BOARD COMPLIANCE

John Armour,[*] Brandon Garrett,[**]
Jeffrey Gordon[***] and Geeyoung Min[****]

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[*] Professor of Law and Finance, University of Oxford and Fellow of the British Academy.

[**] L. Neil Williams, Jr. Professor of Law, Duke University School of Law.

[***] Richard Paul Richman Professor of Law, Columbia Law School; Visiting Professor, University of Oxford.

[****] Adjunct Assistant Professor of Law and Postdoctoral Fellow in Corporate Law and Governance, Ira M. Millstein Center, Columbia Law School.

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ABSTRACT

What role do corporate boards play in compliance? Compliance programs are internal enforcement programs, whereby firms train, monitor and discipline employees with respect to applicable laws and regulation. Corporate enforcement and compliance failures could not be more high-profile, and have placed boards in the position of responding to systemic problems. Both case law on boards' fiduciary duties and guidance from prosecutors suggest that the board should have a continuing role in overseeing compliance activity. Yet very little is actually known about the role of boards in compliance. This paper offers the first empirical account of public companies' engagement with compliance at the board level, drawing on director-level data from BoardEx and data on federal organizational prosecutions from the Duke University and University of Virginia Corporate Prosecution Registry. We find that, despite a standard account that compliance has boomed, few boards actually adopt compliance committees. Less than five per cent of U.S. public companies have done so, although the proportion has grown steadily over time. We use our data to explore why boards establish compliance committees. Our results suggest that there is room for more constructive engagement with compliance by many boards. We conclude by recommending ways in which board compliance might be facilitated or encouraged: reconsidering norms about board size and independence, enhancing accountability of directors to regulators, and tightening state law fiduciary duties regarding oversight.

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Introduction

Do corporate boards care about compliance? Surely, they should, because of the potentially catastrophic consequences of ignoring it. Take the example of the recent compliance failures at Wells Fargo, the large bank, which pioneered a strategy of 'cross-selling' financial products to its customers. This turned out to be profitable, and the bank sought to maximize its roll-out by setting branch staff powerful financial incentives to maximize sales of financial products to its customers. Unfortunately, these incentives triggered widespread fraud on the part of the bank's employees, with customers discovering products had been charged to their names without their consent.[1] After the Wells Fargo scandal broke, regulators identified numerous weaknesses in the firm's compliance programs that had permitted the misconduct to go unchecked. The bank paid about $2 billion in fines and fired over 5,000 employees; the CEO resigned after Congressional hearings.[2] In response, the Board commissioned an outside investigation into how this compliance failure happened on its watch.[3] Yet, federal regulators were deeply unsatisfied with the Board's response. In early 2018, the Federal Reserve took the unusual step of restricting the growth of the bank as four Board members departed; the Fed also sent a letter to the former Board Director, describing his "many pervasive and serious compliance and conduct failures."[4]

This regulatory intervention and Board shakeup was unprecedented, but similarly massive failures involving some of the largest corporations have been common in recent years—from Enron and WorldCom to BP, HSBC, General Motors, Volkswagen and Wells Fargo—resulting in billions paid to enforcers in the United States and resulting changes in corporate governance.[5] Amidst the notoriety attracted by these failures, have sanguine corporate boards taken on a more substantial oversight role in compliance?[6] Surprisingly little literature exists on the

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[1] *In re Wells Fargo & Co Shareholder Derivative Litigation* (N.D. Cal., 2017); *In the matter of Wells Fargo & Company*, Federal Reserve Docket No 18-007-B-HC (2018).

[2] Michael Corkery, *Wells Fargo Fined $185 Million for Opening Accounts*, N.Y. TIMES, Sept. 8, 2016; Chris Arnold, *Wells Fargo Fires 5,000 Employees Over Fake Accounts*, NPR, Sept. 9, 2016.

[3] Independent Directors of Board of Wells Fargo & Co., Sales Practices *Investigation Report (Apr. 10, 2017).*

[4] *John Heltman, Fed* Drops Hammer on Wells Fargo as Four Board Members Ousted, American Banker, Feb. 2, 2018.

[5] See BRANDON L. GARRETT, TOO BIG TO JAIL: HOW PROSECUTORS COMPROMISE WITH CORPORATIONS 292-93 (2014).

[6] See Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125 (2003). For other examples of board-solicited investigations

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role of boards in compliance. In this Article, we present the first empirical examination of this question, using data from public filings and corporate prosecutions. Based on these findings, and on additional information gathered from compliance charters, news reports, and our conversations with compliance officers and with independent board members, we suggest why Boards continue to remain quite reluctant to supervise compliance more actively.[7]

Compliance programs are internal enforcement programs, whereby firms train, monitor and discipline employees with respect to applicable laws and regulation. For the past quarter-century, U.S. authorities have offered explicit incentives for corporations to implement such programs. The federal Sentencing Guidelines for organizations provide a discount for convicted firms that have in place an "effective" compliance program.[8] A firm's compliance effort also gets taken into account in the decision whether the firm is even prosecuted, should misconduct emerge. Prosecutors say they take into account effectiveness of a company's compliance program—as well as subsequent remedial compliance measures—when deciding whether to charge a firm criminally, and the Department of Justice has provided detailed guidance on compliance in this context.[9] A range of regulatory agencies similarly use both carrots and sticks to encourage compliance.[10] The common theme is that even if employees commit misconduct, the firm will get more lenient treatment so long as it had put in place a meaningful compliance program.

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into compliance breakdowns, see, e.g. Anton B. Valukas, *Report to Board of Directors of General Motors Company Regarding Ignition Switch Recalls*, May 29, 2014.

[7] See infra Part III.

[8] US SENTENCING COMMISSION, 2016 GUIDELINES MANUAL, §8C2.5, §8C2.6.

[9] US Dep't of Justice, Criminal Division, Fraud Section, Evaluation of Corporate Compliance Programs (Feb. 8, 2017); see also U.S.A.M. 9-28.000.

[10] *See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, Exchange Act Release No. 44,969, 76 SEC Docket 296 (Oct. 23, 2001), at http://www.sec.gov/litigation/investreport/34-44969.htm (asking, among factors informing SEC discretion, "[d]id the company adopt and ensure enforcement of new and more effective internal controls and procedures designed to prevent a recurrence of the misconduct?"); EPA Incentives For Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 65 Fed. Reg. 19,618 (Apr. 11, 2000); FAR Contractor Business Ethics Compliance Program and Disclosure Requirements, 73 Fed. Reg. 67064, 67091–92 (Nov. 12, 2008); Enforcement Advisory, Div. of Enforcement, U.S. Commodity Futures Trading Comm'n, Cooperation Factors in Enforcement Division Sanction Recommendations (Aug. 11, 2004); Office of Foreign Assets Control, Dep't of the Treasury, 31 C.F.R. § 501.601–.606 (2006); IRS, *Governance and Related Topics--501(c)(3) Organizations* (2008), 2015 WL 9182494, at *7, http://www.irs.gov/pub/irs-tege/governance_practices.pdf ("[t]he organization's governing body bears the ultimate responsibility for setting ethical standards and ensuring they permeate the organization and inform its practices.").

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Boards are formally responsible for oversight of corporations,[11] and directors owe their firms fiduciary duties of loyalty.[12] While traditionally these duties said little about compliance,[13] this changed in the mid-90s, when Chancellor Allen delivered his well-known opinion in *Caremark*.[14] Reflecting the growing significance of corporate compliance efforts in prosecution and sentencing, Chancellor Allen stated that boards now needed to assure themselves that their firm had:

> [I]nformation and reporting systems … that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.[15]

Should such a system of oversight give an indication of problems—a so-called "red flag"—then the board are expected to take steps to investigate and take remedial action.[16] However, all aspects of this "oversight duty"—both to ensure some system of oversight exists, and to take action if it flags a problem—are subject to the business judgment rule. This means that liability is only triggered by a failure so egregious as

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[11] See e.g., DGCL § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by *or under the direction of* a board of directors…") (emphasis added).

[12] *Stone ex rel. AmSouth Bancorporation v. Ritter,* 911 A.2d 362, 370 (Del.2006); *Accord Mills Acq. Co. v. Macmillan, Inc.,* 559 A.2d 1261, 1280 (Del.1989) ("[D]irectors owe fiduciary duties of care and loyalty to the corporation and its shareholders."); *Polk v. Good,* 507 A.2d 531, 536 (Del.1986) ("In performing their duties the directors owe fundamental fiduciary duties of loyalty and care to the corporation and its shareholders.").

[13] Prior Delaware caselaw had suggested that directors were "entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong"—that is, a "red flag". *Graham v. Allis-Chalmers Mfg. Co* 188 A.2d 125, 130 (Del. 1963).

[14] *In re Caremark International Inc., Derivative Litigation* 698 A.2d 959 (Del. Ch., 1996). *See* generally, Hillary A. Sale, *Monitoring* Caremark's *Good Faith,* 32 DEL. J. CORP L. 719 (2007) (detailing history of *Caremark*); Jennifer Arlen, *The Story of* Allis-Chalmers, Caremark *and* Stone*: Directors' Evolving Duty to Monitor*, in CORPORATE LAW STORIES 323 (J. Mark Ramseyer, ed., 2009) (same); Donald C. Langevoort, *Caremark and Compliance: A Twenty Year Lookback*, 90 TEMPLE L. REV. 727 (2018) (review of subsequent developments).

[15] *Caremark, supra* note 14, at 970.

[16] *Graham v. Allis-Chalmers, supra* note 13; *In re Massey Energy Company Derivative and Class Action Litigation,* 2011 WL 2176479 (Del. Ch. 2011); *Melbourne Municipal Firefighters' Pension Trust Fund v. Jacobs,* 2016 WL 4076369 (Del. Ch. 2016); *Wells Fargo*, *supra* note 1; *Oklahoma Firefighters Pension & Retirement System v. Corbat* 2017 WL 6452240 (Del. Ch. 2017).

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to call into question the board's good faith.[17] The rationale is that the board, not the court, knows best how to pursue the firm's internal compliance activities.[18]

As we have seen, both fiduciary duty caselaw and guidance from prosecutors and regulators suggest that the board should have a continuing role in overseeing compliance activity. DOJ Guidance goes so far as to suggest that there should be a direct reporting channel from compliance officers to independent members of the board, to avoid possible conflicts created by going through the CEO.[19] Little relevant guidance, however, prescribes any particular way in which firms should pursue their compliance oversight function.

One way is for boards to add compliance to the remit of their Audit Committees. Following the Sarbanes-Oxley Act of 2002, all public companies are required to have an Audit Committee, comprised exclusively of independent directors, whose job it is to manage the company's relationship with its auditor and oversee its internal financial controls.[20] Boards may conclude that adding oversight of compliance with applicable laws can readily be added to the Audit Committee's mandate, given that they are already engaging in oversight of financial controls. Yet the range of issues raised by compliance with applicable laws generally may be quite different to those arising specifically in relation to financial reporting, implying that more capacity, and different expertise, may be required. Companies that draw this conclusion may establish a distinct Compliance Committee, tasked with oversight of compliance matters other than financial reporting.

The Wells Fargo case is a sharp reminder that so-called "compliance programs" are not always meaningful; nor is the corresponding board "oversight." Many have asked, in the wake of large corporate scandals, why responsible officers such as CEOs and managers did not detect and prevent wrongdoing. Such questions should also be asked about corporate boards. Compliance with regulations and criminal statutes can dramatically affect the performance and success of a company; the stakes can be as high as those for product design, marketing, or strategic planning. Yet little is known about the nature, extent, and efficacy of corporate compliance endeavors, or how boards pursue their role in overseeing them.

Firms are not required to report details of their compliance activities and few, if any, make voluntary disclosures regarding compliance.[21] At the same time, practitioner surveys consistently report that compliance plays a growing influence in

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[17] The necessary degree of oversight failure to trigger liability was later characterized by the Delaware Supreme Court as an "utter fail[ure] to implement any reporting or information controls." *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

[18] As Chancellor Allen put it in *Caremark:* "Obviously the level of detail that is appropriate for such an information system is a question of business judgment." *Caremark, supra* note 14, at 970.

[19] Department of Justice, *Evaluation of Corporate Compliance Programs*, 2 (2017).

[20] Sarbanes-Oxley Act of 2002 §301.

[21] Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 WM. & MARY L. REV. 2075, 2100 (2016).

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corporate life, including the boardroom.[22] This has led some commentators to conclude corporate governance has undergone a "revolution," with the board's oversight role in internal corporate affairs "overtaken by compliance."[23] Others, however, are more skeptical, arguing that corporate law fiduciary duties do not sufficiently incentivize boards to engage with compliance.[24] Plausibly, common patterns of executive and director compensation may create incentives to under-invest in long-term compliance activities.[25] Further, some point to detailed provisions about compliance in deferred prosecution agreements ("DPAs") that firms enter into with the authorities to avoid prosecution.[26] These commonly prescribe enhancements to compliance programs, and sometimes mention board oversight.[27] Would it be necessary for prosecutors to demand that companies do more if boards were already taking these issues seriously? These conflicting perspectives, and the lack of clear evidence, makes it hard to discern whether Wells Fargo and its ilk are just "bad apples", or reflect a more systematic lack of engagement with compliance by public company boards. This is an insecure foundation for policy.

In this paper, we exploit the fact that firms are required to report details of their board structure in their public filings to compile what is to our knowledge the first quantitative evidence on the board's role in compliance. We explore these hypotheses using director-level data from BoardEx and data on federal organizational prosecutions from the Duke University and University of Virginia

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[22] See e.g., PwC, *State of Compliance Study 2016* (2016).

[23] Griffith, *supra* note 21; Stavros Gadinis & Amelia Miazad, *The Hidden Power of Compliance*, working paper, Berkeley Law School, 7 (2018) ("explosive growth" of compliance departments over past decade).

[24] Mercer Bullard, *Caremark's Irrelevance*, 10 BERKELEY BUS. L.J. 15, 50 (2013); W. Robert Thomas, *The Ability and Responsibility of Corporate Law to Improve Criminal Fines*, 78 OHIO ST. L.J. 601, 647-50 (2017); Langevoort, *supra* note 14; John Armour, Geeyoung Min and Jeffrey Gordon, *Taking Compliance Seriously*, working paper (2019).

[25] Armour et al, Taking Compliance Seriously, *supra* note 24.

[26] See Brandon Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853 (2007); Jennifer Arlen, *Removing Prosecutors from the Boardroom: Deterring Crime Without Prosecutor Interference in Corporate Governance*, in PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT 62, 76–81 (Anthony S. Barkow & Rachel E. Barkow eds., 2011); James R. Copeland, *The Shadow Regulatory State: The Rise of Deferred Prosecution Agreements*, 14 CIV. JUST. REP. (2012); Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation through Nonprosecution*, 84 U CHI. L. REV. 323, 355-58 (2017).

[27] *See* Garrett, *Structural Reform Prosecution, supra* note 26, 886-902 (data on use of deferred prosecution agreements to mandate increases in compliance activity); Wulf A. Kaal & Timothy A. Lacine, *The Effect of Deferred and Non-Prosecution Agreements on Corporate Governance: Evidence from 1993-2013*, 70[1] BUS. LAW. 61,82-84, 92-99 (2014) (data on use of deferred prosecution agreements to mandate changes in corporate governance); Rachel E. Barkow, *The New Policing of Business Crime*, 37 SEATTLE U. L. REV. 435, 457-60 (2014) (characterizing DPAs as part of a "new policing" of business crime).

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Corporate Prosecution Registry.[28] We find that, contrary to statistics reported in practitioner surveys, board-level Compliance Committees are still quite rare in U.S. public companies. Although the proportion of firms adopting such committees has risen significantly over time, less than five per cent of U.S. public companies have established a separate Compliance Committee. In other words, the vast bulk of public company boards do not have a standalone compliance oversight function.

This finding appears starkly at odds with the practitioner literature asserting a compliance "revolution." This is unsettling; but how concerned should we be? Does this mean that boards are not taking compliance seriously? An immediate issue is whether establishing a dedicated compliance committee (what we measure) actually makes a difference—as opposed to adding compliance to the Audit Committee's to-do list—or is simply a cosmetic exercise. To shed light on this, we review Compliance Committee and Audit Committee charters. These suggest material differences: CCs are expected to engage in much more focused oversight of compliance policies and personnel than typical Audit Committees. Moreover, interviews with practitioners suggest board members see setting up a compliance committee as a major event. Boards work under tight time constraints, and so there is a real opportunity cost to adding a compliance committee: time used in staffing this committee must be foregone elsewhere. Establishing a new committee, it seems, is not a trivial matter.

In light of this, it is important to understand why CCs are so rare. To make headway, we use our data to explore why boards (do not) establish compliance committees. We present four main findings. First, companies that get prosecuted are much more likely to establish compliance committees. Yet this is not because prosecutors tell them to. We review a comprehensive dataset of DPAs and plea bargains entered into by public companies from 2001 onwards.[29] In only five of 374 cases (less than two per cent) do these agreements actually stipulate the creation of some kind of board compliance committee. Rather, the link appears indirect. Prosecutors do frequently demand enhancements to a firm's compliance activities as part of these settlements; this creates a sharp increase in need for compliance oversight, which boards rationally meet by establishing committees.

