

# Corporate and Securities Law

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The first decade of the new century was a tumultuous one in many areas of life, not least the business and financial world. The decade opened with the bursting of the dot-com bubble and confidence-shaking frauds at Enron and WorldCom, among all too many others. In conjunction with the economic fallout from the 9/11 attacks, these shocks brought the 10-year expansion that had begun in 1991 to a halt.

As the decade wound down, an even larger crisis was sparked when the housing bubble burst in 2007. The financial crisis that followed triggered the so-called Great Recession, which was one of the longest and deepest downturns since the Great Depression of the 1930s.

The United States' capital markets naturally suffered throughout much of the decade. In the wake of the dot-com bubble's bursting as the decade opened, the secondary equity trading markets suffered the first three-year consecutive stock market decline since the 1930s. In turn, the financial crisis at the end of the decade triggered an extended bear market that ran from October 2007 to March 2009.

The primary equity markets also suffered for much of the decade. A decline in primary market transactions like IPOs was to be expected given the adverse economic climate, of course. The data, however, reveal a far more troubling trend. U.S. capital markets steadily became less competitive globally throughout the decade.

The U.S. share of the global IPO market declined, for example, as foreign firms no longer treated the American stock markets as their first choice for raising capital. Likewise, foreign companies long present in the U.S. delisted from U.S. stock markets, while U.S. firms went dark or private at an unusually high rate. At around the same time, the Eurobond market surpassed the U.S. bond markets in the global share of debt issuances.

The growing concern surrounding these developments prompted three major studies, each of which reached broadly similar conclusions and offered comparable policy prescriptions: the Bloomberg-Schumer Report,<sup>1</sup> the Paulson Committee Interim Report,<sup>2</sup> and the Chamber Report.<sup>3</sup> Taken together, and evaluated in light of subsequent developments, the evidence they gathered confirms that the U.S. capital markets became less competitive vis-à-vis other markets in the last decade.

There are many factors contributing to this decline. While it is generally agreed that the growing maturity and liquidity of European and Asian markets is a very important factor, there is

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<sup>1</sup> Michael R. Bloomberg and Charles E. Schumer, *Sustaining New York's and the U.S.'s Global Financial Services Leadership* (2007) [hereinafter the Bloomberg-Schumer Report].

<sup>2</sup> Comm. on Capital Mkts. Reg., *Interim Report of the Committee on Capital Markets Regulation* (2006). The Committee on Capital markets regulation—or, as it is better known—the Paulson Committee subsequently issued a follow up report identifying thirteen competitive measures that the Committee tracks on a quarterly basis. Comm. on Capital Mkts. Regulation, *The Competitive Position of the U.S. Public Equity Market* (2007) [hereinafter the Paulson Committee Report].

<sup>3</sup> U.S. Chamber of Comm., *Capital Markets, Corporate Governance, and the Future of the U.S. Economy* (2006) [hereinafter the Chamber Report].

less agreement as to the role that corporate governance played. On the one hand, the U.S. political establishment blamed the various economic crises of the decade in part on perceived corporate governance flaws. Faced with anti-market, anti-corporate populist backlashes among the polity, Congress responded to the decade's first crisis by passing the Sarbanes-Oxley Act in 2002. At the end of the decade, yet another populist backlash led to passage of the Dodd-Frank Act in 2010. Proponents of both SOX and Dodd-Frank identified alleged corporate governance deficiencies as causal factors in the respective crises to which they responded. Accordingly, both acts created important new corporate governance regulations at the federal level.

On the other hand, a number of commentators identified not flawed corporate governance but rather flawed corporate governance regulation as being an important causal factor in the declining competitiveness of U.S. capital markets. On this view, U.S. corporate governance was not at fault in the economic crises, but rather generally worked well throughout the period. Instead, it was "quack corporate governance" regulation that was at fault.<sup>4</sup>

It is this debate to which this essay is addressed. So as not to hide the ball, the essay comes down squarely on the latter side of the question.

### ***The Decline in U.S. Capital Market Competitiveness***

In the 1990s, the number of foreign issuers listed on the NYSE roughly quadrupled, with NASDAQ experiencing similar growth, while London and the other major European exchanges

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<sup>4</sup> I here borrow Roberta Romano's description of SOX. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 *Yale L.J.* 1521 (2005).

lost market share. Since 2000, however, the situation appears to have reversed. Using global IPOs as an indicator of the relative competitiveness of capital markets, for example, there was a dramatic decline in the U.S.' market share from 48% to 8% between 2000 and 2006.<sup>5</sup>

Although the Paulson Committee reported slight improvement in 2008 and 2009, by the first quarter of 2010 the Committee was again reporting continued “deterioration in the competitiveness of U.S. public equity markets.”<sup>6</sup> As a result, by nearly all measures, the U.S. capital market today remains “much less competitive than it was historically.”<sup>7</sup>

### ***Was Corporate Governance the Problem?***

There is little evidence that poor corporate governance practices contributed to either the economic turmoil of the last decade in general or the declining competitiveness of U.S. capital markets. In the wake of the tech stock bubble, Bengt Holmstrom and Steven Kaplan published a comprehensive review of U.S. corporate governance that concluded the U.S. corporate

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<sup>5</sup> Luigi Zingales, *Is the U.S. Capital Market Losing its Competitive Edge 2* (ECGI Fin. Working Paper 192/2007). Global IPOs are those in which the issuer sells shares outside of its domestic market.

