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THE POLITICIZATION OF AMERICAN CORPORATE GOVERNANCE

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INTRODUCTION

THE governance of publicly-held corporations is effectuated by a number of public and private institutions ranging from the Securities and Exchange Commission (SEC) to the market for corporate control. These institutions vary enormously in terms of their organizational forms and existential motivations, but they share the common characteristic of contributing to the control of agency costs faced by investors in public companies.

Equity investors rely on corporate governance systems. One of the most remarkable aspects of modern economic life is the fact that hundreds of millions of investors have been persuaded to part with hundreds of billions of dollars in exchange for residual claims on the cash flows of companies. The securities that represent these residual claims offer their owners virtually nothing in the way of formal legal protections. Shareholders do not have the right to repayment of their principal, ever. Companies issuing the equity claims have no obligation to repurchase the shares of investors, regardless of how well or poorly the issuing companies perform. These companies also, of course, are under no obligation to pay dividends or make any other sort of payments to equity claimants. And, while U.S. law does offer some protection for investors when managers and directors engage in palpable fraud or outright stealing, there is no judicial oversight of managerial competence, and virtually no review of negligence.¹

The thesis of this article is that the institutions of corporate governance in the United States have become politicized. Regulations have caused the cartelization and ossification of important institutions like the accounting industry and the credit rating industry. Other politically-motivated rules have dramatically hobbled the market for corporate control, which historically has been the cornerstone of corporate governance. The observation generated by this thesis is that the politicization of the process of corporate governance has produced massively perverse results. Specifically, those corporate governance institutions that have performed the worst have been rewarded, while those institutions that have performed the best have been hampered by legal rules designed to impede their ability to operate. Rather than producing genuine reform, the wave of corporate governance, accounting, and capital markets

1. Joseph W. Bishop Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968) (stating that the search for cases in which directors have been held liable for “negligence uncomplicated by self-dealing” is “a search for a very small number of needles in a very large haystack.”).

scandals of the 1990s has generated political responses that benefit narrow interest groups and harm investors. Politics, not economics, determines which corporate governance devices are favored and which are not. As a consequence, the most effective corporate governance devices tend to be disfavored, while ineffective mechanisms are rewarded in the regulatory process.

This article begins with a description of the major institutions of corporate governance, and proceeds to a discussion of how each has performed. These major corporate governance institutions include the accounting firms that audit public companies, the credit rating agencies that determine whether their debt is “investment grade” or not, the market for corporate control that disciplines management of poorly run companies, the organized stock exchange that promulgates corporate governance rules, the market for initial public offerings of company shares, and the Securities and Exchange Commission itself, which regulates markets, oversees corporate disclosure, and, increasingly, formulates corporate governance policies for public companies

The story that emerges is rather depressing. The institutions that have performed the worst—the accounting firms, the SEC, and the credit rating agencies—are thriving, shielded from the consequences of their poor performance by a regulatory system that has rewarded poor performance. By contrast, the institution that has done the best and that holds the most promise for protecting investors—the market for corporate control—has been thwarted by protectionism.

It is highly unlikely that the perverse outcomes described here are entirely random. Rather, these outcomes are probably the result of a series of unrelated individual political decisions that were made under conditions of crisis, in response to political pressure, or as a result simply of following the path of least (political) resistance. Whatever the reason for the outcomes catalogued here, however, one thing is clear: the consequence of this unfortunate series of decisions is a massive diminution in the quality of corporate governance.

I. THE MECHANISMS AND INSTITUTIONS OF CORPORATE GOVERNANCE

As noted at the outset, the institutions of corporate governance are numerous and varied. The list includes all sorts of gate-keepers, such as lawyers, investment bankers, and accountants, as well as corporate boards of directors and financial institutions, which monitor companies to which they

have loaned money. These institutions have two things in common. First, shareholders rely on the institutions of corporate governance to solve the problems inherent in the separation of share ownership and management of large public corporations. The persistent willingness of investors to purchase residual equity interests in firms controlled by others is an astonishing and distinctive feature of U.S. capital markets, which are characterized by far more widely dispersed ownership than other capital markets throughout the world. The proclivity of U.S. investors to part with their investment dollars in far-flung ventures over which they have no practical control, and no legal rights to repayment of principal or to periodic returns (e.g., dividends) on their capital depends critically on the efficient operations of the institutions of corporate governance.

A. Accounting Firms

Accounting information related to the financial condition and financial performance of companies is important for a variety of reasons. As Ted Eisenberg and I have observed previously, in theory at least, companies in the capital markets demand the services of external auditors because investors will not invest unless they can rely on a credible signal that the financial results being reported by the company are accurate.² This need is particularly acute in light of the strong incentives that managers have to misstate earnings and other indicia of financial performance:³

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2. Theodore Eisenberg & Jonathan R. Macey, *Was Arthur Anderson Different? An Empirical Examination of Major Accounting Firm Audits of Large Clients*, 1 J. EMPIRICAL LEGAL STUD. 263, 266 (2004).
 3. Thus, outside auditors do not perform any services for a company that the company does not already perform for itself. The role of the auditor is not to prepare financial reports for clients (that is the role of the accountant). Rather, the auditor's role is to provide a reliable verification of the company's financial reports. See generally Rick Antle, *Auditor Independence*, 22 J. ACCT. RES. 1 (1984); George J. Benston, *The Value of the SEC's Accounting Disclosure Requirements*, 44 ACCT. REV. 515 (1969); Ronald R. King, *Reputation Formation for Reliable Reporting: An Experimental Investigation*, 71 ACCT. REV. 375 (1996); Norman Macintosh et al., *Accounting as Simulacrum and Hyper-reality: Perspectives on Income and Capital*, 25 ACCT., ORGS. & SOC'Y 13 (2000); Brian W. Mayhew, *Auditor Reputation Building*, 39 J. ACCT. RES. 599 (2001); Brian W. Mayhew, et al., *The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Objectivity*, AUDITING: J. PRAC. & THEORY, Sept. 2001 at 49; Ross L. Watts & Jerold L. Zimmerman, *Agency Problems, Auditing, and the Theory of the Firm: Some Evidence*, 26 J. L. & ECON. 613 (1983).

[A]uditors' reputations are central to the standard economic theory of auditing. Only auditors with reputations for honesty and integrity are valuable to audit-clients. The idea is that, absent a reputation for honesty and integrity, the auditor's verification function loses its value. In theory, then, auditors invest heavily in creating and maintaining their reputations for performing honest, high quality audits. High quality audits by independent auditors who have good reputations are assured. The quality assurance is derived from the fact that performing poor-quality audits diminishes the value of the audit firm's investment in reputation.⁴

The so-called "pre-Enron" view of the accounting industry, embraced by the law and economics movement,⁵ predicted that accounting firms compete in a "race-to-the-top" that provides them with incentives to strive to produce high quality audits:

There was a time that the audit function was carried out in a market environment that induced high quality financial reporting. In that era, accounting firms were willing to put their seal of approval on the financial records of a client company only if the company agreed to conform to the high standards imposed by the accounting profession. Investors trusted accountants because investors knew that any accounting firm that was sloppy or corrupt could not stay in business for long. Auditors had significant incentives to 'do superior work' because 'auditors with strong reputations could command a fee premium, and high fees 'signaled quality in the auditing market.'⁶

4. Eisenberg & Macey, *supra* note 2, at 266.

5. *Id.*

6. Jonathan R. Macey & Hillary Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1168 (2003).

Audit firms had incentives to provide high quality audit services because they wanted to protect their reputation for independence and integrity.⁷ As Ted Eisenberg and I have observed previously, “[i]n a world in which auditors have both invested in developing high quality reputations and in which no single client represents more than a tiny fraction of total billings, high audit quality seems assured. Under these conditions, any potential gain to an auditor from performing a shoddy audit, much less from participating in a client’s fraud, would be vastly outweighed by the diminution in value to the auditor’s reputation.”⁸

In sum, even though companies can (and do) audit themselves, they can justify the expense of hiring outside auditors to enhance their financial reputation and credibility with a wide range of current and prospective claimants on their cash flows, including investors, suppliers, customers, and prospective employees. Under this reputational model, companies need independent audits to attract outside capital, because it is widely believed that an auditing firm that discovers a problem would insist on a correction or, ultimately, fire the client. Being fired by an accounting firm has serious implications for the client.⁹ In contrast, economic theory supposed that an accounting firm that dismisses an audit client, however, would, at worst, lose only that client. And even this loss probably would likely be offset as the accounting firm might well gain new clients by virtue of the enhancement in the reputation of the accounting firm that followed from firing the client.

Thus, the “law and economics 101” approach to auditing embraced the view that, even though companies can and do impose their own financial controls and audit themselves, they hire outside auditors to capitalize on the audit firm’s reputation for probity. Hiring an auditor, under this theory,

7. Independence is measured by the percentage of an audit firm’s billings that are derived from a particular client. For example, Andersen was said to be independent of Enron because Andersen had 2,300 other audit clients, and Enron accounted for only about one percent of Andersen’s total revenue from auditing (Andersen’s Enron revenues were reported in 2001 as \$100 million as compared to \$9.34 billion in 2001 audit revenue). *Id.* at 1176, n.33. Of course, Andersen’s independence as a firm did not extend to the partners responsible for doing the actual audit work for Enron. *Id.* at 1168.

8. Eisenberg & Macey, *supra* note 2, at 267.

9. The resignation of an auditor sends a very powerful negative signal to the capital markets and can have dire consequences not only for the firm whose auditor resigns, but also for the managers of the firm. *See, e.g.*, Martin Fackler, *Drawing A Line: Unlikely Team Sets Japanese Banking on Road to Reform*, WALL ST. J., Aug. 6, 2003, at A1 (describing how auditors’ failure to sign off on financial projections of a large Japanese bank caused a crisis that forced the bank to seek a \$17 billion government bailout that put the financial institution under government control).

allowed the client company to “rent” the reputation of the accounting firm, which rents its reputation for care, honesty and integrity to its clients. As one observer characterized the market for auditors’ services:

Public accountants knew they had a lot to lose if their clients’ information turned out to be false or misleading. Auditors who did a superior job would reduce the chance of their clients’ issuing unreliable information and so reduce their own risk of being sued by aggrieved investors. Such suits are costly to auditors; even unsuccessful suits damage their valuable reputations.¹⁰

Unfortunately, the theory was flawed. The basic problem is that the accounting industry is not characterized by robust competition, and investors do not trust the numbers generated by accounting firms.¹¹ As Ted Eisenberg and I have shown, there are no detectable statistically significant distinctions among the big accounting firms with respect to quality.¹² Rather, the accounting firms all perform about the same, and there simply is no way for a company to distinguish itself for probity and honesty in its accounting standards through its selection of auditors, contrary to the assumptions of economic theory.¹³

There are many explanations for the decline in audit quality. These range from a decline in civil liability and changes in organizational form, which resulted in a diminution in incentives for accounting firms to monitor themselves,¹⁴ to changes in the complexity of financial transactions, which

10. Daniel B. Thornton, Financial Reporting Quality: Implications of Accounting Research, Testimony before the Canadian Senate Standing Committee on Banking, Trade and Commerce. (May 29, 2002).

11. According to a 2002 Gallup poll, seventy percent of U.S. investors stated that business accounting issues were hurting the investment climate “a lot.” Raul Atkins, Comm’r, U.S. Sec. & Exch. Comm’n, Remarks at the Federalist Society 20th Annual Convention (Nov. 14, 2002), *available at* <http://www.sec.gov/news/speech/spch111402psa.htm>.

