

2020

## Board Compliance

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### Recommended Citation

John Armour, Brandon L. Garrett, Jeffrey N. Gordon & Geeyoung Min, *Board Compliance*, 104 MINN. L. REV. 1191 (2020).

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## Article

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Introduction .....	1193
I. Boards and Corporate Compliance .....	1203
A. Compliance Programs and Their Rationales .....	1204
1. Regulating Compliance .....	1205
2. Effective Compliance Programs .....	1207
3. The Compliance Function Within a Firm .....	1210
B. Board Oversight of Compliance .....	1212
1. Expectations of the Board from Prosecutors ...	1212
2. Compliance and Directors' Fiduciary Duties ...	1214

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We are grateful for feedback on presentations of this material at the inaugural ComplianceNet Conference at U.C. Irvine School of Law, the Annual Meeting of the Comparative Law & Economics Forum at Amsterdam University, a Corporate Compliance Roundtable at Duke University School of Law, the National Business Law Scholars Conference at University of Georgia School of Law, an Oxford Centre for Socio-Legal Studies Workshop, the 13th Annual Conference of Empirical Legal Studies at Michigan Law School, the 29th Annual Conference of American Law and Economics Association at New York University School of Law, the Law and Society Association 2019 Annual Meeting, the Trans-Pacific Business Law Dialogue at U.C. Irvine School of Law, and at the Canadian Law and Economics Association Annual Meeting at University of Toronto Faculty of Law. We thank Jennifer Arlen, Miriam Baer, Sam Buell, Cristie Ford, Carl Hahn, Sean Griffith, Geoffrey Miller, and Gabriel Rauterberg for invaluable comments on prior drafts, and Paul Bryzyski, Benjamin Kramer, Samuel Nadler, Harrison Newman, Anna Raphael, and Callie Thomas for excellent research assistance.

3.	Boards' Role in Mediating Conflict over Compliance .....	1216
C.	Board Structure and Compliance Oversight .....	1218
1.	Compliance Oversight and Board Committees .....	1219
2.	Board Time as a Scarce Resource .....	1220
3.	Evidence on Compliance Oversight Intensity from Committee Charters .....	1221
4.	Case Studies .....	1222
II.	Empirical Analysis of Board Compliance .....	1225
A.	New Data on Board Compliance .....	1226
1.	Prior Literature .....	1226
2.	Data Sources and Sample Description .....	1229
3.	Time Trends and Industry Distribution .....	1232
4.	Types and Composition of Board Compliance Committees .....	1237
B.	Are Firms Required To Establish Compliance Committees? .....	1238
1.	Qualified Legal Compliance Committees.....	1239
2.	Prosecution Agreements .....	1240
C.	Why Might Firms Choose To Establish Compliance Committees? .....	1242
1.	Heightened Compliance Activity .....	1243
2.	Board Capacity .....	1245
3.	Learning Costs .....	1246
D.	Which Firms Do Establish Compliance Committees?.....	1247
1.	Regression Specification: Main Variables of Interest .....	1248
2.	Control Variables .....	1251
3.	Discussion of Results .....	1252
III.	Rethinking Board Compliance .....	1255
A.	Why Are Compliance Committees Not More Common? .....	1255
1.	Do Companies Invest Enough in Compliance? .....	1257
2.	Do Boards Have Sufficient Capacity? .....	1258
B.	Encouraging Board Compliance? .....	1260
1.	Regulatory Interventions To Strengthen Board Compliance .....	1261
2.	Expanding Board Capacity Through Corporate Governance Innovation .....	1264
3.	Toughening Director Liability Standards Under State Corporate Law .....	1267
	Conclusion .....	1271

## 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.<sup>1</sup> This turned out to be profitable, and the bank sought to maximize its rollout by setting branch staff powerful financial incentives to maximize sales of financial products to its customers.<sup>2</sup> 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.<sup>3</sup> After the Wells Fargo scandal broke, regulators identified numerous weaknesses in the firm’s compliance programs that had permitted the misconduct to go unchecked.<sup>4</sup> The bank ultimately paid about \$575 million in fines and settlements and fired over 5,000 employees; the CEO resigned after Congressional hearings.<sup>5</sup> In response, the Board commissioned an outside investigation into

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1. Consolidated Amended Verified Stockholder Derivative Complaint ¶ 1, *In re Wells Fargo & Co. S’holder Derivative Litig.*, 282 F. Supp. 3d 1074 (N.D. Cal. Oct. 4, 2017) (No. 16-05541) [hereinafter Wells Fargo Complaint] (alleging defendants “defrauded their customers in an attempt to drive up ‘cross-selling,’ i.e., selling complementary Wells Fargo banking products to prospective or existing customers”).

2. Proposed Order to Cease & Desist at 2, *In re Wells Fargo & Co.*, No. 18-007-B-HC (Bd. of Governors of the Fed. Reserve Sys., 2018) [hereinafter Wells Fargo Proposed Order] (“[T]he Firm pursued a business strategy that emphasized sales and growth without ensuring that senior management had established and maintained an adequate risk management framework commensurate with the size and complexity of the Firm, which resulted in weak compliance practices[.]”).

3. Wells Fargo Complaint, *supra* note 1, ¶¶ 1–2.

4. Wells Fargo Proposed Order, *supra* note 2, at 2.

5. Chris Arnold, *Wells Fargo Fires 5,000 Employees Over Fake Accounts*, NPR (Sept. 9, 2016), <https://www.npr.org/2016/09/09/493228759/wells-fargo-fires-5-000-employees-over-fake-accounts> [<https://perma.cc/H7X6-BD79>]; Emily Glazer, *Wells Fargo to Pay States About \$575 Million to Settle Customer Harm Claims*, WALL ST. J. (Dec. 28, 2018), <https://www.wsj.com/articles/wells-fargo-to-pay-states-about-575-million-to-settle-customer-harm-claims-11546016757>. The subsequent scrutiny brought other compliance problems to light. (“The bank has paid out more than \$4 billion in settlements and fines since September 2016, much of it stemming from problems that came to light following the sales scandal.”).

how this compliance failure happened on its watch.<sup>6</sup> 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 Lead Director, describing his "many pervasive and serious compliance and conduct failures."<sup>7</sup>

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 changes in corporate governance.<sup>8</sup> Amidst the notoriety attracted by these failures, have sanguine corporate boards taken on a more substantial oversight role in compliance? Surprisingly little literature exists on the role of boards in compliance.<sup>9</sup> 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 committee and independent board members, we suggest why boards continue to remain quite reluctant to supervise compliance more actively.<sup>10</sup>

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6. INDEP. DIRS. OF BD. OF WELLS FARGO & CO., SALES PRACTICES INVESTIGATION REPORT (Apr. 10, 2017), <https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf> [<https://perma.cc/UUQ5-8YMZ>].

7. John Heltman, *Fed Drops Hammer on Wells Fargo as Four Board Members Ousted*, AM. BANKER (Feb. 2, 2018), <https://www.americanbanker.com/news/fed-drops-hammer-on-wells-fargo-as-four-board-members-fired> [<https://perma.cc/E5V6-4TZC>]; see Wells Fargo Proposed Order, *supra* note 2.

8. See BRANDON L. GARRETT, TOO BIG TO JAIL: HOW PROSECUTORS COMPROMISE WITH CORPORATIONS 292–93 (2014) (detailing the top twenty corporate fines between 2001 and 2012).

9. See Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1134 (2003) (describing several business models which rely heavily on active monitoring by the board). For additional examples of board-solicited investigations into compliance breakdowns, see, for example, ANTON B. VALUKAS, REPORT TO BOARD OF DIRECTORS OF GENERAL MOTORS COMPANY (May 29, 2014), <https://www.aieg.com/wp-content/uploads/2014/08/Valukas-report-on-gm-redacted2.pdf> [<https://perma.cc/F2TQ-RG3R>].

10. See *infra* Part III.

In Part I, we introduce the field of compliance and the role of boards in supervising compliance. Compliance programs are internal enforcement programs, whereby firms train, monitor, and discipline employees with respect to applicable laws and regulations.<sup>11</sup> 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.<sup>12</sup> A firm’s compliance effort is also taken into consideration in deciding whether to prosecute the firm should misconduct emerge.<sup>13</sup> Prosecutors say they take into account the 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 (DOJ) has provided detailed guidance on compliance in this context.<sup>14</sup> A range of regulatory agencies similarly uses both carrots and sticks to encourage compliance.<sup>15</sup> The common

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11. See Veronica Root, *The Compliance Process*, 94 IND. L.J. 203, 205–09 (2019) (illustrating the various responsibilities of compliance programs using the example of the Twenty-First Century Fox and Fox News sexual harassment compliance program).

12. U.S. SENTENCING GUIDELINES MANUAL §§ 8C2.5–2.6 (U.S. SENTENCING COMM’N 2016).

13. U.S. DEP’T OF JUSTICE, CRIMINAL DIV., FRAUD SECTION, EVALUATION OF CORPORATE COMPLIANCE PROGRAMS (2014) [hereinafter EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2014], <https://www.justice.gov/criminal-fraud/page/file/937501/download> [<https://perma.cc/QJA8-SEEF>] (last updated Apr. 2019); U.S. DEP’T OF JUSTICE, CRIMINAL DIVISION, FRAUD SECTION, EVALUATION OF CORPORATE COMPLIANCE PROGRAMS (2017) [hereinafter EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2017] (on file with authors); see also U.S. DEP’T OF JUSTICE, U.S. ATTORNEYS’ MANUAL § 9-28.000 (2018) [hereinafter U.S. ATTORNEYS’ MANUAL], <https://www.justice.gov/archives/usam/archives/usam-9-28000-principles-federal-prosecution-business-organizations#9-28.800> [<https://perma.cc/Z42K-JF4T>].

14. See *supra* note 13.

15. See 31 C.F.R. §§ 501.601–606 (2018) (detailing reporting requirements for organizational compliance with the Office of Foreign Assets Control); Contractor Business Ethics Compliance Program and Disclosure Requirements, 73 Fed. Reg. 67,064, 67,091–67,092 (Nov. 12, 2008); Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 65 Fed. Reg. 19,618 (Apr. 11, 2000) (discussing the policies of the Environmental Protection Agency intended to prevent harm to human health and the environment by providing for reporting of violations); Press Release, Commodity Futures Trading Commission, Identifying Cooperation Factors That May Reduce a Litigant’s Sanctions (Aug. 11, 2004); Report of Investigation Pursuant to Section 21(a) of

theme is that even if employees engage in misconduct, the firm will receive more lenient treatment so long as it had put in place a meaningful compliance program.

Boards are formally responsible for oversight of corporations,<sup>16</sup> and directors owe their firms fiduciary duties of loyalty.<sup>17</sup> While these duties traditionally did not explicitly include compliance,<sup>18</sup> this changed in the mid-1990s, when Chancellor Allen delivered his well-known opinion in *Caremark*.<sup>19</sup> 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 “information and reporting systems . . . that are reasonably designed to pro-

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the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969 (Oct. 23, 2001) (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?”); IRS, GOVERNANCE AND RELATED TOPICS—501(c)(3) ORGANIZATIONS (2008), [https://www.irs.gov/pub/irs-tege/governance\\_practices.pdf](https://www.irs.gov/pub/irs-tege/governance_practices.pdf) [<https://perma.cc/LM6M-WYCM>] (“The organization’s governing body bears the ultimate responsibility for setting ethical standards and ensuring they permeate the organization and inform its practices.”).

16. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2019) (“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)).

17. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006); see also *Mills Acquisition 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.”).

18. 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).

19. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). See generally 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) (discussing the evolution of Delaware law relating to directors’ duty to oversee compliance following *Caremark* and other leading cases on the subject); Donald C. Langevoort, *Caremark and Compliance: A Twenty-Year Lookback*, 90 TEMPLE L. REV. 727 (2018) (reviewing subsequent developments since *Caremark*); Hillary A. Sale, *Monitoring Caremark’s Good Faith*, 32 DEL. J. CORP. L. 719 (2007) (detailing the history of the *Caremark* decision).

vide 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."<sup>20</sup>

Should such a system of oversight give an indication of problems—a so-called “red flag”—then the board is expected to take steps to investigate and take remedial action.<sup>21</sup> 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.<sup>22</sup> This means that liability is triggered only by a failure so egregious as to call into question the board's good faith.<sup>23</sup> The rationale is that the board, not the court, knows best how to pursue the firm's internal compliance activities.<sup>24</sup>

As we have seen, both fiduciary duty case law 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

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20. *Caremark*, 698 A.2d at 970.

21. *See Graham*, 188 A.2d at 130 (“[D]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong.”); *Okla. Firefighters Pension & Ret. Sys. v. Corbat*, No. 12151, 2017 WL 6452240, at \*7–10 (Del. Ch. Dec. 18, 2017); *Melbourne Mun. Firefighters’ Pension Tr. Fund v. Jacobs*, No. 10872, 2016 WL 4076369, at \*8–11 (Del. Ch. Aug. 1, 2016); *In re Massey Energy Co. Derivative & Class Action Litig.*, No. 5430, 2011 WL 2176479, at \*21 (Del. Ch. May 31, 2011) (“If the fiduciaries of a Delaware corporation do not like an applicable law . . . until it is changed, they must act in good faith to ensure that the corporation tries to comply with its legal duties.”); *cf. Wells Fargo Proposed Order*, *supra* note 2 (outlining expectations for the board to improve its compliance efforts).

22. *See Caremark*, 698 A.2d at 970 (stating that while the obligation to be well-apprised of the firm's compliant operations may be placed upon boards, the determination of specific means for monitoring are left to the judgment of the firm).

23. 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).

24. As Chancellor Allen stated in *Caremark*: “Obviously the level of detail that is appropriate for such an information system is a question of business judgment.” *Caremark*, 698 A.2d at 970.



through the CEO.<sup>25</sup> Little relevant guidance, however, prescribes any particular way in which firms should pursue their compliance oversight function.

One approach towards formalizing board oversight of compliance 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.<sup>26</sup> Given this mandatory oversight function in relation to internal financial controls, boards may see it as a natural extension to ask their audit committee also to oversee the company's more general compliance with applicable laws. Yet the range of issues raised by compliance with applicable laws generally is likely quite different from 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, separately from the audit committee, 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.<sup>27</sup> 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.

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25. See EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2019, *supra* note 13, at 10 (suggesting that one way prosecutors should measure effective implementation of compliance programs is whether "those responsible for compliance have . . . direct access to the board of directors").

26. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 746 (codified at 15 U.S.C. § 78j-1 (2012)).

27. See, e.g., STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 183-87 (2011) (describing, for example, weak management practices reaching the CEO and Board level at Washington Mutual).