Second, we find only weak links between factors that might make a firm's exposure to *potential* prosecution seem more likely—such as being in a heavily regulated sector, or a high rate of prior prosecution in their industry. This suggests that even firms for which compliance might be very important are not taking it sufficiently seriously to justify establishment of a dedicated committee. These results suggest that boards take compliance more seriously *after* their firm has got caught. Does this imply a troublingly low background level of board compliance oversight? Our other results give further cause for concern.

Third, we find that prior experience of board compliance oversight makes a difference. Companies with a board member who *also* sits on the board of a firm that

[28] Jon Ashley and Brandon L. Garrett, Duke and UVA Corporate Prosecution Registry, at http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/index.html.

[29] *Id.*

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already has a compliance committee are much more likely to establish one themselves. This finding that experience matters is consistent with the general literature of diffusion of innovations. Moreover, it suggests that these directors' prior experience of board compliance is generally *positive*, as it increases the likelihood of subsequent adoption by other boards on which they serve. Why, then, are compliance committees not more widely adopted?

Our fourth result is that boards with compliance committees tend to be larger. This reinforces the idea that compliance oversight is real work for the board: bigger boards have more capacity.[30] But board capacity is subject to external constraints: institutional investors, proxy advisors, and others advocate small boards comprised mainly of persons who have no employment relationship with the firm (that is, are independent). This may mean that boards often lack the capacity to do compliance oversight other than as an Audit Committee addendum.

These results are at once intriguing and troubling. While our data do not permit any causal interpretation of the findings, they are consistent with theoretical claims that compliance is more often overlooked, rather than overseen, by boards. Moreover, they raise a question within corporate governance about optimal board size. Small boards may be best from the own-firm shareholder point of view but not from the social or diversified shareholder point of view, when compliance is taken into account. A small board lacks resources for sufficient compliance oversight, and it also creates a baseline in which adoption of a compliance committee becomes a signal the board believes the firm has an above average compliance problem, which may negatively affect stock price. Avoidance of such a signal becomes a reason for a board to avoid a compliance committee even when such a committee would be warranted.

In our final section, we consider ways in which board compliance might be facilitated, or encouraged: reconsidering norms about board size and independence, enhancing accountability of directors to regulators, and tightening state law fiduciary duties regarding oversight. We emphasize that our results are just a first step—albeit an important one—and our conclusions are correspondingly tentative. We hope that others will engage with the puzzles they raise, and that the nature and success of board compliance will attract the attention that its importance to policy deserves.

The rest of the Article is structured as follows. In Part I, introduce our research questions. We review the rationale for compliance programs, and more specifically, the board's oversight role. In Part II, we present our empirical results, and seek to interpret them in light of prior literature. Part III concludes with a discussion of the implications of these findings for corporate governance, enforcement, and for policy.

[30] We also make a complementary finding that firms with dedicated compliance committees tend to have smaller Audit Committees. For these firms, the Audit Committee has less capacity, and so is less able to accommodate having compliance added to its list of tasks.

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I. BOARDS AND CORPORATE COMPLIANCE

In this Part, we describe the rise in compliance-focused activity in U.S. corporations, and why, as a result, we and others would have assumed that a fairly large proportion of public companies would have embraced board level compliance oversight through a bespoke committee. We first describe what compliance programs are and their rationales. We describe the incentives offered by a range of regulators to enhance the compliance function, including through definitions of "effective compliance." Second, we describe data from the Duke and University of Virginia Corporate Prosecution Registry, concerning criminal prosecutions of corporations, which often seek to bolster compliance, but which have only in rare occasions required a board-level compliance committee. Third, we describe the relationship between the board and compliance, including in its fiduciary relationship, and more specifically, through the creation of compliance committees.

A. Compliance Programs and their Rationales

Corporations are structured to give managers incentives to generate returns for their investors. In areas where corporate activities may create negative externalities, regulatory obligations—with civil or criminal penalties—are commonly imposed on firms to ensure that investors' returns are aligned with social welfare. For example, environmental obligations seek to ensure that the costs of industrial pollution are internalized by polluters and not shed onto society at large; workplace and product safety regulations set minimum standards for firms with respect to harms to which their work environment or products may expose workers or consumers; and laws prohibiting bribery and corruption, such as the Foreign Corrupt Practices Act of 1977 (FCPA), seek to prevent firms undermining the functioning of public institutions.[31]

For regulatory internalization to work, however, there must be enforcement.[32] Where the probability of enforcement is low, then it is necessary to introduce a very high penalty so as to set the *expected* cost of non-compliance equal to the social costs of the proscribed conduct. In the context of corporate misconduct, high penalties are not uncommon. For example, BP paid $62 billion in fines and clean-up costs after its Deepwater Horizon oil spill,[33] and Wells Fargo has been subjected to an order by the Federal Reserve freezing its growth until compliance failures are remedied, as well as a $1 billion fine from enforcement action by two other regulatory agencies, the Office of the Comptroller of the Currency and the Consumer Financial Protection

[31] Foreign Corrupt Practices Act of 1977, 15 USC §§78dd-1 et seq.

[32] Where the firm's actions harm those who contract with it—customers, investors, employees, and so forth—then violations of rules will attract market sanctions, in the form of harm to its reputation. The problem of enforcement is therefore most acute as respects harms caused by the firm's actions to persons with whom it does not contract.

[33] *BP Draws Line Under Gulf Spill Costs*, Financial Times, July 14, 2016.

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Bureau.[34] Moreover, if a firm depends on a regulatory license, then penalties that remove this license can effectively force it out of business.

However, imposing very high corporate penalties has real *ex post* costs: jobs may be lost, and firms forced into bankruptcy. Enforcers do not relish the prospect of destroying a company, particularly the collateral consequences of doing so, where many employees shared no role in wrongdoing and investors suffer financial losses. It is against this background that corporate compliance programs emerged. The basic idea is that because firms have better information about their employees' character and behavior than does a regulator, firms can monitor misbehavior more cheaply than can public authorities, and it is consequently efficient to delegate.

"Compliance" is the name given to institutions established internally by firms to carry out such delegated enforcement. Such institutions can reduce the incidence of misconduct and the need for socially wasteful corporate penalties. However, installing a compliance program may itself have an ambiguous effect on a firm's expected penalties. While it will likely lower the incidence of misconduct, it will also likely increase the rate of detection of any misconduct that does occur.[35] If the effect on expected liabilities is ambiguous, it may be hard for managers to justify expenditure on compliance programs.

1. Regulating Compliance

To combat this problem, firms have since 1991, with the adoption if the Organizational Sentencing Guidelines (and earlier in certain regulatory settings), been offered explicit discounts to any penalties that might be imposed for misconduct, provided the firm had previously implemented an effective compliance program. These incentives are primarily delivered in the form of a discount to sentencing under the Federal Sentencing Guidelines, [36] a factor to be taken into consideration in deciding whether to prosecute a corporation,[37] and guidance for a range of government agencies assessing whether to exclude a convicted firm from procurement exercises.[38]

[34] Federal Reserve, *supra* note 1; Matthew Goldstein, *Wells Fargo Pays $1 Billion to Federal Regulators*, NY Times, Apr 20, 2018.

[35] Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEG. STUD. 833 (1994).

[36] U.S. SENTENCING COMMISSION, 2016 GUIDELINES MANUAL, §8B2.1.

[37] DEPARTMENT OF JUSTICE (OFFICES OF THE UNITED STATES ATTORNEYS), US ATTORNEYS' MANUAL, §9.28.800; Department of Justice, Evaluation of Corporate Compliance Programs (2017).

[38] General Services Administration (GSA), *Federal Acquisition Regulation*, §9.406-1(a) (debarment); §9.407-1(a)(2) (suspension). The burden of demonstrating responsibility is on the contractor.

The lowering of sanctions fits with the general theory of optimal enforcement: since the firm's own "compliance" activities increase the likelihood of detection, the sanction for non-compliance should be reduced to avoid over-deterrence and then, in the next period, a hollowing-out of the firm's compliance efforts.

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There are also specific requirements associated with 'compliance' and 'internal controls' for a range of sector and activity-specific regulatory obligations. These include anti-money laundering, insider trading and structural separation checks for financial institutions,[39] checks regarding the making of corrupt payments for all firms,[40] internal controls over the production of financial information for publicly-traded firms,[41] and a set of model compliance program guidelines for clinical laboratories.[42] Thus, sometimes compliance is required by statutes and regulations. However, we are unaware of cases where the mandated features of a compliance program include, specifically, the adoption of a compliance committee.

2. Effective Compliance Programs

An effective compliance program, in theory, would be one that minimizes the sum of the costs of misconduct and of the costs of avoiding and detecting such misconduct.[43] In practice, there is little consensus as to how this should be achieved, although companies can and are encouraged to use a variety of techniques to evaluate the effectiveness of compliance efforts, ranging from internal audits, data analytics, to employee surveys, to external assessments.

In some industry surveys, large numbers of companies, in a Lake Woebegone fashion, view their compliance as "well above average relative to their peers."[44] When industry participants speak of 'effective compliance programs', they may refer rather to programs that meet the expectations of the authorities. What this means is that programs meeting these requirements are *deemed* by the authorities to be 'effective'; it does not necessarily follow that they are *actually* effective in the sense of minimizing joint costs.[45] Indeed, despite much exhortation, especially from

[39] Investment Advisers Act of 1940, Rule 206(4)-7 (safeguards against insider trading by personnel); Bank Secrecy Act of 1970, 31 USC §5318(h) (Anti-Money Laundering Programs) and 12 CFR 21.21 (Procedures for Monitoring Compliance); Volcker Rule, Subpart D 12 CFR §44.20; enhanced requirements for large banks: 12 CFR §44.20(c); Appendix B to Part 44, Enhanced Minimum Standards for Compliance Programs Dodd-Frank, at https://www.law.cornell.edu/cfr/text/12/appendix-B_to_part_44.

[40] Foreign Corrupt Practices Act of 1977, 15 USC §§78dd-1 et seq.

[41] Sarbanes-Oxley Act of 2002 §404; SEC Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, at https://www.sec.gov/rules/final/33-8238.htm.

[42] See OIG Model Compliance Plan for Clinical Laboratories, 62 FED. REG. 9435 (1997).

[43] Geoffrey P. Miller, *An Economic Analysis of Effective Compliance Programs*, in Arlen (ed) RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING, 247 (2018).

[44] See, e.g. PwC, State of Compliance 2018 Survey, at https://www.pwc.com/us/en/services/risk-assurance/library/state-of-compliance-study.html (reporting that 85% of respondent corporations rated their compliance as well above average relative to their peers).

[45] For critiques of the current approach, see e.g. Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949 (2009); Todd Haugh, *The Criminalization of Compliance*, 92 NOTRE DAME L. REV. 1216 (2017). *Cf* Dan Richman, *Corporate Headhunting*, 8 HARV L. & POL. REV. 265, 277-

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professional consultants who offer to assist in designing compliance programs, relatively little is known about the structure and efficacy of corporate compliance.[46]

In light of these difficulties, and the fact that firms' compliance activity is primarily incentivized by the prospect of (waiving) regulatory sanctions, we focus here on the structure of 'effective' compliance programs as envisaged by official guidance. While the Organizational Sentencing Guidelines contain a detailed set of requirements for a compliance program to count for sentencing credit, they have actually seen little direct application in recent years. For example, in the fiscal years 2009 through 2012, the U.S. Sentencing Commission reported that no companies received sentencing credit for having an effective compliance program.[47] Rather, it seems that the primary channel through which compliance delivers a discount to firms has shifted to prosecutors rewarding effective compliance with leniency through the use of deferred and non-prosecution agreements ('DPAs').[48] Where a DPA is entered into, the firm is not formally prosecuted and is never sentenced under the Guidelines.

How, then, do compliance programs get taken into account in the prosecution decision? Public statements about compliance from the DOJ had in the past been quite vague. Take this statement:

> The Department has no formulaic requirements regarding corporate compliance programs. The fundamental questions any prosecutor should ask are: Is the corporation's compliance program well designed? Is the program being applied earnestly and in good faith? Does the corporation's compliance program work?[49]

The DOJ guidelines then state that prosecutors should try to assess whether the program is just a "paper program," and should consider "whether the corporation has provided for a staff sufficient to audit, document, analyze, and utilize the results of the corporation's compliance efforts."[50]

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78 (2014) (practice of deferred prosecution agreements is only ten years old and so may be too soon to evaluate long-run impact).

[46] See e.g., Donald J. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 933 (2017); Tom R. Tyler, *Reducing Corporate Criminality: The Role of Values,* 51 AM. CRIM. L. REV. 267, 291 (2014) (calling for "an attempt to develop empirically based policies and practices through a neutral and independent review of what works."). A study of federal DPAs from 2001 through 2012 found that less than a quarter of them (21% or 54 of 254 agreements) actually required the company to assess how effectively its compliance program was functioning (Garrett, Too Big to Jail, supra note 5 , at Ch.3).

[47] U.S. Sentencing Commission, "2009-2012 Sourcebook," Tbl. 54 (2012). Five companies received credit for effective compliance from 1992 through 2012.

[48] The rise of DPAs as the preferred technique for prosecutors dealing with corporate defendants has been well-documented. See e.g., Garrett, Too Big to Jail, *supra* n 5, 82.

[49] Id.

[50] Id.

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Further information about what "effective" compliance means may potentially be found in the terms of individual DPAs negotiated with firms, which are typically made public. Over time, the contours of compliance initiatives disclosed in DPAs can become an additional source—beyond sentencing guidelines, statutes, and regulations—of incentives to involve the Board in compliance, revealing at a granular level the what prosecutors consider important. Federal prosecutors have over the past fifteen years taken the lead in seeking compliance changes in target firms; the DOJ adopted some of the first compliance-focused enforcement guidelines; prosecutors pushed for adoption of corporate monitors to oversee compliance, and have often stated that a central goal of a corporate prosecution is not just to punish corporate crime but also to rehabilitate firms.

Towards the end of the Obama Administration, the DOJ hired a Compliance Counsel Expert, who issued guidance to add more rigor to the scrutiny of corporate compliance. While that Expert left early in the Trump Administration, the guidance remains in effect, albeit with some statements from the DOJ that compliance in the form of independent monitor-supervision should be used more selectively.[51] In February 2017, the DOJ's Criminal Fraud Section published this new guidance, titled "Evaluation of Corporate Compliance Programs."[52] The guidance contains a list of "common questions" and "sample topics" but not any definitive guide, emphasizing that prosecutors must make an "individualized determination" in each case. [53]

3. The Compliance Function Within a Firm

Traditionally, compliance functions were supervised by a company's General Counsel, but today, many firms designate at least some types of ethical and legal compliance as separate from the General Counsel.[54] There is no consensus amongst scholars—nor in industry—on the merits of separating the compliance function(s) from those centered in the General Counsel's office.[55] The argument for an independent compliance function is that locating compliance outside of management, apart from the CEO and General Counsel, and with reporting to the organization's board, can assure an independent and outside perspective. In smaller and non-public companies, it may be necessary for both roles to be located in the same office and

[51] Assistant Attorney General Brian A. Benczkowski Delivers Remarks at NYU School of Law Program on Corporate Compliance and Enforcement Conference on Achieving Effective Compliance, October 12, 2018, at https://www.justice.gov/opa/speech/assistant-attorney-general-brian-benczkowski-delivers-remarks-nyu-school-law-program.

[52] Evaluation of Corporate Compliance Programs, supra note xxx.

[53] Id. at 1.

[54] Michele DeStefano, *Making a Culture of Compliance: Why Departmentalization May Not be the Answer*, 10 HASTINGS BUS. L. J. 71, 101, 155(2014) ("Departmentalizing compliance from legal so as to remove general counsel oversight of compliance may not necessarily be in the public's best interest.")

[55] Tanina Rostain, *General Counsel in the Age of Compliance: Preliminary Findings and New Research Questions*, 21 GEO. J. LEGAL ETHICS 465, 469 (2008).

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person. In large and public companies, though, there is a debate about what structure is preferable.[56]

Obviously, in whichever department or reporting line it is located, the compliance function should be adequately resourced—in this respect, the size of the firm and the nature of the risks assessed in relation to compliance will be determinative.[57] The "resourcing" of compliance should be understood to include not only the direct costs of employing compliance staff and training employees regarding compliance, but also the indirect costs of integrating the program into the firm's business structure. Done properly, this entails careful assessment of the incentives created by aspects of the firm's business model, especially performance targets set for employees. Managers seeking to improve performance are often drawn to implementing performance targets for employees that focus on metrics like sales, costs, or task completion, because these metrics are readily measurable and have an obvious link to the firm's performance. However, the pursuit of such metrics to the exclusion of other considerations has potential to trigger failures in other harder-to-measure and/or less immediately financially relevant aspects of performance, such as safety measures or compliance with law. While most employees have natural instincts to be concerned with these issues, internal ethical or safety concerns can be crowded out by sufficiently strong financial incentives.[58] Taking full account of the compliance implications of these variables may necessitate significant modifications, dulling the performance impact of the incentive schemes. As a consequence, effective compliance can involve substantial indirect costs, at least in the short run.

