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Placebo Ethics

Usha Rodrigues
University of Georgia School of Law, rodrig@uga.edu

Mike Stegemoller
Baylor University

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ARTICLES

PLACEBO ETHICS: A STUDY IN SECURITIES DISCLOSURE ARBITRAGE

Usha Rodrigues and Mike Stegemoller***

ENACTED in response to abuses that led to Enron's fall, Section 406 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "SOX") effectively requires every public company to disclose its code of ethics, and also to disclose immediately, via website or SEC filing, any waivers from the code that the company grants to its top three executives. These waivers offer a unique window not only into the ethical practices of public U.S. companies, but also into how disclosure works "on the ground"—whether companies are actually complying with disclosure rules.

Out of 200 randomly selected firms, we found only one waiver filed over five years disclosed pursuant to Section 406. By exploiting an overlap in disclosure regulations, we were able to crosscheck our sample companies' waiver disclosures. We identified 33 instances in which companies appear to have violated Section 406, and another 70 instances in which companies evaded illegality by watering down their codes to such a degree that they no longer forbid the very En-

* Associate Professor, University of Georgia School of Law.

** Assistant Professor, Texas Tech University. The authors wish to thank Ian Ayres, Robert P. Bartlett III, Daniel Bodansky, Dan T. Coenen, Paul J. Heald, Toby J. Heytens, Edmund W. Kitch, Donald C. Langevoort, Michelle Morris, D. Gordon Smith, Jason Solomon, and participants of the 2009 Stanford/Yale Junior Faculty Forum for helpful comments. Exceptional research assistance was provided by Anil Foreman, Rachel Jones, Michael Schwartz, and Jennifer Sudduth. Mistakes remain our own.

ron-style conflicts of interest that led to the adoption of Section 406. Finally, we studied all *Section 406 waivers filed with the SEC in the six years following SOX's passage—and found only 36 total. Event studies revealed that the market generally did not react to these transactions, suggesting that companies use waivers only to disclose innocuous, immaterial information, and disclose more problematic information, if at all, in more covert ways.*

We draw two conclusions from our research. First, the current regime is unhelpful and inefficient, long on costly and burdensome disclosures, and short on demonstrable benefit. Section 406's disclosure requirement is not functioning as intended. Either by mistake, manipulation, or indifference, companies are evading its requirements. We suggest eliminating the currently unenforced code-of-ethics waiver disclosure mandate, and instead requiring immediate disclosure of related-party transactions involving the company's CEO, CFO, or CAO, regardless of the firm's internal ethics rules. Second, our study highlights the limited utility of regulation by mandated disclosure alone and the inadequacies of website disclosure for securities regulation.

INTRODUCTION

Responses to the recent financial crisis are legion and diverse, but share a common theme: a desire for increased transparency. Of all regulatory methods, disclosure is the most palatable. Sunlight, that "best of disinfectants,"[1] and the market together work their magic with no need for the imposition of substantive—and often politically controversial—mandates on public companies. The argument goes that if commercial banks, investment banks, hedge funds, and other private equity investors had actually known the full extent of the derivatives market, of the collateral debt obligations, and of the credit default swaps, then the financial crisis might have been avoided.

[1] See Louis D. Brandeis, Other People's Money and How the Bankers Use It 92 (1914) ("Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.").

Yet respected market authority Warren Buffet has questioned the value of transparency:

> Improved "transparency"—a favorite remedy of politicians, commentators and financial regulators for averting future train wrecks—won't cure the problems that derivatives pose. I know of no reporting mechanism that would come close to describing and measuring the risks in a huge and complex portfolio of derivatives. Auditors can't audit these contracts, and regulators can't regulate them. When I read the pages of "disclosure" in 10-Ks of companies that are entangled with these instruments, all I end up knowing is that I *don't* know what is going on in their portfolios (and then I reach for some aspirin).[2]

Though every publicly traded corporation in the United States must theoretically comply with this country's mandatory disclosure regime, the public has no way of knowing whether they actually do so. Consequently, scholarly debate about securities laws focuses on the contour of those regulations—and, sometimes, whether they should exist at all. Some critics argue for stricter disclosure obligations to ensure a truly level playing field for all investors. Others decry the costs and burdens of myriad mandatory disclosure requirements, and advocate paring back. The most radical reformers assert that market demands alone can sufficiently motivate companies to voluntarily disclose what is important, and therefore argue for eliminating mandatory disclosure altogether.

All of these scholarly treatments, however, fail to evaluate a matter of key importance in assessing the merits of disclosure regimes: whether companies *actually comply* with current disclosure laws. There is an easy explanation for this gap in the literature. Researchers cannot measure the occurrence of nondisclosure because, by definition, if an event is not disclosed, the information is not public and therefore not measurable. And researchers are not likely to elicit information about nondisclosure from company insiders because revealing the occurrence of such events would be tantamount to confessing a crime.

[2] Letter from Warren Buffet, Chairman of the Board, to Shareholders of Berkshire Hathaway Inc. (Feb. 27, 2009), available at http://www.berkshirehathaway.com/letters/2008ltr.pdf.

We have discovered a rare, if not unique, opportunity to assess the occurrence of corporate nondisclosures, which exists because the law imposes overlapping disclosure requirements. Section 406 of the Sarbanes-Oxley Act of 2002[3] ("Sarbanes-Oxley" or "SOX") requires companies to disclose their codes of ethics (or explain why they do not have them), and then to disclose any waivers from that code granted to top corporate officers. Wholly apart from Section 406, Regulation S-K requires a disclosure of related-party transactions in companies' year-end proxy statements.[4] Our research reveals that, at least for related-party transactions, firms regularly engage in a kind of "disclosure arbitrage," neglecting to disclose ethics waivers at the time when transactions occur (in violation of Section 406 of Sarbanes-Oxley), but disclosing related-party transactions in their year-end proxy statements as required by Item 404 of Regulation S-K. Section 406 was specifically designed to prevent these kinds of related-party transactions, which contributed to Enron's demise. Our findings indicate, however, that current disclosure regulations are neither preventing the targeted behavior nor even revealing the types of activities that interest the marketplace. This finding should give pause to those who would rely on either transparency or a firm's own code of ethics as a tool for effective regulation.

Our study involves three phases. First, we examine the codes of ethics themselves to determine whether and how they are disclosed, as well as how accessible the disclosure is to the public. Our main sample consists of 200 randomly selected firms.[5] In terms of disclosure, Sarbanes-Oxley does not require a code of ethics, but if a firm does not have one it must explain its absence. Unsurprisingly, almost all firms choose to disclose a code rather than explain why they do not have one. Ethics codes are relatively easy to find, generally available via a corporation's website or its Form 10-K,

[3] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 406(a)-(b), 116 Stat. 745, 789 (codified at 15 U.S.C. § 7264 (2006)).

[4] Thomas G. LaWer, Robert Kant & Steve Lapidus, A New Era of Executive Compensation and Related Person Disclosure, *in* Practising Law Institute, Understanding the Securities Laws 2009, at 397, 429 (2009).

[5] We use firms with historical stock price data on the Center for Research in Security Prices database (CRSP). We randomly selected twenty firms from ten size-based portfolios so that firm size was evenly distributed across all publicly-traded companies.

the year-end report required by the Securities and Exchange Commission (SEC or "Commission").[6] In terms of disclosure of codes of ethics themselves, then, the regulation appears to have had its intended effect. However, because of the availability of website disclosure, as companies are restructured or amend their codes of ethics many codes are no longer available to the researcher.

The second and third portions of our study focus on company-granted waivers from the code of ethics. This research is greatly complicated because Congress gave companies the option of website disclosure rather than requiring disclosure on Form 8-Ks[7] filed with the Commission.[8] Therefore, a study of 8-K filings alone cannot provide a reliable list of all disclosed waivers. Only by looking at both SEC filings and web-based disclosures can an exhaustive list be made.

We began our study by looking at the filings of a random sample of 200 firms from January 1, 2003,[9] through December 31, 2007, to

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[6] A firm's proxy statement can (and typically does) incorporate by reference much of its 10-K. See Gerald T. Nowak, The Disclosure Cycle, *in* Practising Law Institute, Securities Filings 2008, at 387, 397 (2008).

[7] Companies are required to file Form 8-Ks to update the market on specified events that occur between the required quarterly filings. For example, if a company enters into or terminates a material definitive agreement, files for bankruptcy, acquires or disposes of a significant amount of assets, changes its accountant, or has a director resign, it must file an 8-K with the SEC within four days of the event. See 17 C.F.R. § 249.308 (2009).

[8] The Act's language is actually somewhat ambiguous because it could be read simply to permit website disclosure. "The Commission shall . . . require the immediate disclosure, by means of the filing of [a Form 8-K], dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of the code of ethics for senior financial officers." 15 U.S.C. § 7264(b) (2006). The SEC interpreted the "or" to give corporations the option of different methods of disclosure, but it could be read instead to give the SEC the option as to which method to require. The General Instructions to Form 8-K read:

> The registrant does not need to provide any information pursuant to this Item 5.05 if it discloses the required information on its Internet website within four business days following the date of the amendment or waiver and the registrant has disclosed in its most recently filed annual report its Internet address and intention to provide disclosure in this manner.

Sec. & Exch. Comm'n, Form 8-K: General Instructions 17 (2008), available at http://www.sec.gov/about/forms/form8-k.pdf. That excerpt, read in conjunction with the Act's language, makes clear that the SEC gives the registrants the option.

[9] Although the Sarbanes-Oxley Act was enacted July 30, 2002, companies were only required to comply with Section 406's code of ethics disclosure requirements and

determine whether each firm disclosed its code and attendant waivers via website or 8-K. We then counted the number of ethics waivers filed via website or with the SEC. Our research revealed no website waiver disclosure and only a single filing on a Form 8-K. In other words, among 200 public companies over a five-year period we found *only one* disclosure made under Section 406.[10]

Several hypotheses could explain why we found only one waiver: (1) companies might be extremely ethical, and may not engage in the kinds of transactions for which disclosure is required; (2) companies that might otherwise engage in unethical conduct may be dissuaded from such conduct by the prospect of SOX-required disclosure; (3) companies might not be preserving their website-disclosed waivers for long;[11] or (4) undesirable insider-favoring conduct may still be occurring, but is not being disclosed. The third hypothesis highlights a serious problem for researchers and is why we argue in Section V.B that the SEC should abandon its experiment with wholly web-based securities disclosure. The fourth hypothesis would be difficult to prove precisely because the required disclosure is not being made—in these circumstances there is no way for a researcher to know of undisclosed conduct *because* it is undisclosed.

Fortunately, companies are required to disclose related-party transactions once a year under separate SEC regulations. Although

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amendment and waiver requirements in annual reports for fiscal years ending on or after July 15, 2003. See Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 47,235, 68 Fed. Reg. 5110 (2003), *reprinted in* [2002–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,818, at 86,883 (Jan. 23, 2003). Thus, 2003 represents only a partial year of data.

[10] The transitory nature of website disclosure makes it impossible to conclude that no more disclosures actually occurred in the time period.

[11] Indeed, the SEC's instructions for Form 8-K require only that a company keep the information on its website for "at least a 12-month period." Sec. & Exch. Comm'n, Form 8-K: General Instructions 17 (2008), available at http://www.sec.gov/about/forms/form8-k.pdf. As Section II.C will discuss, this instability of data is one of the main drawbacks of sole website disclosure. One company's ethics code specifically tracks the Form's language, requiring that a waiver be disclosed on the company website "for at least a 12 month period." NBTY Inc., Code of Business Conduct and Ethics, http://www.nbty.com/phoenix.zhtml?c=85635&p=irol-govConduct (last visited Oct. 23, 2009). After that, the company must only "retain" the disclosure for at least five years; that is, it can remove it from the website and store a record of it. Id. Neither the SEC's instructions nor the company's code discusses what value privately archiving past disclosure provides the public.

Section 406 disclosure requirements differ from related-party-transaction disclosure requirements, there is enough overlap for us in the second part of our study to determine whether some waivers required by Section 406 are not being filed. Sixteen of our sample firms appeared to violate Section 406 by not disclosing transactions as required a total of 33 times. Another 45 sample firms avoided violating the Act in the strict sense, but only by watering down their codes to an arguably illegal degree in 70 separate cases. Astonishingly, then, in a sample of 200 firms over a five-year period we found a total of 103 instances in which companies' own public filings indicated that they failed to make accurate—and arguably required—disclosures. Over 7.5% of these 200 firms seemingly violated the law by participating in flawed disclosures.

One might object that there is no real problem with these violations of Section 406, since, even though the transactions in question are not disclosed as ethics waivers, they are at least disclosed to the market as related-party transactions. But disclosure of the transaction via proxy statement can occur months after the transaction has occurred, whereas Section 406 requires disclosure within four business days. In addition, a disclosure via proxy can be "buried" amongst the many other disclosures required in a company's year-end filing.

In the third portion of our study, we observed *all* code of ethics waivers disclosed via Form 8-K that were ever filed with the SEC from 2002–2007 for *any* company, both inside and outside the 200 sample firms.[12] From the effective date of Sarbanes-Oxley through the endpoint of our study, we found only 36 waivers filed via Form 8-K. In other words, some 25,000 firm-years—based on an estimated 5,000 public companies over our five-year study—produced only 36 waivers filed via Form 8-K. We hypothesize that these vanishingly rare cases involve generally meaningless information. Only the atypical firm chooses to disclose an ethics waiver at all, and we postulate that before doing so the information has been vetted and scrutinized to ensure it appears innocent.

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[12] This data set does not comprise all waivers filed, however, because companies can also file waivers on their websites. Nevertheless, given that we found no waiver disclosure on the websites of the 200 sample companies, we presume this second data set of all 8-K waivers filed with the SEC is fairly robust, though not exhaustive.

We performed event studies for each 8-K, which allowed us to measure the market's reaction to each individual waiver. No discernable change in the overall stock price of these companies occurred, suggesting that waiver-disclosing firms reveal little of real importance via waiver. What is more, there is evidence that firms disclose more questionable transactions in a problematic way, bundling ethics waivers with other information in the same Form 8-K. It is possible that corporate managers intentionally use these bundled disclosures to mask a particularly questionable transaction by combining it with other information. We found that the market reacted negatively to such bundled disclosure—although it is impossible to conclude whether the bundling strategy is not working or whether the market reaction is not as negative as it would be were the news not disguised by pairing it with other information.

Overall, our findings do not reveal companies that fail to disclose altogether—it would be impossible to detect total nondisclosure. They do show, however, that firms do not make disclosures as promptly and openly as Sarbanes-Oxley requires. There are two ways to explain this outcome. According to a benign story, companies are accustomed to complying with related-party transactions because regulations governing such disclosure have been in existence for decades.[13] Codes of ethics, in contrast, are of relatively recent vintage, and firms may have no system in place to flag violations or waivers as they occur. If this benign story is true, two conclusions follow. First, more training may be needed, or internal controls may need to be tightened in order to ensure compliance. Second, there is reason to believe that broader training and education efforts must be undertaken whenever lawmakers put in place new disclosure requirements.

The malign account is that companies are intentionally failing to comply with the requirements governing ethics waivers because regulators are unlikely to detect nondisclosure or pursue it if discovered. Also, firms might have concluded that the market is not

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[13] The current form of related-party transaction disclosure dates back to 1982, but prior forms existed as early as 1942. See Disclosure of Certain Relationships and Transactions Involving Management, Securities Act Release No. 6441, 47 Fed. Reg. 55,661–01 (1982), *reprinted in* [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,281, at 85,534 (Dec. 12, 1982).

familiar with disclosure that singles out these related-party transactions as ethics waivers and therefore will react negatively to them.

