VIRGINIA LAW REVIEW
IN BRIEF

VOLUME 96 APRIL 2, 2010 PAGES 9-15

RESPONSE

PLACEBO STATUTES?: SARBANES-OXLEY AND ETHICS CODE DISCLOSURES

Donald C. Langevoort[*]

IN Placebo Ethics,[1] Usha Rodrigues and Mike Stegemoller ("R&S") show that Section 406 of the Sarbanes-Oxley Act and its implementing rules have failed to generate disclosures that shed enough light on conflicts of interest and related ethical issues involving senior financial executives at publicly traded companies. They suggest two different stories of failure. One is on the part of those making disclosure decisions at public companies, presumably lawyers, who fail to comply with the letter or spirit of the Section 406 rules. The other is on the part of policymakers, particularly at the Securities and Exchange Commission ("SEC"), whose dim articulation of the rules and subsequent failure to enforce enabled such widespread evasion. R&S seem quite troubled by both.

My comments are about these supposed failures and, more generally, the diffusion of securities law compliance norms among publicly traded issuers. I fully agree with R&S that Section 406 has failed to produce much of value. I am less convinced that many thoughtful observers ever expected it to, or that the investing public has somehow been lulled into thinking otherwise.[2]

* Thomas Aquinas Reynolds Professor of Law, Georgetown University Law Center.

[1] Usha Rodrigues & Mike Stegemoller, Placebo Ethics, 96 Va. L. Rev. 1 (2010).

[2] I am reminded here of the suggestion that there is nothing necessarily wrong with statutory placebos designed to generate an illusion of confidence on the part of unsophisticated investors without imposing any costly burden of compliance. See Amatai Aviram, The Placebo

The Sarbanes-Oxley Act is a mishmash of a statute, scattering policy solutions without any particularly coherent theory of what, precisely, led to the fraudulent disclosures at companies like Enron and Worldcom and how such fraud might be prevented in the future. This has led critics like Roberta Romano to deem it political "quackery."[3] Personally, I think the Act on balance has accomplished quite a bit of good for investors and the public, albeit at fairly high cost. But certain provisions are mainly rhetorical, not serious, reform, and Section 406 is one of these.

The cosmetics of Section 406 are apparent enough from the legislative history, which shows Congress's desire to respond to the well-publicized story of how the Enron board allowed some high level executives to take lucrative ownership positions at the special purpose entities that had been constructed to move certain assets and liabilities off-books, with fraudulently favorable accounting as a result. But the drafters made no effort to ban such conflicts—as they did elsewhere with respect to loans to senior executives—or even require "real time" disclosure of the conflicts themselves (which is what R&S want). Rather, Section 406(a) simply directs the SEC to adopt a rule requiring disclosure of whether the issuer has a code of ethics for senior financial officers, such as the Chief Financial Officer ("CFO") and comptroller, that "promote[s]" certain specified standards, while Section 406(b) requires prompt disclosure (via either a filing or through the internet) of any changes to the code or waiver of the code's requirements.

The text of the statute is frightfully ambiguous, a point hardly lost on the SEC as it had to struggle with such basic questions as whether the company's Chief Executive Officer ("CEO") was even meant to be included within its reach. This question of the statute's scope is particularly troublesome because the typical company's code of ethics extends far beyond these two or three positions. This raises the issue of whether Congress actually wanted a different code of ethics for the highest corporate officers, as opposed to the company's directors and other executive officers. It also raises the issue of whether the placement of Section 406 in title IV of Sarbanes-Oxley dealing with "Enhanced Financial Disclosures" rather than in title III on "Corporate Responsibility" was

Effect of Law: Law's Role in Manipulating Perceptions, 75 Geo. Wash. L. Rev. 54 (2006). I do not know whether Section 406 was intended as a placebo, simply has a placebo effect, or whether investors even care.

[3] See Roberta Romano, Sarbanes-Oxley and the Making of Quack Corporate Governance, 114 Yale L.J. 1521 (2005).

meant to signal that Congress's interest was simply in ethical requirements narrowly tied to the integrity of the financial reporting process.

It is probably fair to say that the SEC had no clear idea what to do with these ambiguities, and that resolving them was not its highest priority. In the proposing release, Section 406 disclosure was bundled together with the far more salient issues of auditor review of issuer internal controls (Section 404)—eventually, the bete noire of Sarbanes-Oxley—and audit committee financial expertise (Section 407).[4] The Commission was required to get all that rulemaking and much more proposed within ninety days and adopted within six months.