B. Board Oversight of Compliance

Contemporaneously with the growth of compliance, it has become clear that corporate boards are expected to engage in oversight of these programs. These expectations have two distinct sources: the prosecution and sentencing guidelines discussed in Part A, insofar as they pertain specifically to the role of the board; and developments in directors' corporate law fiduciary duties.

1. Expectations of the Board from Prosecutors

As described in Section I.A, leniency in prosecution and sentencing decisions has been a primary impetus for corporate compliance programs. The relevant

[56] See DeStefano, *supra* note 35, Rostain, *supra* note 35, and Michael W. Peregrine, *Seeking Clarity at the Crossroads of Legal and Compliance*, Corporate Counsel (Sept. 2014).

[57] The experience and qualifications of the CCO may expect to be scrutinized. An ex post review may scrutinize whether the compliance department ever asked for additional resources and the responses received from management.

[58] See e.g. Sverre Grepperud and Pal Andreas Pedersen, *Crowding Effects and Work Ethics*, 20 LABOUR 125 (2006).

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guidance sets expectations specifically about the role of the Board in overseeing compliance programs.

Consider first the Organizational Sentencing Guidelines, which inform prosecution decisionmaking, in addition to judicial sentencing. These were amended in 2010 to highlight Board responsibility. Section 8B2.1 now requires the board to:[59]

> "[B]e knowledgeable about the content and operation of the compliance and ethics program and ... exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program."

The Guidelines go on to state that there should be a direct reporting obligation from the Compliance Officer to the board or a board committee. Corporations may receive mitigation if persons with operational responsibility for the compliance and ethics program "have direct reporting obligations to the governing authority or an appropriate subgroup thereof (*e.g.*, an audit committee of the board of directors)" and that program detected and reported the misconduct.[60] The compliance personnel "shall be given adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority."[61] Thus, the Guidelines reward board involvement in compliance.

Turning to guidance from prosecutors, the DOJ's *Evaluation of Corporate Compliance Programs*, in the section on "oversight," emphasizes the role of the board. It asks: "What compliance expertise has been available on the board of directors?" It then asks, "Have the board of directors and/or external auditors held executive or private sessions with the compliance and control functions? What types of information have the board of directors and senior management examined in their exercise of oversight in the area in which the misconduct occur."[62] The DOJ's Evaluation document then goes on to ask, in the section headed "autonomy": "Have the compliance and relevant control functions had direct reporting lines to anyone on the board of directors? How often do they meet with the board of directors? Are members of the senior management present for these meetings?"[63]

2. Compliance and Directors' Fiduciary Duties

As a matter state organizational law, directors have a fiduciary duty to engage in some level of compliance oversight. The narrowest conception is a duty to act when

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[59] U.S. SENTENCING COMMISSION, 2016 GUIDELINES MANUAL, § 8B2.1(b)(2). Although the Guidelines refer to specifically to a "governing authority," this is taken to mean Board, if the company has one: Definitions, U.S.S.G. 8B2.1 ('Governing authority' means the (A) the Board of Directors; or (B) if the organization does not have a Board of Directors, the highest-level governing body of the organization.")

[60] U.S.S.G. § 8C2.5(f)(C).

[61] Id. at § 8B2.1(a)(3).

[62] Id. at 2.

[63] Id. at 3.

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it comes to directors' attention that there is, or may be, misconduct taking place; such actual knowledge then triggers a duty to investigate and take appropriate consequent steps.[64] The necessary investigation and subsequent action demanded will be a function of the extent of the evidence of the misconduct available to the directors, and the seriousness of the consequences of potential misconduct. Notice, though , that the extent of this *ex post* duty depends crucially on the quality of the information coming to the board. To what extent do the board have a positive duty to ensure an upward flow of information regarding compliance?

Since the well-known 1996 Delaware Chancery Court opinion in *In re Caremark International Inc., Derivative Litigation*,[65] directors have also been expected to ensure some system of oversight is implemented in the first place. As Chancellor Allen explained:[66]

> [I]t would, in my opinion, be a mistake to conclude that … corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

However, the duty is merely one of good faith, failure to meet which would require "a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exists."[67] Or, as it was subsequently put by the Delaware Supreme Court in *Stone v. Ritter*:[68]

> (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

Thus, the Delaware caselaw is as unspecific and general as much of the guidance that comes through both DOJ guidelines and enforcement. Compliance matters; and complete failures of the board to oversee compliance will have grave consequences.

[64] *Graham v Allis-Chalmers*; *In re Massey Energy Company Derivative and Class Action Litigation,* 2011 WL 2176479 (Del. Ch., 2011); *Melbourne Municipal Firefighters' Pension Trust Fund v. Jacobs,* 2016 WL 4076369 (Del. Ch., 2016); *In re Wells Fargo & Co Shareholder Derivative Litigation* (N.D. Cal., 2017); *Oklahoma Firefighters Pension & Retirement System v. Corbat* (Del. Ch., 2017).

[65] 698 A.2d 959 (Del. Ch. 1996).

[66] *Id.* at 970.

[67] *Id.* at 971.

[68] *Stone ex rel. AmSouth Bancorporation v. Ritter,* 911 A.2d 362, 370 (Del.2006).

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But what consists in effective or sound compliance—or its oversight—is left unstated.[69]

3. Conflict Between Boards and the Compliance Function

Apart from the priorities placed on compliance by enforcers, boards themselves have conflicting incentives regarding the compliance function. In particular, conflicts may emerge between immediate financial considerations prioritised by managers and the objectives of effective compliance. Executive compensation is typically tightly linked to a firm's stock price, so as to encourage focus on shareholder value.[70] This can create conflict over the establishment of a compliance program, and over how such a program is run.[71] Assuming that the penalties for regulatory violations are set so as to give shareholders appropriate incentives to internalize social costs, such conflict is a corporate governance problem. That is, managers may fail to take actions to minimize expected penalties that would be in the interests of shareholders.

To see how such costs could emerge, note that although establishing a compliance program can reduce a firm's expected penalties, doing so sends a compound signal to investors. It signals both (1) that the firm is taking compliance seriously (a good thing for investors) and (2) that the firm considers it is *appropriate* to take compliance seriously. This second component may have a negative impact on the stock price. *Ceteris paribus*, whether the firm thinks it is appropriate to invest in compliance is a function of the likelihood of enforcement. Consequently, a firm that discloses a compliance program signals that it anticipates it has a relatively high chance of attracting enforcement.[72] Although the fact that the firm is taking compliance seriously is good news for investors, this can only ever reduce, but not eliminate, expected penalties:[73] the net effect of the signal is therefore likely to be negative. Consequently, managers seeking to maximize the stock price likely prefer not to disclose details of a firm's compliance activities.[74] Consistently with this proposition, firms do not voluntarily disclose any meaningful information about their compliance activity.[75]

[69] See generally Armour et al, Taking Compliance Seriously, *supra* note xxx, at 50-53.

[70] See e.g. Steven N. Kaplan, *CEO Pay and Corporate Governance in the US: Perceptions, Facts, and Challenges*, 25 J. APP. CORP. FIN. 8 (2013).

[71] Arlen & Kahan, *Corporate Governance Regulation*, *supra* note xxx, at 354-57 (2017); Armour et al, Taking Compliance Seriously, *supra* note xxx.

[72] *Ibid.*

[73] The presence of an effective compliance program can reduce a firm's penalty by between 60 to 80 per cent: see US Sentencing Commission, *supra* note 36, §§8C2.5(f), 8C2.6.

[74] *Ibid.*

[75] Griffith, *supra* note 23, at 2138-39. Our own searches of EDGAR filings turned up no meaningful information about corporate compliance activity.

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Conflicts are also likely to emerge in the running of a compliance program. If misconduct is detected, a manager believing the probability of enforcement otherwise to be low may seek to cover up the misconduct, so as to avoid an adverse impact on the stock price. Chief Compliance Officers may find themselves side-lined or even fired by CEOs anxious to avoid this sort of revelation. The fear of such treatment will undermine the efficacy of a compliance program, and consequently the DOJ's guidance now provides that the compliance team should enjoy autonomy from management, facilitated by a direct reporting channel to independent directors.

The board is increasingly viewed as a forum for resolving such conflicts.[76] The DOJ's memorandum and other guidance regarding effective compliance provide that responsibility for internal oversight and monitoring of compliance programs should lie with the board of directors, usually through a committee of independent directors—either the Audit Committee or, where established, a separate Compliance Committee.[77] Boards are expected to understand the goals and operation of their firm's compliance function, which knowledge should be supported by regular reporting and a clear flow of information. Moreover, it is increasingly thought that a direct channel of reporting from compliance to the board is a means of fostering not only autonomy within the compliance program but also open upward transmission of information. The Department of Justice guidance cites to such communication as relevant both to oversight and autonomy.

The board's role in managing conflict between the firm's compliance function and other senior executives lies outside traditional accounts of corporate governance.[78] Most such accounts see the board's role as being to monitor the executives' management of the company in the interests of shareholders, with a view to reducing agency costs.[79] To this end, much emphasis is placed on the need for directors to be independent of executives, to buttress against conflicts of interest. In overseeing compliance, the board are monitoring the executives' resourcing and implementation of the firm's compliance program, and the way in which conflicts between the needs of the compliance function and the pursuit of the business' strategic goals are managed. Because of the financial implications of compliance, the resolution of such conflicts in accordance with regulatory guidance regarding best practice is ultimately in the interests of shareholders.

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[76] See e.g., Martin Lipton, *Risk Management and the Board of Directors*, Harvard Law School Forum on Corporate Governance and Financial Regulation, Nov 19, 2017.

[77] DOJ, *supra* note 19, 2 ("Oversight – What compliance expertise has been available on the board of directors? Have the board of directors and/or external auditors held executive or private sessions with the compliance and control functions? What types of information have the board of directors and senior management examined in their exercise of oversight in the area in which the misconduct occurred?"). See also Ethics & Compliance Initiative, *Principles and Practices of High-Quality Ethics & Compliance Programs: Report of ECI's Blue Ribbon Panel* 19 (2016) ("The E[thics] & C[ompliance] structure ensures independence and regular access to the board and/or the audit committee.")

[78] Griffith, *supra* note 23.

[79] See e.g. FRANK H EASTERBROOK & DANIEL R FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); REINIER KRAAKMAN ET AL, THE ANATOMY OF CORPORATE LAW, 3rd ed (2017).

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C. Board Structure and Compliance Oversight

Neither the DOJ Guidance nor corporate law specify the process through which the board should exercise compliance oversight. Because public companies are required to establish an Audit Committee, which has responsibility for internal financial controls,[80] many firms simply append compliance to the Audit Committee's terms of reference. Both audit and compliance oversight functions involve review of executives' implementation of a system of controls—financial controls or a compliance program, respectively—and a role as arbiter of first instance of any conflicts that arise in relation to executives' conduct and the system of controls or compliance.[81]

1. Compliance Oversight and Board Committees

The core remit of the Audit Committee is essentially to oversee the company's relationship with its auditors. This makes Audit Committees an important component in the SOX regime for oversight of internal financial controls. In addition to their central function of ensuring integrity of the choice of auditor and handling the periodic review by the auditor of firm financial information, audit committees also became responsible for managing the potential conflict created where internal irregularities came to light, or were alleged by employees, where management were implicated or unwilling to act. In order to ensure their independence in performing this role, the Sarbanes-Oxley Act of 2002 requires US public companies to have audit committees staffed entirely by independent directors.[82]

It is easy to see that the Audit Committee's function could lend itself to becoming the channel through which the board exercises compliance oversight. Both involve oversight of executives' implementation of a system of controls—financial controls or a compliance program, respectively—and a role as arbiter of first instance of any conflicts that arise in relation to executives' conduct and the system of controls or compliance.[83] For this reason, many companies simply task their Audit Committee with oversight of the firm's compliance programs in general, as well as the core, and more specific, role of oversight of financial controls.

On the other hand, some firms have established distinct Compliance Committees (CCs), likewise composed of independent directors. When staffed with different personnel from the Audit Committee, this opens up greater bandwidth for engagement, permits the selection of individuals with different expertise, and facilitates any appropriate difference in ethos with respect to decision-making. Of course, such division results in loss of potential complementarities from joint

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[80] Sarbanes-Oxley Act of 2002, § 301.

[81] See generally Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267 (2004).

[82] Sarbanes-Oxley Act of 2002, § 301.

[83] See Cunningham, *The Appeal and Limits of Internal Controls, supra* note xxx.

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oversight of financial and non-financial compliance, making it desirable for there to be at least some overlap in membership. Another approach, which preserves complementarities, is to retitle the Audit Committee as the "Audit and Compliance Committee", reflecting a difference in emphasis as respects expertise and role.

2. Board Time as a Scarce Resource

What difference does it make, whether a Board routes compliance oversight through its Audit Committee or sets up a new CC? A skeptic might see this as a merely cosmetic exercise. However, we believe there are good reasons for thinking that the difference is material, both in terms of the intensity of the oversight, and the cost to the company.

Compliance Officers and independent directors with whom we spoke highlighted the real time commitment that arises from the creation of a new committee. It generates another set of meetings, documents to review, evaluative reports to write, all in addition to the other responsibilities of the board members. Independent director time is a scarce resource. Most public companies constrain their total board size, consistent with empirical studies reporting that larger boards have reduced efficacy. At the same time, to be classed as "independent", a director must not have an employment relationship with their company, meaning that they are of necessity a part-timer. This means that time allocated to membership of a CC must be subtracted from some other aspect of board functioning. The opportunity cost can be very high. These industry professionals suggested that firms would typically only reshape their board structure and create compliance committees based on a strong external shock, like a high-profile scandal or enforcement action. Otherwise, a firm would prefer to focus on compliance through existing internal governance structures.

3. Evidence from Committee Charters

It appears that, where a CC is established, oversight of compliance is likely to be pursued more vigorously than where this is simply added to the Audit Committee's mandate. Reflecting their tighter focus, CC charters are more likely to contain specific deliverables regarding the compliance oversight process. For example, CCs are often tasked with periodic review of internal Codes of Conduct and the functioning of the company's compliance program.[84] In contrast, in a typical Audit Committee charter, compliance is simply mentioned as one of a long-ish list of matters for oversight, to

[84] See e.g., Express Scripts Holding Company, Compliance Committee Charter, at 1; Goldman Sachs BDC, Inc. Compliance Committee Charter, at 1; Goodyear Tire & Rubber Company Committee on Corporate Responsibility and Compliance Charter, at 1; PG&E Corporation, Compliance and Public Policy Committee Charter, at 2; Quest Diagnostics Incorporated, Quality, Safety & Compliance Committee Charter, at 2; Southwest Airlines Co., Safety and Compliance Oversight Committee Charter, at 1-2 (on file with authors).

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which a reactive approach ("review … any issues that arise") may be taken, as opposed to specific prescription for frequency of engagement.[85]

Reflecting the importance attached by prosecutors to a direct channel of reporting, CC charters typically expect them to hold regular meetings with management, and sometimes specifically with the General Counsel and/or Chief Compliance Officer, regarding the nature and functioning of compliance.[86] In some cases, the CC may have responsibility for reviewing the appointment, compensation, and removal of the Chief Compliance Officer.[87] In contrast, a typical Audit Committee will be expected to engage with management regarding financial matters, and review the appointment of the Chief Financial Officer.[88] This means that a CC is likely to establish a much clearer, and more tightly controlled, reporting channel to the Board from the company's compliance function than would be the case with an Audit Committee.

Both CC and Audit Committee mandates will typically confer the power to retain legal and other external experts as necessary to assist the committee.[89] Some CC mandates also confer power to initiate and conduct internal investigations into compliance,[90] although this is by no means universal.[91]

4. Case Studies

In reflecting on the role of compliance committees, it is helpful to consider some case studies in which a CC has played an active role. In each case, we draw on SEC filings and news reports to understand what the committee did, and how it came to be formed.

Lending Club. The board of peer-to-peer lender Lending Club probably lies at the opposite end of the compliance engagement spectrum from the passive Wells Fargo board with which this Article began. In 2016, following an internal review, an error of $22 million in loan sales was brought to the attention of the Lending Club board. The board's response was "swift and decisive," including procuring the prompt

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[85] See e.g. Merck, Audit Committee Charter, para 16 (on file with authors).

[86] Express Scripts Holding Company, *supra* note xxx, at 1-2; Goodyear Tire & Rubber Company, *supra* note xxx, at 2; Goldman Sachs BDC Inc., *supra* note xxx, at 2; PG&E Corporation, *supra* note xxx, at 3; Quest Diagnostics Incorporated, *supra* note xxx, at 2; Southwest Airlines Co, *supra* note xxx, at 1.

[87] See e.g. Goldman Sachs BDC Inc., *supra* note xxx, at 2; Quest Diagnostics Incorporated, *supra* note xxx, at 2.

[88] See e.g. Merck, *supra* note xxx, paras 6-7, 11.

[89] Express Scripts Holding Company, supra note xxx, at 2; Goodyear Tire & Rubber Company, *supra* note xxx, at 2; Goldman Sachs BDC Inc., *supra* note xxx, at 3; PG&E Corporation, *supra* note xxx, at 4; Quest Diagnostics Incorporated, *supra* note xxx, at 3; *cf* Southwest Airlines Co., *supra* note xxx.