12. Eisenberg & Macey, *supra* note 2.

13. *Id.*

14. The shift of organizational form from the general partnership form to the Limited Liability Partnership form reduced the threat of liability faced by audit firm partners not directly involved in auditing a particular client. This, in turn, may have resulted in a diminution in the incentives of accounting firm partners to monitor the performance of their colleagues. The removal of aider and abettor liability risk reduced auditors’ incentives to monitor one another. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (holding that section 10(b) and SEC Rule 10b-5 prohibit only “the making

made financial reporting more difficult.¹⁵ Somewhat more controversially, the provision of consulting services by accounting firms upset the traditional balance of power between issuers and auditors, and contributed to the capture of accounting firms by their clients.¹⁶

of a material misstatement (or omission) or the commission of a manipulative act” and do not prohibit the aiding and abetting of such acts). This decision was thought to have alleviated substantially the legal risks to outside advisors such as auditors and lawyers. This reduction in incentives was exacerbated in 1995 by passage of the Public Securities Litigation Reform Act (PSLRA). Pub. L. No. 104-67 (codified at 15 U.S.C. § 78 (1998)). The PSLRA established new rules of pleading that require plaintiffs’ complaints to “state with particularity all facts giving rise to a strong inference that the defendant acted with the required state of mind” when making a misstatement or omission in financial reporting. The PSLRA also delayed the beginning of discovery until after a court has decided whether to allow the case to go forward on the basis of the heightened pleading standards. Prior to passage of the PSLRA, plaintiffs’ attorneys could begin to gather documents and interview witnesses as soon as their complaint was filed. PSLRA also sharply limited the doctrine of “joint and several liability,” which insures that victims can recover full damages even if one or more of the parties to the fraud cannot pay. Under PSLRA, those whose reckless misconduct contributes to the fraud can be held responsible for only their proportionate share of victims’ losses. As a result, when the primary perpetrator of the fraud is bankrupt, investors cannot fully recover their losses from other entities, such as accounting firms.

15. Auditing became more complex as new and more sophisticated methods of financing proliferated, and as the audit rules themselves became more technical and complex. As a consequence, audit firms that were engaged by large public companies found that the “audit engagement teams” they assigned to perform audits had to spend increasingly large percentages of their time performing audit services for that client.
16. Where accounting firms also provide consulting services, accounting firms might be tempted to use auditing work either as a loss leader or “as a mechanism for ‘opening the door’ with a client for the purpose of pitching their (higher margin) consulting services.” Macey & Sale, *supra* note 6, at 1178. Providing consulting services further erodes auditor independence by shifting the balance of power away from the auditor and in the direction of the audit client when auditors are discussing audit work and retention issues. Worse, consulting services provide a means by which audit clients can reward auditors for succumbing to the client’s wishes about what accounting treatment should be used to report novel or complex transactions and business practices. *Id.* Where auditors only offer clients audit services, the client’s only option is to fire the auditor if the client does not think that the auditor is being sufficiently aggressive or compliant. But when the accountants also are peddling consulting services, the client can employ a “carrot and stick” strategy that rewards the accounting firm for being compliant and punishes the firm for being inflexible. This pressure is particularly acute in an environment in which the firm is the only client of the engagement partner from the accounting firm that is performing the audit, since a partner’s inability to procure lucrative consulting work would be reflected in the salary, promotion, and bonuses of the partner. As John Coffee has observed, it is difficult for an audit client to fire its auditor because such dismissals invite “potential public embarrassment, public disclosure of the reason for the auditor’s dismissal or resignation, and potential SEC intervention.” John C. Coffee, Jr.,

The point here is not simply that accounting firms have failed to distinguish themselves in their role as gate-keepers. This is well known. Rather, consistent with the theory advanced in this article, the point is that the political response to the dismal performance of auditors was not what it should have been. The political response should have been to address the real problems of capture cartelization that plagued, and continue to plague, the accounting industry. However, the response in Sarbanes-Oxley avoided addressing the real problems in the accounting industry and did nothing to improve competitive conditions or to facilitate entry into the accounting profession.

Instead, the legislation dramatically increased demand for the audit services of the four surviving, incumbent accounting firms, thereby imposing massive costs on investors without any clear concomitant benefits. A survey by the Financial Executives International (FEI), an association of top financial executives, reported in *The Economist*, found that companies paid an average of \$2.4 million more for their audits in the year 2004 than they had anticipated prior to the passage of the Act (and far more than the statute's designers had envisaged).¹⁷ As *The Economist* observed, the statute has "provided a bonanza for accountants and auditors—a profession thought to be much at fault in the scandals that inspired the law, and which the statute sought to rein in and supervise."¹⁸

As the General Accounting Office (GAO) has observed, the accounting industry is not competitive, and the elimination of Arthur Andersen dramatically increased the amount of concentration in the industry.¹⁹ The GAO also noted that smaller accounting firms face "significant barriers to entry" and that "market forces are not likely to result in" new entry.²⁰ *The Economist* also observed that the four largest accounting firms—Deloitte,

Understanding Enron: It's About the Gatekeepers, Stupid, 57 BUS. LAW. 1403, 1411-12 (2002). Where a company is both an audit client as well as a consulting client of a particular accounting firm, "the client can easily terminate the auditor as a consultant or reduce its use of the firm's consulting services, in retaliation for the auditor's intransigence." Macey & Sale, *supra* note 6, at 1178. When the client terminates the high margin consulting services provided by the accounting firm and retains only the low margin auditing services, there is no need to make any public disclosure. This means that there is no risk that firing the auditor from a consulting engagement will provoke heightened scrutiny from investors, the SEC, or plaintiffs' class action law firms.

17. *Sarbanes-Oxley, A Price Worth Paying?*, THE ECONOMIST, May 19, 2005, at 71-3.

18. *Id.*

19. *Id.*

20. *Id.*

Ernst & Young, KPMG, and Pricewaterhouse Coopers (PwC)—audit ninety-seven percent of all large companies in America, and that the American Electronics Association, which represents 2,500 companies and is an outspoken critic of the law, maintains that lack of competition “is significantly increasing the costs of section 404 certification.”²¹

Not surprisingly, the large accounting firms are proponents of Sarbanes-Oxley, just as any firm would support legislation that allowed them to increase prices and reduce output. The chief executive of PwC has been called “an enthusiastic advocate of the new law.”²² The head of KPMG’s U.S. business unit recognizes the increase in costs associated with the statute, but asserts that such costs will fall in the future.²³

Turning to the substance of Sarbanes-Oxley, the basic problem with the relationship between auditors and their clients is that the individual auditors who comprise the audit engagement teams that actually conduct the audits of public companies are highly susceptible to capture. They typically spend 100 percent of their time engaged in auditing a single firm. This problem of capture, coupled with reduced incentives to audit, was exactly what generated the problems that Arthur Andersen had in servicing its Enron account.²⁴ Accounting is a service business, and client satisfaction is as important in accounting as it is in all service businesses. Auditors’ careers increasingly have come to depend entirely on the “care and feeding” of their solitary client. Sarbanes-Oxley did nothing to address this problem of client “capture” of their auditors. Although the legislation could possibly have solved the capture problem by requiring public companies to change the accounting firms that audit them periodically, this rather radical change was not implemented. Instead, as a sort of “compromise,” Sarbanes-Oxley requires rotation every five years of the individuals within the accounting firms actually performing the audits of large companies.²⁵

This auditor rotation provision is likely to be both extremely costly and highly ineffectual. The provision will be costly because each new auditor will incur substantial billable start-up costs when she begins her new engagement every five years. The provision will be ineffectual because it will not reduce the tendency of auditors to be captured by their clients and may, in fact,

21. *Id.* (quoting the American Electronics Association).

22. *Id.*

23. *Id.*

24. Macey & Sale, *supra* note 6, at 1169.

25. Harry S. Davis & Megan Elizabeth Murray, *Corporate Responsibility and Accounting Reform*, BANKING & FIN. SERVICES POL’Y REP., Nov. 2002, at 1.

exacerbate those tendencies. A new auditor that is “rotated” onto the account of an accounting firm’s client certainly will not want to receive lower ratings for client satisfaction than her predecessor. In other words, the new auditor rotation provisions may trigger a destructive “race to the bottom” among auditors of reporting companies that want to be aggressive about reporting their financial results. Those auditors willing to use the most creative accounting techniques will receive the highest ratings for customer satisfaction.

In sum, the provisions of Sarbanes-Oxley provided demonstrable benefits for a very discrete interest group—the largest accounting firms. The benefits that the biggest accounting firms provide to investors is not at all clear, given the unreliable nature of the certifications of financial results that they provide. Nevertheless, demand for the services provided by the accounting firms remains strong, not because of market forces, but because of regulation.

The SEC’s regulations have effectively cartelized the accounting industry by requiring that large, publicly held corporations be audited by accounting firms that obtain only a small proportion of their revenues from any one client. This, in turn, means that large public companies can only be audited by very large accounting firms. In my view, this is what led to the massive consolidation that the accounting industry has experienced in recent decades. Sarbanes-Oxley has further entrenched the largest accounting firm’s regulatory cartel, without doing anything to improve the quality of the financial reporting that is of vital importance to investors and capital markets.

Using event study methodology, Ivy Xiyang Zhang has estimated that the net private cost of Sarbanes-Oxley is \$1.4 trillion,²⁶ or about \$460 for every person in the United States. This figure, which *The Economist* has characterized as “astonishing,” is an econometric estimate of the loss in shareholder wealth from the statute.²⁷ In other words, Professor Zhang’s study measures the direct costs of the statute to investors. Some of these losses undoubtedly simply are dead-weight social losses associated with the highly inefficient statute. Another significant portion of the losses, however, reflect wealth transfers from widely dispersed, politically weak shareholders to well-

26. Ivy Xiyang Zhang, Economic Consequences of the Sarbanes-Oxley Act of 2002, 20 (Feb. 2005) (paper, William E. Simon Graduate School of Business Administration, University of Rochester), http://w4.stern.nyu.edu/accounting/docs/speaker_papers/spring2005/Zhang_Ivy_Economic_Consequences_of_S_O.pdf (last visited February 22, 2005).

27. *Sarbanes-Oxley, A Price Worth Paying?*, *supra* note 17.

organized, highly concentrated interest groups, like the biggest accounting firms.

In other words, Sarbanes-Oxley, as it relates to accounting firms, appears to provide a straightforward application of George Stigler's important insight that narrow interest groups tend to dominate the political process.²⁸ Interest groups and their lobbyists and other agents interact with government officials in markets for political support. To survive in these political markets, regulators and politicians are constrained to generate results (in the form of statutes, regulations, and administrative agency action) that tend to benefit highly concentrated groups able to overcome the collective action problems of free-riding and rational ignorance. In this way political markets harm less well-organized groups, such as consumers, and private investors through higher prices and restricted output.²⁹

B. Credit Rating Agencies

Credit ratings from credit rating agencies such as Moody's and Standard and Poor's provide predictive opinions on an isolated characteristic of a company—the likelihood that the company will be able to repay its rated debt in a timely manner. Credit rating agencies attempt to downplay the role that they play in corporate governance, claiming that, because their ratings are grounded on analysis of information generated by the companies themselves, they are not in the business of searching for and exposing fraud.³⁰ This claim is somewhat disingenuous. It is generally accepted that the uninformed investors who inhabit financial markets clearly rely on the ratings generated by the major credit rating agencies. Why this is the case is something of a mystery. Moreover, as Frank Partnoy has observed, there is a great deal of evidence indicating that the product generated by the rating agencies, information, is both stale and inaccurate.³¹ The truly abominable performance of the credit rating agencies in their ratings of a whole host of debt issues,

28. G.J. Stigler, *Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

29. Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 355, 355-58 (1974); Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV., 339, 339-71 (1988).

30. Written Statement of Raymond W. McDaniel, President, Moody's Investors Service, Before the United States Securities and Exchange Commission (Nov. 21, 2002), available at <http://www.sec.gov/news/extra/credrate/moodys.htm>.

