

# Placebo Ethics

Usha Rodrigues\* and Mike Stegemoller<sup>+</sup>

*While there are innumerable theories on the best remedy for the current financial crisis, there is agreement on one point, at least: increased transparency is good. We look at a provision from the last round of financial regulation, the Sarbanes Oxley Act of 2002 (“SOX”), which imposed disclosure requirements tailored to prevent some of the kinds of abuses that led to the downfall of Enron. In response to Enron’s self-dealing transactions, Section 406 of SOX required a public company to disclose its code of ethics and to disclose immediately any waivers from that code the company grants to its top three executives. These waivers offer a unique window not only into ethical practices at public U.S. companies, but also into how disclosure works “on the ground” –whether companies are actually complying with disclosure rules and whether these rules prevent self-dealing transactions.*

*Out of 200 randomly selected firms, we found only one waiver over 4 years disclosed pursuant to Section 406. However, by exploiting an overlap in disclosure regulations, we were able to cross check our sample companies’ waiver disclosure. We find 30 instances where companies appear to be violating the law, and another 74 where companies evade illegality by watering down their codes to an arguably impermissible degree—their codes of ethics do not forbid the same Enron-style conflicts of interest that led to the adoption of Section 406 in the first place. Finally we study all waivers filed by all public companies with the SEC in the four years following SOX’s passage—and find only 36 total. Event studies reveal that the market generally does not react to these transactions, suggesting that companies only use waivers to disclose innocuous, immaterial information.*

*We draw two lessons, one specific, one general. First, the current regime is a bad one, long on costly and burdensome disclosure but short on demonstrable benefit. Section 406’s disclosure requirement is not functioning as intended. Either by mistake or manipulation, companies are evading its requirements and not providing information to the market. We suggest eliminating the code of ethics waiver disclosure requirements, and substituting a requirement of immediate disclosure of related-party transactions involving the CEO, CFO, and CAO. Second, our study casts light more generally on the limited utility of regulating by means of disclosure alone.*

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\* Assistant Professor, University of Georgia School of Law.

<sup>+</sup> Assistant Professor, Texas Tech University.

## **Introduction**

Responses to the current financial crisis are legion and diverse, but share a common theme: a desire for increased transparency. Disclosure is the kind of regulation everyone can embrace: its beauty is that it does not impose substantive burdens on companies, but rather merely requires reporting the actions companies take. The market and sunshine, Brandeis' best of disinfectants,<sup>1</sup> together work their magic with no need for heavy-handed regulators imposing bureaucratic requirements on companies. 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 credit default swaps, so the argument goes, then the current financial crisis might have been avoided.

Yet respected market authority Warren Buffet recently 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).<sup>2</sup>

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 do. Scholarly debate about securities laws focuses on their advisability. Some argue for stricter disclosure obligations to ensure a true "level playing field" for all investors.

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<sup>1</sup> 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.").

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

Others decry the costs and burdens of myriad mandatory disclosure requirements, and advocate paring back. The most radical assert that market demands alone can sufficiently motivate companies to voluntarily disclose what is important, and therefore argue for eliminating mandatory disclosure entirely. None address the question of whether companies *actually comply* with current disclosure laws. It would seem a question impossible to answer. A researcher cannot measure the occurrence of non-disclosure; by definition, because an event is not disclosed, the information is not public and therefore not measurable.

Nevertheless, we have discovered a rare (perhaps unique) opportunity, because of overlap in current disclosure requirements, to investigate the extent of firms' compliance with securities law. Section 406 of Sarbanes Oxley 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. We then compare these disclosures with companies' year-end proxy statements. We discover that, for related-party transactions, at least, 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. Moreover, Section 406 was specifically designed to prevent the type of behavior that contributed to Enron's demise. Our findings show that, with respect to solving this particular problem, disclosure is neither preventing the targeted behavior, nor is it even revealing the types of activities that interest the marketplace. This finding should give pause to regulators who would rely on transparency as a cure-all.

Our study involves three phases. First we examine the codes of ethics themselves: if they are disclosed, means of disclosure, and accessibility. Our main sample consists of 200 randomly selected firms.<sup>3</sup> 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 accessible via a corporation's website or available on a corporation's Form 10-K, the year-end report required by the Securities and Exchange Commission ("SEC" or "Commission").<sup>4</sup> In terms of

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<sup>3</sup> We use firms with historical stock price data on CRSP (the Center for Research in Security Prices). We randomly select twenty firms from ten size-based portfolios so that firm size is evenly distributed across all publicly-traded companies.

<sup>4</sup> A firm's proxy statement can, and typically does, incorporate by reference much of its 10-K. See Gerald T. Nowack, *The Disclosure Cycle*, 1697 PRACTISING L. INST. 387 (2008).

disclosure of codes of ethics themselves, then, the regulation appears to have had its intended effect.

