; H. Justin Pace, *Rogue Corporations: Unlawful Corporate Conduct and Fiduciary Duty*, 85 MO. L. REV. 1, 6, 8–9 (2020)).
[156] *Id*. (citing Roy Shapira, *Mission Critical ESG and the Scope of Director Oversight Duties*, 2022 COLUM. BUS. L. REV. 732 (2022) [hereinafter, Shapira, *Mission Critical ESG*] ("[N]o *Caremark* claim that is based *purely* on nonlegal risk oversight has succeeded in Delaware thus far.")).
[157] Pace & Trautman, *Mission Critical, supra* note 158, at 889.
[158] Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).
[159] *Id.*
[160] Hughes v. Hu, No. 2019-0112-JTL, 2020 WL 1987029, at *5 (Del. Ch. Apr. 27, 2020). ("[I]t is also reasonable to infer that with the Audit Committee having not met for almost a year, there was no possible way that the Audit Committee could have fulfilled all of the responsibilities it was given under the Audit Committee Charter during a fifty-minute meeting.").
[161] *Id*. at *14 (quoting Guttman v. Huang, 823 A.2d 492, 507 (Del. Ch. 2003)).
[162] *See* Construction Indus. Laborers Pension Fund v. Bingle, No. 2021-0940-SG, slip op, at *31 (Del. Ch. Sept 6, 2022) (ruling that the audit committee was not "a nominal, sham committee" despite not discussing cybersecurity for a period of 26 months).

Audit committees with cyber risk as a part of their portfolio must be diligent or risk *Caremark* liability.[163] One way to mitigate *Caremark* risk is to formalize cyber responsibility. *Caremark* claims are typically decided at the motion to dismiss stage on the basis of documents produced by the company in response to a Delaware Corporate Code Section 220 request.[164] Failure to produce a document may result in an inference that it does not exist.[165] Conversely, a paper trail can prevent *Caremark* liability, even if the audit committee's oversight efforts were ineffective in preventing unlawful corporate behavior and harm to the corporation.[166]

An audit committee responsible for cyber issues that lacks cyber expertise will be forced to defer to management, a recipe for *Caremark* liability.[167] One approach to dealing with the desire to assign cyber risk to the audit committee and the good reasons for assigning it elsewhere is to split duties. In *Bingle*, for example, the SolarWinds board delegated financial cyber risk to its audit committee and non-financial cyber risk to its nominating and corporate governance committee.[168] SolarWinds directors were able to escape *Caremark* liability.[169] An audit committee with cyber responsibility can also protect itself with best practices including requiring regular reports on cyber from management, by discussing cyber issues on a regular basis, by setting protocols for reporting "red flags" up to the committee, and by making use of third-party experts.[170]

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[163] *See* Firemen's Ret. Sys., 2021 WL 4593777, *supra* note 160, at *3.
[164] Pace & Trautman, *Mission Critical, supra* note 158, at 900, 902.
[165] *Id.* at 902 (citing Roy Shapira, *A New* Caremark *Era: Causes and Consequences*, 98 WASH. U. L. REV. 1857, 1870–71, 1878 (2021)).
[166] *Id.* at 899.
[167] *See* Hughes v. Hu, No. 2019-0112-JTL, 2020 WL 1987029, at *15 (Del. Ch. Apr. 27, 2020) (noting—in a case that resulted in a successful *Caremark* claim—that the audit committee lack relevant expertise in U.S. accounting standards and thus were forced to defer to a management that "was either incapable of accurately reporting on related-party transactions or actively evading board-level oversight").
[168] *See* Construction Indus. Laborers Pension Fund v. Bingle, No. 2021-0940-SG, slip op, at *8 (Del. Ch. Sept 6, 2022).
[169] *See id.*
[170] Pace & Trautman, *Mission Critical*, *supra* note 158, at 903, 907. *See also* Pace & Trautman, *Imperfect Together*, *supra* note 174 (discussing recent developments in *Caremark* doctrine with a focus on climate issues); H. Justin Pace & Lawrence J. Trautman, *Financial Institution D&O Liability After*

A. SEC Proposed Rules on Cybersecurity Risk

On March 9, 2022, the SEC announced several "proposed amendments to its rules to enhance and standardize disclosures regarding cybersecurity risk management, strategy, governance, and incident reporting by public companies."[171] This announcement is reproduced as Exhibit 2.

Exhibit 2.
SEC Proposes Rules on Cybersecurity Risk, Management, Strategy, Governance, and Incident Disclosure by Public Companies[172]

Press Release

SEC Proposes Rules on Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure by Public Companies

FOR IMMEDIATE RELEASE

2022-39

Washington D.C., March 9, 2022 —

The Securities and Exchange Commission today proposed amendments to its rules to enhance and standardize disclosures regarding cybersecurity risk

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Caremark *and* McDonald's, Rutgers Univ. L. Rev. (forthcoming) (discussing recent developments in *Caremark* doctrine with a focus on officer liability and banking issues).

[171] Press Release 2022-39, SEC Proposes Rules on Cybersecurity Risk, Management, Strategy, Governance, and Incident Disclosure by Public Companies (Mar. 9, 2022), https://www.sec.gov/news/press-release/2022-39 [https://perma.cc/KUT2-TKZU]; *see also* Press Release 2022-20, SEC Proposes Cybersecurity Risk Management Rules and Amendments for Registered Investment Advisers and Funds (Mar. 9, 2022), https://www.sec.gov/news/press-release/2022-20 **[**https://perma.cc/YQ2H-A3RB**]** (requiring Registered Investment Advisers and funds to implement written cybersecurity policies and procedures to address cybersecurity risks that could harm advisory clients and investors).

[172] *See* SEC Proposes Rules on Cybersecurity Risk, *supra* note 191.

management, strategy, governance, and incident reporting by public companies.

"Over the years, our disclosure regime has evolved to reflect evolving risks and investor needs," said SEC Chair Gary Gensler. "Today, cybersecurity is an emerging risk with which public issuers increasingly must contend. Investors want to know more about how issuers are managing those growing risks. A lot of issuers already provide cybersecurity disclosure to investors. I think companies and investors alike would benefit if this information were required in a consistent, comparable, and decision-useful manner. I am pleased to support this proposal because, if adopted, it would strengthen investors' ability to evaluate public companies' cybersecurity practices and incident reporting."

The proposed amendments would require, among other things, current reporting about material cybersecurity incidents and periodic reporting to provide updates about previously reported cybersecurity incidents. The proposal also would require periodic reporting about a registrant's policies and procedures to identify and manage cybersecurity risks; the registrant's board of directors' oversight of cybersecurity risk; and management's role and expertise in assessing and managing cybersecurity risk and implementing cybersecurity policies and procedures. The proposal would require annual reporting or certain proxy disclosure about the board of directors' cybersecurity expertise, if any.

The proposed amendments are intended to better inform investors about a registrant's risk management, strategy, and governance and to provide timely notification to investors of material cybersecurity incidents.

The proposal will be published on SEC.gov and in the Federal Register. The public comment period will remain open for 60 days following the publication of the proposing release on the SEC's website or 30 days following the publication of the proposing release in the Federal Register, whichever period is longer.