31. *Credit Rating Agency Duopoly Relief Act of 2005: Hearing on H.R. 2990 Before the Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters., House Comm. on Fin. Servs.*, 109th Cong. (2005) (statement of Frank Partnoy, Professor of Law, University of San Diego School of Law).

including Orange County, Mercury Finance, Pacific Gas & Electric, Enron, WorldCom, and most recently General Motors and Ford, amply illustrates the point, as do a plethora of academic studies showing that credit ratings changes lag the market.³²

In particular, the Enron case provides a rather illustrative example of the credit ratings' lag behind the market.

Neither Standard & Poor's nor Moody's downgraded Enron's debt below investment grade status until November 28, 2001, four days before the firm's bankruptcy, when the company's share price had plunged to a paltry sixty-one cents. . . . For Enron, the corporation's \$250 million in rated senior unsecured debt had declined in value from ninety cents to thirty-five cents on the dollar in the month preceding its downgrade. In other words, the market rejected the investment grade rating on Enron's debt before the credit rating agencies exercised their power to downgrade it.³³

As with accounting firms, credit rating agencies have not lived up to their promise as important components of the corporate governance infrastructure. And, as with accounting firms, public choice theory and the economic theory of regulation provide the best explanation for the failure of credit rating in American corporate governance. Historically, companies that utilized the public markets for debt and equity utilized credit rating agencies for the same reason they utilized the services of accounting firms: they wanted their financial condition to be verified by a credible, independent source. Demand for the services of rating agencies derived from the fact that companies lowered their capital costs when they subscribed to the services of credit rating agencies, and the savings from such lower capital costs were greater than the costs of the subscription fees charged by the credit rating agencies for assigning a rating to a company's securities.

The historical evolution of the demand for the services of credit rating agencies is identical to that of the accounting firms. Genuine demand fueled

32. "Numerous academic studies have shown that ratings changes lag the market." *Id. See also* Rating Agencies and the Use of Credit Ratings Under the Securities Laws, Concept Release No. 33-8236, 68 Fed. Reg. 35258 (June 4, 2003).

33. Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 406 (2004).

by market forces was displaced by ersatz demand fueled by regulatory requirements. This, in turn, led to the cartelization of both of these industries, as the number of accounting firms auditing large public companies dropped to four, and the number of credit rating agencies that enjoy the coveted status as SEC-sanctioned nationally recognized statistical rating organizations (NRSROs) has dropped to three.³⁴ As cartelization occurred, we also have observed, in both industries, a marked diminution in the quality of the services provided to investors and markets.³⁵

SEC regulation, in the form of the NRSRO designation, has created an artificial demand for ratings, despite their lack of usefulness to investors.³⁶ These regulations require that investors limit their investments in companies to those whose debt is rated by one of the three companies designated by the SEC as NRSROs. The SEC uses NRSRO credit ratings to determine how much capital broker-dealer firms must maintain when they hold debt securities under Rule 15c3-1 of the Securities Exchange Act of 1934. The ratings of NRSROs are also used to measure the credit risk of short-term instruments in the regulation of money market funds under Rule 2a-7 of the Investment Company Act of 1940. Issuers of certain debt securities that receive an investment grade rating from an NRSRO are entitled to register under the Securities Act of 1933 (the 1933 Act) on the shorter Form S-3. Banking and other regulators similarly rely upon NRSRO credit ratings to

34. In 1975, the SEC developed the concept of the nationally recognized statistical rating organization (NRSRO) to identify particular companies supplying credit ratings that could be relied on by the Commission for regulatory purposes. The term NRSRO was originally adopted by the Commission in 1975 solely for the purposes of Rule 15c3-1. *See* Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11497, 40 Fed. Reg. 29795 (July 16, 1975).

35. On the effects of cartelization in the credit-rating industry, see generally, Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43 (2004). Hill calls particular attention to reforming the industry by “encourag[ing] a less concentrated market structure.” *Id.* at 45. For empirical evidence on the perceived poor quality of credit rating agencies, see *Rating the Rating Agencies: The State of Transparency and Competition: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. On Financial Services*, 108th Cong. 101-122 (2003), available at <http://financialservices.house.gov/media/pdf/108-18.pdf>. Reduced competition in the accounting industry, largely as a result of pressures on accounting firms to consolidate in response to the SEC’s auditor independence rules, has “reduced the accounting firms’ incentives to differentiate their products on the basis of quality.” Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1177 (2003).

36. Partnoy, *supra* note 31.

protect the capital of financial institutions. Thus, many regulated financial institutions can only purchase certain types of securities if they have received an investment grade rating from an NRSRO.³⁷

Thus, the best explanation for the puzzle that credit rating agencies simultaneously enjoy great success while providing no information of value to the investing public is that the SEC inadvertently created an artificial regulatory demand for the services of a small number of favored ratings agencies when it misguidedly invented the NRSRO designation. This designation has, over time, caused an artificial demand for ratings, despite their lack of usefulness to investors.

C. The Market for Corporate Control

The most important market-driven component of the U.S. corporate governance infrastructure is the market for corporate control.³⁸ This is because an efficient market for corporate control deters managers from shirking by running the firm below its full performance potential. Because running a firm below its firm potential would make it more likely that the company's incumbent management would be replaced in a hostile acquisition, a robust market for corporate control is vitally important as a corporate mechanism for monitoring and disciplining managers.³⁹

Ironically, however, as the scientific evidence about the importance of the market for corporate control became so overwhelming as to be incontrovertible,⁴⁰ regulations impeding the market for corporate control

37. Statement of Amy Lancellotta, Senior Counsel, Investment Company Institute, for the SEC Hearings on Issues Relating to Credit Rating Agencies, (Nov. 21, 2002), available at http://www.ici.org/statements/tmny/02_sec_2a-7_stmt.html.

38. The U.S. system has historically confronted agency problems through takeovers. A wealth of theoretical arguments and empirical evidence supports the proposition that takeovers address corporate governance problems, particularly by controlling managerial discretion. Shleifer and Vishny observe that "takeovers are widely interpreted as the critical corporate governance mechanism in the United States, without which managerial discretion cannot be effectively controlled." Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 756 (1997).

39. Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169 (1981); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965).

40. A 1983 paper reviews the empirical evidence on the value created by corporate takeovers, finding that corporate takeovers overwhelmingly generate positive value. See Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983). While the vast majority of scholars seem to agree with Jensen &

became ubiquitous.⁴¹ This confluence of events was not random. Rather, the law reflects the private interests of corporate managers, a discrete well-organized interest group whose preferences are championed by organizations such as labor unions and the Business Roundtable.⁴²

As my colleague Roberta Romano has observed, a massive number of empirical studies have found uniformly and unanimously that regardless of the time period or acquisitive form, there are statistically significant positive abnormal returns on the investments of shareholders in companies that receive takeover bids.⁴³ Clearly political theory and not economic theory is required to explain the regulatory burdens that impede the market for corporate control. The following sub-section describes the relationship between the goals of corporate governance and the operation of the market for corporate control. This sub-section is followed by an analysis of the legal impediments that have arisen to impede the market for corporate control.

1. Corporate Governance

The market for corporate control is a pure market process. Government intervention is not needed to correct structural defects in this market. Rather, regulatory intervention, when it occurs, reflects the efforts of special interest groups such as managers and labor unions to impede the markets in order to

Ruback, there are a few notable dissents. *See, e.g.*, ROBERT B. REICH, *THE NEXT AMERICAN FRONTIER*, 140-72 (1983); Robert H. Hayes & William J. Abernathy, *Managing Our Way to Economic Decline*, HARV. BUS. REV., July-Aug. 1980, at 67, 73-74.

41. My colleague Roberta Romano has similarly observed, in her article, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 120-1 (1992), that “The empirical evidence is most consistent with value-maximizing, efficiency-based explanations of takeovers. Yet the thrust of regulation is to thwart and burden takeovers, as if they were non-value-maximizing wealth transfers.” Romano goes on to catalogue the variety of regulations that serve to restrict on the market for corporate control.

42. The Business Roundtable is an association of chief executive officers of leading U.S. corporations founded in 1972 in order: (1) to enable chief executives from different corporations to work together to analyze specific issues affecting the economy and business and (2) to present government and the public with knowledgeable, timely information, and with practical, positive proposals for action. Business Roundtable History, <http://www.businessroundtable.org/aboutUs/history.html>. (last visited April 11, 2006). The Business Roundtable is comprised of the CEOs of around 200 of the largest corporation’s in the U.S. representing about fifty percent of U.S. GDP. Amitai Etzioni, *Special Interest Groups Versus Constituency Representation*, 8 RESEARCH SOC. MOVEMENTS, CONFLICTS & CHANGE 171, 184 (1985).

43. ROBERTA ROMANO, *FOUNDATIONS OF CORPORATE LAW* 230 (1993).

protect incumbent management at firms that are either actual or potential targets.

The market for corporate control is simply risk arbitrage on a very grand scale. Risk arbitrage involves the time-honored process of “buying low and selling high.” Unfortunately, the response by corporate managers to efforts by entrepreneurs to enter this market has been to “buy law” in order to prevent take-over professionals from buying low.

In efficient capital markets, poor performance is hard to hide. When firms fare poorly, such poor performance is reflected in the firm’s share prices, and in a host of other indicators, including accounting data, particularly reported earnings, and sales performance in comparison to rival companies. All of these indicators are highly accessible and visible to a whole host of sophisticated outsiders watching the company, such as analysts, arbitrageurs, and venture capitalists. When these indicators lag relative to industry and sector competitors, potential acquirers have a strong incentive to notice; by acquiring the shares of a poorly managed firm at a depressed price that reflects the firm’s poor performance, the acquirer can institute the changes necessary to restore top corporate performance. Generally, these changes require that the top management of the company being acquired be displaced by a new management team.

Thus, a properly functioning market for corporate control clearly provides benefits for the shareholders of companies whose shares are purchased by the outside bidder. Such shareholders receive a substantial premium, generally around fifty percent of the price at which the target firm’s shares had been trading before the bid.⁴⁴ Moreover, even non-selling shareholders benefit when there is a hostile acquisition of a public company in which they own shares. Such non-selling shareholders benefit when the new management team takes over, reorganizes the target company, and does what successful bidders do: provide better discipline for management, seek strategic synergies with other companies, and sell assets, subsidiaries, divisions, and other components of the target that are not adding value to shareholders. In efficient capital markets, share prices for non-selling shareholders go up when these strategic changes are announced by competent bidders.

44. Theodor Baums & Kenneth E. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the U.S. and Germany*, 17 J. APPLIED CORP. FIN. 44, 59 n.55 (2005); Gregg A. Jarrell et al., *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. Econ. Persp. 49, 52 (1988).

It is quite clear that takeovers provide benefits for target firm shareholders, whether they sell their shares or not. Absent regulatory distortions, the best strategy for target management to use to avoid being ousted in a hostile takeover is to keep share prices high. Higher share prices deter hostile bids by making such bids more costly because they destroy the arbitrage potential that exists when shares are undervalued relative to their true potential.⁴⁵

Because share prices represent the best available, and indeed the only, real time, unbiased assessment of a company's performance and future prospects, by providing strong incentives for target managers to keep such share prices high, the market for corporate control is an elemental component of any corporate governance system in which the owners of residual claims in the company are not in positions of management. Improved corporate governance is a byproduct of an efficient market for corporate control. Such improved governance, however, is not limited to those firms that actually receive premium bids from outside acquirers. Rather, the genius of the market for corporate control as a corporate governance device is that it improves the quality of the corporate performance governance at all publicly held firms whose shares are "contestable."⁴⁶

The reason that the benefits of the monitoring provided by potential bidders is not limited to the shareholders in firms fortunate enough actually to receive a bid from a hostile bidder is because managers who want to avoid being displaced in a hostile takeover must keep the prices of their firms' shares high in order to avoid being ousted in a tender offer. Because managers and boards know that they will be ousted following a successful hostile acquisition, they will work harder to maximize shareholder value in

45. See Easterbrook & Fischel, *supra* note 39. ("Managers will attempt to reduce agency costs in order to reduce the chance of takeover, and the process of reducing agency costs leads to higher prices for shares."). See also Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1264 (1982) (arguing that the market for corporate control "simultaneously gives managers of all firms who wish to avoid a takeover an incentive to operate efficiently and to keep share prices high").

