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## **The Board Committee as a Legal Transplant**

Comparative Analysis illustrated by the example of the Audit Committee

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Bilanzskandale und Missmanagement haben in den vergangenen Jahren den Ruf nach besseren Kontrollmechanismen in der Unternehmensführung laut werden lassen. Audit Committees sind ein wichtiges Werkzeug um eine solche Kontrolle sicherzustellen und sind inzwischen weltweit zum integralen Bestandteil einer guten «Corporate Governance» geworden. Die Audit Committees haben sich in unterschiedlichen kulturellen und rechtlichen Umgebungen etabliert. Wie der Beitrag zeigt, hat die weltweite Zunahme der Bedeutung der «Corporate Governance» das Audit Committee zum Vorzeigebispiel eines «legal transplant» gemacht.

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## I. Introduction

[Rz 1] Throughout recent history, corporate scandals and incidents of mismanagement have repeatedly shaken up capital markets in the United States and elsewhere. Events of this sort have blatantly exposed existing weaknesses in corporate leadership and oversight, notably the prevalence of conflicts of interests at various levels and shortcomings in areas such as internal controls, auditing, compliance or risk management. As a result, press coverage on the work of corporate boards increasingly focused on their role as an oversight organ, raising serious questions regarding the adequacy of the current framework in addressing the above issues.

[Rz 2] Public criticism of the status quo and a call for an increase in «checks and balances» within corporations led to a whole range of new laws and codes in the 1990ies and after the turn of the millennium. Starting in the United States and England, the establishment of specialized board committees was soon recognized as a pivotal tool in improving transparency and internal control mechanisms. Over the past years, the use of board committees has taken hold in Continental Europe and other parts of the world, turning them into an integral part of corporate culture worldwide. While the types and functions of such committees are manifold<sup>1</sup>, the audit committee has been a particular success story. Its rapid diffusion to other legal systems allows for interesting observations on the factors contributing to the dissemination of a specific

<sup>1</sup> For further details on the definition and history of board committees refer to: Thomas Jutzi, *Verwaltungsratsausschüsse im schweizerischen Aktienrecht – unter besonderer Berücksichtigung der Verhältnisse in den USA, Deutschland und England* 4–7 (2008).

legal construct from one legal environment to another and the mechanisms involved in such a process.

[Rz 3] The article will first explore the legal framework for board committees in the United States, England, Switzerland and Germany and provide an overview on current reform efforts on an international level. Taking the spread of the audit committee from the United States to Continental Europe as an example, the article will then analyze the mutual relations between those legal systems and introduce the concept of the *legal transplant*.

## II. The development of board committees on the international scene

### 1. United States of America

[Rz 4] The emergence of board committees as a phenomenon in the US can be traced back to the 1930ies.<sup>2</sup> Since then, there has been a constant effort to increase the efficiency of board committees, especially with regard to audit committees.<sup>3</sup> A watershed moment came with the collapse of Enron in December 2001, which led to a legislative campaign<sup>4</sup> culminating in the adoption of the Sarbanes-Oxley Act (SOX), a law that not only made corporate governance part of a formal legal statute for the first time but also critically amended the Securities Exchange Act (SEA) of 1934.<sup>5</sup> It contains essential provisions regarding board committees, which are further detailed and complemented by the rules set by the Securities Exchange Commission (SEC). Of further relevance to board committees are the admission requirements of US stock exchanges.

[Rz 5] The US provisions regarding board committees are significantly different from other legal frameworks to be examined in this paper since corporate law in the United States, unlike in most other countries, is not genuinely unified but merely harmonized to a certain extent.<sup>6</sup> The legislative competence concerning corporations lies with the federal states.<sup>7</sup> The corporation is the predominant legal status of

<sup>2</sup> Gudrun Girnhuber, *Das US-amerikanische Audit Committee als Instrument zur Vermeidung von Defiziten bei der Überwachungstätigkeit der deutschen Aufsichtsräte* 44–50 (1998).

<sup>3</sup> Peter Böckli, *Audit Committee – der Prüfungsausschuss des Verwaltungsrates auf Gratwanderung zwischen Übereifer und Unsorgfalt* 19–20 (2005).

<sup>4</sup> Mark Strauch, *Der Sarbanes-Oxley Act und die Entwicklungen im US-Aufsichtsrecht* 952 (2003); Peter Böckli, *Schweizer Aktienrecht: mit Fusionsgesetz, Internationalen Rechnungslegungsgrundsätzen (IFRS), Börsengesellschaftsrecht, Konzernrecht und Corporate Governance* § 13 ¶ 388 (2004).

<sup>5</sup> See Thomas L. Hazen, *The Law of Securities Regulation* 357–58 (2006).

<sup>6</sup> Pricewaterhouse Coopers, *Corporate Governance in Deutschland: Entwicklungen und Trends vor internationalem Hintergrund* 46–47 (2005).

<sup>7</sup> Theodor Baums, *Der Aufsichtsrat – Aufgaben und Reformfragen*,

large companies in the United States, comparable to a German Aktiengesellschaft.<sup>8</sup> The duties of and the oversight over the management are defined in the federal states' corporation statutes. According to those, appointment and dismissal of the board of directors as well as all decisions concerning matters of fundamental importance or unorthodox questions are within the responsibility of the shareholders.<sup>9</sup> Different rules apply to small, person-related corporate entities, so called close corporations, as well as public corporations.<sup>10</sup>

### 1.1 The legal framework for board committees in the Sarbanes-Oxley Act

[Rz 6] The US legislator has reacted to the corporate scandals concerning Enron Corp., Tyco International Ltd. or WorldCom Inc.<sup>11</sup> by redesigning corporate governance, realizing that these crises could not be traced back to market-related, legal or financial or other external risks but that they were clearly the result of mismanagement.<sup>12</sup> As a result, the Sarbanes-Oxley Act was enacted in July 2002.<sup>13</sup> The SOX is widely regarded as a milestone in corporate governance legislation and the basis for further legislative action in the European Union and its member states, even though in the meantime criticism has been raised claiming that the SOX places an excessive burden on companies.<sup>14</sup>

[Rz 7] The SOX has the character of a broader framework, whose enforcement was delegated to the Securities and Exchange Commission.<sup>15</sup> The SOX is applicable to companies listed on the stock exchange and their subsidiaries (listed or not)<sup>16</sup>, its provisions focusing on the audit committee and its independence. With the SOX, the establishment of an audit committee has become mandatory for listed public companies.<sup>17</sup> The committee has to consist exclusively of independent members of the board of directors. This means its members are forbidden from receiving any fees or remuneration for consulting activities other than their board and committee

compensation. The audit committee must count at least one recognized financial expert.<sup>18</sup> To qualify as a financial expert, the director needs to have extensive experience with the preparation of financial statements for comparable corporations, with applying relevant account principles for estimates, accruals and reserves, and with internal controls and financial reporting procedures.<sup>19</sup> The auditing and consulting activity of the financial controllers has to be authorized by a prior consent of the audit committee.<sup>20</sup> On the part of the company leadership, there is a duty to disclose vis-à-vis the audit committee (as well as the financial controllers)<sup>21</sup> with regard to all substantial deficiencies within the internal controls system and all occurrences of fraud perpetrated by persons playing an important role within internal controls.<sup>22</sup>

[Rz 8] According to the concept of the legislator, the audit committee also serves as a point of contact for employees to confide in if they notice a violation of rules within the company.<sup>23</sup> In contrast, there are no concrete legal requirements with regard to other types of committees, such as the nomination or the compensation committee.