Firms are not required to report details of their compliance activities and few, if any, make voluntary disclosures regarding compliance.<sup>28</sup> At the same time, practitioner surveys consistently report that compliance plays a growing influence in corporate life, including the boardroom.<sup>29</sup> 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.”<sup>30</sup> Others, however, are more skeptical, arguing that corporate law fiduciary duties do not sufficiently incentivize boards to engage with compliance.<sup>31</sup> Plausibly, common patterns of executive and director compensation may create incentives to under-invest in long-term compliance activities.<sup>32</sup> Further, some point to detailed provisions about compliance in deferred prosecution agreements (DPAs) that firms enter into with the authorities to avoid prosecution.<sup>33</sup>

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

29. See, e.g., PWC, PWC STATE OF COMPLIANCE STUDY 2016, at 3 (2016), <https://www.pwc.se/sv/pdf-reports/state-of-compliance-study-2016.pdf> [<https://perma.cc/737K-PH4L>] (detailing the increasing trend towards board member involvement in compliance efforts).

30. See Stavros Gadinis & Amelia Miazad, *The Hidden Power of Compliance*, 103 MINN. L. REV. 2135, 2146 (2019) (describing “explosive growth of compliance departments” over the past decade); Griffith, *supra* note 28, at 2077 (“American corporate governance has undergone a quiet revolution. Much of its basic role . . . has been overtaken by compliance.”).

31. See Mercer Bullard, *Caremark’s Irrelevance*, 10 BERKELEY BUS. L.J. 15, 27, 50–51 (2013) (arguing factors such as declining stock price and personal criminal liability are more influential on corporate actors than the risk of private liability under *Caremark*); Langevoort, *supra* note 19, at 739–41 (suggesting board members’ compliance incentives may be at odds with their responsibilities to the organization’s financial well-being in situations where corporate malfeasance has already occurred); John Armour et al., *Taking Compliance Seriously*, 37 YALE J. REG. 1, 45–47 (2020); cf. W. Robert Thomas, *The Ability and Responsibility of Corporate Law to Improve Criminal Fines*, 78 OHIO ST. L.J. 601, 647–50 (2017) (suggesting a corporate clawback bylaw would better incentivize officers to prioritize compliance efforts).

32. See Armour et al., *supra* note 31, at 31–38.

33. See Jennifer Arlen, *Removing Prosecutors from the Boardroom: Limiting Prosecutorial Discretion to Impose Structural Reforms*, in PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT 62, 76–81 (Anthony S. Barkow & Rachel E. Barkow eds., 2011) (describing the dual purposes of DPAs as both detection and sanctioning of wrongs, and intervention in affairs of unconvicted corporations to ensure compliance); Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation through Nonprosecution*, 84 U. CHI. L. REV. 323, 355–58 (2017) (referring to deferred prosecution

These commonly prescribe enhancements to compliance programs, and sometimes mention board oversight.<sup>34</sup> 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 make 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 Part II, we present our empirical results and explore the results in light of prior literature. 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 the hypotheses developed in Part I using director-level data from BoardEx and data on federal organizational prosecutions from the Duke University and University of Virginia Corporate Prosecution Registry.<sup>35</sup> 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 percent of U.S. public companies have established a separate Compliance Committee.<sup>36</sup> In other words, the

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agreements as “pretrial diversion agreements” in their discussion of the role of prosecutorial tools in influencing corporate compliance); James R. Copeland, *The Shadow Regulatory State: The Rise of Deferred Prosecution Agreements*, 14 CIV. JUST. REP., May 2012, at 1; Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 854–61 (2007) (describing the use of DPAs as a “spur for institutional reform”).

34. See 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 framework” of business crime); Garrett, *Structural Reform Prosecution*, *supra* note 33, at 886–902 (providing data on the 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 BUS. LAW. 61, 82–84, 92–99 (2014) (discussing the use of deferred prosecution agreements to effectuate changes in corporate governance and providing data on the growing use of DPAs between 1993 and 2013).

35. Jon Ashley & Brandon L. Garrett, *Corporate Prosecution Registry*, DUKE U. L. & UVA L. LEGAL DATA LAB, <http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/index.html> [<https://perma.cc/7U29-3EGU>].

36. See discussion *infra* Part II.

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vast bulk of public company boards do not have a stand-alone 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 (CC) and audit committee (AC) charters. These suggest material differences: CCs are expected to engage in much more focused oversight of compliance policies and personnel than typical ACs. Moreover, interviews with practitioners suggest board members view setting up a CC as a significant matter.<sup>37</sup> Boards work under tight time constraints, and so there is a real opportunity cost to adding a CC: 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. 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 CCs. Yet this is not because prosecutors tell them to. In a comprehensive dataset of 374 DPAs and plea bargains entered into by public companies from 2001 onwards,<sup>38</sup> only five agreements (less than two percent) actually stipulate the creation of some kind of board compliance committee. Rather, the link appears indirect. Prosecutors 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 when compliance might be very important to a particular type of

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37. This is based on our confidential interviews with compliance professionals at S&P 500 companies at the beginning of the project.

38. Ashley & Garrett, *supra* note 35.

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firm, firms 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 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 outside experience of board compliance oversight 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 suggests that experience matters, consistent with the general literature of diffusion of innovations. Moreover, it suggests that these directors' experience of board compliance is generally *positive*, as it increases the likelihood of adoption by other boards on which they serve. Why, then, are compliance committees not more widely adopted?

Fourth, we find that firms with compliance committees tend to be larger and find suggestive evidence that they have bigger boards. This reinforces the idea that compliance oversight entails real costs for the firms: bigger firms have more capacity for compliance expenditures; bigger boards can more easily manage the use of board resources.<sup>39</sup> This may mean that boards often lack the capacity to do compliance oversight other than as an AC addendum.

Taken together, 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.<sup>40</sup> A small board lacks resources for sufficient compliance oversight, and it also creates a baseline in which adoption of a CC signals that the board believes the firm has an

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39. 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.

40. See, e.g., Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 293–94 (1980) (providing agency theory for adoption of small boards, as well as independent directors).

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above-average compliance problem, which may negatively affect stock price. The desire to avoid giving such a signal could become a reason for a board not to establish a CC, even when such a committee would be warranted.

In Part III, 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 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.

In summary, in Part I, we 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.

## 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.”<sup>41</sup> 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 its fiduciary relationship, and more specifically, through the creation of compliance committees.

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41. See *infra* Part I.A.2 (discussing effective compliance programs).

## 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.<sup>42</sup> Similarly, 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.<sup>43</sup> And laws prohibiting bribery and corruption, such as the Foreign Corrupt Practices Act of 1977 (FCPA), seek to prevent firms from undermining the functioning of public institutions.<sup>44</sup>

For regulation to succeed in making companies internalize the social costs of their activities, however, there must be enforcement.<sup>45</sup> Where the probability of enforcement is low, 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.<sup>46</sup> Wells Fargo has also been subjected to an order by the Federal Reserve freezing its growth until compliance failures are remedied, and the company has paid more than \$575 million in fines and settlements to the Office of the Comptroller of the Currency, the Consumer Financial Protection Bureau, the Securities and

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42. See, e.g., Clean Air Act, 42 U.S.C. § 1252 (2012); Clean Water Act, 33 U.S.C. § 7401 (2012).

43. See, e.g., 29 U.S.C. § 651(b)(3) (2012) (“[A]uthorizing the Secretary of Labor to set mandatory occupational safety and health standards applicable to businesses affecting interstate commerce.”).

44. Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78dd-1 to -3 (2012).

45. 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.

46. Ed Crooks, *BP Draws Line Under Gulf Spill Costs*, FIN. TIMES (July 14, 2016), <https://www.ft.com/content/ff2d8bcc-49e9-11e6-8d68-72e9211e86ab> [<https://perma.cc/J9WX-KZYF>].

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Exchange Commission, the DOJ, and the States.<sup>47</sup> 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.<sup>48</sup> 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.<sup>49</sup> 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 in a cheaper way 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.<sup>50</sup> 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.<sup>51</sup> If the effect on expected liabilities is ambiguous, it may be hard for managers to justify expenditure on compliance programs.<sup>52</sup>

### 1. Regulating Compliance

To generate additional incentives to adopt compliance programs, firms are offered explicit discounts to any penalties that

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47. Wells Fargo Proposed Order, *supra* note 2; Glazer, *supra* note 5.

48. See, e.g., GARRETT, *supra* note 8, at 42 (describing the perception that federal prosecutors were responsible for destroying Arthur Andersen).

49. See *id.* at 252 (describing remarks by then Attorney General Eric Holder stating that a prosecution of a financial firm could have negative effects on the United States and world economy).

50. See Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUDS. 833, 846 (1994) (indicating increased corporate enforcement would reduce corporate crimes).

51. See *id.* at 836 (concluding that increasing enforcement expenditures would increase the probability of detection).

52. See *id.* (discussing conflicting incentives created under enforcement expenditures).



might be imposed for misconduct, if they had previously implemented an effective compliance program.<sup>53</sup> These incentives are delivered generally in the form of a discount to sentencing under the Federal Sentencing Guidelines,<sup>54</sup> a factor to be taken into consideration in deciding whether to prosecute a corporation,<sup>55</sup> and guidance for various government agencies assessing whether to exclude a convicted firm from procurement opportunities.<sup>56</sup>

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,<sup>57</sup> checks regarding the making of corrupt payments for all firms,<sup>58</sup> internal controls over the production of financial information for publicly-traded firms,<sup>59</sup> and a set of

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53. See U.S. SENTENCING GUIDELINES MANUAL, *supra* note 12, § 8C2.5(f) (subtracting culpability score if the organization had an effective compliance program). This was introduced generally in 1991, with the adoption of the Organizational Sentencing Guidelines, and earlier in certain regulatory settings.

54. *Id.*

55. See U.S. ATTORNEYS' MANUAL, *supra* note 13 (discussing factors prosecutors should consider when evaluating compliance programs); EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2019, *supra* note 13 (same); EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2017, *supra* note 13 (same).

56. See FAR 9.406-1(a), .407-1(a)(2) (2018) (listing factors the official should consider). 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.

57. See Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2012) (regulating safeguards against insider trading by personnel); Foreign Bank Secrecy Act of 1970, 31 U.S.C. § 5318(h) (2012) (regulating anti-money laundering programs); 12 C.F.R. § 21.21 (2019) (regulating procedures for monitoring compliance); 12 C.F.R. § 44.20(a), (c) (2019) (regulating requirements and enhanced requirements for bank compliance programs); 12 C.F.R. § 44 app. B (2019) (regulating enhanced minimum standards for compliance programs).

58. See Foreign Corrupt Practices Act of 1977, 15 U.S.C. § 78dd-1 to -3 (2012) (regulating prohibited foreign trade practices).

59. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 789 (codified at 15 U.S.C. § 7262 (2012)) (regulating management assessment of internal controls); Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release Nos. 33-8,238, 34-47,986 (effective Aug. 14, 2003), <https://www.sec.gov/rules/final/33-8238.htm> [<https://perma.cc/JU8C-AUJ2>] (same).

model compliance program guidelines for clinical laboratories.<sup>60</sup> 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 board-level 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 the costs of avoiding and detecting such misconduct.<sup>61</sup> In practice, companies can and are encouraged to use a variety of techniques to evaluate the effectiveness of compliance efforts, ranging from internal audits and data analytics, to employee surveys and external assessments. There is little consensus as to how compliance should be achieved.<sup>62</sup>

In some industry surveys, large numbers of companies, in a Lake Wobegon fashion, view their compliance as “well above average relative to . . . their peers.”<sup>63</sup> Yet despite much exhortation, especially from professional consultants who offer to assist in designing compliance programs, relatively little is known about what these compliance programs actually entail and how their quality should be assessed.<sup>64</sup> When industry participants speak of “effective compliance programs,” they may refer to programs that meet the expectations of the authorities. Although

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60. See Publication of the OIG Model Compliance Plan for Clinical Laboratories, 62 Fed. Reg. 9435 (1997).

61. Geoffrey P. Miller, *An Economic Analysis of Effective Compliance Programs*, in RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING 247 (Jennifer Arlen ed., 2018) (exploring the economic meaning of effective compliance programs).

62. See, e.g., Donald C. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 933 (2017) (introducing different opinions); 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”).

63. See, e.g., PWC, 2018 STATE OF COMPLIANCE STUDY 7, <https://www.pwc.com/sk/en/assets/PDFs/2018-state-of-compliance.pdf> [<https://perma.cc/4MZJ-ZPZV>] (reporting that 85% of respondent corporations rated their compliance as well above average relative to their peers).

64. See Langevoort, *supra* note 62, at 933 (questioning about compliance programs). A study of federal DPAs from 2001 through 2012 found that less than a quarter of them (22% or 55 of 255 agreements) actually required the company to assess how effectively its compliance program was functioning. See GARRETT, *supra* note 8, at 75 (presenting the study result).

meeting these requirements is *deemed* by the authorities to be “effective,” it does not necessarily follow that they are *actually* effective in the sense of minimizing the sum of the costs of misconduct and the costs of avoiding and detecting such misconduct.<sup>65</sup>

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.<sup>66</sup> 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 DPAs.<sup>67</sup> When a DPA is entered into, the firm is not formally prosecuted and is never sentenced under the Guidelines.<sup>68</sup>

How, then, do compliance programs get taken into account in the prosecution decision? Public statements about compliance

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65. For critiques of the current approach, see, for example, Todd Haugh, *The Criminalization of Compliance*, 92 NOTRE DAME L. REV. 1215 (2017) (criticizing approaching compliance through a criminal law lens); Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949 (2009) (proposing a new regime to change the current model); and compare with Daniel C. Richman, *Corporate Headhunting*, 8 HARV. L. & POLY REV. 265, 277 (2014) (indicating that the practice of deferred prosecution agreements is only a few decades old and so it may be too soon to evaluate the long-term impact).

66. U.S. SENTENCING COMM’N SOURCEBOOK, TABLE 54: ORGANIZATIONS SENTENCED UNDER CHAPTER EIGHT: CULPABILITY FACTORS (2009–2012), <https://www.ussc.gov/research/sourcebook/archive> [<https://perma.cc/VR2F-4N23>].

67. The rise of DPAs as the preferred technique for prosecutors dealing with large public corporate defendants in the United States has been well-documented. See, e.g., GARRETT, *supra* note 8, at 82 (presenting the chart showing dealings under DPAs).

68. See U.S. ATTORNEYS’ MANUAL, *supra* note 13, § 9-28.200 (“In certain instances, it may be appropriate to resolve a corporate criminal case by means other than indictment . . . DPAs], for example, occupy an important middle ground between declining prosecution and obtaining the conviction of a corporation.”).

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?<sup>69</sup>

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.”<sup>70</sup>

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 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.<sup>71</sup> The DOJ's Criminal Fraud

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69. *Id.* § 9-28.800.