The companies do disclose these transactions via the more standard and less transparent means of year-end proxy statements. We posit that securities enforcement practices, coupled with the special nature of proxy disclosure, explain why companies are willing to disclose this information to the market eventually, although not in the manner the law requires. The SEC is the sole enforcer of Sarbanes-Oxley provisions and has abdicated the field with respect to Section 406. Noncompliance with an unenforced provision may not be surprising. Secondly, related-party disclosures can be delayed and buried with a wealth of other information in proxy statements, so they may appear less damaging.

It thus appears that Section 406 creates the worst of all worlds for ethics: costly disclosure that lacks bite. Companies face the burden of compliance with Section 406. Many firms fail to comply with the disclosure requirements, and many others "comply" only by impermissibly watering down their ethics codes. The handful of disclosed waivers have little effect on the market, suggesting that there is no meaningful disclosure of information. Worse yet, toothless regulation may create a "placebo" effect under which regulators and investors believe that Sarbanes-Oxley has imposed meaningful ethical controls on companies, when in fact companies operate free from real constraint.

We further conclude that disclosure is not always helpful, although it might be the most politically palatable option. In particular, Section 406-style disclosure avoids hard regulatory choices by essentially telling companies: "make up your own ethics rules, and tell us when you break them." In contrast, companies appear more inclined to comply with the "hard" disclosure required by Item 404's related-party transactions: "disclose all transactions with insiders over $120,000." Our findings show that "soft" disclosure is ripe for mistake and manipulation. Section 406 also offers lessons in the tremendous power the SEC exercises. Its discretion in determining what laws to enforce shapes the reality of securities disclosure on the ground.

Soft disclosure requirements, coupled with under-enforcement, combine to lull the market into a false sense of security by creating the illusion of transparency and regulation. Both the SEC and the firms it supervises can point to ethics rules that exist on the books as evidence of a commitment to appropriate behavior, but these so-called ethics rules lack purchase in the real world. Any new reform measures targeting increased transparency in the financial markets should heed the troubling lessons learned from the implementation of Section 406.

I. MANDATORY DISCLOSURE AND SECTION 406

A. Theories of Securities Disclosure

The stated mission of the SEC is to protect investors,[14] and its main tool is mandatory disclosure. As the SEC declares on its website:

> The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security. *Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions.*[15]

The principle of mandatory disclosure—to ensure equal access to information—is fundamental to our securities law. Even so, scholars have long debated whether our mandatory disclosure system is a net positive or negative. At times, calls for deregulation have become strident.[16] Critics decry the costs of collecting and publishing information.[17] Geoffrey Manne has suggested that dis-

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[14] Sec. & Exch. Comm'n, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Oct. 23, 2009).

[15] Id. (emphasis added).

[16] See, e.g., Paul G. Mahoney, The Exchange as Regulator, 83 Va. L. Rev. 1453, 1454 (1997).

[17] Recent complaints have centered on Sarbanes-Oxley's internal controls provision. See Donald C. Langevoort, Internal Controls After Sarbanes-Oxley: Revisiting *Cor-*

closure may also impose indirect costs, including avoiding otherwise desirable activities that can only be pursued in secret.[18] Stephen Choi advocates the regulation of investors rather than firms, so as to facilitate capital aggregation by freeing issuers from oppressive regulation.[19] Roberta Romano proposes allowing states to offer disclosure regimes to compete with the federal government's.[20]

On the other side, a few staunch supporters of our current system of mandatory disclosure remain. Merritt Fox argues that the mandatory disclosure of information creates positive externalities for groups other than shareholders, such as suppliers and customers.[21] Allen Ferrell advocates mandatory disclosure not only in the United States, but also throughout the world, in an effort to equalize international markets.[22] Edward Rock claims that mandatory disclosure creates a "credible commitment" to a certain permanent level of disclosure because it is easy to become a public company but difficult to exit from the system.[23] Some mandatory disclosure proponents damn it with faint praise: Paul Mahoney endorses mandatory disclosure but calls for a paring back of disclosure re-

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porate Law's "Duty of Care as Responsibility for Systems", 31 J. Corp. L. 949, 950 (2006); see also Robert Charles Clark, Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too, 22 Ga. St. U. L. Rev. 251, 293 (2005) ("[T]he costs of section 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 $91,000 per company, or $1.24 billion in the aggregate. The cost to companies in the [Financial Executives International] spring 2005 survey was 48 times the SEC average estimate, and the [American Electronics Association] tally for American companies was 28 times the SEC aggregate estimate." (footnotes omitted)).

[18] Geoffrey A. Manne, The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure, 58 Ala. L. Rev. 473, 482 (2007).

[19] See Stephen Choi, Regulating Investors Not Issuers: A Market-Based Proposal, 88 Cal. L. Rev. 279, 283 (2000).

[20] See Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359, 2365 (1998).

[21] See Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment, 85 Va. L. Rev. 1335, 1345–46 (1999).

[22] Allen Ferrell, The Case for Mandatory Disclosure in Securities Regulation Around the World, 2 Brook. J. Corp. Fin. & Com. L. 81, 124–25 (2007).

[23] Edward Rock, Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure, 23 Cardozo L. Rev. 675, 676 (2002).

quirements on the theory that they reduce agency costs, even though they have little effect on the accuracy of pricing.[24]

What both sides assume in this decades-long debate is that companies comply with mandatory disclosure obligations. This assumption is in a sense natural because it seems inevitable: there is no way for researchers to detect whether companies are not complying with disclosure requirements. Or, put differently, nondisclosure is impossible to measure. In a seminal article, Edmund Kitch describes how mandatory disclosure does not enhance accuracy because, by imposing liability for the production of misinformation, it decreases the total amount of information produced.[25] But he presumes that the mandatory disclosure regime works; that is, that the required information is being produced, and that it is, on the whole, accurate.

What if this assumption is wrong? How can we know whether the required information is indeed being disclosed?[26] Our study reveals that at least *some* information is not being disclosed as required—that information about high-level related-party transactions, which should be disclosed almost immediately and

[24] Paul G. Mahoney, Mandatory Disclosure as a Solution to Agency Problems, 62 U. Chi. L. Rev. 1047, 1047–48 (1995).

[25] Edmund W. Kitch, The Theory and Practice of Securities Disclosure, 61 Brook. L. Rev. 763, 771–72 (1995). Steven L. Schwarcz has made the opposite point, that the problem may be the disclosure of too much information. See Steven L. Schwarcz, Rethinking the Disclosure Paradigm in a World of Complexity, 2004 U. Ill. L. Rev. 1, 5–6 (2004) ("In Enron, for example, there is no dispute that the *existence* of the SPE-transactions was generally disclosed to Enron's investors. The disclosure itself, however, was ultimately said to be inadequate. Although this inadequacy might have been intentionally fraudulent, the better explanation is that Enron's structured transactions were so complex that disclosure either would have had to oversimplify the transactions or else provide detail and sophistication beyond the level of both ordinary and otherwise savvy institutional investors in Enron securities." (footnotes omitted)).

[26] Intelligent (and unscrupulous) issuers may be tempted not to make required disclosures; after all, who would be the wiser? Arrayed against such disclosure-defiance are a variety of mechanisms that encourage honesty. First, firms and officers are liable for misstatements and are subject to private lawsuits under Rule 10b-5 as well as civil prosecution by the SEC or criminal prosecution by the Department of Justice. See 17 C.F.R. § 240.10b-5 (2009). Second, under the Securities Act of 1933, underwriters and accounting firms are also liable, although they have a "due diligence" defense if they have taken reasonable measures to ascertain the truthfulness of the company's public statements. See 15 U.S.C. § 77k(a)–(b) (2006). Lack of enforcement by private right of action, as we will see, coupled with non-enforcement by the SEC, can vitiate the threat of liability.

individually, instead is disclosed tardily and buried amidst other information. We are able to explore not only how the mandatory disclosure system works "on the ground," but also whether a particular disclosure provision did the work it was supposed to do. In the next Section we turn to the history of this particular provision, Section 406 of Sarbanes-Oxley.

B. The Road to Section 406

A chief mechanism for Enron's fraud was the use of special-purpose entities headed by its Chief Financial Officer (CFO), Andrew Fastow, to move liabilities off the company's balance sheet. Enron's Code of Conduct specifically prohibited deals with related parties,[27] and ironically, the company hewed to its code of ethics. Fastow disclosed the transactions to Enron's board of directors, and the board duly waived its code and permitted the deals to go forward.[28]

Against this backdrop, many commentators have attributed Enron's failure to its board of directors, which blithely consented to deals that enriched Fastow and other employees by tens of millions of dollars at the expense of Enron.[29] Accordingly, a specific Sarbanes-Oxley provision dealt with codes of ethics and waivers from them.

The ethics code disclosure requirement, recommended by Senator Corzine, was adopted by the Senate Committee on Banking, Housing, and Urban Affairs without much debate.[30] The Senate Committee observed:

> The problems surrounding Enron Corp. and other public companies raise concerns about the ethical standards of corporations and their senior financial managers. The Committee believes that

[27] Note, The Good, the Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior, 116 Harv. L. Rev. 2123, 2129 (2003) (noting that Enron's officers had failed to comply with many aspects of Enron's code of ethics).

[28] 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, 298–99 (2007).

[29] Id.

[30] Joshua A. Newberg, Corporate Codes of Ethics, Mandatory Disclosure, and the Market for Ethical Conduct, 29 Vt. L. Rev. 253, 274 (2005).

> investors have a legitimate interest in knowing whether a public company holds its financial officers to certain ethical standards in their financial dealings. The bill requires issuers to disclose whether or not they have adopted a code of ethics for senior financial officers and, if not, why not.[31]

The waiver provision was later added to address the specific Enron problem of the board of directors granting waivers to the CFO.[32] Richard Breeden, a former Chairman of the SEC, suggested disclosure of waivers of company ethics or conflicts codes and of any conflict of interest involving a senior officer.[33] The idea was simple: the requirement of disclosure of ethics waivers would either prevent such activity or reveal it to the market, which would presumably react negatively.

Some have argued that Section 406 did not increase the risk of liability for Enron-level fraud.[34] They claim that public companies already have an overarching duty to disclose material information to the market under Rule 10b-5, that the board's decisions to waive the company's ethics code and permit Enron's transactions with its CFO were material, and that disclosure was thus required under pre-SOX law.[35] Under this view, Section 406's only value would be in signaling to investors in a highly focused way that something ethically questionable was going on in the company. Whether one

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[31] See S. Comm. on Banking, Housing, and Urban Affairs, Public Company Accounting Reform and Investor Protection Act of 2002, S. Rep. No. 107-205, at 32 (2002).

[32] See Mori, supra note 28, at 299–300.

[33] The Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002: Hearings Before the H. Comm. on Fin. Servs., 107th Cong. 473 (2002) (statement of Richard C. Breeden, Chairman of the Sec. & Exch. Comm'n from 1989–1993), available at http://financialservices.house.gov/media/pdf/040902rb.pdf.

[34] Joshua Newberg observes that Rule 10b-5 requires the disclosure of all material facts, and that in retrospect the waivers themselves were material. Taking Enron as an example, had Section 406 been in effect while the Enron board was granting waivers, the question remains as to what disclosure would have been adequate. He adds, "Indeed, if Enron had disclosed the waivers of its [code], but had not adequately detailed the transactions, material omissions would still seem to exist despite any technical compliance with § 406." Newberg, supra note 30, at 281–82.

[35] Id. at 282 ("Therefore it seems the significance of § 406 is that it will signal interested investors when an issuer grants waivers of its [code], not that it will provide any meaningful *additional* grounds for liability in many cases."). If one views Rule 10b-5 as merely requiring disclosure of facts that would render statements not misleading, then no independent liability would result.

views Section 406's intended effect as minor or major, however, the key question is the same: how well is Section 406's signaling function working? In Section III.C we attempt to answer that question, but first we describe Section 406's requirements in greater detail.

C. The Requirements of Section 406

Congress and the SEC have to walk a fine line when legislating and rulemaking in the corporate ethics sphere. Internal corporate governance is a matter of state law, and state law has focused considerable attention on related-party transactions.[36] Delaware jurisprudence, to take a notable state law example, evolved from a nineteenth-century approach, declaring all transactions between a corporation and its insiders voidable, to a more nuanced approach.[37] Recognizing that transactions between corporation and insider can sometimes be beneficial (as, for example, when a chief executive officer (CEO) loans the corporation money on generous terms), Section 144 of the Delaware code permits such transactions as long as the material facts of the transaction are disclosed to and approved by non-interested directors or shareholders, or the transaction is fair to the corporation.[38]

SOX's ethics waiver provision, then, was seen as an incursion into a traditional domain of state law.[39] As a result, the law's ethics requirement was couched, somewhat awkwardly, as a disclosure mandate. SOX does not require a code of ethics, but it requires either disclosure of any code a company adopts or an explanation of why a company lacks one.

Section 406 requires the SEC to promulgate rules regarding disclosure of codes of ethics for senior financial officers.[40] Importantly,

[36] Z. Jill Barclift, Codes of Ethics and State Fiduciary Duties: Where is the Line?, 1 J. Bus. Entrepreneurship & L. 237, 250 (2008).

[37] Usha Rodrigues, The Fetishization of Independence, 33 J. Corp. L. 447, 467 (2008).

[38] Del. Code Ann. tit. 8, § 144 (2008).

[39] See, e.g., Robert B. Thompson, Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation, 38 Wake Forest L. Rev. 961, 965–66 (2003).

[40] Section 406 of SOX refers to a code that only applies to senior financial officers: the "principal financial officer and comptroller or principal accounting officer," or individuals performing these functions. See 15 U.S.C. § 7264 (2006). The SEC rules added the "principal executive officer," reasoning that CEOs should be held "'to at

SOX directs the SEC to allow disclosure by Form 8-K, "the Internet[,] or by other electronic means."[41] Congress, however, gave no direction as to how long such disclosure must remain on a company's website.

The SEC elaborated on the disclosure requirements of SOX. The SEC's rules require that public corporations disclose whether the company has adopted a code of ethics that applies to the CEO, CFO, and controller or chief accounting officer (CAO).[42] If the corporation does not have such a code of ethics, it is required to explain why not.[43] A corporation wishing to disclose its code may pursue three options: (1) include the code as an exhibit to the annual report; (2) post the code of ethics on its website, having indicated this intention in its annual report, along with the corporation's internet address; or (3) provide it to any person upon request without charge.[44] Thereafter, any amendments to the code, or waivers of the code for specific transactions or matters involving the three named officers, must be disclosed either on a Form 8-K or, if the company has disclosed its intention to do so in its last annual report, on its website.[45] NYSE Euronext and the NASDAQ have similar disclosure requirements for listed companies.[46]

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least the same standards of ethical conduct' as senior financial officers." Newberg, supra note 30, at 277 (quoting Disclosure Required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177, 68 Fed. Reg. 5110, 5118 (2003), *reprinted in* [2002–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,818, at 86,895 (Jan. 23, 2003)).

[41] 15 U.S.C. § 7264 (2006).

[42] See 17 C.F.R. § 229.406 (2008).

[43] Id. Newberg did not find a single instance of corporations electing not to disclose a code of ethics and providing an explanation why not. See Newberg, supra note 30, at 285 n.170. The findings in our sample are consistent with this result, but there are two cases of companies, both struggling economically, that do not disclose a code and offer no explanation for nondisclosure, in violation of the rule. See Table II, infra, Disclosure Methods for Codes of Ethics.

[44] See 17 C.F.R § 229.406 (2008).

[45] Id.