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In the belief that many corporate actors lack a firm, detailed understanding of their actual costs and potential risks relevant to cyber risk, professors Trautman and Newman have recommended that "[c]apturing structured cost data may allow management, boards, investors, regulators, and national security policy makers to better understand the true costs incurred in cyber defense and breach mediation."[173] Trautman and Newman contend that "[e]xternality costs associated with cyberattack, when ignored by industry, are placing additional burdens upon government and other institutions (such as municipalities, school systems and universities) and citizens when their customer identity data is stolen, resulting in fraud committed against them."[174] The proposed SEC Cyber Data Disclosure Commission is recommended since "[r]egulators, management, directors, and investors need meaningful and comparable structured data to facilitate decisions about this critically important [cyber risk] issue."[175]

V. Pandemic and Audit

> *Through this period of collective, national challenge, we have remained fully operational and committed to our tripartite mission to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. While the agency is engaging on numerous COVID-19 initiatives… we also continue our regular agency operations. For example, we have continued to advance rulemaking initiatives, conduct risk-based inspections, bring enforcement actions, and review and comment on issuer and fund filings.*
>
> *Our staff has been intently focused on continuing to display the level of professionalism and dedication on which our investors and markets have come to rely.*

[173] Lawrence J. Trautman & Neal F. Newman, *A Proposed SEC Cyber Data Disclosure Advisory Commission*, 50 SEC. REG. L.J. 199, 223 (2022), http://ssrn.com/abstract=4097138.
[174] *Id.*
[175] *Id.*

U.S. Securities & Exchange Commission[176]

The Covid-19 pandemic created unprecedented challenges for auditors, audit committees and issuers.[177] The Public Company Accounting Oversight Board (PCAOB), the body that oversees the audits of public companies,[178] reached out to nearly 400 public company audit committee chairs, seeking their insight on the issues their companies were facing in completing their annual audits in the midst of the pandemic.[179] While many of the insights were industry specific, some recurring themes emerged from those discussions. Some audit committee chairs shared that the effect of COVID-19 on the audit function had not been significant to date.[180] But others shared that COVID-19's impact quickly surpassed their expectations.[181]

These audit committee chairs identified a wide range of topics that presented increased risk.[182] These risks included issues related to quality financial reporting, cybersecurity, employee safety and mental health, going concern issues, accounting estimates, impairments,

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[176] SEC Coronavirus (COVID-19) Response, SEC (last modified Apr. 26, 2022), https://www.sec.gov/sec-coronavirus-covid-19-response [https://perma.cc/B4WA-BAWL].

[177] PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, CONVERSATIONS WITH AUDIT COMMITTEE CHAIRS: COVID-19 AND THE AUDIT (Jul. 8, 2020) [hereinafter PCAOB, *COVID-19 and the Audit*] https://pcaobus.org/Documents/Conversations-with-Audit-Committee-Chairs-Covid.pdf [https://perma.cc/DB5G-7JDD].

[178] The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports; *see* PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, https://pcaobus.org/about.

[179] PCAOB, *Covid-19 and the Audit*, *supra* note 198, at 1. ("[T]he Board has committed to engaging more directly and more often with audit committees.").

[180] *Id.*

[181] *Id.*

[182] *Id.* ("For many, these include cybersecurity, employee safety and mental health, going concern, accounting estimates, impairments, international operations, and accounting implications of the Coronavirus Aid, Relief, and Economic Security (CARES) Act.").

international operations, and accounting implications of the Coronavirus Aid, Relief, and Economic Security (CARES) Act.[183]

A. Conducting Audits Remotely

The dynamic brought on by the COVID-19 pandemic forced issuers, audit committees, and the auditors to be more thoughtful and shrewd about how the audit would be executed.[184] Historically, the protocol auditors employed in completing an audit was that an audit team with a staff of two to over twenty for larger companies would deploy to the issuer's place of business and set up on site, where they would remain for several weeks if necessary to complete the audit.[185] However, with the coronavirus now being a factor to consider, auditors were forced to perform these audits remotely.[186]

Accordingly, "addressing risks related to remote work was the most prevalent theme that the PCAOB heard from audit committee chairs about the impact of COVID-19."[187] In that regard, recurring themes that audit committee chairs addressed with their auditors were the following:

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[183] *Id.* at 2 ("Multiple audit committee chairs identified cyber-related risks—such as increased phishing attempts and email security—as also being top-of-mind with the move to remote work.").

[184] INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD, HIGHLIGHTING AREAS OF FOCUS IN AN EVOLVING AUDIT ENVIRONMENT DUE TO THE IMPACT OF COVID-19, STAFF AUDIT PRAC. ALERT (Mar. 2020) [hereinafter IAASB, *Covid-19 Audit Environment*], https://www.ifac.org/_flysystem/azure-private/publications/files/Staff-Alert-Highlighting-Areas-of-Focus-in-an-Evolving-Audit.pdf [https://perma.cc/259G-3RGZ]. ("At the engagement level, auditors should have heightened awareness of the possibility of fraud or error, including fraudulent financial reporting, with the importance of the exercise of professional skepticism top of mind in performing audit procedures.").

[185] Neil Amato, *Audit transformation: Automation is one small step in the journey*, J. ACCT. (Mar. 26, 2022) [hereinafter Amato, *Audit Transformation*], https://www.journalofaccountancy.com/podcast/cpa-news-audit-transformation-automation.html [https://perma.cc/2SPC-ZA7C]. ("It's no longer the days where you're going into their office and holing up for weeks on end and going through file cabinets.").

[186] *See* IAASB, *Covid-19 Audit Environment*, *supra* note 204, at 1 ("Similarly, auditors have to adjust how they obtain sufficient appropriate audit evidence on which to base the audit opinion . . . .").

[187] PCAOB, *Covid-19 and the Audit*, *supra* note 198, at 2.

1. Audit Committee chairs inquired as to whether additional time would be needed to get the audit work done remotely and what further complexities of working remotely added to the audit.[188]

2. Audit Committee chairs wanted to know whether working remotely would affect audit team members' productivity. And if so, would the audit plan need to be updated and, accordingly, would the audit fee need to be revisited?[189]

3. With the issuer's accounting staff now working remotely in most cases, audit committees needed to be concerned with how internal accounting controls were being maintained as well as the auditor's ability to assess the effectiveness of those internal controls.[190]

4. With the auditors working remotely, the audit committee chairs inquired as to whether there were any technology enhancements or collaborative tools that should be considered to support longer-term remote work.[191]

The Audit Committee Chairs also reportedly wanted to know whether the auditor had addressed potential risks of material misstatement related to cybersecurity, and how the auditor planned to respond to those risks.[192]

These inquiries forced both the auditors and the issuers to work through and think about these issues.[193] Interestingly, the increased

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[188] *Id.*
[189] *Id.*
[190] *Id.*
[191] *Id.*
[192] *Id.* ("The auditor's consideration of cybersecurity is addressed in the context identifying and assessing risks of material misstatements to the financial statements and, for integrated audits, in identifying and testing the controls that mitigate those risks.").
[193] *Id.* ("Several also noted that, as the pandemic continues, new risks and uncertainties may arise and that they expect to stay engaged with both management and auditors to understand how they are addressing emerging issues.").

complexity brought on by the pandemic forced issuers, audit committees, and their auditors to be more thoughtful about the most effective approach to completing a quality audit.[194] The auditor's typical approach was to follow the steps the audit team performed during the prior year's audit and then replicate that for the current year.[195] The new set of circumstances brought on by the pandemic, however, forced the auditors to take a fresh perspective on how to approach and complete an audit under challenging circumstances.[196] The auditors now had to be more efficient, more thoughtful, and more strategic about completing their audits while still maintaining quality.[197]

In addition, the auditors had to put renewed focus and emphasis on their risk assessments.[198] An auditor's risk assessment is an exercise whereby the auditor takes a global view of an issuer's operation and makes an assessment as to where the risk areas might be.[199] The term "risk" in this context are those areas in the financial statements that present a heightened risk of material misstatement or material omission.[200] A quality risk assessment helps to guide the auditor in

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[194] *See* IAASB, *Covid-19 Audit Environment*, *supra* note 204, at 1.

[195] Amato, *Audit Transformation*, *supra* note 204, at 3.

[196] *Id.* ("The audit is done very differently today, and thank goodness, as we've gone through COVID, for example, that we have the ability to do remote audits where necessary, again, using technology. But it's not just a matter of being able to be remote, it's a matter of making the process more efficient and enjoyable for the clients.").

[197] *Id.* ("But DAS isn't just about automating what we've always done. It goes further to maximize the potential of technology to add additional value and bring additional insight to the audit and really enhance audit quality.").

[198] IAASB, *Covid-19 Audit Environment*, *supra* note 204, at 3 ("The auditor's responsibilities relating to subsequent events . . . Considering that shifting reporting deadlines increases the period (and therefore the related risks) for events occurring between the date of the financial statements and the date of the auditor's report.").

[199] *Id.* at 1.