[90] Express Scripts Holding Company, supra note xxx, at 2; Quest Diagnostics, *supra* note xxx, at 2.

[91] See e.g. Goodyear Tire & Rubber Company, *supra* note xxx; Goldman Sachs BDC Inc., *supra* note xxx; PG&E Corporation, *supra* note xxx (no mention of investigations); Southwest Airlines Co., *supra* note xxx, at 2 ("It is not the Committee's responsibility to conduct investigations…").

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resignation of the company's founder-CEO.[92] The board then assigned investigation of what had gone wrong to a newly-formed board committee of independent directors, which retained outside counsel. This investigation uncovered additional problems, for which the board decided promptly to reimburse investors for approximately $1 million of losses, as well as calling for the "termination or resignation of senior managers involved" in the relevant loan sales.[93] The Lending Club board took a hands-on and active role in responding to a compliance problem, through the institution of a new committee specifically to handle the investigation. The fact that the company had "promptly self-reported its executives' misconduct following a review initiated by its board of directors," was a relevant factor for the DOJ and SEC in subsequently deciding not to prosecute the firm.[94] However, this hands-on Board engagement with compliance did not result in creation of a compliance committee.

AIG. Another example of a firm adopting a compliance committee during an intensive regulatory investigation is AIG, which ultimately paid $1.6 billion to regulators, and created a new board compliance committee before settling those actions.[95] In the mid-2000s AIG faced prosecution for manipulating its financial statement through use of reinsurance to create income. *Before* entering into a non-prosecution agreement, it created two board committee to focus on compliance and regulation.[96] One of those committees actually played a role in resolving the enforcement matter. The new Regulatory, Compliance and Legal Committee was led by Stephen L. Hammerman, a retired New York City deputy police commissioner, which was "helping AIG executives negotiate a possible settlement with New York State Attorney General Eliot Spitzer and prepare a global compliance program."[97] The creation of the new committee may have been a vehicle for adding board members who could assist AIG with such negotiations.

Las Vegas Sands. Our third case study illustrates the establishment of a compliance committee as a response to prosecutors' requests. In 2013 Las Vegas Sands entered a non-prosecution agreement with the DOJ for Bank Secrecy Act violations, under the terms of which the company was required to create a compliance committee. The Compliance Committee Charter for Las Vegas Sands Corp., specifies that the three directors on the committee shall all be independent directors. That committee meets at least four times a year, but with similar oversight responsibilities (although a specified focus on gaming law compliance and ant-corruption and money

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[92] Form 8-K, Lending Club Corporation, May 6, 2016.

[93] Form 8-K, Lending Club Corporation, March 31, 2016 and June 22, 2016; SEC, *SEC Charges Lending Club Asset Management and Former Executives With Misleading Investors and Breaching Fiduciary Duty*, Press Release 2018-223, Sept 28, 2018.

[94] SEC, *Lending Club*, *supra* note xxx.

[95] Daniel Hays, *AIG Pays $1.64 Billion To Settle Fraud Charges with State, Federal Regulators*, Property Casualty 360, Feb. 12, 2006.

[96] *AIG Restructures Its Executive Governance, Adds 2 Outside Directors to Board*, Insurance Journal, Apr. 21, 2005, at *https://www.insurancejournal.com/news/national/2005/04/21/54166.htm*.

[97] Joann S. Lublin, Compliance Panels Slowly Take Hold, Wall Street Journal, Jan. 9, 2006.

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laundering law). When Las Vegas Sands was subsequently prosecuted once more, this time for FCPA violations, it settled the matter with another non-prosecution agreement in 2017, which credited the firm for having a board-level compliance committee (it had "established a new Board of Directors Compliance Committee.").

In some of these cases, the CC was established during a period of very high internal focus on compliance, but in others, like in the Lending Club example, no such committee was created. In none of those in which a CC was established, was the relevant committee dissolved after the investigations had closed. This evidence suggests that choosing to oversee compliance through a separate committee is more than a cosmetic matter for a Board, but something that carries real costs and plausibly has an impact on the intensity of oversight. In the next Part, we present our empirical findings about the extent of CC adoption by public companies, and the attributes of companies most likely to adopt them.

II. Empirical Analysis of Board Compliance

In this Part, we present novel empirical data and analysis to help understand how and why corporate boards respond to the challenge of compliance oversight. Despite the recent emphasis on the board's role in corporate compliance, to our surprise we find that the vast majority (nearly 94 per cent) of U.S. public companies do not have compliance committees at the board level. That said, the number of public companies that do have such committees is slowly increasing, and we find higher rates of adoption in certain highly regulated industries. Moreover, creation of a compliance committee is more likely among firms with a history of prosecution and with outside directors who previously served on other boards that had compliance committees. We detail these results below.

A. New Data on Board Compliance

1. Prior Literature

There is a general dearth of academic empirical literature on corporate compliance activities. The central challenge in identifying compliance investment is that firms generally do not disclose details about their compliance programs.[98] To understand why not, note first that securities laws do not *mandate* disclosure of compliance expenditure.[99] Moreover, managers and directors have no incentive to *volunteer* this information.[100] This is because disclosing an investment in compliance

[98] Griffith, *supra* note xxx.

[99] *Id.*

[100] A well-known justification for mandatory disclosure in securities regulation is that in a purely voluntary disclosure regime, managers will disclose too little. The most general reason given is that managers will prefer not to share with their competitors information that is a source of competitive advantage. See Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not

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may be taken as a signal that the firm considers there is sufficient risk of malfeasance to make its compliance investment worthwhile and feels obliged to give its shareholders a heads-up.[101] Because even the most effective compliance program cannot entirely deflect the costs of prosecution, the stock price may well fall. As managers and directors are both paid primarily in stock, they are likely to prefer to avoid this.[102]

Firms, however, are required to report the existence of a Compliance Committee.[103] Such "corporate governance" information is part of the mandatory disclosure associated with the annual proxy solicitation for the election of directors.[104] Shortly after the Sarbanes-Oxley Act of 2002, public companies came to be required to disclose charters of their audit, compensation and nomination committees.[105] This led to a practice of companies disclosing charters of every board committee, presumably to avoid any potentially misleading omissions regarding the interpretation of the charters of the three committees for which disclosure is mandated. As a result, it is possible to compile a dataset of board compliance committees and their charters.[106]

Nevertheless, board compliance committees have themselves been little studied. The only prior empirical literature about board compliance comes in the form of practitioner surveys, typically conducted by large accounting firms. For example,

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Investor Empowerment, 85 Va. L. Rev. 1335 (1999). The incentive problem we identify here in relation to compliance investment is more specific, and likely more intense, than this general rationale.

[101] See Armour et al, Taking Compliance Seriously, *supra* note xxx.

[102] *Id.*

[103] Indeed, we argue below that signal conveyed by adoption of a Compliance Committee – a costly investment in compliance that is subject to mandatory disclosure – is a significant explanatory factor for the low adoption rate.

[104] See Rule 141-101 specifying the content of Schedule 14A, specifically Item 7 (Directors and Executive Officers), which points to Item 407 of Regulation S-K (17 CFR § 229.407). The regulation requires disclosure of attendance of directors at board meetings and committee meetings, which of course requires identification of all board committees.

[105] SEC Rules have required disclosure of audit committee charters since 2000 (originally a triennial obligation) in the firm's proxy statements: SEC Schedule 14A, Item 7(e)(3), CFR § 240.14a-101, effective January 31, 2000. See https://www.sec.gov/rules/final/34-42266.htm. This was extended to an annual obligation in the financial statements in 2003: SEC Regulation S-K, Item 401(i)(2), CFR § 229.401(i)(2), effective April 25, 2003. See https://www.sec.gov/rules/final/33-8220.htm#P485_149589. The NYSE Listed Company Manual was amended in 2003 to require all NYSE-listed companies to have audit, compensation and nomination committee charters, and to disclose these: NYSE Rulemaking: SEC (Release No. 34-47672; File No. SR-NYSE-2002-33), April 11, 2003, Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance. Nomination committee charter disclosure in proxy statements has also been required by SEC Rules since the beginning of 2004: SEC Schedule 14A, Item 7(d)(2)(ii)(A), CFR §240.14a-101, effective January 1, 2004. In 2006, these rules were consolidated into SEC Regulation 407: see See 71 FR 53254, Sept. 8, 2006.

[106] In most cases, information on a company's board committees are under "Investor Relations" tab on the company's website.

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PwC's annual *State of Compliance* report, a widely-cited source for compliance literature,[107] stated in 2016 that "20% [of companies] have Board of Directors that formed a separate, stand-alone compliance/ethics committee."[108] The representativeness of these figures is, however, questionable when attention is paid to the survey methodology. PwC states that the survey was conducted on "more than 800 executives globally", most of whom are compliance professionals.[109] There is a concern that the survey responses were submitted disproportionately from those who work at firms that already have a strong focus on compliance. In this Article, we seek to assess whether these surveys, and the recent literature on the effect of enforcement on compliance practices, correctly assert that firms so commonly form such committees at the board level. For the largest companies in terms of market capitalization, a recent article by EY, another major accounting firm, reported that 16% of S&P 500 companies have compliance committees based on the companies' proxy statement filed in 2018.[110] Still, this report does not offer the full picture of the use of board compliance committees in public companies, including the evolution over time.

Another strand of prior literature considers the impact of criminal prosecutions on board structure. A number of scholars have noted the often-extensive scope of the matters negotiated with prosecutors as part of a DPA. In addition to large financial penalties, DPAs frequently mandate enhancements to existing internal compliance programs, cooperation investigations, the appointment of an independent corporate monitor, and, in some cases, changes to corporate governance structures.[111] Of particular relevance is Kaal and Lacine (2014), which evaluates corporate governance-related provisions in all publicly available DPAs (N = 271) over the period 1993-2013. They report that eight per cent of these DPAs (meaning, 22) contained provisions requiring the company concerned to make changes to its existing board structures, "often creating new board committees".[112] This suggests that entry into a DPA may sometimes be a trigger for the establishment of a compliance committee. However, the low absolute number of such prosecutions of public companies means

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[107] Griffith, supra note xxx; Robert C. Bird and Stephen Kim Park, *Turning Corporate Compliance into Competitive Advantage,* 19 U. PA. J. BUS. L. 285 (2017).

[108] PwC, State of Compliance Study 2016: Laying a Strategic Foundation for Strong Compliance and Risk Management, 3 (2016).

[109] PwC, *supra* note 108, foreword.

[110] EY Center for Board Matters, *A Fresh Look at Board Committees* (June 2018). The report is based on the 418 proxy statements filed as of 15 May 2018, at https://www.ey.com/Publication/vwLUAssets/ey-cbm-a-fresh-look-at-board-committees/$FILE/ey-cbm-a-fresh-look-at-board-committees.pdf.

[111] See generally, Garrett, *Structural Reform Prosecution,* supra note xxx; Arlen & Kahan, *Corporate Governance Regulation*, *supra* note xxx.

[112] Wulf A. Kaal and Timothy A. Lacine, *The Effect of Deferred and Non-Prosecution Agreements on Corporate Governance: Evidence from 1993–2013,* 70 BUS. LAW. 61, 96 (2014).

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that this form of prosecutorial settling-up cannot account for the extent of CC adoption.[113]

2. Data Sources and Sample Description

Our empirical study utilizes four main data sources: 1) BoardEx: an extensive database detailing board membership and structure, including committees, to determine whether companies have established a CC, and if so, when;[114] 2) Duke/UVA Corporate Prosecution Registry: an extensive data on corporate prosecutions including plea agreements, trial convictions, and all deferred and non-prosecution agreements ("D/NPAs") entered into by the DOJ with organizations from 1990 onwards to explore links between the exposure to corporate prosecution and CC adoption,[115] 3) CRSP-Compustat: a widely-used financial dataset with details of firm financial attributes such as firm performance and firm size,[116] and 4) SEC EDGAR: listed companies' periodic filings and proxy statements to cross-refer information about companies.[117] By merging these four major data sources, we compiled a dataset to examine the interaction between ex-post enforcement and ex-ante governance changes. Our dataset consists of a panel of 6,372 unique U.S. public companies for the period 2004-2017, giving a total of 51,620 firm-years. Table 1 (depicted in the Appendix) sets out the details of variable names, variable descriptions, and data sources. Table 2 presents summary statistics for each variable.

[Table 1 about here]

[Table 2 about here]

3. Time Trends and Industry Distribution

Figure 1 shows the number (vertical axis) and proportion (bold numbers) of US public companies having used a Compliance Committee during the period 2004-2017. We take a 'Compliance Committee' for these purposes to include (i) a 'stand-alone'

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[113] *See* Garrett, *Too Big to Jail, supra* note xxx, at Ch. 10 at 273 (describing how from 2001 to 2012, 273 public companies were prosecuted).

[114] BoardEx, at http://corp.boardex.com/data/. BoardEx has data from 1999, but the inclusion of public companies is incomplete prior to 2004 mainly because companies were not under regulatory pressure to disclose committee information. In 2003, the SEC approved major stock exchange rules on board committees (e.g., audit, compensation, and nomination board committees.) *See e.g.*, NYSE Listed Company Manual Section 303A.07 Audit Committee Additional Requirements (approved August 22, 2003); NASD Rule 4350 (d).

[115] This Corporate Prosecution Registry was established by one of the authors at Duke University and the University of Virginia. Jon Ashley and Brandon L. Garrett, Duke and UVA Corporate Prosecution Registry, at http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/index.html.

[116] CSRP-Compustat Merged, Fundamental Annual.

[117] See Edgar Company Search, at https://www.sec.gov/edgar/searchedgar/companysearch.html.

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Compliance Committee, (ii) a 'Risk and Compliance Committee' or (iii) restyling an Audit Committee as 'Audit and Compliance' during the relevant period. While the trend is slowly and consistently upward, the overall level remains low, with only 4.85 per cent of public companies having adopted such a committee by 2017.

[Figure 1 about here]

Our findings are in marked contrast to the results reported in the PwC survey, which estimated that 20 per cent of companies had established a CC by 2016.[118] Our data suggest CCs are used far less frequently than had previously been believed to be the case. It appears likely that the survey was carried out with PwC's clients, raising an obvious issue of selection bias: firms that have compliance officers are likely to report that they engage in other compliance activities. A more recent article by EY reported that 16% of S&P 500 companies have compliance committees in 2018.[119]

Table 3 shows the industry distribution of firms that have established CCs. Industry classification is according to the Fama-French 48-industry classification ("FFI48") scheme.[120] As can be seen in Table 3, the industries that are the heaviest adopters of CCs are banking, healthcare, pharmaceutical products, business services, and medical equipment. An intuitive explanation is that these industries are all heavily regulated; in most cases some form of compliance program is mandated by substantive regulation.[121] Firms that are required to set up a compliance program are presumably more likely to think it worthwhile to establish a committee at the Board level to oversee that program.

[Table 3 about here]

In Table 4 we compare, by industry, the proportion of firms that faced DOJ prosecutions, and the proportion of firms that adopted compliance committees during our sample period. There is not an obvious relationship. Firms in the pharmaceutical and medical equipment industries, which have relatively high rates of CC adoption, also have two of the highest prosecution rates during our sample period. However, the same is not true for banking and healthcare, which have relatively low

[118] *Supra*, notes 108-109 and text thereto.

[119] EY Center for Board Matters, *A Fresh Look at Board Committees* (June 2018). The report is based on the 418 proxy statements filed as of 15 May 2018. See https://www.ey.com/Publication/vwLUAssets/ey-cbm-a-fresh-look-at-board-committees/$FILE/ey-cbm-a-fresh-look-at-board-committees.pdf.

[120] Eugene Fama and Kenneth French, *Industry Cost of Equity*, 43 J. FIN. ECON. 153 (1997); see generally Procedures Using Fama and French 48 Industry Classifications, at https://wrds-www.wharton.upenn.edu/pages/support/research-wrds/research-guides/procedures-using-fama-and-french-48-industry-classification/. Fama-French 48 Industry Classifications were created by using each company's four-digit Standard Industrial Classification collected from EDGAR. Id.

[121] For examples of such statutes, see supra note xxx.

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prosecution rates yet high rates of CC adoption. Moreover, the petroleum and natural gas industry has a relatively high prosecution rate (the second-highest of any industry over our sample period) but a very low rate of CC adoption.

[Table 4 about here]

4. Types and Composition of Board Compliance Committees

Figure 2 shows the breakdown of Compliance Committee adoption by three different types of nomenclature (namely: a stand-alone "Compliance Committee", a "Risk and Compliance Committee" without a stand-alone Compliance Committee, and re-naming the Audit Committee as "Audit and Compliance" without a stand-alone Compliance Committee) over the period 2004-2017. As can be seen in Figure 2, a *stand-alone* Compliance Committee by far the most frequent way in which a compliance committee is explicitly recognized at board level.

[Figure 2 about here]

Table 5 below provides descriptive statistics on the composition of board compliance committees in our study period. The average compliance committee has three members; of those members, more than 85 per cent are independent directors. Moreover, about 30 per cent of compliance committee members contemporaneously serve on their company's Audit Committee. Conversely, approximately 10 per cent of compliance committee members sit exclusively on that committee. On average, compliance committee members have been served as board members of the company for 7.6 years.