The second and third portions of our study focus on company-granted waivers from the code of ethics. Such research is greatly complicated because the SEC gave companies the option of website disclosure rather than requiring disclosure on Form 8-Ks<sup>5</sup> filed with the Commission. Therefore, a study of 8-K filings alone will not provide a reliably exhaustive list of all disclosed waivers.

Methodologically, we deal with this problem in two ways. We study the filings of the 200 random sample firms from January 1, 2003<sup>6</sup> through December 31, 2007 and discern whether each firm discloses its code and attendant waivers via website or 8-K. For those firms choosing website disclosure, we determine if there is in fact any disclosure of waivers on the company website. Only *one waiver* was found in this sample, disclosed via 8-K filing.

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) the undesirable conduct may still be occurring, but is not disclosed. The last case, of course, would be difficult to prove precisely because the required disclosure is not being made; 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 Section 406 disclosure requirements differ from related-party-transaction disclosure requirements, there is enough overlap for us determine whether some waivers required by Section 406 are not being filed. 15 of our sample firms violate Section 406 by not disclosing transactions as required, a total of 30 times. Another 46 sample firms avoid violating the Act strictly speaking, but

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<sup>5</sup> 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 if a director resigns, a company must file an 8-K with the SEC within 8 days of the event. *See* SEC General Instructions to Form 8-K, 7 C.F.R. § 249.308 (2008).

<sup>6</sup> 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 amendment and waiver requirements in annual reports for fiscal years ending on or after July 15, 2003. *See*, SEC, Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release No. 33-8177 (Jan. 23, 2003). Thus 2003 represents only a partial year of data.

only by watering down their codes to an arguably indefensible degree, for a total of 74 times. Astonishingly, then, in a sample of 200 firms over a four-year period we find a total of 103 times where companies failed to make accurate and arguably required disclosures. 15 of 200 firms, or 7.5%, actually violate the law.

One might object that there is no real problem with these violations of Section 406—even though the transactions in question are not disclosed as ethics waivers, at least they are being disclosed to the market as related-party transactions. But although disclosure of the transactions is ultimately made, rather than the near-real-time (four business days) disclosure required by Section 406, disclosure of the transaction can occur *months* after the transaction has occurred. Moreover, it is “buried” amongst the many other disclosures required in a company’s year-end filing.

In the third portion of our study, we observe *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.<sup>7</sup> Since the adoption of Sarbanes-Oxley through the time of this study, we found only 36 waivers filed via Form 8-K for all publicly traded companies. Again, out of roughly 5,000 publicly traded companies over 4+ years (over 20,000 firm-years), we find only 36 waivers filed via Form 8-K.

For these companies, we perform event studies, which allow us to measure the market’s reaction to each individual waiver. We discover no discernable change in the overall stock price of these companies. We conclude that companies generally use waivers only to reveal innocuous information. However, there is some evidence that firms disclose more questionable transactions differently. Firms tend to bundle their disclosure of some ethics waivers with other information in the same Form 8-K. We speculate that this behavior is an attempt to disguise a particularly questionable transaction by combining it with other information. We find that the market reacts negatively to such bundled disclosure, although it is impossible to conclude whether the bundling strategy is not working (not fooling the market) or whether companies save this strategy for their worst news, and 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 true non-disclosure. Instead, they show companies that disclose eventually, but not as promptly and openly as Sarbanes Oxley requires. We interpret this result in two ways.

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<sup>7</sup> This data set does not comprise all waivers filed, however, because companies can also file waivers on their websites. Nevertheless, given that there is 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.

According to a benign story, companies are used to complying with related party transactions—regulations governing their disclosure have been in existence for decades.<sup>8</sup> In contrast, codes of ethics are of relatively recent vintage, and firms may have no system in place to flag violations or waivers as they occur. In turn, this benign story could lead to two conclusions. First, more training may be needed, or internal controls may need to be tightened in order to ensure compliance. It might also suggest a need for broader training and education efforts whenever introducing new disclosure requirements.

The malign story, in contrast, suggests that companies are intentionally failing to comply with the requirements governing ethics waivers, on the theory that regulators would be unlikely to detect non-disclosure. Firms may have concluded that the market is not familiar with disclosure that singles out these related-party transactions as ethics waivers, and may react unduly negatively to them. To gain some legal cover, however, the companies do disclose these violating transactions via the more standard, and presumably acceptable, means of year-end proxy statements, in which the related party disclosures can be delayed and buried with a wealth of other information.