[200] PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, RELEASE NO. 2010-004 at A1 - 2 (Aug. 5, 2010), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket_026/release_2010004_risk_assessment.pdf?sfvrsn=6326eac2_0 [https://perma.cc/856L-Z8N6] ("[A]udit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated . . . Risks of material misstatement at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions.").

where to focus time, effort, and resources in getting comfortable with a particular account balance or balances.[201]

B. Logistical Issues

Logistical issues had to be addressed as well. Audit committee chairs had to work with their issuer and the auditors to resolve matters such as how year-end inventory counts would be performed.[202] Prior to the pandemic, auditors typically performed a physical count of year-end inventory, usually on a test basis, to verify that the inventory recorded on the balance sheet was a fair representation of the actual inventory on hand.[203] The pandemic would now force auditors to perform this function remotely. Many issuers resolved this logistical challenge by using cameras.[204] Issuer staff, for example, would walk the warehouse where the issuer kept the inventory while audit staff observed the inventory count through the camera, thereby verifying the inventory items' existence.[205] Ultimately, this approach worked well, and the auditors were able to test inventory account balances adequately with this method.[206]

C. Accounting Estimates

Additionally, there were specific accounting issues and challenges that the pandemic brought to bear. Audit Committees had to be on top of these issues to make sure they were being handled

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[201] IAASB, *Covid-19 Audit Environment*, *supra* note 204, at 1, 2.

[202] *Id.* at 2 ("In such circumstances, the independent auditor must satisfy himself that the client's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by a count of all items each year.").

[203] *See* PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, ACCOUNTING STANDARD 2510, https://pcaobus.org/oversight/standards/auditing-standards/details/AS2510 [https://perma.cc/6NCM-VTE5].

[204] Ovaska & Murphy, *Remote Auditing*, *supra* note 145 ("Some firms have taken a creative approach, Wilson said, employing drones and other technology for inventory control . . . Some firms have even purchased technology for clients to help with video access").

[205] *Id.* ("King said he found remote work cheaper for his clients and firm and provided his employees and contractors with a more flexible work environment.").

[206] *Id.* ("Wilson is encouraged by how quickly firms moved to remote work when the conditions of the pandemic called for it.").

properly.[207] U.S. public companies record financial information using Generally Accepted Accounting Principles (GAAP), which is an accrual-based accounting method requiring that certain financial statement items be recorded using estimates and approximations.[208] For example, companies are required to estimate what portion of their current account receivables will go uncollected during the 12-month period comprising the issuer's fiscal year.[209] The issuer must record that amount on the income statement as an expense item referred to as "*allowance for doubtful accounts*."[210] Historically, companies used prior years' collection history to record the current year's expense, which was deemed a reasonable approach for accruing the expense.[211] But with the pandemic now disrupting the equation, issuers were faced with a variable that made such estimates much harder to predict.[212] Thus, management had to exercise much more judgment in making these estimates.[213] In turn, the auditors were then tasked with assessing

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[207] *Id.* ("Building relationships during on-site audits can be more challenging when auditors are not interacting with clients who are pressed to find space for visiting auditors, or when fieldwork is compressed into a short period of time.").

[208] Robert Jennings, *Cash or Accrual? Choosing or changing a method for tax purposes*, J. ACCT. (May 1, 2001), https://www.journalofaccountancy.com/issues/2001/may/cashoraccrual.html [https://perma.cc/TS9U-JHL3].

[209] *Allowance for Doubtful Accounts Guide to Understanding the Allowance for Doubtful Accounts*, WALLSTREETPREP, https://www.wallstreetpre p.com /knowledge/allowance-for-doubtful-accounts [https://perma.cc/BA99-DCK8].

[210] *Id.*

[211] *Id.*

[212] Joseph Radigan, *How the Coronavirus may Affect Financial Reporting and Auditing*, J. ACCT. (Mar. 17, 2020) [hereinafter Radigan, *Coronavirus: Financial reporting and Auditing*], https://www.journalofaccountancy.com/news/2020/mar/how-coronavirus-may-affect-financial-reporting-auditing-23087.html [https://perma.cc/TB5H-DGDC] ("Because of the extensive and unpredictable nature of the coronavirus epidemic, auditors can expect that their assessments of clients' accounting estimates will be even more complicated than usual in upcoming reporting periods").

[213] *Id.* ("'In keeping with recommendations from the Securities and Exchange Commission, audit firms are working in close collaboration with public companies' audit committees and management to help ensure financial reporting and auditing processes remain robust and as timely as possible amid the global coronavirus crisis . . . .").

the reasonableness of estimates that were now being made in an unprecedented context.[214]

D. Going Concern Issues

Whether the entity would be able to survive the pandemic at all was an item on the Audit Committee's radar.[215] Public accountants refer to this as a "going concern" issue.[216] An auditor's issuance of a "going concern" opinion in its report is akin to a death sentence for the company.[217] An auditor's report that includes a going concern opinion is telling the investing public that the auditor has taken a close look at this company's financial and results of operations, and based on that review, the auditor has concerns whether this company can remain viable.[218] This opinion would likely have a great negative impact on the value of a company's stock.[219] With the pandemic either slowing or grinding some businesses to a halt indefinitely, the "going concern" issue loomed large with many companies.[220]

The above matters are merely an overview of the types of issues that issuers, their audit committees, and the auditors faced in their efforts in performing a quality audit amidst a raging pandemic. Ironically, the audit industry found significant benefits in auditing remotely.[221] The

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[214] *Id.* ("The audit profession will remain in close contact with regulators as the impact of the virus on companies, auditors, and the audit process continues to be assessed . . . .").

[215] *Id.* ("[C]ompanies that had problems may face a struggle to survive. 'They're going to be dealing with going concern issues and how to evaluate them' for clients that are suffering from cash shortfalls . . . .'").

[216] *Id.*

[217] *Id.*

[218] *Id.* ("With so much business activity squeezed and substantial doubt about when business will resume something of a normal pattern, companies that had problems may face a struggle to survive").

[219] Kevin C. W Chen & Bryan K. Church, *Going Concern Opinions and the Market's Reaction to Bankruptcy Filings*, 71 THE ACCOUNTING REV. 117, 117 (1996).

[220] Radigan, *Coronavirus: Financial Reporting and Auditing*, *supra* note 232 ("Prepare for an increase in going concern disclosures").

[221] Ovaska & Murphy, *Remote Auditing*, *supra* note 145 ("Wilson's consulting firm conduct its latest biennial Anytime, Anywhere Work survey in 2020 and found 61% of the 223 CPA firms surveyed plan to conduct more than half of their audit work remotely in the future. That same question, when asked pre-pandemic, only had 17% of firms indicating they'd conduct the majority of their audit work away from client locations").

auditors realized that the audits could be performed just as effectively and efficiently remotely, perhaps even more so in many cases.[222] With the advancements in technology, the issuers typically share financial information with their auditors electronically anyway, thus obviating the need for in-person interaction for most situations.[223] Further, issuer staff expressed appreciation in remote audits, citing less disruption to their workday from auditors making inquiries throughout the day.[224] Auditors found that they could work more efficiently remotely versus on site.[225] In many instances, client accommodations for an audit team can be left wanting as the audit team may be stuffed into a very small space in which to work.[226] In addition, the audit team may also face technology or connectivity issues all while trying to function with limited space for work papers, storing files, etc.[227] As a result of the pandemic, both the auditors and the issuers found that working remotely worked better for both.[228]

It appears that the public accounting industry and the clients that they audit may reach a new normal where remote audits will be the rule going forward regardless of whether COVID-19 is a factor.[229] The efficiency, convenience, and increased quality in many cases will likely result in remote audits being deemed as a best practice going forward.[230] All told, it appears that U.S. public companies navigated the pandemic well in relation to meeting its annual audit obligations.

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[222] *Id.*
[223] *Id.*
[224] *Id.*
[225] *Id.* ("Clients value time spent building the relationship and getting valuable advice from their auditors, but that isn't usually happening during fieldwork, which can be done more efficiently from the firm's office in many, many cases.").
[226] *Id.*
[227] *Id.* ("Building relationships during on-site audits can be more challenging when auditors are not interacting with clients who are pressed to find space for visiting auditors, or when fieldwork is compressed into a short period of time").
[228] *Id.* ("King found remote work created more efficient experiences for staff and clients.").
[229] *Id.*
[230] *See id.*

VI. Corporate Impact from Climate Change

> *Last year, for the first time, the U.S. Financial Stability Oversight Council identified climate change as an "emerging and increasing threat to U.S. financial stability."*
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> *A recent climate risk assessment from the Office of Management and Budget found that the U.S. government will need to spend an additional $25 billion to $128 billion annually for policies to mitigate climate-related financial risks. And an analysis by the Network for Greening the Financial System estimated that, under current policy pathways, climate change could reduce U.S. GDP by 3 to 10 percent by the end of this century…*
>
> *Investors with $130 trillion in assets under management have requested that companies disclose their climate risks. And 5,000-plus signatories to the UN Principles for Responsible Investment—a group with a core goal of helping investors protect their portfolios from climate-related risks—manage more than $121 trillion as of June 2022.*
>
> *SEC Commissioner*
> *Jaime Lizárraga*
> *October 17, 2022*[231]

Climate change is "an immense societal risk."[232] The risks are, simply put, enormous.[233] Climate risk can be categorized as either physical risk or transition risk.[234] Physical risk "refers to the loss of

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[231] Jaime Lizárraga, SEC Comm'r, Address at The Future of ESG Data, London, United Kingdom, Meeting Investor Demand for High Quality ESG Data (Oct. 17, 2022), https://www.sec.gov/news/speech/lizarraga-speech-meeting-investor-demand-high-quality-esg-data [https://perma.cc/N6PK-HWE4].