[Table 5 about here]

These data suggest that CC adoption is actually quite low amongst U.S. public companies; certainly, considerably lower than had previously been thought to be the case. In light of this, we would like to understand the factors that make firms more or less likely to adopt compliance committees.

B. Are Firms Required to Establish Compliance Committees?

A threshold question is whether adoption of a board-level CC is voluntary or compelled. If firms adopt CCs only where compelled, this would imply that the low take-up is because firms generally do not see CCs as valuable. In this section, we investigate how much of CC adoption is explicable in this way.

While a firm might in theory be required to adopt a CC by applicable substantive regulation, the lack of a board-level compliance committee does not directly violate any current substantive regulations.[122] There are regulatory

[122] *Supra*, text following note **42**.

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mandates for "compliance," but not a board level committee. However, there are two potential exceptions to this.

1. Qualified Legal Compliance Committees

The first is an SEC Rule on "Qualified Legal Compliance Committees" ("QLCC") promulgated in 2003 as part of the post-Enron concern about corporate compliance. [123] Although Rule 205 does not mandate a board level compliance committee, it permits a version of such a committee to be used as an alternate mechanism for "up the ladder" mandatory reporting of material misconduct observed by the company's outside attorneys. The Sarbanes-Oxley Act required attorneys to report evidence of material misconduct to the company's chief legal officer and/or chief executive officer,[124] and if these persons do not respond properly, to the audit committee or the entire board of directors.[125] As an exception to this requirement, the SEC offered an alternative reporting mechanism for attorneys. If the issuer establishes a QLCC, attorneys may fulfill their reporting obligation by reporting the matter to the QLCC.[126] When the rule was first introduced, some commentators suggested firms whose attorneys found the standard reporting channel onerous would establish QLCCs.[127] This might consequently be a channel through which some companies felt it necessary to establish compliance committees.[128]

However, the SEC's definition of a QLCC for these purposes does not require a stand-alone committee. Any committee that includes at least two independent directors and one audit committee member—*including the Audit Committee itself*—qualifies as a "QLCC".[129] Thus an issuer motivated solely by Rule 205 would generally find it much more straightforward to constitute the Audit Committee as the "QLCC" for these purposes, rather than to go to the trouble of establishing a new standalone compliance committee.[130] This suggests that Rule 205 is unlikely to have been a significant driver of compliance committee creation.

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[123] 17 C.F.R. § 205.3(b) (1) (2003). See Jill Fisch & Caroline Gentile, Q*ualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517 (2003).

[124] 17 C.F.R. § 205.3(b) (1) (2003). Public Company Accounting Reform and Investor Protection Act of 2002, commonly referred to as the Sarbanes-Oxley Act of 2002, § 307, 15 U.S.C.A. § 7245.

[125] *Id.* § 205.3(b) (3).

[126] Id. § 205.3(c)(1).

[127] Fisch & Gentile, *supra* note xxx, at 547 (2003) ("These attorneys face less work, uncertainty, and exposure to liability when reporting to a QLCC.").

[128] See Robert Eli Rosen, *Resistances to Reforming Corporate Governance: The Diffusion of QLCC's* 74 FORD. L. REV. 1251 (2005).

[129] 17 C.F.R. § 205.2(k) (1) (2003).

[130] Fisch and Gentile, supra note xx, at 542; Donald Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 823 (2001).

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To verify this, we searched our data for examples where firms had established standalone QLCCs, as opposed simply to designating the Audit Committee for this purpose. We found that the number of active stand-alone QLCCs has always been very low and has decreased over the years. Their peak was in 2004, when the concept had first been introduced; in that year 20 companies inaugurated standalone QLCCs. These amounted to 14 per cent of the total number of companies with standalone compliance committees at that point (136). The number of QLCCs fell steadily over the period of our study, such that by 2017, only three public companies (ArcBest Corp., Brunswick Corp., and Comerica Inc.) retain stand-alone QLCCs. That is less than two per cent of the total companies with standalone compliance committees (157). Clearly, SEC Rule 205 has not stimulated a significant number of compliance committee formations in our dataset.

2. Prosecution Agreements

A second circumstance in which companies might be required to adopt CCs would be if this were demanded by prosecutors as part of a DPA or other settlement, as in our case study of Las Vegas Sands.[131] But how frequently does this happen? To shed light this, we reviewed the text of all prosecution agreements entered with public companies since 2001, in the Duke & University of Virginia Corporate Prosecution Registry.[132] There are 381 public firms in the Registry that were prosecuted during the period 2001-2018. Thirteen received declinations, one was acquitted at trial, four received pre-trial dismissals, and three received trial convictions; those cases are not examined here.

In this analysis, we focus on the 374 public firms prosecuted in that registry, including the 192 that entered into deferred and non-prosecution agreements and the 168 that entered into plea agreements.[133] This dataset is significantly larger than that previously considered by Kaal and Lacine, primarily because we include plea agreements as well as DPAs.[134] However, our data do not include compliance undertakings that may also be ordered as part of court-supervised probation, since the terms of special probation are not always available on public dockets.[135]

We coded all agreements that referred to the board by imposing any new affirmative obligation on the board (as opposed to not referring to the board at all, or acknowledging prior acts of the board with respect to compliance). Of the 374 cases, the text of 45 public companies' agreements are missing; they are not available on

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[131] Section I.C.4, *supra.* See also Kaal and Lacine, *supra* note xxx, at 85 fig.1 (2014) (finding that 31% of agreements had requirements affecting boards, but only 8% mandated new board committees).

[132] See Ashley & Garrett, supra note xxx.

[133] We do not examine the cases of 13 more public companies that received declinations, 4 dismissals, three were convicted at trial, and 1 was acquitted at trial.

[134] Kaal and Lacine, *supra* note xxx, at 82 (describing dataset). These authors review 271 DPAs entered into over the period 1993-2013.

[135] U.S.S.G. § 8D1.4, Application Note 1.

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dockets or were not made available by the DOJ. Of the 329 remaining cases, 115 (31%) included terms that imposed some obligation on the board.[136] Of those cases, only five agreements (1.5 per cent) required the creation of board-level compliance committees.[137] Prosecutors clearly do not demand that boards establish CCs as part of plea agreements or DPAs.[138] To be sure, some other cases may also involve parallel agreements with regulators who themselves imposed obligations on the board. Nevertheless, it seems that firms very rarely create compliance committees because prosecutors negotiate them as part of a DPA or plea agreement.

What we learn from the combination of these inquiries is that the vast majority of the firms that establish compliance committees are not compelled to do so. Rather, it is a voluntary decision.

C. Why Might Firms Choose to Establish Compliance Committees?

These observations shift our focus to the cases in which CC adoption is voluntary; where boards choose to oversee compliance through a separate committee. Given that less than five per cent of public companies have established a CC between 2004-2017, these firms are early adopters of the new corporate practice. As discussed in Section I.C, adopting a CC has real costs for a firm's board, but also has a real significance in terms of enhanced oversight capability. What are the factors that might make a firm choose to do so?

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[136] This is consistent with Kaal and Lacine's finding that 38% of DPAs in their sample required some type of "board changes." Kaal and Lacine, *supra* note xxx, at 95.

[137] The Computer Associates Agreement from 2004 required the company to establish a compliance committee (or a combined audit and compliance committee), as well as add two independent directors to its board, and create a new audit department that reports to the new board committee. See Computer Associates Agreement, at http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/detail-files/589.html. The 2008 Unum Group agreement required the establishment of a new compliance committee of the Board. See Unum Group Agreement, at http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/detail-files/738.html. The 2012 Moneygram International agreement required the bank to create "an Independent Compliance and Ethics Committee of the Board of Directors with direct oversight of the Chief Compliance Officer and the Compliance Program," and that the committee have responsibility "for ensuring that the Company is in compliance with all aspects of the Agreement." Moneygram Int'l Deferred Prosecution Agreement (M.D.P.A. 2012), at http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/MoneyGram.pdf. The 2013 non-prosecution agreement with Las Vegas Sands required the creation of a board-level compliance agreement. Las Vegas Sands Non-Prosecution Agreements, at http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/Las-Vegas-Sands-Corp-NPA.pdf. The 2014 Stryker Corp. agreement required the creation of a new compliance committee and that the Board, or a designated committee, "shall conduct a review of the effectiveness of Stryker's Compliance Program as it relates to the marketing, promotion, and sale of medical devices." See Styker Corp. Agreement, at http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/detail-files/770.html.

[138] The finding is qualitatively similar to that reported by Kaal and Lacine (8%), *supra*, note xxx.

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1. Heightened Compliance Activity

All other things equal, such a step would be most functional for companies that where a CC is a complement to other large investments in compliance programs—meaning, where the extra compliance oversight through a compliance committee would enhance the effectiveness of core compliance activities and vice versa. Neither the absolute level not an increase in compliance investments is readily measurable in most contexts because, as we have described in Part II.A.1, firms typically don't disclose the scope of their compliance activity, in part because of fear of sending an adverse signal. Nevertheless, there are a number of readily-identifiable circumstances that might be expected to be associated with an increase in compliance investment so that compliance committee adoption would not carry the usual negative signal. Thus, firms are free to exploit the complementarities.

One relevant indicator may be an enforcement event, such as prosecution or a DPA. When firms enter into DPAs—a public event with high salience—they commonly agree to increase their pre-existing level of compliance activity. And in the period leading up to a DPA, firms may invest heavily in conducting an internal investigation and co-operating with the authorities. Such a ramping-up of compliance investment could also be a trigger for boards stepping in to engage in more direct oversight through a CC, as in the cases of Lending Club and AIG, even if this is not specifically mandated by prosecutors.

This conjecture is borne out in our dataset of DPAs and plea agreements. While prosecutors very rarely require establishment of a compliance committee,[139] many of these agreements nevertheless envisage expansions in compliance that will involve the board in some way. Ninety-six (29 per cent) of these prosecution agreements created new positions that report directly to the board.[140] In some of those cases, still more is required, such as that the compliance officer must make at least quarterly reports to the board. Some agreements required creation of a compliance officer for a specific compliance risk, such as the Online Pharmacy Compliance Officer created in the United Parcel Services agreement. [141] On the other hand, some cases specifically suggest a more occasional role; the Monsanto agreement, for example, asks that the board hire an outside auditor to assess its FCPA compliance not less than once every five years.[142]

[139] *See supra*, Section II.B.2.

[140] For example, 71 settlements, chiefly in FCPA cases, contained the following language, requiring that the company to:

"Assign responsibility to one or more senior corporate executives for the implementation and oversight of the company's anti-corruption compliance policies. These officials shall have authority to report directly to independent monitoring bodies, the company's board of directors, and shall have an adequate level of autonomy from management."

[141] United Parcel Service Deferred Prosecution Agreement (N.D.C.A. 2013), at http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/UPS.pdf

[142] Monsanto Deferred Prosecution Agreement (D.D.C. 2015), at http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/monsanto.pdf.

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In additional cases, an independent monitor is appointed, and the reports of that monitor would be normally reviewed by the board (even if the publicly released agreement does not say so specifically). Some agreements do discuss the board-monitor relationship. For example, the Exactech case requires that the Chairman of the board, CEO, President, CFO, Executive Vice President for R&D, Corporate Counsel, and Chief Compliance Officer all will meet quarterly with the Monitor.[143] Such a role would end when the agreement ends.[144]

While there is variation in individual agreements, the general thrust is for DPAs to impose heightened compliance obligations on the company, and in a third of cases, directly to expect more board engagement. While these do not direct the board to establish a CC, the heightened compliance investment, and associated oversight expectations, may be expected to make it more likely for such companies to establish a CC. A DPA is often a trigger for a step up in compliance by the company; this in turn should be a cause for increased oversight. Board committee oversight makes internal compliance efforts more effective; heightened internal compliance provides more compliance-relevant information to funnel to the board committee, making oversight more effective.

Risk of prosecution is, of course, hard to measure, especially where it turns on factors that are internal to the firm. However, it seems reasonable to expect that firms in *regulated industries* may expect heightened scrutiny of their actions.[145] Another relevant indicator may be *rates of prosecution* in a firm's industry in recent years. This can convey information about the resources and enforcement priorities of prosecutors, which vary over time. Thirdly, with respect in particular to exposure to prosecution under the Foreign Corrupt Practices Act, one might expect this to be highest for firms that do business in corruption-prone jurisdictions.[146]

2. Board Capacity

Our discussion in this Part has so far focused on benefits to firms from establishing a CC. Yet as we saw in Part 1.C, the costs may also be significant, given the scarcity of independent directors' time. Consequently, the structure of a firm's board may affect its willingness to contemplate setting up a new compliance

[143] Exactech Deferred Prosecution Agreement (D.N.J. 2010), at http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/exactech.pdf.

[144] Some agreements similarly state that the board must review compliance pursuant to the agreement during the term of the agreement, without imposing a further ongoing obligation. The AmerisourceBergen Specialty Group agreement is an example. Plea Agreement, U.S. v. AmerisourceBergen Specialty Group, 1:17-cr-00507 (E.D.N.Y. 2017), at http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/amerisourcebergen.pdf.

[145] Such firms may have additional reasons for investing in compliance programs, as aspects of these may be required by the applicable regulation.

[146] See Stefan Zeume, *Bribes and Firm Value*, 30 REV. FIN. STUD. 1457 (documenting effects on firms with subsidiaries in countries prone to corruption of passage of FCPA-equivalent legislation in the U.K.)

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committee, as opposed to channeling compliance work to the existing Audit Committee. A new compliance committee will require personnel—primarily independent directors—to staff it. We know from our interview research (Section I.C.2) that independent directors, who have only part-time relationships with their companies, face very tight time constraints. Consequently, we might expect that firms with larger boards, and in particular, with more independent directors, would be more likely to establish a compliance committee. The flipside of the same issue is the Audit Committee's capacity to take on compliance oversight work. The larger a firm's Audit Committee, the greater the capacity for compliance oversight to be routed through the Audit Committee as opposed to the inauguration of a new CC.

3. Learning Costs

The pattern of CC adoption—rare, but gradually increasing over time—is consistent with other types of innovation in corporate governance. Even if new mechanisms are beneficial, it is costly for boards who face tight time constraints to learn about these benefits. These learning costs put a brake on the diffusion of new practices. As a consequence, boards may be more likely to adopt a new innovation of which one or more of their members have prior experience in a different context—for example, through sitting on the board of a different company at which the innovation has been deployed. Prior studies suggest that interlocking directors (that is, directors who serve on the boards of more than one company concurrently) can function as a transmission mechanism for learning about a range of new corporate governance practices.[147] These include poison pill adoption, CEO compensation, option

[147] See e.g., Gerald F. David, Agents without Principles? *The Spread of the Poison Pill through the Intracorporate Network*, 36 Ad Sci. Q. 583 (1991) (showing that poison pill adoptions increase with interlocking directors); Kevin F. Hallock, *Reciprocally Interlocking Boards of Directors and Executive Compensation*, 32 J. FIN. & QUANT. ANAL. 331, 338 (1997) (suggesting that firms whose CEOs are reciprocally interlocked by serving on each other's boards pay their CEOs substantially higher because these CEOs may have both the incentive and the opportunity to raise each other's pay); Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802, 811 (2005) ("Unless executives have an informational advantage that allows them to develop superior forecasts regarding the future market movements that drive these predicted returns, the results suggest that the official grant date must have been set retroactively."); Erik Devos et al., *Are Interlocked Directors Effective Monitors?* 38 FIN. MGMT. 861 (2009) (documenting that the presence of interlocked directors is associated with the reduced sensitivity of CEO turnover to firm performance); Id. at 862 ("A more recent stream in this line of research suggests that the presence of interlocked directors and connected boards may compromise the effectiveness of board monitoring, especially with respect to the setting of compensation of CEOs."); John M. Bizjak et al., *Option Backdating and Board Interlocks*, 22 REV. FIN. STUD. 4821, 4838 (2009) (showing that interlocking directors were an important conduit contributing to the spread of backdating of option grants); Christine Shropshire, *The Role of the Interlocking Director and Board Receptivity in the Diffusion of Practices*, 35 ACADEMY OF MGMT REV. 246, 252-253 (2010) (theoretically proposing that "the likelihood of knowledge transfer increases if the interlocking director serves on the relevant board committee at the focal firm."); Michal Barzuza and Quinn Curtis, *Board Interlocks and Outside Directors' Protection*, 46 J. LEGAL STUD. 129 (2017) (suggesting that interlocking directors contribute to outside directors' knowledge and bargaining power in restring directors' indemnification protection).

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backdating and indemnification protection. Applied to our current context, it may be that directors who have experienced a compliance committee in operation at another company may be a source of information for colleagues about the benefits (or costs) of these bodies.

D. Which Firms Do Establish Compliance Committees?

Having explored reasons why firms might choose to establish a board compliance committee, we are now in a position to test these in our data. In this Part, we present multivariate regression results that shed light on these hypotheses.