70. *Id.*

71. Assistant Attorney General Brian A. Benczkowski, Dep't of Justice, Remarks at N.Y.U. School of Law Program on Corporate Compliance and Enforcement Conference on Achieving Effective Compliance (Oct. 12, 2018), <https://www.justice.gov/opa/speech/assistant-attorney-general-brian-benczkowski-delivers-remarks-nyu-school-law-program> [<https://perma.cc/5BZJ-CXV5>].

Section published this guidance in 2017,<sup>72</sup> with an updated version in April 2019,<sup>73</sup> titled “Evaluation of Corporate Compliance Programs.” The guidance contains a list of “common questions” and “sample topics” but not any definitive guide, emphasizing prosecutors must make an “individualized determination” in each case.<sup>74</sup>

### 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.<sup>75</sup> 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.<sup>76</sup> One argument for an independent compliance function is that locating compliance outside of management, apart from the CEO and General Counsel, and reporting to the organization’s board, can assure an independent and outside perspective.<sup>77</sup> Another is that instilling an effective culture of compliance may necessitate a focus that is not strictly legalistic but rather that seeks to foster ethical behavior in employees.<sup>78</sup> In smaller and non-public companies, resource constraints may force both roles to be located in the same office and person. In large and public

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72. EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2017, *supra* note 13.

73. EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2019, *supra* note 13.

74. *Id.* at 1–2.

75. See, e.g., Michele DeStefano, *Creating a Culture of Compliance: Why Departmentalization May Not Be the Answer*, 10 HASTINGS BUS. L.J. 71, 101 (2014) (indicating that a compliance professional is not necessarily a legal professional).

76. See Tanina Rostain, *General Counsel in the Age of Compliance: Preliminary Findings and New Research Questions*, 21 GEO. J. LEGAL ETHICS 465, 469 (2008) (raising questions “about the role of in-house counsel in implementing and overseeing compliance mechanisms inside the corporation”).

77. *Cf. id.* at 471 (indicating that in-house lawyers had compromised their independence by moving inside).

78. See, e.g., CHRISTOPHER HODGES & RUTH STEINHOLTZ, *ETHICAL BUSINESS PRACTICE AND REGULATION: A BEHAVIOURAL AND VALUES-BASED APPROACH TO COMPLIANCE AND ENFORCEMENT* 214–36 (2017) (proposing an ethical approach to compliance).

companies, though, there is a debate about what structure is preferable.<sup>79</sup>

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.<sup>80</sup> 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.<sup>81</sup> 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.<sup>82</sup> While most employees have natural instincts to be

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79. See Michael W. Peregrine, *Seeking Clarity at the Crossroads of Legal and Compliance*, CORP. COUNS. (Sept. 18, 2014), <https://s3-us-east-2.amazonaws.com/mwe.media/wp-content/uploads/2019/04/05161327/cc091814.pdf> [<https://perma.cc/G9TH-E5YT>] (discussing the debate). Compare DeStefano, *supra* note 75, at 155 (“Departmentalizing compliance from legal so as to remove general counsel oversight of compliance may not necessarily be in the public’s best interest.”), with Rostain, *supra* note 76, at 490 (suggesting “the general counsel may be well positioned to play a significant gatekeeping role in their companies”).

80. The experience and qualifications of the Chief Compliance Officer (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.

81. EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2019, *supra* 13, at 13 (“Has the company considered the implications of its incentives and rewards on compliance? How does the company incentivize compliance and ethical behavior? Have there been specific examples of actions taken (*e.g.*, promotions or awards denied) as a result of compliance and ethics considerations? Who determines the compensation, including bonuses, as well as discipline and promotion of compliance personnel?”).

82. See Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. Rev. 687, 702–

concerned with these issues, internal ethical or safety concerns can be crowded out by sufficiently strong financial incentives.<sup>83</sup> 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.

In Part I.A, we have seen that firms are given incentives by regulators and prosecutors to establish internal compliance programs. Prosecutors give guidance on what they look for in an “effective” compliance program. Fully implementing this may be costly for firms. Although firms extol the virtues of their compliance programs, relatively little is known about their actual success in reducing the incidence of misconduct.

## 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. First, the prosecution and sentencing guidelines discussed in Part I.A, insofar as they pertain specifically to the role of the board, which we review in Part I.B.1. Second, developments in directors’ corporate law fiduciary duties, which we review in Part I.B.2. We then discuss in Part I.B.3 how board oversight of compliance may entail mediating conflict between senior executives and the firms’ compliance function.

### 1. Expectations of the Board from Prosecutors

As described in Part I.A.2, leniency in prosecution and sentencing decisions has been a primary impetus for corporate compliance programs. The relevant guidance sets expectations specifically about the role of the board in overseeing compliance programs. Consider first the organizational sentencing guidelines, which inform prosecution decision-making, in addition to judicial sentencing. These were amended in 2010 to highlight

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04 (1997) (noting the significance of employee compensation and promotion policies for efficacy of compliance programs).

83. See Sverre Grepperud & Pal Andreas Pedersen, *Crowding Effects and Work Ethics*, 20 LABOUR 125 (2006) (analyzing effects of monetary rewards on intrinsic motivation).

board responsibility.<sup>84</sup> Section 8B2.1(b)(2)(A) now requires the board to “be 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.”<sup>85</sup>

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.<sup>86</sup> 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.<sup>87</sup> 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.”<sup>88</sup> Thus, the Guidelines reward board involvement in compliance.

Turning to guidance from prosecutors, the DOJ’s *Evaluation of Corporate Compliance Programs*, in the section titled “Oversight,” emphasizes the role of the board.<sup>89</sup> It asks: “What compliance expertise has been available on the board of directors?”<sup>90</sup> 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

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84. See U.S. SENTENCING GUIDELINES MANUAL, *supra* note 12, ch. 8.

85. *Id.* § 8B2.1(b)(2)(A). Although the Guidelines refer specifically to a “governing authority,” this is taken to mean the board, if the company has one. *Id.* § 8B2.1 cmt. 1 (“‘Governing authority’ means the [sic] (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.”).

86. *Id.* § 8B2.1(b)(2)(C) (“Specific individual(s) within the organization shall be delegated day-to-day operational responsibility for the compliance and ethics program. Individual(s) with operational responsibility shall report periodically to high-level personnel and, as appropriate, to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program.”).

87. *Id.* § 8C2.5(f)(3)(C)(i)–(iii).

88. *Id.* § 8B2.1(b)(2)(C).

89. EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2017, *supra* note 13.

90. *Id.*



oversight in the area in which the misconduct occurred?”<sup>91</sup> 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?”<sup>92</sup>

## 2. Compliance and Directors’ Fiduciary Duties

As a matter of state organizational law, directors have a fiduciary duty to engage in some level of compliance oversight.<sup>93</sup> The narrowest conception is a duty to act when 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.<sup>94</sup> 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.<sup>95</sup> Notice, though, that the extent of this *ex post* duty depends crucially on the quality of the information coming to the board.<sup>96</sup> To what extent does 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*,<sup>97</sup>

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91. *Id.*

92. *Id.* at 3.

93. *See, e.g.*, Reiter v. Fairbank, C.A. No. 11693-CB, 2016 WL 6081823, at \*1 (Del. Ch. Oct. 18, 2016).

94. *See In re Wells Fargo & Co. S’holder Derivative Litig.*, 282 F. Supp. 3d 1074, 1107 (N.D. Cal. 2017) (citing *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006)); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963); *Okla. Firefighters Pension & Ret. Sys. v. Corbat*, C.A. No. 12151-VCG, 2017 WL 6452240, at \*1 (Del. Ch. Dec. 18, 2017); *Melbourne Mun. Firefighters’ Pension Tr. Fund v. Jacobs*, C.A. No. 10872-VCMR, 2016 WL 4076369, at \*7 (Del. Ch. Aug. 1, 2016) (citing *Stone*, 911 A.2d at 370); *In re Massey Energy Co. Derivative & Class Action Litig.*, C.A. No. 5430-VCS, 2011 WL 2176479, at \*22 n.157 (Del. Ch. May 31, 2011) (citing *Stone*, 911 A.2d at 370).

95. *See, e.g.*, U.S. SENTENCING GUIDELINES MANUAL, *supra* note 12, § 8C2.5(f).

96. *See cases cited supra* note 94.

97. 698 A.2d 959 (Del. Ch. 1996).

directors have also been expected to ensure some system of oversight is implemented in the first place. As Chancellor Allen explained:

[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.<sup>98</sup>

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[.]”<sup>99</sup> Or, as it was subsequently put by the Delaware Supreme Court in *Stone v. Ritter*: “(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.”<sup>100</sup>

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. But what consists in effective or sound compliance—or its oversight—is left unstated.<sup>101</sup>

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98. *Id.* at 970.

99. *Id.* at 971.

100. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

101. See *Armour et al.*, *supra* note 31, at 45–47. Recent cases suggest the emergence of an affirmative duty of board-level compliance oversight where the firm is subject to a comprehensive regulatory scheme applicable to an essential feature of its business, for example, *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019) (concerning food safety regulation for core product), or where the firm is subject to a specific compliance decree entered into to resolve a prior regulatory failure, for example, *In re Facebook, Inc. Sec. 220 Litig.*, Consolidated C.A. No. 2018-0661-JRS, 2019 WL 2320842, at \*2 (Del. Ch. May 31, 2019) (declaring that where a board fails to oversee compliance with a consent decree, “Delaware courts traditionally have viewed stockholder allegations that a board failed to oversee the company’s obligation to comply with positive law, or positive regulatory mandates, more favorably in the *Caremark* paradigm than allegations

### 3. Boards' Role in Mediating Conflict over Compliance

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 prioritized 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.<sup>102</sup> This can create conflict over the establishment of a compliance program, and over how such a program is run.<sup>103</sup> 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.<sup>104</sup> All other things equal, whether the firm thinks it is appropriate to invest in compliance is a function of the likelihood of enforcement.<sup>105</sup> Consequently, a firm that discloses a compliance program signals that it anticipates it has a relatively high chance of attracting enforcement.<sup>106</sup> 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:<sup>107</sup> the net effect of

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that a board failed to oversee the company's efforts generally to avoid business risk").

102. See, e.g., Steven N. Kaplan, *CEO Pay and Corporate Governance in the U.S.: Perceptions, Facts, and Challenges*, 25 J. APPLIED CORP. FIN. 8, 15 (2013).

103. See Arlen & Kahan, *supra* note 33, at 354–57; Armour et al., *supra* note 31, at 20–31.

104. See Armour et al., *supra* note 31, at 4.

105. See, e.g., *id.* at 13–14.

106. *Id.* at 29–30.

107. The presence of an effective compliance program can reduce a firm's penalty by between sixty to eighty percent. See U.S. SENTENCING GUIDELINES MANUAL, *supra* note 12, §§ 8C2.5(f), 8C2.6.

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.<sup>108</sup> Consistent with this proposition, firms do not voluntarily disclose any meaningful information about their compliance activity.<sup>109</sup>

Conflicts are also likely to emerge in the running of a compliance program. If misconduct is detected, a manager believing there to be a low probability of enforcement may seek to cover up the misconduct, so as to avoid an adverse impact on the stock price.<sup>110</sup> Chief Compliance Officers may find themselves sidelined 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 the board.<sup>111</sup>

The board is increasingly viewed as a forum for resolving such conflicts.<sup>112</sup> 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.<sup>113</sup> Boards are ex-

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108. *See id.*; Armour et al., *supra* note 31, at 5.

109. Griffith, *supra* note 28, at 2138–39. Our own searches of EDGAR filings turned up no meaningful information about corporate compliance activity.

110. *See* Armour et al., *supra* note 31, at 12 n.50.

111. EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2019, *supra* note 13, at 11 (“Do the compliance and relevant control functions have direct reporting lines to anyone on the board of directors and/or audit committee? How often do they meet with directors?”).

112. *See, e.g.*, Martin Lipton et al., *Risk Management and the Board of Directors*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 20, 2018), <https://corp.gov.law.harvard.edu/2018/03/20/risk-management-and-the-board-of-directors-5/> [<https://perma.cc/DS5R-CGUR>] (describing the board's oversight role).

113. EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2017, *supra* note 13, at 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-

pected to understand the goals and operation of their firm's compliance function, which should be supported by regular reporting and a clear flow of information.<sup>114</sup> 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 an open upward transmission of information.<sup>115</sup> The DOJ guidance cites to such communication as relevant both to oversight and autonomy.<sup>116</sup>

The board's role in managing conflict between the firm's compliance function and other senior executives lies outside traditional accounts of corporate governance.<sup>117</sup> Most 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.<sup>118</sup> To this end, much emphasis is placed on the need for directors to be independent of executives, to buttress against conflicts of interest.<sup>119</sup> In overseeing compliance, the boards are monitoring the executives' resourcing and implementation of the firm's compliance program and the management of conflicts between compliance needs and the pursuit of strategic goals.<sup>120</sup> Because of the financial implications of compliance, resolving such conflicts in accordance with regulatory guidance regarding best practice is ultimately in the interests of shareholders.

### C. BOARD STRUCTURE AND COMPLIANCE OVERSIGHT

Neither the DOJ guidance nor corporate law specifies the process through which the board should exercise compliance

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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.").

114. See, e.g., EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2017, *supra* note 13, at 2–3.

115. EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2019, *supra* note 13, at 10.

116. *Id.* at 4 ("Another hallmark of a well-designed compliance program is appropriately tailored training and communications.").

117. Griffith, *supra* note 28, at 2081.

118. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHER, THE ECONOMIC STRUCTURE OF CORPORATE LAW 91–93 (1991); John Armour et al., *The Basic Governance Structure: The Interests of Shareholders as a Class*, in THE ANATOMY OF CORPORATE LAW 41, 50 (3d ed. 2017).

119. See, e.g., Armour et al., *supra* note 118, at 62–67.

120. See, e.g., *id.*

oversight.<sup>121</sup> But the choice of process may matter. In Part I.C.1, we introduce two distinct ways in which a board can handle compliance oversight: first, by adding compliance oversight to the remit of its existing audit committee, or second, by establishing a distinct compliance committee. In Part I.C.2, we suggest that the choice between these alternatives is not simply a cosmetic matter, but may affect both the intensity of compliance oversight and the cost to the company. In Part I.C.3, we support this view with evidence about the way in which AC and CC charters allocate compliance oversight tasks. In Part I.C.4, we present case studies of boards that have established CCs.

### 1. Compliance Oversight and Board Committees

Because public companies are required to establish an AC, which has responsibility for internal financial controls,<sup>122</sup> many firms simply append compliance to the AC'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.<sup>123</sup>

The core remit of the AC is essentially to oversee the company's relationship with its auditors.<sup>124</sup> This makes ACs an important component in the Sarbanes-Oxley 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, ACs 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 (SOX) requires U.S. public

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121. See, e.g., EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2019, *supra* note 13; cases cited *supra* note 101.