[46] The NYSE requires listed companies to adopt and disclose a code of business conduct and ethics for directors, officers, and employees, and to "promptly disclose *any* waivers of the code for directors or executive officers." NYSE Inc., Listed Company Manual § 303A.10 (2009), available at http://nysemanual.nyse.com (emphasis added). The NASDAQ merely requires that listed companies adopt a code of conduct that complies with the requirements of Sarbanes-Oxley and SEC regulations. NASDAQ Inc., NASDAQ Manual Rule 4350(n) (2006). Some of our sample companies violated the NYSE rule by not disclosing a waiver granted to officers like the

The results of this regulatory regime have been underwhelming, to say the least. Waivers have received little attention in the business press or in legal and economic scholarship. A LexisNexis search[47] revealed a single *Business Wire* story making reference to a waiver, reporting a company press release stating that a director of Patterson Companies, Inc. would resign from the board rather than seek a waiver from the company's code of ethics after his firm invested in a Patterson supplier.[48] The article praises the decision as a commitment to the values and ethics of the corporation. Indeed, it is not even, strictly speaking, a "waiver" story, but rather a story on action taken to avoid the need for a waiver from the company's code.

D. Prior Ethics Waiver Literature

Scant literature exists regarding waivers of ethics codes, and most of it merely speculates on Section 406's effects. Corporate ethics codes generally have been criticized as mere "window-dressing."[49] Several studies appear to cast doubt on these codes' ability to change employee behavior.[50] Along with the generalized fear that ethics codes are ineffectual, there is a more specific concern that the disclosure requirements of SOX have had the unintended effect of causing corporations to weaken their ethics codes.[51]

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chief operating officer, but we did not track violations of exchange rules, only of Sarbanes-Oxley.

[47] We searched the LexisNexis Academic database for news announcements from "U.S. Newspapers & Wires" for the following two terms: "waiver" and "code of ethics." There were seventy-eight search results, of which only one was a company's granting a waiver of the firm's code of ethics.

[48] Patterson Companies Reports Change in Board of Directors, Business Wire, July 29, 2005.

[49] See, e.g., Kimberly D. Krawiec, Cosmetic Compliance and the Failure of Negotiated Governance, 81 Wash. U. L.Q. 487, 487 (2003); Harvey L. Pitt & Karl A. Groskaufmanis, Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct, 78 Geo. L.J. 1559, 1630–31 (1990).

[50] Krawiec, supra note 49, at 511 ("Despite the pervasiveness of ethics codes in corporate America and the insistence by many legal compliance professionals on their importance as a deterrence tool, little evidence exists to support the theory that ethics codes modify employee behavior."). Krawiec observes that the studies finding a significant relationship between ethics codes and employee behavior have methodological flaws. Id.

[51] See Note, supra note 27, at 2135–36.

Soon after SOX's passage, there was speculation that the law's disclosure mandate would increase the chances that companies would soften the language of their codes, constricting the universe of prohibition so that there would be less exposure for failure to reveal a waiver.[52] Indeed, a Practising Law Institute (PLI) publication counsels that "the less frequently a [c]ompany needs to grant waivers, the better."[53] After all, having a code in place and failing to enforce it may well be worse than having no code at all, because management may be seen as openly flouting its own rules.[54] For example, Wal-Mart, a corporation famous for its strict code of ethics, fired marketing executive Julie Roehm for having a personal relationship with a subordinate and receiving gifts, "including liquor and lavish dinners," from suppliers.[55] She responded by suing the company, claiming that it applied a double standard and that Wal-Mart's top executives had also received gifts from vendors.[56] Companies might well conclude that a weaker code of ethics would lead to less liability. In short, Section 406 have a perverse effect: instead of increasing transparency, it may encourage firms to rewrite codes of ethics to minimize the need for any disclosure at all.[57]

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[52] Id. at 2137–38 ("In light of the new disclosure requirements, general counsel may advise the boards of public companies to draft very narrow codes to avoid ever having any waivers to disclose. The aversion to public disclosure stems from the concern that shareholders and regulators will not give due consideration to the beneficial aspects of otherwise prohibited activities that receive waivers, and consequently, that well-informed decisions to grant waivers will be perceived negatively in the market and, even worse, second-guessed in litigation when hindsight proves those business decisions to be poor ones." (footnotes omitted)); see also Manne, supra note 18, at 488.

[53] Russell J. Bruemmer & Leslie Sturtevant, The Influence of Corporate Governance and Codes of Conduct on Effective Compliance Programs, *in* 2 Corporate Compliance Institute 2004, at 129, 147 (Karen S. Guarino et al. eds., 2004). The authors do go on to note that "the code of ethics should not be drafted solely with minimizing waivers in mind, or the code may risk running afoul of the SEC, NYSE, and NASDAQ substantive requirements." Id.

[54] Pitt & Groskaufmanis, supra note 49, at 1643.

[55] James Bandler & Gary McWilliams, Wal-Mart Chief Bought Ring from Firm's Vendor, Wall St. J., May 30, 2007, at A4. "'Instead of working solely in Wal-Mart's interest,' [Ms. Roehm] 'frequently put her own first. She did not merely fail to avoid conflicts of interest, she invited them,'" according to Wal-Mart's court filings. Louise Story & Michael Barbaro, Wal-Mart Fights Back over Firings, N.Y. Times, Mar. 20, 2007, at C1 (quoting Wal-Mart's court filings).

[56] Bandler & McWilliams, supra note 55, at A4.

[57] See Manne, supra note 18, at 488; Note, supra note 27, at 2140. ("Companies will include only the bare minimum needed to comply with the SEC's suggested topics for

Until now, almost no empirical work has been done on the effect of these ethics requirements—neither on disclosure of the codes themselves, nor on waivers granted from the codes. A single study in 2006 limited itself to waivers filed with the SEC and did not explore the possibility of cross-checking with related-party transactions.[58] One of us undertook a limited investigation of waivers filed via 8-K, and this study grew out of that preliminary work.[59]

II. RANDOM SAMPLE

A. Methodology

We examined a sample of firms covered by the Center for Research in Security Prices database (CRSP). From CRSP, we formed ten portfolios of firms based on each firm's market value of equity—the product of the price of the firm's common stock and its shares of common stock outstanding—as of December 2003, the end of the first full year of SOX. We then randomly selected twenty firms from each of the size deciles so that firm size was evenly distributed across all publicly traded companies.

Table I shows the mean and median market value of equity for each decile. Decile one has an average market value of equity of $5 million, and decile ten has an average market value of equity of approximately $11.4 billion.

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a code, and the public filing of codes will not matter because investors will be unable to distinguish one vague, boilerplate code from another.").

[58] See Mori, supra note 28, at 304–05.

[59] See Usha Rodrigues, From Loyalty to Conflict: Addressing Fiduciary Duty at the Officer Level, 61 Fla. L. Rev. 1, 1–2 (2009).

Table I. Market Value of Equity of Random Sample

This table is arranged by decile, sorted from smallest (1) to largest (10). The number of observations within each decile is in the last column. The numbers in the middle two columns are in millions of dollars.

Decile	Mean ($ mil)	Median ($ mil)	Obs.
1	5.0	4.6	20
2	17.3	17.5	20
3	31.6	32.8	20
4	61.0	63.4	20
5	89.7	90.6	20
6	185.1	192.3	20
7	331.9	318.1	20
8	642.0	623.4	20
9	1,567.5	1,467.0	20
10	11,382.1	8,027.5	20

Within each decile there is little industry concentration. There are only two deciles in which there are five firms with the same two-digit Standard Industrial Classification (SIC) code: decile six has five firms in the depository institutions industry (SIC code 60), and decile eight has five firms in the business services industry (SIC code 73), which is a diverse industry containing disparate fields ranging from advertising services to medical equipment leasing.[60] Considering the sample's three largest industries, we find that 12.5% (25) of sample firms are depository institutions, 9.5% (19)

[60] Standard Industrial Classification codes are four-digit numerical codes assigned by the U.S. government to business establishments to identify their primary business. The classification was developed to facilitate the collection, presentation, and analysis of data; and to promote uniformity and comparability in the presentation of statistical data collected by various agencies of the federal government, state agencies, and private organizations. NAICS and SIC Codes, http://www.library.ilstu.edu/page/73 (last visited Oct. 29, 2009).

are in the business services industry, and 8.5% (17) are in the chemical and allied products industry.

B. Code Disclosure

Having identified 200 sample firms, we began our study by examining the disclosure of codes of ethics. We studied whether companies choose to disclose their codes of ethics, the method of disclosure, and how easy it would be for an interested investor to find the code.

1. Compliance

a. Presence of Code

We found that most companies—all but 31 of the 200 sample firms—disclose their codes of ethics. In Panel B of Table II, we describe the 31 firms for which we could not locate a code. Ten companies state that their code of ethics is on their website, but we were unable to locate it there. In nine cases, we found through news sources that the firm either failed or filed for bankruptcy. These companies did not have a working website and are not listed on any exchanges. Five of the firms were involved in a merger, and the surviving firm was significantly different from the firm we initially identified. Two companies reincorporated under a new name. Of the remaining companies, three firms went private and, therefore, the regulations pertaining to publicly filed companies no longer applied to them. Three remained publicly listed on the exchange, but did not have codes of ethics. According to EDGAR, one of these three companies has never made any filings with the SEC, while a second has not filed in more than a year.

b. Method of Disclosure

In Panel A of Table II, we show the ways by which companies make their codes of ethics available to investors. The most onerous disclosure mechanism involves writing to the company's secretary to request a copy of the code. Only five companies in our sample require a written request.

Thirty-three (17%) of our sample firms include a copy of the code of ethics on Form 10-K (a company's year-end filing, often incorporated in its annual report), rather than posting it to the website. We presume that placing the code of ethics in the 10-K makes it less accessible for investors than posting the code on the company website. If 10-Ks are the mode of disclosure, investors must either find the forms on EDGAR, the SEC's public access database containing company financial information, or rely on company websites that list SEC filings (for example, by navigating to a firm's "investor relations" page and clicking on "SEC filings"). Either way, an investor must have enough knowledge of securities filings to know to search for 10-Ks out of the alpha-numeric soup of SEC forms (8-Ks, 10-Q, 14-A, etc.). Thirty-three companies chose to include the code of ethics in their 10-K, 20-F or 40-F.[61]

Almost 66% (131) of the firms in our sample chose to post their code of ethics on their websites, and these firms usually disclose in the 10-K that the code is posted in this way. Eleven companies provide a direct URL to the site where the code is located.

[61] There was one disclosure made via 20-F and one disclosure made via 40-F. These are annual report equivalents for foreign private issuers.

Table II. Disclosure Methods for Codes of Ethics

Description	Number of Observations	% of Total
Panel A. Disclosure Method		
Website	131	65.5%
No Code of Ethics	21	10.5%
10-K, 20-F, 40-F	33	16.5%
False Assertion of Disclosure Could Not Find Code on Web	10	5%
Request Sent to Company Secretary	5	2.5%
Total	200	100%
Panel B. Missing Codes (No Code or False Assertion of Disclosure)		
False Assertion of Disclosure: Could Not Find Code on Web	10	32%
Failed or Disappeared	9	29%
Merged	5	16%
Still Publicly Listed	3	10%
Stock De-listed	2	6.5%
Reincorporated	2	6.5%
Total	31	100%

2. Ease of Discovery

In this Subsection, we consider two quantifications of how difficult it would be to locate a company's code of ethics: 1) the number of documents an investor must navigate and 2) the number of clicks required to find the code.

a. From Document to Document

First, we examined the number of documents an investor must navigate to find a firm's code of ethics. Each document that an investor must view in order to get to the code of ethics is counted as a single "step." Because the required initial disclosure is in Form

10-K, we began there.[62] There was only one step if the company disclosed its code of ethics directly in the 10-K. When the 10-K referred the user directly to the website where the code of ethics was located, finding the code took two steps. Similarly, if the 10-K referred investors to the proxy statement, which contained the code, two steps were required. Finally, in some instances the 10-K referred the user to a proxy statement, which then directed the user to the company website for a copy of the code of ethics, a total of three steps. A large majority of codes, some 79%, could be found in two steps or less.

Table III. Overall Ease of Discovery of Ethics Codes

Number of Steps to Find Ethics Code	Number of Companies	% of Total
1	33	20%
2	96	59%
3	35	21%
Total	164[63]	100%

b. From Click to Click

Successful navigation to a company's website may not end the search for the company's ethics code. A company may "bury" its code within the website, requiring investors to navigate through several pages before finally finding the code itself. To measure this complexity, each webpage that an investor navigates in order to view the code of ethics is counted as a single "click."[64] Table IV

[62] The SEC's requirement that companies disclose their disclosure method in the 10-K presumes that investors start with the 10-K in their quest to find a company's code of ethics. Ethics-minded investors arguably would be more likely to start with the company's website, and this method of discovery is discussed below, in Subsection II.A.2.b.

[63] The total of 164 is derived by subtracting from the original 200 the 21 companies that have no code, the 10 companies for which a code ultimately could not be located, and the 5 companies that require individuals to write to the company secretary in order to receive the code.

[64] We presume that an investor interested in a company's code of ethics would know to click on a link titled "Investor Relations" (or something similar) and then on "Corporate Governance," "Ethics," or a similar link. Of course, an extremely ethics-minded investor could avoid the multiple clicks by simply performing a Google search

summarizes the data we collected on ease of access to website-disclosed codes.

Table IV. Ease of Discovery for Website Disclosed Codes

Number of Clicks to Find Ethics Code	Number of Companies	% of Total
1	4	3.1%
2	27	20.8%
3	64	49.2%
4	18	13.8%
5	4	3.1%
6	2	1.5%
7	1	0.8%
No code found	10	7.7%
Total	130[65]	100%

As Table IV reveals, we found that almost all companies disclose codes, and they are generally easy to find, although a sizable minority (19%) required four or more steps. Arguably the most troubling of our findings was that we failed to locate the codes of ethics of ten companies, notwithstanding the companies' assertions that their codes had been disclosed. In these cases, the company may receive some benefit from claiming to have a code of ethics, even though no investor will ever see it.

C. The Website Problem

Before turning to the subject of waivers, we pause to flag the special problems that website disclosure causes for our study. Normally companies make filings with the SEC, which are imme-

for a company's name, coupled with "code of ethics." Our methodology aims to recreate the browsing of an investor interested in researching a company and exploring its website by clicking through various investor relations materials, but not so focused on ethics that "company name" plus "ethics code" would be the initial search term.

[65] This number adds up to one fewer than the total number of companies that disclosed via website because one company's code of ethics could only be found by searching "backyard burger conduct code" on an internet search engine. This search took one directly to a PDF containing the code of conduct.

diately available for electronic research via the SEC's EDGAR database. While the web likewise provides immediate disclosure, EDGAR archives these disclosures, preserving them for investors, analysts, and researchers in an easily accessible format. Commercial services like 10-K Wizard and LiveEdgar also offer sophisticated searching capabilities at a modest price.

In contrast, internet disclosure is unpredictable and ephemeral. The vagaries of corporate existence mean that many smaller public companies fail or are acquired, taking with them their websites and their codes of ethics. As we discuss in the next Part, waivers pose even more complicated opportunities for gaming the system. In fact, the SEC's Form 8-K instructions only require that a company maintain waiver information on its website for twelve months.[66] Because of these problems, we advocate in Section V.B concurrent EDGAR and website disclosure.

III. SAMPLE WAIVERS

In this Part, we move to the heart of our findings: the disclosure of waivers from the codes of ethics. We first examine the means of waiver disclosure, and then discuss the lone waiver we found for the 200 sample firms over the five surveyed years. We then examine all the related-party transactions that the 200 sample firms reported in their year-end proxy statements and crosscheck to see whether these firms fail to report waivers when required to do so. We close by discussing the unusual case of three Viacom waivers that, although not a part of our sample, raise important issues regarding the operation of Section 406.