[232] Pace & Trautman, *Imperfect Together*, *supra* note 174, at 778. ("As evidence of man-made climate change continues to mount, climate change has become an immense societal risk with a shorter and shorter runway for mitigation.").

[233] *See generally*, *id.* at 798–807 (giving examples of some of the more severe risks from climate change).

[234] *Id.* at 827 ("Climate risk can be divided between physical risk and transition risk").

revenue streams or assets or additional investments caused by physical effects of climate change such as sea level rise, wildfires or water stress," and so forth.[235] That risk can be either chronic or acute.[236] Transition risk refers to "the loss of revenue streams or assets or additional investment that arises from the firm's efforts to reduce or eliminate [greenhouse] emissions that cause climate change," as well as to "societal changes such as public policy initiatives or from competitors switching to a low carbon alternative product that consumers demand."[237] Climate litigation risk typically falls under transition risk.[238]

Climate change has become a topic of discussion at board meetings.[239] How much will naturally depend on the relative level of climate risk to a particular company. The board's job is especially difficult because it "must also balance other, valid competing interests, including other important environmental concerns."[240] Discussion of climate change has not fully penetrated audit committees, with well over

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[235] Shivaram Rajgopal, *The Proposed SEC Climate Disclosure Rule: A Comment from Shivaram Rajgopal*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE (Aug. 22, 2022) [hereinafter Rajgopal, Comment on Climate Disclosure Rule], https://corpgov.law.harvard.edu/2022/08/22/the-proposed-sec-climate-disclosure-rule-a-comment-from-shivaram-rajgopal/ [https://perma.cc/9PCR-EZLQ].

[236] Pace & Trautman, *Imperfect Together*, *supra* note 174, at 827 (citing Lisa Benjamin, *The Road to Paris Runs Through Delaware: Climate Litigation and Directors' Duties*, 2020 UTAH L. REV. 313, 348) [hereinafter Benjamin, *Climate Litigation and Director Duties*]) ("Physical risk can be acute or chronic.").

[237] Rajgopal, *Comment on Climate Disclosure Rule*, *supra* note 260.

[238] Pace & Trautman, *Imperfect Together*, *supra* note 174, at 828 ("Transition risk also includes . . . litigation risk "stemming from the attribution of climate change to [their] activities or the failure to manage the impacts of climate change on the business.").

[239] *See* Shapira, *Mission Critical ESG*, *supra* note 176, at 758 ("Nowadays . . . boards regularly discuss broader ESG concerns, from racial diversity to climate change."). *See also* Lawrence J. Trautman & Neal F. Newman, *The Environmental, Social and Governance (ESG) Debate Emerges from the Soil of Climate Denial*, 53 U. MEMPHIS L. REV. 67 (2022), http://ssrn.com/abstract=3939898.

[240] Pace & Trautman, *Imperfect Together*, *supra* note 174, at 830 (citing Strine et al., *Caremark and ESG*, *supra* note 164, at 1905; Benjamin, *Climate Litigation and Director Duties*, *supra* note 261, at 378).

half reporting they never discuss it.[241] This may not be an entirely bad thing. It would be "dangerous to give climate risk responsibility solely to already overloaded audit committees"[242] not just because audit committees are overloaded, but because they are unlikely to have the relevant expertise. An audit committee member with a traditional profile—such as "a top KPMG accountant or a CFO at a Fortune 100 company"—may have "no training or expertise to address" non-financial issues, including climate change.[243] Barely half of respondents to a survey of audit committee members report that there was more than one member of their audit committee who was climate literate.[244]

Boards rarely delegate climate responsibility as a whole to the audit committee, with one survey of audit committee members finding fifty-four percent of companies in the Americas give overall responsibility to the board as a whole, while just 9 percent give overall responsibility to the audit committee.[245] But it will be difficult for audit committees to escape responsibility for climate risk entirely, with the need "at the very least to ensure that the potentially significant impact that climate change can have on asset valuations and completeness of liabilities is appropriately reflected in the financial statements that the company discloses."[246] Despite the importance of climate change to society, it may not follow that climate change is necessarily mission

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[241] DELOITTE, THE AUDIT COMMITTEE FRONTIER – ADDRESSING CLIMATE CHANGE at 3, 5 (2021) [hereinafter Deloitte, *Audit Committee Frontier*], https://www2.deloitte.com/global/en/pages/ris k/articles/frontier-topics-audit-committees-climate-audit-committee.html?nc=1 ("Among the survey results described below, nearly 60% of all audit committee members surveyed indicate that they do not discuss climate on a regular basis, and over half do not consider themselves "climate literate.").

[242] Pace & Trautman, *Imperfect Together*, *supra* note 174, at 838 (citing Strine, et al., *Caremark and ESG*, *supra* note 164, at 1915–16).

[243] Strine et al., *Caremark and ESG*, *supra* note 164, at 1916–17.

[244] Deloitte, *Audit Committee Frontier*, *supra* note 265, at 7 (Showing 52% of global respondents and 51% of American respondents said they had more than one committee member who was climate literate.).

[245] Both risk and nomination/governance committees were more likely to have overall climate responsibility; *see Id.* at 14 (explaining that 54% of American companies gave control to the entire board while 9% gave control to an audit committee and 13% of American companies gave control to a risk committee while 10% gave control to a nomination/governance committee).

[246] *Id.* at 21.

critical for all companies.[247] Exposure to climate risk varies from company to company.[248]

> The insurance, agriculture (especially wineries), and skiing industries face critical physical climate risk . . . The beverage and clothing industries face transition risks as they attempt to reduce their water inputs. The construction industry faces transition risks as it attempts to reduce the (frankly massive) carbon emissions associated with both building and operating buildings. Oil and gas companies and coal companies face serious climate transition risks [from policy changes]. Automakers face serious climate transition risks . . . as consumers switch to electric cars. Agriculture companies, and especially meat companies, will soon also face serious climate transition risks . . . as plant-based meats, including cultivated meat, become available.[249]

One of the biggest challenges companies and their audit committees face today is the ESG movement.[250] The acronym "ESG" is short for environmental, social, and governance.[251] "While 'environmental' extends beyond just climate change, the increased concern over climate change has put climate change at the forefront of both the 'E' and ESG overall."[252] ESG is an investor-driven phenomenon and thus

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[247] Pace & Trautman, *Imperfect Together, supra* note 174, at 828.
[248] *Id.* at 831 ("[C]limate change is *not* mission critical for many companies. Determining whether a risk is "mission critical" for the purposes of *Caremark* liability is contextual and company-specific.").
[249] *Id.* at 827–28 (citations omitted).
[250] *See* Stephen M. Bainbridge, *Don't Compound the* Caremark *Mistake by Extending it to ESG Oversight*, 77 BUS. LAWYER 651, 651 (2022) (questioning whether boards of directors should be held liable for failure to adequately oversee their companies' ESG compliance).
[251] *Id.* ("To say that environmental, social, and governance ("ESG") investing is now a major phenomenon is to understate the facts.").
[252] Pace & Trautman, *Imperfect Together, supra* note 174, at 779 (citing Strine, et al., *Caremark and ESG*, *supra* note 164, at 1902).

may be particularly relevant for audit committees charged with oversight of securities disclosures.[253]

Companies also face increasing regulatory burdens and litigation risk in the climate space.[254] "Environmental Protection Agency ('EPA') rules and regulations are an obvious source" of climate regulation.[255] The DOJ, and especially its Environmental and Natural Resources division, are active where environmental issues and criminal statutes collide.[256] Issuers already have an obligation to disclose material climate risk, but the SEC has proposed a rule that would dramatically increase required disclosures.[257] Overpromising on popular net-zero pledges may lead to liability under consumer protection law.[258] Local governments are getting inventive in their attempts to pursue climate litigation, with New York City suing energy companies for "illegal trespass due to sea-level rise" and a group of California cities and counties including state law strict liability, design defect, failure to warn, and negligence claims in their climate litigation.[259]

As with cyber risk, the addition of climate-related responsibilities to the audit committee leads to increased risk of Caremark liability for failures of oversight.[260] Failure to implement claims are possible if a board fails to implement controls and hold board-

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[253] *See id.* at 810 ("Since 2010, investor demand for, and company disclosure of information about, climate change risks, impacts, and opportunities had grown dramatically.").