<sup>6</sup> Press Release, Comm. on Capital Mkts. Reg., *Q1 2010 Sees Fresh Deterioration in Competitiveness of U.S. Public Equity Markets, Reversing Mild Improvements* (June 2, 2010).

<sup>7</sup> Press Release, Comm. on Capital Mkts. Reg., *Third Quarter 2009 Demonstrates First Signs of Mild Improvement in Competitiveness of U.S. Public Equity Markets, Reversing Mild Improvements* (Dec. 1, 2009).

governance regime was “well above average” in the global picture.<sup>8</sup> Even when the fallout from the bubble was taken into account, returns on the U.S. stock market equaled or exceeded those of its global competitors during five time periods going back as far as 1982. Likewise, U.S. productivity exceeded that of its major Western competitors. In general, the trend with respect to major corporate governance practices had been towards enhanced management efficiency and accountability. Pay for performance compensation schemes, takeovers, restructurings, increased reliance on independent directors, and improved board of director processes all tended to more effectively align management and shareholder interests. As for the bursting of the housing bubble, “[a] striking aspect of the stock market meltdown of 2008 is that it occurred despite the strengthening of U.S. corporate governance over the past few decades and a reorientation toward the promotion of shareholder value.”<sup>9</sup> A recent report commissioned by the New York Stock Exchange reached the same conclusion, finding that “the current corporate governance system generally works well.”<sup>10</sup>

If corporate governance was not the problem, what drove the decline in U.S. capital market competitiveness? According to the Paulson Commission, “one important factor contributing to this trend is the growth of U.S. regulatory compliance costs and liability risks

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<sup>8</sup> Bengt Holmstrom and Steven N. Kaplan, *The State of U.S. Corporate Governance: What’s Right and What’s Wrong?* 1 (ECGI Finance Working Paper No. 23/2003, Sept. 2003).

<sup>9</sup> Brian R. Cheffins, *Did Corporate Governance “Fail” During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 *Bus. Law.* 1, 2 (2009).

<sup>10</sup> Report of the New York Stock Exchange Commission on Corporate Governance 2 (Sept. 23, 2010).

compared other developed and respected market centers.”<sup>11</sup> This essay therefore focuses on two questions: First, has the risk of anti-fraud liability affected the competitiveness of U.S. capital markets? Second, did the federalization of key aspects of corporate governance during the last decade generate net regulatory costs adversely affecting those markets?<sup>12</sup>

### ***The Impact of Anti-Fraud Liability Risk***

In 2008, the Supreme Court handed down one of the most consequential securities cases to come before it in many years, *Stoneridge Investment Partners v. Scientific-Atlanta*.<sup>13</sup> What makes *Stoneridge* instructive for our purposes is not the specific legal issues or the holding, but rather the Supreme Court majority’s concern for the loss of U.S. competitiveness.

The practical consequences of an expansion [of Rule 10b-5 liability] ... provide a

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<sup>11</sup> Paulson Committee Report, supra note 2.

<sup>12</sup> In addition to the factors discussed herein, the Paulson Committee also argued that state corporate law inadequately protects shareholder rights in such areas as takeover defenses, shareholder voting, shareholder access to the proxy statement, and executive compensation. For analysis and defense of state law in these areas, see Stephen M. Bainbridge, Reshaping the Playing Field, Reg., Winter 2008, at 28; Stephen M. Bainbridge, Unocal at 20: Director Primacy in Corporate Takeovers, 31 Del. J. Corp. L. 769 (2006); Stephen M. Bainbridge, Executive Compensation: Who Decides?, 83 Tex. L. Rev. 1615 (2005).

<sup>13</sup> *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

further reason to reject petitioner's approach. In *Blue Chip*, the Court noted that extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies. Adoption of petitioner's approach would expose a new class of defendants to these risks. As noted in *Central Bank*, contracting parties might find it necessary to protect against these threats, raising the costs of doing business. Overseas firms with no other exposure to our securities laws could be deterred from doing business here. This, in turn, may raise the cost of being a publicly traded company under our law and shift securities offerings away from domestic capital markets.<sup>14</sup>

The point is not that we should live in a world of caveat emptor. An effective anti-fraud regime has obvious benefits. It serves to compensate defrauded investors. It deters fraud. It provides a bond making issuer disclosures more credible and thereby lowers the cost of capital. The question remains, however, whether the current U.S. anti-fraud regime imposes costs that reduce these benefits.

An affirmative answer to that question is suggested by a survey of global financial services executives, which found that the litigious nature of U.S. society and capital markets has a negative impact on the competitiveness of those markets.<sup>15</sup> The key problem appears to be the prevalence of private party securities fraud class actions, which do not exist in most other major capital market jurisdictions.

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<sup>14</sup> Id. at 163-64 (citations omitted).

<sup>15</sup> Bloomberg Schumer Report, supra note 1, at 73.

Between 1997 and 2005 there was a steady increase in both the number of securities class action filings and the average settlement value of those suits.<sup>16</sup> The total amount paid in securities class actions peaked in 2006 at over \$10 billion, even excluding the massive \$7 billion Enron settlement.<sup>17</sup> The vast majority of such settlement payments historically have been made either by issuers or their insurers, rather than by individual defendants.<sup>18</sup> As a result, the vast bulk of securities settlement payments come out of the corporate treasury, either directly or indirectly in the form of higher insurance premiums. In either case, settlement payments reduce the value of the residual claim on the corporation's assets and earnings. In effect, the company's current shareholders pay the settlement, not the directors or officers who actually committed the alleged wrongdoing.