### 1.2 Self-regulation of the Securities and Exchange Commission (SEC) und admission requirements to stock exchanges

[Rz 9] The provisions of the Sarbanes-Oxley Act are complemented by the rules of the SEC, which either repeat and clarify the content of the SOX provisions or further elaborate on them<sup>24</sup>. The SEC has adopted regulations that effectively require all companies listed on US stock exchanges or the Nasdaq to establish audit committees appointing and overseeing external financial controllers. All members of the audit committee have to be independent, i.e. they must not be employed, paid for consulting services, be major shareholders or in any other way be associated with the company.<sup>25</sup> The regulations also apply to non-US companies as long as they are listed on a US stock exchange.<sup>26</sup> To avoid conflicts with national law, there are exceptional rules, such as the mandatory employee representation in the board of directors or provisions regarding the shareholders' final responsibility for the appointment of the financial controllers.<sup>27</sup> The SEC has furthermore created rules strengthening existing regulations concerning the independence of auditors by requiring

Zeitschrift für Wirtschaftsrecht, 8 (1995).

<sup>8</sup> Pricewaterhouse Coopers, supra n. 6 at 47.

<sup>9</sup> Baums, supra n. 7 at 8.

<sup>10</sup> Baums, supra n. 7 at 8.

<sup>11</sup> See Pricewaterhouse Coopers, supra n. 6 at 46; Gerrit J. Brink & Frank Romeike, *Corporate Governance und Risikomanagement im Finanzdienstleistungsbereich: Grundlagen, Methoden, Gestaltungsmöglichkeiten* 3 (2005).

<sup>12</sup> Brink & Romeike supra n. 11 at 3.

<sup>13</sup> Andreas Dutzi, *Der Aufsichtsrat als Instrument der Corporate Governance – Ökonomische Analyse der Veränderungen im Corporate-Governance-System börsennotierter Aktiengesellschaften* 48–49 (2005).

<sup>14</sup> Pricewaterhouse Coopers, supra n. 6 at 47.

<sup>15</sup> Paul Atkins, *Der US-Sarbanes-Oxley Act: Zielsetzungen, Inhalt und Implementierungsstand*, 1 Der Konzern, 260–66 (2003).

<sup>16</sup> Thomas Berndt & Ivo Hoppler, *Whistleblowing – ein integraler Bestandteil effektiver Corporate Governance*, 48 Der Betriebsberater (BB), 2623–28 (2005).

<sup>17</sup> SOX § 301; also see SEA § 10A.

<sup>18</sup> SOX § 407.

<sup>19</sup> Böckli, supra n. 4 at § 14 ¶ 72.

<sup>20</sup> SOX § 202(i)(1)(A).

<sup>21</sup> SOX § 302(a)(5).

<sup>22</sup> Böckli, supra n. 4 at § 14 ¶ 74.

<sup>23</sup> Böckli, supra n. 4 at § 14 ¶ 81.

<sup>24</sup> Hazen, supra n. 5 at 357–58.

<sup>25</sup> Böckli, supra n. 4 at § 14 ¶ 50–56.

<sup>26</sup> Strauch, supra n. 4 at 955.

<sup>27</sup> SOX § 301; also see SEC Release No. 33–8220 of 9 April 2003, Final Rule: Standards Relating to Listed Company Audit Committees.

approval by the audit committee for services not directly related to financial auditing, by completely prohibiting certain non auditing-related services, by increasing the standards for conflicts of interest, by requiring a rotation of partners at the mandated accounting firm as well as the examination by two partners, and finally by defining the relation between the independent controllers and the audit committee. The audit committee must be informed by the financial controller when it comes to certain conspicuities and questionable accounting standards applied by the company.<sup>28</sup> The regulations also prohibit the destruction or falsification of evidence and stipulate that accounting documentation is to be stored by auditing firms. These new rules also apply to non-US companies, however they allow for a certain degree of flexibility where there is a potential for conflict with national law, for instance with regard to the status of the supervisory board in dual structures and employee representation.<sup>29</sup> The rules for compensation and nomination committees are less far-reaching; however, the corporate governance rules of the NYSE require the appointment of a nomination and a compensation committee, each of which has to consist entirely of independent members.<sup>30</sup>

## 2. England

[Rz 10] Unlike in American law, in English law the basic framework for the internal organization of the board of directors is not embedded in formal legislative acts, but merely in codes and reports.<sup>31</sup> Just as for corporate governance in general, the board committee culture of corporate entities appears only in codes that do not have the binding nature of a formal statute of law. The English company law, enacted in the Companies Act<sup>32</sup>, does not mention board committees at all. The basic understanding of board committees in England can be summarized as follows: There should be as few strict rules applicable to companies as possible, the conduct of the company management should however be as transparent as possible.<sup>33</sup> Following the rule «*comply or explain*», the English Combined Code requires that violations of certain standards set by these legally non-binding corporate governance codes are explained.<sup>34</sup> At the end of 1992, the Cadbury-Committee

published a report («Financial Aspects of Corporate Governance») in England that is legally binding for all companies traded at the London stock exchange and has become renowned across the globe.<sup>35</sup> The so called Cadbury Report, which emphasizes shareholders' interests and aims at an improvement of corporate governance structures, for the first time in England examined the structure and mode of operation of the board of directors; based on the report, recommendations were put forward in the form of a Code of Best Practice.<sup>36</sup> The Cadbury Report not only mentions the audit, nomination and remuneration committees<sup>37</sup> but also defines their scope of competence. For example, an audit committee should be composed of at least three independent members and it has to meet with an external auditor and the financial management at least once a year in the absence of executive directors.<sup>38</sup>

[Rz 11] The Cadbury Report has been implemented to a large extent not least because of the fact that the London stock exchange has made the annual reporting on the implementation of the Code of Best Practice mandatory for all listed companies.<sup>39</sup> For this reason, board committees are widespread in England these days and appear in various forms. The Cadbury Report was developed further with the Greenbury Report (1995) and the Hampel Report (1998).<sup>40</sup> Another notable report is the so called Higgs Report (January 2003), on whose basis further recommendations were made, which were in turn embedded in the revised British Combined Code on Corporate Governance (Combined Code) of July 2003.<sup>41</sup> An important goal of the Combined Code, which was renamed to UK Corporate Governance Code in May 2010, is the strengthening of auditing by independent directors with a focus on the auditors' independence. The EU Commission follows the example of the Code in its recommendations of 2004.<sup>42</sup> Revisions of the German Corporate Governance Code of 2005 also took a leaf out of the Combined Code.<sup>43</sup> The independence of the auditors is assured by having non executive directors appointed by a separate nomination committee or a separate remuneration committee. According to

<sup>28</sup> Strauch, supra n. 4 at 955.

<sup>29</sup> SOX §§ 208(a) and 802 in connection with SEC Regulation S-X und S-K; SEC Release No. 33-8183 of 28 January 2003, Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence.

<sup>30</sup> See Final NYSE Corporate Governance Rules secs. 303A.04 and 303A.05. Similar rules apply to companies listed on the NASDAQ, in their case a majority of independent directors is sufficient however: see NASDAQ Stock Market Rule 4350(c)(3)(A).

<sup>31</sup> Böckli, supra n. 4 at § 14 ¶ 100-105; Marcus Lutter, *Information und Vertraulichkeit im Aufsichtsrat* ¶ 352-55 (2006).

<sup>32</sup> See for more details: Palmer's Company Law, *Annotated Guide to the Companies Act 2006* (2007).

<sup>33</sup> Jutzi, supra n. 1 at 41.

<sup>34</sup> Bernhard Nagel, *Unabhängigkeit der Kontrolle im Aufsichtsrat und*

*Verwaltungsrat: Der Konflikt zwischen der deutschen und der angelsächsischen Konzeption*, Neue Zeitschrift für Gesellschaftsrecht, 168 (2007); Böckli, supra n. 4 at § 14 ¶ 13-15.