46. In this context, the term contestable means susceptible to the market for corporate control. A firm's shares are contestable in the market for corporate control if a majority of the shares are in the hands of independent (non-management-affiliated) value-maximizing shareholders. Where, for example, a majority of the voting shares of a company are in the hands of small-stake shareholders or institutional investors focused on share price performance, the company's shares are contestable. By contrast, the company's shares are not contestable where shares are parked with friendly institutional investors or where incumbent management and their allies have shares with supermajority voting rights that prevent an outside acquirer from obtaining a majority of the voting shares.

order to avoid that possibility. Thus, a takeover threat will not only discipline management, but also discipline the non-monitoring board.⁴⁷

The tender offer was invented in the 1960s, and fundamentally changed the economic landscape for American corporations. As Theo Baums and Ken Scott recently observed, prior to the introduction of the tender offer, launching a proxy fight for the election of directors was the only way that a challenger could hope to oust an underperforming incumbent management team.⁴⁸

As a corporate governance device, proxy fights suffer from two distinct disadvantages relative to takeovers. First, incumbent management enjoys a number of structural advantages over outsiders in proxy contests. Incumbent management controls the timing of the contest, and can charge election expenses to the company. The incumbents also have better information about who the company's shareholders are and about what issues are likely to appeal to particular cohorts of shareholders. Moreover, when a company is involved in a proxy fight, shareholders are required to choose between the incumbent management team, which is a known quantity, and a group of unknown outside raiders.⁴⁹

47. As important as the market for corporate control clearly is, it nonetheless is possible to overstate the role played by this particular market in corporate governance. In particular, the market for corporate control is not capable of dealing with recent corporate governance problems at firms like Enron and WorldCom, which involve artificially inflated earnings, profits, and other measures of corporate performance. See E.S. Browning, *Abreast of the Market: Investor Confidence Remains Fickle*, WALL ST. J., Sept. 9, 2002, at C1 ("Scandals at Enron, WorldCom, Global Crossing, Tyco International, Adelphia Communications, ImClone Systems and a host of other companies have raised questions about whether corporate earnings reports and corporate executives can be trusted."). The market for corporate control exerts powerful disciplinary pressure on under-performing management by providing arbitrage possibilities where share prices lag because companies have slothful or corrupt management. The depressed share prices in such companies present attractive investment opportunities for entrepreneurial corporate raiders, who profit by purchasing a controlling interest in under-performing companies and installing more competent and motivated management. See Shleifer & Vishny, *supra* note 38, at 756 (noting that the raider benefits when the share prices of the target firm rise to reflect the improved earnings generated by the new management team). However, the market for corporate control only disciplines bad management when the target firm's share prices are depressed. Because accounting fraud causes share prices to be artificially inflated rather than depressed, the takeover entrepreneurs who drive the market for corporate control have no incentive to launch the hostile takeovers that discipline managers employing questionable accounting practices to over-inflate their companies' share prices. *Id.*

48. Baums & Scott, *supra* note 44, at 58-59.

49. *Id.*

But the more profound deficiency in proxy contests as corporate governance devices is that those launching proxy contests lack credibility relative to those launching takeover contests in the form of tender offers. Potential acquirers making tender offers for a controlling block of a company's shares have enormous credibility because they are risking their own capital to acquire the controlling block. Having gained control of the company, tender offerors stand to benefit by managing the business in such a way as to increase the value of their shares, and the shares of their fellow shareholders.

By contrast, an entrepreneur who launches a proxy contest need not, in theory, own any shares in the target company whose board she seeks to displace. Rather, the outside "raider" asks that shareholders take it on faith that a successful proxy battle will lead to improvements in corporate governance. Thus, it is not surprising in the least that proxy contests are rarely successful unless organized and conducted by raiders who have very significant investments in the shares of the target firms. Only raiders who also large block at the time they launch their proxy contests can make a credible commitment to the target firm shareholders that their goal is to maximize the value of the entire firm, rather than to obtain the private benefits of control simply to loot the firm.

Thus, the emergence of the hostile tender offer in the 1960s should be viewed as a major innovation in the history of corporate governance. It provided the first large-scale, self-effectuating corporate control devices. The hostile tender offer is large-scale because it affects all shareholders and because it involves the deployment of massive resources by outside bidders. These resources are required to monitor potential target companies, to evaluate which incumbent management teams are operating so inefficiently that they warrant being displaced in a hostile bid, to effectuate the hostile acquisition, and to implement the strategic plan to redeploy the target company's assets to higher value uses.

The market for corporate control is self-effectuating because it emerges spontaneously from market forces without the need for any action taken or resources deployed on the part of the subject company. An efficient market for corporate control is such an effective corporate governance device that it dramatically facilitates the separation of equity ownership and managerial responsibility in unique ways not replicable by other corporate governance devices. In particular, the tender offer, which is the pivotal device in the market for corporate control, obviates the need for target company shareholders to make comparisons of the relative merits of competing management teams before deciding whether to approve a proposed change in

control transaction. Rather, as Baums and Scott have observed, “[w]ith the development of the tender offer in the 1960s, [shareholders] didn’t have to make a comparison between alternative management teams but merely a comparison between the price being offered by the acquirer and the market price under current management.”⁵⁰

Under this system, acquirers seeking control of target companies began to fare much better than they had when the principal strategy available to them was the proxy contest, but target management fared worse. As the market for corporate control became more effective as a governing device, life became less comfortable for incumbent management, who felt increasing pressure to maintain high share prices in order to reduce the probability that they would face a hostile tender offer for control.

2. Politics and the Market for Corporate Control

In addition to simply being more responsive to the needs of shareholders, management resorted to a number of additional tactics in response to the tender offer era. First, in 1968, “[m]anagement struck back” against the unfettered operation of the market for corporate control by supporting the passage of the Williams Act, which deterred corporate takeovers by dramatically increasing both the out-of-pocket costs and the legal risks that bidders face when launching a tender offer.⁵¹

Specifically, the Williams Act appropriates valuable property rights in information belonging to bidders by requiring such bidders to disclose such information to the financial markets. Among other things, the Williams Act requires that individuals, groups, and firms making tender offers supply the markets with their identities, their plans for the target firm, and their sources of financing.⁵² The requirements of the Williams Act made it easier for target firm management to entrench themselves by giving them “earlier warning” about an outside bid, and more time to resist.⁵³

As a consequence of the Williams Act and other anti-takeover efforts, hostile takeovers began a steady decline from fourteen percent to four percent of all mergers and acquisition activity.⁵⁴

50. *Id.*

51. *Id.* at 58.

52. Williams Act of 1968, Pub. L. No. 90-439, § 3, 82 Stat. 454, 456 (1968).

53. Baums & Scott, *supra* note 44, at 58.

54. Henry G. Manne, *Bring Back the Hostile Takeover*, WALL ST. J., June 26, 2002, at A18.

In addition to their legislative efforts, managers championed a number of changes to their charters and bylaws designed to impede the market for corporate control. As Baums and Scott have observed, managers and their attorneys implemented staggered boards of directors; abolished the right of shareholders to remove directors without cause, to hold special meetings, or to act by written consent without meeting; and employed supermajority shareholder vote requirements to approve clean-up mergers which members of the prior board had not approved.⁵⁵

Two factors prevented managers from being able to accomplish very much to retard the market for corporate control. First, fundamental changes to a company's corporate governance structure require that a company change its articles of incorporation, which, in turn, requires shareholder approval. Rational shareholders would not approve proposed changes to the governance structure of a company that would make them worse off by impeding the operation of the market for corporate control.

Second, there were important innovations in the market for corporate control, particularly the emergence of the leveraged buy-out and junk bond financing, which facilitated the takeover market and tended to counteract the pernicious effects of managerial entrenchment efforts.⁵⁶

The Delaware judiciary struck a grave blow to shareholders and to the free operation of the market for corporate control when it upheld the use of a radical new anti-takeover device, the poison pill in *Moran v. Household International*.⁵⁷ That case deserves to be counted as the worst opinion in the history of corporate law. Countless trillions of dollars in shareholder wealth have been lost by the failure of state court judges, particularly in Delaware, to protect the interests of shareholders during corporate control contests.⁵⁸

a. The Poison Pill

Technically called a shareholder rights plan, the term "poison pill" is the nickname for a particular device utilized by public companies to avoid a hostile takeover by making themselves unattractive to the investor who wants to make the hostile acquisition. Poison pills prevent hostile takeovers by

55. Baums & Scott, *supra* note 44, at 58-59.

56. See, e.g., Ronald Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 837-38 (1981).

57. *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985).

58. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 204 (1991).

increasing the costs of acquiring a large block of shares in a target company whose board has installed a poison pill. A poison pill involves the issuance by a company of a new class of stock, usually preferred shares, that provide holders with the rights to purchase additional shares, either in the target company, so-called “flip-in” pills, or even in the acquirer, so-called “flip-over” pills, whenever certain triggering events occur. The most common triggering event is the acquisition of a certain threshold percentage (often thirty percent) of target firm shares by any acquirer that the target company board finds unacceptable. Should an outside bidder make acquisitions that exceed the designated threshold without the permission of the target firm’s board of directors, the target firm’s shareholders are able to purchase additional shares at hugely discounted prices. The device is called a poison pill because these discount purchases have the intended effect of diluting the ownership interests of the outside bidder, who is specifically precluded from participating in the discount purchases permitted to the other investors.

Because poison pills have been technically evaluated as representing merely the issuance of a new class of shares, which most companies can do without shareholder approval, poison pills may be implemented by corporate boards without any shareholder action. When adopted, the rights initially attach to the corporation’s outstanding common stock, cannot be traded separately from the common stock, and are priced so that exercise of the option would be economically irrational. As mentioned above, the pill or shareholder rights become exercisable and can trade separately from the common stock only when a triggering event occurs.

A pill’s flip-over feature typically is triggered when the target is merged into the acquirer or one of its affiliates after the acquirer obtains the specified percentage of the target’s common stock. When this triggering event occurs, the target firm’s shareholders become entitled to purchase common stock of the acquiring company, typically at a deeply discounted price. These purchases have the effect of impairing the acquirer’s capital structure and drastically diluting the interest of the acquirer’s previous stockholders. The pre-existing shareholders in the bidding firm are harmed by flip-over poison pills because triggering the flip-over pill gives target shareholders the option to purchase shares of the acquiring company at deeply discounted prices, which dilutes the interests of the pre-existing shareholders of the acquirer.

Where flip-over pills are triggered by the merger of the acquirer and the target, flip-in pills are triggered merely by the acquisition of a specified percentage (usually twenty percent) of the issuer’s common stock. When a flip-in pill is triggered, all target firm shareholders except the acquirer are permitted to buy shares in the target at a deeply discounted price.