[254] *See id.* at 778–79 ("Legal risk associated with climate change is also increasing as lawmakers and regulatory bodies respond to the threat of climate change by increasing the regulatory burden on businesses.").

[255] *Id.* at 807.

[256] *See id.* at 808. (Describing how the DOJ has pursued criminal charges against chemical plants for the wasteful illegal flaring of gas).

[257] *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21,334 (proposed April 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249).

[258] Shapira, *Mission Critical ESG*, *supra* note 176, at 780 ("[overpromising] exposes the companies to consumer and regulatory enforcement actions when it turns out that their walk does not match their talk.").

[259] Benjamin, *Climate Litigation and Director Duties*, *supra* note 261, at 336, 338.

[260] *See id.* at 378.

level discussions of climate risk.[261] Failure to monitor claims are possible if a board fails to respond to climate-related "red flags."[262] Climate-related Caremark risk will typically be lower than cyber-related Caremark risk both because many companies face relatively lower climate risk and because of the frequently long-time horizons associated with climate risk.[263] Climate-related Caremark risk "is a risk that can be carefully managed by the board."[264] As in the cyber context, an audit committee with climate responsibility can "protect itself with best practices including requiring regular reports on [climate risk] from management, by discussing [climate] issues on a regular basis, by setting protocols for reporting 'red flags' up to the committee, and by making use of third-party experts."[265]

A. SEC Request for Public Comments

During early 2021, Acting SEC Chair Allison Herren Lee questioned "whether current disclosures adequately inform investors [requesting] . . . public input from investors, registrants, and other market participants on climate change disclosure."[266] Observing that, "[t]he Securities and Exchange Commission . . . has periodically

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[261] *Id.* at 378-379 ("Directors will breach their duties of care and loyalty if they fail to understand the risks of climate change to their business and, where these risks are considerable, have failed to convey these risks to shareholders.").

[262] *Id.* at 379. ("Litigation claims are likely to arise when fiduciary actors fail to share and disclosure relevant information and risks to shareholders or fail to take adaptive actions based on their knowledge.").

[263] Virginia Harper Ho, *Climate Disclosure Line-Drawing & Securities Regulation*, 56 UC DAVIS L. REV. 1875, 1902-03 (2022-2023) ("[E]mpirical studies analyzing the relationship between sustainability measures and financial performance in the aggregate cannot support any conclusion about the materiality of particular environmental or social factors across all firms.").

[264] *See* Pace & Trautman, *supra* note 173, at 833 ("The risk of Caremark liability related to climate change is not zero, but it is a risk that can be carefully managed by the board.").

[265] *Supra* Part IV.

[266] Allison Herren Lee, Acting Chair, SEC, Request for Comment on Climate Disclosures (Mar. 15, 2021), https://www.sec.gov/news/public-statement/lee-climate-change-disclosures [https://perma.cc/M53C-9KWZ] ("In light of demand for climate change information and questions about whether current disclosures adequately inform investors, public input is requested from investors, registrants, and other market participants on climate change disclosure.").

evaluated its regulation of climate change disclosures within the context of its integrated disclosure system," Chair Herren Lee states:

> In 2010, the Commission issued an interpretive release that provided guidance to issuers as to how existing disclosure requirements apply to climate change matters. The 2010 Climate Change Guidance noted that, depending on the circumstances, information about climate change-related risks and opportunities might be required in a registrant's disclosures related to its description of business, legal proceedings, risk factors, and management's discussion and analysis of financial condition and results of operations. The release outlined certain ways in which climate change may trigger disclosure obligations under the SEC's rules. It noted legislation and regulations governing climate change, international accords, changes in market demand for goods or services, and physical risks associated with climate change.
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> Since 2010, investor demand for, and company disclosure of information about, climate change risks, impacts, and opportunities has grown dramatically. Consequently, questions arise about whether climate change disclosures adequately inform investors about known material risks, uncertainties, impacts, and opportunities, and whether greater consistency could be achieved. In May 2020, the SEC Investor Advisory Committee approved recommendations urging the Commission to begin an effort to update reporting requirements for issuers to include material, decision-useful environmental, social, and governance, or ESG factors. In December 2020, the ESG Subcommittee of the SEC Asset Management Advisory Committee issued a preliminary recommendation that the Commission require the adoption of standards by which corporate issuers disclose material ESG risks.[267]

During March 2021 Acting Chair Allison Herren Lee requested that the SEC staff conduct an evaluation of "disclosure rules with an eye

[267] *Id.* (internal citations omitted).

toward facilitating the disclosure of consistent, comparable, and reliable information on climate change."[268]

B. SEC Climate and ESG Task Force

Demonstrating the recent focus and priority of ESG, on March 4, 2021, the SEC announced the creation of a Climate and ESG Task Force within the Division of Enforcement.[269] This new task force is "a Division-wide effort, with 22 members drawn from the SEC's headquarters, regional offices, and Enforcement specialized units."[270] The SEC states:

> Consistent with increasing investor focus and reliance on climate and ESG-related disclosure and investment, the Climate and ESG Task Force will develop initiatives to proactively identify ESG-related misconduct. The task force will also coordinate the effective use of Division resources, including through the use of sophisticated data analysis to mine and assess information across registrants, to identify potential violations.
>
> The initial focus will be to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules. The task force will also analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies. Its work will complement the agency's other initiatives in this area, including the recent appointment of Satyam Khanna as a Senior Policy Advisor for Climate and ESG. As an integral component of the agency's efforts to address these risks to investors, the task force will work closely with other SEC Divisions and Offices, including the Divisions of Corporation Finance, Investment Management, and Examinations . . .

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[268] *Id.*
[269] Press Release 2021-42, SEC, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42 [https://perma.cc/4VSX-LY97].
[270] *Id.*

> . . . Climate risks and sustainability are critical issues for the investing public and our capital markets," said Acting Chair Allison Herren Lee.[271]

C. Public Comments Received

By January 2022 SEC Chair Gary Gensler reflected upon his first nine months on the job with *The Wall Street Journal*, concluding that "the SEC has taken longer than Mr. Gensler originally expected to propose a rule requiring public companies to report more information about the risks they face from climate change."[272] Agencies are required by federal agency law "to seek comments from the public and study a rule's costs and benefits before finalizing major changes, a process that usually takes at least several months."[273] Accordingly, on May 9, 2022, the SEC announced that it extended the public comment period on the proposed rulemaking, entitled "The Enhancement and Standardization of Climate-Related Disclosures for Investors," which ended on June 17, 2022.[274]

VII. Recruiting Audit Committee Members

> *A nominating and governance committee is responsible for two things: first, nomination for election by the shareholders of the individuals that are coming onto the board; and second, defining and understanding what the principles of governance are within the board as well as within the organization. So,*

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[271] *Id.*
[272] Paul Kiernan, *SEC Chief Pushes to Tighten Rules This Year,* WALL ST. J., Jan. 20, 2022, at A2.
[273] *Id.* ("Federal law requires agencies to seek comments from the public and study a rule's costs and benefits before finalizing major changes, a process that usually takes at least several months.").
[274] SEC Proposed Rule, The Enhancement and Standardization of Climate-Related Disclosures for Investors, Release Nos. 33-11061, 34-94867 (May 9, 2022)*; see* Press Release, SEC, SEC Extends Comment Period for Proposed Rules on Climate-Related Disclosures, Reopens Comment Periods for Proposed Rules Regarding Private Fund Advisers and Regulation ATS (May 9, 2022) ("The public comment period for proposed rulemaking "The Enhancement and Standardization of Climate-Related Disclosures for Investors," Release Nos. 33-11042, 34-94478 (March 21, 2022) will now end on June 17, 2022.").

