ISSN 1045-6333

HARVARD

JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS

CORPORATE GOVERNANCE CHANGES IN THE WAKE OF THE SARBANES-OXLEY ACT: A MORALITY TALE FOR POLICYMAKERS TOO

Robert Charles Clark

Discussion Paper No. 525

September 2005

Harvard Law School
Cambridge, MA 02138

This paper is also a discussion paper of the
John M. Olin Center's Program on Corporate Governance

JEL Classification: D70, G30, G32, G34, G38, K22

Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too

Robert Charles Clark*
Harvard University Distinguished Service Professor

Abstract

This paper seeks to draw a lesson for designing major reforms of corporate governance in the future. It recalls the key events leading to the recent seismic shift in corporate governance policies applicable to American public corporations, and identifies the four sources of policy changes – the Sarbanes-Oxley Act, new listing requirements, governance rating agencies, and tougher judicial opinions (notably in Delaware) about perennial corporate governance issues. It presents a synthetic overview of the numerous reforms, which at the most general level aim to fix the audit process, increase board independence, and improve disclosure and transparency. It pauses to identify the vast territory of unchanged corporate governance rules that are still left to state law, and then examines some of the empirical studies that bear on whether the governance reforms can be confidently predicted to have strong positive results for investors. The exercise suggests an irony: Studies about the impacts of the most costly reforms, those concerning audit practices and board independence, are fairly inconclusive or negative, while studies about proposals for shareholder empowerment and reduction of managerial entrenchment indicate that changes in these areas – which in general are only atmospherically supported by the SOX-related changes – could have significant positive impacts. Admittedly, the general evidence for mandatory disclosure does suggest that the new round of enhanced disclosures, which are only moderately costly, will have good effects.

The concluding section presents and explains a new approach for the next crisis-generated reform movement. It is based on the notion that bandwagons are unavoidable, but their motivating impact can be leveraged and their bad effects alleviated by good statutory design. In particular, legal reforms in the area of corporate governance should have bite but should also be explicitly structured to authorize and mandate (1) serious empirical study of the effects of particular regulatory changes (or existing rules), (2) periodic reassessment of regulations in light of such evidence (while also considering experience and analytical arguments, of course), and (3) explicit decisions to reaffirm or alter regulations in light of these reassessments.

---

* Harvard University Distinguished Service Professor. This essay, which was first written for an audience of European corporate lawyers and law professors, has benefited greatly from the helpful comments of colleagues and practitioners, including Lucian Bebchuk, Marjorie Knowles, Mark Moore, Mark Ramseyer, and Paul Washington. Mistakes and misjudgments are all my own.

Table of Contents

Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too

by

I. Introduction

Let us begin by trying to identify the main plot lines of a now familiar true story.

In early 2000, the American stock markets crashed, after a long boom period during the 1990s. Stock prices continued to be low for several years, until recovery began in 2003. As many described it, the bubble had burst. During the period of depressed prices, scandals emerged. Some of the companies that had seen high-flying stock prices but were now in bankruptcy, or at least in serious financial trouble, were discovered to have been boosted artificially by major accounting frauds or manipulations that persisted for remarkable time periods (e.g., Enron, WorldCom). Others were found to be financially weaker than previously perceived because, among other things, their executives had engaged in major self-dealing transactions or extractions of personal benefits (e.g., Tyco, Adelphia). As the facts were uncovered, journalists publicized them in a vivid and persistent way.

Eventually a somewhat different genre of scandals, involving securities market institutions and securities trading practices, also made the news. Key chapters starred Dick Grasso, the New York Stock Exchange chief whose total pay package came on stage as wildly excessive, Martha Stewart, an instantly recognized business personality who was alleged to have participated in insider trading and a subsequent cover-up effort, and Eliot Spitzer, the New York Attorney General who brought to light and noisily attacked mutual fund late trading and timing abuses.

The gripping accounts of malfeasance generated a widespread rush to reform. Thoughtful observers found it hard to deny that the reform movement had some aspects of a witch hunt. Denial is always a handy psychological defense mechanism, and the repeated dramatic stories of the scandals made it possible for investors to divert themselves from the nagging suspicion or painful realization that they themselves had succumbed to over-optimism and self-delusion during the long dreamy days of the bubble. Mr. Greenspan could sermonize about "irrational exuberance," but for most of us it was far better to attribute evil to the devils, not to ourselves. The media frenzy helped this effort, as did the ensuing felt need of politicians to do something about the problems.

As social psychologists would put it, there was a great deal of "social facilitation" of the ideas that the bubble's bursting had a lot to do with bad behavior (as opposed to general economic forces and widespread overvaluations) and that major legal reform to stop corporate fraud was a needed response.[1] That is, there was a loud and crowded "bandwagon" moving inexorably toward reform.

Because the bandwagon, once it began rolling, had tremendous inertial force, there was little time for serious, detailed examination of the costs and benefits of proposed reforms, or for close examination of reliable empirical evidence. As a result, after the reforms were enacted, and the markets began to recover, and the scandal stories began to feel like reruns of old television shows, there was a great deal of complaining by corporate managers and others about the high cost and the irrationality of the sweeping reforms that were enacted.

Nevertheless, the bandwagon's reform measures did not come out of thin air as new inventions, nor were they arbitrary ideas. Some major reform measures were "taken off the shelf," so to speak, and modified for the occasion. Accordingly, they reflected previously accumulated policy positions that were based on experience, anecdotes, general policy arguments, and the outcome of long-running competitive posturing by "good corporate governance proponents" and their targets.

For example, the new reforms stress the supposed importance of having corporate boards of directors that are composed of a majority of independent directors, as well as the value of having key board committees – those involved with oversight of audits, executive compensation, and nomination of new directors – composed entirely of independent directors. The reform measures went on to mandate these practices. In fact, these practices had long been advocated as crucial parts of the platform of good governance policies urged – and acted upon, when voting shareholder resolutions – by large, activist institutional investors such as TIAA-CREF. As we shall see later on in this paper, this long history presents an irony: These particular reform ideas were around long enough to have stimulated some empirical studies that cast doubt on their validity, yet this study-based skepticism was set aside during the reform movement.

As another example, the new reform movement stressed the value of not permitting external auditors to perform certain lucrative non-audit services, such as information technology consulting, for their corporate audit clients, in order to eliminate conflicts of interest and make audits more reliable. This approach was also a preexisting policy goal of certain good governance advocates, even though it was based mainly on arguments and existing empirical studies cast doubt on it.

---

[1] This characterization is not meant to deny that there were major frauds, or that discovery of them even in a non-declining market would have provoked strong reactions. The suggestion is simply that the market-crash context greatly amplified the reactions.

For some thoughtful key players in the process, uncertainties about the actual effects of the proposed reforms were readily tolerable, because in their view the most important function of adopting dramatic new measures was to "restore public trust" in public corporations and the securities markets. After all, even placebos can really alleviate illness.

In any event, the bandwagon process did produce major changes in corporate governance standards applicable to U.S. corporations. They did not come all at once, or from one standard-setting source, but in related waves. It is important to identify four big phases in the process:

(1) the federal Sarbanes-Oxley Act of 2002 (hereafter, "SOX")[2], which enacted sweeping governance changes and called for the Securities and Exchange Commission (hereafter, "SEC") to adopt implementing rules and procedures on various topics;

(2) the new listing requirements for publicly traded companies governed by the New York Stock Exchange ("NYSE"), which impose new Corporate Governance Rules (hereafter, the "NYSE CG Rules")[3];

(3) the growth in influence of increasingly detailed and stringent corporate governance rating systems devised by private governance rating agencies and proxy advisers[4]; and

(4) an apparent change in the tone and emphasis of judicial opinions, at least in important courts of Delaware,[5] where more than half of American public companies are incorporated.

---

[2] 15 U.S.C.A. §§ 7201 et seq.

[3] Final NYSE Corporate Governance Rules (approved by the SEC on June 30, 2003, except § 303A.08, which was approved on Nov. 4, 2003), codified in § 303A of the NYSE's Listed Company Manual. The NASD also adopted roughly similar listing criteria, but for simplicity this paper will refer only to the new NYSE listing requirements.

[4] See, e.g., the web pages introducing the "Corporate Governance Quotient" system used by Institutional Shareholder Services, http://www.isscgq.com/RatingCriteria.htm (home page) and http://www.isscgq.com/RatingCriteria.htm (list of 61 rating criteria), or the "Board Effectiveness Ratings" system used by The Corporate Library, http://www.thecorporatelibrary.com/Products-and-Services/board-effectiveness-ratings.html.

[5] For example, a Delaware opinion questioned the independence of certain directors in In re Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. Ch. 2003), and in doing so might have been interpreted by some observers as developing a remarkably tough and new conception of director independence that went beyond even the new rules of the NYSE. (However, close examination of the facts of the case, and reflection on the reality that Delaware law often prefers general principles rather than mechanical rules, indicate that the opinion does not represent a real shift in Delaware jurisprudence.) A good companion example is In re The Walt Disney Company Derivative Litigation, 825 A.2d 275 (Del. Ch. 2003), an opinion in the litigation about former Disney executive Michael Ovitz's rich severance payment. The opinion shows a severe re-emphasis on diligent good process as a prerequisite to directors obtaining the protection of the

The third item on the list warrants a brief initial comment. The rating agencies, which are mostly private, for-profit entities that sell advice and/or consult for clients, include Institutional Shareholder Services ("ISS"), the largest and most influential of the active agencies, as well as Governance Metrics International ("GMI"), the Corporate Library, Moody's, and Standard & Poor's. Their detailed ratings are intended to be of value to shareholders, such as institutional investors deciding whether to buy or sell stock in a company or how to vote on proxy issues related to the company, and also to other investors, e.g., bondholders, and to companies themselves. Some agencies, such as Glass, Lewis and Company, focus heavily on providing targeted advice on voting issues at individual companies.

A final aspect of the story needs to be told. In the immediate aftermath of SOX, investors, businessmen, and government officials in other countries were sometimes inclined to shake their heads at the U.S. scandals and the ensuing regulation, which often struck them as wildly overzealous (and annoyingly costly when it purported to reach foreign companies doing business in or having stock listings in the U.S.). But eventually fraud and scandals were rediscovered to be international phenomena. After the outpouring of news stories about the Parmalat and Royal Dutch/Shell companies, corporate governance reform came to be seen as yet another example of a global issue.

The remainder of this paper addresses the content of the massive complex of changes in U.S. corporate governance (which, for simplicity, are sometimes referred to as "the SOX-related changes"). Section II offers a synthetic, thematically organized overview of the major changes, as well as some preliminary observations about the likely effectiveness and costs of particular subsets of corporate governance changes. Section III identifies the vast realm of important corporate governance standards that have not yet been altered by the new regime. Section IV discusses the empirical evidence relevant to judging the wisdom of the SOX-related corporate governance changes. Section V reflects on whether it is realistic to demand that major legal reforms be made in a more rational fashion, and offers a proposal for the future.

II. The Major Governance Changes: A Reconstructive Overview and Preliminary Assessment

The corporate governance changes called for by the first three developments just identified – SOX, new listing requirements, and governance rating agencies – are numerous and vary greatly in how much they change

business judgment rule. To be sure, the Chancery Court's 2005 decision in favor of the defendants, In re The Walt Disney Company Derivative Litigation, Consol. C.A. No. 15452 (Del. Ch. Aug. 9, 2005), also confirmed that the emphasis was still on process, not hindsight assessment of directors' wisdom and judgment.

previous practices and raise costs. More than a few corporate executives have grumbled about them, and concluded that they amount to serious overkill. In this section, I try to deal with the problem of complexity by organizing the changes within a few thematic clusters. I also begin to explore the question of whether the benefits exceed the costs by identifying the likely assumptions and arguments behind each cluster of changes. On both dimensions, my initial effort is to be sympathetic to the changes, and to understand them from the viewpoint of a well-motivated, public-spirited proponent. In a later section (IV) I will adopt the more critical stance of an academic observer searching for evidence and proof.