The effect of securities class actions thus is a wealth transfer from the company's current shareholders to those who held the shares at the time of the alleged wrongdoing. In the case of a diversified investor, such transfers are likely to be a net wash, as the investor is unlikely to be systematically on one side of the transfer rather than the other. Because there are substantial transaction costs associated with such transfers, moreover, the diversified investor is likely to

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<sup>16</sup> See Paulson Committee Report, *supra* note 2, at 75. A mid-decade dip in filings was probably caused by the lack of volatility in U.S. stock markets during the period and the fading of the substantial litigation generated by the bursting of the dot-com bubble. Bloomberg-Schumer Report, *supra* note 1, at 74.

<sup>17</sup> Statement of the Financial Economists Roundtable on the International Competitiveness of U.S. Capital Markets, 19 *J. Applied Corp. Fin.* 54, 55 (2007) [hereinafter FER].

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

experience an overall loss of wealth as a result of the private securities class actions. Legal fees to plaintiff counsel typically take 25-35% of any monetary class action settlement, for example, and the corporation's defense costs are likely comparable in magnitude.<sup>19</sup>

The circularity inherent in the securities class action process reduces the effectiveness of private anti-fraud litigation as both a deterrent and means of compensation. As to deterrence, because it is the company and not the individual wrongdoers that pays in the vast majority of cases, the system fails to directly punish those individuals. As to compensation, the transaction costs associated with securities litigation ensure that investors are unlikely to recover the full amount of their claims. Indeed, there is evidence that investors recover only two to three percent of their economic losses through class actions.

The analysis to this point has implicitly assumed that all securities fraud class actions are meritorious. When one considers the potential for frivolous or nuisance litigation, the potential impact of litigation on the capital markets is compounded. To be sure, the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998 heightened the pleading standards for securities fraud claims, allowed an automatic stay of discovery while a motion to dismiss is pending, created a uniform federal cause of action, and otherwise tried to reduce frivolous securities class action. While there is some empirical evidence that the PSLRA and SLUSA have reduced—but not eliminated—the number of frivolous suits, there is also evidence that they have had the unintended effect of reducing meritorious suits in which pre-filing indicia of fraud are more difficult to identify and plead with particularity as

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<sup>19</sup> Id.

required by the new pleading standard.<sup>20</sup>

The accurate perception that exposure to the U.S. capital markets significantly increases an issuer's litigation risk has a measurable impact on the attractiveness of those markets. A study of domestic issuers found, ~~for example~~, that issuers with prior experience with securities fraud class actions and those in standard industry classifications having a high incidence of such litigation tended to resort to offshore financing more often than other issuers.<sup>21</sup> As for foreign issuers, they are "deeply" concerned by the "cost of litigation" associated with securities class actions and "risk of huge enforcement actions."<sup>22</sup>

When asked which aspect of the legal system most significantly affected the business environment, senior executives surveyed indicated that propensity toward legal action was the predominant problem. Worryingly for New York, the city fares far worse than London in this regard: 63 percent of respondents thought the UK (and by extension London) had a less litigious culture than the United States, while only 17 percent felt the U.S. (and by extension New York) was a less litigious place than the United Kingdom.<sup>23</sup>

Because "the only way foreign companies can protect themselves" from litigation risk "is

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<sup>20</sup> Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 *Vand. L. Rev.* 1465 (2004).

<sup>21</sup> Stephen J. Choi, *Assessing the Cost of Regulatory Protections: Evidence on the Decision to Sell Securities Outside the United States* (Yale Law & Economics Research Paper No. 253, March 21, 2001), available at SSRN: <http://ssrn.com/abstract=267506>.

<sup>22</sup> Howell E. Jackson, *Summary of Research Findings on Extra-Territorial Application of Federal Securities Law*, 1743 *PLI/Corp* 1243, 1253 (May 20, 2009).

<sup>23</sup> Bloomberg-Schumer Report, *supra* note 1, at 75, 77.

to move out of the United States altogether,” “a lot of companies are doing” precisely that.<sup>24</sup>

The litigation risk problem is not limited to securities class actions. We see essentially identical concerns in areas such as state corporate law derivative litigation. In a seminal empirical study of derivative litigation, Professor Roberta Romano found that derivative litigation is relatively rare.<sup>25</sup> Of those cases that go to trial, shareholder-plaintiffs almost always lose. As is generally true of all litigation, however, most derivative suits settle. Only half of the settled derivative suits resulted in monetary recoveries, with an average recovery of about \$6 million. In almost all cases, the legal fees collected by plaintiff counsel exceeded the monetary payments to shareholders. Romano further concluded that nonmonetary relief typically was inconsequential in nature.

Like securities class actions, derivative litigation mainly serves as a means of transferring wealth from investors to lawyers. At best, derivative suits take money out of the corporate treasury and return it to shareholders minus substantial legal fees. In many cases, moreover, little if any money is returned to the shareholders, but legal fees are almost always paid.

As for deterrence, there is no compelling evidence that derivative litigation deters a substantial amount of managerial shirking and self-dealing. To the contrary, there is evidence that derivative suits do not have significant effects on the stock price of the subject corporations, which suggests that investors do not believe derivative suits deter misconduct.<sup>26</sup> There is also

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<sup>24</sup> Jackson, *supra* note 22, at 1254.

<sup>25</sup> Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 *J. L. Econ. & Org.* 55 (1991).