Poison pills impede the market for corporate control by eliminating the possibility of hostile takeovers in firms with poison pills in place. Significantly, the shareholder rights distributed by companies as poison pills can be redeemed by the target at little or no cost to the issuing company. Redeeming the rights eliminates the poison pill, and permits an acquisition to proceed. In other words, the consequence of the poison pill is to require acquirers to obtain the approval of target company boards of directors before proceeding. The harm to acquiring firm shareholders from the triggering of a poison pill is so severe that the poison pill has never been intentionally triggered.⁵⁹

Thus, the poison pill has effectively destroyed the hostile takeover. Those companies with the most venal management teams are immune from ouster in a hostile takeover. Only companies with benign, other-regarding boards of directors will redeem their poison pill rights plans and permit outside acquirers to effectuate a change in control.

b. The Delaware Judiciary

In a key passage in *Moran*, the Delaware Supreme Court observed that permitting companies to implement poison pill rights plans without shareholder votes would not have deleterious corporate governance effects because such plans would be subject to intense scrutiny by the courts. In particular, with respect to the poison pill rights plan adopted by Household International, the Court asserted that:

[T]he Rights Plan is not absolute. When the Household Board of Directors is faced with a tender offer and a request to redeem the Rights, they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard as they were held to in originally approving the Rights Plan.⁶⁰

Unfortunately, state courts in general and the Delaware courts in particular have not lived up to their obligation to protect shareholders by

59. Baums & Scott, *supra* note 44, at 59.

60. *Moran*, 500 A.2d at 1354.

policing the implementation, if not the adoption, of poison pills.⁶¹ Instead, the requirement that the decision to use the pill be evaluated by state courts to determine whether the decision is consistent with the directors' fiduciary responsibilities has "turned out to be of little substance."⁶² Subsequent decisions have permitted target company boards of directors to thwart outside acquisition attempts by leaving their poison pill rights plans in place on the basis of highly dubious justifications. For example, in *Paramount Communications v. Time, Inc.*, the court was persuaded not to act to force management to redeem its pill on the thin reed of management's highly self-serving claim that it had a "strategic plan" that it thought would lead to greater returns to shareholders than the acquirer was offering.⁶³

The decision in *Time* is particularly troubling because the bid was all cash and was made for 100 percent of the target company's shares.⁶⁴ The only coherent justification for defensive tactics such as the poison pill is that they protect shareholders from coercive two-tiered bids, in which shareholders are induced to sell their shares to a bidder offering to purchase less than 100 percent of the company's outstanding shares because they are concerned that the bidder will obtain control of the firm and mismanage it, thereby driving down the value of any remaining shares.⁶⁵ These sorts of two-tiered offers are coercive because target firm shareholders face a collective action problem similar to a prisoner's dilemma: the best outcome for all shareholders would be for none to tender in the first stage of a coercive two-tiered offer, but the best outcome for any individual shareholder would be to be able to sell her shares for cash, particularly if the coercive bidder's bid succeeds.

In *Moran* itself, the court justified allowing the target firm to retain its poison pill because the pill was adopted "in reaction to what it perceived to be the threat in the market place of coercive two-tier tender offers."⁶⁶ Later court decisions have ignored the fundamental distinction between two-tiered bids and cash bids for 100 percent of the stock in the target company.⁶⁷ For

61. See Baums & Scott, *supra* note 44, at 59 (observing that the requirement that use of the pill must pass muster with the Delaware Supreme Court "proved hollow").

62. Baums & Scott, *supra* note 44, at 59.

63. *Paramount Communications v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1989). See also *Unitrin v. Am. Gen. Corp.*, 651 A.2d 1361, 1385 (Del. 1995).

64. *Time*, 571 A.2d at 1142.

65. William J. Carney, *Shareholder Coordination Costs, Shark Repellents and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. BAR FOUND. RES. J. 341, 350-53 (1983).

66. *Moran v. Household Int'l*, 500 A.2d 1346, 1356 (Del. 1985).

67. See, e.g., *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1342 (Del. 1987) ("This Court has recognized the coercive nature of two-tier partial tender offers.");

example, in *Time*, the Delaware Supreme Court permitted the firm to retain its poison pill despite the fact that the bidder was offering all cash for 100 percent of the target firm's shares, thereby obviating any argument that the pill was needed to protect target firm shareholders from the coercive effect of a two-tier bid.⁶⁸

Thus, courts have failed to live up to their promise to protect shareholders from the use of the poison pill to insulate incumbent management from the salutary effects of the market for corporate control. In addition, courts have failed to restrict the use of poison pills to their proper context—the regulation of coercive two-tiered tender offers. Moreover, courts have ignored the chilling effects that poison pill rights plans have on the market for corporate control, and hence, on the governance of the publicly held corporation. Specifically, by making hostile acquisitions more costly and more difficult, poison pills impose significant disincentives on acquirers. Not only are acquirers deprived of incentives to make bids, they also are deprived of incentives to engage in the costly search process necessary to identify under-valued firms.

In *Moran*, the Delaware Supreme Court appears to have gone out of its way to ignore these incentive effects. The court blithely observed that the target firm's poison pill was not suspect merely because it did not prevent stockholders from receiving tender offers, failing to understand the plaintiffs' cogent argument that allowing the poison pill would cause shareholders to "lose their right to receive and accept tender offers."⁶⁹ Unable or unwilling to see beyond the banal technicality that bidders retain the power to make a hostile tender offer for firms with poison pill rights plans, the court failed to acknowledge that such plans destroy bidders' incentives to do so unless they can engineer a way to get the approval of the target firm's board of directors (in which case, of course, the bid is no longer hostile).⁷⁰

Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 (Del. 1985) (finding a "grossly inadequate" two-tier offer to be coercive).

68. 571 A.2d at 1140.

69. 500 A.2d at 1354.

70. There are at least two ways that bidders can obtain the approval of the target firm's board. The first is by making the tender offer contingent on the decision by the target company's board to redeem the pill. This contingency is now a routine part of the tender offers bidding process. Bidders can also obtain the approval of the target firm's board by launching a proxy contest for control of the target board simultaneously with the announcement of a tender offer. By acquiring control of the board, the bidder can use such control to redeem the pill. Staggered boards of directors, of course, make the latter

Thus, by judicial fiat, the Delaware courts have removed from the marketplace the hostile tender offer, which is the most powerful corporate governance device in the shareholders' corporate governance arsenal. As Baums and Scott presciently have observed, "Delaware jurisprudence seems to be willing, in substance . . . to give management something approaching an absolute veto over hostile tender offers despite overwhelming evidence that they confer large benefits on target shareholders."⁷¹ Again, just as courts and legislatures have undermined the vitality of credit rating agencies and accounting firms, they have undermined the market for corporate control.

D. Organized Stock Exchanges

Organized stock exchanges, particularly the New York Stock Exchange (NYSE), used to play an important role in U.S. corporate governance. When a public corporation listed on a stock exchange, that corporation was making a credible commitment to abide by a set of corporate governance rules designed to maximize shareholder wealth.⁷² The commitment was made credible by the threat of delisting, which, historically, had draconian effects on companies because of the lack of alternative trading venues for shares in public companies. Over time, however, advances in technology and the development of markets have weakened the primacy of the traditional exchanges. A whole host of competitors for the traditional stock exchanges have emerged.

Traditionally, firms have not listed on more than one venue. When firms changed from one trading venue to another, it was usually because they had grown and were promoted from the over-the-counter markets to the NYSE. Decisions by highly successful companies such as Google and Microsoft to remain in the over-the-counter markets, along with the ability of firms such as Hewlett-Packard simultaneously to be listed on both the NYSE and NASDAQ, illustrate the change in the traditional ordering.

The modern stock exchange is subject to vigorous competition from a variety of sources, including both rival exchanges and alternative trading venues such as Electronic Communications Networks and Alternative Trading Systems. This competition has strained the exchanges' capacity for

tactic more difficult for bidders. See Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy*, 54 STAN. L. REV. 887 (2002).

71. Baums & Scott, *supra* note 44, at 59.

72. Jonathan R. Macey & Maureen O'Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 STAN. L. REV. 563, 569 (2005).

self-regulation and undermined their incentives to regulate in the public interest with respect to issues related to the corporate governance of their members. Moreover, the available evidence indicates that the organized exchanges do not even act as stand-alone regulators anymore. Instead, they are better understood as conduits for the SEC, which coordinates the corporate governance regulations that ostensibly are promulgated under the exchanges' authority as self-regulatory organizations.⁷³ As the *Special Study on Market Structure, Listing Standards and Corporate Governance*, pointed out, "the SEC had adopted a practice of encouraging the exchanges 'voluntarily' to adopt given corporate governance listing standards and in the process has urged the exchanges' listed companies and shareholders to reach consensus on those standards."⁷⁴ The SEC now coordinates the regulatory price fixing among the exchanges' self-regulatory organizations with respect to every facet of the exchanges' relationships with listed companies. Thus, the SEC has undermined the traditional way that exchanges competed with one another to provide efficient corporate governance rules.

A cogent example of this phenomenon is the one-share, one-vote listing requirement. During the 1980s, the managers of several firms that were listed on the NYSE were concerned about the possibility of a hostile takeover, and wanted to adopt a particularly potent defensive strategy, which involved recapitalizing the firm with additional classes of voting stock, to be held by management, which would have significantly greater voting rights than the shares held by other shareholders. The problem with this recapitalization strategy was that it clearly violated a long-standing NYSE rule providing that all shares of common stock of listed companies could have one, and only one, vote.⁷⁵

73. The available evidence here consists largely of series of episodes in which the exchanges fail to self-regulate, often followed by a coordinated regulation led by the SEC. Self-regulation by the exchanges is in general dysfunctional in significant part because securities are often traded simultaneously in multiple venues, thus inhibiting the ability of exchanges to unilaterally enforce regulations. See Macey & O'Hara, *supra*, note 72, at 575, 577-79 ("As a purely descriptive matter, the available evidence is inconsistent with the assertion that rival trading venues compete to produce corporate law rules. Rather, the accurate depiction of the competitive situation is that the SEC *coordinates* the regulatory standards of the exchanges and the Nasdaq in order to prevent competition among these trading venues from occurring at all.")

74. *Id.* at 571, 577. See also Robert Todd Lang et al., American Bar Association, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1503 (2002).

75. See ANNETTE B. POULSEN & KEN LEHN, SEC OFFICE OF CHIEF ECONOMIST, UPDATE—THE EFFECTS OF DUAL-CLASS RECAPITALIZATIONS ON SHAREHOLDER WEALTH: INCLUDING EVIDENCE FROM 1986 AND 1987, Table 1 (1987). See also Jeffrey N. Gordon,

The SEC was deeply concerned that several high-profile listed firms, notably General Motors Corporation (GM) and Dow Jones, Inc., wanted to engage in these so-called “dual-class recapitalizations.” The NYSE was alarmed when both of these firms decided to proceed with their plans to offer dual classes of voting stock, in flagrant violation of the NYSE’s rules. For the NYSE, delisting these firms would have caused a significant loss of both prestige and revenue. But for GM and Dow Jones, the consequences would have been negligible. Delisting would have meant that shares in the two firms would have been traded on an NYSE competitor such as the American Stock Exchange (AMEX) or the NASDAQ, both of which permitted dual-class recapitalizations.

This episode illustrates the NYSE’s inability to enforce its own corporate governance rules in today’s new world of competing trading venues. Ultimately, the NYSE was forced to relax its listing requirements in order to avoid losing two of its most valuable listings. In order to avoid a recurrence of this embarrassing episode, the NYSE then petitioned the SEC to impose a uniform voting rights standard for all publicly traded firms. Although the SEC granted the NYSE’s request, the SEC’s uniform voting rights standard was ruled invalid as an impermissible extension of the Commission’s regulatory authority into the realm of corporate governance, which traditionally is the domain of the states.⁷⁶

Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 CAL. L. REV. 1, at 4 (1988), in which Gordon counts over eighty public firms that have “adopted, or proposed to adopt, capital structures with two classes of common stock.” In footnote 2, Gordon adds, “One recent estimate is that since 1985 the number of companies with dual classes of stock has risen from 119 to 306.” *Id.* at 4 n.2 (citing *Dual Stock Categories Spur Powerful Debate Over Stability vs. Gain*, Wall Street Journal, May 17, 1988, at p. 1, col. 6).