Many of the post-SOX governance changes can be grouped under three headings: audit-related changes, board-related changes, and changes in disclosure and accounting rules. In addition, some changes created increased duties and liabilities for key corporate actors and gatekeepers. Other proposed changes, such as those calling for greater shareholder empowerment, seem to be only atmospherically related to the changes generated in response to the major scandals.

A. Audit-Related Changes

The headline scandals involving companies like Enron and WorldCom tended to involve accounting frauds -- or, at the least, presentations of financial data and business relationships that were obscure, confusing and incomplete, and so misleading to outside investors. Given this fact, it is not surprising that many of the most important post-SOX governance changes relate to the processes of auditing and presenting financial data. Indeed, it is a fair guess that the largest dollar impact of the post-SOX changes stems from the audit-related changes. At first blush this situation is almost reassuring, especially if one has heard tirades by executives or academics against the board-related governance changes.

The audit-related changes may themselves be grouped into two major categories: conflict-reducing rules and action-forcing rules.

1. Conflict-reducing rules.

Some of the post-SOX governance changes are aimed at eliminating or reducing relationships that may pressure, seduce, or tempt external auditors not to act as diligent judgmental monitors of their corporate clients. The underlying premise is that, with these changes in relationships, the auditors and those they audit are less likely to fall into a pattern of acting as reciprocating friends who may sometimes slip into maximizing their own joint interests at the expense of the public investors.

Here is a partial list of some of the major conflict-reducing rules:

(a) Limits on multiple roles and services by auditors.

(i) Under SOX § 201, which adds § 10A(g) to the Securities Exchange Act of 1934,[6] external auditors are prohibited from providing certain kinds of non-audit services to their auditing clients. For example, they may not provide financial information systems design and implementation, a formerly lucrative line of business. In practical terms, this means they may not help clients choose, install, and operate accounting-related computer and software systems.

Other now-prohibited services include bookkeeping services, appraisal or valuation services, actuarial services, internal audit outsourcing services, management functions or human resources, investment banking services, legal services, and other services that might be determined by regulation to be impermissible. As a consequence, for example, companies that have to test balance-sheet goodwill amounts for impairment must hire separate valuation firms to back up their judgments, and companies with pension plans usually hire separate actuarial firms to back up the estimates and assumptions used in computing the company's figures for pension plan assets and liabilities.

The obvious theory behind these rules of separation is that, without them, an auditing firm will be tempted to accede to pressure by client company managers to go along with dubious accounting judgments and obscure presentations, since the firm may fear losing profitable non-auditing business if it does not cooperate.

Notably absent from the list of prohibited services is tax compliance work. This absence might be justified by the thought that the sheer efficiency of having such work done by an auditing firm that has already invested in learning the details of the company's business and financial situation outweighs any residual conflict of interest. Other non-prohibited non-audit services include due diligence work in connection with proposed acquisitions.

(ii) Public companies must now disclose the size, i.e., dollar amount, of audit and audit-related services versus permitted non-audit services. In theory, such disclosure allows investors to better gauge how much the external auditor may still be pulled by a conflicting interest. This in turn raises an obvious question: What will the rational public investor do with such insight?

(iii) The governance rating agencies purport to supply an answer: If, in their judgment, the ratio of non-audit services to audit services is too high, the company gets a lower governance rating, and shareholders are advised to take this into account when making investments or casting votes. In a severe case, institutional investors may sponsor a shareholder resolution requesting that the company's board reduce the non-audit services, or may mount a campaign to withhold votes from director candidates.

---

[6] 15 U.S.C. §§ 78a et seq.

(iv) Some shareholder activists have sponsored resolutions asking companies to cease non-audit services entirely, even though they are legally allowed.

(b) Shift of power to hire and compensate the external auditors.

Under SOX § 301,[7] the power to hire, fire, and compensate the external auditors must reside in the company's audit committee, as opposed to the management or the board of directors as a whole. New rules also require that all members of the audit committee be "independent," and the new definitions of independence are stricter than past conceptions of independence.[8]

Once again, the underlying theory is that it is useful to eliminate a relationship – managers choosing and paying the very firm that is asked to audit the financial process overseen by those managers – that may tempt auditors not to act as diligent judgmental monitors, as opposed to reciprocating friends. The shift from the whole board to the audit committee is based on the notion that the whole board -- which unlike the audit committee is not required to consist entirely of independent directors -- may be too easily influenced by the managers' preferences and interests.

Note that this mandated shift of power is a preemption of law making power normally exercised by the states in the American corporate system. By itself, for example, Delaware corporate law would put the power to hire auditors in the whole board, unless it chose to delegate that power.

(c) Reduction of interpersonal bonding between auditors and the audited.

Under SOX § 203[9] and related governance changes, there are both term limits and restrictions on personnel flow. Although the idea of having a mandatory periodic rotation of audit firms was dropped, the new regime requires that audit engagement partners and audit reviewing partners – the most important auditing firm employees who deal with the executives of an auditing client – must be rotated off the engagement after five years.

The underlying premise is that, with time, the personal relationship between these partners and the client company managers may become so strong as to weaken the resolve of the former to act as diligent judgmental monitors.

---

[7] See Exchange Act § 10A(m)(2); cf. NYSE CG Rules § 303A.06, -.07.
[8] See Exchange Act § 10A(m)(3); NYSE CG Rules § 303A.02.
[9] Exchange Act § 10A(j).

Similarly, audit firm employees who have worked on an audit of a client company may not switch over and become employees of that client until a specified "cooling off" period has run.[10] The fear is that audit firm employees anticipating such a (presumably nice) career shift will be tempted to curry favor with the executives whose financial oversight they are supposed to be monitoring and judging.

2. Action-inducing rules.

The other subset of audit-related governance changes is based on the theory that law can usefully require or encourage strict or meaningful auditing to happen. Hopefully, it can do so by mandating certain kinds of action, by mandating arrangements that affect powers and incentives, and by mandating regulatory bodies and processes. Here, the focus is not on reducing conflicts of interest but on raising the probability that auditing will be "real" and will amount to monitoring and judging that is diligent, genuine, and successful in uncovering the whole truth.

Here are some of the rules within this subset:

(a) Required internal control processes.

SOX § 404, which requires attestations about the effectiveness of internal accounting controls, is having a dramatic effect on public companies. Under the new regime, public companies must have a system of internal controls, management must make disclosures and attestations about the internal controls, and the external auditors must also test and evaluate the system. As a result, many companies have had to build up their internal auditing staff. They have devoted great resources to documenting processes more completely and improving the security of and access to their financial information systems. And they seem fated to pay external auditing firms section 404-type fees that are 50 to 100 percent as large as the regular auditing fees. Correlatively, audit committees have devoted significant time and energy to monitoring the implementation of new controls and the process of getting ready for section 404 attestations.

(b) Certification of financial reports.

SOX § 302 provides a simpler and more elegant example of an effort to induce more diligent activity. It requires the SEC to adopt rules requiring principal executive officers and principal financial officers of reporting

---

[10] SOX § 206, adding Exchange Act § 10A(*l*)(one year wait for audit firm employee who worked on audit, before becoming higher-level financial employee at client); cf. NYSE CG Rules § 303A.07(c)(iii)(G)(company's audit committee must set clear hiring policies about former audit firm employees). As a result of the latter provision, some listed companies have adopted longer-than-one-year cooling off periods, e.g., three years.

companies to certify quarterly and annual reports. Specifically, these officers must now verify that they have actually reviewed the report in question, that to their knowledge it does not contain material falsehoods or omissions, that the financial statements present the company's condition and operating results in a way that is fair and complete in all material respects, that they are responsible for and have evaluated internal controls, and that they have disclosed any significant control deficiencies to the external auditors and to the audit committee; they must also disclose certain changes in controls and corrective actions that have been taken. Presumably, CEOs and CFOs who were mindful of their fiduciary duty of care were already reviewing quarterly and annual reports in the manner contemplated by SOX. The main intended effect of the statutory certification requirement is that it will "focus the mind" of these officers and make them more diligent and assiduous – and more demanding of their subordinates. Anecdotal evidence suggests that it has raised consciousness and made executives more careful.

(c) Financial literacy and financial expertise on audit committees.

As previously noted, new rules put the power to hire and compensate external auditors in audit committees composed entirely of independent directors, as a way of reducing conflicting pressures. But they also seek to increase the chance that the committees will monitor well and effectively, by requiring that all of a company's committee members be financially literate and by encouraging the company (via a disclosure requirement) to have at least one financial expert on the committee.[11]

(d) New auditing process regulator (PCAOB).

SOX also required the creation of a new, independent regulatory body called the Public Company Accounting Oversight Board (PCAOB), the function of which is to oversee and regulate external auditing firms and their auditing processes.[12] The PCAOB has begun its task of auditing audit firms and adopting new auditing standards. It appears to be having a major impact on accounting firms.

3. Preliminary reactions.

As a first guess, the audit-related governance changes that seem likely to have the greatest benefits are those restricting external auditors from providing various non-audit services to their audit clients and those requiring companies to have and attest to internal controls systems.

---

[11] See SOX § 301, adding Exchange Act § 10A(m)(standards for audit committee, e.g., concerning responsibilities and independence); SOX § 407 (disclosure of audit committee financial expert); NYSE CG Rules § 303A.07(a), Commentary (financial literacy requirement).

[12] See SOX §§ 101-109.

The boost to auditor independence and backbone from the former is a theoretical prediction, of course, but many dispassionate observers with business experience expect it to be real and important.

As for internal controls, a fair number of public company CEOs have already expressed the view that the process of getting ready for section 404 attestation has helped them to improve their management information systems. In addition, some experts believe that better internal controls are more important to improvement of the quality of public financial statements than better external auditing or stricter liability rules.

At the same time, both of these changes are also very costly.

Interestingly, the cost to accounting firms of having to forego the provision of non-audit services is being offset – perhaps more than offset – by the ability to charge huge new fees in connection with the section 404 process. But the total cost to public companies themselves – large new fees (because of section 404), higher regular audit fees, and the continued need or practice of buying certain non-audit consulting services (albeit from different vendors) – is undoubtedly much higher, as is the cost to the corporate system as a whole. To some observers, the changes still seem likely to generate a net benefit. To others, the costs appear so large that a finding of net social benefit seems wildly implausible. In this context, good empirical studies that put numbers on both sides of the equation could be extraordinarily useful.

Early experience under SOX § 404 dramatizes both the problem and the need for careful study. As discussed more fully below (in Section IV.A), reports about the first year of implementation (2004) indicate staggering costs, but survey evidence and other considerations raise genuine doubts about whether the benefits exceed the costs.

As a first guess, the rules requiring a relocation of power to hire and compensate external auditors in the audit committee, and the rules limiting personnel shifting between auditors and their clients, seem likely to have relatively low ongoing costs, but also seem to be modest in their likely beneficial impacts. As for the PCAOB, the costs are moderately significant, but it seems premature to assess this body at this point in time. With luck, the PCAOB should have a powerful positive impact on the system.

B. Board-Related Changes

As in the case of the new audit-related changes in governance, many of the recently mandated or encouraged changes concerning boards of directors seem designed to reduce conflicts of interest or interpersonal pressures in order to make it more likely that the directors will act as judgmental monitors of management rather than as reciprocating colleagues. In addition to these conflict-reducing rules, there are various standards that are thought to have a more general benefit, because they require directors to engage in processes that may increase their self-awareness and diligence, or because they increase the ability and incentives to directors to act diligently on behalf of public shareholders. These standards, some of which are required by regulatory bodies but others of which are urged by governance rating agencies, might be classified as action-inducing standards.

1. <u>Conflict-reducing standards</u>.

(a) <u>Majority of independent directors</u>.

Most notably, new listing standards require public companies to have a majority of independent directors on their boards (with an exception for controlled companies).[13]

(b) <u>Stricter definitions of independence</u>.