122. Standards Relating to Listed Company Audit Committees, Securities Act of 1933 Release No. 33-8220 (Apr. 9, 2003).

123. See Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267, 273–74 (2004).

124. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 2, 116 Stat. 745, 747 (codified at 15 U.S.C. § 7220 (2012)).

companies to have audit committees staffed entirely by independent directors.<sup>125</sup>

It is easy to see that the AC's function could lend itself to becoming the channel through which the board exercises compliance oversight. Both ACs and CCs 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.<sup>126</sup> For this reason, many companies simply task their AC with oversight of the firm's compliance programs in general, as well as the core, and more specific, role of oversight of financial controls.<sup>127</sup>

On the other hand, some firms have established distinct CCs, likewise composed of independent directors.<sup>128</sup> When staffed with different personnel from the AC, 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 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 AC as the "Audit and Compliance Committee," reflecting a difference in emphasis as respects expertise and role.<sup>129</sup>

## 2. Board Time as a Scarce Resource

We have seen that while some boards deal with compliance oversight by adding it to the list of the AC's responsibilities, others choose to establish a separate CC to handle compliance. What difference does it make whether a board routes compliance

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125. *Id.* § 301.

126. See Cunningham, *supra* note 123, at 273–74.

127. See *id.* at 301–06 (describing certain companies' implementation of internal auditing controls).

128. For examples, see *infra* Part I.C.3.

129. See Deloitte, *Boards: Understand the Rules for Ethics and Compliance Oversight*, WALL STREET J.: RISK & COMPLIANCE J. (May 2, 2018), <https://deloitte.wsj.com/riskandcompliance/2018/05/02/boards-understand-the-rules-for-ethics-and-compliance-oversight/> [<https://perma.cc/TY7Q-DEPF>] (noting also that "NYSE-listed companies are required to have the audit committee oversee legal and regulatory compliance").

oversight through its AC 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.<sup>130</sup> 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.<sup>131</sup> 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 on Compliance Oversight Intensity 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 AC’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.<sup>132</sup> In contrast, a typical audit committee will be expected

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130. Joann S. Lublin, *Small Boards Get Bigger Returns*, WALL STREET J. (Aug. 26, 2014), <https://www.wsj.com/articles/smaller-boards-get-bigger-returns-1409078628> [<https://perma.cc/Q63U-LHUC>].

131. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 2, 116 Stat. 745, 751 (codified at 15 U.S.C. § 7220 (2012)).

132. See, e.g., CIGNA, COMPLIANCE COMMITTEE CHARTER (2019); GOLDMAN SACHS BDC, INC., COMPLIANCE COMMITTEE CHARTER (2013); GOODYEAR TIRE



to perform oversight functions mainly regarding financial matters.<sup>133</sup> 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 beyond financial matters. Both CC and AC mandates will typically confer the power to retain legal and other external experts as necessary to assist the committee.<sup>134</sup> Some CC mandates also confer power to initiate and conduct internal investigations into compliance,<sup>135</sup> although this is by no means universal.<sup>136</sup>

To lend context to our discussion of the way in which boards allocate compliance oversight responsibility to their committees, we conclude this Part with a discussion of three case studies of firms that have chosen to establish distinct CCs.

#### 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.

*LendingClub.* The board of peer-to-peer lender LendingClub 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

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& RUBBER CO., COMMITTEE ON CORPORATE RESPONSIBILITY AND COMPLIANCE CHARTER (2017); PG&E CORP., COMPLIANCE AND PUBLIC POLICY COMMITTEE CHARTER 2 (2019); QUEST DIAGNOSTICS INC., QUALITY, SAFETY & COMPLIANCE COMMITTEE CHARTER (2018); SW. AIRLINES CO., SAFETY AND COMPLIANCE OVERSIGHT COMMITTEE CHARTER (2019) (on file with authors).

133. See, e.g., MERCK, AUDIT COMMITTEE CHARTER ¶¶ 6–7, 11 (2019), <https://www.merck.com/about/leadership/board-of-directors/Charter%20-%20Audit%20Committee%20-%20May%202019.pdf> [<https://perma.cc/8DVQ-CFRR>].

134. CIGNA, *supra* note 132, at 2; GOLDMAN SACHS BDC, INC., *supra* note 132, at 3; GOODYEAR TIRE & RUBBER CO., *supra* note 132, at 2; PG&E CORP., *supra* note 132, at 4; QUEST DIAGNOSTICS INC., *supra* note 132, at 3; cf. SW. AIRLINES CO., *supra* note 132, at 2 (specifying the committee may consult with outside counsel).

135. CIGNA, *supra* note 132, at 2; QUEST DIAGNOSTICS, INC., *supra* note 132, at 2.

136. See, e.g., GOLDMAN SACHS BDC, INC., *supra* note 132; GOODYEAR TIRE & RUBBER CO., *supra* note 132; PG&E CORP., *supra* note 132 (making no mention of investigations); SW. AIRLINES CO., *supra* note 132, at 2 (“It is not the Committee’s responsibility to conduct investigations . . .”).

\$22 million in loan sales was brought to the attention of the LendingClub board.<sup>137</sup> The board's response was "swift and decisive," including procuring the prompt resignation of the company's founder-CEO.<sup>138</sup> The board then assigned investigation of what had gone wrong to a newly-formed board committee of independent directors, which retained outside counsel.<sup>139</sup> 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.<sup>140</sup> Thus, the LendingClub 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.<sup>141</sup> However, this hands-on Board engagement with compliance did not result in creation of an on-going compliance committee.

*AIG.* An 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.<sup>142</sup> In the mid-2000s AIG faced prosecution for manipulating its financial statement through use of reinsurance to create income.<sup>143</sup> *Before*

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137. Peter Rudegeair, *LendingClub CEO Fired Over Faulty Loans*, WALL STREET J., May 9, 2016.

138. LendingClub Corp., Current Report (Form 8-K) (May 6, 2016).

139. *Id.* at 5.

140. *Id.*; LendingClub, Corp., Current Report (Form 8-K) (June 22, 2016); SEC Charges Lending Club Asset Management and Former Executives with Misleading Investors and Breaching Fiduciary Duty, Sec. & Exch. Comm'n, Press Release 2018-223 (Sept. 28, 2018) [hereinafter SEC Press Release], <https://www.sec.gov/news/press-release/2018-223> [<https://perma.cc/6EKZ-76CV>].

141. SEC Press Release, *supra* note 140.

142. Daniel Hays, *AIG Pays \$1.64 Billion To Settle Fraud Charges with State, Federal Regulators*, PROP. CASUALTY 360 (Feb. 12, 2006), <https://www.propertycasualty360.com/2006/02/12/aig-pays-1-64-billion-to-settle-fraud-charges-with-state-federal-regulators/?slreturn=20190826184258> [<https://perma.cc/5K68-JAHC>].

143. See Non-Prosecution Agreement, U.S. Dep't of Justice & AIG Financial Products Corp. (Nov. 30, 2004), <http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/aig-fp.pdf> [<https://perma.cc/6TJJ-WZ97>].

entering into a non-prosecution agreement, it created two board committees to focus on compliance and regulation.<sup>144</sup> 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.”<sup>145</sup> 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.<sup>146</sup> The Compliance Committee Charter for Las Vegas Sands Corp. specifies that the three directors on the committee shall all be independent directors.<sup>147</sup> That committee meets at least four times a year, but with similar oversight responsibilities (although a specified focus on gaming law compliance and anti-corruption and money laundering law).<sup>148</sup> When Las Vegas Sands was 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.”).<sup>149</sup>

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144. *AIG Restructures Its Executive Governance, Adds 2 Outside Directors to Board*, INS. J. (Apr. 21, 2005), <https://www.insurancejournal.com/news/national/2005/04/21/54166.htm> [<https://perma.cc/EXQ7-DQ6D>].

145. Joann S. Lublin, *Compliance Panels Slowly Take Hold*, WALL STREET J. (Jan. 9, 2006), <https://www.wsj.com/articles/SB113676266099241116> [<https://perma.cc/3WHU-AUW9>].

146. *See* Non-Prosecution Agreement, U.S. Attorney’s Office & Las Vegas Sands Corp. (Aug. 26, 2013), <https://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/Las-Vegas-Sands-Corp-NPA.pdf> [<http://perma.cc/L4Y3-HJXJ>].

147. *Compliance Committee Charter*, Las Vegas Sands Corp. (July 23, 2019), [https://s21.q4cdn.com/635845646/files/doc\\_downloads/committee-charters/2019/Compliance-Committee-Charter-Final-July-23-2019.pdf](https://s21.q4cdn.com/635845646/files/doc_downloads/committee-charters/2019/Compliance-Committee-Charter-Final-July-23-2019.pdf) [<http://perma.cc/7PHC-V74H>].

148. *Id.*

149. *See* Non-Prosecution Agreement, U.S. Dep’t of Justice, Fraud Section,

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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 LendingClub example, no such committee was created. In none of those cases 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 Part I.A, we outlined how and why regulators and prosecutors give firms incentives to establish internal compliance programs. We saw in Part I.B that both prosecutorial guidance and corporate law fiduciary duties now envisage a role for boards specifically in overseeing such internal compliance programs, and that this may entail mediating conflict between senior executives and such programs. In Part I.C, we considered particular ways in which boards may perform their compliance oversight function, comparing the adoption of a stand-alone CC with the addition of compliance oversight to the AC's list of duties. The choice between these is not dictated either by prosecutorial guidance or by fiduciary duties. While establishing a CC seems likely to permit more intense compliance oversight, it is also likely to be more costly for boards to establish and staff. In Part II, 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%) 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. In Subpart A, we summarize the prior literature on corporate compliance activities, then describe the sources of our data, provide an overview of these data, including by detailing our results in a time trend. In Subpart B, we examine to what degree board compliance committees are required, either by the SEC or in prosecution agreements. In Subpart C, we ask why a company might create a CC, presenting results concerning cases in which CC adoption is voluntary. In Subpart D, we present results concerning the types of companies in which boards adopt CC's.

#### 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.<sup>150</sup> To understand why not, note first that securities laws do not *mandate* disclosure of compliance expenditure.<sup>151</sup> Moreover, managers and directors have no incentive to *volunteer* this information.<sup>152</sup> This is because disclosing an investment in compliance may be taken as a signal that the firm considers the risk of malfeasance sufficient to make its compliance investment worthwhile and feels obliged to provide notice of that risk to its shareholders.<sup>153</sup> Because even the most effective compliance program cannot entirely deflect the costs of prosecution, the stock price may fall. As managers and directors are both paid primarily in stock, they are likely to prefer to avoid this.<sup>154</sup>

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150. Griffith, *supra* note 28.

151. *Id.*

152. 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 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.

153. See Armour et al., *supra* note 31.

154. *Id.* at 22.

Firms, however, are required to report the existence of a compliance committee.<sup>155</sup> Such “corporate governance” information is part of the mandatory disclosure associated with the annual proxy solicitation for the election of directors.<sup>156</sup> Shortly after the Sarbanes-Oxley Act of 2002, public companies came to be required to disclose charters of their audit, compensation and nomination committees.<sup>157</sup> 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.<sup>158</sup>

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, PwC’s annual *State of Compliance* report, a widely-cited source for compliance literature,<sup>159</sup> stated in 2016 that “20% [of companies] have Boards of Directors that formed a separate,

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155. 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.

156. See 17 C.F.R. § 229.407 (2019) (containing Item 407 of Regulation S-K referenced by Schedule 14A); *id.* § 240.14a-101 (2000) (specifying content of Schedule 14A and Item 7 (Directors and Executive Officers)). The regulation requires disclosure of attendance of directors at board meetings and committee meetings, which of course requires identification of all board committees.

157. SEC Rules have required disclosure of audit committee charters since 2000 (originally a triennial obligation) in the firm’s proxy statements. See *id.* § 240.14a-101, Item 7(e)(3). This was extended to an annual obligation in the financial statements in 2003. See 17 C.F.R. § 229.401(i)(2) (2003). The NYSE Listed Company Manual was amended in 2003 to require all NYSE-listed companies to have and disclose audit, compensation, and nomination committee charters. See Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment Relating to Corporate Governance, Release No. 34-47672, SEC Docket No. SR-NYSE-2002-33 (Apr. 11, 2003). Nomination committee charter disclosure in proxy statements has also been required by SEC Rules since the beginning of 2004. See 17 C.F.R. § 240.14a-101, Item 7(d)(2)(ii)(A) (2004). In 2006, these rules were consolidated into SEC Regulation 407. See 71 Fed. Reg. 53,254 (Sept. 8, 2006) (to be codified at 17 C.F.R. § 229.407).

158. In most cases, information on a company’s board committees are under the “Investor Relations” tab on the company’s website.

159. Robert C. Bird & Stephen Kim Park, *Turning Corporate Compliance into Competitive Advantage*, 19 U. PA. J. BUS. L. 285 (2017); Griffith, *supra* note 28.

stand-alone compliance/ethics committee.”<sup>160</sup> 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 in both private and public companies.<sup>161</sup> Because the report is based on respondents’ voluntary return of the survey, 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.<sup>162</sup> Upon closer examination, this report picks up all committees that may undertake any compliance *function* rather than committees that are specifically called “compliance committees.” Using our more restrictive (but still quite inclusive) definition, we find that the fraction of S&P 500 companies with compliance committees increased from 5.3% to 6.8% over the 2004–2017 period, a considerably lower fraction.<sup>163</sup>

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 with investigations, the appointment of an independent corporate monitor, and, in some cases, changes to corporate governance structures.<sup>164</sup> Of

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160. PwC, STATE OF COMPLIANCE STUDY 2016: LAYING A STRATEGIC FOUNDATION FOR STRONG COMPLIANCE AND RISK MANAGEMENT 3 (2016), <https://www.pwc.se/sv/pdf-reports/state-of-compliance-study-2016.pdf> [<https://perma.cc/FVC8-XGVQ>].

161. *Id.*, Foreword.