It appears, then, that Section 406 creates the worst of worlds for ethics: costly disclosure that lacks bite. Companies face the burden of compliance with Section 406. Many fail to comply with the disclosure requirements, and many others comply only by watering down their ethics codes impermissibly. The handful of disclosed waivers have little effect on the market, meaning that there is no meaningful disclosure of information. Worse yet, toothless regulation may create a “placebo” effect, where investors believe that Sarbanes-Oxley has imposed meaningful ethical regulation 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 telling companies, essentially: “make up your own ethics rules, and tell us when you break them.” Our findings show that this kind “soft” disclosure is ripe for mistake (the benign story) or manipulation (the malign story). In contrast, companies are more inclined to comply with the “hard” disclosure required by Item 404’s related party transactions: “disclose all transactions with insiders over \$120,000.” “Soft disclosure” may lull the market into a false sense of security by creating the illusion of transparency and regulation. In fact, this type of disclosure may generate unproductive information for the market, *i.e.*

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<sup>8</sup> The current form of related party transaction disclosure dates back to 1982, but prior forms existed as early as 1942. *See* 47 F.R. 55661-01 (1982).

“noise.” Any new reform measures targeting increased transparency in the financial markets should heed this lesson from Sarbanes-Oxley.

## **I. Literature**

The stated mission of the SEC is to protect investors.<sup>9</sup> Its main tool is mandatory disclosure. To quote from 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.*<sup>10</sup>

As the SEC states, this principle of mandatory disclosure to ensure equal access to information for all investors is fundamental to our securities law. Still, securities scholars have continued to debate whether our mandatory disclosure system is a net positive or negative. In the recent past, calls for deregulation have been strident and ascendant.<sup>11</sup> Critics decry the fact that information is costly and burdensome to collect.<sup>12</sup> More troublingly, Geoff

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<sup>9</sup> See Securities Exchange Commission, How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, <http://www.sec.gov/about/whatwedo.shtml> (last visited March 12, 2009).

<sup>10</sup> *Id.* (emphasis added).

<sup>11</sup> See, e.g., Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1454 (1997).

<sup>12</sup> Recent complaints have centered around Sarbanes-Oxley’s internal controls provision. See Donald C. Langevoort, 31 J. CORP. L. 949, 949-50 (2006); See also Robert Charles Clark,

Manne suggests that there may be indirect costs to disclosure, including avoiding otherwise desirable activities if they require impermissible secrecy.<sup>13</sup> Stephen Choi advocates for regulating investors rather than firms, in order to give issuers more freedom from oppressive regulation in which to operate.<sup>14</sup> Roberta Romano proposes allowing states to offer disclosure regimes to compete with the federal government's.<sup>15</sup>

On the other side remain a few brave advocates for our current system of mandatory disclosure. Merritt Fox argues that the mandatory disclosure of information creates positive externalities for groups other than shareholders, such as suppliers and customers.<sup>16</sup> Allen Ferrell argues for mandatory disclosure not only in the United States, but worldwide.<sup>17</sup> Ed Rock argues that mandatory disclosure creates a "credible commitment" to a certain permanent level of disclosure, because it is relatively easy to become a public company, but relatively difficult to exit from the system.<sup>18</sup> Even some mandatory disclosure proponents seem to damn it with faint praise: Paul Mahoney, even as he endorsed mandatory disclosure, called for a paring back of disclosure requirements on the theory that its true benefit is to reduce agency costs, rather than to increase accuracy in pricing.<sup>19</sup>

What both sides presume in this decades-long debate is that mandated disclosure is in fact made, *i.e.*, that companies comply with mandatory

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22 GA. ST. U. L. REV. 251, 293 ("the 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 FEI spring 2005 survey was 48 times the SEC average estimate, and the AeA tally for American companies was 28 times the SEC aggregate estimate.").

<sup>13</sup> Geoff Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 482 (2007).

<sup>14</sup> See generally Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000).

<sup>15</sup> See generally Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

<sup>16</sup> See Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment*, 85 VA. L. REV. 1335, 1345-46 (1999).

<sup>17</sup> Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81 (2007).

<sup>18</sup> Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 675-76 (2002).

<sup>19</sup> Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1047-48 (1995).

disclosure obligations. This presumption is in a sense natural, because it seems inevitable: there is no way for researchers to detect if companies are not complying with disclosure requirements—put differently, nondisclosure is impossible to measure. In a seminal article, for example, Ed Kitch describes how mandatory disclosure does not enhance accuracy because, by imposing liability for the production of misinformation, it deters the total amount of information produced.<sup>20</sup> But he presumes that the mandatory disclosure regime works, that is, that the right information is being produced, and that it is by and large accurate and complete.

What if it isn't? How can we know whether the required information is indeed being disclosed?<sup>21</sup> We can't, of course, but our study exploits a partial redundancy in the rules and 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 individually, is instead being disclosed tardily and is buried amidst other information. In doing so, we can 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 our next section, we turn to the history of this particular provision, § 406 of Sarbanes-Oxley.