Of equal importance, the definitions of independence are stricter than previous notions.[14] For a director to be "independent" under the NYSE CG Rules, for example, he or she not only may not be an officer or employee of the company, but also may not have been an employee during the past three years and may not have a close relative who is an employee. Compensation committee interlocks will also negate independence.[15] So will a higher-level position in another entity that does a significant amount of business with the public company. In addition, directors who are affiliated with charities that receive substantial contributions from the public company may no longer count as independent.[16] And some governance rating agencies and shareholder groups employ even stricter definitions of independence.

(c) <u>Key committees can have only independent directors</u>.

In addition, the new rules require that certain key committees be comprised entirely of independent directors.[17] Most obviously, this rule applies

[13] NYSE CG Rules § 303A.01.

[14] NYSE CG Rules § 303A.02.

[15] Thus, if Alex is a director of Mad Corp. and an executive officer of Cow Corp., and Bob, the CEO of Mad Corp., is on the board and the compensation committee of Cow Corp., then Alex does not qualify as an "independent" director of Mad Corp. So he does not help Mad Corp. meet its majority-independent requirement, and he cannot serve on the key Mad Corp. board committees (audit, nominating, and compensation).

[16] The rules require an exercise of judgment in these cases. See NYSE CG Rules § 303A.02(b)(v), Commentary, and § 303A.02(a). But a company would be foolish to classify a director as independent if he served as an executive or an active board member of a charity receiving large gifts from the company.

[17] NYSE CG Rules § 303A.04(a), -.05(a), -.06, -.07(b).

to the audit committee -- and in fact, independence standards for this committee are the strictest of all. The premise is that, if conflicting pressures and loyalties are stripped away as much as possible from both the external auditors and the audit committee, these players may be bolder about saying "no" to management's accounting policy choices and judgmental estimates.

Complete independence is also required of the members of the compensation committee, with the hope that maybe such a group will be somewhat more likely to exercise real oversight and control of executive compensation.

Finally, complete independence is required of the nominating committee, which recommends new director candidates. If fully independent, this committee may be less likely to gravitate only toward director candidates who, even if formally independent, are likely to accede to management's wishes even when doing so is unwise. Granted, if a group of current independent directors who are excessively amenable to management's wishes are on the nominating committee, and if they informally consult with and accede to the chief executive's preferences about possible candidates, they may continue to nominate like-minded new directors. But over the longer run this particular structural requirement (independent nominating committees) could have profound consequences, or at least lead to somewhat different results than traditional practices, which often gave CEOs de facto power to nominate.

(d) Companies must have key committees: audit, compensation, nominating.

More subtly, but just as important, new rules require that public companies have all of these key committees: an audit committee, a compensation committee, and a nominating committee.[18] Thus, a company cannot simply relegate the task of nominating new directors to the entire board, which will likely contain the CEO and other insiders, even though state corporate law clearly would allow such an arrangement. Moreover, the committees must have written charters that specify certain powers and tasks, and these charters are to be made public. (These requirements might also be listed under the section on action-inducing standards, of course; I mention them here to give a sense of the impact of the new committee standards taken as a whole.)

Considered together, all of these new standards have had a dramatic impact of board composition. They have led many public companies to

[18] NYSE CG Rules § 303A.04-.07.

rearrange their boards, both by dropping and by adding members (often at higher cost), and to abandon older practices. Thus, for example, a company cannot make an otherwise quite independent university president a director and hope to place him on the audit or governance or compensation committees – for all of which there is now a need to find new independent directors -- or on any of the ad hoc committees formed to assess related party transactions or shareholder lawsuits, unless the company foregoes making major contributions to the director's university.

(e) <u>Supermajority of independent directors</u>?

The standards urged by the governance rating agencies go beyond the legal and listing requirements in important ways. For example, some give serious weight to having a supermajority of independent directors and also define independence in even stricter ways than does the NYSE.

(f) <u>Independent chairpersons</u>.

Some agencies also urge a related conflict-reducing structural change: separating the positions of CEO and chairman of the board, and having the latter be an independent director. Some advocates of independent chairpersons go further and argue that they should not be retired CEOs of the company in question, even though other observers say that some of the wisest and best board chairs have been of this kind.

The assumptions behind such standards are that the board chairman controls the agenda and the information flow to the board, and that having an independent director fill the role makes it more likely that time and attention will not be unduly shifted away from topics where genuinely informed discussion might lead to criticisms of management or suggestions that changes in business policy need to be made. This separation may be especially important to good governance advocates who sincerely believe that independence on the board should not go too far, and that having a board with the CEO and a substantial minority of insiders who really know the company's business is invaluable. Such an advocate can try to achieve both the virtues of a mixed board and a real alleviation of subtle conflicts by urging a bare majority of independent directors but insisting on a decidedly independent chair of the board.

Other would-be standard setters would be satisfied if a company has an independent chairman or, if not, an independent "lead" director or "presiding" director whose job is to preside over executive sessions of the independent directors, serve as a conduit of information and concerns between such directors and the CEO, and advise on the agenda of meetings.

(g) <u>Regular executive sessions</u>.

Finally, new standards require independent directors of the board and of the key committees to hold regularly scheduled executive sessions – meetings at which management and other insiders are not present.[19] At least one key reason for doing this – others can be imagined -- is that the practice makes it somewhat more likely that the participating directors will not feel inhibited about expressing views that might be construed as doubting the integrity or talent of the top managers or the wisdom of their opinions and decisions. Once again, the aim is to remove a subtle psychological pressure to refrain from acting as a judgmental monitor of management.

2. Action-inducing standards.

A medley of other new governance standards are aimed at enhancing the practical ability and the incentives of directors to act diligently, as well as the feedback that they receive and may use to adjust and improve their performance. In principle, these kinds of standards may help directors perform all their functions better, not just the function of monitoring management for misbehavior.

(a) Financial literacy and expertise.

As noted already, new standards require all members of audit committees to be "financially literate."[20] They also require the board of directors of a public company to determine whether one or more of the audit committee members is a "financial expert."[21] If yes, the company must identify the expert(s); if no, the company must disclose that fact and explain why. The assumption is that having financial literacy and expertise on the committee makes it less likely that questionable, confusing, or misleading accounting policies and judgments will go undetected and uncorrected. A great deal of angst has gone into the process of interpreting the quoted terms and applying them.

(b) Limits on over-boarding.

Some rating agencies urge clearly defined standards against over-boarding. ISS, for example, insists that directors not serve on more than six public company boards. The rationale is that heavily committed directors are unable to do a good job. The principle is thought to be so important that it ought to be embodied in a clear bright-line rule, even if doing so results in some over-inclusion and under-inclusion. For example, it stifles the fully retired but smart and energetic CEO who has no regular job but wants to serve on eight boards of fairly simple and unproblematic public companies, but it excuses the full-time

[19] NYSE CG Rules § 303A.03.
[20] NYSE CG Rules § 303A.07(a), Commentary.
[21] SOX § 407.

executive who runs a demanding company but also imagines he can serve on the boards of three large, complicated, and troubled public companies.

(c) Director stock ownership.

Some governance rating agencies insist that independent directors should own significant amounts of stock in their companies. A significant amount might be defined as stock having a market value three to five times greater than the director's annual cash compensation for serving as director. Collateral standards are that the director should not sell stock so as to reduce ownership below a certain threshold while serving as a director, and for some time afterwards, absent compelling special circumstances; that holding stock options isn't sufficient to meet the ownership requirement; and even that directors should be paid substantially or almost exclusively in stock (plus cash sufficient to pay likely current income tax liability caused by receipt of the stock).

The aim of these standards is to align incentives: The raters assume that a director who owns a personally significant amount of stock is more likely, other things being equal, to act in the interests of the shareholders as a group.

(d) Governance guidelines and codes of ethics.

New standards require boards to adopt and disclose both "corporate governance guidelines" and "a code of business conduct and ethics."[22] The standards specify the topics and issues that must be covered in the guidelines and the codes.

(e) Self-assessments.

New standards also require boards to engage formally in periodic self-assessments and evaluations.[23] Perhaps there is an analogy here to religious traditions that assume one will behave better after examining one's conscience. (To be sure, the religious analogy suggests it might also be important after examining the board's conscience to be sorry for the sins, do some penance, and resolve to act better in the future. But it may take our modern legal systems a while to catch up with these insights.)

It is worth noting that an older generation of alleged good governance standards, such as term limits and/or fixed retirement ages for directors, were based on a belief that, on balance, they might result in a larger percentage of directors who were practically able to do their jobs well, whether those jobs involved monitoring management or participating in oversight of major business decisions. Perhaps because these ideas have been criticized for so long as having

---

[22] NYSE CG Rules § 303A.09, -.10.

[23] NYSE CG Rules § 303A.09, 7th bullet point.

more costs – losing talented directors with great and painstakingly accumulated knowledge, insight, and influence – than their supposed benefits, the governance rating agencies appear to be shifting their emphasis toward other norms, such as those mentioned above. Other old-generation norms, like insisting that directors attend a high percentage of meetings, do their homework, and participate actively in discussions, are still honored, but seem less emphasized because they are, so to speak, incorporated by reference in newer enthusiasms like the regular and formal self-assessments of boards.

3. Preliminary reactions.

What are we to make of all these board-related corporate governance changes?

(a) Rational basis and (rough) theoretical coherence.

As the description above should suggest, the changes as a whole are not irrational. They are based on analytical arguments, or easily uncovered assumptions, about how structures and rules of action affect human behavior and move it in a desired direction, and these assumptions are in turn based on observations of human nature. The changes are based on theory, even if the theories are rather casual and not always explicit, and the theory is based on experience, even if the experiences have not been studied methodically and critically.

In the case of the conflict-reducing board-related changes, the underlying theory is surprisingly coherent: All of the changes can be understood as ways of trying to reduce roles, situations, and pressures (financial, social, and psychological) that might weaken the performance of boards as judgmental monitors of managers, who may sometimes be tempted to engage in conduct – especially, but not only, conduct relating to full and honest presentation of financial results – that is not in the best longer run interest of investors.

In the case of the action-inducing changes, the unifying theory is that standards should be set to raise the likelihood that directors will have the practical ability, the incentives, and the feedback to perform well. In principle, this theory holds regardless of what one thinks the optimal mix of directorial functions should be. But in the entire context of reform, and given the fact that many of the action-inducing changes are aimed at independent directors, the motivating goal is to make directors into more effective judgmental monitors of managers.

Thus, not only are the new governance changes not irrational, but they possess a startling degree of thematic unity.

(b) Skepticism about beneficial impacts.

But to say that changes in standards have a rational basis is not to say that they are optimal, or even good on balance. Some or all of the changes may not have the desired impacts to any measurable degree, and they may create costs that exceed their benefits. Especially in the case of the conflict-reducing standards for boards, both sorts of arguments have made repeatedly and vigorously. Many corporate executives have expressed skepticism that the new rules will actually lead to significantly more, and more genuinely meaningful, "monitoring" of management in a way that will in fact reduce the prevalence of accounting manipulations, unfair self-dealing, excessive executive compensation, or future scandals in the wake of market downturns. Similarly, a number of academics have bemoaned the absence of serious, well executed, empirical studies validating a significant positive connection between most of the new standards and shareholder value. They have also noted that when reasonably serious studies have been done on certain governance factors, the results have been negative. A somewhat fuller discussion of these reviews is set out below, in section IV. But the overarching point is clear: much of the reform movement is based on seemingly plausible hypotheses, or a priori theorizing, but not also on serious and methodical study of the facts.

(c) Costs of board-related changes.

To many, this situation is objectionable, since there is little doubt that the new standards have imposed sizable costs on companies. Some of the costs are dominantly one-time or occasional in nature, such as the costs of finding and recruiting new independent directors (often at higher pay rates than in the past), hiring law firms to supply the required committee charters, and so forth. Others are ongoing incremental costs, such as the costs of holding regular executive sessions, the practical need that may be felt to hire separate counsel for audit committees and perhaps all independent directors on an ongoing basis, and the continuing need to pay directors for larger workloads and perceived risks.