162. EY CTR FOR BRD MATTERS, A FRESH LOOK AT BOARD COMMITTEES (2018), [https://www.ey.com/Publication/vwLUAssets/ey-cbm-a-fresh-look-at-board-committees/\\$FILE/ey-cbm-a-fresh-look-at-board-committees.pdf](https://www.ey.com/Publication/vwLUAssets/ey-cbm-a-fresh-look-at-board-committees/$FILE/ey-cbm-a-fresh-look-at-board-committees.pdf) [<https://perma.cc/5R8G/RMUU>]. The report is based on the 418 proxy statements filed on May 15, 2018. *Id.*

163. See *infra* Table 3.

164. See generally Arlen & Kahan, *supra* note 33 (examining the practice 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 8% of these DPAs (meaning, 22) contained provisions requiring the company concerned to make changes to its existing board structures, “often creating new board committees.”<sup>165</sup> 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 that this form of prosecutorial settling-up cannot account for the extent of CC adoption.<sup>166</sup>

## 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;<sup>167</sup> (2) Duke/UVA Corporate Prosecution Registry: an extensive database on corporate prosecutions including plea agreements, trial convictions, and all DPAs entered into by the DOJ with organizations from 1990 onwards to explore links between the exposure to corporate prosecution and CC adoption;<sup>168</sup> (3) CRSP-Compustat: a widely-used financial dataset with details of firm financial attributes such as firm performance and firm size;<sup>169</sup> and (4) SEC EDGAR:

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DPA-mandated reforms and discussing appropriate application); Garrett, *Structural Reform Prosecution*, *supra* note 33 (discussing the background and examples of DPA-required internal reforms).

165. Kaal & Lacine, *supra* note 34, at 95–96.

166. See GARRETT, *supra* note 8, at 267 (describing how from 2001 to 2012, 273 public companies were prosecuted).

167. Data, BOARDDEX, <http://corp.boardex.com/data/> [<https://perma.cc/7MRK-N59D>]. 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., Order Approving NYSE Proposed Rule Change Relating to Corporate Governance, Release No. 34-50625, SEC Docket No. SR-NYSE-2004-41 (Nov. 3, 2004), <https://www.sec.gov/rules/sro/nyse/34-50625.pdf> [<https://perma.cc/4THH-4GST>]; SEC Marketplace Rules, NASDAQ Rule § 4350(d), SEC, [https://www.sec.gov/rules/other/nasdaqllcf1a4\\_5/nasdaqllcamendrules4000.pdf](https://www.sec.gov/rules/other/nasdaqllcf1a4_5/nasdaqllcamendrules4000.pdf) [<https://perma.cc/5NE8-3EDM>].

168. The Corporate Prosecution Registry was co-created by one of the authors. Ashley & Garrett, *supra* note 35.

169. *CRSP-Compustat Merged*, CTR. FOR RES. IN SECURITY PRICES,



listed companies' periodic filings and proxy statements to cross-reference information about companies.<sup>170</sup> 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 6372 unique U.S. public companies for the period 2004–2017, giving a total of 51,620 firm-years. Table 1 sets out the details of variable names, variable descriptions, and data sources. Table 2 presents summary statistics for each variable.

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<http://www.crsp.com/products/research-products/crspcompustat-merged-database> [<https://perma.cc/75Z8-DR9P>].

170. See *Edgar Company Search*, SEC, <https://www.sec.gov/edgar/searchedgar/companysearch.html> [<https://perma.cc/X4K5-3XEF>].

**Table 1.** Variable Descriptions

Variable Name	Variable Description	Source
Compliance Committee	Dummy for whether firm has a board-level Compliance Committee (including stand-alone compliance committee, compliance and risk, or audit and compliance)	BoardEx
DOJ Enforcement	Dummy for DOJ enforcement during previous three years	Duke-UVA Corporate Prosecution Registry
DOJ Exposure	Rate of prosecution in the same industry (under Fama-French 48 industry classification) during previous three years	Duke-UVA Corporate Prosecution Registry/BoardEx
CC Interlock	Dummy for firm having at least one director who concurrently serves on board of another company with a Compliance Committee	BoardEx
Ave. Dir. Age	Average age of board members	BoardEx
Male Board	Ratio of male board members	BoardEx
Board Size	Number of board members	BoardEx
Aud. Cttee. Ratio	Ratio of Audit Committee members to entire board members	BoardEx
NonExecDir. Ratio	Ratio of non-executive directors to total board members.	BoardEx
Delaware Inc.	Dummy for Delaware incorporation	SEC EDGAR
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

**Table 2.** Summary Statistics

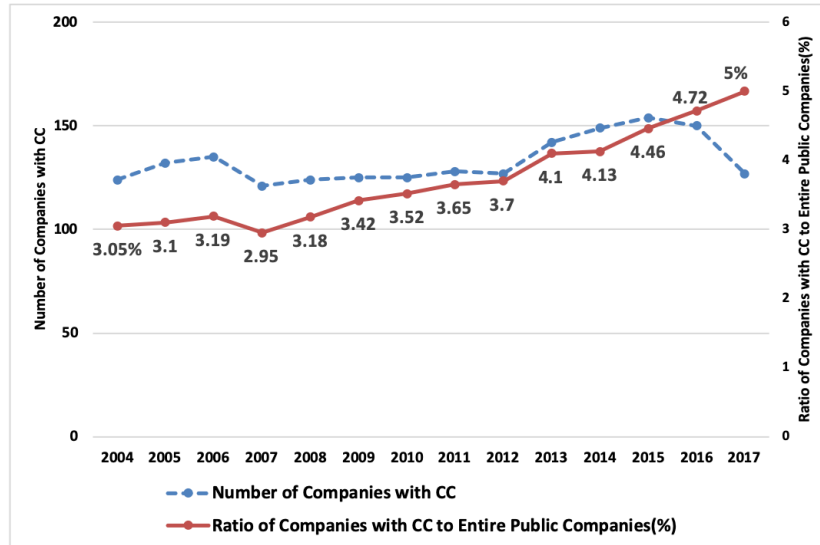
Variable Name	N	Mean	Std. Dev.	Median	Min	Max
Compliance Committee	50,945	0.04	0.19	0	0	1
DOJ Enforcement	50,945	0.01	0.10	0	0	1
DOJ Exposure	50,945	0.002	0.004	0.001	0	0.04
CC Interlock	50,945	0.18	0.39	0	0	1
Director Average Age	50,945	61.33	5.17	61.6	33.5	82.17
Male Board	50,945	0.90	0.10	0.90	0.20	1.00
Board Size	50,945	8.94	2.72	9	2	26
Audit Committee Ratio	50,945	0.48	0.13	0.44	0.171	1.00
NonExecDir. Ratio	50,945	0.83	0.10	0.86	0.20	1.00
Delaware Inc.	50,945	0.57	0.49	1	0	1
Firm Size: log(total assets)	50,945	6.52	2.10	6.53	1.70	12.33
RoA <sub>(t-1)</sub>	48,360	-0.03	0.22	0.03	-1.57	0.32
Tobin's Q <sub>(t-1)</sub>	48,385	1.95	1.47	1.42	0.47	10.85

### 3. Time Trends and Industry Distribution

Figure 1 shows the number (vertical axis) and proportion (bold numbers) of U.S. 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 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% of public companies having adopted such a committee by 2017.

171. In 2004, Sutron Corporation did not have an audit committee. SUTRON CORP., 2004 DEFINITIVE PROXY STATEMENT (2005), <https://www.sec.gov/Archives/edgar/data/728331/000072833105000038/proxy05.txt> [<https://perma.cc/8L39-B4M9>] (“The Board does not have an audit committee or nominating committee.”).

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



**Note:** Our sample companies represent all U.S. public companies from BoardEx, excluding investment funds and trusts. The dashed line shows the *total number* of public companies that have a Compliance Committee at the board level. The solid line shows the *percentage* of public companies that have a Compliance Committee at the board level. “Compliance Committee” includes any board committee that uses the term “compliance” in its official name.

Our findings are in marked contrast to the results reported in the PwC survey, which estimated that 20% of companies had established a CC by 2016.<sup>172</sup> 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 had compliance committees in 2018.<sup>173</sup>

172. See *supra* notes 160–61 and accompanying text.

173. See EY CENTER FOR BOARD MATTERS, *supra* note 162. The report is based on the 418 proxy statements filed as of May 15, 2018.

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.<sup>174</sup> As can be seen in Table 3, the industries that are the heaviest adopters of CCs are banking, healthcare, pharmaceutical products, medical equipment, and business services. An intuitive explanation is that these industries are all heavily regulated; in most cases some form of compliance program is mandated by substantive regulation.<sup>175</sup> Firms that are required to set up a compliance program are presumably more likely to find it worthwhile to establish a committee at the board level to oversee that program.

**Table 3.** Top 5 Industries of firms adopting Compliance Committees, 2004–17

Industry (FFI48)	% of companies from each industry out of entire companies with CC
Banking	28.00%
Healthcare	12.46%
Pharmaceutical Products	12.14%
Medical Equipment	8.62%
Business Services	7.67%

In Table 4 we compare, by industry, the proportion of firms that faced DOJ enforcement, and the proportion of firms that adopted compliance committees over the period 2004–17. There is not an obvious relationship. Firms in the pharmaceutical, utilities, and medical equipment industries, which have relatively

174. Eugene Fama & Kenneth French, *Industry Cost of Equity*, 43 J. FIN. ECON. 153 (1997). See generally THE WHARTON SCH., UNIV. OF PENN., PROCEDURES USING FAMA AND FRENCH 48 INDUSTRY CLASSIFICATIONS (1993), <https://wrds-www.wharton.upenn.edu/pages/support/research-wrds/research-guides/procedures-using-fama-and-french-48-industry-classification/> [<https://perma.cc/Q6PH-BSGU>] (showing Fama-French industry classifications). Fama-French 48 Industry Classifications were created by using each company's four-digit Standard Industrial Classification collected from EDGAR. *Id.*

175. For examples of such statutes, see *supra* note 157.

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 prosecution rates yet high rates of CC adoption. Moreover, while the aircraft industry has the highest prosecution rate of any industry over our sample period, no company in the industry has adopted a CC.

**Table 4.** Likelihood of DOJ enforcement and frequency of Compliance Committee adoptions by industry, 2004–17

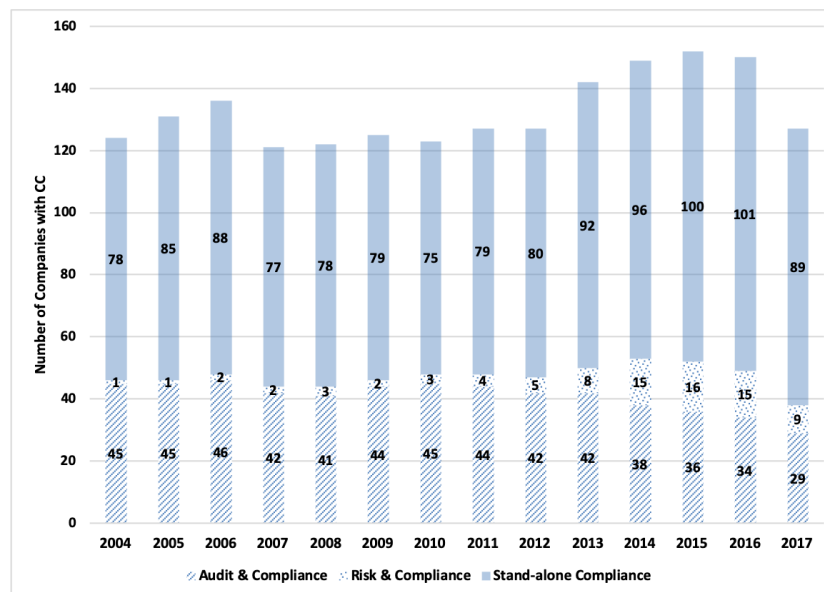
Industry Classification (FBI 48)	Non-Prosecuted Firms	Prosecuted Firms	Total Firms	% of Prosecuted Firms	% of CC use
Aircraft	21	3	24	12.50%	0%
Food Products	66	8	74	10.81%	2.70%
Shipbuilding, Railroad	12	1	13	7.69%	0%
Utilities	127	10	137	7.30%	2.19%
Automobiles and Truck	67	5	72	6.94%	0%
Petroleum and Natural	190	14	204	6.86%	1.47%
Coal	14	1	15	6.67%	0%
Agriculture	17	1	18	5.56%	0%
Chemicals	106	6	112	5.36%	0%
Medical Equipment	208	10	218	4.59%	1.83%
Almost Nothing	47	2	49	4.08%	2.04%
Pharmaceutical Products	499	19	518	3.67%	2.90%
Wholesale	161	6	167	3.59%	0.6%
Transportation	108	4	112	3.57%	2.68%
Insurance	166	6	172	3.49%	2.33%
Printing and Publishing	56	2	58	3.45%	0%
Apparel	58	2	60	3.33%	0%
Construction	61	2	63	3.17%	4.76%
Electrical Equipment	61	2	63	3.17%	0%
Business Supplies	35	1	36	2.78%	0%

Industry Classification (FBI 48)	Non-Prosecuted Firms	Prosecuted Firms	Total Firms	% of Prosecuted Firms	% of CC use
Machinery	149	4	153	2.61%	1.96%
Measuring and Control	119	3	122	2.46%	2.46%
Computers	199	5	204	2.45%	1.47%
Retail	274	6	280	2.14%	1.43%
Banking	753	16	769	2.08%	5.98%
Healthcare	114	2	116	1.72%	28.44%
Restaurants, Hotels, Motels	115	2	117	1.71%	2.56%
Steel Works Etc.	64	1	65	1.54%	0%
Construction Material	70	1	71	1.41%	1.40%
Personal Services	71	1	72	1.39%	0%
Business Services	805	7	812	0.86%	1.97%
Electronic Equipment	365	2	367	0.55%	1.36%
Beer & Liquor	18	0	18	0%	0%
Candy & Soda	5	0	5	0%	0%
Communication	175	0	175	0%	0%
Consumer Goods	64	0	64	0%	0%
Defense	12	0	12	0%	0%
Entertainment	72	0	72	0%	2.78%
Fabricated Products	16	0	16	0%	0%
Non-Metallic and Industrial Metal Mining	30	0	30	0%	3.33%
Precious Metals	10	0	10	0%	0%
Real Estate	55	0	55	0%	0%
Recreation	34	0	34	0%	2.94%
Rubber and Plastic Products	37	0	37	0%	0%
Shipping Containers	10	0	10	0%	0%
Textiles	13	0	13	0%	0%
Tobacco Products	8	0	8	0%	0%
Trading	397	0	397	0%	1.76%

#### 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 is by far the most frequent way in which a compliance committee is explicitly recognized at the board level.

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



**Note:** Our sample companies represent all U.S. public companies from BoardEx, excluding investment funds and trusts. For a given year, solid bars show the number of public companies with a “stand-alone” Compliance Committee; bars with dots show the number of public companies with a “Risk and Compliance Committee”; and bars with diagonals show the number of public companies with an Audit committee restyled as an “Audit and Compliance Committee.”

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% are independent directors. Moreover, about 30% of compliance committee members contemporaneously serve on their company's Audit committee. Conversely, approximately 10% 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.** Characteristics of Board Compliance Committees of US Public Companies, 2004–17.