The final adoption shows the lack of ambition, particularly on the key question that bothers R&S: the meaning of waiver. Waiver is defined in item 5.05 of form 8-K to mean approval of a "material departure" from the code, or failure to take action with respect to a material departure that has been made known to any executive officer. But that definition is ambiguous on a point that R&S worry about: what if the code is written to permit conflicts of interest so long as they are fully disclosed to and approved by an independent committee as fair to the corporation? After all, that is the way duty of loyalty issues are normally handled under state corporate law, which Congress showed no inclination to preempt. Is such a fairness determination a material departure, or simply the conclusion that nothing is amiss and thus not a departure at all?[5]

This is the one substantive point about which I disagree with R&S: their claim, made a couple of times in the article, that a sound corporate ethics code is supposed to prohibit all conflict-of-interest transactions involving senior executives. In fact, all that needs to be prohibited are those conflict-of-interest transactions that are undisclosed or unfair to the corporation. A typical ethics code just establishes a process for this, usually involving reporting of the conflict and a mechanism for determining whether it is fair by disinterested members of the board of directors.

[4] See Disclosures Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, available at http://www.sec.gov/rules/proposed/33-8138.htm (proposed Oct. 22, 2002).

[5] This ambiguity is discussed thoroughly in Madoka Mori, A Proposal to Revise the SEC Instructions for Reporting Waivers of Corporate Codes of Ethics for Conflicts of Interest, 24 Yale J. on Reg. 293 (2007). Mori cites advice by a well-known corporate lawyer urging clients to narrow the scope of what might be considered a waiver, and one corporate code that specifically defines an approval as not a waiver. Id. at 305–06.

That brings us back to the ambiguity of the meaning of waiver, which is so obvious that the Commission staff could hardly have missed it. The exceedingly influential American Bar Association ("ABA") Committee on Federal Regulation of Securities did not, writing a comment letter taking the position that an approval is not a waiver, and asking the Commission to make that clear in the text of the rule.[6] No doubt fully aware of the Committee's view, the Commission stayed silent about this when the rule was adopted.

This strategic silence allowed the ABA's interpretation to stand without objection, without also forcing the Commission to deal with how easily this reading could render Section 406 of so little consequence. I suspect that the interpretation was quickly picked up on through the many forums securities lawyers have for learning from each other, especially from the profession's elite members who control committees like the ABA's. Diffusion of this norm—mimetic behavior—followed fairly predictably.[7] And the SEC subsequently did nothing to try to change it. There have been no high-profile Section 406 cases challenging the narrow construction of waiver. So far as I am aware, no high-level Corporation Finance Division staff have challenged it in the numerous settings where they speak to the lawyers each year about critical disclosure issues. Nor, apparently, have issuers gotten into serious trouble with the staff in the regular reviews of '34 Act disclosure filings companies face (another Sarbanes-Oxley innovation),[8] even though the failures to disclose would be at least as evident to the staff in those reviews as they were to R&S.

So is that wrong? As noted at the outset, R&S are severely critical of practicing lawyers for this evasion of the "spirit" of Section 406, and of the SEC for enabling it. I am not convinced. As to the lawyers, this takes us to an interesting question in professional responsibility: what is the

[6] See Letter from Stanley Keller, Esq., on behalf of the American Bar Association Committee on Federal Regulation of Securities (Dec. 19, 2002) available at http://www.sec.gov/rules/proposed/s74002/skeller121902.htm ("[A] decision that particular conduct does not constitute a code violation as a result of factual investigation or code interpretation should not be deemed 'waiver[].'").

[7] For a discussion of the diffusion of the meaning of the Sarbanes-Oxley Act more generally, with reference to these mimetic processes, see Donald C. Langevoort, The Social Construction of Sarbanes-Oxley, 105 Mich. L. Rev. 1817, 1819 (2007).

[8] It is possible that such criticism has occurred in the review process in individual cases, but that the staff's concerns have not been made public enough to effect a change in behavior among issuers generally.

line between legitimate and illegitimate evasive behavior, when the text of a law or administrative rule is ambiguous? Should "spirit" matter? Without rehashing that extensive debate here (I have participated elsewhere[9]), my sense is that most lawyers—including very reasonable, respectable ones—feel no moral obligation to fill in the gaps in a rule when Congress or an agency is unwilling or unable to state the obligation clearly, especially when the agency itself evidently shows little interest in corrective action. This is even more so if the lawyers have doubts about the legitimacy of the law. The belief that diffused quickly after Sarbanes-Oxley in key interpretive communities was that too much of it was bad political theater, imposing an unfair burden on honest issuers and costing their shareholders too much for the meager benefits derived.[10]