Compared to the costs of the audit-related changes discussed earlier, however, all these costs seem likely to be more modest in their size and impact. The cost to large accounting firms of having to sever audit-related services from lucrative non-auditing services is massive, and the costs to public companies of having to comply with section 404 requirements concerning internal controls is dramatic. Next to the dollar figures associated with those changes, the measurable costs of restructuring boards to have more independent directors and tighter formal structures and processes seem relatively modest, though genuinely significant.[24] The greater source of worry for the dispassionate policy

[24] See, e.g., James S. Linck, Jeffrey M. Netter and Tianxia Yang, "Effects and Unintended Consequences of the Sarbanes-Oxley Act on Corporate Boards," (March 15, 2005), available at http://papers.ssrn.com/paper.taf?abstract_id=687496, which found that the costs to large firms of payments to non-employee directors per $1,000 of sales increase from 13 to 15 cents. Contrast this with 404 costs discussed below at notes 35-39.

analyst lies in the thought that the board-related governance changes may have serious indirect costs that the advocates of change did not foresee or appreciate. On a mundane level, such unanticipated costs might include things like a gathering tide of customs about hiring separate outside lawyers for a greater range of governance-related tasks. But the more subtle concerns involve impacts on the functioning of boards, to which we now turn.

(d) Indirect costs: harm to board function?

Perhaps the most intriguing and profound critique of the Sarbanes-Oxley Act, the NYSE listing requirements, and the standards of governance rating agencies is that the central thrust or core objective of these changes is misguided. Amplifying the "policeman-watching-managers" role of boards, at least to the severe extent envisaged by these governance changes, will inhibit and conflict with the other useful roles that boards of directors should play. The net effect may well be negative.

To understand this criticism as more than mere rhetoric, it is useful to reflect on basics: What are boards of directors supposed to do? What do they do that is useful? And which of their useful tasks is in fact most valuable to a company and its shareholders? Perhaps then we can return to the question of conflict among functions.

Boards of directors have at least two major roles, or categories of functions: management and monitoring. The managerial role is often thought to be performed better when there is a "collegial and collaborative" mode of interaction among directors and officers. But the monitoring role seems to call for directors to act as non-committal policemen and judges.

The monitoring role is easier for outside observers to grasp. There are two main categories of monitoring. Directors have ongoing fiduciary duties to look out for, and to control, behavior by managers that amounts to fraud, theft, excessive pay, extravagance, slack, poor performance, or avoidance of key issues. In addition, they have an actual and sometimes decisive decision-making role in certain discrete, big, but very occasional transactions involving conflict-of-interest situations. Examples include related party transactions, hostile takeover bids, management plans to buyout public shareholders, and reactions to shareholder derivative suits. In all such situations, the directors' valuable function is, at least in significant part, to act as impartial judges who look out for the best interests of shareholders, even if it means opposing the wishes of management. Since the managers are often their familiar acquaintances, if not friends, the directors' capacity to behave as impartial judges has always been doubted, but there has always been a supply of hopeful reformers.

Lawyers, judges, and law professors are acutely familiar with these monitoring aspects of the directors' role, since they are what motivate legal advice, lawsuits, judicial opinions, and most meditations about better legal rules. Fact situations in which managers' behavior is apparently bad and directors ought to catch it and react also tend to be fairly discrete, definite, and psychologically salient. They are the stuff of stories; they make good drama. Consequently, when they surface, they are also likely to be objects of fascination by journalists, the general public, and politicians.

But directors are also supposed to participate in the management of the company's business. Indeed, the classic statement of the directors' role, in section 141(a) of the Delaware General Corporation Law, declares that the business of a corporation is to be managed by or under the direction of the board of directors. The managerial role is highlighted in the definitional description of the board. The monitoring role gets no such billing.[25] The managerial role involves a huge array of fundamental business decisions: deciding upon lines of business, business strategy, securities offerings and other modes of financing, acquisitions strategy, dividend and repurchase strategy, choice of the CEO, choice of marketing approaches, design of compensation systems, and much more. Most of these business decisions have little to do with monitoring managers for potential misconduct. Or, perhaps more accurately, they do not involve monitoring for misconduct except as a collateral or subsidiary matter. The primary focus of board deliberations is on the business merits of decisions. Many outsiders appear not to appreciate the extent to which this is so.

In practice, of course, the managerial role of directors is subtle, and to casual observers it may seem so passive as to be of doubtful significance. The directors' managerial role has at least two major parts. The board acts as intelligent sounding board for regular presentations by the company's officers, and it has a formal and often decisive decision making (voting) role with respect to major business decisions or transactions.

Both modes of action can be viewed in a way that can, and often does, lead observers to question the real power or value of boards. In the first mode, which probably accounts for the vast majority of time spent at board meetings, the directors basically act as an audience, which may be more or less prepared and more or less reactive and interactive. One could respond to this pattern by opining that acting as an audience is not a big deal, and shouldn't count as participating in management. In the second mode, directors do exercise decisive voting power over major business decisions. But one could respond to this fact

[25] Historical research highlights this intriguing dichotomy. "Significantly, the rationale for corporate boards most favored by modern scholars – that boards exist to monitor managers on behalf of passive investors – is the rationale that finds the least support [of 4 reasons considered, including need for central management and benefits of group decision making] in the historical origins of the corporate board." Franklin A. Gevurtz, "The Historical and Political Origins of the Corporate Board of Directors," 33 Hofstra L. Rev. 89, 169 (2004).

by opining that, because the directors usually vote to approve what management proposes, once again their role seems only modestly greater than a ceremonial one.

Both of these reactions miss the importance of the directors' participation on the ex ante behavior of managers. The mere fact that the top executives know they have to make formal presentations about key issues on a regular basis to an audience that may probe and criticize, and that has formal power to remove them, elicits a great deal of valuable behavior. Facts are gathered more carefully and completely, ideas and judgments are made more explicit, competing considerations are anticipated and dealt with, and modes of articulation that can withstand scrutiny outside the inner circle are found. The consequence of all these efforts to better "explain and sell" the executive viewpoint may well be to clarify strategic thinking and improve decision making. Thus, having to go to the board may have a vital impact on the business, compared to a world in which there is no comparable obligation on the part of managers. The impact of the process is subtle and diffuse, and therefore hard to prove and measure definitively, but it may well constitute the most valuable consequence of having a board of directors.

Similarly, the fact that the top executives know that they have to present a proposed major financing, or business acquisition, or compensation plan, to a board that will ask questions and has power to say yes or no, will tend to limit the range of proposals that the executives dare to propose, and push them somewhat closer and more reliably toward plans that benefit shareholders. The impact is valuable, even if clearly imperfect.

Granted that boards, by serving as unavoidable and often knowledgeable, well prepared and power-holding audiences and final decision makers, do elicit such desirable behavior on the part of the company officers who plan and formulate business decisions, what does this reality have to do with the conflict-of-functions argument against SOX-related efforts to strengthen the monitoring role of boards?

The answer depends, in part, on how much the managerial role of directors really depends on the existence of a collegial and collaborative mode of interaction among directors and officers, since that mode of interaction is what the monitoring stance is thought to threaten.

Assessing the supposed threat is a difficult matter of judgment. It may well be a nontrivial cost of the SOX-related governance changes. But there are some countervailing considerations.

First, as the above analysis suggests, the ability of boards to elicit good planning and analytic behavior by officers depends on the status of the board as an unavoidable audience with formal decision making power over key issues. It is not obvious that a board with such status will elicit much less, or much poorer, planning and analysis because it adopts a judgmental rather than a friendly and collaborative stance.

Second, it is not impossible to imagine that a board can act in a friendly and collegial way when discussing most business decisions but shift to the stance of an impartial judge when confronted with a situation involving a potentially serious conflict of interest between the officers and the shareholders. Admittedly, switching hats in this way can be difficult. The shift is easier to envisage in some situations, e.g., when the directors are asked to approve a large and one-time related party transaction, than others, e.g., when the directors are asked to approve the CEO 's compensation package.

Third, and most obviously, even if the SOX-related corporate governance changes do have some negative effects on the managerial role of boards, it may still be the case that the gains in terms of prevention of frauds and scandals outweigh these negative effects.

In summary, the SOX-related corporate governance changes may threaten the valuable role of boards as participants in management as opposed to monitoring, but it is far from certain that the net effect is serious or negative. Ultimately, the question is an empirical one.

C. Disclosure Enhancements and Accounting Rule Changes

A third large category of post-SOX governance changes involve financial disclosures to shareholders and other public investors. The underlying premise is that better information enables investors to use their powers (to buy, sell, vote, sue) more effectively, and will result in fewer bad investment decisions, less and shorter mispricing of securities, and fewer frauds and scandals. Some of the new rules alter disclosure requirements directly; others are designed to induce more effective action.

1. <u>Rules requiring greater, faster, and different disclosures</u>.

Some new rules are quite obviously a response to fact situations presented by the well-publicized major scandals. Others attempt a more general improvement. The general aim is to improve disclosure requirements in areas where "things could come undone," that is, where it seems especially likely that financial statements could prove misleading and wrongly motivated or even fraudulent. Some notable examples follow.

(a) <u>Off-balance-sheet arrangements</u>.

The new regime requires public companies to disclose more about special purpose entities and off-balance-sheet arrangements.[26] These requirements seem inspired by the Enron fiasco. In a similar vein – that is, in response to "earnings manipulations" revealed in the scandals – SOX § 401(b) directs the SEC to issue rules requiring companies to reconcile pro forma figures with Generally Accepted Accounting Principles ("GAAP").

(b) Critical accounting policies.

Public companies must now identify and discuss their "critical accounting policies" in their annual form 10-K reports (which are filed with the SEC and available online to the public). A critical accounting policy is one that is heavily dependent on managerial judgments and estimates, and also economically significant to the company in question. Examples would include revenue recognition policies that allow amortizing rather than expensing certain business-related expenditures at a company like WorldCom, methods for estimating oil reserves at a company like Royal Dutch/Shell, and goodwill impairment testing at a company that completed an acquisition spree just before an economic downturn.

(c) Related party transactions.

New rules require public companies to disclose more, and more about, related party transactions. The premise is that such transactions might be unfair to the company and its shareholders, and public disclosure may discourage unfairness or facilitate remedial action. Disclosure might also make investors more generally aware of self-dealing risks at the company in question.

(d) Accelerated filing requirements.

SOX mandates accelerated filing requirements for public companies.[27] For example, after a transitional period of tightening, quarterly reports will have to filed much more quickly after the end of the quarter. Insider transactions in a company's securities must also be disclosed more promptly.[28]

(e) Expensing stock options.

Effective in 2005, companies are required to expense stock options -- an accounting approach that was previously blocked by strong and successful opposition. The new rule, embodied in standards of the Financial Accounting Standards Board, is designed to better reflect economic reality, although, like many such improvements, it involves a move to greater use of estimates or

[26] SOX § 401(a), adding Exchange Act § 13(j).
[27] See, e.g., SOX § 409, adding Exchange Act § 13(l)("real time" issuer disclosures).
[28] SOX § 403, adding Exchange Act § 16(a).

judgments about the future (and therefore might lead to more volatile reported results and facilitate manipulation). This rule change is interestingly different in character from those involving special purpose entities or critical accounting policies. The latter rules seem provoked by and responsive to the major scandals, but the move to option expensing involves a long-debated reform proposal that simply became more politically feasible in the new post-SOX environment.