A. Means of Disclosure

Along with disclosing their code of ethics, companies must indicate how waivers of the code will be disclosed. Ninety-two of the 200 companies, or 46% of the sample, indicate that ethics waivers will be made on their website. Three companies indicate that they will disclose waivers via Form 8-K.[67] Forty-six companies, or 23%

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[66] Sec. & Exch. Comm'n, Form 8-K: General Instructions 17 (2008), available at http://www.sec.gov/about/forms/form8-k.pdf.

[67] None of these companies, however, chose to set out their code of ethics in their 10-Ks.

of the sample, do not specify a means of disclosure, but the SEC's rules require affirmative disclosure of an intention to disclose waivers on a website, so silence signals a commitment to use the SEC form, the 8-K.[68] Twenty-one companies did not publish a code of ethics, so we categorize their disclosure method as "not applicable." The remaining 38 companies simply state that disclosure will be made by "some approved means," without indicating further what means they will use. This last set of companies create a special risk of confusion for investors, who are left facing the possibility that the firm will use 8-Ks, the company website, or some other undefined disclosure mechanism that might be "approved"—either by the SEC, by the relevant stock exchange, or perhaps even by the company itself.

Table V summarizes the data we gathered regarding the chosen means of waiver disclosure.

Table V. Disclosure of Waivers

	Number of Companies	% of Total
Disclosure via Website	92	46%
8-K	3	1.5%
Silent	46	23%
Not Applicable	21	10.5%
Some Approved Means	38	19%
Total	200	100%

B. Single Disclosed Waiver

Of our sample of 200 companies over five years, we found evidence of *only one* waiver disclosure. BioTime, Inc., a biotechnol-

[68] See 17 C.F.R. § 229.406(d) (2008) ("If the [corporation] intends to satisfy the disclosure requirement under Item 10 of Form 8-K regarding an amendment to, or a waiver from, a provision of its code of ethics that applies to the [corporation's] principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and that relates to any element of the code of ethics definition enumerated in paragraph (b) of this Item by posting such information on its Internet website, [the corporation must] disclose [its] Internet address and such intention.").

ogy firm, disclosed a waiver on October 10, 2007, in a Form 8-K filed with the SEC.[69] BioTime's CEO, Dr. Michael West, had recently been hired from his position as President and Chief Scientific Officer at Advanced Cell Technology, a "potential" competitor of BioTime. BioTime's code of ethics prohibited its employees from holding a financial interest in or consulting with a competitor. The BioTime board granted a waiver to allow Dr. West to consult for Advanced Cell Technology and serve on its board through the end of the year. In addition, it allowed him to hold common stock and stock options in Advanced Cell Technology.

In our view, this sample waiver is relatively innocuous and far removed from the corporate misbehavior that brought about Enron's downfall. If a company hires an officer from within its industry, it is to be expected that it might look to a competitor or "potential competitor," and that the hired officer might have stock or options in his or her ex-employer. To be sure, the BioTime waiver also authorized continued consulting and board service for the potentially competing firm. The permitted service for "two masters," however, lasted only three months and was understandable as a transition device.

C. Compliance Assessment: Related-Party Transactions

There are several explanations for the absence of waiver disclosure in our sample. First, companies might be extremely ethical, and may not engage in the kinds of transactions that require disclosure. Second, companies that might otherwise engage in unethical conduct may be dissuaded from such conduct by the prospect of SOX-mandated disclosure. Third, companies may not be preserving website waivers long enough for us to detect them; indeed, the SEC only requires waiver publication via website for twelve

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[69] The full text of the waiver states:

> BioTime's Code of Ethics states that employees should not provide consulting services to a competitor or hold a financial interest in a competitor. BioTime has granted Dr. West [CEO] a waiver from that provision of its Code of Ethics with respect to the Advanced Cell Technology, Inc. common stock and stock options he owns. Dr. West may also provide certain consulting services to his former employer and to [sic] remain on its board of directors until December 31, 2007. Advanced Cell Technology, Inc. is a potential competitor of BioTime in [the] field of regenerative medicine and stem cell technology.

Biotime, Inc., Current Report (Form 8-K), at 5 (Oct. 10, 2007).

months, so that waivers in the first three years of the study might have been legitimately removed from public view.[70] Finally, the undesirable conduct still may be occurring, while simply not being disclosed as required by Section 406. This last possibility is difficult to prove precisely because the required disclosure is not being made.

The overlap of different securities disclosure regulations, however, creates an alternative way to measure compliance with Section 406's disclosure requirements. Item 404 of Regulation S-K requires disclosure in a company's 10-K[71] of any transaction or proposed transaction in which the corporation "was or is to be a participant and the amount involved exceeds . . . $120,000 . . . and in which any related person had or will have a direct or indirect material interest."[72] "Related persons" are defined as: (a) a corporation's current or nominated directors and executive officers, and their immediate family;[73] or (b) a person or group known to be the beneficial owner of more than 5% of the corporation's voting securities, or their immediate family.[74] Related-party transactions must be disclosed annually in a company's 10-K or its proxy statement[75]—in contrast to waivers of a company's code of ethics under

[70] One inherent weakness of our study is, of course, the transient nature of website disclosure. We studied the disclosures companies made or should have made one to five years in the past. While filings with the SEC create a permanent archive, website disclosure is ephemeral. Thus, some of our violations might have been properly disclosed via website, but permissibly removed after twelve months. Still, we conducted our study in the summer of 2008; presumably, if companies were appropriately disclosing waivers, we would have found at least some from 2007 and early 2008. The fact that we found none, coupled with the fact that only 45% of our sample opted for website disclosure at all, leads us to conclude that noncompliance is probably common.

[71] Item 13 of Form 10-K requires compliance with Item 404 of Regulation S-K. Sec. & Exch. Comm'n, Form 10-K: General Instructions 11 (2009), available at http://www.sec.gov/about/forms/form10-k.pdf.

[72] See SEC Item 404, 17 C.F.R. § 228.404 (2008).

[73] "Immediate family" is defined as "any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law of such director, executive officer or nominee for director, and any person (other than a tenant or employee) sharing the household of such director, executive officer or nominee for director." Id.

[74] See Instructions to SEC Item 403, 17 C.F.R. § 228.403 (2008); SEC Item 404, 17 C.F.R. § 228.404(a) (2008).

[75] Securities law allows a firm's Form 10-K to incorporate by reference its definitive proxy statement, if such statements are filed with the Commission within 120 days af-

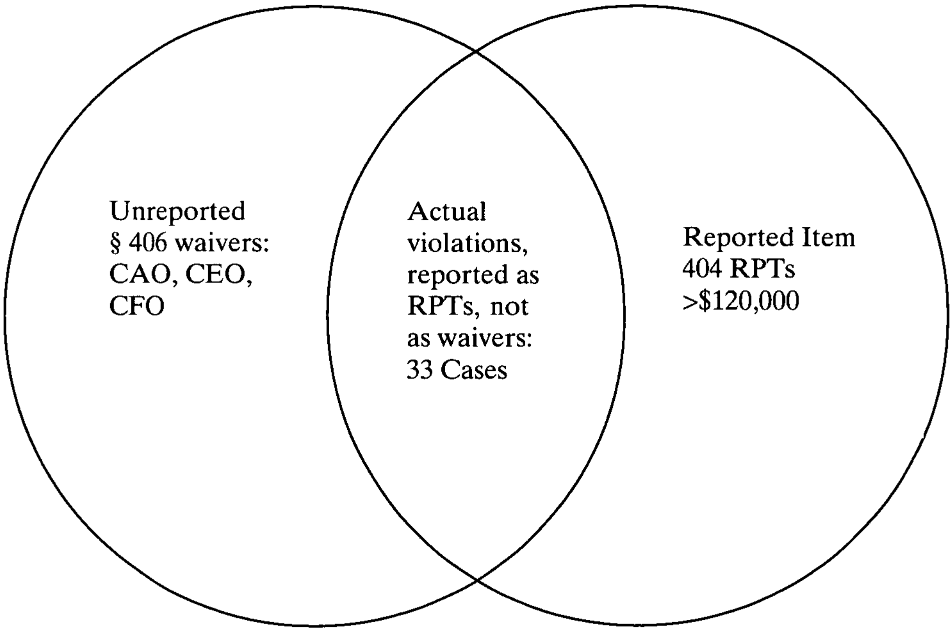
Section 406, which must be disclosed within four business days on a Form 8-K or on the company's website.[76]

The fit is not perfect. Section 406 and Item 404 differ with regard to the individuals covered, and the amount and nature of transactions to be disclosed. Even so, the overlap is substantial. Codes of ethics generally should ban related-party transactions with senior officers (although, as we note in Subsection III.C.2, not all do). Item 404 applies to all related-party transactions over $120,000 between the corporation and a relatively large set of corporate insiders. Section 406 targets senior financial officers (the CEO, CFO, CAO, or officers performing similar duties), and each of these persons is clearly a corporate "executive officer" for purposes of Regulation S-K. Given this commonality of coverage, we reviewed all reported related-party transactions for the sample companies from 2003–2007. We then pulled out and analyzed the subset of transactions involving Section 406 level officers. We compared them with the reported codes of ethics for the sample companies. With one exception, *we found no evidence that any of these transactions were disclosed as a waiver, even when Section 406 clearly required disclosure.* See Figure 1.

ter the end of the fiscal year covered by the registrant's Form 10-K. Most of the related-party transactions we found were, in fact, reported in proxy statements. See Nowak, supra note 6, at 409 ("Part III of Form 10-K is essentially parallel to the proxy statement disclosure required by Regulation 14A. Accordingly, such information may be incorporated by reference to the registrant's definitive proxy or information statement involving the election of directors.").

[76] See 17 C.F.R. § 249.308 (2008); Sec. & Exch. Comm'n, Form 8-K: General Instructions 2 (2008), available at http://www.sec.gov/about/forms/form8-k.pdf.

Figure 1



1. Actual Violations

Out of 200 sample companies, 16 companies appear to have violated SOX.[77] The total number of actual violations for all companies was 33. The number of actual violations is as follows:

[77] Sometimes firms disclose related-party transactions that occurred in prior years. Therefore, a single transaction might be disclosed on three successive proxy statements. We have counted a single transaction as one violation of Section 406, on the theory that Section 406 is a one-time disclosure requirement. If the transaction is "ongoing" (that is, a multi-year loan or an interlocking director position), however, we do not treat each subsequent disclosure as another violation. In other words, we presume that Section 406 is focused on getting information to the market quickly and Item 404 is more focused on providing a snapshot of the related-party transactions in which a company currently engages.

Table VI. Actual Violations

Type of Transaction	Number of Transactions
Asset Sales	6
Family Hires	9
Leases	5
Loans	6
Other	2
Services	5
Total	33

"Asset sales" occur when the company purchases assets from an officer or an entity controlled by an officer, or when an officer or an entity controlled by an officer makes a purchase from the company. These sales present problems because of the conflict of interest that arises in determining the terms of the sale. In one example of an asset sale, the company purchased a London condo from its CEO for $12.5 million.[78]

"Family hires" occur when a company hires a member of an officer's family for a position within the company or the company uses a family member's services. These hires present conflicts because the terms of the employment agreement may seem unduly favorable, the family member may appear to be (or actually be) unqualified for the position, or the service provider may be receiving a premium over market rates or providing sub-par services. In a typical example of a family hire, a company hired the stepson of its co-CEO as the Vice President of Franchise Development, at an annual salary of $95,000.[79] The same company also used the brother

[78] DSG Int'l., Definitive Proxy Statement (Form DEF 14A), at 5 (Oct. 13, 2004). DSG's ethics code forbids "[m]aintaining financial interest even if passive in any organization doing business with the Company." DSG Int'l., The Company's Business Code Of Conduct Policy (Ex. 10.1 to Form 20-F), at 2 (June 16, 2003).

[79] See Cal. Pizza Kitchen, Inc., Definitive Proxy Statement (Form DEF 14A), at 20 (May 1, 2006). California Pizza Kitchen's ethics code states, "there is a likely conflict of interest if you: [c]ause CPK to engage in business transactions with your relatives or friends," and that "[a]ny waiver of this Code for executive officers or directors may be made only by the Board of Directors or Audit Committee and will be promptly disclosed to the public as required by law and the Nasdaq rules." Cal. Pizza Kitchen, Inc., Code of Ethics and Business Conduct for Employees, Officers and Directors 2, 9,

of its co-CEO as a real estate broker, paying $71,000 in 2003,[80] $76,165 in 2002, and $145,143 in 2001.[81]

In the category of "leases," the corporation usually rents property, either real or personal, to or from an officer of the corporation. In one case, for example, a company leased a branch office in Alabama from a corporation in which the President and CEO of the company owned a minority interest and was president.[82]

Many corporations enter into lending arrangements with insiders. Some loans involve transactions in which an officer or director extends credit to the corporation, thereby securing the benefit of interest payments. More commonly, corporations lend money to insiders. Making loans can be problematic, however, if the loans are made in terms unfavorable to the corporation or if they reduce ready cash flow for corporate use.[83] In one example from the "loan" category, the company had provided a revolving loan in an amount not to exceed $1,500,000 to an entity in which the CEO owned a substantial interest.[84]

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http://media.corporate-ir.net/media_files/irol/12/122300/Code_of_Ethics103108.pdf (last visited Nov. 1, 2009).

[80] Cal. Pizza Kitchen, Inc., Definitive Proxy Statement (Form DEF 14A), at 20 (May, 1 2006).

[81] Cal. Pizza Kitchen, Inc., Definitive Proxy Statement (Form DEF 14A), at 44 (June 18, 2004). Recall that this company's code of ethics states, "there is a likely conflict of interest if you: [c]ause CPK to engage in business transactions with your relatives of friends." Cal. Pizza Kitchen, Inc., Code of Ethics and Business Conduct for Employees, Officers and Directors 2, http://media.corporate-ir.net/media_files/irol/12/122300/Code_of_Ethics103108.pdf (last visited Nov. 1, 2009).

[82] Charter Fin. Corp., Definitive Proxy Statement (Form DEF 14A), at 4, 21 (Jan. 28, 2004). Its ethics code states that "[n]o officer or employee should have any personal business dealings with the Company or its subsidiaries except as a customer for financial services.... Investments and dealings prohibited to Charter officers and employees should be avoided by the members of the employee's family." Charter Fin. Corp., Conflict of Interest Policy and Code of Conduct (Ex. 14 to Form 10-K) (Dec. 22, 2003).

[83] Section 402 of Sarbanes-Oxley prohibits loans to executives. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 402, 116 Stat. 745, 787 (codified at 15 U.S.C. § 78m(k) (2006)) ("It shall be unlawful for any issuer . . . directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer."). It is unclear whether the loans in this category have been structured to avoid violation of Section 402, or whether they are violating the provision.

[84] Mun. Mortgage & Equity LLC, Annual Report (Form 10-K), at 72–73 (June 22, 2006). The Code of Ethics for Senior Financial Officers, Mun. Mortgage & Equity,

2. *Gaming the System*

Many of the surveyed companies use the slippage between Section 406's waiver requirements and Item 404's related-party transaction requirements to their advantage. Most of the surveyed companies do not ban "related-party transactions" in their code of ethics.[85] Section 406, remember, requires nothing more than reporting of waivers to a company's own particular code of ethics. If the code is "diluted," so that it fails to prohibit related-party transactions, then it would appear no waiver is needed.[86] Although these related-party transactions occur frequently, by virtue of their omission from the code of ethics, the companies can—at least so it would seem—avoid altogether mandatory near-real-time disclosure of these transactions via their websites or 8-Ks.