<sup>26</sup> See Daniel R. Fischel and Michael Bradley, *The Role of Liability Rules and the Derivative*

substantial evidence that adoption of a charter amendment limiting director liability has no significant effect on the price of the adopting corporation's stock, which suggests that investors do not believe that duty of care liability has beneficial deterrent effects.<sup>27</sup>

A radical solution to these problems would be to limit state and federal private rights of action. We might bar corporate liability in private class actions except for cases in which the issuer was a party to the fraudulent transaction as seller or buyer of its securities. This would eliminate the circularity problem inherent in such suits to the benefit of diversified investors. At the same time, it would allow the continued use of criminal and civil enforcement by the Justice Department and SEC, as well as private party class actions against culpable officers and directors. Because these tools likely are much more effective deterrents, the costs of such a reform likely would not exceed the benefits to investors.

Similarly, we might eliminate state law derivative litigation. As we have seen, derivative litigation appears to have little if any useful deterrent effects. Further, eliminating derivative litigation would not eliminate director accountability. Directors would remain subject to various forms of market discipline, including the important markets for corporate control and employment, proxy contests, and shareholder litigation where the challenged misconduct gives rise to a direct cause of action. The same is true with respect to eliminating corporate liability in securities class actions, of course.

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Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 Cornell L. Rev. 261 (1986).

<sup>27</sup> See, e.g., Michael Bradley and Cindy A. Schipani, The Relevance of the Duty of Care Standard in Corporate Governance, 75 Iowa L. Rev. 1 (1989); Roberta Romano, Corporate Governance in the Aftermath of the Insurance Crisis, 39 Emory L.J. 1155 (1990).

If eliminating securities class actions or derivative litigation seems too extreme, why not allow firms to opt out of the derivative suit process by charter amendment? Virtually all states now allow corporations to adopt charter provisions limiting director and officer liability. Since corporate law properly consists of a set of default rules the parties generally should be free to amend, there seems little reason not to expand the liability limitation statutes to allow corporations to opt out of derivative litigation or securities class actions.

### *Regulatory Compliance Costs*

Issuers seeking access to the U.S. capital markets face a daunting array of complex and costly regulatory requirements. In contrast to the U.K., where the Financial Services Authority is the sole regulator, U.S. capital market participants are slotted into multiple regulatory silos each with one or more government regulatory agencies. Dealing with multiple bodies of regulation and multiple regulators inevitably adds complexity, redundancy, and cost to transactions. Accordingly, as the Chamber concluded, “this patchwork structure is not keeping up with the extraordinary growth and internationalization of our markets.”<sup>28</sup>

In the U.K., the FSA has adopted a principles-based approach to regulation, in contrast to the rules-based approach of U.S. securities regulation.<sup>29</sup> While principles are broad and abstract,

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<sup>28</sup> Chamber Report, *supra* note 3, at 5.

<sup>29</sup> See generally Lawrence A. Cunningham, A Prescription to Retire the Rhetoric of “Principles-Based Systems” in *Corporate Law, Securities Regulation, and Accounting*, 60 *Vand. L. Rev.* 1411 (2007), which nevertheless criticizes the principles versus rules dichotomy as imprecise

rules are detailed and complex. Principles confer a substantial amount of discretion upon regulators on a case-by-case basis. While rules are defined ex ante with little scope for ex post discretion, principles are set out broadly ex ante and are developed ex post in a highly contextual way.

Proponents of principles-based regulatory schemes argue that they allow firms to adapt their individual compliance procedures to their own unique business needs and practices. In contrast, rule-based systems assume ~~that~~ one size fits all. In addition, principles-based regulatory schemes are less adversarial and litigious than rules-based ones because regulators in the former tend to focus on guidance rather than litigation. The Bloomberg-Schumer Report argued that these differences put U.S. capital markets at a significant disadvantage:

Without the benefit of accepted principles to guide them, U.S. regulators default to imposing regulations required by various legislative mandates, many of which date back several decades. These mandates are not subject to major reviews or revisions and therefore tend to fall behind day-to-day practice. This failure to keep pace with the times has made it hard for business leaders to understand how the missions of different regulators relate to their business, and this in turn means that regulators have come to be viewed as unpredictable in their actions toward business.

The Report also noted that the cost of compliance with U.S. regulations has risen dramatically in recent years.

Securities firms reported on average almost one regulatory inquiry per trading day, and large firms experienced more than three times that level. The cost of compliance

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and inexact.

estimated in an Securities Industry Association report had reached \$25 billion in the securities industry alone in 2005 (up from \$13 billion in 2002). This increase is equivalent to almost 5 percent of the industry's annual net revenues. Although there are benefits from an increase in compliance-related expenditures, the report found that "a substantial portion of these increased costs were avoidable, reflecting, among other things: duplication of examinations, regulations and supervisory actions; inconsistencies/lack of harmonization in rules and regulations; ambiguity; and delays in obtaining clear guidance."<sup>30</sup>

The problem is not simply the rules-based nature of the U.S. system, but also the sheer volume of regulations with which issuers must comply:

A recent study by the Federal Financial Institutions Examination Council, the coordinating group of U.S. banking and thrift regulators, revealed that more than 800 different regulations have been imposed on banks and other deposit-gathering institutions since 1989. Regulations to implement the legislative requirements of the Sarbanes-Oxley Act of 2002 (SOX) are a good example. They are universally viewed by CEOs and other executives surveyed as being too expensive for the benefits of good governance they confer. Consequently, SOX is viewed both domestically and internationally as stifling innovation. "The Sarbanes-Oxley Act and the litigious environment are creating a more risk-averse culture in the United States," one former senior investment banker stated. "We are simply pushing people to do more business overseas rather than addressing the