2. Action-inducing rules.

One way to induce better disclosure, and increase the likelihood that new disclosure rules will be implemented in both letter and spirit, is to add new duties and liabilities for agents and gatekeepers.[29] A salient example is the requirement in SOX § 302 that both the CEO and the CFO of a company must personally certify its financial statements in the company's public filings. In a sense, the certification adds little of substance, because it does not require these individuals to be become guarantors of accuracy, to assert matters beyond their knowledge and good faith belief, or to report on actions (e.g., personally reviewing the financial statements) that previously they were clearly free to skip. Yet the need to sign a certification certainly does focus the mind, and undoubtedly has made some CEOs more cautious and demanding of their financial staffs.

3. Preliminary reactions.

Most of the new disclosure requirements seem sensible in their basic concept and likely to be beneficial if well executed. They will generate costs, and some additional work for accountants and securities lawyers, but the costs seem likely to be modest by comparison to other requirements. Perhaps the major concern, then, is simply whether they will be effective in forestalling future frauds and scandals. To the extent that new rules are specific and clear-cut, and respond decisively to a particular kind of financial manipulation or fraud unveiled by a recent scandal, they may in fact decrease the chance that the particular fraud will occur again in the future. But that may only mean that future manipulators will manipulate other aspects of the financial statements. New forms of fraud will certainly emerge, but they are hard to anticipate. Nevertheless, it seems imprudent to object strongly to the new disclosure requirements, absent compelling evidence that their costs are quite enormous and they have generated more confusion than insight. The burden of proof should be on objectors.

[29] A large fraction of SOX is devoted to laying out new standards of accountability and new liabilities and penalties. See Titles VIII (corporate and criminal fraud accountability), IX (white-collar crime penalty enhancements), and XI (corporate fraud and accountability).

D. Shareholder Empowerment

Finally, it is worth noting that some recent reform proposals are not mandated by SOX or the associated stock exchange listing requirements, and do not fit within the trio of major reform strategies -- fix the audit process, board structure, and disclosure rules – animating those governance changes. But these other proposals almost certainly would not be taken so seriously now had not the regulatory atmosphere been shifted toward more reform in the wake of SOX.

Perhaps the best illustration of this point is the proposed SEC rule to allow shareholder nomination of directors under certain conditions.[30] More precisely, the rule would allow shareholders meeting the requirements to put alternative nominees on the company's proxy statement, which is distributed to all of its shareholders at the company's expense, and thus save these shareholders from the high cost of preparing and distributing their own proxy materials, as they must do now if they wish to start a proxy fight. (In part because of these extra costs, proxy fights are rare, and usually occur only in the context of an attempted takeover.) The proposed rule is fairly modest, in that users of it must meet significant conditions. Under the original proposal, a shareholder or group of shareholders holding five percent of the company's outstanding shares could place a nominee (or more than one, depending on the board's size) on the proxy statement only if, in the previous proxy season, either (i) a majority of shareholders voted for a shareholder-sponsored resolution calling for the shareholder nomination process or (ii) 35 percent or more of the votes cast with respect to directors were withheld from the company's nominees for directorships. In effect, disgruntled shareholders would have to be active during two proxy seasons in order to get an alternative director on the board in this way.

Despite the proposed rule's limits and conditions, it generated a great deal of criticism and lobbying by management groups who argued that it would damage the collegiality and good functioning of boards, and would be used too much by special interest investors, like union pension funds and public pension funds, that are really pursuing objectives other than the maximization of shareholder value. As a result, the proposal was stalled, and later was effectively abandoned.

Another example of an atmospherically facilitated governance change is the shift from classified boards to annual election of all directors at an increasing number of companies. The shift has long been advocated by some governance rating agencies as a way of decreasing a de facto defense against corporate takeovers – a defense that the agencies think is likely to lower the investment

[30] Proposed Rule: Security Holder Director Nominations, SEC Release Nos. 34-48626 (October 14, 2003); IC-26206; File No. S7-19-03.

returns reaped by shareholders. More recently, the negative view of classified boards has been backed up by serious and thorough academic empirical research.[31] In the last two proxy seasons in the U.S., both shareholder and management sponsored resolutions to move toward annual election of all directors have increased and generally gotten high votes, and a significant (though modest) number of companies have actually changed. Though the originating impulse behind this reform was to facilitate takeovers rather than to enable shareholders more easily to express collective displeasure at a company's governance practices, it is quite unlikely that the reform would have gained such momentum apart from the atmosphere created by the SOX-related governance changes.

Preliminary reactions. The shift to annual elections is probably the most solidly grounded reform movement in recent years; it seems very likely to yield shareholders a net benefit in the aggregate. The proposal to allow shareholders to use a company's proxy machinery to nominate alternative director candidates under certain conditions is more debatable, but it seems justified as a "safety valve" measure for protecting shareholder interests. In sum, the reform movement generated by the post-boom scandals seems to have had good but limited indirect consequences in this area. There is, however, a long way to go before shareholders in U.S. public corporations are as fully empowered as some leading academics, such as Harvard's Professor Lucian Bebchuk, would like.[32]

III. The Vast Territory of Unchanged Corporate Governance: New Frontier or Protected Habitat?

Although the SOX-related reform movement is widely thought of as momentous (a typical characterization: "the biggest set of securities and corporate law changes since the mid-1930s, when the Securities Act and the Securities Exchange Act were adopted"), it is also instructive to reflect on its limits. Consider the scope of corporate governance changes discussed above. What is left out or ignored? That is, which problems and potentially relevant areas for reform are largely skipped in the post-SOX wave of legal changes affecting public corporations?

---

[31] See Lucian Arye Bebchuk, John C. Coates IV, and Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy," 54 Stanford L. Rev. 887-951 (2002) (evidence that staggered boards greatly increase the likelihood that targets of hostile bids remain independent, and considerably reduce returns to target company shareholders in both short and long run); Lucian Arye Bebchuk and Alma Cohen, "The Costs of Entrenched Boards," (John M. Olin Center for Law, Economics, and Business, Harvard Law School, Discussion Paper Series No. 478, 2004), forthcoming in J. of Financial Economics (2005)(evidence that staggered boards are correlated with lower firm value).

[32] Lucian Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 183 (2005). This paper synthesizes and extends much of Professor Bebchuk's recently published work.

The largely untouched areas include at least four major territories:

(1) The first is substantive corporate law concerning self-dealing, related party transactions, the setting of executive compensation, and the extraction of private benefits from management positions and controlling relationships. For example, suppose the chief executive officer of a major Delaware corporation sells it a private business of which he was the chief owner. Delaware law does not flatly prohibit the transaction, but does require that it be "fair" to the corporation. There is extensive case law on the meaning of fairness, and extensive case law on who has the burden of proving fairness or unfairness, depending on particular circumstances and the procedures that were followed. For the most part, SOX does not interfere with this regime. (There is, however, a new rule against personal loans to officers and directors, which reflects the fact pattern of one horrific scandal.[33])

(2) A second un-appropriated territory is substantive corporate law concerning major corporate transactions such as mergers and acquisitions, responses to takeover bids, and management buyouts or other going private transactions. For example, highly developed Delaware case law allows an incumbent board and management group to respond to an unwanted takeover bid by adopting and deploying a shareholder rights plan (a "poison pill"), but also imposes limits on the specific characteristics and the uses of such pills. The case law also calls for directors to get the best deal possible for shareholders when they do put a company up for sale. SOX and the related governance changes do not attempt to preempt or rewrite these important legal standards.

(3) A third territory has seen only a limited sprinkling of reform-related new settlements. Apart from the board committee restructurings and the limited shareholder-empowerment reforms noted in section II above, the basic allocation of powers among officers, directors, and shareholders has not been changed by the SOX-related reforms. That is, preexisting corporate law rules continue to govern whether or not shareholders have the power to initiate and adopt various critical types of charter or bylaw amendments, or to initiate major transactions like mergers or sales of control, or to initiate corporate distributions. In most respects, American corporate law does not give such important powers to shareholders. SOX does little to change this state of affairs.

(4) A fourth area of preservation consists of the rules shaping the private enforcement mechanisms for these substantive corporate law matters. That is, state law rules still control the bringing of shareholder derivative suits to challenge self-dealing transactions on their merits, or suits to invoke the doctrinal limits on use of takeover defenses, or suits to settle the locus of power to amend

[33] SOX § 402, adding Exchange Act § 13(k). In addition, NYSE CG Rules § 303A.08 requires listed companies to give their shareholders the opportunity to vote on all equity compensation plans and material revisions to them, with limited exceptions.

important bylaws. State law doctrine also governs challenges to board decisions about shareholder demands that the directors should cause the company to sue its officers.

Why are all these legal areas left undisturbed? In part, they were not changed because the prominent scandals didn't seem to implicate many of them. For example, the WorldCom, Tyco, or Parmalat scandals did not arise because of self-seeking resistance by management to unwanted takeover bids.

But in larger part, the SOX-related reforms were limited because the four groups of items listed above are still thought to be within the province of state law in the U.S. system. In theory, for example, one could have responded to the Enron and Tyco scandals by giving the SEC power to make rules specifying when off-balance-sheet transactions are and are not permitted (as opposed to rules about making them transparent by better disclosure), and by giving the SEC power to make rules about the types and amounts of executive compensation and perquisites that are permissible. Yet such reforms were not seriously considered. Despite the occasional preemptive incursions into state law topics – such as the new federal rules about audit committees, or the prohibition against loans to officers and directors – the SOX-related reforms were not based on a policy decision to effect a major "paradigm shift" in the allocation of law making authority between the federal government and the states. True, recent federal lawmaking and rulemaking has encroached on and threatened Delaware's powerful lawmaking role, but, as Professor Mark Roe has astutely noted, the Delaware authorities have responded to this threat by adjusting legal doctrine in a way that may limit further incursions.[34] This process, dubbed "Delaware's [real] competition" by Professor Roe, is still active. The Feds haven't won – yet.

IV. The Search for Evidence: Are the Reforms Really Improvements?

The SOX-related corporate governance changes are undeniably costly to companies, but their benefits are far harder to document. Although this paper will not attempt an encyclopedic review of the empirical literature, it will introduce a set of surveys and studies that suggest the nature of the underlying policy dilemma.

A. Internal Controls

To inhabitants of executive suites and corporate boardrooms, the most salient cost of the SOX-related reforms is probably the expense of testing,

[34] Mark J. Roe, "Delaware's Competition," 117 Harvard L. Rev. 588-646 (2003).

improving, and reporting on internal controls pursuant to SOX section 404. By all accounts, the costs have been far higher than originally anticipated by regulators and Congress. By comparison, other governance changes seem trivial, and not worth continuing complaints. Yet one of the deepest ironies of SOX is that corporate America's expensive process of renovating internal controls pursuant to section 404 seems unlikely to forestall the kinds of high-level frauds that triggered public outcry and governance reform.

This observation requires some explanation. Recall that section 404 requires the managements of public companies to make disclosures and attestations about the companies' systems of internal controls, and requires external auditors to test and evaluate the systems. The PCAOB provided general guidance about the process, and as a result the internal and external auditing teams of public companies have engaged in extensive testing of controls, which result in reports that may identify numerous "significant" or "material" weaknesses in controls; the companies then proceed to "remediate" the deficiencies. The first year of implementation of the section 404 requirement was 2004, and there really was no closely comparable pre-existing legal requirement or best practice, so there has not been time to conduct serious large scale, long term empirical studies of the effects of the new requirement on fraud prevention and detection, or on other aspects of corporate performance. Nevertheless, a consideration of five points taken together raises serious doubts about whether the benefits of 404 exceed its costs.