> *things like the ethics and integrity statements are the purview of this committee, making sure that objectives are in alignment. From the nominating and governance standpoint, most corporations have somewhere between seven and twelve directors, depending on the size of the corporation. It is important to have a mix of skills and experiences because you want to make sure that you've got enough individuals on your board to really help understand the direction of the long-term sustainability and strategy of the company. Therefore, just like in a normal hiring process, the goal is to bring people onto the board that can help the company go to the next level. Accordingly, most organizations use something called a skills and experience matrix.*
>
> *Michele Hooper*
> *Seasoned Corporate Director*[275]

A major responsibility of every board is to recruit and approve nominees for election as directors.[276] Generally, the board will designate the Nominating and Governance ("N&G") Committee to be responsible for this task.[277] The N&G Committee should consist solely of independent directors as defined by the rules of the NYSE[278] and the

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[275] *See* Trautman*, Corporate Directors*, *supra* note 111, at 490.

[276] *See* George Anderson et al., Nominating/Governance Committee: Responsibilities and Operations, SPENCERSTUART at 8 (2019) ("It requires nominating/governance committees to have a written charter (posted on the company's website) detailing roles and responsibilities.").

[277] *Id.* at 5 ("Today, the Roles and Responsibilities of Nominating/Governance Committees Frequently Encompass the Following Areas: Board composition: Evaluate the expertise, qualifications, skills, attributes, diversity, contributions and independence of incumbent directors and director candidates; oversee ongoing director succession planning; develop and recommend criteria for board composition and director candidates; lead searches for new director candidates; recommend individuals for election or re-election to the board.").

[278] *See* SEC, NASD & NYSE Rulemaking Rel. No. 34-48745, NASD and NYSE Rulemaking: Relating to Corporate Governance (Nov. 4, 2003), http://www.sec.gov/rules/sro/34-48745.htm [https://perma.cc/B7G3-FM7Y] (elaborating on need of independent directors in Nominating and Governance committees regarding corporate governance).

board's corporate governance guidelines.[279] A written charter for every standing committee should be adopted by the full board.[280]

When evaluating the qualifications of candidates, the N&G Committee will be well advised to look for the following minimum desired personal attributes, qualifications, qualities, professional skills, and experience in all director candidates.

A. Desired Personal Attributes

A fundamental starting point for director recruitment and selection will ask, "[w]hat human qualities are desired for every board member?"[281] Every board should agree on a clear statement of desired personal attributes of all board members, to provide guidance to support the nominating and governance committee as they search for director candidates.[282] "[E]ach director candidate should possess the following necessary core personal attributes: high standards of ethical behavior, availability, outstanding achievement in the individual's personal and professional life, possession of strong interpersonal and communication skills, independence, and soundness of judgment."[283]

B. Personal Integrity

"High standards of ethical behavior" and "personal integrity . . . are an absolute must."[284] Elsewhere, Professor Trautman has written:

> The potential cost to the enterprise and other directors is just too high to assume any likely risks. The risk of litigation due to lapses in personal integrity is a major reason why, when looking for replacements, boards tend to find directors who are already well-known to at least one sitting director. This propensity appears motivated by the desire to mitigate perceived risks by

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[279] *See id.*

[280] *See* NYSE, EURONEXT CORPORATE GOVERNANCE GUIDELINES*,* (Sept. 23, 2010) [hereinafter NYSE, Euronext Guidelines] (discussing the need for boards to have a written charter for their committees).

[281] *See* Trautman*, Corporate Directors*, *supra* note 111, at 470 (emphasizing the need of every board to find the human qualities and skills that would be the minimum qualification for a director).

[282] *Id.*

[283] *Id.*

[284] *Id*.

sitting directors. The risk, to both reputation and personal net worth, is likely reduced by recruitment of a new "already-known" director.[285]

C. The Regulatory Requirements of Independence

The important quality of independence is evidenced by an ability to represent the total corporate interests of the company (as opposed to representing the interests of any particular group—for non-management directors, they must be independent in fact of management and the Corporation).[286] Most notable of the regulatory developments during the past several decades is the insistence that certain board committees be composed entirely of independent directors.[287] Independence is now required for members of the audit, compensation, and nominating and governance committees.[288]

1. Board Statement About Independence

"Each board should adopt a clearly-written statement specifying what constitutes director independence."[289] As an example, presented here as Exhibit 3 is the statement defining independence, and discussing details of the board's analysis of relevant facts as adopted by JPMorgan Chase & Co.

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[285] *Id.*

[286] *See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1471 (2007) ("Independent directors have a comparative advantage for these different tasks.").

[287] *Id.* at 1468 ("The New York Stock Exchange requires most listed companies to have boards with a majority of independent directors and audit and compensation committees comprised solely of independent directors.").

[288] *See* NYSE, *Euronext Guidelines*, *supra* note 300 (highlighting the need for members of committees to have the ability to act independently).

[289] Lawrence J. Trautman, *The Matrix: The Board's Responsibility for Director Selection and Recruitment*, 11 FLA. ST. U. BUS. REV. 75, 84 (2012) [hereinafter Trautman, *Director Selection and Recruitment*].

Exhibit 3.
JPMorgan Chase & Co.
Corporate Governance Principles[290]

2. Board composition…

2.2 Definition of independence

Independence determinations. The Board may determine a director to be independent if the Board has affirmatively determined that the director has no material relationship with the Firm, either directly or as a partner, shareholder or officer of an organization that has a relationship with the Firm. Independence determinations will be made on an annual basis at the time the Board approves director nominees for inclusion in the proxy statement and, if a director joins the Board between annual meetings, at such time. Each director shall notify the Board of any change in circumstances that may put his or her independence as defined in these Corporate Governance Principles at issue. If so notified, the Board will reevaluate, as promptly as practicable thereafter, such director's independence. For these purposes, a director will not be deemed independent if:

(i) the director is, or has been within the last three years, an employee of the Firm or an immediate family member of the director is, or has been within the last three years, an executive officer of the Firm;
(ii) the director or an immediate family member of the director has received, during any 12-month period within the last three years, more than $120,000 in direct compensation from the Firm, other than (a) director and committee fees and pension or other deferred compensation for prior service (provided that such compensation is not contingent in any way on continued service) and (b) compensation received by a

[290] JPMorgan Chase & Co., *Corporate Governance Principles of JPMorgan Chase & Co.*, (last visited Mar. 2022), https://www.jpmorganchase.com/about/governance/corporate-governance-principles.

family member for service as a non-executive employee of the Firm; (iii) the director is a current partner or employee of the Firm's independent registered public accounting firm, an immediate family member of the director is a current partner of such accounting firm or a current employee of such accounting firm who personally works on the Firm's audit, or the director or an immediate family member of the director was within the last three years (but is no longer) a partner or employee of such accounting firm and personally worked on the Firm's audit within that time; or (iv) the director or an immediate family member of the director is, or has been within the last three years, employed as an executive officer of a company in which a present executive officer of the Firm at the same time serves or served on the compensation committee of that company's board of directors.

An “immediate family member” includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person's home.

Relationship to an entity. The relationship between the Firm and an entity will be considered in determining director independence where a director serves as an officer of the entity or, in the case of a for-profit entity, where the director is a general director or a retired officer of the entity unless the Board determines otherwise. Such relationships will not be deemed relevant to the independence of a director who is a non-management director or a retired officer of the entity unless the Board determines otherwise.

Where a director is an officer of an entity that is a client of the Firm, whether as borrower, trading counterparty or otherwise, the financial relationship between the Firm and the entity will not be deemed material to a director's independence if the relationship was entered into in the ordinary course of business of the Firm and on terms substantially similar to those that

> would be offered to comparable counterparties in similar circumstances.
>
> A director who is an employee, or whose immediate family member is an executive officer, of another company that makes payments to or receives payments from the Firm for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million or 2% of such other company's consolidated gross revenues will not be deemed independent until three years after falling below such threshold.
>
> For these purposes, payments exclude loans and repayments of principal on loans, payments arising from investments by the entity in the Firm's securities or the Firm in the entity's securities, and payments from trading and other similar financial relationships.
>
> Where a director is a partner or associate of, or Of Counsel to, a law firm that provides services to the Firm, the relationship will not be deemed material if neither the director nor an immediate family member of the director provides such services to the Firm and the payments from the Firm do not exceed the greater of $1 million or 2% of the law firm's consolidated gross revenues in each of the past three years.[291]

D. Soundness of Judgment

"A demonstrated soundness of judgment and effectiveness, as evidenced by a pro-active and results oriented approach to problem solving, and the ability to make independent, analytical inquiries of factual patterns is desired."[292] "Also helpful is an interest in and familiarity with management theory and best business practices."[293]

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[291] *Id.*; *see also* Shana A. Elberg, Joseph O. Larkin, Lisa Laukitis, Maxim Mayer-Casiano & Caroline S. Kim, *What Exactly Is an Independent Director? (Hint: It's More Complicated Than You Think),* SKADDEN (Feb. 25, 2022), https://www.skadden.com/-/media/files/publications/2022/02/the-informed-board/what-exactly-is-an-independent-director-hint-its-more-complicated-than-you-think.pdf [https://perma.cc/T7ZU-KU77].