1. Regression specification: Main variables of interest

We first identify variables that reflect, or at least proxy for, the presence of the factors we described in Part II.C as affecting firms' choices whether or not to establish a board compliance committee. Our variable *DOJ Prosecution* seeks to capture the effect of prosecution. It is a dummy (binary) variable taking the value 1 if the firm was on the receiving end of a DOJ enforcement action in the previous three years, whether in form of a DPA or a plea agreement. Turning to the risk, or likelihood of prosecution, we use a variable *DOJ Exposure*, which measures the prosecution rate of peer companies in the same industry (examining the time period from 2004 to 2017, based on Duke/UVA Corporate Prosecution Registry data). We also use industry dummy variables, which allow us to explore the effect of being in a regulated industry.

To explore relationships with board structure, we include variables *Board Size*—that is, the total number of board members; *Independent D. Ratio*—the proportion of the board that is comprised of independent directors—and *Audit Cttee Size*—namely, the number of people sitting on the Audit Committee. Finally, our variable *CC Experience* captures whether any of the company's board members has prior experience as a board member in other company with CC.[148]

[148] We constructed this variable by first identifying all directors in our data serving on two or more boards (that is, "interlocking" directors), of which one or more had adopted a compliance committee. In our entire dataset, there are 447,883 director-year observations, of which 18,791 (4.2 per cent) involved serving on boards of companies that had adopted board compliance committees and 1,615 (0.36 per cent) related to interlocking directors sitting on at least one board with a compliance committee. For each interlocking director identified in this way, we then examined the timing their board appointments relative to compliance committee adoption in each relevant company. If an interlocking director is appointed to the board of each company in the same year as, or before, the year that company adopts a compliance committee, we identify that director as a potential channel to spread compliance committees by using a dummy variable. In contrast, interlocking directors who only arrive at a company after it adopted a compliance committee cannot be a diffusion channel. We then converted this director-level data into the company-level variable CC Experience by giving a value of 1 to a company that has at least one interlocking director whose board appointment predated the adoption of a compliance committee for any given year.

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Table 6 reports logit regression results for our panel of US public firms during the period 2004-2017.[149] The dependent variable is whether a firm adopts a compliance committee in a particular year. We take "compliance committee" adoption for these purposes to include standalone compliance committees, risk and compliance committees, and audit and compliance committees,[150] although we have seen in Figure 2 that the lion's share of this activity is standalone compliance committees.

[Table 6 about here]

2. Control variables

In all specifications, we include year and industry fixed effects. We also include a number of additional covariates ("control variables") that might be expected to affect CC adoption. First, the size of the firm, as captured by *Total Assets*. There is a fixed cost associated with CC establishment, and the size of compliance investments are likely to be increasing with the size of the firm. Thus, we would expect firm size to be correlated with CC adoption, which in fact it is in all our regression specifications. Second, firm prior performance, as captured by *RoA* (return on assets) and *Tobin's Q*,[151] in each case lagged by one year.[152] Neither appears to have any significant relationship with CC adoption. We also include a dummy variable for whether the firm is incorporated in *Delaware*, because a prior literature establishes that, because of Delaware's pre-eminence as a jurisdiction of choice for public companies, firms incorporated there are different in many respects from firms that choose to remain in their home states.[153] We find no significant effect of Delaware incorporation on CC adoption.

Finally, we include a variable relating to board characteristics—*Board Gender,* the fraction of male directors on the board, in case gender diversity affects openness to CC adoption. The coefficient for this variable is not statistically significant.

3. Discussion of Results

[149] Logit regression is used because the dependent variable in this case is binary. Coefficients report marginal effects.

[150] See *supra*, Section II.B.3.

[151] "Tobin's Q" is here taken to be the ratio of a firm's market value to the book value of its assets, a commonly-used proxy for firm performance. On the derivation of this measure, its common use, and limitations, see Robert Bartlett and Frank Partnoy, The Misuse of Tobin's Q, working paper UC Berkeley Law School (2018).

[152] "Lagging" the variable by one year means that when considering values of variables from year *x,* the value of the lagged variable that is included is for year *x – 1*.

[153] See e.g., Lucian Bebchuk and Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J. L. & ECON. 383 (2003); John Armour, Bernard Black and Brian Cheffins, *Is Delaware Losing its Cases?*, 9 J. EMP. LEG. STUD. 605, 607 (2012); Kate Litvak, *How Much Can We Learn by Regressing Corporate Characteristics Against the State of Incorporation?,* forthcoming, J. L. FIN. & ACCT (2019).

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We now turn to our main results of interest. The variable *DOJ Prosecution* is positive and strongly statistically significant (at the 99 per cent level) in specifications (1) and (2). This suggests that the increased investment in compliance programs commonly demanded in DPAs and plea agreements (reviewed in Part II.C.1) is associated with the adoption of CCs by these firms. Because we know that the DPAs and plea agreements almost never mandate the creation of a CC, this implies that these firms establish CCs to enhance the firm's overall compliance capacity in light of the compliance investments that are otherwise required.

What about risk of prosecution? Although the coefficients for *DOJ Exposure* have the expected sign (positive), it is notable that neither of them is anywhere near statistically significant. As we use industry fixed effects, we can also explore the whether there is a greater pattern of CC use in regulated industries. As discussed in Part II.C.1, firms in regulated industries such as financial services, healthcare and pharmaceuticals may face higher expectations regarding compliance activity and increased. However, apart from healthcare,[154] the coefficients for these three industry dummies (unreported) are not significant.

Turning to board capacity, the variable *Board Size* has a positive coefficient in all the regression models and is (weakly) statistically significant at the 90 per cent level in models (1), (2) and (4). Moreover, the proportion of independent directors—*Independent D. Ratio*—has a positive and statistically significant (at the 95 per cent level) coefficient in all our models. These results are consistent with the idea that CC adoption may be made easier by the presence of more (independent) directors, which increases the capacity of the board to staff a compliance committee. Similarly, the coefficient on *Audit Cttee Size* is negative and strongly statistically significant (at the 99% level of above) in all specifications, suggesting that a larger Audit Committee has greater capacity to add compliance oversight to its terms of reference, serving as a substitute for separate CC. Of course, these results are simply a correlation, and might reflect the consequence of CC adoption, rather than part of its cause.[155] That is, firms with CCs may have more independent directors and smaller Audit Committees *because* they have chosen to set up, and staff, a compliance committee.

Finally, we also find some support for the idea that director interlocks may provide a mechanism for diffusion of CC adoption. The coefficients for *CC Experience* are positive and strongly statistically significant (at the 99 per cent level) in models (1) and (4). This suggests that "learning effects" may be present in CC adoption: boards learn from the experience of their members about the way in which CCs function.

These results remain the same when we run the regressions with the same independent variables and the adoption of stand-alone compliance committees as the

[154] The coefficients for the healthcare industry dummy are positive and significant at the 99% level in all models.

[155] That is, no causal inference can be drawn about the relationship between board size and CC adoption.

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dependent variable. This means that when companies adopt "stand-alone" compliance committees, the same considerations apply.

[Table 7 about here]

* * *

To summarize: our results show that companies are more likely to adopt compliance committees if they have been targets of prosecution, and/or if one of their board members has prior experience of the use of compliance committees. However, there is surprisingly little evidence that companies for which compliance investment is likely to be more valuable to the firm—in regulated industries, or industries facing increased levels of prosecution activity—are likely to adopt CCs. More fundamentally, the overall level of adoption of compliance committees among public companies is still extremely low: less than five per cent. This provokes a normative enquiry: does it matter that the use of CCs is so infrequent? And if so, what should policymakers and boards do about it? It is to these questions that we turn in Part III.

III. RETHINKING BOARD COMPLIANCE

A. Why are Compliance Committees Not More Common?

In the wake of corporate scandals, many have asked how to create accountability within corporations. There is, as Samuel Buell has described, a responsibility gap, where in the largest corporations, the CEOs and high-level officers may not have been aware of misconduct, but they also may have presided over a non-compliance system in which strong incentives existed to profit from misconduct.[156] Criminal prosecutions have not been effective at targeting higher-level officers, including because it is often quite difficult to show that they were aware of misconduct; indeed they may have been unaware.[157] Yet, the public has clamored for accountability, including through criminal convictions.[158] Such convictions might lead to severe punishment for misconduct with grave social consequences, but it does not prevent future compliance breakdowns.

One way to accomplish those forward-looking goals is to require corporations to create better compliance programs. However, as discussed, little consensus exists regarding what sort of compliance works or what type of oversight boards should provide over compliance. Enforcers, whether regulators or prosecutors, are not able to easily ensure day-to-day oversight over compliance reforms, although they have

[156] Samuel Buell, *The Responsibility Gap in Corporate Crime*, 12 CRIM. L. & PHIL. 471 (2018).

[157] See Daniel C. Richman, *Corporate Headhunting*, 8 HARV. L. & POL. REV. 265 (2014).

[158] Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REV. BOOKS, Jan. 9, 2014; Jean Eaglesham & Anupreeta Das, *Wall Street Crime: 7 Years, 156 Cases and Few Convictions*, Wall St. J., May 27, 2016.

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sometimes attempted to do so with the use of independent corporate monitors.[159] Instead, it often lies to the board to ensure that compliance reforms are in place. That is why creation of a compliance oversight function at the board level has been understood as relevant to the board's oversight role and as a way for the compliance function to be elevated in importance and relatively more autonomous from management.

Of course, the needs of individual companies vary. A central message of corporate governance research is that there are few general truths about what works best in board structure—much of the answer depends on the characteristics of the individual firm.[160] Consistently with this, we see that firm-level attributes predict compliance committee adoption. Our concern here is not with firm-level variation, but the low aggregate level of adoption.

In Part I.C, we characterized the adoption of a compliance committee as not a matter of "window dressing" for a board, but as having real costs and benefits. Our empirical results are consistent with this framing. Firms are more likely to adopt CCs on making increases in compliance investment, and constraints on board capacity to staff a CC reduce their likelihood of adoption. Against this background, we now consider two further possible interpretations of our results.

1. Do Companies Invest Enough in Compliance?

Our results about the link between prosecution and CC adoption suggest that compliance committees are associated with greater underlying investments in compliance. We know from the text of DPAs and plea agreements that these CCs are not created because prosecutors demand them; rather it seems most likely that companies choose to create them to oversee the heightened compliance programs that we also know—from the text of the agreements—that prosecutors *do* demand.

One plausible explanation for the low aggregate uptake of compliance committees is therefore that companies generally do not make sufficient compliance investments to justify a new committee devoted to their oversight. Of course, given that expenditure on compliance is typically not disclosed, this can only be conjecture. And whether it is problematic or not requires us to identify a baseline level of "desirable" compliance investment.

While little is known about the utility of corporate compliance programs in reducing underlying levels of misconduct, it is clear that the implementation of an effective compliance program is taken into account by prosecutors and other enforcement agencies in reducing penalties *ex post* for firms that have done so. So, from the firm's point of view, compliance programs can be a worthwhile investment simply to reduce expected enforcement costs. Were firms responding to this incentive,

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[159] Vikramaditya Khanna & Timothy L. Dickinson, *The Corporate Monitor: The New Corporate Czar?,* 105 MICH. L. REV. 1713 (2007).

[160] See e.g., Renée B. Adams, Benjamin E. Hermalin, and Michael S. Weisbach, *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. ECON. LIT. 58 (2010).

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we would expect to see more extensive compliance programs in regulated industries, and in industries facing increased prosecution rates. Yet we find little, if any, evidence for either of these. A possible explanation is that firms are underinvesting in compliance, relative to what would minimize their expected exposures.

Why might firms do this?[161] If compliance investment is not disclosed, investors will find it difficult to take into account the effects such a program will have on expected enforcement costs. Consequently, it will be under-valued by the market. Executives and directors whose compensation is delivered largely in stock will seek to maximize the market valuation, and so may tend to underinvest in compliance. Moreover—as discussed above—disclosing extensive compliance investment is unlikely to be appealing, either, because this will reveal to investors the extent of the expected enforcement costs to which compliance responds.[162]

2. Do Boards Have Sufficient Capacity?

A complementary explanation, which is also consistent with our results, is that limits on board members' time capacity may constrain their engagement in compliance oversight in most companies.

Two parts of our results are relevant to this. First, the fact that prior experience of CC use by one or more board members increases the likelihood that a company will adopt a CC. This is consistent with the existence of learning costs—the time and resources taken for board members to inform themselves of new developments. As a result, boards may plausibly be unaware of the benefits of compliance committees unless these are relayed to them by a colleague with experience. This matches with a factor emphasized by our interviewees—that boards' time is tightly constrained and so they are highly focused in their activities. However, the fact that the effect of prior experience is strongly positive suggests that boards who do learn about CCs find them worthwhile to adopt. In turn, this implies that boards' tight focus may come at the price of missing out on learning about potentially beneficial innovations in governance.

A second relevant aspect of our results is the linkage we report between board size, proportion of independent directors, and CC adoption. While these correlations, by themselves, do not suggest any particular causal relationship, we think they might do if board time capacity generally faces restrictions that are beyond board members' control. As is well-known, widely-accepted norms of "good governance" prescribe that at least a majority of a public company's board should be independent.[163] To be

[161] This discussion draws on a fuller argument set out by three of us elsewhere: Armour et al, Taking Compliance Oversight Seriously, *supra* note xxx.

[162] Id.

[163] See, e.g., New York Stock Exchange Listed Company Manual, §303A.01 ("Listed companies must have a majority of independent directors.")

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independent, one cannot be an employee of the company.[164] This means that independent directorships must necessarily be part-time positions. Boards (and board committees) meet several times a year. At each relevant meeting, board members will spend a day or so preparing for the meeting by reading the materials. But outside these periods, independent directors will not be engaging with the company's affairs. To do more might challenge their status as non-employees, and hence their independence.

At the same time, an influential school of thought emphasizes the performance benefits of "smaller boards." In theory, optimal board size depends on a trade-off between various relevant factors, such as range of expertise (suggesting more members) and cohesiveness (suggesting fewer members). A body of practitioner literature focuses on the results of academic studies and practitioner surveys that report performance benefits associated with boards of around eight to ten members. While these results are averages that describe practice, in the hands of some corporate governance advisors they can easily acquire normative significance as "rules of thumb" that then constrain practice going forward.[165]

Putting these pieces together, it board independence requirements coupled with constraints—or even just some drag—on board size can easily add up to very tight limits on a board aggregate time budget. This, in turn, could constrain capacity to adopt a compliance committee.

B. Encouraging Board Compliance?

One implication that is suggested by our empirical inquiry is the potential gap between the socially optimal and privately optimal board size and capacity. Board size, as we have observed, is heavily influenced by academic studies (which have become conventional wisdom) that indicate that smaller boards are associated with

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[164] New York Stock Exchange Listed Company Manual, §303A.02(b)(i) ("[A] director is not independent if … [t]he director is, or has been within the last three years, an employee of the listed company.")

[165] See e.g., Stephen Bainbridge, *Board Size: Is there an Optimum?*, ProfessorBainbridge.com May 8, 2009 (https://www.professorbainbridge.com/professorbainbridgecom/2009/05/board-size-is-there-an-optimum.html, last accessed Feb 16, 2019) (surveying academic literature and concluding: "A Korn/Ferry survey of corporate directors found: 'According to respondents, the optimal board size is two inside directors and eight outside.' Sounds about right to me."); Robert Reiss, *The 10 Best Practices for an Effective Board*, Forbes blog, Nov 25, 2015 (https://www.forbes.com/sites/robertreiss/2015/11/25/the-10-best-practices-for-an-effective-board/#cb8f00f413b9, last accessed Feb 16, 2019))("The best group of an average-sized American public company would be nine to twelve board members.") Nicholas J. Price, *Best Practices: Board Size and Corporate Governance*, Diligent Governance blog, Sep. 25, 2017 (https://diligent.com/blog/board-size-corporate-governance, last accessed Fe. 16, 2019) (discussing prior studies and noting that "less is more"); see also Australian Institute of Company Directors, *Number of Directors—Board Size,* (http://aicd.companydirectors.com.au/~/media/cd2/resources/director-resources/director-tools/pdf/05446-3-1-mem-director-tools-gr-number-of-directors_a4-web.ashx, last accessed Feb 16, 2019), at 2 ("rule of thumb" suggesting 8-12 directors for large Australian listed company). The central academic paper is David Yermack, *Higher Market Valuation of Companies With a Smaller Board of Directors*, 40 J. FIN. ECON 185 (1996) (finding inverse correlation between board size and firm value

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higher stock prices, which in turn has led to a boards of approximately 10 to 12 directors. For many companies, a compliance committee would be costly from a shareholder point of view because of the diversion of constrained director attention away from business performance issues -- *unless the company had previously been targeted as a violator*, which is the pattern we observe. Yet greater compliance oversight at the board level is likely to reduce the incidence of law violation by the firm. This is implication of our study of CC charters, which show the sharper focus and additional resources that compliance committees bring to compliance oversight. It is highly unlikely that our system of criminal and administrative enforcement has achieved the socially optimal level of corporate compliance. In short, pursuit of the *privately optimal* board size and structure may well have generated a board capacity constraint that results in a *socially-suboptimal* adoption of compliance committees.