First, the measurable costs of section 404 to American corporations in its first year of implementation were very large. One December 2004 estimate by the AeA (American Electronics Association) put compliance costs for American corporations in the aggregate at $35 billion.[35] A survey by Charles River Associates of 90 companies in the Fortune 1000 list found total average compliance costs of $7.8 million per company ($1.9 million extra to external auditors, plus $5.9 million of new internal and other costs).[36] Given average annual company revenues of $8.1 billion in the sample, the costs amounted to a 10 basis points charge on revenues and, of course, a much higher percentage of their net income. Similarly, a survey in March 2005 by Financial Executives International (FEI) of 217 public companies with average revenues of $5 billion found average section 404 compliance costs of $4.36 million, up 39 percent from what the companies expected to pay in mid-2004.[37] Reports from particular companies indicate that the relative burden on certain kinds of large public

---

[35] American Electronics Association(AeA), "Sarbanes-Oxley Section 404: The 'Section' of Unintended Consequences and its Impact on Small Business," (February 2005), paper available at AeA website, www.aeanet.org, at 2.
[36] Charles River Associates (CRA), "Sarbanes-Oxley Section 404: Costs and Remediation of Deficiencies," (2005), at 2.
[37] Financial Executives International (FEI), "Sarbanes-Oxley Section 404 Implementation Survey," (March 2005), press release and paper available at FEI website, http://www.fei.org/404_survey_3_21_05.cfm.

companies – for example, those with numerous relatively small subsidiaries, such as advertising and marketing companies – was significantly higher. One such company with nearly $10 billion in annual revenues and over $700 million in net income estimated that the cost of complying with section 404 was $70 million and that, contrary to earlier hopes, the ongoing costs of compliance would be only moderately lower. Ongoing compliance costs are expected to decline sharply at most companies, but are likely to remain very significant, despite pronouncements by the PCAOB and SEC that try to encourage more targeted and therefore less costly approaches to testing internal controls.

Second, the costs of 404 are vastly higher than originally predicted by the SEC and lawmakers. At the time of SOX's enactment, the SEC estimated compliance costs of $91 thousand per company, or $1.24 billion in the aggregate.[38] The cost to companies in the FEI spring 2005 survey was 48 times the SEC average estimate, and the AeA tally for American companies was 28 times the SEC aggregate estimate. Whatever the best survey or measure of actual compliance costs may be, it seems quite clear that original predictions were not just off, but wildly off. This conclusion highlights an important puzzle: How should we understand the fact that well-intentioned policymakers with genuine expertise and rich experience can predict the future so badly? More importantly, if the phenomenon is a natural feature of human nature and social and political forces, what implications should it have for the future design of regulatory statutes? (I return to this question in part V.)

Third, the costs of section 404 are regressive; they are not proportional to company size. The AeA survey of smaller public companies indicated that those with less than $100 million in annual revenues had compliance costs amounting to 2.55 percent of revenues, and those in the $100 to $499 million range had compliance costs amounting to 0.53 percent of revenue.[39] Obviously, a 53 basis points charge on smaller company revenues is notably higher than the 8 to 12 basis points estimated for large public companies on the basis of surveys like those noted above. Put another way, there are economies of scale in the implementation and testing of internal controls. These differences were not anticipated in cost predictions at the time of enactment of SOX. There is now real concern that some smaller public companies are going private to avoid SOX-related costs, and other smaller companies will be deterred from going public.

[38] SEC, "Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," Release No. 33-8238 at n. 174, June 11, 2003, http://www.sec.gov/rules/final/33-8238.htm. Remarkably, this estimate, which in hindsight looks ludicrously small, was itself revised upward from an earlier one, after the SEC received comments and criticisms about that earlier one.

[39] See AeA report, note 35 supra, at 5. See also Susan W. Eldridge and Burch T. Kealey, "SOX Costs: Auditor Attestation under Section 404," (June 2005), available at FEI website, http://www.fei.org/files/spacer.cfm?file_id=1627.

Fourth, on the benefit side of the equation, there is some circumstantial evidence suggesting that incremental improvements in fraud detection because of section 404 are likely to be modest. A study by the Association of Certified Fraud Examiners of detection methods in cases of fraud causing $1 million or more in losses found that only 8.2 percent of cases were detected by internal controls.[40] Fraud was most often discovered because of a tip (42.6 percent) – that is, because of a person who wanted to reveal it – or by accident (18.0 percent), and sometimes in the process of internal auditing (24.6 percent) or external auditing (16.4 percent) of books and records – that is, activities in which professionals are looking for possible mistakes or misbehavior. To be sure, the presence of internal controls may prevent or deter some frauds in the first place, and detection patterns may change in a world of controls improved by 404, but it would be good to have evidence of such effects.

Fifth, reflection on concrete examples helps to illuminate why 404 costs are so high but benefits may be modest. Examples of remedial actions pressed upon companies by auditors in connection with 404 reviews include the following: having the technical support "help desk" document every call it receives from employees; requiring employees to respond to thousands of emails to prove they received them; proving that all of the physical keys to an office in Europe have been accounted for since it opened in 1995; and requiring an auditor to attend a meeting to prove it took place.[41] More generally, since these selected examples have a tendentious flavor, the section 404 attestation requirement is costly because it has pressed companies to document control processes much more fully and elaborately; to define and enforce restrictions on access to information technology systems; to separate accounting and financial functions more fully, even in smaller offices (e.g., the person who opens an account for an alleged new vendor should not be allowed to authorize payments to that account); and to improve many financial-system procedures. It is not at all unreasonable to suppose that such changes will yield benefits (though query net benefits) in terms of better information systems and reduced risk of lower-level fraud.

But higher-level fraud is another matter. The great scandals that led to SOX, like those in WorldCom and Enron, seem to have depended much more on extremely aggressive or irresponsible accounting judgments, estimates, and characterizations made by people at fairly high levels in the affected organizations. The paradigmatic case is misclassification of very large expenditures as amortizable over time rather than as current expenses, not whether the company promptly prevents departing employees from having continued access to the computer system. It therefore remains to be seen whether America's freshly repainted internal control systems will deter the more

---

[40] See Association of Certified Fraud Examiners (CFE), "2004 Report to the Nation on Occupational Fraud and Abuse," study available at http://www.cfenet.com/pdfs/2004RttN.pdf, at 18.
[41] See AeA report, note 35 supra, at 2.

serious kinds of fraud on investors. At the present time, there seems to be a great mismatch between the specific natures of the reform-generating scandals and the actual remedies imposed by section 404.

B. Auditors' Non-Audit Services

On some important standards of conduct embodied in the SOX-related governance changes, there does already exist significant empirical research published in academic journals (or available online), but it does not support the new legal rules or governance guidelines, or does not clearly resolve the question whether the new standards will produce major public policy benefits.

For example, consider the fear that providing lucrative ancillary services to an audit client might compromise an external auditor's independence and make the audit less good for investors. This concern, which is longstanding and predates SOX, led to a fair number of serious empirical studies published in academic journals. Researchers have tried to measure the degree of supposed risk to independence by looking at factors such as the ratio of non-audit fees to audit fees charged to a client and the relative importance of the client to the external auditor. They have measured "audit quality" [that which might be hurt by lack of independence] by looking at plausible indicators such as abnormal accruals [which suggest aggressive estimates or classifications motivated by an improper purpose rather than an honest estimate of a company's situation and prospects], restatements of previously issued financial statements [which suggest that something wrong was done in the past, and not caught by the auditor], earnings "surprises," qualified audit opinions, and other variables. They have looked at large samples of companies in different markets and segments over different time periods, and have tried to control for various factors that might skew results or help uncover hidden regularities, such as whether it matters that the external auditor was one of the Big Five (now, Four) auditing firms.

In her excellent survey of 25 empirical studies on this issue, Professor Roberta Romano reports that the overwhelming majority (19) found no negative association between provision of non-audit services and audit quality.[42] (Indeed, three of these found a positive connection.) Of the remaining six studies, five found that audit quality was compromised by the provision of non-audit services, and one found that result in one of several model specifications.

---

[42] See Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 114 Yale L.J. 1521, 1535-37 (2005). Professor Romano's fine article also provides a thorough and careful review of studies on independent audit committees, executive loans, and executive certification of financial statements, as well as an analysis and critique of the legislative process leading to SOX. A quicker but wider overview of evidence, which cites some intriguing additional studies, is given in Larry Ribstein, "Sarbanes-Oxley after Three Years," (draft of June 20, 2005), abstract and paper available at the SSRN website, http://papers.ssrn.com/abstract_id=746884.

However, the initial and leading study that found a negative impact has been refined and redone in subsequent studies, with the result that the original findings did not hold up. In sum, as Romano points out, the conclusion that audit quality and auditor independence are not jeopardized by provision of non-audit services is supported not only by the great majority of studies, but by those that use the most sophisticated techniques and whose findings are most robust to different specifications of their models.

Admittedly, a persistent regulatory optimist might make several mitigating observations or claims about these studies. First, the studies looked overwhelmingly at pre-SOX data, and one can readily imagine that looking at pre-SOX data is not a good test of the effects of SOX. For example, an audit firm operating in the year 2000 may have been too lax with an audit client not because it already provided that client with non-audit services but because it wanted to win the non-audit business with that client and the law then allowed it to do so. What this and other possibilities suggest is that additional empirical research is desirable. (On the other hand, it may be quite difficult to accomplish: since SOX now flatly prohibits provision of specified non-audit services to all public companies audited by an external auditor, the researcher cannot simply compare clients that do and don't receive the non-audit services from their auditors. Other tests of the law's impact, or lack of it, must be devised.) Second, the great majority of the empirical studies do not seem to establish any benefits from combining audit and non-audit services, so the SOX-mandated separation should generate no great concern. Third, the managements of corporations and audit firms have adjusted to the mandated separation, and there seems to be relatively little demand from them to return to the previous situation. That is, unlike the case with section 404, this (unsupported) regulatory reform is not causing ongoing costs that are both significant and visible.

Nevertheless, all of these arguments seem rather feeble as justifications for the mandatory separation rules, given the clear thrust of the empirical evidence that is available.[43]

C. Independent Directors

Consider now the board-related changes brought about by the reforms. Although there are many aspects to these reforms, the most salient is the push for boards that are dominated by independent directors. What is the evidence that this shift actually helps shareholders?

---

[43] A related point might be made about the possibility, suggested by some of the studies, that there might be a benefit from applying the prohibition on non-audit services to a small subset of public companies, such as those with smaller market caps, lower institutional holdings, higher insider holdings, smaller boards, and a lower percentage of independent directors and audit committee members. If there is such a subset of companies, a rational legislator would try to tailor regulatory requirements to them, in order to eliminate costs that have few or no benefits.

There is a medley of studies suggesting a positive impact. Lin (1996) reported research indicating that outsider-dominated boards are more likely to participate in major restructuring events like mergers, takeovers, and tender offers.[44] Similarly, Cotter, Shivdasani, and Zenner (1997) offered evidence indicating that outside directors enhance shareholder wealth during tender offers.[45] Others found that outsider-dominated boards are more likely to remove poorly performing CEOs (Weisbach 1988)[46] and to nominate outside CEOs (Borokhovich, Parrino, and Trapani 1996).[47] (Note, however, that it can and has been argued that the tendency to appoint a new CEO from the outside, as opposed to promoting the best inside candidate, is often a bad strategy for companies to follow.) A more recent study links higher bond ratings and lower bond yields to greater institutional ownership and stronger outside control of the board (Bhojraj and Sengupta 2003).[48] An earlier study (Rosenstein and Wyatt 1990) even documented an association between increased shareholder wealth and the addition of outsiders to the board.[49] And another recent study examining the correlation at a point in time between no less than 51 supposed good governance factors and six measures of firm performance in a large sample did find an association between board independence (as indicated by whether or not the board had a majority of outside directors) and four of their measures, though not Tobin's Q (Brown and Caylor 2004).[50]

Nevertheless, more exhaustive and directly relevant research fails to show a general connection over time between more independent boards and firm profitability or performance. Sanjai Bhagat and Bernard Black (2002) reported evidence from the first large-scale, long-time-horizon study of the relationships among board independence, board size, and the long-term performance of large American firms.[51] They looked at data on the financial performance and growth from 1985 to 1995 for 934 of the largest United States firms, and found that firms with more independent boards do not achieve improved profitability. Interestingly, they found evidence that low-profitability firms did tend to

---

[44] L. Lin, "The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence," 90 Northwestern U. L. Rev. 898-966 (1996).