<sup>35</sup> Baums, supra n. 7 at 12.

<sup>36</sup> Peter Böckli, *Corporate Governance: Der Stand der Dinge nach den Berichten «Hampel», «Viénot» und «OECD» sowie dem deutschen «KonTraG», 1 Schweizerische Zeitschrift für Wirtschafts- und Finanzmarktrecht, 3 (1999).*

<sup>37</sup> Cadbury Report secs. 4.30, 4.35, 4.42.

<sup>38</sup> Baums, supra n. 7 at 12-15.

<sup>39</sup> Böckli, supra n. 36 at 4.

<sup>40</sup> Böckli, supra n. 36 at 11.

<sup>41</sup> Hans Caspar Von der Crone, *Arbeitsteilung im Verwaltungsrat*, in 79 VERWALTUNGSRAT UND GESCHÄFTSLEITUNG 86 (Charlotte M. Baer ed., 2006).

<sup>42</sup> Böckli, supra n. 3 at 20.

<sup>43</sup> Nagel, supra n. 34 at 167.

the Combined Code (and UK Corporate Governance Code), audit committees are recommended for all public corporations in England.<sup>44</sup>

### 3. Switzerland

[Rz 12] In Switzerland, board committees were first legally established in the *Code of Obligations* of 14 June 1881.<sup>45</sup> The Code of Obligations of 18 December 1936<sup>46</sup> – like the law currently in force – contained two articles relevant for the appointment of board committees in corporations: art. 714 para. 2, which specifically mentioned the term «board committee», and art. 717 para. 1 and 2 dealing with the delegation of management and external representation functions to board directors and third parties. The corporate law currently in force (Swiss Code of Obligations, abbr. CO)<sup>47</sup> stipulates in art. 716a para. 2 und art. 716b the board's right to appoint committees; however, it doesn't contain any explicit legal obligation of companies to organize themselves internally by way of board committees.<sup>48</sup> The legal framework for board committees contained in CO art. 716a para. 2 und art. 716b has, since entry into force of these two provisions in 1992, been complemented by soft law in the form of self-regulation codes, private compendia or recommendations.<sup>49</sup>

#### 3.1 Legal Framework

[Rz 13] In the Swiss Code of Obligations, board committees of corporations are explicitly mentioned only in CO art. 716a para. 2 and art. 726 para. 1. These two discretionary provisions regulating the appointment and dismissal of board committees are however not the only relevant rules. CO art. 716b para. 1, which deals with the delegation of management functions to members of the board of directors and third parties in general, is also part of the legal framework for the appointment of board committees in the Code of Obligations.

[Rz 14] According to CO art. 716a para. 2, it is permitted for the board of directors to delegate the preparation and execution of its decisions as well as the supervision of transactions to committees.<sup>50</sup> Substantively speaking, this concerns the execution of auxiliary activities in the competence field defined in CO art. 716a para. 1 as «non-transferable» and

«inalienable» with relation to the board of directors; among those activities are the «overall management of the company and the issuing of all necessary directives» mentioned in subparagraph 1 or the «the organization of the accounting, financial control and financial planning systems as required for management of the company» mentioned in subparagraph 3.<sup>51</sup> It ensues from the wording and the systematic context of CO art. 716a para. 2 however, that an internal organization of the board of directors by means of committees is not only possible in the context of «non-transferable» and «inalienable» functions but also in the board's other competence areas. The delegation of duties to a committee is limited in two ways by CO art. 716b para. 1 and art. 716a para. 1: first, the assignment of management duties to committees is a delegation in the sense of CO art. 716b para. 1 if the committee is equipped with decision power in this domain. If such a competence to make management decisions is to be assigned to a committee, the formal requirements set by CO art. 716b para. 1 must be respected. Second, the establishment of a committee with functions that are unassignable according to CO art. 716a para. 1 is only permitted if the committee is equipped with no decision power. Therefore, the law currently in force basically provides for two types of board committees: committees that only deal with the preparation and execution of board decisions as well as the supervision of transactions and hence have no decision power and, on the other hand, committees that can be equipped with management and decision competencies.<sup>52</sup> These two types of board committees differ with regard to the formal requirements as well as the effects of a delegation.<sup>53</sup> CO art. 716a para. 2 is especially significant because – unlike CO art. 716b – it allows the board of directors to delegate certain tasks without any specific authorization by the general assembly, as long as they don't fall within the scope of management duties. Yet there is room for hybrid forms of these two types of board committees if the respective legal conditions and limitations for the assigned functions are met.

[Rz 15] Equally relevant for board committees is CO art. 717 para. 1, which defines the duty of care for members of the board of directors. Performing various duties «with all due care» – in particular the duty to provide for adequate internal

<sup>44</sup> Combined Code (and UK Corporate Governance Code) sec. C.3.1.

<sup>45</sup> CO art. 620 para. 2 (1883), entry into force on 1 January 1883.

<sup>46</sup> In force from 1 July 1937 until 30 June 1992; see Peter Kunz, *Der Minderheitenschutz im schweizerischen Aktienrecht – Eine gesellschaftsrechtliche Studie zum aktuellen Rechtszustand verbunden mit Rückblick und mit Vorschau sowie rechtsvergleichenden Hinweisen* § 3 ¶ 56–100 (2001).

<sup>47</sup> Revision of the Code of Obligations (Title 26: Die Aktiengesellschaft) of 4 October 1991, in force since 1 July 1992 (art. 663 e–g in force since 1 July 1993).

<sup>48</sup> Jutzi, supra n. 1 at 117–128.

<sup>49</sup> Böckli, supra n. 4 at § 14 ¶ 315–320.

<sup>50</sup> Gion Giger, *Corporate Governance als neues Element im schweizerischen Aktienrecht* 321 (2003).

<sup>51</sup> Rolf Watter & Katja Roth Pellanda, *commentary on art. 716a CO, in 1062 BASLER KOMMENTAR ZUM SCHWEIZERISCHEN PRIVATRECHT, OBLIGATIONENRECHT II, 1066–73* (Heinrich Honsell, Nedim Peter Vogt & Rolf Watter eds., 2008).

<sup>52</sup> Böckli, supra n. 4 at § 13 ¶ 405; Peter Forstmoser, Arthur Meier-Hayoz & Peter Nobel, *Schweizerisches Aktienrecht* § 29 ¶ 30–35 (1996); Hans Caspar von der Crone, Antonio Carbonara & Larissa Marolda Martinez, *Corporate Governance und Führungsorganisation in der Aktiengesellschaft*, 100 Schweizerische Juristen-Zeitung, 406–07 (2004); Roland Müller, Lorenz Lipp & Adrian Plüss, *Der Verwaltungsrat: Ein Handbuch für die Praxis* 58–59 (2007); Georg Krneta, *Praxiskommentar Verwaltungsrat – Art. 707–726, 754 OR und Spezialgesetze* 1646 (2005); Giger, supra n. 50 at 321–322.

<sup>53</sup> Jutzi, supra n. 1 at 142–171.

organization<sup>54</sup> – can necessitate the establishment of board committees.<sup>55</sup> Besides, there are several provisions in corporate law that have to be taken into account when it comes to the appointment, internal organization and the dismissal of board committees.<sup>56</sup>

### 3.2 Self-regulation codes

[Rz 16] With corporate governance becoming more prominent on the public agenda, the economic and political establishment in Switzerland has attempted to elaborate new measures to avoid future corporate scandals and improve business management. As a result of these efforts, the Swiss Code of Best Practice for Corporate Governance (Swiss Code), a set of recommendations issued by the umbrella organization of Swiss business enterprises «*economiesuisse*», and the legally binding Directive on Information relating to Corporate Governance (DCG) by the SWX Swiss Exchange came into force on 1 July 2002.