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<sup>30</sup> Bloomberg-Schumer Report, supra note 1, at 83.

real issues head on.”<sup>31</sup>

### *The Sarbanes-Oxley Debacle*

Over the last decade, the Sarbanes-Oxley Act has emerged as the poster child for burdensome compliance costs. Four key SOX provisions were criticized from the outset for preempting state corporate law and for lacking justification in the empirical literature.<sup>32</sup> These were:

- Section 301 required public corporations to have an audit committee comprised exclusively of independent directors;
- Section 201 prohibited accounting firms from providing a wide range of nonaudit services to the public corporations they audit;
- Section 402(a) prohibited most loans by corporations to their executives, even though many such loans were effected to facilitate managerial acquisitions of their employer’s stock, which would have the desirable effect of aligning managers’ and shareholders’ interests; and
- Sections 302 and 906 required the CEO and CFO to certify their firm’s SEC filings.

These provisions have proven to be extremely burdensome and costly. The additional audit committee responsibilities imposed under § 301 have been a prime factor in the increased

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<sup>31</sup> Id.

<sup>32</sup> See generally Romano, *supra* note 4, at 1529-42, on which the following discussion draws.

work load of corporate directors and, as a result, in the increase in director compensation.<sup>33</sup> In addition, there are important conflicts between § 301's mandate that the audit committee establish and oversee a corporate whistle blowing program and EU directives with respect to data protection. As a result, for example, the French data protection authority struck down whistle blowing systems proposed by two subsidiaries of U.S. corporations subject to both § 301 and French data protection law.<sup>34</sup>

A study of Mexican corporations listing on and delisting from U.S. capital markets found that SOX sections 302 and 906 contributed significantly to delisting decisions.<sup>35</sup> SOX § 302 provides that when a reporting corporation files either an annual or quarterly report both the CEO and CFO must individually certify that he or she has reviewed the report and, to his or her knowledge, the report does not contain any material misrepresentation or omission of material fact. Both officers must also certify that, to their knowledge, the financial statements and other financial information contained in the report fairly present in all material respects the corporation's financial condition and results of operations for the period covered by the report. Section 302 also requires that the CEO and CFO individually certify in writing that they have

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<sup>33</sup> Judith Burns, *Corporate Governance (A Special Report) — Everything you Wanted to Know About Corporate Governance But Didn't Know to Ask*, Wall St. J., Oct. 27, 2003, at R6.

<sup>34</sup> Michael Delikat, *Developments Under Sarbanes-Oxley Whistleblower Law*, in *Internal Investigations 2007: Legal, Ethical & Strategic Issues* (June 2007), available on Westlaw at 1609 PLI/Corp 19.

<sup>35</sup> Eugenio J. Cardenas, *Mexican Corporations Entering and Leaving U.S. Markets: An Impact of the Sarbanes-Oxley Act of 2002?*, 23 Conn. J. Int'l L. 281 (2008).

disclosed to the outside auditors and the audit committee “all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer’s ability to record, process, summarize, and report financial data and have identified for the issuer’s auditors any material weaknesses in internal controls.” They must also certify to having told the auditors and audit committee about “any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer’s internal controls.” Finally, they must identify any significant changes in internal controls subsequent to the date of their evaluation, including any actions taken to correct any significant deficiencies and material weaknesses in those controls.

Congress liked the certification idea so much that Congress put it into SOX in two different places. In addition to the various certification requirements of § 302, § 906 amended the federal criminal code to add a new provision requiring that each “periodic report” filed with the SEC be accompanied by a written certification from the CEO and CFO that the “periodic report ... fully complies with” the relevant statutes and that the “information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.”

Taken together, sections 302 and 906 significantly increase the regulatory burden on the CEO and CFO. In turn, because best practice requires the assistance of other key corporate executives, much of the top management team’s time will now be devoted to preparing these certifications instead of conducting business. In addition, of course, the heightened liability exposure created by these sections increases the risks to which these executives are subject, for which they will demand compensation. The monetary and opportunity costs associated with compliance are not insignificant.

### *Section 404*

As it turned out, however, none of the provisions discussed above proved to be SOX's most contentious mandate. Instead, that dubious honor fell to Section 404's requirement that management and the firm's outside auditor certify the effectiveness of the company's internal controls over financial reporting. SOX § 404(a) ordered the SEC to adopt rules requiring reporting companies to include in their annual reports a statement of management's responsibility for "establishing and maintaining an adequate internal control structure and procedures for financial reporting" and "an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." Section 404(b) required that the company's independent auditors attest to the effectiveness of the company's internal controls.

Section 404 looks at first like a mere disclosure requirement. It requires inclusion of internal control disclosures in each public corporation's annual report. This disclosure statement must include: (1) a written confirmation by which firm management acknowledges its responsibility for establishing and maintaining a system of internal controls and procedures for financial reporting; (2) an assessment, as of the end of the most recent fiscal year, of the effectiveness of the firm's internal controls; and (3) a written attestation by the firm's outside auditor confirming the adequacy and accuracy of those controls and procedures. It is not the disclosure itself that makes § 404 significant, of course; instead, it is the need to assess and test the company's internal controls in order to be able to make the required disclosures. These costs have two major components. First, there are the internal costs incurred by the corporation in

conducting the requisite management assessment. Second, there are the fees the corporation must pay the auditor for carrying out its assessment.