[292] Trautman, *Director Selection and Recruitment*, *supra* note 314, at 87.

[293] *Id.*

E. Required Skills and Experience

Elsewhere, Professor Trautman has written that, "Every board should set forth a statement of desired experience attributes for each director candidate." [294] These, he explains, might include such characteristics as:

- *General business experience* – Possess a general understanding of elements related to the success of a company like ours in the current business environment.
- *Specific industry knowledge* – Possess a reasonable knowledge about our businesses.
- *Financial acumen* – Have a good understanding of business finance and financial statements.
- *Educational and professional background* – Possess a complementary set of skills within a framework of total board knowledge base.
- *Diversity of background and viewpoint* – Bring to the board an appropriate level of diversity.
- *Other attributes* – Provide those special attributes identified as needed.[295]

F. Diversity Considerations

Professor and corporate director Seletha Butler reported that "[m]uch of [her] research about board diversity looks at who is on that audit committee and the criteria that a financial expert must have in terms of experience to earn a place of prominence."[296] In sum, Professor Butler states that her "research shows that it is very difficult for minority directors to be nominated for election. There just has not been as much traction to have a more diverse slate on that committee, given the background that minority individuals tend to have."[297]

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[294] *Id.*
[295] *See id.*
[296] Trautman, *Corporate Directors*, *supra* note 111, at 474 (*quoting* Seletha R. Butler, *"Financial Expert": A Subtle Blow to the Pool and Current Pipeline of Women on Corporate Boards*, 14 GEO. J. GENDER & L. 1 (2013)).
[297] Trautman, *Corporate Directors*, *supra* note 111, at 474-75; *see also* Butler, *supra* note 320, at 1, 33.

Unfortunately, as this Article goes to press, little significant progress has been achieved during recent decades toward diversity on corporate boards. University president Ruth Simmons has previously served as a director of Fiat Chrysler, Goldman Sachs (during the 2007-08 U.S. financial crisis), MetLife inc., Mondelez International, Inc., Pfizer, Texas Instruments, just to name a few.[298] President Simmons states, "It seems people want other directors to be individuals who are their friends and colleagues, with very similar tastes and very similar approaches . . . To be candid, the discussion around the . . . nominating / governance committee is often tragically biased."[299] She observes:

> There are very prominent African Americans in this country who have the required financial knowledge, who have the contacts, who have enough of the education needed in all areas to be wonderful corporate directors. I've repeatedly heard boards pass on candidates because the minority candidates: may be too 'controversial'; they may be too 'outspoken'; or they may be too 'full of themselves.' And so, it's just that kind of thing that you hear repeatedly in boardrooms in passing overqualified individuals, particularly out-spoken, intelligent, capable candidates . . . who are women and/or minorities. And the idea is, 'we don't want all that noise in the boardroom.' We just want somebody who is going to be like us; it's very discouraging.[300]

Director Michele Hooper concludes, "you get on a board because of who you know. This is the case for everybody."[301] Professor Seletha Butler adds that she thinks director recruitment is "about the network that potential directors have and those individuals being tapped

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[298] *See* Trautman*, Corporate Directors*, *supra* note 111, at 460.
[299] *Id.* at 519-20. ("It seems people want other directors to be individuals who are their friends and colleagues, with very similar tastes and very similar approaches . . . To be candid, the discussion around the boardroom and around the nominating / governance committee is often tragically biased").
[300] *Id.* at 520.
[301] *Id.* ("'To your point about getting recruited . . . you get on a board because of who you know. . . . This is the case for everybody . . . [and] how 75 to 80% of people go onto boards,' says Michele Hooper.").

by [decision makers having] … the ability to advocate for them."[302] A study of director elections for the period 2008 to 2018 shows that shareholders value diversity on boards.[303] Professors Gow, Larcker, and Watts write "that gender diversity is significantly more important to shareholders than racial diversity," and that there is "greater additional support for diverse boards rather than for individual candidates."[304] However, they note:

> [I]t is possible that public support of diversity is 'cheap talk' . . . Additionally, shareholders may prioritize a candidate's skills and experience over diversity, given their binding fiduciary responsibilities or because of concerns of anti-ESG backlash from their investors . . . [T]he extent to which shareholders back their commitments to board diversity through voting remains and empirical question.[305]

VIII. Contemporary Challenges

> *Innovation doesn't come just from updating software and hardware; it also comes from the manner in which products are offered… Beyond the innovations and technologies, our economy is changing in other ways. Today, investors are demanding additional information from companies beyond what they've sought historically, with respect to climate risk, human capital, and cybersecurity risk…*
>
> *Again, 'no regulation can be static in a dynamic society.'*

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302 *Id.*

303 *See* Ian D. Gow, David F. Larcker & Edward M. Watts, *Board Diversity and Shareholder Voting* (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 245, 2023) at 1 ("Using a broad sample of director elections from 2008 through 2018, we find evidence that shareholders provide greater voting support for diversity on boards, particularly gender diversity."); *but see* Ian D. Gow, David F. Larcker & Edward M. Watts, *Board Diversity and Shareholder Voting* 5–6 (Rock Ctr. for Corp. Governance at Stanford Univ. Working Paper No. 245, 2020) [hereinafter Gow et al., 2020 Board Diversity Working Paper], https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3733054.

304 *Id.* at 1, 12.

305 *Id.* at 1-2.

Gary Gensler
Chair
U.S. Securities and
Exchange Commission
January 19, 2022[306]

In addition to the topics discussed *supra*, including the impact of rapid technological change,[307] auditing cyber risk,[308] auditing during the 2020-22 global pandemic,[309] and new disclosure and compliance requirements resulting from climate change, a focus on reflections about contemporary challenges impacting audit committees is warranted.[310]

A. Directorship Time Constraints

During just the last few years unusual circumstances have resulted in historically high time requirements of those serving on corporate audit committees.[311] Supply chain disruptions resulting from the 2020-22 global pandemic and Russian invasion of Ukraine have caused many boards and their audit committee members to be operating in crisis mode for months at a time.[312] For example, audit committee chair Michele Hooper states:

> I am on an airline board and I'm also on the United Health Group board, a health care board. So, I'm right in the thick of this pandemic. Part of the responsibilities

[306] Prepared Remarks: "Dynamic Regulation for a Dynamic Society" Before the Exchequer Club of Washington, D.C., Gary Gensler, Chair, U.S. Securities and Exchange Comm. (Jan. 19, 2022), https://www.sec.gov/news/speech/gensler-dynamic-regulation-20220119 [https://perma.cc/3QF6-SA5N].
[307] *See supra* § III.
[308] *See supra* § IV.
[309] *See supra* § V.
[310] *See supra* § VI.
[311] *See* Strine et al., *Caremark and ESG*, *supra* note 164, at 1915 ("audit committees' core responsibilities in accounting and financial compliance, prudence, and integrity have grown even more challenging, complex, and time consuming.").
[312] Ken Kim, Meagan Martin, & George Rao, *Russia-Ukraine War Impact on Supply Chains and Inflation*, KPMG (2022), https://kpmg.com/kpmg-us/content/dam/kpmg/pdf/2022/economic-analysis-russia-ukraine-war-impact-supply-chains-inflation.pdf [https://perma.cc/8VSV-EJF6].

that we have as directors is that we have an oversight role. We are not management. Management is responsible for understanding the company's immediate situation and coming up with plans, making day-to-day decisions, bringing those strategy recommendations to the board, making sure that the board understands what is going on and has ability to provide input and direction. On my airline board, as I'm sure you can imagine, as this pandemic unfolded, we had telephonic board meetings once or twice a week. This schedule became normal procedure until the middle of September 2020, and then we went to just the normal schedule for board meetings and other things that developed so we have been in the thick of things, but the actual responsibility for making those day-to-day plans for decision making falls on management. Airlines are a regulated industry—requiring, working with the government, working with those regulators and the other peers that we have so that we provide a united front from an industry perspective.