[Rz 17] The Swiss Code sets substantive requirements regarding the internal organization of companies: in sections 21 to 27 of the Swiss Code and in Annex 1 there are rules regarding board committees. In accordance with other, foreign corporate governance codes the establishment of three board committees is recommended: an audit committee, a compensation committee and a nomination committee. The list is non-exhaustive, so that companies can provide for further committees. It is moreover possible to combine the functions of several board committees if all committee members fulfil the relevant requirements. The Swiss Code contains above all provisions regarding the composition and the tasks of the different committees.

[Rz 18] It is a distinctive feature of the Swiss Code that only board committees in accordance with CO art. 716a para. 2 are treated, i.e. committees that are only entrusted with the preparation and execution of board decisions or the supervision of transactions and therefore have no decision power whatsoever. This is determined in sec. 21 of the Swiss Code, which states that the board of directors is to appoint committees from its midst who closely analyze certain subjects or human resource issues and report to the board of directors to facilitate the preparation of its decisions or its supervisory function. Thus the responsibility for the tasks delegated to committees ultimately remains with the board of directors.

[Rz 19] The Directive on Information relating to Corporate Governance (DCG) had to be implemented by the companies listed on the SWX Swiss Exchange (SWX) for the first time in their financial reports for 2002. Its latest version went into force on 1 July 2009. The legal basis for the DCG are art. 8 of the Swiss Stock Exchange Act (SESTA) and the Listing Rules

(LR) of the SWX. The DCG is applicable to all issuers whose ownership rights are listed on the SWX and whose seat is in Switzerland.

[Rz 20] The ratio legis of the DCG is the publication of information: it is evident that market powers can only have a regulating effect if the information necessary for an assessment is publicly made available. It is thus the goal of the DCG to guarantee transparency in corporate governance matters and a corresponding improvement of the issuers' information policy. For this reason, the information to be published in the financial report is specified in the Annex to the Directive. Even though the DCG comes in the form of a self-regulation code, it does – unlike the Swiss Code – not merely serve as a recommendation: the sanctions commission of the SWX can impose sanctions on issuers who conceal information or make false or misleading statements. Possible sanctions include a reproof, the publication of concealed information, a fine of up to CHF 200'000, a trading suspension, delisting or the publication of the sanction.

[Rz 21] The transparency requirements concerning the internal organization and functioning of the board of directors can be found in sec. 3.5 of the DCG. According to this provision, the distribution of tasks, the working mode of the board of directors and its committees as well as the composition, the duties and the responsibilities of the different committees have to be made available. A simple enumeration of those committees is insufficient however. Rather, the respective functions of the committees have to be described in detail. Above all, this is due to the fact that the terminology used in business practice tends to be inconsistent: as a result of the organizational autonomy of the board of directors and the non-binding nature of the Swiss Code, the audit committee or the compensation committee of a company A does not necessarily have the exact same tasks as the respective committees in a company B.

## 4. Germany

[Rz 22] The German law for public companies is characterized by a dual structure consisting of a board of directors and a board of supervisors<sup>57</sup>, entailing that directors must not be members of the supervisory board and vice versa.<sup>58</sup> The systemic difference to American (and Swiss) corporate law<sup>59</sup> easily leads to the conclusion that committees of a German board of directors aren't really comparable to committees established by US boards. The «*culture*» of committees in both legal traditions is, however, related in many aspects. On the one hand, this has to do with the fact that the board of

<sup>54</sup> CO art. 716a para. 1 subpara. 2.

<sup>55</sup> Jutzi, supra n. 1 at 118–121.

<sup>56</sup> For further details see: Jutzi, supra n. 1 at 137–228.

<sup>57</sup> See Jutzi, supra n. 1 at 8.

<sup>58</sup> However, there is a notable trend for members of the board of directors to join the board of supervisors immediately after stepping down as directors: see Nagel, supra n. 34 at 168–73.

<sup>59</sup> Strauch, supra n. 4 at 952–956.

directors and the management in a US company don't necessarily have to be closely linked from a human resources perspective; on the other hand, the German law relating to internal organization of supervisory boards, much like Swiss law, is distinctively influenced by the American corporate committees culture.<sup>60</sup> This is reflected in the terminology: it is no coincidence that the current version of the German Corporate Governance Code (GCGC) uses the term «audit committee» to describe the German «Prüfungsausschuss».<sup>61</sup>

#### 4.1 Legal Framework

[Rz 23] Already during the era of the «*Allgemeine Handlungsbuch*» of 1884 larger corporations had a tendency towards a greater specialization, which resulted in an organized division of tasks among members of the supervisory board.<sup>62</sup> At that point in time, when corporate law was first put into a formal legal framework, the supervisory board was seen as a shareholder committee dealing with the concerns of shareholders outside the general assembly and working as a link between the board of directors and the general assembly.<sup>63</sup> In the face of the growing complexity and importance of oversight, supervisory committees were established in order to deal with specific tasks.<sup>64</sup> Legal doctrine, however, showed a certain reluctance in calling for such a development.<sup>65</sup> In time, the legislator came to see the benefits of committees, so that in the Corporate Act (CA) of 1937 the creation of committees was for the first time formally provided for in a legal statute.<sup>66</sup> Later, in the Corporate Act of 1965, the legislator faced the prevalent deficiencies and structural changes in the economy<sup>67</sup> by framing restrictions in order to prevent the delegation of certain important decisions to committees.<sup>68</sup> These days, much like in Swiss law, the legal framework of supervisory committees is characterized by an interlocking of formal hard law as well as soft law created by a commission, a government commission in the case of Germany.<sup>69</sup> The Corporate Act permits the establishment of committees

in CA § 107 para. 3<sup>70</sup> but does not require their existence: «The supervisory board can appoint one or more committees from its midst, namely to prepare or to execute its decisions.» Besides these consulting or preparing committees the following section of the same provision indirectly allows for decision-making committees by explicitly prohibiting the delegation of decisions only for a certain number of matters. Thus German law features a bisection between committees with and such without any decision power, similarly to Swiss law. As opposed to Swiss board committees however, German supervisory committees cannot be assigned with management functions.

[Rz 24] The composition, the function, the working mode and other details relating to board committees are laid out in the Corporate Governance Code.<sup>71</sup> As a special feature compared to Swiss law, CA § 161 requires the supervisory board and the board of directors of listed companies to provide a statement of compliance on an annual basis. This statement should give the shareholders an idea of the extent to which the recommendations by the GCGC were respected and will be complied with during the running business year.<sup>72</sup> While, in principle, the board of supervisors is autonomous when it comes to delegation and internal organization with relation to committees, its autonomy is limited by the responsibility area and the legal competence assigned to it according to the law<sup>73</sup> – much like in Switzerland with CO art. 716a para. 1 and art. 716b<sup>74</sup>. German law defines this limitation more explicitly in CA § 107 para. 3 than Swiss law does: «The tasks according to para. 1 sentence 1, § 59 para. 3, § 77 para. 2 sentence 1, § 84 para. 1 sentence 1 and 3, para. 2 and para. 3 sentence 1, § 111 para. 3, §§ 171, 314 para. 2 and 3 as well as decisions that certain types of transactions may only be executed with the consent of the supervisory board cannot be assigned to a committee in place of the supervisory board.» The board of supervisors has to act within those legal boundaries. Decisions assigned to the plenum by law cannot be delegated to a committee (*plenum reservation*). Moreover, the board can only delegate tasks that are assigned to it by law, i.e. the committee cannot exercise more rights than the board itself possesses.