LLC, Code of Ethics for Senior Financial Officers, http://www.munimae.com/aboutMuniMae/docs/CodeOfEthics-SeniorOfficers.pdf (last visited Oct. 26, 2009), requires compliance with Code of Ethics and Principles of Business Integrity, which provides:

> You are expected to avoid any situation in which your personal interests conflict, or have the appearance of conflicting, with those of the company.... Loans to, or guarantees of obligations of, directors, officers and employees are of special concern.... For directors and executive officers, advance disclosure to and approval by the Chief Executive Officer, Chief Financial Officer and the disinterested members of the Board of Directors are required.... *Any waiver of the Code for executive officers or directors of the Company may be made only by the Company's Board of Directors or by a committee of the Board of Directors and must be promptly disclosed to the Company's shareholders.*

Mun. Mortgage & Equity, LLC, Code of Ethics and Principles of Business Integrity 4–5, 12, http://www.munimae.com/aboutMuniMae/docs/CodeOfEthics.pdf (last visited Oct. 26, 2009) (emphasis added). While the actual amount loaned never exceeded $900,000, we characterize the provision of a $1.5 million revolving line of credit as a loan.

[85] Only 30 companies include related-party transactions within their code of ethics.

[86] Parallel literatures exist on, for example, website privacy policies. See, e.g., Corey A. Ciocchetti, E-Commerce and Information Privacy: Privacy Policies as Personal Information Protectors, 44 Am. Bus. L.J. 55, 68–69 (2007); Allyson W. Haynes, Online Privacy Policies: Contracting Away Control over Personal Information?, 111 Penn St. L. Rev. 587, 612–13 (2007); James P. Nehf, Shopping for Privacy Online: Consumer Decision-Making Strategies and the Emerging Market for Information Privacy, 2005 J.L. Tech. & Pol'y 1, 4–5 (2005). For a parallel analysis of the No Child Left Behind Act, see James E. Ryan, The Perverse Incentives of the No Child Left Behind Act, 79 N.Y.U. L. Rev. 932, 944 (2004). In each case, the law permits the entity to create the standard to which it will ultimately be held, thus encouraging the elucidation of a weak standard in the first instance.

A close reading of the Act suggests, however, that this tactic may be illegitimate. Section 406(c) of the Act defines "code of ethics" as follows:

> [T]he term "code of ethics" means such standards as are *reasonably necessary* to promote—
>
> (1) honest and ethical conduct, *including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships*;
>
> (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and
>
> (3) compliance with applicable governmental rules and regulations.[87]

It may be that, by omitting related-party transactions from their codes of ethics, companies are in violation of Section 406(c)(1), because prohibiting related-party transactions is "reasonably necessary" to promote "ethical handling of actual or apparent conflicts of interest between personal and professional relationships." At the very least, these codes violate the intention or "spirit" of Section 406's disclosure requirements. As discussed in Section I.B, Section 406's waiver provision was specifically enacted to address Enron's related-party transactions with its CFO, Andy Fastow. Yet the majority of our sample companies do not forbid related-party transactions in their codes.

Instead, companies tend to have generic "conflicts of interest" provisions.[88] And even when the provisions address related-party transactions, they use "weasel wording" that makes it hard to find an actual violation. For example, a code may say that choosing a

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[87] 15 U.S.C. § 7264 (2006) (emphasis added). The SEC's final rules elaborated on the Act's requirements, providing that, in addition to the legislatively mandated requirements, the code must provide for "(4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and (5) Accountability for adherence to the code." 17 C.F.R. § 229.406(b) (2008).

[88] Note, however, that one code does not even address conflicts of interest at all. See Telava, Inc., Code of Ethics (on file with authors).

service provider because of family relationship is a conflict[89] or forbid a company employee from dealing directly with a supplier who is also a relative.[90] Companies are sure to argue that these codes do not require waivers for related-party transactions. In the first case, a service provider can be a family member, as long as the hiring did not occur "because of" the relationship. In the second, as long as the CFO is not *directly* dealing with his spouse's company, there is no violation, even if the corporation is sending millions of dollars of business her way. Ironically, the SEC initially proposed rules that required companies to address "[a]voidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict"[91]—wording that at least invokes related-party transactions—in their ethics codes. The SEC, however, eliminated this requirement in the final rule "because the conduct addressed by this component already is addressed by the first prong of the proposed definition, requiring honest and ethical conduct and the ethical handling of actual and apparent conflicts of interest."[92]

There is much room to criticize the SEC's retreat in this area because there is evidence that some related-party transactions significantly reduce shareholder wealth. In particular, stockholders react negatively when (1) a related-party transaction is initiated *after* the

[89] Devry Inc., Code of Business Conduct and Ethics, http://www.devryinc.com/corporate_information/pdfs/code_of_conduct.pdf (last visited Oct. 26, 2009) (Forbidding "[d]irecting business to a supplier based on the fact that the supplier is owned, managed by or employs a relative").

[90] See, e.g., Ocean Bio-Chem, Inc., Code of Ethics (Ex. B to Form DEF 14A), at 2 (Apr. 13, 2004) ("Unless approved in advance by an employee's supervisor, neither an employee nor his or her spouse, domestic partner, or any other member of the employee's immediate family may directly or indirectly have a financial interest (whether as an investor, lender, employee or other service provider) in a competitor, or in a customer or supplier *if that employee or his or her subordinates deal directly or indirectly with that customer or supplier in the course of his or her job with the Company.*") (emphasis added).

[91] Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 46,701, 67 Fed. Reg. 66,208 (2002), *reprinted in* [2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,733, at 86,352 (Oct. 22, 2002) (footnotes omitted).

[92] Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 47,235, 68 Fed. Reg. 5110, 5118 (2003), *reprinted in* [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,828, at 86,896 (Jan. 29, 2003).

counterparty becomes related to the firm; and (2) a transaction entails the handing down of executive positions to family members.[93] Also, researchers have found that firms that engage in certain related-party transactions are more likely to manage earnings, possibly to mask expropriation occurring through the related-party transaction.[94] Finally, a recent study suggests that Hong Kong-listed firms acquire assets from related parties at prices that are higher, and sell assets to them at prices that are lower, than in similar deals that are arm's-length transactions.[95] When viewed as a whole, this evidence suggests that firms should police transactions of this kind closely.

3. *"In Spirit" Violations*

Whatever results sound policy might support, the practical reality is that Section 406's reach is limited. In particular, even though Section 406 came as a response to Enron's board-approved related-party transactions, many companies omit these transactions entirely from their codes of ethics. Arguably, these companies hurt only themselves, because the market will internalize the weakness of their codes of ethics, and discount stock prices accordingly. But for our purposes, these "in spirit" violations show how easily and routinely companies can evade the intent of regulation when it is couched in terms of disclosure.

Consider this example: DHB Industries, Inc. subleased a facility from an LLC controlled by the CEO's wife and beneficially owned by his minor children. Payments to the LLC were $682,000 in 2003.[96] DHB also bought $29 million of products from a company owned by the CEO's wife, and $560,000 in services from a third

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[93] See Michael D. Ryngaert & Shawn E. Thomas, Related Party Transactions: Their Origins and Wealth Effects 3–4, 30–31 (Sept. 20, 2007) (unpublished manuscript, available at http://ssrn.com/abstract=970689).

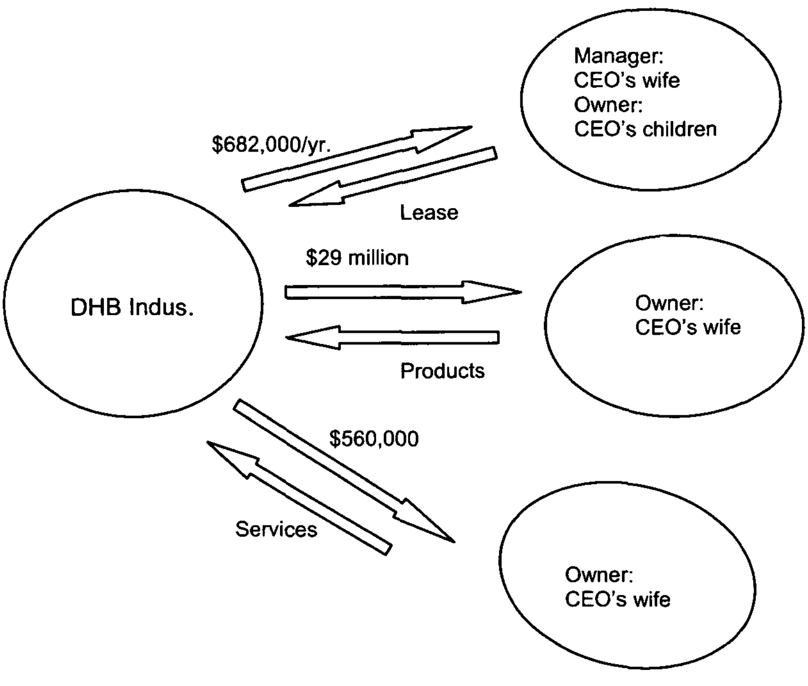
[94] See Elizabeth A. Gordon & Elaine Henry, Related Party Transactions and Earnings Management 4–8, 25–26 (Nov. 9, 2005) (unpublished manuscript, available at http://ssrn.com/abstract=612234).

[95] See Yan-Leung Cheung et al., Buy High, Sell Low: How Listed Firms Price Asset Transfers in Related Party Transactions, 33 J. Banking & Fin. 914, 915, 923–24 (2009).

[96] DHB Capital Group Inc., Definitive Proxy Statement (Form DEF 14A), at 13–14 (Nov. 24, 2004). Note: in an apparent re-branding move, DHB changed its name after the fraud allegations emerged. See infra note 101.

company owned by the wife in 2003.[97] See Figure 2. DHB's ethics code provides, however, that "[c]onflicts of interest are prohibited . . . except under guidelines approved by the Company's Board of Directors."[98] Because we do not know what the guidelines state, we cannot classify this as an actual violation. (Incidentally, the CEO also charged more than $2 million of non-business expenses on company credit cards[99] and was eventually charged with fraud.[100])

Figure 2



[97] DHB Capital Group Inc., Definitive Proxy Statement (Form DEF 14A), at 14 (Nov. 24, 2004).
[98] DHB Industries, Inc., Code of Business Conduct and Ethics (Ex. 14 to Form 10-K), at 3 (Mar. 17, 2005).
[99] DHB Capital Group Inc., Definitive Proxy Statement (Form DEF 14A), at 7 (Nov. 24, 2004).
[100] Press Release, Sec. & Exch. Comm'n, SEC Charges Former CEO of Military Body Armor Supplier With Financial Fraud and Insider Trading (Oct. 25, 2007), available at http://www.sec.gov/news/press/2007/2007-221.htm.

In 70 instances, the company reported a related-party transaction in proxy materials, but its code of ethics did not prohibit the transaction so as to trigger a disclosure obligation under Section 406. Unfettered by the latter constraint, the companies were free to delay reporting these transactions until their annual filings, rather than filing a waiver to the codes of ethics within four business days of the transaction. We term this an "in-spirit violation," because while the nondisclosure of a waiver may not technically violate SOX, it violates the spirit of the Act by permitting transactions involving conflicts of interest at the highest levels of the corporate organization.[101] Out of 200 companies, 45 violated the spirit of the Sarbanes-Oxley Act. Once again, Table VII breaks down the types of transactions into separate categories—namely asset sales, family hires, interlocking positions, leases, loans, products, and services.

In one example of an "in spirit" asset sale violation, Atlantic Tele-Network, Inc.'s board of directors authorized discussions regarding the sale of all of its remaining assets in the corporation's business in Haiti, including an office building and thirteen tower sites, to its Chairman. The Chairman was also the father of Atlantic Tele-Network's Chief Executive Officer.[102] Because Atlantic Tele-Network's code of ethics did not prohibit related-party transactions and required merely reporting a conflict of interest to the company's general counsel,[103] it was able to delay disclosure of the sale for almost a full year.[104]

American Pacific Corp. provides an example of a family-hire "in spirit" transgression. That firm was a 70% holder of a corporation in which the CEO's brother, sister-in-law, and nephew were minority holders. This other company also leased space to American Pacific.[105]

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[101] For this discussion we leave to one side the question whether the Act actually permits omitting related-party transactions from codes of ethics.

[102] Atlantic Tele-Network, Inc., Definitive Proxy Statement (Form DEF 14A), at 30 (Apr. 30, 2007).

[103] Atlantic Tele-Network, Inc., Code of Ethics, http://www.atni.com/corp_gov.php#coe (last visited Oct. 26, 2009).

[104] The transaction occurred in May 2006, and the disclosure was filed in April 2007. See Atlantic Tele-Network, Inc., Definitive Proxy Statement (Form DEF 14A), at 30 (Apr. 30, 2007).

[105] American Pacific Corp., Preliminary Proxy Statement (Form DEF 14A), at 6, 15 (Jan. 28, 2005). Its ethics code provides that "[n]o director or employee of the Company shall have any outside business or financial interest, direct or indirect, in any

"Interlocking positions" occur when an officer is also an officer, director, partner, or employee of a company that either provides services to the corporation, does business with the corporation, or is in competition with the corporation. Interlocking positions are problematic because the officer or director serving in an interlocking position has fiduciary duties to different companies whose interests may conflict. In one example of interlocking positions, Atlantic Tele-Network acquired a significant minority interest in, and provided funds to, LighTrade, Inc. Atlantic Tele Network's CEO was also an officer of LighTrade, Inc.[106]

In one example of a lease that was a violation "in spirit," Granite City Food & Brewery entered into a leasing agreement for equipment. The agreement was with an entity in which Granite City's CEO had a substantial interest.[107]

In a loan example, Atlantic Tele-Network acquired a significant minority interest in LighTrade and wrote off $570,000 of secured loans as uncollectible. The company's Chairman, the CEO's father, had invested at least $600,000 in LighTrade.[108]

The "products" category encompasses instances in which the firm purchases products from or sells products to an entity in which one of its executive officers has a substantial interest. For example, Calavo Growers, Inc. bought papayas from an entity owned by the company's CEO for $2.92 million in one year.[109] Using a form of "trust us" disclosure described more fully below in Subsection III.C.5, the corporation stated that because some of its directors, officers, and employees grow produce and enter into marketing

Outside Concern or Competing Concern, which conflicts with the interests of the Company, or which interferes with his or her ability to fully perform his or her job responsibilities." American Pacific Corp. & Subsidiaries, Standards of Business Conduct, http://media.corporate-ir.net/media_files/irol/78/78284/StandardsBusinessConduct.pdf (last visited Oct. 26, 2009). But it does not cover the relatives of employees, so there is no actual violation when the minority holders are the CEO's brother, sister-in-law, and nephew.

[106] Atlantic Tele-Network, Inc., Definitive Proxy Statement (Form DEF 14A), at 17 (Apr. 18, 2006).

[107] Granite City Food & Brewery Ltd., Definitive Proxy Statement (Form DEF 14A), at 35 (Sept. 25, 2007).

[108] Atlantic Tele-Network, Inc., Definitive Proxy Statement (Form DEF 14A), at 17 (Apr. 18, 2006).

[109] Calavo Growers, Inc., Definitive Proxy Statement (Form DEF 14A), at 15 (Mar. 1, 2004).

agreements with Calavo, there would be no violations requiring waivers "as long as the terms of the agreements are no more favorable to the directors, officers and employees than agreements that we enter into with third parties."[110] While these transactions might indeed have been market-priced, investors are left to trust the company's assertion without recourse to the facts of the particular transaction.