When SOX was adopted neither Congress nor the SEC appreciated just how costly these compliance processes would prove. The SEC estimated that the average cost of complying with § 404 would be approximately \$91,000.<sup>36</sup> In fact, however, a 2005 survey put the direct cost of complying with § 404 in its first year at \$7.3 million for large accelerated filers and \$1.5 million for accelerated filers.<sup>37</sup> “First-year implementation costs for larger companies were thus eighty times greater than the SEC had estimated, and sixteen times greater than estimated for smaller companies.”<sup>38</sup>

These costs include average expenditures of 35,000 staff hours on § 404 compliance alone, which proved to be almost 100 times the SEC’s estimate. In addition, firms spent an average of \$1.3 million on external consultants and software. Finally, on average, they incurred an extra \$1.5 million (a jump of 35%) in audit fees.<sup>39</sup>

To be sure, some of these costs were one-time expenses incurred to bring firms’ internal controls up to snuff. Yet, many other SOX compliance costs recur year after year. For example, the internal control process required by § 404 relies heavily on on-going documentation. As a result, firms must constantly ensure that they are creating the requisite paper trail. Accordingly,

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<sup>36</sup> Joseph A. Grundfest and Steven E. Bochner, *Fixing 404*, 105 Mich. L. Rev. 1643, 1646 (2007) (footnotes omitted).

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

<sup>38</sup> *Id.* at 1645-46.

<sup>39</sup> Stephen M. Bainbridge, *The Complete Guide to Sarbanes-Oxley* 4 (2007).

while second year compliance costs dropped, those costs remained many times greater than the SEC's estimate of first year costs.<sup>40</sup>

In addition to the direct costs of complying with § 404, firms incurred a number of indirect costs. Director workload increased, for example, forcing firms to increase director compensation. Audit committees have been especially impacted, on average meeting more than twice as often post SOX as they did pre SOX. Director liability exposure also increased due to the harsh criminal and civil sanctions associated with violations of § 404 and other SOX requirements. As a result, not only did director compensation rise, but D&O insurance premiums more than doubled post-SOX.

These costs are disproportionately borne by smaller public firms. Director compensation at small firms increased from \$5.91 paid to non-employee directors on every \$1,000 in sales in the pre-SOX period to \$9.76 on every \$1000 in sales in the post-SOX period. In contrast, large firms incurred 13 cents in director cash compensation per \$1,000 in sales in the pre-SOX period, which increased only to 15 cents in the Post-SOX period. Likewise, companies with annual sales less than \$250 million incurred \$1.56 million in external resource costs to comply with § 404. In contrast, firms with annual sales of \$1-2 billion incurred an average of \$2.4 million in such costs. Accordingly, while SOX compliance costs do scale, they do so only to a rather limited extent. At many smaller firms, the disproportionately heavy additional costs imposed by § 404 are a significant percentage of their annual revenues. For those firms operating on thin margins, SOX compliance costs can actually make the difference between profitability and losing money.

Both the recurring nature and disproportionate impact of these costs is confirmed by a

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<sup>40</sup> Grundfest and Bochner, *supra* note 36, at 1646.

recent study of the impact SOX had on the operating profitability of a sample of 1428 firms. Average cash flows declined by 1.3% post-SOX. Costs ranged from \$6 million for small firms to \$ 39 million for large firms. These costs were not limited to one-time first year implementation expenses. Instead, substantial costs and reduced profits recurred throughout the four year study period. In the aggregate, the sample firms lost about \$75 billion over that period.<sup>41</sup>

Section 404 admittedly had laudatory goals. Faulty internal controls, after all, contributed to many corporate scandals during the dot-com era. Section 404 also has had some beneficial effects. Some of the fall in securities filings mid-decade may have resulted from companies having adopted better internal controls and disclosure procedures in response to § 404, for example. Some companies may have benefited from greater intra-firm transparency.

While regulators and Congress have sought to alleviate some of the costs associated with § 404 compliance,<sup>42</sup> there is no doubt that § 404—along with the rest of SOX and the broader

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<sup>41</sup> Anwer S. Ahmed et al., *How Costly is the Sarbanes Oxley Act? Evidence on the Effects of the Act on Corporate Profitability* (Sept. 2009), available at <http://ssrn.com/abstract=1480395>.

<sup>42</sup> The Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (hereinafter cited as “The Dodd-Frank Act”) permanently exempted nonaccelerated filers from compliance with Section 404(b). Meredith P. Burbank, *Dodd-Frank Act Permanently Exempts Non-Accelerated Filers From SOX Auditor Attestation Requirement*, <http://www.lexology.com/library/detail.aspx?g=8ee7ed34-1fe6-40a7-b31c-655070fd9f1d>. The Act further “directs the SEC to conduct a study within the next nine months to determine how the burden of compliance with Section 404(b) could be reduced for companies with market capitalizations between \$75 million and \$250 million.” *Id.*

U.S. regulatory regime—has had and continues to have a deleterious effect on the U.S. capital markets. As The Financial Economists Roundtable observed, there is “little reason to believe that ...the benefits of § 404 will exceed the costs.”<sup>43</sup>

These costs have substantially distorted corporate financing decisions. On the one hand, SOX discouraged privately held corporations from going public. Start-up companies opted for “financing from private-equity firms,” rather than using an IPO to raise money from the capital markets. Because “going public is an important venture capital exit strategy, partially closing the exit could impede start-up financing, and therefore make it harder to get ideas off the ground.”<sup>44</sup> In addition to the decline in domestic IPOs, there was a decrease in new foreign listings on U.S. secondary markets.<sup>45</sup> The net effect was the declining market share of U.S. markets in such transactions as global IPOs. “Martin Graham, director of the London Stock Exchange’s (LSE’s) market services, said that Sarbanes-Oxley has ‘undoubtedly assisted our efforts’ and emphasized the LSE’s ability to draw new listings from foreign companies.”<sup>46</sup>

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<sup>43</sup> FER, *supra* note 17, at 57.