[Rz 25] When it comes to the composition of the committees, the supervisory board is largely autonomous for lack of a regulation in the Corporate Act; it is however influenced

<sup>60</sup> Stephan Lechner, *Vermeidung und Aufdeckung von «Top Management Fraud» durch das unternehmerische Überwachungssystem*, 41 Deutsches Steuerrecht, 1854–59 (2006).

<sup>61</sup> GCGC sec. 5.3.2.

<sup>62</sup> Jan Lieder, *Der Aufsichtsrat im Wandel der Zeit – Leitlinien der geschichtlichen Entwicklung sowie der Fortentwicklung des deutschen Aufsichtsratssystems* 162 (2006).

<sup>63</sup> Lieder, supra n. 62 at 808.

<sup>64</sup> Lieder, supra n. 62 at 750.

<sup>65</sup> Lieder, supra n. 62 at 162.

<sup>66</sup> CA § 92 para. 4 (1937).

<sup>67</sup> Beate Maasch-Feisel, *Die Kompetenz zur Bildung von Verwaltungsratsausschüssen* 126, 131 (1984).

<sup>68</sup> CA § 107 para. 3 subsec. 2.

<sup>69</sup> Johannes Semler, *§§ 161–178 des deutschen Aktiengesetzes*, in MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ, BAND 5/1 § 161 AktG ¶ 246 (Bruno Kropff & Johannes Semler eds., 2003).

<sup>70</sup> However, § 27 para 3 of the Co-Determination Act (Mitbestimmungsgesetz) of 1976 requires the establishment of a mediation committee.

<sup>71</sup> Semler, supra n. 69 at § 161 AktG ¶ 416–420.

<sup>72</sup> For more a more detailed analysis of the compliance statement see Carlo Heck, *Haftungsrisiken im Zusammenhang mit der Entsprechenserklärung zum Deutschen Corporate Governance Kodex gem. § 161 AktG 10 ff.* (2006).

<sup>73</sup> Johannes Semler, *§§ 76–117 des deutschen Aktiengesetzes*, in MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ, BAND 3 § 107 AktG ¶ 251 (Bruno Kropff & Johannes Semler eds., 2004).

<sup>74</sup> See Giger, supra n. 50 at 322.

by the legally guaranteed participation rights of employees.<sup>75</sup> These participation rules – with the exception of § 27 para. 3 of the Participation Act (*Mitbestimmungsgesetz*) requiring a conciliation committee with equal representation – do not directly interfere with the board's autonomy to compose its committees, i.e. the composition of the committees generally does not have to reflect the ratio of shareholders and employees sitting in the board<sup>76</sup>; however, according to case law, the interests of shareholders and employee representatives need to be reflected in the internal organization of the supervisory board, notably in its committee structure.<sup>77</sup> According to the practice of the Federal Court of Justice the committee must function in an optimal way. For example, expert knowledge of certain shareholders is no justification to pass over employee representatives when composing a board committee<sup>78</sup>; according to the Court, employee representatives must not be discriminated against when it comes to committee appointments.<sup>79</sup>

#### 4.2 Self-regulation codes

[Rz 26] In 2001, the federal government (Federal Ministry of Justice) established a government commission under the guidance of Gerhard Cromme<sup>80</sup>, which in 2002 adopted the German Corporate Governance Code (GCGC). Throughout the past years, the Code has been further elaborated by the commission, the latest revision dating from 2010. Even after the introduction and publication of the GCGC the government commission stayed in place and now works as a type of assessment and oversight entity supervising the implementation of the Code and initiating revisions if needed.

[Rz 27] Based on the compliance declaration according to CA § 161, the GCGC is an accepted guideline for corporate management, containing rules relating to business administration as well as 81 recommendations and 20 suggestions for management and oversight of listed companies.<sup>81</sup> The GCGC thus constitutes a broader framework provided by the government to be interpreted and implemented by listed companies. At the same, the GCGC also targets non-listed companies.<sup>82</sup> The implementation of the Code works according to the principle of «*comply or explain*», which requires companies to comply with the Code and to make compliance

assurances in case of alterations or discrepancies.<sup>83</sup> This allows for an adaptation of the Code to the specific needs of certain business sectors or firms. However, the GCGC remains legally non-binding.<sup>84</sup>

[Rz 28] The creation of committees is regulated in section 5.3 of the GCGC: according to section 5.3.1 the supervisory board shall appoint specialized committees «*in accordance with the specific needs of the company and the number of its members*». The committees should increase the efficiency of the oversight work and the treatment of complex issues. The third sentence of the recommendation, which states: «*The respective committee chairpersons regularly report to the supervisory board on the work of the committee*», merely repeats the content of CA § 107 para. 3 sentence 3. According to section 5.3.2 of the GCGC the board should establish an audit committee dealing «*in particular*» with the following topics: accounting, risk management, independence of the auditor, the determination of the focal points in the auditing process, and compensation agreements. The chairperson of the audit committee should have expert knowledge and relevant experience with accounting standards and internal control mechanisms and should be no former director of the company.<sup>85</sup> Furthermore according to section 5.3.3, the supervisory board shall appoint a nomination committee suggesting adequate candidates which the board can propose to the general assembly for election. Despite the Recommendation of the EU Commission<sup>86</sup>, the GCGC – unlike the Swiss Code – does not provide for a compensation committee; it is however likely a question of time until this type of board committee will be well-established in Germany. Moreover, the current version of section 5.3.4 already provides the board of supervisors with the authority to delegate other subject-matters to committees. The compensation of board members is such a possible subject-matter, besides the business strategy or investment and financing issues. CA § 107 para. 3 explicitly authorizes the supervisory board to deal with such matters.<sup>87</sup> Finally, section 5.3.5 of the Code recommends that the supervisory board may allow for committees to prepare its meetings and even make decisions on its behalf. This provision however does not go beyond the scope of CA § 107 para. 3 and thus is of merely declarative nature.<sup>88</sup>

<sup>75</sup> Semler, supra n. 73 at § 107 AktG ¶ 243, 261.

<sup>76</sup> Semler, supra n. 73 at § 107 AktG ¶ 242.

<sup>77</sup> Decision of the German Federal Supreme Court in civil matters: BGHZ 122, 342.

<sup>78</sup> Decision of the German Federal Supreme Court in civil matters: BGHZ 122, 342/362.

<sup>79</sup> Semler, supra n. 73 at § 107 AktG ¶ 242.

<sup>80</sup> Dieter Kuck, *Aufsichtsräte und Beiräte in Deutschland: Rahmenbedingungen, Anforderungen, professionelle Auswahl* 41 (2006); Lieder, supra n. 62 at 553.

<sup>81</sup> Lieder, supra n. 62 at 553.

<sup>82</sup> Kuck, supra n. 80 at 42.

<sup>83</sup> Kuck, supra n. 80 at 42.

<sup>84</sup> Lieder, supra n. 62 at 553.

<sup>85</sup> See GCGC sec. 5.3.2 sentence 2.

<sup>86</sup> See section V.III. below.

<sup>87</sup> Semler, supra n. 69 at § 161 AktG ¶ 424.

<sup>88</sup> Semler, supra n. 69 at § 161 AktG ¶ 425.