As a director, along with my peers, we have responsibility for understanding the company's situation—then, weighing in helping to understand our actions, because this pandemic has been very, very expensive to corporate entities, but also very costly to our employees. Our airline industry is now a mere fraction of our former selves. We probably had to let go, either through voluntary or involuntary separation, almost 40,000 people. So it has been a horrific event, but what has happened requires transparency and insistence upon openness. Directors have a duty to make sure that the board and management inquires and understands the informed overview of all those issues impacting the company. In addition, it is my belief that it is important that we are open, honest, and transparent to the employee base. It's important that our employees and regulators know what we know—so, we're all in this together. And I think that's really the only way that we're going to have the most positive result on the other side of this tragedy.[313]

[313] Trautman*, Corporate Directors*, *supra* note 111, at 516-17.

Seasoned director Ron McCray adds, "[a]nother thing that we learned during the past few months is the destructive impact the pandemic has had on the sub-supply chains."[314] Mr. McCray explains that:

> [C]ompanies are having a tougher time depending on the industry sourcing materials or getting a product to market. This required focus on the supply chain has made us think about how we organize for the future, what we are learning and can glean from this crisis, so that when we get on the other side of this crisis, we will be smarter. As painful as this pandemic experience has been, it appears that one or more green shoots of insight are emerging . . . about how we might go to market differently during the future, or how we might use office space differently, for instance—and how we might source material differently. So that during the future, we are positioned where we are more efficient or effective with procedures in place.[315]

Next, we comment about increased regulatory requirements impacting corporate boards and their audit committees.

B. SEC Focus on Accounting Firms and Independence

During mid-March 2022, *The Wall Street Journal* reported that, "[a]uditors are a shareholder's first line of defense against sloppy or dodgy accounting."[316] SEC Enforcement Director Gurbir Grewal warns during a December 2021 speech before a national conference of auditors that, "[y]ou will see that we have a firm commitment moving forward to continue to target deficient auditing by auditors, auditor independence cases, [and] cases around earnings management.'"[317] All of the "Big Four" public accounting firms have encountered SEC issues previously about this topic. For example:

> In the current investigation, the SEC has asked audit firms to disclose instances to regulators in which the

[314] *Id.* at 517.
[315] *Id.*
[316] Dave Michaels, *Big Four in Accounting Face SEC Investigation,* WALL ST. J., Mar. 16, 2022, at A1.
[317] *Id.*

firms provided services such as consulting, tax advice, and lobbying to audit clients, according to the people familiar with the matter. The SEC also asked for information on any cases in which audit firms obtained contracts that reimburse them for losses caused by lawsuits over their work, or made fees contingent on a particular result or outcome, they said.

PwC paid almost $8 million in 2019 to settle SEC claims that it helped an audit client design software that was part of its accounting-compliance systems. The arrangement violated audit-independence rules because it put PwC in the position of potentially auditing its own project-management functions, according to an SEC settlement order.

Regulators alleged that a PwC accountant handled the negotiations for the software work at the same time he worked on the client's annual audit. PwC settled the case without admitting or denying the SEC allegations, while the accountant paid a $25,000 fine and agreed to be suspended from auditing public-company financial statements for four years.

Ernst & Young has twice in the past seven years settled SEC investigations alleging it violated independence rules. In 2014, regulators accused the firm of lobbying congressional staff on behalf of two audit clients. An Ernst & Young subsidiary sent letters signed by an executive of an audit client to lawmakers' staff and directly lobbied for a bill that would help the business of an audit client, the SEC alleged.

Ernst & Young paid $4 million to settle the SEC claims without admitting or denying wrongdoing.

KPMG paid $8.2 million in 2014 to settle an SEC investigation that alleged it provided prohibited non audit services such as bookkeeping to affiliates of companies whose books it audited.

Deloitte & Touche paid $1.1 million in 2015 to settle an SEC enforcement action claiming audit independence violations. Both firms settled without admitting or denying misconduct.[318]

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[318] *Id.*

Accordingly, regulatory developments impacting public company accounting and auditing firms may also impact the future of audit committees in ways not easily foreseeable. While regulatory developments always bear watching, we now highlight helpful resources from The Center for Audit Quality and The Institute of Internal Auditors.

1. Center for Audit Quality

An affiliate of the American Institute of CPAs (AICPA) and based in Washington D.C., The Center for Audit Quality (CAQ) describes itself as "a nonpartisan public policy organization serving as the voice of U.S. public company auditors and matters related to the audits of public companies."[319] In addition:

> The CAQ promotes high-quality performance by U.S. public company auditors; convenes capital market stakeholders to advance the discussion of critical issues affecting audit quality, U.S. public company reporting, and investor trust in the capital markets; and using independent research and analyses, champions policies and standards that bolster and support the effectiveness and responsiveness of U.S. public company auditors and audits to dynamic market conditions.[320]

The Center for Audit Quality (CAQ) offers substantial and timely resources for those interested in the rapidly changing auditing

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[319] *See* Comment Letter to SEC: File No. S7-09-22: Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure; Release Nos. 33-11038; 34-94382; IC-34529 (May 9, 2022), Ctr. For Audit Quality, https://thecaqprod.wpenginepowered.com/wp-content/uploads/2022/05/caq_SECcybersecurity_comment_05_2022_final.pdf [https://perma.cc/7J9M-P2MJ].

[320] *Id.*

landscape.[321] Particularly timely is the CAQ's focus on challenges resulting from rapidly changing technologies.[322]

2. *Institute of Internal Auditors*

Based in Central Florida and founded in 1941, The Institute of Internal Auditors (IIA) is an international professional association having more than 218,000 members globally and is comprised of 150+ chapters serving in excess of 70,000 members in the United States, Canada, and the Caribbean alone.[323] The IIA describes itself as "the internal audit profession's leader in standards, certification, education, research, and technical guidance throughout the world. Generally, members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security."[324] The IIA states:

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[321] *See* CTR. FOR AUDIT QUALITY, VALUE OF THE AUDIT: A BRIEF HISTORY AND THE PATH FORWARD (June 2021), https://www.thecaq.org/value-of-the-audit-2/; *see also* CTR. FOR AUDIT QUALITY, AUDIT QUALITY DISCLOSURE FRAMEWORK (Jan. 2019), https://thecaqprod.wpenginepowered.com/wpcontent/uploads/2019/03/caq_audit_quality_disclosure_framework_2019-01.pdf ([T]his Framework is voluntary and provides examples of quantitative and qualitative information that individual firms may find useful as they determine and design disclosures that may provide stakeholders with insight about key matters that could contribute to audit quality…").]

[322] CTR. FOR AUDIT QUALITY, FRAUD AND EMERGING TECH: ARTIFICIAL INTELLIGENCE AND MACHINE LEARNING (Apr. 2021), https://thecaqprod.wpenginepowered.com/wp-content/uploads/2021/04/afc_fraud-and-emerging-tech-artificial-intelligence-and-machine-learning_2021-04.pdf ("[C]ompanies need to be involved and pay attention to their AI technology and related data from the inception stages of designing the model, through the development, deployment, and iterative adjustment stages. The risks in the table below should be considered when implementing AI technology . . . .").

[323] About Us, About the IIA, Institute of Internal Auditors, https://www.theiia.org/en/about-us/. ("Nobody understands your critical role as an internal auditor like The IIA, and nobody goes to bat for you like us, either. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations….")

[324] *Id.* ("[G]enerally, members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security . . . .").

> Members enjoy benefits offered by the North American Service Center, including local, national, and global professional networking; world-class training; certification; standards and guidance; research; executive development; career opportunities; and more. IIA members throughout North America enjoy free members-only webinars and member savings on national conferences such as the General Audit Management (GAM) and Ignite Conferences.[325]

IX. Conclusion

Global political instability and economic disruption flowing from the 2020-22 worldwide pandemic continues to impact corporate governance in the United States and results in significant demands placed on corporate audit committees. We discussed the role, composition, and important operating characteristics of highly functioning audit committees. The preceding pages explored many of the contemporary challenges facing audit committees, particularly those resulting from climate change, cyber threat and other ESG issues.

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325 *Id.*