<sup>44</sup> Bainbridge, *supra* note 39, at 6 (quoting Larry Ribstein). The undesirability of becoming subject to the SOX regime is further confirmed by evidence of a trend for start ups to follow an exit strategy of selling to private rather than public companies. Ehud Kamar et al., *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* (Rand Working Paper No. WR-300-2-EMKF, 2008).

<sup>45</sup> See Joseph D. Piotroski and Suraj Srinivasan, *Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings*, 46 *J. Acct. Res.* 383 (2008).

<sup>46</sup> Chamber Report, *supra* note 3, at 7.

Conversely, there has been a trend towards public companies exiting the public capital markets. A Foley & Lardner survey, for example, found that after SOX some 21 percent of responding publicly held corporations were considering going private.<sup>47</sup> A study by William Carney of 114 companies going private in 2004 found that 44 specifically cited SOX compliance costs as one of the reasons they were doing so.<sup>48</sup>

In light of this evidence, it is hardly surprising that all of the major reports on capital market competitiveness viewed SOX and, especially, § 404 as a significant drag on the competitiveness of those markets. The Bloomberg-Schumer Report cited the “concerns of small companies and non-US issuers regarding the Section 404 compliance costs involved in a U.S. listing.”<sup>49</sup> The Paulson Committee noted that § 404 compliance “costs can be especially significant for smaller companies and foreign companies contemplating entry into the U.S. market.”<sup>50</sup> The Chamber of Commerce argued that:

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<sup>47</sup> Bainbridge, *supra* note 39, at 6.

<sup>48</sup> William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of “Going Private,”* 55 *Emory L.J.* 141 (2006).

<sup>49</sup> Bloomberg-Schumer Report, *supra* note 1, at 20.

<sup>50</sup> Paulson Committee Report, *supra* note 2, at 5. The Committee downgraded the importance of § 404 relative to the other concerns it identified, which Romano suggests may have been the result of political calculations about the feasibility of obtaining legislative approval for the Committee’s various recommendations and the Committee’s focus on the problems faced by the stock markets rather than those of small companies. Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 *Yale J. on Reg.* 229, 246 (2009).

European, Chinese, and Indian companies that do not list their shares on U.S. markets are not required to comply with Section 404. They can save that money—this year and for every year hereafter—and direct it toward R&D, customer discounts, or a host of other uses that serve to improve their long-term competitiveness and make it that much harder for U.S. companies to compete.<sup>51</sup>

Citing the probability that the costs of compliance would continue to outweigh any benefits thereof, the Financial Economists Roundtable recommended that issuers be allowed to opt out of § 404.<sup>52</sup>

### ***The Recurrent Problem***

Egregious as it was, the failure of Congress and the SEC to forecast accurately the impact of § 404 in particular and SOX in general was not especially surprising. In a remarkably brief period, with minimal legislative processing, Congress slapped together a number of reform proposals that had been kicking around Washington for a long time and sent the mix to President Bush for signing.

Simply put, the corporate governance provisions were not a focus of careful deliberation by Congress. SOX was emergency legislation, enacted under conditions of limited legislative debate, during a media frenzy involving several high-profile corporate fraud and insolvency cases. These occurred in conjunction with an economic downturn, what appeared to be a free-

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<sup>51</sup> Chamber Report, *supra* note 3, at 14.

<sup>52</sup> FER, *supra* note 17, at 57.

falling stock market, and a looming election campaign in which corporate scandals would be an issue. The healthy ventilation of issues that occurs in the usual give-and-take negotiations over competing policy positions, which works to improve the quality of decision-making, did not occur in the case of SOX.<sup>53</sup> It's hardly surprising that legislation crafted in such a haphazard fashion turned out to be far more costly than anyone expected.

Unfortunately, SOX is merely one instance of the larger, on-going problem with the way corporate governance is regulated in the United States. Since the Founding, states have had primary responsibility for regulating corporate governance. "It ... is an accepted part of the business landscape in this country for states to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares."<sup>54</sup> Hence, the Supreme Court opines that "[n]o principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations."<sup>55</sup> Although the claim is contested, the better view is that the states—by which I mean Delaware—have done a good job in this area.<sup>56</sup>

Around the beginning of the last century, however, economic progressives began arguing for federal preemption. After the Great Crash of 1929, serious consideration in fact was given to creating a federal law of corporations. Instead, of course, Congress chose to adopt the now familiar federal securities laws. Although these laws federalized some aspects of corporate governance, they left the primary regulatory responsibility to the states.

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<sup>53</sup> Romano, *supra* note 4, at 1528.

<sup>54</sup> *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 91 (1987).

<sup>55</sup> *Id.* at 89.

<sup>56</sup> See Stephen M. Bainbridge, *Corporation Law and Economics* 15 (2002) (citing authorities).