76. *Business Roundtable v. SEC*, 905 F.2d 406, 407 (D.C. Cir. 1990), declared the SEC’s rule invalid. However, by the time the Court had ruled, the NASDAQ, the AMEX, and the NYSE had adopted the SEC’s proposed rule, and none was willing to risk its ongoing relationship with the SEC by returning to its previous rule. Barbara Franklin, *New Stock Issue Rules: ‘Technical’ Changes Seen Resulting in Tougher Enforcement*, N.Y.L.J., Sept. 7, 1989, at 5. It should be added that the ruling in *Business Roundtable v. SEC* that the SEC lacked the authority to promulgate rules of corporate governance has been weakened considerably, if not eviscerated entirely, by the Sarbanes-Oxley Act of 2002, which gave a significant amount of new power to the SEC in the realm of corporate governance. Sarbanes-Oxley Act of 2002, 15 U.S.C.A. §§ 7211-7219 (2005).

E. Initial Public Offerings

Another poorly understood institution of corporate governance is the initial public offering. When a company makes a public offering of securities, it commits itself to rigorous monitoring by a cadre of lawyers, investment bankers, and financial analysts, all of whom face reputational and legal risks for failure to do an adequate job of protecting investors, a process which, in this context, involves serving a gate-keeping function.⁷⁷ The gate-keeping function in initial public offerings revolves around the due diligence investigation that the underwriters perform in connection with the offering. The term “due diligence” does not appear anywhere in the 1933 Act, the Securities Exchange Act of 1934, or any SEC rule.⁷⁸ The origins of the term are in the language of section 11 of the 1933 Act, which exempts from liability underwriters who reasonably believed, after “reasonable investigation,” that no disclosure violations occurred in the offering, and from the language of section 12(a)(2) of the 1933 Act, which precludes liability for underwriters who exercised “reasonable care” and did not know or could not have known of such violations.⁷⁹

As for both aspects of the term “due diligence,” the issue of whether a due diligence investigation was sufficient is determined with reference to “the standard of reasonableness [that is] required of a prudent man in the management of his own property.”⁸⁰ This reasonableness standard is used to evaluate both the adequacy of an underwriter’s due diligence efforts as well as to determine whether the underwriter will be permitted to assert a due diligence defense.

77. Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 654 (1984).

78. Securities Act of 1933, 15 U.S.C.A. §§ 77a-77aa (2006); Securities Exchange Act of 1934, 15 U.S.C.A. §§ 78a-78kk (2006).

79. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 207-08 (1976) for an example of the usage of the term “due diligence” in relation to section 11 of the 1933 Act (“§ 11 of the 1933 Act unambiguously creates a private action for damages when a registration statement includes untrue statements of material facts or fails to state material facts necessary to make the statements therein not misleading . . . [E]xperts such as accountants who have prepared portions of the registration statement are accorded a ‘due diligence’ defense,” which is “[i]n effect, a negligence standard” whereby “[a]n expert may avoid civil liability with respect to the portions of the registration statement for which he was responsible by showing that ‘after reasonable investigation’ he had ‘reasonable ground[s] to believe’ that the statements for which he was responsible were true and there was no omission of a material fact.”).

80. 15 U.S.C.A. § 77k(c).

The issue of what constitutes appropriate due diligence is highly contextual. Courts recognize that “[i]t is impossible to lay down a rigid rule suitable for every case defining the extent [of an underwriter’s due diligence obligations].”⁸¹ However, some important general points can be made about the nature of due diligence investigations that are applicable to all financing transactions. Specifically, it is clear that investors rely on underwriters to discover and ensure the disclosure of the essential facts relevant to the financing and to the company engaged in the transactions. Banks conducting due diligence investigations should meet with the management of the issuer in the context of their due diligence investigations. Such meetings are necessary for the underwriter to establish its “due diligence defense” under section 11 of the 1933 Act. However, the underwriter also has an affirmative duty to verify the accuracy of statements made by management as well as those contained in a registration statement.

In addition, regardless of what else might have been done, due diligence has not been adequately performed in three situations. Due diligence is clearly insufficient in those situations: (a) where “red flags” suggesting inaccurate registration information were not pursued adequately; (b) where those conducting the due diligence did not critically analyze and evaluate the information at their disposal; or (c) where reliable, independent, outside sources of information were not contacted for the purpose of challenging, supporting, and verifying the information provided by company management.⁸²

As noted above, underwriter due diligence investigations typically begin with inquiries into the nature of the issuer’s business, including an investigation of the nature of the industry in which the issuer is involved, and with discussions with the issuer’s management. During these discussions, management usually provides the underwriter with information that management believes should appear in the registration statement. These discussions are helpful to the extent that they enable the underwriter to gain a

81. *Escott v. BarChris*, 283 F.Supp. 643, 697 (S.D.N.Y. 1968).

82. *See, e.g.*, *Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341, 372-73 (2d Cir. 1973); *In re Int’l Rectifier*, 1997 WL 529600 at *7-8 (C.D. Cal. Mar. 31, 1997); *Weinberger v. Jackson*, 1990 U.S. Dist. LEXIS 18394 at *6-9 (N.D. Cal. Oct. 11, 1990); *Univ. Hill Found. v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 898-99 (S.D.N.Y. 1976); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 582 (E.D.N.Y. 1971); *BarChris*, 283 F. Supp. at 696-97. *See also* Jack C. Auspitz & Daniel W. Levy, *A Litigator’s View of Due Diligence Obligations*, 30 S&P’S REV. SEC. & COMMODITIES REG. 215 (1997); Dennis Block & John Hoff, *Underwriter Due Diligence in Securities Offerings*, N.Y.L.J., May 27, 1999, at 5.

general understanding of the issuer's business and to assess whether management is capable of carrying out its prospective goals.

A due diligence investigation should not end with the receipt of information from management just described. For a due diligence investigation to be adequate, the banks performing the due diligence must independently verify that the information has been given.⁸³ Courts have recognized that independent verification is a critical step in the due diligence process.⁸⁴

Underwriters will also examine the issuer's current financial health and its future financial prospects as part of their due diligence investigation. This step necessarily involves a review of the issuer's financial statements which, in turn, requires underwriters to refer to the analysis and opinions of the issuer's independent auditors. Underwriters should nevertheless carefully scrutinize the auditor's report and letters to management to determine whether potential problem areas were uncovered during the audit. Moreover, underwriters should look at general financial issues—including profits and revenue, budget concerns, and the internal audit controls the issuer has in place—to reach a sufficient comfort level with the issuer's overall financial condition. In addition, underwriters will address various legal issues that could potentially affect the accuracy of the registration statement and the adequacy of its disclosures.

It is well-established that bankers whose investigations are deficient are not entitled to take refuge in a due diligence defense. The reasonableness required of underwriters' due diligence investigations also depends upon the

83. See, e.g., *Chris-Craft Indus.*, 480 F.2d 341, 372-73; *Int'l Rectifier*, 1997 WL 529600 at *7-8; *Weinberger*, 1990 U.S. Dist. LEXIS 18394 at *6-9; *Univ. Hill Found.*, 422 F. Supp. 879, 898-99; *Feit*, 332 F. Supp. 544, 582; *BarChris*, 283 F. Supp. at 696-97.

84. For example, the court in *BarChris* based its determination that the underwriters had not established a due diligence defense in large part on the fact that the lead underwriter delegated much of its diligence responsibility to counsel—who merely took documents produced by the issuer and statements made by the issuer at face value, without any independent verification. 283 F. Supp. at 697. Similarly, the court in *University Hill Foundation v. Goldman, Sachs & Co.* concluded that when an underwriter possesses information that may indicate potential problems with the offering materials, its “normal due diligence procedures [are] inadequate and . . . require more concrete verification of management representations and projections.” 422 F. Supp. at 902. See also *Chris-Craft*, 480 F.2d at 372-73 (noting that minutes from the issuer's board meeting in underwriter's possession “if not sufficient in themselves to lead a reasonable person to believe that the registration statement was misleading, certainly would have impelled a reasonable person to explore further”).

type of materials that they are reviewing.⁸⁵ The responsibilities of those conducting due diligence requires that banks do more than simply review an auditor's audit opinion. For example, the Seventh Circuit, in *Sanders v. John Nuveen & Co.*, pointed out that the banks performing the due diligence did not meet with the auditors or review the accounting work papers which might have revealed evidence of fraud between the issuer and the auditors.⁸⁶ Significantly, unaudited financial statements are not considered to be expertised, requiring underwriters to conduct a reasonable investigation whenever the financial statements they are dealing with in the course of their due diligence have not been audited.

Underwriters commonly delegate certain aspects of due diligence investigations to others, such as attorneys, accountants, and the lead underwriter. Relying on others to conduct certain aspects of diligence, however, risks preventing the underwriter from being able to establish a due diligence defense. For this reason, an underwriter ought not to rely blindly on

85. Specifically, section 11(b)(3)(A)-(D) of the Securities Act of 1933 divides the contents of the registration statement into two clearly-delineated portions—"non-expertised" materials and "expertised" materials. Securities Act of 1933, § 11(b)(3)(A)-(D), 15 U.S.C. § 77k(b)(3)(A)-(D) (2000). Underwriters seeking to establish a due diligence defense as to the "non-expertised" portions of the registration statement (that is, materials "not purporting to be made on the authority of an expert") must prove that, at the time of the registration's effective date, they had "reasonable grounds to believe and did believe . . . that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(b)(3)(A).

Underwriters can establish a due diligence defense as to "expertised" portions of the registration statement (that is, "[those portions] made on the authority of an expert") by demonstrating that after a "reasonable investigation" they had "no reasonable ground to believe and did not believe . . . that the statements [contained in the expertised section] were untrue or that [they omitted] a material fact." 15 U.S.C. § 77k(b)(3)(B)-(C).

Accordingly, the issue with regard to the expertised portions is not "reasonable investigation," but "reasonable reliance"—the underwriter must not have uncovered any facts that would give it a reason not to rely on an expert's representations. Reports of auditors on audited financial statements of the issuer are examples of "expertised" opinions upon which underwriters typically rely. *See, e.g., In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489, 1498 (N.D. Cal. 1992) ("Given the complexity of the accounting issues, the Underwriters were entitled to rely on [the auditor's] expertise."). *See also Miller v. Pezzani (In re Worlds of Wonder Sec. Litig.)*, 35 F.3d 1407, 1421 (9th Cir. 1994). Only the audited, certified financial statements are "expertised" for section 11 purposes. *See BarChris*, 283 F. Supp. 643, 683-84; *See also Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303, 323 (S.D.N.Y. 1996), *aff'd*, 108 F.3d 1370 (2d Cir. 1997), finding that underwriters may not always rely on auditors.

86. *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1227-28 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981).

the people to whom it delegates responsibility. Rather, monitoring the entire due diligence process—even those aspects that are delegated—is necessary to ensure that an underwriter’s agents will more likely conduct an adequate investigation, thus protecting the underwriter from liability while decreasing the time it takes to complete the investigation.⁸⁷

The point of this description of the due diligence process is to illustrate how companies subject themselves to monitoring by outsiders when they decide to go public. Unfortunately, a variety of factors are conspiring to reduce the incentives of firms to go public. First, while civil liability is necessary to provide incentives for investment banks and other gatekeepers to monitor, where liability is imposed willy-nilly, without regard to the efforts made by investment banks to investigate, firms will respond by declining to go public or by selling their shares far less frequently.⁸⁸ This in turn results in less interaction between the company and its gatekeepers, with a concomitant reduction in monitoring, leading, in turn, to a diminution in the quality of corporate governance for the firm.