Table VII. "In Spirit" Violations

Type of Transaction	Number of Transactions (Excluding Actual Violations)
Asset Sales	16
Family Hires	16
Interlocking Positions	1
Leases	8
Loans	7
Products	5
Services	13
Other	4
Total	70

4. Repeat Players

Perhaps unsurprisingly, we find that companies who violate Section 406 once tend to do so multiple times.[111] Of 37 companies violating at least once, 17 do so more than once. DHB Industries, the corporation discussed above in Figure 2, had six violations (all "in spirit") over the sample period. DHB's former CEO and COO were each charged with securities fraud, insider trading, tax eva-

[110] Calavo Gowers, Inc., Code of Business Conduct and Ethics, http://www.calavo.com/CALAVO%20Ethics%20Policy.pdf (last visited Oct. 26, 2009).

[111] The reader may have noted that one company, Atlantic Tele-Network, appears repeatedly in the previously listed examples.

sion, and other criminal offenses; the SEC also filed a civil complaint against the former CEO accusing him of similar violations.[112]

5. "Trust Us"

Finally, we treat as a separate category "trust us" disclosures involving banks and two other companies. Most banks disclosed that they made loans or had commercial relationships with their officers and directors. They did not disclose the individual recipients of the loans or the amounts received, but rather made blanket disclosures such as that loans to executive officers were made "on substantially the same terms . . . as those prevailing at the time for comparable transactions with other persons."[113] We group these disclosures separately, since we are unable to determine whether the CEO, CFO, or CAO received loans, or what the terms and amounts were. Some banks specified the total of these "insider loans," which in one case was as low as $418,666, and in another case was as high as $33 million, representing "approximately 1.4% of consolidated stockholders' equity."[114] One company included this singularly unhelpful disclosure:

> From time to time in the ordinary course of business, the Company does business with and/or engages in other transactions between itself and certain affiliated parties. Management of the Company believes that such dealings and transactions are immaterial in nature and have been on terms no less favorable to the Company than those that could have been obtained from unaffiliated parties.[115]

[112] Press Release, Sec. & Exch. Comm'n, SEC Charges Former CEO of Military Body Armor Supplier With Financial Fraud and Insider Trading (Oct. 25, 2007), available at http://www.sec.gov/news/press/2007/2007-221.htm; Robert E. Kessler, Point Blank Founder Held; Ex-CEO Arrested, Charged With Looting Company, Sun-Sentinel, Oct. 26, 2007, at 1D.

[113] Pacwest Bancorp, Definitive Proxy Statement (Form DEF 14A), at 39 (Apr. 11, 2007); see also Charter Fin. Corp., Definitive Proxy Statement (Form DEF 14A), at 21 (Jan. 28, 2004).

[114] Associated Banc-Corp, Definitive Proxy Statement (Form DEF 14A), at 31 (Mar. 11, 2008); Charter Fin. Corp., Definitive Proxy Statement (Form DEF 14A), at 21 (Jan. 28, 2004).

[115] See Back Yard Burgers, Inc., Definitive Proxy Statement (Form DEF 14A), at 15 (Apr. 19, 2004).

We place these kinds of disclosures in a separate category because they show that the corporation conducts business with its insiders without disclosing the specifics. On one hand, these companies signal that related-party transactions do occur, but on the other hand they assure investors that these "inside deals" are identical to arm's-length transactions. This practice is the ultimate non-transparent disclosure. The whole premise of related-party disclosure—indeed, of all disclosure—is that the devil is in the details; such imprecise disclosure makes a mockery of the requirements by not giving the market concrete information.

Table VIII.

Type of Transaction	Number of Transactions
Banks	12
Other	2

6. *Assessing the Extent of Actual Harm to the Market*

Whether an undisclosed deal involves an asset purchase, family purchase, lease, or loan, or whether a company just asks the public to "trust us," a predictable response to the pattern of waiver disclosure described above is "no harm, no foul." On this view, even though insider transactions are not disclosed as waivers under Section 406, they *are* being disclosed, as Congress intended, by way of publicly available proxy materials.

There are, however, significant problems with this "so what?" response. First and foremost, immediate disclosure differs from eventual disclosure. Any investor or would-be investor would want to know about related-party transactions[116]—one of the starkest conflicts of interest within a corporation—immediately; otherwise, that person might well rely on the absence of such information during the very time it is held back. Presumably, for this reason, Section 406 requires near-real-time 8-K or website disclosure for CEO-level waivers. Item 404, in contrast, channels information to investors only *once a year*, in the 10-K or proxy. In short, by not

[116] Related-party transactions occur when a company completes a transaction with directors or officers or their family members.

reporting CEO-level transactions as conflict waivers, companies may delay disclosure by a year; in almost all cases the delay will far exceed the brief four-day period established by Section 406.

Furthermore, proxy statements contain information that ranges far beyond related-party transactions. Typically, they set forth stock option plans, biographies of directors, executive officers, promoters and control persons, executive compensation, stock holdings of large shareholders and management, issues to be voted on, and accounting fees and services. Thus, proxy disclosure is muddled disclosure, providing companies with the opportunity to obscure negative information by disclosing it along with a plethora of other matters. If investors have a large amount of information to process and only limited time and attention (as they do), then disclosing information in a "noisy" setting may distract investors from otherwise pertinent information.[117] Notably, there is evidence that such behavior marks accounting disclosure and reporting choices.[118] And if diversionary disclosure occurs in these contexts, why should it not occur in providing information about self-dealing transactions?

The Subsections below discuss variations of the "no harm, no foul" objection. Subsection III.C.6.a discusses the possibility that separate SEC rules might have the effect of requiring disclosure of insider transactions in the four-day 8-K timeframe, and concludes that most disclosure is, in fact, delayed. Subsection III.C.6.b addresses the possibility that firms might be predisclosing insider transactions, so that, rather than being delayed, information in the proxy is brought to the market *before* the transactions occur. Similarly, we find that most companies do not practice ex ante disclosure. We conclude that Section 406 disclosure practice, in contravention of the law, truly does delay the process of revealing insider transactions to the marketplace.

[117] For more on this phenomenon, see generally Daniel Kahneman, Attention and Effort (1973).

[118] David Hirshleifer & Siew Hong Teoh, Limited Attention, Information Disclosure, and Financial Reporting, 36 J. Acct. & Econ. 337, 339–44 (2003).

a. Immediate Disclosure Not Identified as Ethics Waiver

Our findings present the twin problems of disclosure delayed and disclosure mislabeled. Transactions that should be disclosed on Form 8-Ks within four business days after occurrence and identified as waivers are instead not disclosed until the year-end proxy statement and, in consequence, are buried among other information. Such delay and obfuscation might be avoided, however, if other SEC rules required 8-K disclosure of related-party transactions.

Notably, under already existing law some related-party transactions must be disclosed almost immediately. Item 1.01 of Form 8-K requires firms to disclose via 8-K the entry into a "material definitive agreement" not made in the ordinary course of business. The instructions elaborate that all agreements (regardless of whether they are in the ordinary course of business) must be disclosed via 8-K if they involve, among other issues, "*[a]ny contract* to which directors, *officers*, promoters, voting trustees, security holders named in the registration statement or report, or underwriters *are parties* other than contracts involving only the purchase or sale of current assets having a determinable market price, at such market price."[119] Thus—as Figure 3 highlights—a subset of the related-party transactions we found were, or should have been, disclosed within four business days both in Form 8-Ks as material definitive agreements and separately as ethics waivers.

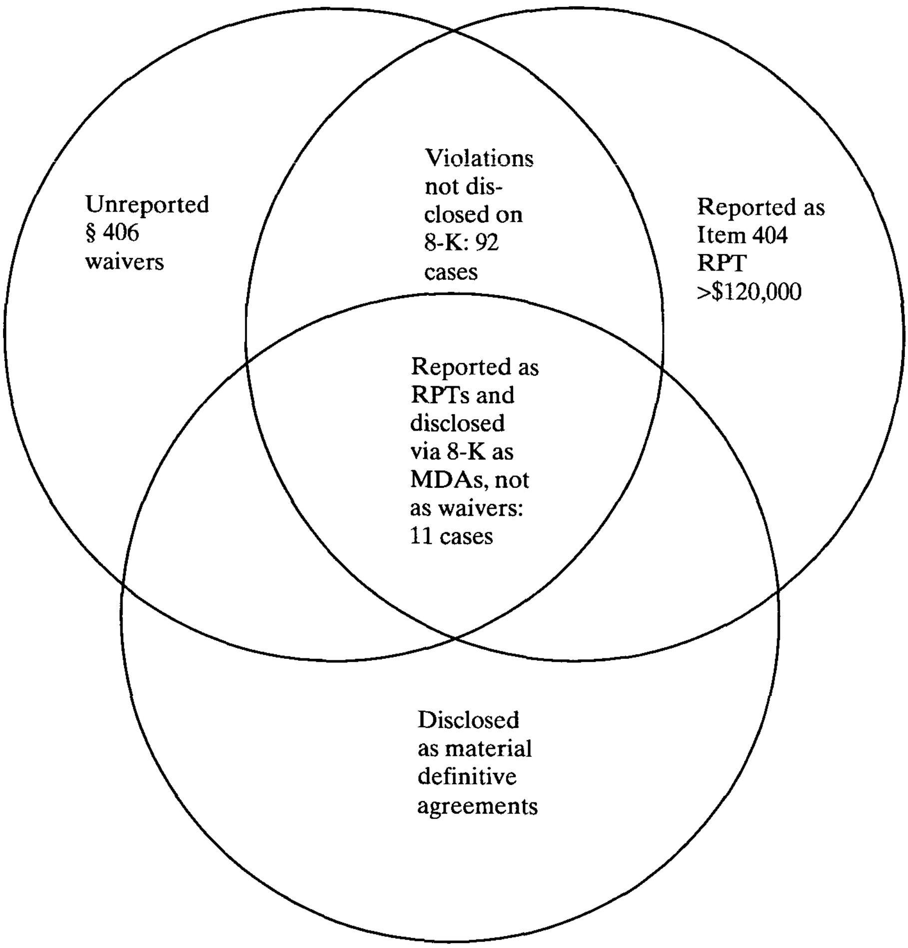
Of the 103 total cases where belated disclosure occurred via proxy, only 11 were disclosed via 8-K as material definitive agreements near the time they occurred; 10 were "in spirit" violations and 1 was an actual violation.[120] So we are left with 92 related-party transactions that were disclosed in the year-end proxy but should

[119] Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975—Regulation S-K, 17 C.F.R. § 229.601(b)(10)(ii)(A) (2008) (emphasis added).

[120] One transaction was disclosed via 8-K but did not clearly state that the CEO was the purchaser of the company's asset, so we did not treat it as adequate disclosure of the nature of the transaction.

have been disclosed as waivers immediately. Of those 92, 63 are "in spirit" violations, and 29 are actual violations of Section 406.[121]

Figure 3



[121] Research into the possibility of this Form 8-K disclosure is complicated by the fact that most related-party transactions disclosed in the year-end proxies are not dated; in fact, only 38 are dated.

b. Timing of Disclosure

Disclosure of related-party transactions in annual reports instead of via 8-K waiver clearly causes delay. But if companies disclose *proposed* or *upcoming* related-party transactions in their proxies, investors might actually be better informed than if they had to wait for ex post disclosure via 8-K (where disclosure is required within four business days *after* the transaction).

For this reason, we examined when companies chose to disclose their related-party transactions in proxy materials. For 22 companies, we could not tell whether the disclosure was made before or after the transaction. Only four companies clearly made all of their related-party transaction disclosures before they went through with the transaction. Thirty companies made all of their related-party transaction disclosures after they went through with the transaction. Thirty-six companies made some related-party transaction disclosures both before and after the transaction occurred, usually disclosing that the company has in the past engaged in certain behavior and would continue to do so in the future.

Because a substantial majority of companies do not disclose related-party transactions ex ante, it appears that proxies are not regularly providing information on prospective conflict transactions to investors.

7. The Waivers that Weren't

The above Subsections of this Part have described our findings regarding the "on the ground" practice of ethics waiver disclosure. Our sample of 200 companies revealed only one ethics waiver over five years that was appropriately labeled and disclosed as a waiver.[122] We began Section III.C with a question: where are all the waivers? Our cross-check against company proxy statements provides an answer: many related-party transactions that should have been disclosed as waivers were not actually revealed to the market.

The 33 actual violations are cases where the ethics code clearly prohibits the transaction at issue and the corporate conduct thus demonstrably required a waiver. The 70 "in spirit" violations, in

[122] While it is true that some of these transactions might have been appropriately disclosed as waivers via website and then removed, we have no way of identifying such cases because of the uncertain nature of website disclosure.

contrast, are cases where, because of "weasel wording," we are unable to find an actual violation. Often firms do not prohibit related-party transactions or provide internal mechanisms for their approval.

In the only prior study of ethics waivers, Madoka Mori hypothesized a version of our "in spirit" violations as an explanation for the dearth of ethics waivers under Section 406. In a study of *all* waivers filed with the SEC from 2004–2006 (ignoring the possibility of website disclosure),[123] Mori found only 26 waivers.[124] Her explanation for the small number, like ours, focuses on companies playing fast and loose with regulatory definitions. Instead of focusing on the definition of "code of ethics," however, Mori focused on what she termed a "hypertechnical" definition of the term "waiver."[125] According to her, although Sarbanes-Oxley and the SEC's rules do not define the term, the instructions to Form 8-K define waivers as "approval by the [company] of a material departure from a provision of the code of ethics."[126] Mori observed that companies may well have sidestepped the need to disclose waivers by adopting codes that provide for "approvals, permissions, or authorizations."[127] With such code language in place, Mori posited, a company could reason that an approval is not a "departure," and thus need not be disclosed.[128]

Although Mori's theory may accurately describe the rationale of some corporations for not reporting more waivers, the chairman of Enron's audit committee and finance committee tried a similar sleight-of-hand before the Senate when he testified that there was no waiver of Enron's code of conduct when it "approved" the related-party transactions with Fastow.[129] Nevertheless, a Senate staff report rejected the Enron official's proffered sophistry and characterized the behavior as a waiver.[130]

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[123] We discuss the results of our parallel study in Part IV, which reveals 36 total ethics waivers through 2007. Unlike Mori, we conducted event studies of the disclosed waivers.

[124] Mori, supra note 28, at 304.

[125] Id. at 293.

[126] Id.

[127] Id. at 305–06.

[128] Id. at 306.

[129] Id. at 298 n.20.

[130] Id. at 299.

To make yet another interpretive argument, it may be that the companies that failed to disclose waivers relied on the materiality language of the instructions to argue that the transactions were not "material" departures from the code. Again, this argument is strained. The SEC obviously believes a reasonable investor would find related-party transactions of over $120,000 to be material, presumably not because of their dollar value (minor in comparison to the assets of a large public company), but because of what they represent—the possibility that the CEO, CFO, and CAO are just in the game to enrich themselves at the expense of shareholders.

These interpretive questions reveal important points about how disclosure rules work "on the ground." In 33 cases companies seem to have violated the law. In 70 cases companies might have relied on watered-down ethics codes that do not prohibit related-party transactions, internal approval mechanisms (Mori's hypothesis), or a characterization of the transaction as non-material in order to evade the reach of Section 406. The net effect is that, despite a disclosure mandate intended to reveal corporate transactions with the CEO, CFO, and CAO, companies are routinely allowing their senior officers to engage in conflicting interest transactions without immediately disclosing them to the market as required by Section 406.

D. The Curious Case of Viacom

During the course of research outside of our sample, we found three waivers filed by Viacom via website. This discovery demonstrates first that companies do use their websites to disclose waivers. More important, these disclosures illustrate how the website disclosure option may facilitate misleading behavior, even at a Fortune 500 company.