## 5. Transnational tendencies: European Union (EU) and Organization for Economic Cooperation and Development (OECD)

### 5.1 Reform efforts

[Rz 29] In Europe a broad range of measures were initiated in order to achieve an optimization of corporate governance structures and to find an answer to the troubling state of European companies. Generally, all concepts are aiming to define a set of standards for corporate governance to serve as an optimal guideline for corporate executives and to diminish existing deficiencies within management and oversight in companies.<sup>89</sup> In 2004, the OECD updated and published the OECD Principles on Corporate Governance.<sup>90</sup> These serve as non-binding guidelines for national legislators and, in a broader sense, can be viewed as a set of standards aimed at political decision-makers, investors, companies and other interested stakeholders. The OECD Principles and the EU law relating to board committees presented below.

### 5.2 OECD Principles on Corporate Governance

[Rz 30] The Corporate Governance Principles established by the OECD in 2004 are not legally binding, yet they are viewed as a global work of reference by market actors. The Principles mention several types of board committees<sup>91</sup>, while largely focusing on the most important of committees: the audit committee. The oversight role of the audit committee should, according to the Principles, encompass external controlling<sup>92</sup>, the internal audit and risk management system, as well as compliance with relevant internal and external regulations.<sup>93</sup> The rights and duties, the composition and the operating process of the committee has to be clearly defined in a charter.<sup>94</sup> The OECD Principles generally view the audit committee as an effective oversight tool, which considerably improves the reliability and transparency of financial reporting.<sup>95</sup>

### 5.3 Recommendation by the EU Commission of 15 February 2005

[Rz 31] Presently, there are pan-European standards regarding the establishment and function of board committees: influenced by changes in US law<sup>96</sup>, the EU Commission issued

a Recommendation on 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board.<sup>97</sup> These recommendations however do not entail an implementation duty for member states, rather they take into account that corporate governance relies on different concepts in each member state and that considerable efforts are presently made to further develop them. Nevertheless, these recommendations constitute a milestone in the promulgation of board committees in Europe: for the first time, we have common – albeit non-binding – guidelines for all EU member states, which will most probably cause audit, compensation and nomination committees to take root across Europe sooner or later, while leading to a harmonization of board committee cultures in the various member states.

[Rz 32] In its recommendations, the Commission calls upon member states to strengthen the role of independent non-executive directors or supervisory board members in the boards of listed companies.<sup>98</sup> Administrative, management and oversight committees shall contain an adequate mix of executive and non-executive directors in order to make sure that no single individual or small group of individuals can dominate decision-making procedures<sup>99</sup> and to avoid potential conflicts of interest within the board of directors or supervisors.<sup>100</sup> Besides, the EU Commission recommends the creation of the same three committees as the Swiss Code does, i.e. a nomination, a compensation and an audit committee. These three committees may, as a principle, only issue recommendations as part of the preparation process for decisions to be taken by the board itself. Unlike the Swiss Code however, the EU recommendation allows board members to delegate part of their decision-making power to committees if they deem it appropriate, if such a delegation is admissible and appears reasonable according to national law.<sup>101</sup> The recommendation further comprises minimal standards concerning the creation, composition and the role of committees, specific requirements for their members as well as details regarding the responsibilities of the nomination, compensation and audit committee, respectively. As an example, the audit committee must be composed only of non-executive directors, the majority of which should be independent.<sup>102</sup>

<sup>89</sup> Kuck, *supra* n. 80 at 41.

<sup>90</sup> Kuck, *supra* n. 80 at 41.

<sup>91</sup> E.g. the compensation committee (OECD Principles 61), the ethics committee (OECD Principles 62) and the nomination committee (OECD Principles 65).

<sup>92</sup> OECD Principles 55.

<sup>93</sup> OECD Principles 58–66.

<sup>94</sup> OECD Principles 65.

<sup>95</sup> OECD Principles 55–57.

<sup>96</sup> Lieder, *supra* n. 62 at 756; Jutzi, *supra* n. 1 at 38–40.

<sup>97</sup> Commission Recommendation 2005/162/EC, Official Journal of the European Union L52/51 (25 February 2005).

<sup>98</sup> To ensure an independent and effective management oversight, the EU Commission postulates a «sufficient number» of independent non-executive or supervisory directors. Not only should they refrain from management activities within the company, they should avoid any type of conflict of interest in general. Considering the diverse legal systems in EU member states, the EU Commission opted against determining a specific number of independent directors. See Recommendation, *supra* n. 97 secs. 3–5.

<sup>99</sup> Recommendation, *supra* n. 97 secs. 6 and 7 of the introduction clauses.

<sup>100</sup> Recommendation, *supra* n. 97 secs. 6 and 7 of the introduction clauses.

<sup>101</sup> Recommendation, *supra* n. 97 secs. 10 of the introduction clauses.

<sup>102</sup> Recommendation, *supra* n. 97 sec. 4.1 of Annex I.

Moreover, the competence of the committee should not be limited to auditing the financial data of the company, it should also cover the review of internal controlling and risk management systems and provide for efficiency in internal auditing.<sup>103</sup>

#### 5.4 Directive 2006/43/EC

[Rz 33] In the meantime, the EU has made one further step. In Directive 2006/43/EC of 17 May 2006 by the European Parliament and the Council on statutory audits of annual accounts and consolidated accounts, for the first time, it explicitly laid down an obligation to establish an audit committee:<sup>104</sup> art. 41 of the Directive stipulates that public-interest entities are required to establish an audit committee.<sup>105</sup> The purpose of the audit committee is the independent and competent review of a company's financial reporting process.<sup>106</sup> At least one member of the audit committee must have sufficient expertise in accounting and auditing.<sup>107</sup> Yet the practical interpretation of this provision remains with the EU member states. For example, member states can lay down that in certain companies<sup>108</sup> the tasks of the audit committee are carried out by the supervisory board or the board of directors as a whole. Also, companies that have another body exercising a similar function are not required to create a separate audit committee.<sup>109</sup> Furthermore, member states can exempt a number of companies from their obligation to appoint audit committees. This mainly includes subsidiaries in a corporate group, where an audit committee in the parent company is sufficient. Further entities that can be exempted are investment companies, issuers of asset backed securities and credit institutes

with less than 100 mio. Euros in issued bonds.<sup>110</sup> In summary, there is a general obligation to establish an audit committee on the one hand, on the other hand EU member states have room to limit this obligation to a great extent via their national regulations. Nevertheless, this Directive is an important, albeit cautious first step towards a legal institutionalization of audit committees in Europe.

### III. The mutual relation of legal systems as exemplified by the audit committee

#### 1. The history of the audit committee

[Rz 34] It appears that the creation of an audit committee was first suggested around the end of the 1930ies and the beginning of the 1940ies as a reaction to a financial misstatement scandal by the firm McKesson&Robinson in the United States:<sup>111</sup> Thereupon, a panel of the New York Stock Exchange NYSE and the US Securities and Exchange Commission recommended the establishment of an audit committee composed of external directors whose main task it was to elect the annual account auditors.<sup>112</sup> The idea of a board of directors addressing the auditing process via a special committee however soon disappeared and only resurfaced in the United States in 1967.<sup>113</sup> After several scandals around the end of the 1960ies and the beginning of the 1970ies, the call for an audit committee got louder again in the US:<sup>114</sup> especially the collapse of the Penn Central Company in 1970, by then the largest bankruptcy in the history of the United States, led to numerous mutually interacting interventions of the SEC, the stock markets and at a later stage the legislator. In 1972 the US Securities and Exchange Commission reiterated its recommendation from 1940<sup>115</sup> and two years later required that the names of the audit committee members be mentioned in the proxy statement<sup>116</sup> or, if there is no audit

<sup>103</sup> Recommendation, supra n. 97 sec. 4.2 of Annex I.

<sup>104</sup> Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, Official Journal of the European Union L157/87 (9 June 2006).

<sup>105</sup> According to the definition in art. 2(13) of the Directive, public-interest entities are entities that are of significant public relevance because of the nature of their business, their size or the number of their employees. This includes companies whose securities are traded on a regulated market as well as banks and credit institutions.