As Frank Easterbrook has explained, we observe the strange phenomenon of companies simultaneously disbursing cash to investors by paying dividends and raising cash from investors by making initial public

87. See *BarChris*, 283 F. Supp. at 696-97 (attorney’s failure to adequately examine corporate minutes and contracts binding on underwriters). See, e.g., *Dannenberg v. Painewebber Inc. (In re Software Toolworks Sec. Litig.)*, 50 F.3d 615, 625-26 (9th Cir. 1994) (finding it inadequate for underwriters to rely on a company’s assurances as to its financial condition where the underwriters had access to all available information); see also *Obligations of Underwriters, Brokers and Dealers in Distributing and Trading Securities*, Securities Act Release No. 33-5275, [Securities Act/Exchange Act Binder Vol. 2] Fed. Sec. L. Rep. (CCH) ¶ 4506B at 4057 (July 26, 1972) (noting that reliance on the managing underwriter is reasonable if the participating underwriter is satisfied that “the managing underwriter ma[de] the kind of investigation that the participant would have performed if it were the manager,” and that “the manager’s program of investigation and actual investigative performance are adequate.”).

88. The seminal article on the effect of underwriters’ civil liability on the new issues market is Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776 (1972). When prices go up, demand goes down. Since increased risk of liability is, from the issuers’ point of view, part of the anticipated price of going public, when the risk of liability goes up, the demand by issuers to make public offerings will decline. Over-imposing of civil liability on securities underwriters creates other inefficiencies in the public offerings market, see, e.g., Seha M. Tahic, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. Fin. 789, 790 (1988) (discussing empirical evidence suggesting that “gross underpricing [of IPOs] serves as an efficient form of protection against legal liabilities . . . [i]n other words, it is a form of implicit insurance against potential liabilities that may arise from the ‘due diligence’ and disclosure requirements of the federal securities regulations.”).

offerings of equity on the same class of securities.⁸⁹ The best explanation for this apparently odd behavior is that it is in investors' interests for companies to submit themselves regularly to the monitoring function of the due diligence process associated with initial public offerings.

From this perspective, the recent changes in the tax code that dramatically reduce the tax rates on dividend payments can be viewed as strengthening the corporate governance infrastructure in the U.S. by removing an impediment to paying dividends.⁹⁰ This reduction, however, is scheduled to expire.⁹¹ The reduction should be made permanent, and additional regulatory changes should be implemented to encourage companies to make regular offerings of their equity securities in public offerings.

F. The Securities and Exchange Commission

The SEC is playing an increasingly active role in corporate governance. For example, in late 2005, the SEC put three high-profile corporate directors on notice that the Commission was considering filing suit against them for failing to spot fraud by Conrad M. Black at Hollinger Corporation. The three executives, James R. Thompson, Richard R. Burt, and Marie-Josée Kravis, constituted the audit committee of Hollinger's board of directors from 1998 to October 2003.⁹²

As the *New York Times* reported in its account of the SEC's activities,

89. Frank H. Easterbrook, *supra* note 77, at 650-51.

90. Historically, dividends were taxed as ordinary income, at rates as high as 38.6 percent. The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003 reduced the taxes on dividends received from U.S. companies, certain mutual funds, and so-called "qualified" foreign corporations (generally those incorporated in a U.S. possession, eligible for benefits under a U.S. tax treaty that meets certain criteria or readily traded on an established U.S. exchange as stock or an ADR) to fifteen percent for most taxpayers. For lower income individuals, the tax rate on dividends drops to five percent, decreasing to zero percent in 2008. These new, lower rates of fifteen percent and five percent are effective for dividends received beginning January 2003 and are scheduled to expire beginning in 2009.

91. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 1-117 Stat 501, 752 (2003).

92. James R. Thompson is a former governor of Illinois and a partner with the law firm of Winston & Strawn; Richard R. Burt is a former United States ambassador to Germany; and Marie-Josée Kravis is the spouse of financier Henry R. Kravis and a member of the boards of the Ford Motor Company and IAC/InterActive Corp.

[i]f the S.E.C. does file a civil suit against Mr. Thompson, Mr. Burt and Mrs. Kravis, it would be an unusual attempt to hold independent directors to account for not being vigilant enough about a suspected fraud. None of the three directors received any of the money from payments that are the subject of various actions against the Hollinger co-founder Conrad M. Black and his associates.”⁹³

An internal report by a special committee of Hollinger’s board written under the direction of Richard C. Breeden, a former SEC chairman, said that the audit committee was characterized by an “inexplicable and nearly complete lack of initiative, diligence or independent thought” which led to “self-righteous and aggressive looting” of the company.⁹⁴

The SEC’s aggressive pursuit of these directors in a civil action clearly illustrates the Commission’s shift from its traditional role of policing the capital markets and promoting full disclosure by public companies to its new, if unauthorized, role of corporate governance watchdog.⁹⁵ The SEC has found that corporate governance pays. Despite the deficiencies in the Commission’s own corporate governance,⁹⁶ and its lack of success in regulating, the SEC in recent years has been hugely rewarded in the only two ways that matter for regulatory agencies: massive budget increases and significant new powers.

The Commission’s performance can most charitably be characterized as anemic in every aspect of its mission during the wave of scandals that rocked corporate America and Wall Street. The SEC failed to anticipate or to deal decisively with the wave of corporate governance scandals—such as, *inter alia*, Enron, WorldCom, Global Crossing, Adelphia, Tyco, Waste Management, and Sunbeam. The SEC similarly failed to regulate in its own core areas of expertise—disclosure and capital market regulation—as evidenced by the mutual fund market timing and late trading scandals, the

93. Richard Siklos, *S.E.C. Puts Three Hollinger Directors on Notice*, N.Y. TIMES, Dec. 15, 2005, at C1.

94. *Id.* at C2.

95. *See* Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (litigation related to SEC attempt to bar securities exchanges from listing corporations that reduced the per share voting rights of already existing common share holders).

96. *See* Stephen Taub, *GAO Criticizes SEC Internal Controls*, CFO.COM, Nov. 23, 2005, http://www.cfo.com/article.cfm/5213245?f=home_breakingnews. (last visited Apr. 11, 2006).

scandals involving securities analysts' conflicts of interest, spinning and laddering of initial public offerings, and the breakdown in the corporate governance of the securities exchanges. In each of these areas, the SEC was motivated to act not on its own initiative, but in pallid response to the more energetic activities of the New York Attorney General, Elliott Spitzer.

Despite its failures, the SEC's budget more than doubled during the period from 2001-2004, increasing from \$422.8 million to \$913 million. The SEC also received a sizeable \$100 million budget increase in fiscal year 2003. Although the SEC was not the only agency to receive a budget increase during this period, the Commission was the only federal agency to receive substantial budget increases in both 2003 and 2004.⁹⁷ Testifying before the House Subcommittee on Science, Department of State, Justice, and Commerce; and Related Agencies, then-SEC Chairman William Donaldson said President George W. Bush's request for \$841.5 million in fiscal 2004 "recognizes that the Commission's needs are growing and ongoing."⁹⁸ That funding, which was provided to the SEC, would, according to Donaldson "enable us to meet the remaining fast-approaching deadlines of the Sarbanes-Oxley Act, hire over 800 new staff [and] advance initial start-up funds to the Public Company Accounting Oversight Board."⁹⁹ The 2005 budget request of \$893 million for the SEC, an increase of \$81 million, was ten percent above the 2004 level.¹⁰⁰ The President's FY 2004 budget for the SEC was the largest increase in the history of the agency, nearly doubling the SEC budget over FY 2002 levels. The resources were used to hire new accountants, lawyers, and examiners "to protect investors and combat corporate wrongdoing."¹⁰¹

97. Susan Dudley & Melinda Warren, *Regulatory Spending Soars: An Analysis of the U.S. Budget for Fiscal Years 2003 and 2004*, 2004 Annual Report 14-19 (July 2003), available at http://wc.wustl.edu/Reg_Budget_final.pdf.

98. William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm'n, Testimony Concerning Appropriations for Fiscal 2004 Before the Subcomm. on Commerce, Justice, State, and the Judiciary of the H. Comm. on Appropriations, (Mar. 13, 2003), available at <http://www.sec.gov/news/testimony/031303tswhd.htm>.

99. *Id.*

100. Actually, the SEC's FY 2005 budget request to Congress totaled \$913 million and was 12.5 percent above the amount authorized for the SEC in fiscal 2004. The amount consisted of \$893 million in new budget authority and \$20 million in anticipated balances from the prior year. This budget request—the first crafted by Chairman Donaldson since his arrival in February 2003—permitted the Commission to hire 106 new employees. Press Release, Securities and Exchange Commission, SEC Releases FY 2005 Budget Information, available at <http://www.sec.gov/news/press/2004-11.htm>.

101. Press Release, Office of the Press Secretary, Fact Sheet: Restoring Economic Confidence and Tackling Corporate Fraud (Jan. 11, 2003), available at <http://www.whitehouse.gov/>

As I have observed before, these huge budget increases were strongly supported by the Investment Company Institute (ICI)¹⁰² and the Securities Industry Association, (SIA),¹⁰³ which are the principal interest groups representing, respectively, the mutual fund industry and the securities industry.¹⁰⁴

In 2001, SEC staff received the largest pay increases of any administrative agency in the U.S. government when Congress enacted the Pay Parity Act.¹⁰⁵ The House Committee on Financial Services voted to increase the SEC's pay at its first markup session, elevating SEC staff members to the same pay scale as employees of the Federal Reserve Board and the Comptroller of the Currency.¹⁰⁶

From a corporate governance perspective, these gigantic budget increases and large pay raises seem highly anomalous to say the least. For most observers, the SEC's performance was dismal.¹⁰⁷ New York Attorney General Eliot Spitzer even observed, "heads should roll" at the SEC for its failure to detect and act upon abuses in the mutual fund industry and elsewhere.¹⁰⁸ This criticism, of course, seems highly inconsistent with the increases in pay and power that characterize Congress's response to the SEC's failures.

More generally, as I have observed previously:

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- news/releases/2003/01/20030111-1.html (last visited July 24, 2004).
102. Press Release, Investment Company Institute, ICI Supports Bush SEC Budget Proposal (Jan. 6, 2003), available at http://www.ici.org/statements/nr/2003/03_news_sec_budget.html.
103. Press Release, Securities Industry Association, SIA Supports President's Effort to Increase SEC Budget: Well-Funded Regulator is Key to Building Public Trust and Confidence in Capital Markets, (Feb. 4, 2003) (on file with author).
104. Jonathan R. Macey, *Positive Political Theory and Federal Usurpation of the Regulation of Corporate Governance: The Coming Pre-emption of the Martin Act*, 80 NOTRE DAME L. REV. 951, 968 nn.51-52 (2005).
105. Investor and Capital Markets Fee Relief Act, Pub. L. No. 107-123, 115 Stat. 2390 (2002).
106. *Id.* at 2398. see also U.S. SECURITIES AND EXCHANGE COMMISSION, PAY PARITY IMPLEMENTATION PLAN AND REPORT (Mar. 6, 2002), <http://www.sec.gov/news/studies/payparity.htm> (last visited Apr. 11, 2006).
107. John C. Coffee Jr., *A Course of Inaction: Where Was the SEC When the Mutual Fund Scandal Happened?*, 2004-APR LEGAL AFF. 46, 49 (2004) (discussing the SEC's passivity with regard to the mutual fund crisis); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 948-49 (1994).
108. *Senators Slam SEC in Funds Scandal*, CBS NEWS, Nov. 3, 2003, <http://www.cbsnews.com/stories/2003/11/04/national/main581683.shtml> (last visited Apr. 11, 2006). see also *Senators Blast SEC Over Mutual Fund Scandal*, USA TODAY, Nov. 3, 2003, http://www.usatoday.com/money/perfi/funds/2003-11-03-fund-hearing_x.htm.

Firms that are subject to market forces at best shrink and sometimes shrivel and die when they under-perform. In other words, the market punishes rather than rewards failure in the private sector. The recent spate of scandals, particularly among mutual funds and market analysts, can hardly be viewed as a success story for the Securities and Exchange Commission. In case it were needed, this recent wave of scandals can be viewed as additional evidence that administrative agencies are not subject to the same Darwinian pressures as firms in the private sector. . . . [T]he crisis of confidence in U.S. capital markets was clearly beneficial to the SEC in general.¹⁰⁹

The unwarranted budget expansion and pay increases at the SEC are yet another example of the increasing politicization of institutions of corporate governance, a process which has richly rewarded poor performance.