First, some background: prior to the publications of these Viacom waivers, Sumner Redstone, the firm's Chairman and CEO, controlled 70.8% of Viacom's votes through his control of National Amusements, a major holder of Viacom class A shares.[131] The

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[131] Viacom, Inc., Exhibit (Ex. 99 to Form 8-K), at 7–8 (Oct. 28, 2004). National Amusements, Inc., through its wholly-owned subsidiary, NAIRI, Inc., owned shares of Viacom. See infra note 135. Because both are controlled by Redstone, we treat them as a single entity for purposes of this discussion.

common stock of Viacom is divided into two classes. Class A shares entitle the owner to one vote per share, while class B shares—the only other form of Viacom common stock—afford the owner no voting rights. Viacom announced that it was instituting a stock repurchase program in keeping with a plan, not uncommon among public companies, to use excess capital to buy up outstanding shares. In general, the announcement of such programs triggers an increase in share prices because investors assume that a firm will undertake a buyback only if the firm's shares are undervalued.[132] These repurchases, then, result in an essentially tax-deferred distribution to shareholders, since capital gains can be postponed.[133]

Using its website, Viacom disclosed an October 28, 2004 agreement with National Amusements, Inc.;[134] it later disclosed two similar agreements in 2005 and 2007, and their corresponding Section 406 waivers on its website.[135] The agreements are identical in nature. Each was entered into by National Amusements (the entity controlled by Redstone) and Viacom, and each permitted National Amusements to participate in Viacom's repurchase program of common stock.[136] In particular, the agreements allowed National Amusements (essentially Redstone) to participate in the repurchase program by allowing its Viacom class B shares (not class A

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[132] See Clifford P. Stephens & Michael S. Weisbach, Actual Share Reacquisitions in Open-Market Repurchase Programs, 53 J. Fin. 313, 316 (1998).

[133] Eugene F. Fama & Kenneth R. French, Financing Decisions: Who Issues Stock?, 76 J. Fin. Econ. 549, 554 (2005).

[134] See Viacom, Inc., Waiver of Conflict of Interest (Oct. 29, 2004), http://www.cbscorporation.com/assets/documents/waivers[1].pdf. Viacom has since split into CBS Corporation and Viacom; the 2004 agreement is on the website of the surviving company, CBS Corporation.

[135] Viacom, Inc., Waiver of Conflict of Interest (Jan. 1, 2006) (updated June 26, 2007), http://www.viacom.com/investorrelations/Investor_Relations_Docs/New_Viacom_BCS_Waiver.pdf. In 2005, Viacom spun off from CBS Corporation; the waivers for the 2005 agreement and 2007 agreements are disclosed on the spin-off company's site, Viacom.com.

[136] A $3 billion program was introduced in 2005. Press Release, Viacom, Inc., Viacom Announces $3 Billion Stock Purchase Program for Post-Separation 'New' Viacom (Dec. 12, 2005), available at http://www.mywire.com/a/PRNewswire//1111931?&pbl=273. A $4 billion program was introduced in 2007. Press Release, Viacom, Inc., Viacom Board Authorizes New $4 Billion Common Stock Purchase Program (May 30, 2007), available at http://www.prdomain.com/companies/V/Viacom/newsreleases/200753142526.htm.

shares) to be bought by Viacom in tandem with the repurchase of class A and class B shares on the open market. The waivers state that the agreements are "intended to maintain [National Amusements'] percentage equity ownership in Viacom, which would otherwise increase as a result of purchases made by Viacom pursuant to the stock purchase program."[137] This statement suggests that Redstone's relative percentage of both class A and B shares would remain constant as a result of the program. In fact, however, the agreements provided only that Mr. Redstone's class B shares were to be repurchased.

There are two stories we can tell about these waivers, one benign and one malign. According to the benign version, the agreement is meant to do no more than what the waiver states—that is, to maintain National Amusements' (and through it Sumner Redstone's) ownership percentage. In other words, without the agreements, Redstone's ownership interest would increase by mere virtue of the decrease in the number of outstanding shares. Indeed, his equity ownership percentage remains about the same.

A more sinister (and perhaps more believable) story is that the stock purchase plan and accompanying National Amusements/Viacom agreements effectuate a consolidation of Redstone's control, simultaneously permitting him to take cash out of the firm.

As seen in Table IX, Redstone's total equity ownership changes very little from 2003, before the repurchase program is announced, to 2008.[138] But because Redstone only sold back the non-voting class B shares while other stockholders relinquished both class A and class B shares, he increased his control of the firm (via class A shares) by about 12%. Thus, Redstone increased his liquidity by selling class B shares while increasing his control over Viacom by simply allowing the firm to repurchase all class A shares except his own.

[137] Viacom, Inc., Waiver of Conflict of Interest (Jan. 1, 2006) (updated June 26, 2007), http://www.viacom.com/investorrelations/Investor_Relations_Docs/New_Viacom_BCS_Waiver.pdf.

[138] Note that Viacom spun off from CBS Corp. between the 2005 and 2006 proxy statements, thus drastically changing the shares-outstanding figures.

Table IX. Viacom Common Stock Ownership of Sumner Redstone

	Dec. 31, 2002	Jan. 31, 2004	Jan. 31, 2005	Jan. 31, 2006	Feb. 28, 2007	Feb. 29, 2008
A shares outstanding	134,927,417	132,240,431	131,502,564	64,746,608	59,204,427	57,373,071
B shares outstanding	1,620,258,015	1,609,582,323	1,509,115,879	658,818,097	631,454,028	580,818,177
Redstone's A shares	93,658,828	93,658,908	93,658,908	46,829,454	46,829,454	46,829,454
Redstone's B shares	104,334,828	104,345,072	98,016,075	40,099,894	33,059,452	26,850,810
Redstone's % A (voting) shares	69.4%	70.8%	71.2%	72.3%	79.1%	81.6%
Redstone's % B (nonvoting) shares	6.4%	6.5%	6.5%	6.1%	5.2%	4.6%
Redstone's total equity ownership	11.3%	11.4%	11.7%	12.0%	11.6%	11.5%

None of this was disclosed in the Section 406 website waivers. Rather than telling the market, "I'm increasing my voting control of Viacom and at the same time taking money out for my wholly-owned subsidiary," the waivers suggested only that Redstone's shares would be required as part of the overarching stock buy-back plan. The notices thus implied that Redstone's voting control would not increase, when it actually did by a significant measure.

Whatever one concludes about the motives that gave rise to these events, Viacom's disclosure choices are interesting to say the least. As noted, all three waivers were filed on the companies' websites (the 2007 waiver was filed as an "update" to the 2005 waiver, making it appear from the website that only one waiver was disclosed, even though there were really two), and all state that an 8-K was filed with the SEC outlining the term sheet for the agreement. All 8-K filings were in fact made as disclosed. Each filing, however, was made only under the heading of "Entry into a Material Definitive Agreement"; none made any mention of an ethics waiver under Section 406.[139] In other words, although the company disclosed the agreements to the market in real time via an 8-K, each agreement was flagged as requiring conflict waivers only in website disclosure, not in the SEC filings.

The Viacom waivers are interesting on at least two fronts. First, they show that website disclosures sometimes occur. Despite the fact that almost half of our sample firms (46%) provided for website disclosure, we did not find a single website disclosure. Second, the Viacom waivers raise a prospect we had not initially anticipated. Viacom was forced by SEC rules to disclose National Amusements' stock repurchase contract as a "material definitive agreement," thus providing near-real-time disclosure via 8-K. It simultaneously chose to avoid the taint of labeling the transaction as one that departed from the firm's internal ethics rules. To be sure, the agreement itself was disclosed, and an efficient markets argument would state that investors could process that information without any need to attach to it an "ethics waiver" designation. Avoiding a Form 8-K disclosure of ethics waivers seems to have mattered to Viacom, however, because it chose a convoluted path of double disclosure (both via website and via 8-K) that avoided having to flag the transaction's questionable ethical component in the filing made with the SEC.[140]

We are unaware of other types of disclosure that the SEC permits companies to make by website publication rather than by SEC filings. The Viacom example points out some of the problems that lurk in this legal regime. For example, there is no guidance as to how to label waivers: Viacom was able to make two waivers look like one by adding its 2007 waiver as an "update" to the 2005 one. Failing to require continued web access means a corporation can erase a checkered ethical past in a matter of twelve months. In fact,

[139] Viacom, Inc., Current Report (Form 8-K) (June 26, 2007); Viacom, Inc., Current Report (Form 8-K) (Dec. 23, 2005); Viacom, Inc., Current Report (Form 8-K) (Oct. 29, 2004).

[140] An alternative explanation, however, is that Viacom, having told investors that it would disclose waivers on its website, felt constrained to disclose the waivers on its website rather than just putting the information in the material definitive agreement 8-K or companion waiver 8-K.

as of March 2009, it seems impossible to navigate the Viacom website so as to find the disclosed waivers, although the link provided in the footnotes was still functional at the time of writing. If the disclosures had to be made on Form 8-Ks filed with the SEC, however, a centralized, permanent record would exist. Website disclosure seems to presume that investors will continually prowl a company's investor relations site on the lookout for disclosure of an ethics waiver. This presumption, in our view, is unrealistic and has given rise only to confusion and incompleteness in Section 406 disclosures.

IV. All Conflict Waivers Filed with the SEC

A. Methodology

In addition to researching the random sample of 200 companies described in Part III, we also used a subscription-based search engine, 10k Wizard, to search SEC filings. In particular, we searched 8-K and 8-K/A forms under Item 5.05 (the appropriate heading for a Section 406 waiver) and the terms "code," "ethics," and "waiver." Because many 8-K filings make reference to Item 5.05 only by stating that it was "not applicable," we screened out the term "applicable." This data set does not include all reported waivers, however, because companies can also disclose waivers on their websites. Nevertheless, given that we found no waiver disclosure on the websites of the 200 sample companies, we presume that this second data set of all 8-K waivers filed with the SEC is fairly robust, though not exhaustive.

B. Observations about Waivers

Our search yielded 29 companies filing 36 waivers between 2004 and 2007. As shown in Table IX, we classified waivers into six different categories. The most numerous, "wealth transfers," covers instances in which there is a transfer of wealth from the firm to one of its officers or directors. Wealth transfers take three main forms: (1) the firm acquires another firm owned by a manager or director; (2) the firm undertakes a real estate transaction (that is, leasing or buying) in which the real estate is owned by a manager or director of the firm; or (3) the firm buys a service or product from a company in which a manager or director holds a stake. In an illustrative real estate transaction, the corporation amended a current lease arrangement for the corporation's headquarters with its chief executive officer.[141] As an example of the "services" category, the corporation authorized a licensing and manufacturing services agreement with a company controlled by the corporation's CEO.[142]

The category with the second most numerous observations is "interlocking positions." By way of example, Wheeling-Pittsburgh Corp. authorized its CEO and its president to act as minority owners, directors, and executive officers of a company that competed with the corporation in a few narrowly defined ventures.[143]

We classified five waivers as disclosing related-party transactions. In one example, IVAX Corp. waived its code of ethics to permit its entry into a consulting agreement with a company controlled by the CEO's nephew and a services agreement with the same CEO's son.[144]

There are five waivers we classified as "blackout transactions." These waivers include instances in which the corporation allows an officer or director to purchase or sell stock during a period when such sales are usually prohibited, a so-called "blackout period." In one case, the chairman of the board of National Coal Corp. was authorized to sell 100,000 shares of stock to an investor outside of the designated trading window.[145]

The "personal investment" category contains four waivers that center on a director's or manager's personal investments, including those involving the securities of the firm. For example, a waiver was granted to the president of American Capital Strategies, allowing him to invest in a private placement and an initial public offering of firms unrelated to the firm's investment activities.[146]

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[141] Hauppauge Digital, Inc., Current Report (Form 8-K), at 2 (Oct. 18, 2006).

[142] Marvell Tech. Group Ltd., Current Report (Form 8-K), at 2 (Aug. 11, 2005).

[143] Wheeling-Pittsburgh Corp., Current Report (Form 8-K), at 4 (Dec. 6, 2006).

[144] IVAX disclosed the agreement with the CEO's nephew on two occasions. See IVAX Corp., Current Report (Form 8-K), at 2 (Oct. 12, 2004) (providing for eighteen-month term of agreement); IVAX Corp., Current Report (Form 8-K), at 2 (Sept. 21, 2005) (providing for renewal). IVAX disclosed the employment agreement with the CEO's son in a different waiver. See IVAX Corp., Current Report (Form 8-K), at 2 (Feb. 8, 2005).

[145] Nat'l Coal Corp., Current Report (Form 8-K), at 2 (Apr. 3, 2007).

[146] See Am. Capital Strategies, Ltd., Current Report (Form 8-K), at 2 (Dec. 21, 2006).

Finally, there are four waivers that do not fit into any of these five categories; we classified these waivers as "other." In one case, Tivo, Inc. filed a waiver that authorized a board member to sit on more boards than the firm's code of ethics permitted (a maximum of two board seats).[147] In a waiver that involved a CFO's claim of an abuse of power, Hooper Holmes chose to take no action against a CEO who had obtained company reimbursement for $23,000 of personal expenses, which the company deemed immaterial.[148] A waiver filed by G-III Apparel allowed two of its directors to acquire an interest in a customer.[149] Additionally, Overstock.com filed a waiver allowing one director to make a personal loan to another director.[150] This seemingly harmless waiver, in contrast to waivers granted to managers and directors in the context of transfers of wealth from the company to the director or manager, highlights the vast range of actions covered by codes of ethics and code waivers.

C. Predictions

Given the large number of publicly traded companies—over 5,000—and the five-year time span of the study, the number of waivers filed is surprisingly low. Notably, the SEC predicted in 2002 that filings of code amendments and waivers would be "relatively rare events,"[151] but at the same time it envisioned that such "rare" events would result in an increase of 4,400 filings per year.[152] Even assuming that the SEC expected that most filings would concern amendments and only a quarter would concern waivers, there would still be 1,100 filings per year or a total of 5,500 over the sample period. The total number of filed waivers we found was 36.

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[147] Tivo, Inc., Current Report (Form 8-K), at 2 (Feb. 15, 2005).

[148] Hooper Holmes, Inc., Current Report (Form 8-K), at 2 (Oct. 25, 2004).

[149] G-III Apparel Group Ltd., Current Report (Form 8-K), at 1 (Nov. 9, 2004).

[150] Overstock.com, Inc., Current Report (Form 8-K), at 2 (Aug. 6, 2007).

[151] Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 46,701, 67 Fed. Reg. 66,208 (2002), *reprinted in* [2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,773, at 86,352 (Oct. 22, 2002) ("We believe that changes to a company's code of ethics and waivers from a code will be relatively rare events. Therefore, we expect that on average, a company will file a Form 8–K to report such an event once every three years, resulting in a total increase of 4,400 filings on Form 8–K per year.").

[152] Id. In its calculation, the SEC may have failed to consider the possibility of website disclosure.

A review of the content of the waivers also indicates that the disclosed information is of little significance. Unlike the information on related-party transactions obtained by examining proxy statements and cross-checking with ethics codes,[153] these 36 waivers are generally ethically unobjectionable. We hypothesize that, because of the relative newness and scarcity of Section 406 ethics waivers, firms have been loath to file them except in cases that show no signs of unfairness to the company. Thus, we predict that any filed waivers involve generally useless information and that the market will not react to the information disclosed.

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[153] See supra Section III.C.

Table X. Waivers

This table shows the number of observations of each type of waiver found. In Panel A we classified waivers in the first column and reported the number of each type in the second column. In the remaining columns we reported the cumulative abnormal return (CAR) for the three days around the filing of the waiver (file date), the report of the waiver prior to filing (report date), and the date that the action triggering the waiver occurs (event date). In Panel B we split the waivers into those that are filed alone (lone disclosure) and waivers that are accompanied by some other material event in the 8-K (simultaneous disclosure). We reported the CAR for the three days around the filing date only in Panel B.