[45] James F. Cotter, Anil Shivdasani, and Marc Zenner, "Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?" 43 J. of Financial Economics 195-218 (1997).

[46] Michael S. Weisbach, "Outside Directors and CEO Turnover," 20 J. of Financial Economics 431-60 (1988).

[47] K. Borokhovich, R. Parrino, and T. Trapani, "Outside Directors and CEO Selection," 31 J. of Financial and Quantitative Analysis 337-55 (1996).

[48] Sanjeev Bhojraj and Partha Sengupta, "Effect of Corporate Governance on Bond Ratings and Yields: The Role of Institutional Investors and Outside Directors," 76 J. of Business 455-75 (2003).

[49] Stuart Rosenstein and Jeffrey G. Wyatt, "Outside Directors, Board Independence, and Shareholder Wealth," 26 J. of Financial Economics 175-91 (1990).

[50] Lawrence D. Brown and Marcus L. Caylor, "Corporate Governance and Firm Performance" (Dec. 7, 2004), abstract and paper available at SSRN website, http://papers.ssrn.com/abstract_id=586423.

[51] Sanjai Bhagat and Bernard Black, "The Non-Correlation Between Board Independence and Long-Term Firm Performance," 27 Iowa J. Corp. L. 231-72 (2002).

respond to their troubles by increasing the proportion of independent directors on their boards, but no evidence that the strategy worked. They also found that their basic result -- no correlation between board independence and firm performance -- was robust: it persisted when they ran a variety of statistical tests, and when they controlled for factors like board size, firm size, industry effects, CEO stock ownership, stock ownership by outside directors, and the number and size of 5 percent blockholders. (Interestingly, they also found no consistent correlation between board size and firm performance, though there were "hints" of the negative correlation found in other studies.)

What might explain such results?[52] Perhaps the clue lies in the indeterminacy of the abstract arguments for and against the value of requiring a clear majority of independent directors. On the plus side, one can easily list three reasons why independent directors might add value. (1) They have less incentive than insiders to act contrary to the interests of shareholders. (For example, they don't receive their primary salaries from the corporation, and their directors' fees are relatively modest.) Moreover, they have personal incentives, like protecting their own reputation, to act in a way that avoids external criticism and potential lawsuits. Consequently, for example, they may be more prone to accept rather than resist a takeover bid. (2) They are less likely than insiders to feel controlled by or beholden to the CEO, and therefore more likely to play a monitoring role when that is needed. (3) Many independent directors are accomplished in their own spheres, and may bring considerable wisdom and much-needed outside perspective to board discussions of business strategy.

But on the negative side, it is also easy to list reasons why independent directors may not add value. (1) Independent directors will have spent much less time with the company, and will have much less detailed information and understanding of it, than inside directors such as divisional heads and the chief financial officer. Accordingly, the independents may be much less able to contribute meaningfully to the managerial function of the board. Put otherwise, specific knowledge may trump general wisdom and outside perspective. (One could even argue that independent directors will not know enough about the company to act as good monitors of potential misconduct and self-dealing, even though it is hard to go on and argue that inside directors, with their conflicted interests, would do better in this role.) (2) Independent directors may meddle too much. This is a variation on the thought that the monitoring role may interfere with the managerial role of the board. (3) Independent directors may not be "really" independent, because whatever the formal procedures they are de

[52] I pass over the obvious possibility that different studies may suggest different impacts because they define "independence" differently. As noted later in the text, newly strict independence requirements should make us cautious about concluding that the existing empirical evidence indicates that majority-independent boards won't matter in the future.

facto selected by management,[53] and because they have insufficient personal incentive to act very independently.

An alternative explanation for the Bhagat and Black results would appeal to the logic of market competition and to the notion that board composition is endogenous. As Professors Miwa and Ramseyer point out in connection with their study of outside directors in Japan,[54] the reason that board composition does not have an observable effect on performance is not necessarily that board composition doesn't matter. If the relevant markets are competitive, the firms that survive will be those with firm-specifically appropriate governance structures – some will have more and different outside directors than others, according to their industry, situation, and needs -- and any regression of performance on governance structures will yield insignificant results. That can be the case even if governance is very important for performance. If valid, however, this explanation seems to counsel against one-size-fits-all governmental mandates or rating agency guidelines requiring all public companies to have a specified percentage of outside directors.

In any event, Bhagat and Black do not view their study as supporting a return to the 1960s, when boards were insider dominated and usually passive. They are mainly concerned to caution investors against accepting the advice of governance rating agencies that insist on, or strongly value, boards with a "supermajority" of independent directors, that is, with only one or two insiders (e.g., the CEO and the CFO). In their view, having a substantial minority of insiders might bring subtle benefits, and companies should be free to experiment with such a mixed model. In addition, they also take pains to acknowledge that boards dominated by independent directors might achieve more measurable good effects if additional and supportive reforms are implemented – for example, if independent directors are given stronger incentives and made more accountable to shareholders, if new selection procedures result in more "truly" independent directors, and if good committee structures are put in place. (As noted previously, SOX-related reforms also impose much stricter definitions of independence. This change is yet another factor that might make a difference in the future behavior of boards.)

Because SOX and the new listing requirements do call for such supplementary reforms to boost the majority-independent board model, and these reforms have recently been put in place at most public companies, it may

---

[53] This possibility seems consistent with studies showing that executive pay is higher when more of the independent directors have been appointed under the current CEO. See John E. Core, Robert M. Holthausen, and David E. Larcker, "Corporate Governance, Chief Executive Compensation, and Firm Performance," 51:3 J. of Financial Economics 371-406 (1999); Richard Cyert, Sok-Hyon Kang, and Praveen Kumar, "Corporate Governance, Takeovers, and Top-Management Compensation," 41:2 Academy of Management Journal 200-08 (2002).

[54] Yoshiro Miwa and J. Mark Ramseyer, "Who Appoints Them, What Do They Do? Evidence on Outside Directors from Japan," paper available from authors (revised draft, May 2004).

be that a future long-term, rigorous empirical study will find a positive connection to shareholder value. In the interim, however, we proceed on the basis of theory and faith.

Although the focus of this subsection has been on the listing requirement for a majority of independent directors on the whole board of directors, it should be noted that a more refined requirement, now embodied in the SOX rule that audit committees may consist only of independent directors, has also been subjected to empirical testing. Professor Romano, in her survey of 16 relevant studies, reports that they do not support the hypothesis that such a requirement will reduce the probability of financial statement wrongdoing or otherwise improve corporate performance.[55] This summary conclusion is based on the clear majority of the studies and, more importantly, on those using the more sophisticated techniques.

D. Other Standards and Studies: "Good Governance" Factors, Bundles, Transparency, and Shareholder Empowerment

The realization that "we may not know what we are doing" in the area of governance reform becomes even stronger when we reflect on a longer list of "good governance practices" urged by the rating agencies, which give high or passing marks only to boards that have the following:

(1) a supermajority of independent directors;
(2) a relatively small board size;
(3) a separate (i.e., independent, non-CEO) board chairman;
(4) a specified number and length of meetings;
(5) regular executive sessions (at which company officers are not present);
(6) regular evaluations of the CEO;
(7) regular self-evaluations of the board;
(8) minimum stock ownership requirements for directors; and
(9) limits on director tenure (term limits and/or retirement ages).

For most of these practices, the empirical evidence bearing on their correlation with shareholder value is limited and/or mixed, and does not prove decisively that they cause increases in value.[56] In the case of practices (1) and (2),

---

[55] See Romano, supra note 42, at 1532.

[56] For example, the Brown and Caylor study, cited above at note 50, finds a positive association between 2 of their 6 measures of firm performance and a binary score based on whether the CEO and Board chair positions are separated <u>or</u>, if not, the Board has a lead director. They also find a positive association between 2 of their performance measures (not the same 2) and a binary score based on whether the board has at least 6 but no more than 15 members. See also David Yermack, "Higher Market Valuation for Firms with a Small Board of Directors," 40 J. of Financial

as we saw, there is significant evidence, but the evidence does not prove that there is a major beneficial impact from the practices. In the case of item (8), there is evidence that supports the practice (Bhagat, Cary, and Elson 1999),[57] although it is not conclusive (because it was not a longitudinal study and so does not show causality) and it does not clearly imply that having specific guidelines for all directors is a good thing.

In light of this uncertainty, and the cost of implementing new practices, it is not surprising that some well-informed academic commentators, such as Jeffrey Sonnenfeld, have lashed out against the easy insistence on each new refinement of “good governance practice” that is urged by the rating agencies.[58]

In principle, a “bundle” of supposed good governance characteristics might be more likely to have a decisive positive impact that is measurable when one looks at evidence. But studies to date are only modestly encouraging. For example, David Larcker, Scott Richardson, and Irem Tuna of the University of Pennsylvania examined the relation between a broad set of corporate governance factors and various measures of managerial behavior and organizational performance. They used a sample of 2,106 firms and distilled 39 structural measures of corporate governance (e.g., board characteristics, stock ownership, institutional ownership, activist stock ownership, existence of debt-holders, mix of executive compensation, and anti-takeover variables) into 14 “governance factors.” Although the factors had some small explanatory power in accounting for variations in their dependent variables (e.g., Tobin’s Q, accounting restatements, etc.) – but not always in the expected direction – their general conclusion was hardly an endorsement: “Overall, our results suggest that the typical structural indicators of corporate governance used in academic research and institutional rating services have very limited ability to explain managerial behavior and organizational performance.”[59]

When we turn to the disclosure-related set of recent corporate governance changes, the evidentiary picture looks somewhat better. There is good empirical evidence that some major regulatory efforts to extend or improve transparency have had positive effects for investors. For example, in a recent careful study Allen Ferrell (2004) shows that the 1964 extension of mandatory disclosure requirements to over-the-counter (“OTC”) stocks in the U.S. was accompanied by

---

Economics 185 (1996). Such studies may supply a rational basis for competing private rating agencies to devise and market their governance ranking systems, but do not seem sufficient to warrant mandatory regulation imposing the suggested practices on all companies.

[57] Sanjai Bhagat, Dennis Cary, and Charles Elson, “Director Ownership, Corporate Performance, and Management Turnover,” 54(3) Business Lawyer 45-61 (1999).

[58] See Jeffrey Sonnenfeld, “Good governance and the misleading myths of bad metrics,” 18(1) Academy of Management Executive 108-113 (2004). Sonnenfeld is Associate Dean for Executive Programs at the Yale School of Management.

[59] David F. Larcker, Scott A. Richardson, and A. IremTuna, "How Important is Corporate Governance?" (September 2004), abstract and paper available at SSRN website, http://papers.ssrn.com/abstract_id=595821.

a dramatic reduction in the volatility of OTC returns.[60] By itself, this is great news for investors. The paper also finds evidence suggesting that the regulatory change was accompanied by abnormal positive returns to holders of OTC stocks.

Nevertheless, there is often real uncertainty about the supposed positive effects of specific new disclosure requirements, such as the new rules about quicker filing of quarterly reports, new accounting rules about when so-called variable interest entities must be consolidated with a company in its disclosed financial statements, or new SEC guidance calling for companies to give overviews or executive summaries of their companies' business and operations in the Management Discussion and Analysis section of the annual 10-K report. Quite obviously, it seems unreasonable to expect that it would be possible or practical to conduct research showing the benefits of such particular rules. Nevertheless, more general tests of the impact of major new disclosure requirements, or sets of requirements, may be practical and desirable.