Our empirical survey shows that 94 per cent of public companies still do not have compliance committees. Thus far public authorities have not mandated compliance committees except in five corporate prosecutions, and occasionally in other areas of civil enforcement.[166] In general the enforcers mandate increased compliance but have not taken the next corporate governance step. In this section we explore three mechanisms to close the gap between the socially optimal and privately optimal level of board compliance oversight: first, an illustrative set of direct federal regulatory interventions; second, corporate governance innovations to expand board capacity; and third, toughening of the state corporate law director liability standard for failure of compliance oversight.

1. Regulatory Interventions to Strengthen Board Compliance

Regulators could adopt a more directive role in requiring, or at least promoting, board responsibility for compliance. We have described a real reluctance among enforcers to require that boards create compliance committees.[167] We have also described that more companies do create such committees when, following an enforcement action, prosecutors do more strongly signal, if not require, that boards oversee compliance using a committee-structure.[168] An enforcement strategy, however, sends messages primarily to companies facing consequences for violations, and only secondarily to others in industry that observe enforcement outcomes. Indeed, the lack of relationship between compliance committee adoption and *exposure* to DOJ enforcement (as proxied by industry prosecution rates) suggests that these secondary messages are not getting through. It is more challenging for enforcers to send positive messages regarding best practices, as opposed to practices that result in enforcement and sanctions.

[166] The OCC has sometimes required creation of board compliance committees as well. *OCC Orders Bank to Refund Up to $14 Million*, 60 Consumer Fin. L.Q. Rep. 223 (2006).

[167] See supra, Section II.C.1.

[168] See supra, Section II.D.

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What would a more directive regulatory regime look like? One option—surely overkill—would simply be to require all public company boards to have a compliance committee. A more tailored version would be to require compliance committees for companies in industries where the importance and density of federal regulation give rise to the greatest under-compliance concerns. For example, three industries where the public interest in compliance is especially high are: healthcare, in light of the federal economic support via Medicare and Medicaid; pharmaceuticals, in light of extensive federal standard setting and monitoring; and financial services, in light of the important consumer protection issues as well as the systemic stability concerns. A further measure would be for regulator not only to require a CC but also establish standards of CC "best practice." This would reduce the risk that CC activity was mostly window-dressing.[169]

Another regulatory approach would look to augmenting the board's compliance capacity, either as a general matter or for targeted industries. This approach has been followed in some settlement agreements, which require the appointment of a "board compliance expert" who participates in all board meetings with a compliance presentation.[170] This is an outsider to the board with extensive compliance expertise who may be given prior notice of the compliance presentation and the opportunity to insist on deeper examination if he/she is dissatisfied. Alternatively, the regulator could require as part of its "qualification" requirements that the board have at least one director who would count as a "compliance expert" regarding the regulatory regime to which the company is subject. The combination of the Sarbanes-Oxley Act and stock exchange listing requirements achieved a similar objective regarding financial expertise of audit committee members.[171]

An approach that would provide more flexibility to boards would be for the primary regulator to require certifications from boards regarding their compliance oversight. Some agencies have followed this approach in resolving enforcement actions with non-complying companies. In the healthcare context, for example, the Department of Health and Human Services, Office of Inspector General issued in 2015 guidance to corporate boards on healthcare compliance, highlighting that "every Board is responsible for ensuring that its organization complies with relevant Federal, State and local laws."[172] There was a perception that boards were "inclined

[169] For example, the Corporate Integrity Agreement entered by Tenet Health Care, in a False Claims Act case, not only required that the chief compliance officer report directly to the board, but that the compliance committee of the board conduct a review of the effectiveness of the compliance program

[170] Tuomey Healthcare System Agreement, at oig.hhs.gov/fraud/cia/agreements/Tuomey_dba_Tuomey_Healthcare_ System_10162015.pdf; *see also* Meghana Joshi, *DOJ and OIG Increasing Focus on Personal Executive and Board Accountability in Light of Recent Changes, Compliance Officers Should Incorporate A Number of Guidelines into Their Everyday Practice*, 18 J. Health Care Compliance 23, 26 (2016).

[171] Sarbanes-Oxley Act of 2002, §407. See also NYSE Listed Company Manual Sections ¶¶ 303A.06, 303A.07; Nasdaq Listing Rule ¶ 5605(c).

[172] OIG, *et al. Practical Guidance for Health Care Governing Boards on Compliance Oversight*, (2015), https://oig.hhs.gov/compliance/compliance-guidance/docs/Practical-Guidance-for-Health-Care-Boards-on-Compliance-Oversight.pdf.

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to address only global issues and view matters such as compliance as technical 'day-to-day' issues, which are the province of trained staff."[173] For that reason, some regulators have intensified their focus on the responsibility of directors.[174] They have emphasized the role of the board in ensuring ongoing risk assessment and auditing as well as regular "executive sessions" with members of the compliance team.[175]

Boards may have taken heed of this.[176] Agreements in the health care context often include "a resolution, signed by each member of the Board summarizing its review and oversight of [the center's] compliance with Federal health care program requirements and the obligations of this CIA."[177] These agreements have included certifications of compliance, that the Board has made a "reasonable inquiry" into compliance, including a "Compliance Review," and that based on this, the Board has concluded that the company has an "effective compliance."[178] Thus, the board's oversight responsibilities are formally recognized and bolstered, but without specifying a structure for that oversight. Such certifications could be mandated for all companies in certain regulated industries, or by all public companies, and not just ones found to engage in violations.

2. Expanding Board Capacity through Corporate Governance Innovation

There are three readily identifiable corporate governance innovations that would expand board capacity. The first is to increase board size with an eye towards increasing compliance committee adoptions. Increasing board size may stimulate a virtuous circle in the case of compliance committees: increased board capacity lowers the cost of CC adoption (because there is less trade-off with board attention to core business matters); lowering the cost reduces the adverse signal of CC adoption; in turn, more CCs further reduce the adverse signal. This could be the approach of asset managers and other institutional investors who want to pursue (and to be seen

[173] Joseph T. Kelley, *Board Governance, Compliance, and Behavioral Health*, 2015 WL 9182494, at *1.

[174] OIG and AHLA, *The Health Care Directors Compliance Duties: A Continued Focus of Attention and Enforcement* (2011).

[175] Kelley, *supra*, at *5-6.

[176] Deann M. Baker, *Key Methods to Develop and Mature Your Compliance Program Changing an Organization's Culture May Take A Lot of Time and Energy, but It Can Be Done*, 10 J. HEALTH CARE COMPLIANCE 37 (2008).

[177] Jeremy Sternberg, *HHS-OIG Corporate Integrity Agreements Are Now Aiming at Corporate Directors and Executives*, Holland & Knight, LLP, (2013), at http://www.jdsupra.com/legalnews/hhs-oig-corporate-integrity-agreements-a-11456/. *See, e.g.* Hutchinson Regional Medical Center's Corporate Integrity Agreement, at http://oig.hhs.gov/fraud/cia/agreements/hutchinson_regional_medical_center_09092013.pdf.

[178] Kathleen McDermott, Arianne Callender, *Compliance Certifications and the Era of Accountability-A Forecast to Debate*, 5 J. Health & Life Sci. L. 158, 174-75 (2012).

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pursuing) "stewardship" agendas.[179] Such investors commonly hold fully-diversified portfolios. Compliance failures, meaning, violation of law, commonly result in negative externalities felt elsewhere in the portfolio. One doesn't need to believe that all regulation is optimal to think that compliance failures will on average result in social welfare losses that the diversified shareholder would prefer to avoid.

For the firm that adopts a CC, a further strengthening of compliance oversight would come through explicit authorization in the committee charter to launch investigations and retain outside experts at its discretion. For example, the HCA Healthcare committee charter states that the committee "may retain any independent counsel, experts or advisors (accounting, financial or otherwise) that the Committee believes to be necessary or appropriate."[180] It also states that the "Committee may conduct special reviews or investigations as it may deem necessary or appropriate to fulfill its responsibilities."[181]

A second possibility is the addition of a compliance expert as a director (which is easier if the board is expanded) [182] or adopting through self-help the regulatory intervention described above. This proposal is to enlist a compliance expert to sit with the board during presentations of compliance-related matters, in observer/monitor status. This outsider would be more effective if he/she has a prior briefing on the compliance presentation and the opportunity to insist on deeper examination if he/she is dissatisfied.

A third possibility is to vary the board model to add an outside director who is specifically empowered to focus on the company's compliance issues. Such a director would be sufficiently resourced to serve as an independent monitor of the company's own compliance efforts. The required time and expertise would call for higher compensation levels than the typical part-time director of the current board model. This suggestion echoes a well-known strand in the corporate governance literature, which questions the efficacy of part-time boards and looks for a new category of director.[183] One important question is whether higher director pay would compromise

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[179] See, e.g., BlackRock, BlackRock Investment Stewardship, 2018 Annual Report (Aug. 30, 2018), available at https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2018.pdf (last visited Feb. 24, 2019).

[180] HCA Healthcare Inc., Audit and Compliance Committee Charter, January 23, 2018, at https://investor.hcahealthcare.com/sites/hcahealthcare.investorhq.businesswire.com/files/doc_library/file/HCA_-_Audit_and_Compliance_Committee_Charter_Jan_2018.pdf.

[181] Id.

[182] Roy Snell, *It's Time to Get Serious About Board Expertise Not Just Anyone Should Be Serving As the Compliance Expert on Your Board*, 13 J. HEALTH CARE COMPLIANCE 3 (2011).

[183] See e.g. Ronald J. Gilson and Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STANFORD LAW REVIEW 863 (1991). More recently Profs. Gilson and Gordon have proposed an optional board model in which companies could chose to add "empowered directors" who would have much deeper engagement with the firm and who would be given additional resources and access (and compensation). Ronald J. Gilson and Jeffrey N. Gordon, *Board 3.0 – An Introduction* (forthcoming 2019, THE BUSINESS LAWYER), available at https://ssrn.com/abstract=3332735. The focus of their concern has been the firm's strategy and

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director independence, because the director with a sweet deal would have special reason to avoid antagonizing the CEO. The increasingly important role of the independent nominating-governance committee[184] in identifying director candidates and vetting the director performance should offer some protection on this dimension. Service in this role might be time-limited and directors could well seek a reputation for vigorous compliance oversight.

3. Toughening Director Liability Standards Under State Corporate Law

A distinctly different direction would be for the Delaware courts to increase the prospect of director liability for breach of fiduciary duty as respects compliance oversight failures. Under the *Caremark* standard, boards' duties to engage in good faith oversight have two aspects: a general (and on-going) duty to ensure that there is *a* system of compliance in place, and a specific and conditional obligation to respond in good faith to any "red flags" that this system should subsequently bring up.[185] A breach of duty can be triggered only by a failure of oversight so comprehensive as to call into question the board's good faith.

The practical question for boards is the extent to which they are required by their duties to act in relation to monitoring. The answer, at least as regards ensuring there is a system of oversight in place, is that their actual obligation is minimal. In Chancellor Allen's view, the *Caremark* duty would only be violated by "a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exists." [186] Or, as it the Delaware Supreme Court subsequently put it in *Stone v. Ritter*,[187] that "the directors utterly failed to implement any reporting or information system or controls."

This boils down to a continuing monitoring obligation that is essentially binary: either there is no effort at all, or there is some effort. Any level of positive effort greater than zero seems to suffice for directors to meet their fiduciary obligations in this context. Consider the following account of the sorts of board-level failures that would be necessary to ground a claim for liability:[188]

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operational performance but the model could be focused on compliance oversight for firms where compliance failures are a major business risk.

[184] See, e.g., New York Stock Exchange Listed Company Manual, ¶ 303A.04 (requiring Nominating/Corporate Governance Committee consisting solely of independent directors and tasked with identifying

[185] *Caremark, supra* note xxx.

[186] Caremark, *supra* note **Error! Bookmark not defined.** at 971.

[187] Stone v. Ritter, *supra* note **Error! Bookmark not defined.**, at 370.

[188] Guttman v. Huang 823 A.2d 492, 507 (Del. Ch., 2003). *See also* David B. Shaev Profit Sharing Account v. Citigroup, Inc. 2006 WL 391931 at 5 (Del. Ch., 2006).

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"[C]ontentions that the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation."

The recent case of *Horman v. Abbey*,[189] concerning allegations of *Caremark* violations by the board of UPS in relation to the transportation of illegal tobacco products, provides an illustrative example. The fact that the plaintiffs conceded that the board had established an Audit Committee whose responsibilities included "oversight of 'the Company's compliance with legal and regulatory requirements.'" and that the board was "provided updates about legal compliance through reports from the UPS Legal Department" was fatal to their claim that the board had failed to implement any reporting or compliance systems.[190] By simply establishing these structures, the board had met their *Caremark* obligations.

Of course, if the board actually come to be aware of any compliance failures, then it will be much easier to argue that they acted in good faith if they did not follow them up vigorously.[191] Yet this gives board members a reason to prefer a *less* vigorous approach to continuing monitoring and oversight, on the basis that this will make it less likely that any compliance failure will ever come to their attention. Because a busy Audit Committee has less time to hear reports on compliance than does a dedicated Compliance Committee, they will be less likely to hear about any compliance *failures*. Yet the Delaware courts specifically eschew making judgments on the efficacy of reporting systems. [192] As we have seen, the question is characterized as one of existence, rather than quality.

[189] 2017 WL 242571 (Del. Ch., 2017).

[190] *Id,* at 8.

[191] Gadinis and Miazad, *supra* note xxx.

[192] See e.g., In re General Motors Company Derivative Litigation 2015 WL 3958724, at *2 (Del. Ch. 2015) ("The Complaint does not allege a total lack of any reporting system at GM; rather, the Plaintiffs allege the reporting system should have transmitted certain pieces of information, namely, specific safety issues and reports from outside counsel regarding potential punitive damages. In other words, GM had a system for reporting risk to the Board, but in the Plaintiffs' view it should have been a better system."); Guttman v. Huang, *supra* text to note xxx; In re David B. Shaev Profit Sharing Account v. Armstrong, 2006 WL 391931, *5 (Del. Ch. 2006) ("The plaintiff conceded at oral argument that Citigroup had a wide range of compliance systems in place, and that they had no reason to believe that these systems were not functioning in a basic sense."); In re Lear Corp., 967 A.2d 640, 654 (Del. Ch. 2008) ("The complaint makes clear that the Lear board held regular meetings and received advice from several relevant experts. The plaintiffs have therefore not come close to pleading facts suggesting that the Lear directors 'consciously and intentionally disregarded their responsibilities' and thereby breached their duty of loyalty."); Horman v. Abney, 2017 WL 242571, *8 (Del. Ch. 2017) ("The Audit Committee's Charter, also referenced in the Complaint, establishes that the Audit Committee's general responsibility for oversight includes oversight of 'the Company's compliance with legal and regulatory requirements. ...' Thus, the Complaint itself reveals that the Plaintiffs have not plead

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By setting the hurdle for directors so low, the *Caremark* standard effectively precludes judicial consideration of compliance issues, whether at board level of below. One of the historical roles of the Delaware Chancery Court has been to build out the substance of fiduciary duty in wide-ranging contexts, not just through liability determinations but through developing ideas of "best practice" in the course of detailed analysis of particular cases. The almost-invariable dismissal of cases alleging the board's failure of compliance oversight per the *Caremark* standard has cut off this path for development. This has left a vacuum in best practice of compliance into which federal prosecutors have stepped, increasingly requiring firms to upgrade their compliance programs as a condition for a settlement. Unfortunately, this discretionary "regulation by settlement" is seemingly ill-equipped to guide boards how to discharge their responsibilities.

A more assertive approach to oversight liability would have at least two beneficial consequences. On the one hand, it would encourage boards to take compliance oversight more seriously, and trigger more energetic engagement with issues such as committee composition, the possibility of empowered board members, and underlying compliance investment. At the same time, it would create the opportunity for the Delaware courts to begin once again to offer meaningful guidance as to governance practices. While judges may be diffident about their expertise on compliance, their failure to engage has left less-diffident prosecutors to engage in corporate governance oversight. [193]

Of course, a more onerous interpretation of directors' fiduciary oversight duties by no means implies that companies should automatically establish a compliance committee. We view it as important to focus on the board's separate and independent responsibility to assure compliance, but the evidence described in this Article does not support any requirement of a board compliance committee as a matter of state fiduciary law. Rather, board compliance depends on sound management compliance, using a variety of mechanisms.

CONCLUSION

In this Article, we present empirical findings concerning how, contrary to the existing literature, far fewer public companies in the U.S. adopt board compliance committees than previously understood. We find that less than five per cent cent of public companies have board-level compliance committees. What explains this pattern, largely of non-adoption of board compliance committees?

To make headway, we use our data to explore why boards (do not) establish compliance committees. We present four main findings. First, companies that get prosecuted are much more likely to establish compliance committees. Yet this is not because prosecutors tell them to. We review a comprehensive dataset of DPAs and

particularized facts that the Board 'utterly' failed to adopt or implement any reporting and compliance systems.")

[193] For a detailed proposal to expand director liability for compliance oversight failures, see Armour et al, Taking Compliance Seriously, *supra* note 24.