Type of Waiver	Filed 8-Ks	CAR –file date	CAR – report date	CAR – event date
Panel A				
Blackout Transactions	5	-3.1% [5]	1.4% [5]	-0.5% [5]
Interlocking Positions	7	-1.2% [5]	3.7% [5]	6.7% [5]
Personal Investments	4	-1.1% [4]	-4.0% [4]	-2.9% [4]
Related-party Transactions	5	1.2% [5]	-2.8% [5]	-3.8% [5]
Other	4	3.2% [4]	-1.6% [4]	-1.6% [4]
Wealth Transfers	11	-0.7% [7]	1.0% [7]	1.0% [7]
Total	36	-0.4% [30]	-0.1% [30]	0.0% [30]
Panel B				
Simultaneous Disclosure	19	-2.3%* [14]		
Lone Disclosure	17	1.3% [16]		

* represents a statistical difference between simultaneous and lone at the 5% level

D. Price Evidence on Waivers

For each of the 29 firms that filed waivers, we examined the abnormal return to the firm's shareholders around the filing of the Form 8-K that contains the waiver to the firm's ethics code. We were unable to find price data for firms on five of the 36 filing dates. Also, the Marvell Technology Group filed two waivers on the same day, which are both classified as wealth transfers in Table IX. Thus, we reported only one abnormal return associated with these two waivers. This process leaves 30 waivers for the analysis.

The abnormal return we examined is the cumulative abnormal return (CAR) to the firm from the day before to the day after the date of interest (days -1, 0, and +1 where 0 is the day of interest) minus the cumulative return on those same days of a value weighted index of all firms in CRSP. In Panel A, the third column of Table V, we reported CARs around the date that the waiver is filed with the SEC. The three-day average abnormal return around that date is a statistically insignificant -0.5%, and the range of these abnormal returns is -12.2% to 10.3%. This means that the market did not react to these waivers in a statistically significant way. Further, when we examine returns within each subcategory, we find that no subcategory is significantly different from zero at 5% significance or less.

We also examined returns around the date a report is generated within the firm (column four) and the date that the event which triggered the waiver filing occurs (column five). In all but four cases, the date the report is generated within the firm is at least one day earlier than the actual filing date. Thus, we re-ran our analysis from column three using this new report date. We found that both the entire sample CAR and the sub-sample CARs are not different from zero. So, it appears either that there is no leakage of information, or that, if there is, the information is not important to shareholders.

For 25 firms, the Form 8-K reports an event date on which the waiver occurred. It is reasonable to assume that some market participants knew about the waiver on the date it actually occurred rather than the date of the filing. Therefore, we also examined the abnormal return using this new date, keeping the original filing date for one firm for which we could not find an event date. In column five, the average CAR using the event date is 0.0%. These results suggest that, on average, waivers to codes of ethics are not bad news to investors.

Finally, we examined transactions based on whether there is simultaneous disclosure of another event (for example, a simultaneous merger announcement alongside a waiver of a particular director of the bidder owning stock in the target). One view of the timing of the filing of waiver information is that particularly bad waiver filings may be coupled with other information in order to distract investors. A more generous view is that waivers are filed as they are approved. In Panel B of Table IX, we present evidence that suggests that these disclosures are coupled with other information about half of the time—14 filings are simultaneous with some other non-waiver event and 16 filings are not accompanied by any other information in the Form 8-K. Interestingly, the filings made alongside some other disclosure are associated with -2.3% abnormal returns to shareholders; this reduction in shareholder wealth is significantly different from zero at the 10% level. Further, non-simultaneous waiver filings are associated with a statistically insignificant abnormal return of 1.3%. These two returns are significantly different from each other at the 5% level. This result is consistent with firms attempting to hide particularly bad news in the context of the filing of a waiver by coupling it with other news.

For robustness, we examined the abnormal returns at the time of the filing in a multivariate setting. In this setting, we controlled for simultaneous filings using a binary variable equal to one if the waiver is simultaneously filed by the firm along with other information and zero otherwise. We included this binary variable because firms may choose to disclose particularly bad waivers in concert with other news for the reasons given above. We also controlled for the market value of equity of the filing firm, because firm size is a well-known proxy for risk; small firms are riskier than large firms. Finally, we controlled for the reason for the waiver (for example, violation of blackout period, related-party transaction, etc.) using a series of binary variables. We determined significance levels of the coefficients using heteroskedasticity-consistent standard errors with a small sample adjustment.[154]

[154] See generally James G. MacKinnon & Halbert White, Some Heteroskedasticity-Consistent Covariance Matrix Estimators with Improved Finite Sample Properties, 29

We found that the only significant independent variables are the indicator variable for simultaneous filings, with a negative coefficient, and the size variable, with a positive coefficient. This result confirms the univariate findings that firms may hide bad news by coupling it with other news. We are hesitant to conclude much from the significance finding for the size variable, given the general nature of disclosure practice in small firms.[155] Lastly, because none of the binary variables that describe the reason for the waiver are significant, it appears that the market does not view a particular type of waiver-worthy behavior as systematically worse than the others. This multivariate analysis, however, must be taken with some healthy skepticism given the very small sample size.

In some sense, our results mirror studies of the "comply-or-explain" governance approach taken by regulators in Canada, the United Kingdom, and the European Union.[156] Under this regime, firms must either comply with a regulator-supplied list of best practices for corporate governance or explain the reason for noncompliance.[157] Most empirical analyses of comply-or-explain governance structures conclude that complying firms do not outperform noncomplying firms.[158]

Yet it would be wrong to conclude from our results that the market is indifferent to ethics waivers if, in fact, they were reported as Congress envisioned when it enacted SOX. As Section I.B makes clear, many transactions that should rightly be disclosed as waivers are not being reported. Indeed, we posit that most companies only report waivers that do not reveal negative information. We cannot conclude from the current waiver survey that the market would be indifferent to ethics waivers if firms honored both the letter and spirit of Section 406. To do so would be as if the IRS were to announce amnesty for all tax evaders, receive amnesty requests from

J. Econometrics 305 (1985); Halbert White, A Heteroskedasticity-Consistent Covariance Matrix Estimator and a Direct Test for Heteroskedasticity, 48 Econometrica 817 (1980).

[155] Because they tend to disclose less, any release of information can affect small-firm price, unlike a large firm such as Microsoft that can make multiple SEC filings every day.

[156] Sanjai Bhagat, Brian Bolton & Roberta Romano, The Promise and Peril of Corporate Governance Indices, 108 Colum. L. Rev. 1803, 1863–64 (2008).

[157] Id. at 1864.

[158] Id.

only 100 taxpayers, none of whom owe more than $1,000, and conclude that no large-scale tax evasion exists in the United States.

The wide range of transactions that give rise to waivers of codes of ethics—together with the very small number of observations of waiver reporting and the sporadic nature in which the codes of ethics themselves are reported (or not)—is instructive. It seems that the only systematic conclusion possible from our findings is that the code of ethics is either effective medicine or placebo. We conclude the latter.

One example is particularly helpful in expressing our view. On November 6, 2006, Global Telecom & Technology adopted a code of ethics and on November 8, 2006, filed a waiver from the code. The 8-K states that:

> The Company's Chairman of the Board and Executive Chairman, H. Brian Thompson, currently serves on the boards of directors of Comsat International, Inc., Sonus Networks, Inc. and Bell Canada International, Inc[.], each a communications company and potentially a competitor of the Company. In light of the fact that Mr. Thompson's relationships with such potential competitors existed prior to the adoption of the Code, the Board of Directors of the Company determined that Mr. Thompson's service on these other boards of directors would not interfere with the performance of his duties with the Company.[159]

According to this filing, the board deems certain behaviors unethical, including service of directors on boards of potential competitors. The current chairman clearly violates Global's code of ethics, but because he engaged in the problematic conduct both before and after the company adopted the ethical code, his behavior is deemed acceptable. Though this statement by the board is illogical at best, the board nonetheless goes on to waive this behavior. The Global Telecom & Technology waiver underscores the seemingly nonsensical and costly busywork that requiring a corporate code of ethics represents.

[159] Global Telecomm. & Tech., Inc., Current Report (Form 8-K), at 2–3 (Nov. 8, 2006) (announcing ethics code and providing for waiver).

CONCLUSION

A. Ethics Disclosure

Our findings suggest that the current regime is a bad one, long on burdensome disclosure (and internal decision-making about the need to disclose) but short on demonstrable benefit. Whether we should do away with the disclosure requirement or provide guidelines for more detailed ethics disclosure is an open question. As a preliminary matter, we suggest that companies not be allowed to claim that they have a code of ethics if their code does not forbid related-party transactions. As described in Part III, the board's acceptance of Enron's related-party transactions was what led to Section 406's waiver disclosure provision in the first place. To call something that permits such behavior a code of ethics is absurd in light of the context within which SOX was written.

More fundamentally, we suggest eliminating the code of ethics waiver requirements altogether. The ability of companies to "game the system" by creating their own codes has led to weak codes and empty disclosures. The tiny minority of companies that disclose waivers save them for innocuous transactions, except when they are bundled with other information. Instead, companies delay revealing the more unsavory related-party transactions by disclosing them only in year-end proxies, where they can be buried in the rubble of sundry disclosures. Instead, we would require immediate disclosure of related-party transactions involving the CEO, CFO, and CAO on the theory that Section 406 was reasonable in presuming that investors want to know about these transactions immediately.

One might object that the related-party transaction threshold, a mere $120,000, is too low, especially in the context of the operation of a corporation with a market capitalization of billions of dollars. But these transactions are significant not because of their actual cost to the firm, but because they signal that agency costs may be severe, and that the firm's officers may be intent on securing their own benefits rather than honoring their fiduciary duties.

We argue that these changes will result in more meaningful, targeted disclosures. Paul Mahoney has observed that the mandatory disclosure regime might have developed specifically as a response to agency cost problems.[160] He traced the history of the 1933 Securities Act, which was modeled on common law rules addressing corporate promoters who would take secret fees or fail to disclose that they owned the land being sold to the nascent corporation.[161] Understood in this light, our whole disclosure system is about revealing agency costs, not about enhancing accuracy of stock prices. A renewed focus on the real and present agency cost problem thus returns securities disclosure law to its roots and central concern.

B. Website Disclosure

Honoring specific congressional instructions, the SEC permitted compliance with securities laws via website disclosure for the first time in promulgating regulations pursuant to Section 406. Our research demonstrates the perils of this approach. As researchers, we dislike company website disclosure because it makes research much more difficult. This type of research arguably makes markets more efficient and provides monitoring of managers. The SEC's EDGAR provides a reliable, consolidated database for study. In contrast, website disclosure is unpredictable and there is no requirement that companies keep such disclosure public. Indeed, Viacom has now made it impossible to navigate to the waivers from its Investor Relations page.[162] The SEC itself only requires disclosure "for at least 12 months." [163] After that, companies must only "retain" the disclosure for at least five years.[164] The SEC does not discuss what good such an internally archived record of past disclosure does the public. In fact, it does no good at all. When a company files with the SEC, in contrast, the information is available forever.

The Viacom waivers illustrate the perils of permitting disclosure by website alone. Viacom, after all, was able to pick and choose which information it would disclose where. To the SEC, it dis-

[160] See Mahoney, supra note 24, at 1048.

[161] Id. at 1056–60. Mahoney's article responded to the justification of mandatory securities disclosure for the purposes of "accuracy enhancement," that is, ensuring that a stock's publicly traded price accurately reflects all available information.

[162] See supra Section IV.D.

[163] Sec. & Exch. Comm'n, Form 8-K: General Instructions 17 (2008), available at http://www.sec.gov/about/forms/form8-k.pdf.

[164] Id.

closed a material definitive transaction and only by website did it disclose the required ethics waiver. Further, if the Viacom case is at all representative, companies can misleadingly file waivers as "updates," making it seem as if there has been only one waiver when in fact there have been several.

Securities researchers are not the only ones misled. If, as we have found, waivers need only be disclosed for twelve months,[165] then an investor will not be able to look to a company's website in order to determine whether a company engages in a pattern and practice of granting waivers over the years. Also troubling is the fact that our study found that in ten cases—5% of our sample—companies claimed to be disclosing codes of ethics on their websites even though no code of ethics could be found.

We conclude that permitting sole website disclosure is a bad idea, period. If the SEC wants to go down the website disclosure path, it should require dual disclosure—via website *and* SEC filing. Dual disclosure would make information easier to access without imposing significant additional costs on firms, which must generate the disclosure statement either way. Allowing for sole website disclosure makes it harder to find information and provides no real benefit to companies except to give them an opportunity to downplay and disguise questionable transactions. The SEC could impose standardized URLs, such as CompanyEthicsCode and CompanyEthicsWaivers, to ensure that the codes and waivers are easily accessible to the public, and require that such disclosures remain public for at least five years. We are unaware of any other areas in which the SEC permits sole website disclosure. This experiment should end here.

C. The Limits of Unenforced Disclosure

Our study shows that requiring disclosure can only do so much. How generalizable this insight is remains in question. Sarbanes-Oxley did not provide a means of private enforcement for most of its provisions.[166] Courts have been reluctant to read a private cause of action into the Act even in easily identifiable cases, such as

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[165] Id.

[166] Faith Stevelman, Foreword, Corporate Governance Five Years After Sarbanes-Oxley: Is There Real Change?, 52 N.Y.L. Sch. L. Rev. 475, 495 (2007-2008).

where a firm may recover funds from executives following an accounting restatement.[167] Enforcement of Section 406's disclosure requirements is therefore left to the SEC, but to date it has not instigated a single enforcement action under Section 406. Our study thus demonstrates the tremendous discretion the SEC has with respect to enforcement priorities. It also suggests that the basic consequence of underenforcement is the imposition of disclosure requirements on paper that are ignored in real life.

We view Section 406's ethics waiver rules as "soft" disclosure: at best these rules facilitate error; at worst they invite manipulation. The combination of soft disclosure rules and non-enforcement gives companies every incentive to disclose as little as possible. Whether companies rely on an overly narrow definition of "waiver" (as Mori posits), invoke the "material departure" limit (as the text of Section 406 permits), or game the system by failing to include related-party transactions in their codes of ethics, companies are evading the clear intent of the law. A "hard" disclosure approach, under which a company must disclose any related-party transactions of more than $120,000, appears to work better. Otherwise companies can bend the rules to duck or delay incriminating disclosures whenever possible.

Under a "benign" view, in contrast, a company's failure to disclose an ethics waiver under Section 406 may result from an honest mistake. Companies may not be complying because they have not set up systems to monitor their high-level officers' conduct and raise red flags when the ethics code is violated. A "hard" disclosure regime would reduce this risk as well. This is especially true because related-party transaction regulation has been around for decades and companies already have established mechanisms in place for identifying and reporting examples of the types of behavior as to which we would mandate prompt disclosure.

This benign hypothesis has resonance for the recent financial crisis. Educating all of the appropriate individuals within an organiza-

[167] Section 304 provides that chief executive officers and chief financial officers must forfeit their bonuses and trading profits if an accounting restatement reveals that, through misconduct, a company's financial statements were inflated. See Allison List, Note, The Lax Enforcement of Section 304 of Sarbanes-Oxley: Why is the SEC Ignoring Its Greatest Asset in the Fight Against Corporate Misconduct?, 70 Ohio St. L.J. 195, 200–06 (2009).

tion and developing controls and systems for disclosure may be a difficult but crucial step in implementing any new disclosure regulations if they are to succeed. But without enforcement, compliance levels will probably be low.

Our findings demonstrate the perils of attempting to regulate substantively while still purporting to respect corporations' autonomy. Investors are lulled by the false appearance of ethics regulation, when in reality ethics rules are both diluted and flouted.