<sup>106</sup> The specific tasks of an audit committee (or a similar entity with the same purpose) include: (a) supervision of the financial reporting process; (b) monitoring the internal control, internal audit and risk management systems; (c) monitoring the statutory audit of the annual and consolidated accounts; (d) ensuring the independence of the auditors, especially with regard to non-auditing services; (e) the nomination of candidates for election as auditors. The accountability with regard to internal control, internal audit and risk management however remains with the management of the audited company. Also, the accountabilities of the boards of directors and supervisors remain untouched. See Directive, supra n. 104 art. 41(2-4).

<sup>107</sup> Directive, supra n. 104 art. 41(1).

<sup>108</sup> Entities as defined by art. 2(1) point (f) of Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading, Official Journal of the European Union L 345/64 (31 December 2003).

<sup>109</sup> Directive, supra n. 104 art. 41(5).

<sup>110</sup> Directive, supra n. 104 art. 41(5).

<sup>111</sup> For more details on the McKesson&Robinson case refer to: Rudolf Bak, *Audit Committee – Instrument der Unternehmensüberwachung des Verwaltungsrates* 2–3 (2006); Louis Braiotta, *The Audit Committee Handbook* 437 (2004); Hans-Werner Gassner, *Das Audit Committee – Überwachungsinstrument für Bank-Verwaltungsräte?* 8 (1996); Girnghuber, supra n. 2 at 31–32.

<sup>112</sup> Braiotta, supra n. 111 at 437; Bruno Glaus, *Unternehmensüberwachung durch Schweizer Verwaltungsräte* 248 (1990).

<sup>113</sup> Frederick L. Neumann, *The Audit Committee, Chapter 17*, in *HANDBOOK FOR CORPORATE DIRECTORS* Chapter 17.2 (Edward Paul Mattar & Michael Ball eds., 1985).

<sup>114</sup> For an overview on the different scandals see: Braiotta, supra n. 111 at 152–156.

<sup>115</sup> SEC Accounting Series Release No. 123, March 1972: Standing Audit Committees Composed of Outside Directors.

<sup>116</sup> In the US every shareholder can transfer his voting rights to the management of the company. When soliciting shareholder votes, the company has to disclose information on impending decisions and their business

committee, that the reason for its absence be explained.<sup>117</sup> The NYSE was the first stock exchange in the US to adopt regulations concerning audit committees: in January 1977 it issued the so called «Audit Policy» obliging companies listed on the NYSE to create an audit committee.<sup>118</sup> In contrast, the American Stock Exchange (AMEX) at first abstained from making the audit committee an admission criteria, and only did so in 1991.<sup>119</sup> After that, the development in the US went quick: the Blue Ribbon Report, a report authored by an interdisciplinary expert panel in 1999, was of particular importance; it detailed how the oversight activity of audit committees could be further improved, causing stock exchanges and the SEC to revise their rules relating to audit committees.<sup>120</sup> The audit committee as an institution was thus developed in the US by way of self-regulation, with no public legal framework existing for a long time.<sup>121</sup> The first formal law on audit committees in the US was introduced in 1991 with the Federal Deposit Insurance Corporation (FDIC) Improvement Act by Congress, yet the federal legal obligation to create an audit committee was extended to banks only.<sup>122</sup> The self-regulation phase ended in 2002 with the Sarbanes-Oxley Act: the SOX determines the top management's oversight duties regarding finance and accounting systems and procedures. These tasks can, in principle, be exercised by the board of directors as a whole<sup>123</sup>, though companies beyond a certain size *de facto* depend on a permanent, specialized audit committee due to the complexity of many issues.<sup>124</sup>

[Rz 35] In Europe, audit committee only spread at a later stage. The precursor in Europe was England: the Cadbury Report of 1992 contains recommendations on the audit committee and describes its responsibilities<sup>125</sup> as well as the necessary cooperation with the management, the auditor and internal accounting.<sup>126</sup> The Cadbury Report was complemented by the Hampel Report in 1998, which basically

constitutes an enhancement of the first report although putting more emphasis on internal controlling.<sup>127</sup> As a reaction to criticism that internal accounting was still being neglected despite the Hampel Report, the British of Chartered Accountants (ICAEW) published the Turnbull Report in 1999. The goal of the Turnbull Report was to create a continuous oversight procedure, embedded into the business process and monitored by the board of directors or the audit committee.<sup>128</sup> The audit committee was to ensure that reports on internal controls were drafted on a quarterly basis. This development led to the adoption of the Combined Code by the London Stock Exchange (LSE) in 2003 stipulating that the board of directors should appoint an audit committee from its midst, including at least three non-executive members and with a majority of members being independent; the audit committee is further required to set up a written charter regulating its responsibilities and its competence.<sup>129</sup> As a reaction to the various initiatives in the US – especially the Blue Ribbon Report and the Sarbanes-Oxley Act – other reports were issued in England, such as the Higgs Report in 2002 or the Smith Report a year later, which further enhanced and elaborated the existing recommendations concerning audit committees while aiming at a harmonization with the laws and recommendations in the United States.<sup>130</sup>

[Rz 36] Continental Europe lagged behind for a long time. It was only with the adoption of the Corporate Governance Code in 2002 that the supervisory board in Germany was encouraged to create an audit committee.<sup>131</sup> The situation in Austria was similar: audit committees were first recommended there in 2002, too.<sup>132</sup> The process started a little earlier in France with the Viénot Report already suggesting the establishment of an audit committee in 1995 in order to ensure adequacy and consistency in finance and accounting matters as well as the functioning of the corresponding internal procedures.<sup>133</sup> As mentioned before, there are also pan-European regulations relating to the establishment and the functioning of audit committees: the Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board<sup>134</sup> on the one hand, and the Directive 2006/43/EC of 17 May 2006 by the European Parliament and

implications to its shareholders in a so called «proxy statement» prior to the general assembly.

<sup>117</sup> SEC Accounting Series Release No. 165, December 20, 1974: Notice of Amendments to require Increased Disclosure of Relationships between Registrants and Their Independent Public Accountants.

<sup>118</sup> Girnghuber, supra n. 2 at 29–30.

<sup>119</sup> Braiotta, supra n. 111 at 441. An important reason for this was the fact that a survey conducted in 1979 had shown that 87% of companies listed on the AMEX had already opted to set up an audit committee: see Bak, supra n. 111 at 13.

<sup>120</sup> For a detailed overview see: Bak, supra n. 111 at 7–9.

<sup>121</sup> Glaus, supra n. 35 at 248; Christine Windbichler, *Zur Trennung von Geschäftsführung und Kontrolle bei amerikanischen Grossgesellschaften – Eine «neue» Entwicklung und europäische Regeln im Vergleich*, 3 Zeitschrift für Unternehmens- und Gesellschaftsrecht 50–58 (1985).

<sup>122</sup> FDIC Improvement Act 1991 § 112 subsec. 36(g)(1).

<sup>123</sup> SOX § 2(a)(3) SOX; § 205(a)(58).

<sup>124</sup> Jutzi, supra n. 1 at 13–14; Bak, supra n. 111 at 18 ff.

<sup>125</sup> Especially regarding the supervision of financial reporting, accounting and internal control systems.

<sup>126</sup> Cadbury Report secs. 4.35–4.38 and Appendix 4.

<sup>127</sup> Hampel Report secs. 6.10–6.15.

<sup>128</sup> Böckli, supra n. 4 at § 14 ¶ 116.

<sup>129</sup> Combined Code sec. D.3.1.

<sup>130</sup> See Bak, supra n. 111 at 34–38.