In part, at least, that is legal realism at work. R&S appeal to the "spirit" of Section 406 and the illegitimacy of a narrow construction of waiver mainly by reference to a Senate subcommittee investigative report that criticized Enron directors for "waiving" the code of ethics under circumstances where the code explicitly gave the board approval authority.[11] That certainly supports a broader interpretation of waiver, and I suspect R&S are right that this comes closer to the intention of whoever wrote the text of Section 406. But the word is still ambiguous; a far better one—hardly obscure—would have been "approval," not waiver.[12]

Perhaps the SEC was being unfaithful to Congress in letting this issue slide. Surely it could have structured item 5.05 to force a far greater number of real time conflict disclosures if it had wanted. But I am will-

[9] See Donald C. Langevoort, Someplace Between Philosophy and Economics: Legitimacy and Good Corporate Lawyering, 75 Ford. L. Rev. 1615 (2006) (participating in a symposium on ethically responsible legal advice).

[10] See Langevoort, supra note 7. As I point out, the prevailing interpretation in the legal community is muddied by the fact that Sarbanes-Oxley substantially increased the importance (and hence economic value) of expert securities law advice, so that lawyers are unlikely to question its legitimacy too strongly. Id. at 1840–41.

[11] See Permanent Subcomm. on Investigations of the S. Comm. on Governmental Affairs, The Role of the Board of Directors in Enron's Collapse, S. Rep. No. 107-70 (2002), available at http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/enron/senpsi70802rpt.pdf. Apparently, the term "waiver" was used by Enron insiders to describe the board approval, even though Enron's code explicitly contemplated an approval process. Id. at 25 & n.59.

[12] In terms of statutory construction, it is by now a familiar point that investigative reports do not have to get majority votes on the floor of the House or Senate, are not necessarily the work of the drafters of a later-enacted statute, and are fairly cheap talk. When spirit does not show up clearly in a statute, it is often (though not always) because such clarity would have endangered crucial political support.

ing to cut the SEC some slack here. Congress was not directing the SEC to institute a real time conflicts disclosure regime—Section 406 is written too narrowly (limited to accounting and financial executives) and too abstrusely for that to be the stated goal. Just as important, Congress was directing the SEC to address many other, far bigger issues under the same tight deadline—Section 404, initially bundled together with the code of ethics provision, being the notorious example. Roughly simultaneously, the staff was working on attorneys' "up the ladder" reporting obligations, audit committee reform, and many other contentious rulemaking projects. All these were adding costly burdens on corporations in terms of additional disclosure and internal controls obligations, and I suspect that the Commission was becoming tired of piling on much more.

Nor is it clear that being more expansive in the rulemaking would have done all that much good in addressing truly problematic conflicts. Both waivers and approvals carry with them the implication that independent directors think the transaction was fair to the corporation. To be sure, disclosure of an approval or waiver without disclosing facts known to the company that suggest unfairness is false and misleading, and therefore actionable. But the worst of the transactions will not be disclosed accurately in any event—we have long known that the value of "loyalty"-based disclosure requirements is not that they actually cause revelation of misconduct that insiders take pains to conceal, but simply that they trigger a federal remedy for nondisclosure ex post in addition to the often inadequate state law remedy for breach of fiduciary duty.[13] Those remedies do not require an enhanced Section 406. And Section 406 simply does not try to reach what probably is the most problematic form of conflict-of-interest transactions, those involving controlling shareholders.

In fact, the Commission subsequently embarked on a different kind of effort to force more real time disclosure in this area, via item 1.01 of form 8-K, whose instructions—through a hard-to-follow cross reference to item 601(b) of regulation S-K—essentially put self-dealing contracts in the category of definitive agreements outside ordinary course so as to require prompt disclosure, assuming materiality. R&S raise doubts about

[13] See generally Donald C. Langevoort, Seeking Sunlight in Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability, 79 Wash. U. L.Q. 449 (2001); Robert Thompson & Hillary Sale, Securities Fraud as Corporate Governance: Reflections on Federalism, 56 Vand. L. Rev. 859 (2003).

the level of compliance here as well, although it is hard to test rigorously given the materiality qualifier. They also recommend at the very least that conflict of interest transactions be specially flagged under item 1.01. I certainly concur with the latter suggestion, and would also emphasize the need for guidance that would make clear how materiality ought to be applied in this setting.

Placebo Ethics is an extremely valuable article for its empirical findings about conflict of interest disclosure (or lack thereof) and its spot-on demonstration of how the SEC's interpretive and enforcement policies can deflate a statutory disclosure requirement. R&S are right that, as implemented, Section 406 is hardly worth the effort. But Sarbanes-Oxley's code of ethics provision never had that much potential in the first place given the way Congress drafted it, so I am not quite as inclined as they are to blame either the Commission or the securities bar for their roles in trivializing it.