In the interim, Congress normally has had far more important things on its agenda than corporate governance. It is only in the aftermath of the sort of crises that took place in the last decade that corporate governance becomes a matter of national political concern. Because Congress acts on corporate governance in response to a crisis, it tends to act hurriedly, as in the case of SOX.<sup>57</sup> The pressure of time tends to give advantages to interest groups and other policy entrepreneurs who have prepackaged purported solutions that can be readily adapted into legislative form. Hence, for example, many of SOX's provisions were "recycled ideas" that had been "advocated for quite some time by corporate governance entrepreneurs."<sup>58</sup> Unfortunately, because these policy entrepreneurs tend to be critics of markets and corporations, the resulting new laws often "impose regulation that penalizes or outlaws potentially useful devices and practices and more generally discourages risk-taking by punishing negative results and reducing the rewards for success."<sup>59</sup>

Larry Ribstein and Roberta Romano have independently demonstrated that this pattern is a reoccurring phenomenon in American law, going back even before the New Deal.<sup>60</sup> Indeed, according to Stuart Banner, the same pattern of boom, bust, and regulation can be seen far back into the Nineteenth Century:

Banner contends that the reason for the association is that deep-seated popular

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<sup>57</sup> Romano, *supra* note 4, at 1523 ("SOX was enacted in a flurry of congressional activity ....").

<sup>58</sup> Romano, *supra* note 4, at 1523.

<sup>59</sup> Larry E. Ribstein, *Bubble Laws*, 40 *Hou. L. Rev.* 77, 83 (2003).

<sup>60</sup> Ribstein, *id.* at 83-94; Romano, *supra* note 4, at 1590-94.

suspicion of speculation comes in bad financial times to dominate otherwise popular support for markets, resulting in the expansion of regulation. That is to say, financial exigencies embolden critics of markets to push their regulatory agenda. They are able to play on the strand of popular opinion that is hostile to speculation and markets because the general public is more amenable to regulation after experiencing financial losses.<sup>61</sup>

At that time, SOX was merely the latest iteration of this process.

When the economy suffered through an even worse patch at the end of the decade, it was thus perfectly predictable that another round of regulation would be forthcoming. The story of the housing bubble's burst, the subprime mortgage crisis, and the Great Recession is far too complex to recount herein. Suffice it to say that, as was the case with SOX, populist outrage motivated Congress to pass the Dodd-Frank Act, which I have elsewhere characterized as "Quack Federal Corporate Governance Round II."<sup>62</sup>

### *Can Anything Be Done?*

There are three major reasons why federal intervention in corporate governance tends to be ill conceived. First, federal bubble laws tend to be enacted in a climate of political pressure

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<sup>61</sup> Romano, *supra* note 4, at 1593.

<sup>62</sup> Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, \_\_\_ Minn. L. Rev. \_\_\_ (forthcoming).

that does not facilitate careful analysis of costs and benefits. Second, federal bubble laws tend to be driven by populist anti-corporate emotions. Finally, the content of federal bubble laws is often derived from prepackaged proposals advocated by policy entrepreneurs skeptical of corporations and markets.

In her critique of SOX, Roberta Romano proposed that these problems could be addressed in several ways:

The straightforward policy implication of this chasm between Congress's action and the learning bearing on it is that the mandates should be rescinded. The easiest mechanism for operationalizing such a policy change would be to make the SOX mandates optional, i.e., statutory default rules that firms could choose whether to adopt. An alternative and more far-reaching approach, which has the advantage of a greater likelihood of producing the default rules preferred by a majority of investors and issuers, would be to remove corporate governance provisions completely from federal law and remit those matters to the states. Finally, a more general implication concerns emergency legislation. It would be prudent for Congress, when legislating in crisis situations, to include statutory safeguards that would facilitate the correction of mismatched proposals by requiring, as in a sunset provision, revisiting the issue when more considered deliberation would be possible.<sup>63</sup>

In adopting Dodd-Frank, Congress ignored that advice. As a result, Dodd-Frank suffers from the

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<sup>63</sup> Romano, *supra* note 4, at 1594-95.

same three flaws as its predecessors.

The federal role in corporate governance thus appears to be a case of what Robert Higgs identified as the ratchet effect.<sup>64</sup> Higgs demonstrated that wars and other major crises typically trigger a dramatic growth in the size of government, accompanied by higher taxes, greater regulation, and loss of civil liberties. Once the crisis ends, government may shrink somewhat in size and power, but rarely back to pre-crisis levels. Just as a ratchet wrench works only in one direction, the size and scope of government tends to move in only one direction—upwards—because the interest groups that favored the changes now have an incentive to preserve the new status quo, as do the bureaucrats who gained new powers and prestige. Hence, each crisis has the effect of ratcheting up the long-term size and scope of government.

We now observe the same pattern in corporate governance. As we have seen, the federal government rarely intrudes in this sphere except when there is a crisis. At that point, policy entrepreneurs favoring federalization of corporate governance spring into action, hijacking the legislative response to the crisis to advance their agenda. Although there may be some subsequent retreat, the overall trend has been for each major financial crisis of the last century to result in an expansion of the federal role. The unfortunate conclusion thus seems to be that there is no cure insight for the corporate governance aspects of the American Illness.

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<sup>64</sup> See Robert Higgs, *Crisis and Leviathan: Critical Episodes in the Growth of American Government* 150-56 (1987) (describing the “ratchet effect” by which Congress increases not only the scale but also the scope of the federal government on a permanent basis).