<sup>131</sup> GCGC sec. 5.3.2.

<sup>132</sup> Sec. 40 of the Austrian Code of Corporate Governance (January 2010 edition) reads: «Irrespective of the size of the supervisory board, it shall set up an audit committee in the case of exchange-listed companies.»

<sup>133</sup> Rapport sur le Conseil d'Administration des Sociétés cotées (VIÉNOT I), Paris 1995, 20.

<sup>134</sup> Recommendation, supra n. 97.

the Council on statutory audits of annual accounts and consolidated accounts<sup>135</sup> on the other hand.

[Rz 37] In Switzerland, the public debate relating to the audit committee only caught on a relatively short time ago. Although there were publications on this topic in the 1970ies already<sup>136</sup>, a serious interest in audit committees only arose in the 1990ies in connection with the growing interest for questions of accountability of the board of directors.<sup>137</sup> At that point, the call for an increased efficiency by creating institutionalized audit committees emerged in Switzerland, too.<sup>138</sup> With the growing international relevance of the audit committee, the number of publications on said topic continuously increased after the turn of the millennium.<sup>139</sup> The audit committee was one of the main concerns of the Swiss corporate governance initiatives in 2002, resulting in the publication of the Swiss Code and the DCG, the former recommending the establishment of an audit committee at least for public corporations as well as medium and large-sized non-listed corporations.<sup>140</sup>

## 2. The audit committee as a legal transplant

[Rz 38] Almost no other legal field is more manifestly influenced by Anglo-American law than corporate law; this is especially true for corporate governance and the internal organization of the board of directors or the supervisory board. Yet the reception of Anglo-American legal constructs in Continental European corporate law is associated with certain difficulties and has led to some discomfort on the continent. The author Peter Böckli described the mood relating to the increasing spread of the audit committee as follows: «In many, mainly medium-sized companies the skepticism typical of the pragmatic Swiss people still prevails: «It all used to work just as well without this thing!»» Despite this view, which was common in many countries in Continental Europe and to a certain extent still is, many of those countries have

introduced the audit committee by now. It became evident that audit committees can be established regardless of the company's administrative structure. The audit committee is just as widespread in the US and England, where the board model is prevalent, as it is in Germany or Austria, who are home to the dual model. The same counts for Switzerland and France with their delegation model or their mixed model, respectively, which are a compromise between the two former models. Hence it appears that audit committees are internationally seen as a useful tool to improve oversight in companies, regardless of the surrounding legal environment or culture. The audit committee in US corporate law is what comparative law scholars call a legal transplant. This metaphorical term was coined by Alan Watson to describe the spread of a legal rule or a system of rules from one country to another, similar to the way legal constructs from the Roman era were received in modern European legal systems. The term legal transplant is however more discerning than the classical concept of reception because it indicates the difficulties involved in fitting a foreign concept into another legal system.

[Rz 39] Having said that, it is not surprising that the audit committee quickly took root in Switzerland and other places. Holger Fleischer identified two decisive factors as a cause: First, the corporation is a «trans-cultural creation» that took shape over centuries by way of a convergence of various ideas emanating from different national (European) legal systems; unlike concepts invented by Friedrich Carl von Savigny or Pierre Legrand, it is not the product of a single nation or legal tradition. Second, the powers of globalization, especially the globalization of the financial markets, are loosening up the social and cultural attachment of law. While Montesquieu was right to assume in his work «*Esprit des Lois*» in 1748 that laws reflect the spirit of geographic environments and national customs, today's corporation constitutes a highly technical, purpose-oriented legal construct that has largely detached itself from its cultural and contextual roots.

[Rz 40] The law is increasingly influenced by the international capital markets, which work as a catalyst for harmonization: «Business law is no longer the dominant driving force; more often it is driven by the mighty winds of globalization: (capital) markets make law! [...]». As an example, audit committees nicely show that stock exchanges increasingly act as legislators: the appointment of audit committees was dictated by the admission rules of the New York Stock Exchange long before the federal legislator made them mandatory in the Sarbanes-Oxley Act. Also the fact that some time ago the terms risk management and compliance were rarely mentioned in board meetings in Continental Europe did not prevent the audit committee from spreading. Nonetheless, the establishment of an audit committee – just like any other type of committee – should never be an end in itself, it should much rather be justified by specific circumstances and constitute a clear benefit for the company.

<sup>135</sup> Directive, supra n. 104.

<sup>136</sup> See for example: André Zünd, *Kontrolle und Revision in der multinationalen Unternehmung – Die Überwachung als Führungsmittel internationaler Konzerne*, in SCHRIFTENREIHE ZU PLANUNG UND KONTROLLE IN DER UNTERNEHMUNG 298 (1973).

<sup>137</sup> This is evidenced in the growing amount of publications on the topic: Hanspeter Thiel & Axel König, *Die Ausgestaltung des Rechnungswesens, der Finanzkontrolle und der Finanzplanung*, in JAHRBUCH ZUM FINANZ- UND RECHNUNGSWESEN 23–28 (Hans Siegart ed., 1994); Peter Böckli, *Die unentziehbaren Kernkompetenzen des Verwaltungsrates*, 46–49 (1994); Guido Jud, *Die Überwachung der Unternehmen durch deren Organe unter Berücksichtigung der Verhältnisse in den USA und in Deutschland* 69–88 (1996); Glaus, supra n. 35 at 75.

<sup>138</sup> Böckli, supra n. 137 at 46.

<sup>139</sup> For an overview refer to the bibliography in Bak, supra n. 111 at LV-CX.

<sup>140</sup> Swiss Code secs. 23 and 24. A similar rule is contained in the Swiss Federal Banking Commission Circular of 27 September 2006 on Auditing and Internal Control (EBK-RS 06/6), which entered into force on 1 January 2007; for further details see: Jutzi, supra n. 1 at 27.

### 3. The trend towards an institutionalization and regulation of audit committees

[Rz 41] The audit committee is no longer a matter specific to any nation or legal system; rather, first efforts are being made to work out basic, internationally recognized principles to achieve harmonization by way of a common legal framework for the transnational capital market. Besides the developments in the EU, the OECD Principles of Corporate Governance may be mentioned as an example with an explicit link to audit committees.<sup>141</sup> There will doubtlessly be further steps towards an international institutionalization of the audit committee: the trend seems to be in its initial phase. The same should be true for the compensation and nomination committees, even though the process there is still at an earlier stage.

[Rz 42] Apart from this international trend, the concepts of the compensation, the nomination and in particular the audit committees also evolve within national borders. With relation to committees and corporate governance in general, there is a noticeable trend moving from self-regulation towards an external regulation.<sup>142</sup> In many countries, audit committees were first dealt with in self-imposed private codes, only later were they legally institutionalized on a public level. Unlike the United States or the EU, certain European countries, such as Switzerland, are lacking an explicit obligation to establish audit committees; however, it appears to be merely a question of time until such an obligation will become a reality – if only for certain types of companies.<sup>143</sup>

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<sup>141</sup> OECD Principles 55-66.

<sup>142</sup> Peter V. Kunz, *Corporate Governance – Tendenz von der Selbstregulierung zur Regulierung*, in 471 Festschrift für Peter Bockli zum 70. Geburtstag 495–96 (Ernst A. Kramer, Peter Nobel & Rober Waldburger eds., 2006).

<sup>143</sup> The draft version of a Circular by the Swiss Federal Banking Commission of 3 May 2005 contained a binding obligation to appoint an audit committee for institutes exceeding a certain size or degree of complexity. The Circular now in force (see supra n. 140) however replaced it with a mere duty to «comply or explain»: see Jutzi, supra n. 1 at 27.