Variable	N	Mean	Std. Dev.	Min	Max
Size of CC	1,863	4.43	1.68	1	15
Ratio of NonExecDir.	1,863	0.85	0.21	0	1
Ratio of Audit committee Members on CC	1,863	0.31	0.46	0	1
Ratio of Directors Exclusively Serve on CC	1,863	0.10	0.19	0	1

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. The lack of a board-level compliance committee does not directly violate any current substantive regulations.<sup>176</sup> There are regulatory mandates for compliance, but not mandates requiring the creation of a board level committee. However, there are two potential exceptions to this: Qualified Legal Compliance Committees and Prosecution Agreements.

176. See text accompanying note 60, *supra*.

### 1. Qualified Legal Compliance Committees

The first possible route to a mandatory CC is via the SEC Rule on “Qualified Legal Compliance Committees” (QLCC) promulgated in 2003 as part of the post-Enron concern about corporate compliance.<sup>177</sup> 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.<sup>178</sup> The Sarbanes-Oxley Act required attorneys to report evidence of material misconduct to the company’s chief legal officer and/or chief executive officer,<sup>179</sup> and if these persons do not respond properly, to the audit committee or the entire board of directors.<sup>180</sup> 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.<sup>181</sup> When the rule was first introduced, some commentators suggested firms whose attorneys found the standard reporting channel onerous would establish QLCCs.<sup>182</sup>

This might consequently be a channel through which some companies felt it necessary to establish compliance committees.<sup>183</sup>

However, the SEC’s definition of a QLCC for these purposes does not require a stand-alone committee.<sup>184</sup> Any committee that includes at least two independent directors and one audit committee member—including the Audit committee itself—qualifies as a “QLCC.”<sup>185</sup> Thus an issuer motivated solely by Rule 205

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177. 17 C.F.R. § 205.3(b)(1) (2010); *see also* Jill Fisch & Caroline Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 523 (2003).

178. 17 C.F.R. § 205.3(b)(1).

179. *Id.*; *see also* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 307, 116 Stat. 745 (codified at 15 U.S.C. § 7245 (2012)).

180. 17 C.F.R. § 205.3(b)(3).

181. *Id.* § 205.3(c)(1).

182. Fisch & Gentile, *supra* note 177, at 547 (“These attorneys face less work, uncertainty, and exposure to liability when reporting to a QLCC.”).

183. *See* Robert Eli Rosen, *Resistances to Reforming Corporate Governance: The Diffusion of QLCC’s*, 74 FORDHAM L. REV. 1251 (2005) (explaining the need for compliance committees).

184. 17 C.F.R. § 205.3(b)(1).

185. *Id.* § 205.2(k)(1).

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 stand-alone compliance committee.<sup>186</sup> This suggests that Rule 205 is unlikely to have been a significant driver of compliance committee creation.

To verify this, we searched our data for examples where firms had established stand-alone QLCCs, as opposed to simply 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. Its peak was in 2004 when the concept was first introduced; in that year, twenty companies inaugurated stand-alone QLCCs. These amounted to 14% of the total number of companies with stand-alone 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.) retained stand-alone QLCCs. That was less than 2% of the total companies with stand-alone 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.<sup>187</sup> But how frequently does this happen? To shed light on this, we reviewed the text of all prosecution agreements entered with public companies since 2001 in the Duke & University of Virginia Corporate Prosecution Registry.<sup>188</sup> There are 381 public firms in the Registry that were prosecuted during the period from 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.

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186. Fisch & Gentile, *supra* note 177, at 542; Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 823 (2001).

187. See *supra* Part I.C.4; see also Kaal & Lacine, *supra* note 34, at 85 fig.1 (finding that 31% of agreements had requirements affecting boards, but only 8% mandated new board committees).

188. See Ashley & Garrett, *supra* note 35.

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.<sup>189</sup> This dataset is significantly larger than that previously considered by Kaal and Lacine, primarily because we include plea agreements as well as DPAs.<sup>190</sup> 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 judicial dockets.<sup>191</sup>

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 dockets or were not made available by the Department of Justice. Of the 329 remaining cases, 115 (35%) included terms that imposed some obligation on the board.<sup>192</sup> Of those cases, only five agreements (1.5%) required the creation of board-level compliance committees.<sup>193</sup> Prosecutors clearly do not demand that boards establish CCs as part of plea agreements or

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189. We do not examine the cases of thirteen more public companies that received declinations, four dismissals, three convictions at trial, and one acquittal at trial.

190. Kaal & Lacine, *supra* note 34, at 84 (describing the author's dataset reviewing 271 DPAs entered into from 1993–2013).

191. U.S. SENTENCING GUIDELINES MANUAL, *supra* note 12, § 8D1.4, Application n.1.

192. This is consistent with Kaal and Lacine's finding that 38% of DPAs in their sample required some type of "board changes." Kaal & Lacine, *supra* note 34, at 95.

193. 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* Deferred Prosecution Agreement, U.S. Dep't of Justice & Comput. Assocs. Int'l (2004), <http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/detail-files/589.html> [<https://perma.cc/2F9T-9F22>]. The 2008 Unum Group agreement required the establishment of a new compliance committee of the Board. *See* Deferred Prosecution Agreement, U.S. Dep't of Justice & Unum Grp. Agreement (2008), <http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/detail-files/738.html> [<https://perma.cc/ZWE3-36KV>]. 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 responsibility "for ensur-

DPA.<sup>194</sup> 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 5% of public companies established a CC between 2004–2017, these firms are early adopters of the new corporate practice. As discussed in Part 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? In this subpart, we consider three: heightened compliance activity, the availability of capacity among board members, and the gradual diffusion of information about CCs.

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ing that the Company is in compliance with all aspects of the Agreement.” Deferred Prosecution Agreement, U.S. Dep’t of Justice & MoneyGram Int’l (2012), <http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/MoneyGram.pdf> [https://perma.cc/C855-LCLB]. The non-prosecution agreement with Las Vegas Sands required the creation of a board-level compliance agreement. Non-Prosecution Agreement, U.S. Dep’t of Justice & Las Vegas Sands Corp. (2013), <http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/Las-Vegas-Sands-Corp-NPA.pdf> [https://perma.cc/PW9S-SA88]. 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.” U.S. Dep’t of Justice & Stryker Corp., Plea Agreement (2014), <http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/detail-files/770.html> [https://perma.cc/R7DS-8BZV].

194. The finding is qualitatively similar to that reported by Kaal & Lacine, *supra* note 34, at 96 (finding that just 8% of firms had adopted a compliance committee after prosecution).

### 1. Heightened Compliance Activity

All other things equal, a CC would be most useful for companies in which it could complement other large investments in compliance programs. Where a firm has an extensive compliance program, the compliance oversight intensity a CC can deliver would be useful to enhance the effectiveness of that program. Neither the absolute level of, nor an increase in, compliance investments is readily measurable in most contexts because, as we have described in Part II.A.1, firms typically do not disclose the scope of their compliance activity, in part because of fear of sending an adverse signal.<sup>195</sup> 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.<sup>196</sup> 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.<sup>197</sup> 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 LendingClub 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,<sup>198</sup> many of these agreements nevertheless envisage expansions in compliance that will involve the board in some way. Ninety-six (29%) of these prosecution agreements created new positions that report directly to the board.<sup>199</sup> In some of those cases, still more is required, such as

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195. See *supra* Part II.A.1.

196. See Elizabeth Daniels, Note, *Getting DPA Review and Rejection Right*, 16 CONN. PUB. INT. L.J. 101, 120 (2016) (“[A]ll DPAs in this area require continued cooperation, heightened compliance mechanisms, and law-abiding conduct measured over a set period of time . . .”).

197. See, e.g., GARRETT, *supra* note 8, at 71–72.

198. See *supra* Part II.B.2.

199. For example, seventy-one settlements, chiefly in FCPA cases, contained the following language, requiring the company to: “Assign responsibility to one

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 Service agreement.<sup>200</sup> 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.<sup>201</sup> 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 meet quarterly with the Monitor.<sup>202</sup> Such a role would end when the agreement ends.<sup>203</sup>

While there is variation in individual agreements, the general thrust is for DPAs to impose heightened compliance obligations on the company, and, in one-third of cases, directly to expect more board engagement. While these do not direct the board

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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." *See, e.g.*, Deferred Prosecution Agreement, U.S. Dep't of Justice & Zimmer Biomet (2017), <http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/zimmer-biomet-2017.pdf> [<https://perma.cc/KG76-DXDE>].

200. Deferred Prosecution Agreement, U.S. Dep't of Justice & United Parcel Serv. (2013), <http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/UPS.pdf> [<https://perma.cc/B7KF-9GVV>].

201. Deferred Prosecution Agreement, U.S. Dep't of Justice & Monsanto Co. (2005), <http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/monsanto.pdf> [<https://perma.cc/3MX9-Y9XZ>].

202. Deferred Prosecution Agreement, U.S. Dep't of Justice & Exactech, Inc. (2010), <http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/exactech.pdf> [<https://perma.cc/5B7G-4CC9>].

203. 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. *See, e.g.*, Plea Agreement, United States v. AmerisourceBergen Specialty Grp., No. 1:17-CR-00507-NG (E.D.N.Y. Sept. 27, 2017), <http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/agreements/amerisourcebergen.pdf> [<https://perma.cc/Y6KQ-N976>].

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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.<sup>204</sup> 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.<sup>205</sup>

## 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 I.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 committee, as opposed to channeling compliance work to the existing AC. A new compliance committee will require personnel—primarily independent directors—to staff it. We know from our interview research<sup>206</sup> 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 CC. The flipside of the

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

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

206. See *infra* Part III.A.2.



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same issue is the AC's capacity to take on compliance oversight work. The larger a firm's AC, the greater the capacity for compliance oversight to be routed through the AC 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 facing tight time constraints to learn about these benefits.<sup>207</sup> 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

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207. See *infra* Part I.C (explaining that the scarcity of a director's time may increase the cost of implementation).

governance practices.<sup>208</sup> These include poison pill adoption,<sup>209</sup> CEO compensation,<sup>210</sup> option backdating,<sup>211</sup> and indemnification protection.<sup>212</sup> 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 subpart, we present multivariate

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208. See, e.g., Michal Barzuza & Quinn Curtis, *Board Interlocks and Outside Directors' Protection*, 46 J. LEGAL STUDS. 129 (2017) (suggesting that interlocking directors contribute to outside directors' knowledge and bargaining power in restoring directors' indemnification protection); John M. Bizjak et al., *Option Backdating and Board Interlocks*, 22 REV. FIN. STUDS. 4821, 4838 (2009) (showing that interlocking directors were an important conduit contributing to the spread of backdating of option grants); Gerald F. David, *Agents Without Principles? The Spread of the Poison Pill Through the Intracorporate Network*, 36 ADMIN. SCI. Q. 583 (1991) (showing that poison pill adoptions increase with interlocking directors); 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."); Kevin F. Hallock, *Reciprocally Interlocking Boards of Directors and Executive Compensation*, 32 J. FIN. & QUANTITATIVE ANALYSIS 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."); Christine Shropshire, *The Role of the Interlocking Director and Board Receptivity in the Diffusion of Practices*, 35 ACAD. MGMT. REV. 246, 252–53 (2010) (theoretically proposing that "the likelihood of knowledge transfer increases if the interlocking director serves on the relevant board committee at the focal firm").

209. See generally David, *supra* note 208 (discussing the theories of the poison pill and its use by management teams).

210. See generally Hallock, *supra* note 208 (explaining the concept of CEO interlocks and how they can lead to higher compensation).

211. See Bizjak et al., *supra* note 208.

212. See Barzuza & Curtis, *supra* note 208.

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regression results that shed light on these hypotheses. 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 outside experience of the use of compliance committees. However, the overall level of adoption of compliance committees among public companies is still extremely low: less than 5%.

#### 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 Enforcement* 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, resulting in a DPA, a plea agreement, or a conviction. 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 over the period 2004–2017, 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; *NonExecDir. Ratio*—the proportion of the board that is comprised of directors who are not also executives—and *Aud. Cttee. Ratio*—namely, the ratio of directors sitting on the Audit committee to the entire board membership. Finally, our variable *CC Interlock* indicates whether any of the company's board members also sits on the board of another company with a CC.<sup>213</sup> This captures outside experience with CC implementation.

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213. We constructed this variable by first identifying in each sample year all “interlocking” directors in our data concurrently serving on two or more boards, of which at least one had adopted a compliance committee. We then converted this director-level data into the company-level dummy variable *CC Interlock* by giving a value of 1 to a company that has at least one interlocking director concurrently sitting on the board of *another* company with a compliance committee for any given year.

Table 6 reports logit regression results for our panel of U.S. public firms during the period 2004–2017.<sup>214</sup> The dependent variable, Compliance Committee, is a dummy (binary) variable taking the value 1 if a firm adopts a compliance committee in a particular year. We take “compliance committee” adoption for these purposes to include stand-alone compliance committees, risk and compliance committees, and audit and compliance committees,<sup>215</sup> although we have seen in Figure 2 that the lion’s share of this activity is stand-alone compliance committees. Model (1) shows relationships between each variable and CC adoption when all variables of interest are included. Models (2)–(4) each include only one of three main variables of interest (DOJ Enforcement, DOJ Exposure, and CC Interlock) to consider whether the results are robust to the exclusion of the other two variables.

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214. We use a logit regression because the dependent variable in this case is binary. The coefficients report marginal effects.

215. *See supra* Part II.B.1.