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plea bargains entered into by public companies from 2001 onwards. In only five of 374 cases (less than two per cent) do these agreements actually stipulate the creation of some kind of board compliance committee. Rather, the link appears indirect. Prosecutors do frequently demand enhancements to a firm's compliance activities as part of these settlements; this creates a sharp increase in need for compliance oversight, which boards rationally meet by establishing committees.

Second, we find only weak links between factors that might make a firm's exposure to potential prosecution seem more likely—such as being in a heavily regulated sector, or a high rate of prior prosecution in their industry. This suggests that even firms for which compliance might be very important are not taking it sufficiently seriously to justify establishment of a dedicated committee. These results suggest that boards take compliance more seriously after their firm has got caught. Does this imply a troublingly low background level of board compliance? Our other results give further cause for concern.

Third, we find that prior experience of board compliance makes a difference. Companies with a board member who also sits on the board of a firm that already has a compliance committee, are much more likely to establish one themselves. This finding that experience matters is consistent with the general literature of diffusion of innovations. Moreover, it suggests that these directors' prior experience of board compliance is generally positive, as it increases the likelihood of subsequent adoption by other boards on which they serve. Why, then, are compliance committees not more widely adopted?

Our fourth result is that boards with compliance committees tend to be larger and have more independent directors. This reinforces the idea that compliance oversight is real work for the board: bigger boards have more capacity. Board capacity is subject to external constraints: institutional investors, proxy advisors, and others advocate small boards comprised mainly of independent persons, who have no employment relationship with the firm. This may mean boards often lack capacity to do compliance oversight other than as an Audit Committee addendum.

These results are at once intriguing and troubling. While our data do not permit any causal interpretation of the findings, they are consistent with theoretical claims that compliance is more often overlooked, rather than overseen, by boards. This has implications for both corporate law and corporate prosecutions, which have sought to promote greater board oversight of compliance. We conclude by considering ways in which board compliance might be facilitated or encouraged: reconsidering norms about board size and independence, enhancing accountability of directors to regulators, and tightening state law fiduciary duties regarding oversight.

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APPENDIX: FIGURES AND TABLES

Table 1. Variable Descriptions

Variable Name	Variable Description	Source
Compliance Committee	Dummy for whether firm has a board-level Compliance Committee (including standalone compliance committee, compliance and risk, or audit and compliance).	BoardEx
DOJ Prosecution	Dummy for DOJ prosecution (DPA or plea agreement) in previous three years.	Duke-UVA Corporate Prosecution Registry
DOJ Exposure	Rate of prosecution in the previous 3 years in the firm's industry	Duke-UVA Corporate Presecution Registry/BoardEx
CC Experience	Dummy for firm having at least one director who previously served or concurrently serves on board of another company with a Compliance Committee.	BoardEx
Board Size	Number of directors on Board.	BoardEx
Audit Cttee. Size	Number of directors on Audit Committee.	BoardEx
Independent Dir. Ratio	Ratio of independent directors on the board	BoardEx
Delaware	Dummy for Delaware incorporation.	SEC EDGAR
Board Gender	Ratio of board members that are male.	BoardEx
Firm Size	Natural logarithm of book value of firm's total assets.	CRSP-Compustat Merged-Fundamental Annual
RoA $_{(t-1)}$	Return on Assets in previous year.	CRSP-Compustat Merged-Fundamental Annual
Tobin's $Q_{(t-1)}$	Ratio of firm's market value to book value of its assets in previous year.	CRSP-Compustat Merged-Fundamental Annual

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Table 2. Summary Statistics

Variable	N	Mean	Std. Dev.	Min	Max
Compliance Committee	51,606	0.04	0.19	0	1
DOJ Prosecution	51,606	0.01	0.10	0	1
DOJ Exposure	51,619	0.003	0.004	0	0.02
CC Experience	51,606	0.004	0.06	0	1
Board Size	51,606	8.46	2.53	1	33
Audit Committee Size	51,606	3.48	1.57	1	21
Independent Dir. Ratio	51,606	0.82	0.10	0	1
Delaware	51,606	0.56	0.50	0	1
Board Gender	51,606	0.90	0.10	0.2	1
Firm Size	51,579	6.54	2.10	1.70	12.27
RoA $_{(t-1)}$	48,601	-0.03	0.22	-1.50	0.32
Tobin's $Q_{(t-1)}$	48,618	1.93	1.46	0.48	10.69

Table 3. Top 5 Industries of firms adopting Compliance Committees, 2005-17

Industry (FFI48)	% of companies from each industry out of entire companies with CC
Banking	27.00%
Healthcare	14.19%
Pharmaceutical Products	9.30%
Business Services	7.23%
Medical Equipment	6.10%

Table 4. Likelihood of DOJ enforcement and frequency of Compliance Committee adoptions by industry, 2005-17

Industry (FFI48)	% of DOJ enforcement within the industry	% of CC Adoption within the industry
Petroleum and Natural Gas	5.88%	0.9%
Medical Equipment	4.84%	12.1%
Pharmaceutical Products	2.90%	6.55%
Wholesale	2.87%	1.15%
Retail	2.36%	3.38%
Healthcare	1.55%	31%
Banking	1.52%	11.16%
Business Services	0.7%	2.9%

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Table 5. Characteristics of Board Compliance Committees of US Public Companies, 2004-17.

Variable	N	Mean	Std. Dev.	Min	Max
Size of CC	2,098	3.346997	1.549899	1	16
Ratio of Independent Directors	2,098	.8550974	.2078398	0	1
Ratio of Audit Committee Members on CC	2,098	.3119024	.4618924	0	1
Ratio of Directors Exclusively Serve on CC	2,098	.0999951	.1915115	0	1

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Table 6. Determinants of Compliance Committee Adoptions

VARIABLES	(1) Compliance Committee	(2) Compliance Committee	(3) Compliance Committee	(4) Compliance Committee
DOJ Prosecution	0.842***	0.871***		
	(0.291)	(0.285)		
DOJ Exposure	7.611		10.23	
	(10.78)		(10.32)	
CC Experience	8.375***			8.378***
	(1.040)			(1.038)
Board Size	0.0578*	0.0530	0.0522	0.0572*
	(0.0337)	(0.0326)	(0.0324)	(0.0336)
Audit Cttee Size	-0.112***	-0.113***	-0.111***	-0.110***
	(0.0369)	(0.0356)	(0.0356)	(0.0368)
Independent D. Ratio	2.379**	2.323**	2.352**	2.413**
	(1.006)	(0.951)	(0.953)	(1.009)
Delaware	-0.102	-0.0896	-0.0972	-0.109
	(0.173)	(0.166)	(0.165)	(0.173)
Board Gender	0.0875	-0.0151	-0.0493	0.0497
	(0.603)	(0.577)	(0.578)	(0.603)
Firm Size	0.201***	0.203***	0.220***	0.218***
	(0.0518)	(0.0493)	(0.0486)	(0.0510)
$RoA_{(t-1)}$	0.611	0.677*	0.683*	0.618
	(0.411)	(0.404)	(0.407)	(0.415)
Tobin's $Q_{(t-1)}$	0.0158	0.0183	0.0141	0.0109
	(0.0503)	(0.04643)	(0.0466)	(0.0504)
Year FE	Y	Y	Y	Y
Industry FE	Y	Y	Y	Y
Observations	41,539	41,539	41,539	41,539
Pseudo R_2	0.183	0.126	0.124	0.181

Note: Logit models of the likelihood that a firm will have a Compliance Committee in a particular year. *Compliance Committee* includes standalone compliance committees, risk and compliance committees, and audit and compliance committees. DOJ Enforcement data are from the Corporate Prosecution Registry at Duke University and the University of Virginia. *DOJ Prosecution* is a dummy for whether the firm has been the subject of a DPA or plea agreement in the previous 3 years. *DOJ Exposure* is the rate of prosecution in the previous 3 years in the firm's industry. Data on board membership and structure are from BoardEx. *CC Experience* is a dummy for whether any member of the board has sat, or currently sits, on the board of another company with a Compliance Committee. *Board Size* is total number of directors; *Audit Cttee Size* is the number of members of the firm's Audit Committee; *Independent D. Ratio* is the proportion of the company's board who are independent directors; and *Board Gender* is the proportion of the board members that are male. Data on state of incorporation are taken from EDGAR; *Delaware* is a dummy for incorporation in that state. Financial data are taken from Compustat. *Firm Size* is the natural logarithm of the firm's total assets; $RoA_{(t-1)}$ is the firm's Return on Assets in the previous year; *Tobin's Q* $_{(t-1)}$ is the firm's market to book ratio in the previous year and *Total Assets* is the book value of the firm's assets.

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Values in RoA, Tobin's Q, and Total Assets are winsorized at one percent in both tails. All models have year and industry fixed effects (using Fama-French 48 industry classification). Robust standard errors in parentheses (*** p<0.01, ** p<0.05, * p<0.1).

Table 7. Determinants of Stand-alone Compliance Committee Adoptions

VARIABLES	(1) Stand-alone Compliance Committee	(2) Stand-alone Compliance Committee	(3) Stand-alone Compliance Committee	(4) Stand-alone Compliance Committee
DOJ Prosecution	1.074***	1.078***		
	(0.315)	(0.313)		
DOJ Exposure	9.604		15.14	
	(12.77)		(11.99)	
CC Experience	5.102***			5.113***
	(0.237)			(0.240)
Board Size	0.0293	0.0267	0.0269	0.0298
	(0.0385)	(0.0373)	(0.0368)	(0.0381)
Audit Cttee Size	-0.231***	-0.228***	-0.225***	-0.227***
	(0.0502)	(0.0479)	(0.0479)	(0.0502)
Independent D. Ratio	1.807	1.847	1.880	1.849
	(1.210)	(1.146)	(1.151)	(1.216)
Delaware	-0.0836	-0.0639	-0.0771	-0.0956
	(0.210)	(0.203)	(0.201)	(0.209)
Board Gender	-0.0490	-0.139	-0.181	-0.102
	(0.698)	(0.669)	(0.670)	(0.699)
Firm Size	0.288***	0.285***	0.312***	0.315***
	(0.0607)	(0.0578)	(0.0563)	(0.0591)
$RoA_{(t-1)}$	0.517	0.621	0.622	0.518
	(0.476)	(0.476)	(0.479)	(0.481)
Tobin's $Q_{(t-1)}$	0.0287	0.0284	0.0221	0.0212
	(1.272)	(1.231)	(1.200)	(1.261)
Year FE	Y	Y	Y	Y
Industry FE	Y	Y	Y	Y
Observations	41,539	41,539	41,539	41,539
Pseudo R_2	0.216	0.156	0.152	0.213

Robust standard errors in parentheses (*** p<0.01, ** p<0.05, * p<0.1).

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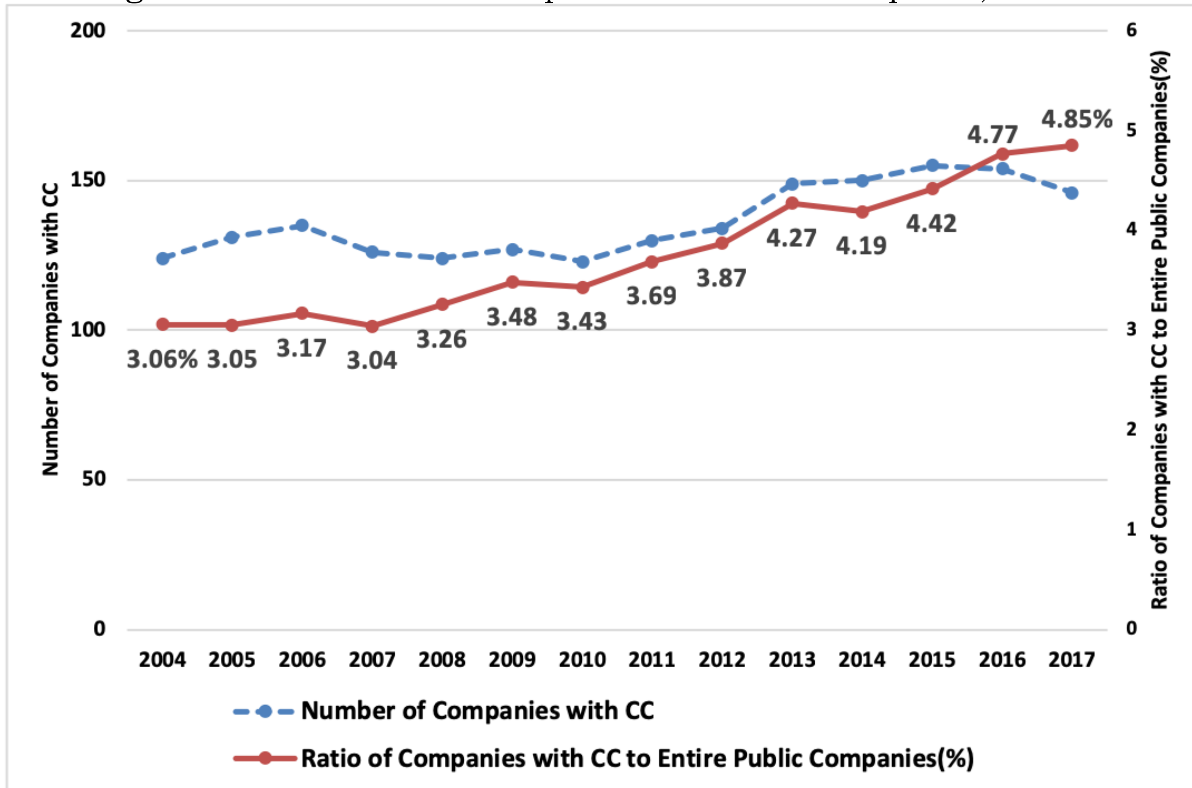
Figure 1. Time Trend in Compliance Committee Adoptions, 2004-17



Note: data are from BoardEx. Sample is all US public companies. The dashed line shows total number of public companies having a Compliance Committee. The solid line shows percentage of public companies having a Compliance Committee. "Compliance Committees" include those titled as "Compliance Committee"; "Risk and Compliance Committee" and "Audit and Compliance Committee".

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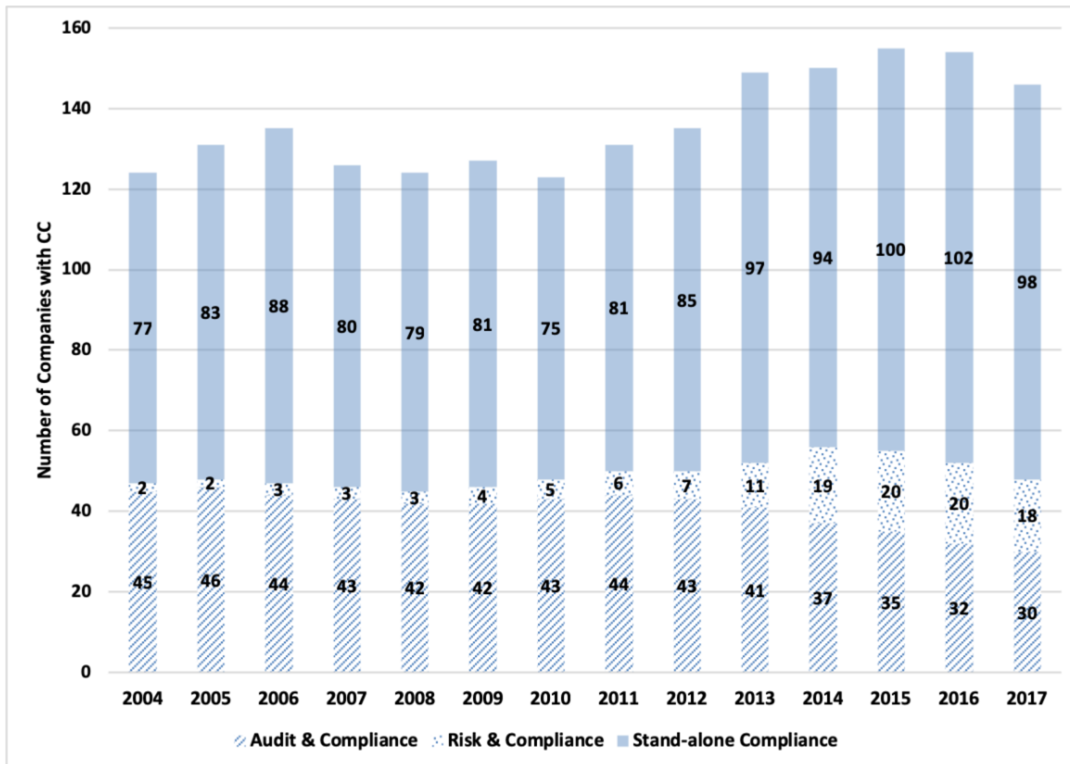
Figure 2. Types of Compliance Committees by Years, 2004-17



Note: Data are from BoardEx. Sample is all US public companies. Solid bars show number of public companies having adopted a 'stand-alone' Compliance Committee; bars with dots show numbers adopting a 'Risk and Compliance Committee' (without a stand-alone Compliance Committee) and bars with diagonals show numbers restyling their Audit Committee as 'Audit and Compliance' without a stand-alone Compliance Committee.

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