Whatever one might say about the increases in salary and power enjoyed by the SEC, these changes most emphatically do not represent pay for performance. At best, one can say that the SEC, like the accounting industry and the credit rating agencies, is being rewarded in spite of its failure to protect investors or to promote the public interest.

II. INSTITUTIONS OF CORPORATE GOVERNANCE: PAY FOR NON-PERFORMANCE

In the preceding section, we reviewed six of the most important institutions that constitute the U.S. corporate governance infrastructure. The most effective of these institutions, the market for corporate control, has been stifled by regulations that shift the balance of power away from bidders and target firm shareholders and towards incumbent management. Another effective corporate governance tool, the initial public offering, is seldom used because of litigation risk and regulatory burdens.

Regulations have transformed other institutional features of the corporate governance landscape. Specifically, accounting firms, credit rating agencies, and stock exchanges used to play a large and useful role in the governance of publicly-held firms. Over time, however, regulation has undermined the

109. Jonathan R. Macey, *Wall Street in Turmoil: State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117, 120-121 (2004).

effectiveness of these institutions as well. Where there used to be market-driven demand for the services of auditors, rating agencies, and organized stock exchange, the demand for these services is now a construct of complex regulatory regimes that not only require public companies to purchase the services generated by these firms, but effectively cartelize the industries that provide these services. In the case of accounting firms and credit rating agencies, regulators have cartelized the industry by erecting barriers to entry that limit to a handful the number of firms that can compete to provide these services. In the case of the organized stock exchanges, regulations not only dramatically restrict entry, they also limit competition and innovation by coordinating the internal governance rules of the exchanges.

Hovering somewhere above this complex and depressing picture is the Securities and Exchange Commission, which has been generously rewarded for its own non-performance. Responding to political pressure, the SEC has pressed for changes in corporate governance rules that are both costly and ineffectual, but that help the SEC to expand its own constituency. The new rules regarding expanding shareholders' access to the corporate election machinery and the governance of mutual funds both fit this description. They purport to be devices aimed at improving corporate governance, but in fact, they are likely to be highly ineffectual.

A. The SEC's Shareholder Access Proposal

In 2003, the SEC proposed Rule 14a-11, which represents a major change in the ability of outsiders to gain access to corporate voting machinery.¹¹⁰ If enacted, this rule would permit qualifying outside shareholders to require the corporations in which they own shares to place their nominee on the corporation's ballot along side the company's own nominees.¹¹¹ Companies subject to the rule also would be required to publish the nominee's supporting statement.

110. Security Holder Director Nominations, Concept Release No. 34-4826, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003).

111. Only shareholders who meet four criteria will have access to the company's proxy materials. The four criteria for such shareholders are: (a) beneficial ownership of more than five percent of the company's voting stock, held continuously for at least two years; (b) declaration of intent to continue owning the requisite number of securities through the date of the relevant shareholders' meeting; (c) eligibility to report their holdings on Schedule 13G rather than 13D; and (d) filing of a Schedule 13G before their nomination is submitted to the corporation. *Id.*

The rule would give shareholder groups this access to the corporate proxy machinery only if one of two triggering events were to occur. The first triggering event is majority shareholder approval of a shareholder proposal to authorize shareholder nominations that has been placed on the ballot under SEC Rule 14a-8.¹¹² The second triggering event is the casting of thirty-five percent or more of the total votes in a corporate election by shareholders electing to withhold proxy authority from the incumbent board of directors.¹¹³ If one of these two triggering events occurs, then at the following annual meeting at which directors are to be elected, shareholder nominees must be included in the company's ballot and accompanying proxy statement.¹¹⁴ As I have observed before, this ineffectual proposal reflects the SEC's "desperate attempt to regain control of the regulatory agenda"¹¹⁵ in the field of capital markets regulation.

The SEC could, if it were so inclined, enact voting rules that improved the quality of corporate governance by reducing the ability of incumbent managers to bypass shareholders' efforts to vote on management proposals such as poison pills that impede the market for corporate control. Specifically, the SEC has withheld vigorous support of the shareholder rights by-law, which would allow investors to enact corporate bylaws requiring directors to permit shareholders to vote on the issue of whether a company should nullify anti-takeover devices such as the poison pill, when a company receives a fully funded cash takeover bid for all of its outstanding shares at a substantial premium to market.¹¹⁶

Along these lines, the explicit provisions in the SEC's proposed rules that make it impossible for shareholders to replace a majority of incumbent directors are critical to understanding the SEC's proposal regarding director nominations. According to the proposal, any candidate nominated by the shareholders must be an independent director under listing standards applicable to the issuer and must also be independent of the shareholders that nominate him or her. This means that a nominee, no matter how much support she has from the shareholders, cannot be affiliated with an outside group seeking to gain control of the board. Moreover, only one candidate can

112. *Id.*

113. *Id.*

114. *Id.*

115. Jonathan R. Macey, *Securities and Exchange Nanny*, WALL ST. J., Dec. 30, 2003, at A10.

116. See Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFSTRA L. REV. 835, 837 (1998).

be nominated if the board has fewer than nine members.¹¹⁷ Two candidates may be nominated if the board is composed of nine to nineteen directors and votes are withheld from two management nominees.¹¹⁸ The number of nominees increases to a maximum of three if the board is composed of twenty or more directors and votes are withheld from three management nominees.¹¹⁹ Thus, under the SEC's proposal, shareholders can only replace two-ninths of the board, far less than the majority necessary for control. And even this pale version of a control contest is diminished further by the fact that it takes two election cycles before any shareholder nominees can be elected because one election is necessary in order to obtain the votes necessary to trigger an election the following year. The time lag extends still further because shareholders and shareholder groups must have held over five percent of the issuer's securities for at least two years to nominate a candidate for the board.¹²⁰

Thus, the SEC's proposed rule cannot be construed as bolstering the faltering market for corporate control, because it cannot be used to facilitate a control transaction. Rather, as I have previously observed, the SEC's proposed new rule is a "poorly disguised attempt [by the SEC] to link itself to a new constituency: public interest pension funds and other 'activist' shareholder groups, whose preferences and agendas are unlikely to reflect the profit-maximization motive that is embraced by the average investor."¹²¹

B. SEC Mutual Fund Board Chairman Independence Rule

In another example of the new, post-Enron SEC, on June 23, 2004, by a vote of three to two, the SEC voted to require that the chairs of mutual funds' boards of directors be independent of the advisors of such funds.¹²² Commissioner Cynthia A. Glassman commented on the complete lack of empirical or theoretical justification for this proposal:

117. Security Holder Director Nominations, 68 Fed. Reg. at 60,797.

118. *Id.*

119. *Id.* 60,797-98

120. *Id.* at 60,799.

121. Macey, *supra* note 109, at 136.

122. Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Securities Act Release No. 8433, Exchange Act Release No. 49,909, Investment Company Act Release No. 26,486, 17 C.F.R. § 239, 240, and 274, 69 Fed. Reg. 39,798.

It is a fact that many of the top-rated funds today based on high performance and low fees have inside chairs. Why should we tell shareholders they can no longer have the form of governance that produced this high level of performance? And further, why should we require them to pay for it? There can be no doubt that this requirement will add to fund expenses. An independent chair cannot be expected to have—and in most cases, will not have—hands-on knowledge about fund operations. Therefore, to be effective, the chair would have to hire a staff. Shareholders will bear that expense as well as the likely additional cost of the independent chairman. In sum, the benefits are illusory, but the costs are real.¹²³

Commissioner Glassman also noted the lack of empirical evidence for the assumption, inherent in this rule, that mutual funds with independent chairs have either higher returns or lower overhead and administrative costs than mutual funds chaired by insiders:¹²⁴

As with the SEC's proposed shareholder ballot-access rule, it appears that in promulgating the chairman independence rule, the Commission is clearly less concerned with shareholder welfare and the quality of U.S. capital markets than it has been in the past. The public interest concern with the quality of U.S. investors and capital markets appears to have been replaced by a regulatory agenda that includes rulemaking oriented towards special-interest groups.¹²⁵

In the post-Enron world, the SEC, always a political support-maximizing bureaucracy, is guided by political considerations, not policy considerations in its determination of what new corporate governance rules should be promulgated and in determining how its existing rules should be enforced.

123. Cynthia A. Glassman, Statement by SEC Commissioner Regarding Investment Company Governance Proposal Address at U.S. Securities and Exchange Commission Open Meeting (June 23, 2004), *available at* <http://www.sec.gov/news/speech/spch062304cag.htm>.

124. *Id.*

125. Macey, *supra* note 109, at 137.

Rather than use its interpretive and regulatory powers to promulgate regulations that improve the functioning of the market for corporate control or encourage initial public offerings, the SEC has chosen to allocate its resources towards cosmetic measures, like shareholder ballot access and independent board chairs for mutual funds. The only bottom line that will be improved by passage of these measures is the SEC's own.¹²⁶

CONCLUSION

The SEC's success in procuring more resources, in the form of higher budget allocations, does not necessarily mean that the SEC's power and prestige have increased in the wake of the corporate scandals that have rocked Wall Street. Also, the SEC's budget increases do not reflect heightened public recognition of the SEC's relevance or effectiveness. Rather, the SEC's success in the budgetary process reflects the need for federal officials to appear to be "doing something" in the wake of the crises that have emerged on Main Street (e.g., Enron, Global Crossing, Adelphia, Tyco, Waste Management, and Sunbeam) and in the wake of the scandals that the SEC's main rival, Eliot Spitzer, has uncovered on Wall Street (e.g., financial analysts and market timers at mutual funds).

As an economic matter, corporate governance rules can be categorized as either effective or ineffective. As a political matter, corporate governance rules can be categorized as either favored or disfavored. Strikingly, this article has shown that those corporate governance rules that seem to be most favored in the political realm are precisely those rules that are least effective in practice. By contrast, those corporate governance rules that are the most effective, as measured by the extent to which they reduce agency costs and enhance shareholder wealth, are those that are least favored in the realm of politics. These observations do not bode well for the future of the U.S. economy.

126. Coffee, *supra* note 107, at 46, 49 (discussing the SEC's passivity with regard to the mutual fund crisis). *See also* Macey, *supra* note 107.

SEC Budget History vs. Actual Expenses, 1990-2005			
Fiscal year	Spending authority (thousands)	Actual obligations (thousands)	Annual increase in budget authority
1990	\$ 166,633	\$ 165,211	---
1991	\$ 189,083	\$ 187,689	13.5 %
1992	\$ 225,792	\$ 224,281	19.4 %
1993	\$ 253,235	\$ 251,871	12.2 %
1994	\$ 269,150	\$ 266,249	6.3 %
1995	\$ 300,437	\$ 284,755	11.6 %
1996	\$ 300,921	\$ 296,533	0.2 %
1997	\$ 311,100	\$ 308,591	3.4 %
1998	\$ 315,000	\$ 311,143	1.3 %
1999	\$ 341,574	\$ 338,887	8.4 %
2000	\$ 377,000	\$ 369,825	10.4 %
2001	\$ 422,800	\$ 412,618	12.1 %
2002	\$ 513,989	\$ 487,345	21.6 %
2003	\$ 716,350	\$ 619,321	39.4 %
2004	\$ 811,500	\$ 755,012	13.3 %
2005	\$ 913,000	\$ 887,227	12.5 %

U.S. Sec. & Exch. Comm'n, Frequently Requested FOIA Document: SEC Budget History vs. Actual Expenses, <http://www.sec.gov/foia/docs/budgetact.htm> (last visited Apr. 11, 2006).