**Table 6.** Determinants of Compliance Committee Adoptions

Independent Variables	Dependent		Variable	
	(1) Board Compliance Committee	(2) Board Compliance Committee	(3) Board Compliance Committee	(4) Board Compliance Committee
DOJ Enforcement	0.839*** (0.281)	0.857*** (0.282)		
DOJ Exposure	3.424 (7.805)		9.099 (7.782)	
CC Interlock	0.463*** (0.130)			0.465*** (0.129)
Ave. Dir. Age	-0.00271 (0.0138)	-0.00364 (0.0138)	-0.00385 (0.0138)	-0.00291 (0.0138)
Male Board	0.302 (0.623)	0.178 (0.615)	0.146 (0.615)	0.270 (0.623)
Board Size	0.0830*** (0.0300)	0.0875*** (0.0295)	0.0884*** (0.0295)	0.0839*** (0.0300)
Aud. Cttee. Ratio	1.129** (0.453)	1.127** (0.457)	1.160** (0.456)	1.162** (0.453)
NonExecDir. Ratio	1.174 (0.905)	1.338 (0.907)	1.357 (0.909)	1.193 (0.907)
Delaware Inc.	-0.0885 (0.168)	-0.0666 (0.169)	-0.0746 (0.168)	-0.0950 (0.168)
Firm Size	0.163*** (0.0492)	0.194*** (0.0485)	0.211*** (0.0479)	0.179*** (0.0486)
RoA <sub>(t-1)</sub>	0.767* (0.410)	0.715* (0.413)	0.721* (0.416)	0.774* (0.413)
Tobin's Q <sub>(t-1)</sub>	0.0101 (0.0455)	0.0146 (0.0451)	0.0104 (0.0452)	0.00562 (0.0457)
Year FE	Y	Y	Y	Y
Industry FE	Y	Y	Y	Y
Observations	41,261	41,261	41,261	41,261
Pseudo R <sub>2</sub>	0.1291	0.1252	0.1232	0.1271

**Note:** Logit models of the likelihood that a firm will have a Compliance Committee in a particular year. *Compliance Committee* includes stand-alone compliance committees, risk and compliance committees, and audit and compliance committees; *DOJ Enforcement* 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 same industry during the previous three years; *CC Interlock* is a dummy for whether any board member concurrently sits on the board of another company with a Compliance Committee; *Ave. Dir. Age* is average age of board members; *Male Board* is the ratio of male board members; *Board Size* is total number of board members; *Aud. Cttee. Ratio* is the ratio of Audit committee members to entire board members; *NonExecDir. Ratio* is the ratio of non-executive board members to

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entire board members; *Delaware Inc.* is a dummy for Delaware incorporation; *Firm Size* is the natural logarithm of the firm's total assets; *RoA<sub>(t-1)</sub>* is the firm's Return on Assets in the previous year; *Tobin's Q<sub>(t-1)</sub>* is the firm's market to book ratio in the previous year. 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).

## 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,<sup>216</sup> in each case lagged by one year.<sup>217</sup> 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 prior literature establishes that due to 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 incorporated in their home states.<sup>218</sup> We find no significant effect of Delaware incorporation on CC adoption.

Finally, we include two variables relating to board characteristics: *Male Board* and *Ave. Dir. Age* in case gender diversity

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216. "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. For a discussion of the derivation of this measure, its common use, and its limitations, see Robert Bartlett & Frank Partnoy, *The Misuse of Tobin's Q*, VAND. L. REV. (forthcoming 2019).

217. "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  $x - 1$ .

218. See, e.g., John Armour et al., *Is Delaware Losing Its Cases?*, 9 J. EMPIRICAL LEGAL STUDS. 605, 607 (2012); Lucian Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 383-89 (2003); Kate Litvak, *How Much Can We Learn by Regressing Corporate Characteristics Against the State of Incorporation?*, J.L. FIN. & ACCT. (forthcoming 2019).

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or average age of directors affects openness to CC adoption. The coefficient for these variables is not statistically significant.

### 3. Discussion of Results

We now turn to our main results of interest. The variable *DOJ Enforcement* is positive and strongly statistically significant (at the 99% level) both with and without influence of the other two variables of interest as shown in specifications (1) and (2) respectively. This means that companies that have faced DOJ enforcement during the previous three years are much more likely to adopt CCs at the board level. 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 specifically mandate the creation of a CC,<sup>219</sup> 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. This means that the industry risk of prosecution does not influence the likelihood of CC adoption by companies in that industry. As we use industry fixed effects, we can also explore 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 healthcare, pharmaceuticals, and petroleum and natural gas—may face higher expectations and scrutiny regarding compliance activity. However, apart from healthcare,<sup>220</sup> the coefficients for these three industry dummies (unreported) are not significant.

We also find that director interlocks may provide a mechanism for diffusion of information about CCs. The coefficients for *CC Interlock* are positive and strongly statistically significant (at the 99% level) with or without the influence of *DOJ Enforcement* and *DOJ Exposure*, as shown in models (1) and (4). That is, boards with a director who has outside experience of CCs are much more likely to adopt a CC. This suggests that “learning

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219. See *supra* note 194 and accompanying text.

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

effects” may be present in CC adoption: boards learn from the experience of their members about the way in which CCs function.

Turning to board capacity, the variable *Board Size* has a positive coefficient in all the regression models and is statistically significant at the 95% level in all models. This result is consistent with the idea that CC adoption may be made easier by the presence of more directors, which increases the capacity of the board to staff a compliance committee. This is independent of the size of the audit committee, which we capture separately through *Aud. Cttee. Ratio*. The coefficient on *Aud. Cttee. Ratio* is positive and statistically significant (at the 95% level) in all specifications.<sup>221</sup> In an unreported test, we saw that adoption of a CC was not associated with an increase in board size. This suggests that firms with greater board capacity have a stronger predisposition to set up a CC.

Finally, there appears to be a strong firm size effect in CC adoption. The coefficient for *Firm Size* is positive and strongly statistically significant (at the 99% level) in all specifications. That this is significant, independent of board size, suggests that the channel through which firm size is related to CC adoption is not simply that larger firms have larger boards. Rather, it is plausibly driven by larger firms having larger-scale compliance endeavors, which in turn are more likely to justify board oversight through a CC.

Table 7 shows that the results for *DOJ Enforcement*, *DOJ Exposure*, *CC Interlock*, and *Firm Size* remain very similar when we measure the relationship between independent variables we used in Table 6 and the adoption of “stand-alone” CCs, which excludes CCs combined with either audit or risk committees. However, the results for *Board Size* and *Aud. Cttee. Ratio* are not statistically significant.

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221. This latter result may be due to the inclusion in the dependent variable of cases where firms rebrand their audit committee as “Audit and Compliance,” which would be expected to be associated with a larger AC.



**Table 7.** Determinants of Stand-alone Compliance Committee Adoptions

Independent Variables	Dependent		Variable	
	(1) Stand-alone Compliance Com- mittee	(2) Stand-alone Compliance Com- mittee	(3) Stand-alone Compliance Com- mittee	(4) Stand-alone Compliance Com- mittee
DOJ Enforcement	1.010*** (0.300)	1.026*** (0.305)		
DOJ Exposure	4.870 (10.000)		12.85 (9.999)	
CC Interlock	0.561*** (0.147)			0.561*** (0.145)
Ave. Dir. Age	0.0112 (0.0176)	0.00990 (0.0174)	0.00937 (0.0174)	0.0106 (0.0176)
Male Board	0.254 (0.727)	0.0849 (0.714)	0.0538 (0.715)	0.221 (0.729)
Board Size	0.0160 (0.0365)	0.0248 (0.0359)	0.0278 (0.0357)	0.0190 (0.0364)
Aud. Cttee. Ratio	0.282 (0.569)	0.286 (0.563)	0.338 (0.564)	0.332 (0.571)
NonExecDir. Ratio	0.938 (1.098)	1.199 (1.094)	1.215 (1.097)	0.957 (1.102)
Delaware Inc.	-0.0714 (0.201)	-0.0434 (0.203)	-0.0583 (0.201)	-0.0833 (0.200)
Firm Size	0.235*** (0.0578)	0.270*** (0.0572)	0.295*** (0.0559)	0.259*** (0.0565)
RoA <sub>(t-1)</sub>	0.732 (0.475)	0.659 (0.479)	0.663 (0.483)	0.737 (0.480)
Tobin's Q <sub>(t-1)</sub>	0.0147 (0.0505)	0.0194 (0.0504)	0.0133 (0.0506)	0.00816 (0.0508)
Year FE	Y	Y	Y	Y
Industry FE	Y	Y	Y	Y
Observations	41,261	41,261	41,261	41,261
Pseudo R <sub>2</sub>	0.1554	0.1496	0.1462	0.1519

Robust standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

**Note:** Logit models of the likelihood that a firm will have a stand-alone compliance committee in a particular year. *Stand-alone Compliance Committee* solely counts stand-alone compliance committees, excluding compliance committees combined with audit committees or risk committees. *DOJ Enforcement* is a dummy for whether the firm has been the subject of a DPA or plea agreement in the previous three years; *DOJ Exposure* is the rate of prosecution in the same industry during the previous three years; *CC Interlock* is a dummy for whether any board member concurrently sits on the board of another company with

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a Compliance Committee; *Ave. Dir. Age* is average age of board members; *Male Board* is the ratio of male board members; *Board Size* is total number of board members; *Aud. Cttee. Ratio* is the ratio of Audit committee members to entire board members; *NonExecDir. Ratio* is the ratio of non-executive board members to entire board members; *Delaware Inc.* is a dummy for Delaware incorporation; *Firm Size* is the natural logarithm of the firm's total assets; *RoA<sub>(t-1)</sub>* is the firm's Return on Assets in the previous year; *Tobin's Q<sub>(t-1)</sub>* is the firm's market to book ratio in the previous year. 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).

Our results show that companies are more likely to adopt compliance committees if they have been targets of prosecution and if one of their board members has outside experience with using a CC. However, there is surprisingly little evidence that companies for which compliance investment is likely to be more valuable—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 5%. 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? We turn to these questions 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.<sup>222</sup> Criminal prosecutions have not been effective at targeting higher-level officers, in part because it is often quite difficult to show that they were aware of misconduct;

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<sup>222</sup> See generally Samuel Buell, *The Responsibility Gap in Corporate Crime*, 12 CRIM. L. & PHIL. 471 (2018) (discussing the concept of the responsibility gap).

indeed they may have been unaware.<sup>223</sup> Yet, the public has clamored for accountability, including through criminal convictions.<sup>224</sup> 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 sometimes attempted to do so with the use of independent corporate monitors.<sup>225</sup> Instead, it often lies to the board to ensure that compliance reforms are in place.<sup>226</sup> 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.<sup>227</sup>

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.<sup>228</sup> Consistent with this, we see that firm-level attributes predict CC adoption. Our concern here is not with firm-level variation, but the low aggregate level of adoption. In Part I.C, we

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223. See Daniel C. Richman, *Corporate Headhunting*, 8 HARV. L. & POL'Y REV. 265, 268–71 (2014).

224. See Jean Eaglesham & Anupreeta Das, *Wall Street Crime: 7 Years, 156 Cases and Few Convictions*, WALL STREET J. (May 27, 2016), <https://www.wsj.com/articles/wall-street-crime-7-years-156-cases-and-few-convictions-1464217378> [<https://perma.cc/Y2T6-LY5F>]; Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REV. BOOKS, (Jan. 9, 2014), <https://www.theregreview.org/2014/01/13/rakoff-no-high-level-prosecutions/> [<https://perma.cc/5RE2-TPTC>].

225. See Vikramaditya Khanna & Timothy L. Dickinson, *The Corporate Monitor: The New Corporate Czar?*, 105 MICH. L. REV. 1713, 1717–19 (2007).

226. See Gadinis & Miazad, *supra* note 30.

227. See Lipton et al., *supra* note 112 (noting the importance of a strong “tone at the top” on compliance from the board).

228. See, e.g., Renée B. Adams et al., *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. ECON. LIT. 58 (2010).

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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 (i) more likely to adopt CCs upon making increased investment in compliance, and (ii) constraints on board capacity to staff a CC make their adoption less likely. 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<sup>229</sup> 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;<sup>230</sup> 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.<sup>231</sup>

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.<sup>232</sup> 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, we would expect to see more extensive compliance programs in regulated industries, and in industries facing increased prosecution rates.

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229. *Supra* Parts II.C.1, II.D.3.

230. *Supra* Part II.B.

231. *Supra* Part II.B.

232. *Supra* Part I.A.

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Yet we find little, if any, evidence for either of these.<sup>233</sup> A possible explanation is that firms are underinvesting in compliance, relative to what would minimize their expected exposures.

Why might firms do this? 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.<sup>234</sup> Moreover—as discussed above—disclosing extensive compliance investment is unlikely to be appealing, because this will reveal to investors the extent of the expected enforcement costs to which compliance responds.<sup>235</sup>

## 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, experience with 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 board members' time is tightly constrained and they are highly focused in their activities. However, the fact that the effect of such experience is strongly positive suggests 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 learning about potentially beneficial innovations in governance.

A second relevant aspect of our results is the linkage we report in Table 6 between board size, the proportion of board participation in the AC, and CC adoption.<sup>236</sup> While these correlations, by themselves, do not suggest any particular causal

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233. *Supra* Part II.D.3.

234. This discussion draws on a fuller argument set out by three of us elsewhere. *See* Armour et al., *supra* note 31.

235. *Id.* at 23–24.

236. *Supra* Part II.D.3.

relationship, we think they are suggestive, in light of the capacity constraints of board members who might be candidates for service on a CC. 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.<sup>237</sup> Moreover, public companies are required to establish an AC staffed exclusively by independent directors.<sup>238</sup> To be independent, one cannot be an employee of the company.<sup>239</sup> 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.”<sup>240</sup> 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).<sup>241</sup> A body of practitioner literature focuses on the results of academic studies and practitioner surveys that report performance benefits associated with boards of around ten to twelve members.<sup>242</sup> 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.<sup>243</sup>

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237. See, e.g., N.Y. STOCK EXCH., INC., NYSE LISTED CO. MANUAL § 303A.01 (2009) (“Listed companies must have a majority of independent directors.”).

238. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745 (codified at 15 U.S.C. § 7201 (2012)).

239. N.Y. STOCK EXCH., INC., *supra* note 237, § 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 . . .”).

240. See *infra* note 243 and accompanying text.

241. See *infra* note 243 and accompanying text.

242. See *infra* note 243 and accompanying text.

243. AUSTL. INST. OF CO. DIRS., NUMBER OF DIRECTORS—BOARD SIZE 2, [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](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) [<https://perma.cc/ELQ2-9VYF>] (providing a “rule of thumb” suggesting 8–12 directors for a large Australian listed company); see, e.g., Stephen Bain-

Putting these pieces together, board independence and audit committee 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 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 higher stock prices.<sup>244</sup> For many companies, a CC 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.<sup>245</sup> Yet greater compliance oversight at the board-level is likely to reduce the incidence of law violations by the firm.<sup>246</sup> This is an implication of our study of CC charters, which shows the sharper focus and additional resources that compliance committees bring to compliance oversight.<sup>247</sup> It is highly unlikely that our system of criminal and administrative enforcement has achieved the socially

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bridge, *Board Size: Is There an Optimum?*, STEPHEN BAINBRIDGE'S J.L., RELIGION, POL. & CULTURE (May 8, 2009), <https://www.professorbainbridge.com/professorbainbridgecom/2009/05/board-size-is-there-an-optimum.html> [<https://perma.cc/22FC-9GRJ>] (surveying academic literature and concluding that “[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.”); Nicholas J. Price, *Best Practices: Board Size and Corporate Governance*, DILIGENT INSIGHTS (Sept. 25, 2017), <https://diligent.com/blog/board-size-corporate-governance> [<https://perma.cc/BX3Z-ZB5V>] (discussing prior studies and noting that “less is more”); Robert Reiss, *The 10 Best Practices for an Effective Board*, FORBES (Nov. 25, 2015, 8:47 AM), <https://www.forbes.com/sites/robertreiss/2015/11/25/the-10-best-practices-for-an-effectiveboard/#cb8f00f413b9> [<https://perma.cc/6YX3-9RGC>] (“The best group of an average-sized American public company would be nine to twelve board members.”). The central academic paper is David Yermack, *Higher Market Valuation of Companies with a Smaller Board of Directors*, 40 J. FIN. ECON. 185 *passim* (1996) (finding inverse correlation between board size and firm value).