Given that the SOX-related corporate governance changes are more heavily focused on board independence than on empowering shareholders, it is ironic that some of the strongest evidence of good effects for shareholders has to do with shareholder rights, not board independence. As noted earlier, Bebchuk, Coates, and Subramanian have provided strong evidence on the negative effects of staggered boards and, therefore, the positive benefits of allowing shareholders to vote on all directors annually. In a study looking at a larger mix of factors, Gompers, Ishii, and Metrick (2003) reported that companies with strong shareholder rights had higher annual returns, profits, and sales growth than companies with weak shareholder rights.[61] There are also, of course, a now classic series of multi-country studies by LaPorta and colleagues on the link between legally induced investor protections (in particular, protection of minority public shareholders) and the growth and vitality of securities markets.[62]

More recently, an empirical study by Bebchuk, Cohen, and Ferrell (2004) makes an even stronger case that the high-impact factors are those that relate to managerial entrenchment – a result indicating that removal of entrenchment devices or empowering shareholders to defeat them would enhance shareholder

[60] Allen Ferrell, "Mandated Disclosure and Stock Returns: Evidence from the Over-the-Counter Market," Olin Paper No. 453 (2004), available for download at http://www.law.harvard.edu/programs/olin_center/corporate_governance/.
[61] Paul Gompers, Joy Ishii, and Andrew Metrick, " Corporate Governance and Equity Prices," 118 Quarterly J. of Economics 107-55 (2003).
[62] Rafael LaPorta, Florencio Lopez-de-Silanas, and Andrei Shleifer, "Corporate Ownership Around the World," 54 J. of Finance 471 (1999); ___ ___ and Robert Vishny, "Investor Protection and Corporate Governance," 58 J. of Financial Economics 3 (2000); ____ ____ "Law and Finance," 106 J. of Political Economy 1113 (1998); ____ ____ "Legal Determinants of External Finance, 52 J. of Finance 1131 (1997).

value.[63] They looked into which provisions, among a set of 24 governance provisions followed by the Investor Responsibility Research Center (IRRC), are correlated with firm value and stockholder returns. They separated out six provisions – four "constitutional" provisions that prevent a majority of shareholders from having their way (staggered boards, limits to shareholder bylaw amendments, supermajority requirements for mergers, and supermajority requirements for charter amendments), and two "takeover readiness" provisions that boards put in place to be ready for hostile takeover attempts (poison pills and golden parachutes). They found that increases in an index based on these six factors are monotonically associated with economically significant reductions in firm valuation, as measured by Tobin's Q. They also found that these six factors fully drive the correlation, found in prior work, between the IRRC's 24 factors indicating bad governance, on the one hand, and reduced firm value and lower stock returns during the 1990s, on the other hand. In other words, the other 18 bad-governance factors, which concerned things like director liability, indemnification provisions, and not having a secret ballot, were not found to matter.

To be sure, empirical research is an ongoing process, and one can expect studies that may appear to indicate different rankings of relevant factors, and perhaps to paint a different overall picture. For example, Brown and Caylor (2004) report a large-sample study examining the correlations at a point in time between 51 ISS-type governance factors (organized into 8 categories), and find that the overall score ("Gov-Score") based on these governance factors is strongly correlated with firm performance; that the suggested relative rankings of categories is different from those suggested by other researchers (including Gompers et al. and Bebchuk et al.); that certain previously noted factors, like option burn rate, do seem important; and that certain previously unstudied (or understudied) factors, like the independence of the nominating committee, do show significant positive correlations with some measures of performance.[64] This and other research studies are subject to critique by methodological experts, of course. Importantly for policymakers, it does (and should) take time for a dominant view to emerge among the experts.

In any event, the studies to date do not constitute a rousing endorsement of the whole complex of SOX-related reforms.

Taken as a whole, the empirical studies about what does and does not matter for shareholder value suggest that the most valuable reforms for shareholders may come about, if at all, in the future. Perhaps such reforms will

---

[63] Lucian Bebchuk, Alma Cohen, and Allen Ferrell, "What Matters in Corporate Governance?" discussion paper no. 491 (September 2004), available for download at http://www.law.harvard.edu/programs/olin_center.

[64] Lawrence D. Brown and Marcus L. Caylor, "Corporate Governance and Firm Performance" (Dec. 7, 2004), abstract and paper available at SSRN website, http://papers.ssrn.com/abstract_id=586423.

result from the continuing competition between Delaware and the federal government. Perhaps they will arise from a federal appropriation of legal territory now left to the states. And perhaps they will come about in some other way.

V. The Difficulty of Making Good Law: Can We Raise the Odds?

This concluding section meditates on the lessons that might be drawn from our recent experience with major corporate governance changes. The stance I take is not one of denunciation, nor is it a strident call for repeal of SOX and related rule changes. Many of the lawmakers and rule makers involved in these changes did a commendable job of trying to identify and implement the most plausible reforms. The reforms may yet prove to be beneficial on balance, especially if the hoped-for general effect on investor trust is real. And the more important task for the future is not to undo new governance practices like majority-independent boards but to adjust the mix of governance practices toward those that, like annual elections, have a demonstrated positive impact. Complete roll-backs are best limited to supposed reforms that are later shown by good and widely accepted evidence to have a very high continuing cost and no or minimal positive impact.[65]

Nevertheless, the search for strong empirical evidence supporting a belief that key items in the recent wave of corporate governance changes will have a major positive impact is generally disappointing. This conclusion in turn invites us to reflect on a recurring dilemma faced by legal policymakers. The dilemma may be framed – perhaps too sharply – in terms of two conflicting propositions.

<u>Thesis</u>: <u>Major legal change often depends on a bandwagon effect to happen</u>.

Therefore, it is probably fatuous, or unrealistic, simply to urge a more rational and knowledge-based legislative and rule making process.[66] The sequential pattern of general disaster followed by the uncovering of particular wrongs, the resulting widespread outrage, and clamor-responsive major reform, is likely to recur in the future, and to be the pattern embracing the next great wave of corporate law changes. This is a hard proposition for serious policy analysts and academic proponents of reform to swallow, but it seems to be so.

---

[65] Perhaps, for example, SOX § 404 (on internal controls) will eventually be shown to fall into this category.

[66] Thus, I find myself deeply sympathetic to Professor Larry Ribstein's call for "humble regulation," see Ribstein note 42 supra, at 21-22, and happily join in his appeal. But I doubt that it will be granted when the next hurricane of reform ideas arrives in Congress. Other approaches to rationalizing the law are also needed.

Antithesis: But bandwagon-generated reforms may be grossly suboptimal for society and may even be perverse, at least in some respects.

Why do suboptimal reforms get passed when there is a bandwagon process? They happen because the overall reformist impulse is based so much on emotions (literally, the motivators to action) and preconceptions, neither of which may be fully appreciated or well understood, and both of which tend to impede efforts to engage in "scientific" policy making and careful examination of evidence, because the latter may take too long and be inconclusive. As a result, the costs of some enacted reforms may exceed the benefits, and real problems may not be solved, or even alleviated in a major way.

Synthesis? What techniques might narrow the gap between realistic engines of change and genuinely (or optimally) valuable policy changes?

That is, how can we facilitate major legal reforms that are more likely to have a large net benefit to society? In my view, SOX itself has the seeds of an answer, though the seeds need to be treated with greater care in the next major reform movement. Title VII of SOX directs federal regulatory bodies to carry out studies about a variety of matters, such as the consolidation of accounting firms (a phenomenon that arguably poses large threats to competition and perhaps also to effective regulation of auditing customs and standards), enforcement actions involving securities laws, and certain practices of investment banks and financial advisors. Ironically, though, title VII does not mandate studies of the main practices SOX was legislating into existence, even though they are very costly but not really proven.

But the research provisions of title VII do suggest a new approach to making major new waves of regulation responsive to the best obtainable empirical evidence about what works and at what cost. Instead of (a) trying to scout out (and/or do) and carefully evaluate all the needed research before the reform statute is enacted – which, as I have suggested, is unrealistic – or (b) trying to get the major reform statute changed some years later, when the good evidence is in – which is also unrealistic, because now there are likely to be political apathy and vested interests standing in the way of statutory change[67] – the drafters of the reform statute can (c) try to build in a carefully specified process for empirical research and responsive regulatory adjustments or improvements. This technique assumes that the reform statute will grant

[67] Thus, I am also sympathetic to Professor Romano's preference for creating statutory default rules that companies can opt out of by following prescribed procedures, especially when (as is often the case) the evidence supporting the default rule is far from conclusive. See Romano, note 42 supra, at section III.A. This approach should certainly be considered when new reforms are about to be enacted. But I am not optimistic that Congress can often be persuaded, at reasonable cost, to convert already enacted legal rules into defaults. Once again, additional approaches to legal rationality seem needed.

enforcement authority and significant rule making and implementation authority to a regulatory agency such as the SEC.

Below are some suggested principles to be followed in the design of such new laws:

- Include provisions that both enable and require the regulators to conduct or fund empirical studies of the effects of governance practices and changes. List, as topics to be so studied, all of the major provisions created by the statute in question, not just the topics that seem to be the "hot items" of the day, unless and to the extent that there are already compelling, systemic, and broadly accepted studies supporting particular provisions. Include appropriations or industry-"taxing" authority to fund the mandated studies.

- Empower, encourage, and sometimes require regulators to reassess rules, on a specified periodic basis, in light of such studies and to make appropriate changes in the rules, including (ideally) the power to convert mandatory rules to default rules and the power simply to drop rules that seem baseless, or that demonstrably impose large costs while showing no or tiny proven benefits after serious studies have been carried out.

- Enunciate most legislative reforms as principles whose specific content is to be (1) spelled out by the regulators by a specific date [SOX does a fair amount of this, but it could have done more], but later (2) reassessed and revised in light of emerging empirical evidence (as well as accumulating experience and new arguments), on a generally specified timetable [SOX is not so good on this second dimension]. Give regulators explicit and specific power to recommend statutory changes in the principles, based on new evidence and experience.

The general theme behind these recommendations is simple. The drafters of the statute should explicitly acknowledge, at every opportunity, that reform is a work in progress, not something to be gotten over with once and for all.

Admittedly, this policy stance faces a potentially serious practical problem of its own. The human instinct for closure is very strong, especially when people are consumed with psychologically self-defensive moral outrage, as often happens in the context of a bandwagon-amplified reform frenzy. This tendency could create cognitive dissonance for lawmakers who are presented with provisions for doing research and making adjustments. They may prefer to avoid the dissonance by not considering such provisions.

Similarly, there is a tendency for people with aroused emotions to prefer bright-line solutions. This may lead lawmakers to become impatient with provisions for doing research and making adjustments. The provisions may strike them as pedantic, wishy-washy, and even subversive, since they allow for subsequent actions that might "water down" the reform instead of improving it. When lawmakers – or their monitors in the news media and the excited public -- are in the state of reform frenzy, they may find any calls for further study, evidence gathering, and critical thought – even calls for future effort that clearly do not prevent (because they accompany) major reforms now – ridiculous. They may counter with angry generalizations, e.g., "We don't need a study to decide that fraud and theft are wrong, or that rampant wrongdoing has occurred. And we don't need a study to figure out whether good internal controls {or X, or Y, or Z} are important and should be required; it's obvious. This is all about integrity and accountability, and basic morality. It's time to act."

Nevertheless, putting a research and reassessment procedure into a law should be much more palatable to the riders of a bandwagon than a policy stance that says lawmakers should wait until they get good empirical evidence before enacting reforms in response to a crisis. The mere fact that SOX contains its title VII indicates that the suggested approach is practical, for it would simply elaborate and strengthen the research and reassessment technique.

In any event, my profound hope is that a properly formulated procedure for future evidence gathering and rule adjustment could be presented in an acceptable way, perhaps by appealing to lawmakers' desire to portray themselves as rational and reasonable, that is, as Platonic guardians of the public good. Such an appeal would not be ignoble flattery. It would be a call to the highest morality.

In summary, legal reforms in the area of corporate governance should have bite but should also be explicitly structured to authorize and mandate (1) serious empirical study of the effects of particular regulatory changes (or existing rules), (2) periodic reassessment of regulations in light of such evidence (while also considering experience and analytical arguments, of course), and (3) explicit decisions to reaffirm or alter regulations in light of these reassessments.