244. *Supra* Part III.A.2.

245. *See supra* Part II.

246. *See supra* Part II.

247. *See supra* Part II.

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 study shows that ninety-four percent of public companies still do not have compliance committees.<sup>248</sup> Thus far public authorities have not mandated compliance committees except in five corporate prosecutions, and occasionally in other areas of civil enforcement.<sup>249</sup> In general, the enforcers mandate increased compliance but have not taken the next corporate governance step.<sup>250</sup> 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.<sup>251</sup>

#### 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.<sup>252</sup> We have also described that more companies do create such committees when, following an enforcement action, prosecutors more strongly signal, if not require, that boards oversee compliance using a committee-structure.<sup>253</sup> An enforcement strategy, however, sends messages primarily to companies facing consequences for violations and only secondarily to others in industry that observe enforcement outcomes.<sup>254</sup> Indeed, the lack of relationship between compliance committee adoption and *exposure* to DOJ enforcement (as proxied by industry prosecution rates) suggests that these secondary

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248. *Supra* Part II.A.3.

249. 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).

250. *See supra* Part I.B.3.

251. *See infra* Part III.B.1.

252. *See supra* Part II.C.1.

253. *See supra* Part II.D.

254. *See supra* Part II.D.



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.

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 CCs 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: health care, 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.<sup>255</sup> A further measure would be for a 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.<sup>256</sup>

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.<sup>257</sup> This is an outsider to the board with extensive compliance expertise who may be given prior notice of the compliance presentation and the opportunity

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255. See *supra* note 16.

256. 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. See Press Release, Office of Inspector General, *OIG Executes Tenet Corporate Integrity Agreement Unprecedented Provisions Include Board of Directors Review* (Sept. 28, 2006), <https://oig.hhs.gov/fraud/docs/press/Tenet%20CIA%20press%20release.pdf> [<https://perma.cc/KW5E-EKAV>].

257. Corporate Integrity Agreement, Office of the Inspector General of the Department of Health and Human Services & Tuomey D/B/A Tuomey Healthcare System, at 1, 27 (2015) [hereinafter *Corporate Integrity Agreement*]; 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, 25 (2016).

to insist on deeper examination if dissatisfied.<sup>258</sup> 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.<sup>259</sup> The combination of the Sarbanes-Oxley Act and stock exchange listing requirements achieved a similar objective regarding financial expertise of audit committee members.<sup>260</sup>

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.<sup>261</sup> In the health care context, for example, the Department of Health and Human Services, Office of Inspector General issued guidance in 2015 to corporate boards on health care compliance, highlighting that “every Board is responsible for ensuring that its organization complies with relevant Federal, State, and local laws.”<sup>262</sup> There was a perception that boards were “inclined to address only global issues and view matters such as compliance as technical ‘day-to-day’ issues, which are the province of trained staff.”<sup>263</sup> For that reason, some regulators have intensified their focus on the responsibility of directors.<sup>264</sup> 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.<sup>265</sup>

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258. Corporate Integrity Agreement, *supra* note 257, at 7–8.

259. Joshi, *supra* note 257, at 25.

260. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407, 116 Stat. 746 (codified at 15 U.S.C. § 7201 (2012)); *see also* N.Y STOCK EXCH., INC., *supra* note 237, § 303A.06–07; NASDAQ LISTING RULE § 5605(c) (2009).

261. OFFICE OF INSPECTOR GEN. ET AL., PRACTICAL GUIDANCE FOR HEALTH CARE GOVERNING BOARDS ON COMPLIANCE OVERSIGHT 16 (2015).

262. *Id.*

263. Joseph T. Kelley III, *Board Governance, Compliance, and Behavioral Health*, HEALTH CARE L. ENFORCEMENT & COMPLIANCE, 2015 WL 9182494, at \*1 (2016).

264. OFFICE OF THE INSPECTOR GEN. ET AL., THE HEALTH CARE DIRECTOR'S COMPLIANCE DUTIES: A CONTINUED FOCUS OF ATTENTION AND ENFORCEMENT (2011).

265. Kelley, *supra* note 263, at \*5–6.

Boards may have taken heed of this.<sup>266</sup> 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 [Corporate Integrity Agreement].”<sup>267</sup> 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” regime.<sup>268</sup> 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 pursuing) “stewardship”

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266. Deann M. Baker, *Key Methods to Develop and Mature Your Compliance Program*, 10 J. HEALTH CARE COMPLIANCE 37, 37 (2008).

267. Jeremy Sternberg, *HHS-OIG Corporate Integrity Agreements Are Now Aiming at Corporate Directors and Executives*, JDSUPRA (Oct. 31, 2013), <http://www.jdsupra.com/legalnews/hhs-oig-corporate-integrity-agreements-a-11456/> [<https://perma.cc/4S9P-6MZX>]; see, e.g., Corporate Integrity Agreement Between The Office of Inspector General of the Dept. of Health and Human Serv. & Hutchinson Regional Med. Ctr. (2013).

268. 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).

agendas.<sup>269</sup> Such investors commonly hold fully-diversified portfolios.<sup>270</sup> Compliance failures, meaning, violations of law, commonly result in negative externalities felt elsewhere in the portfolio.<sup>271</sup> One does not 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.”<sup>272</sup> It also states that the “Committee may conduct special reviews or investigations as it may deem necessary or appropriate to fulfill its responsibilities.”<sup>273</sup>

A second possibility is the addition of a compliance expert as a director (which is easier if the board is expanded)<sup>274</sup> 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. For example, Standard Chartered Bank, an international bank headquartered in the UK, established a Board Financial Crime Risk Committee in 2014, comprised of five independent directors and three external advisors with expertise and experience in combating financial crime.<sup>275</sup>

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269. See, e.g., BLACKROCK, BLACKROCK INVESTMENT STEWARDSHIP: 2018 ANNUAL REPORT (2018).

270. Armour et al., *supra* note 31, at 54.

271. *Id.*

272. HCA HEALTHCARE INC., AUDIT AND COMPLIANCE COMMITTEE CHARTER 2 (2018), [https://investor.hcahealthcare.com/sites/hcahealthcare.investorhq.businesswire.com/files/doc\\_library/file/HCA\\_-\\_Audit\\_and\\_Compliance\\_Committee\\_Charter\\_Jan\\_2018.pdf](https://investor.hcahealthcare.com/sites/hcahealthcare.investorhq.businesswire.com/files/doc_library/file/HCA_-_Audit_and_Compliance_Committee_Charter_Jan_2018.pdf) [<https://perma.cc/L8CA-ZZWE>].

273. *Id.* at 8.

274. See Roy Snell, *It's Time to Get Serious About Board Expertise*, 13 J. HEALTH CARE COMPLIANCE 3 *passim* (2011).

275. Press Release, Standard Chartered, Standard Chartered Forms Board

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.<sup>276</sup> One important question is whether higher director pay would compromise director independence, because the director with a sweet deal would have a special reason to avoid antagonizing the CEO. The increasingly important role of the independent nominating-governance committee in identifying director candidates and vetting the director performance should offer some protection on this dimension.<sup>277</sup> Service in this role might be time-limited and directors could well seek a reputation for vigorous compliance oversight.

While it appears that tools are at hand to increase board capacity to facilitate engagement with compliance, a question remains whether boards have sufficient incentives to wish to do so. These incentives are clearly affected by their corporate law duties, to which we now turn.

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Financial Crime Risk Committee (Dec. 10, 2014), <https://www.sc.com/en/media/press-release/standard-chartered-forms-board-financial-crime-risk-committee/> [<https://perma.cc/7W3T-SK9R>].

276. See, e.g., Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991). More recently Professors Gilson and Gordon have proposed an optional board model in which companies could choose to add "empowered directors" who would have much deeper engagement with the firm and who would be given additional resources and access (and compensation). The focus of their concern has been the firm's strategy and operational performance, but the model could be focused on compliance oversight for firms where compliance failures are a major business risk. Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0 – An Introduction*, 74 BUS. LAW. 351 (2019).

277. See, e.g., N.Y. STOCK EXCH., INC., NYSE LISTED CO. MANUAL § 303A.04 (2009) (requiring Nominating/Corporate Governance Committee consisting solely of independent directors and tasked with identifying qualified individuals to become board members).

### 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.<sup>278</sup> 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.<sup>279</sup>

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."<sup>280</sup> Or, as the Delaware Supreme Court subsequently put it in *Stone v. Ritter*,<sup>281</sup> 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:<sup>282</sup>

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278. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

279. *Id.*

280. *Id.*

281. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

282. *Guttman v. Huang*, 823 A.2d 492, 507 (Del. Ch. May 5, 2003); *see also* *David B. Shaev Profit Sharing Account v. Citigroup, Inc.*, No. Civ.A. 1449-N, 2006 WL 391931, at \*1, \*5 (Del. Ch. Sept. 27, 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.<sup>283</sup>

The recent case of *Horman v. Abney*, concerning allegations of *Caremark* violations by the board of UPS in relation to the transportation of illegal tobacco products, provides an illustrative example.<sup>284</sup> 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.<sup>285</sup> By simply establishing these structures, the board had met their *Caremark* obligations.<sup>286</sup>

Of course, if the board actually came 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.<sup>287</sup> 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.<sup>288</sup> As we

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283. *Shaev Profit Sharing Account*, 2006 WL 391931, at \*5.

284. *Horman v. Abney*, C.A. No. 12290-VCS, 2017 WL 242571, at \*1 (Del. Ch. Jan. 19, 2017).

285. *Id.* at \*8.

286. *Id.*

287. *Gadinis & Miazad*, *supra* note 30.

288. *See, e.g., Horman*, 2017 WL 242571, at \*8 (“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 particularized facts that the Board ‘utterly’ failed to adopt or implement any reporting and compliance systems.”); *In re General Motors Co. Derivative Litig.*, C.A. No. 9627-VCG, 2015 WL 3958724, at \*2 (Del. Ch. June, 26 2015) (“The Complaint does not allege a

have seen, the question is characterized as one of existence, rather than quality. Thus *Caremark* as read through *Stone v. Ritter* may have a perverse effect on board-level compliance oversight. The creation of a CC, or even lodging a more explicit compliance function in another committee, creates duties and liability risks that directors would not otherwise have and thus may discourage board-level compliance activity.

By setting the hurdle for directors so low, the *Caremark* standard effectively precludes judicial consideration of compliance issues, whether at board-level or 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.<sup>289</sup> 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.<sup>290</sup> Unfortu-

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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.”); *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.”); *Shaev Profit Sharing Account*, 2006 WL 391931, at \*5 (“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.”); *Guttman v. Huang*, 823 A.2d 492 (Del. Ch. 2003).

289. E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004?: A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1404 (2005) (“Delaware judges have had a substantial role in shaping best practices in corporate governance.”).

290. See Barkow, *supra* note 34 (characterizing DPAs as part of a “new policing” of business crime); Garrett, *Structural Reform Prosecution*, *supra* note 33 (providing data on the use of deferred prosecution agreements to mandate increases in compliance activity); Kaal & Lacine, *supra* note 34, at 82–84, 92–99 (2014) (analyzing data on use of deferred prosecution agreements to mandate changes in corporate governance).



nately, this discretionary “regulation by settlement” is seemingly ill-equipped to guide boards how to discharge their responsibilities.<sup>291</sup>

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.<sup>292</sup>

The Delaware Supreme Court appears to have signaled a tougher line on board engagement in compliance in its recent decision in *Marchand v. Barnhill*,<sup>293</sup> decided after earlier versions of this Article were circulated.<sup>294</sup> This was a suit alleging breach of *Caremark* duties by the board of Blue Bell, an ice cream manufacturer, which had suffered an outbreak of listeria ultimately causing the deaths of three people and considerable losses for the firm.<sup>295</sup> Blue Bell had a compliance program that the plaintiff did not contest was in breach of applicable FDA regulations.<sup>296</sup> Rather, the plaintiff’s claim was that the firm did not have in place a *board-level* system of compliance oversight, such that red flags about listeria in the firm’s processing plants were not reported to the board until it was too late.<sup>297</sup> For this reason, the Supreme Court rejected the company’s motion to dismiss the plaintiff’s suit.<sup>298</sup>

This decision is encouraging from the perspective of our analysis because the Court emphasizes that directors’ *Caremark*

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291. Arlen, *supra* note 33, at 76–81; Copeland, *supra* note 33, at 10.

292. For a detailed proposal to expand director liability for compliance oversight failures, see Armour et al., *supra* note 31.

293. *Marchand v. Barnhill*, 212 A.3d 805 (Del. Ch. 2019).

294. An earlier version of this Article was cited by the Court. *Id.* at 824 n.115.

295. *Id.* at 822.

296. *Id.* at 823.

297. *Id.* at 811.

298. *Id.* at 817.

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obligations are specific and non-delegable: the board needs to attend to the company's central compliance risk and there must be a board-level oversight of the compliance mechanism put in place. "*Caremark* . . . does require that a board make a good faith effort to put in a reasonable system of monitoring and reporting about the corporation's central compliance risks."<sup>299</sup> "[T]o satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it."<sup>300</sup> Thus, *Marchand v. Barnhill* appears to cabin *Stone v. Ritter*'s highly deferential approach to evaluating the sufficiency of board compliance oversight. *Caremark* read through *Marchand* now seems to require board compliance oversight matched to the external compliance regime.

Of course, a more demanding interpretation of directors' fiduciary oversight duties by no means implies that companies should automatically establish a CC. 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 CC 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 5% 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 specifically require them to do so. We review a comprehensive dataset of DPAs and plea bargains entered into by public companies from 2001 onwards. In only 5 of 374 cases (less than 2%) do these agreements actually stipulate the creation of

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299. *Id.* at 824.

300. *Id.* at 821.

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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 settlements, creating 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 outside 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 CC are much more likely to establish one themselves. This finding that outside experience matters is consistent with the general literature of diffusion of innovations. Moreover, it suggests that these directors' experience of board compliance is generally positive, as it increases the likelihood of adoption by other boards on which they serve. Why, then, are CCs not more widely adopted?

Our fourth result is that boards with compliance committees tend to be larger and have more independent directors. This, again, 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 concluded 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. Compliance programs seek to prevent some of the most serious and socially harmful corporate misconduct. The role of corporate boards in monitoring the compliance program has become increasingly pivotal and deserves more attention from both inside and outside of the boardroom.