## **II. 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, Andrew Fastow, to move liabilities off the company's balance sheet. But Enron's Code of Conduct

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<sup>20</sup> Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 771-72 (1995). Recently 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).

<sup>21</sup> Intelligent (and unscrupulous) issuers may be tempted not to make required disclosures: 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 Section 10b-5 as well as civil prosecution by the SEC or criminal prosecution by the Department of Justice or U.S. Attorneys. 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).

specifically prohibited deals with related parties.<sup>22</sup> 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.<sup>23</sup>

Among the missed opportunities to prevent Enron's collapse, then, many commentators pointed to the company's board of directors which, despite the presumed demands on the time and energy of CFO of a major public company, blithely and without question consented to deals which wound up enriching Fastow and other employees by tens of millions of dollars, at the expense of Enron.<sup>24</sup> Accordingly, a specific Sarbanes-Oxley provision dealt with codes of ethics and waivers from them.

The ethics code disclosure requirement was adopted without much debate.<sup>25</sup> Senator Corzine proposed the code of ethics disclosure, observing:

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 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.<sup>26</sup>

The waiver provision was later added to address the specific Enron problem of the board of directors granting waivers to the CFO.<sup>27</sup> Richard Breeden, a former Chairman of the SEC, suggested disclosure of waivers of

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<sup>22</sup> Notes, *The Good, the Bad, and Their Corporate Code of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behaviour*, 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).

<sup>23</sup> See Mori, *supra* note \_\_\_, at 297-98.

<sup>24</sup> *Id.*

<sup>25</sup> Joshua A. Newberg, *Corporate Codes of Ethics, Mandatory Disclosure, and the Market for Ethical Conduct*, 29 VT. L. REV. 253, 274 (2005).

<sup>26</sup> See Senate Comm. on Banking, Hous., and Urban Affairs, Pub. Co. Accounting Reform and Investor Prot. Act of 2002, Report to Accompany S. 2673 Together with Additional Views, S. REP. NO. 107-205, at 32 (2002).

<sup>27</sup> 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, 299 (2007).

company ethics or conflicts codes and of any conflict of interest involving a senior officer.<sup>28</sup> 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.

In some sense, Section 406 might not have increased liability for Enron-level fraud.<sup>29</sup> Public companies already have an overarching duty to disclose material information to the market under Rule 10b-5. In hindsight, Enron's transactions with its CFO were clearly material, and should have been disclosed. Section 406's real value, then, appears to be in signaling to investors that something ethically questionable may be going on in the company.<sup>30</sup> The idea must be, if we force boards to disclose the occurrence of waivers, the market will gain valuable information that it would not otherwise obtain. The next question is: how well is Section 406's signaling function working? In the following sections we attempt to answer that question.

### **III. Random sample**

#### *A. Methodology*

We examine a sample of firms covered by the Center for Research in Security Prices database (CRSP). From CRSP, we form ten portfolios of firms based on each firm's market value of equity as of December 2003 – the end of the first full year of SOX. We then randomly select 20 firms from each of the size deciles. The market value of equity is the product of the price of the firm's common stock and its shares of common stock outstanding. We randomly select twenty firms from ten size-based portfolios so that firm size is evenly distributed across all publicly traded companies.

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<sup>28</sup> *The Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002: Hearings Before the House Comm. on Fin. Servs.*, 107th Cong. 473 (2002).

<sup>29</sup> Joshua Newberg observes that Section 10b-5 requires the disclosure of all material facts, and 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, 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 \_\_, at 281-82.

<sup>30</sup> See Newberg, *supra* note \_\_, at 281-82 ("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.").

Table I shows the mean and median market value of equity for each decile. Decile one (the smallest size decile) has an average market value of equity of \$5 million, and decile ten has an average market value of equity of about \$11.4 billion.

**Table I. Market value of equity of random sample**

This table shows the mean and median dollar value of the twenty firms in each size decile. The first column contains the decile sorted from smallest (1) to largest (10). Market value of equity is the product of the number of common shares outstanding and the price per share of the firm's common stock. The number of observations within each decile is in the last columns. 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 concentration of industry. 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 industries from advertising services to medical equipment leasing. Considering the sample's three largest industries, we find that 12.5% (25) of sample firms are depository institutions, 9.5% (19) are in the business services industry, and 8.5% (17) are in the chemical and allied products industry.

## ***B. Applicable rules***

Congress and the SEC had to walk a fine line when legislating and rulemaking in the corporate ethics sphere. Internal corporate governance is a matter for state law.<sup>31</sup> SOX's ethics waiver provision was seen as an incursion into a traditional domain of state law, corporate governance.<sup>32</sup> So the SEC's ethics requirement was couched, somewhat awkwardly, as a disclosure requirement: it did not require a code of ethics, but required disclosure of it or an explanation of why a company lacked one.

Section 406 of the Sarbanes Oxley Act of 2002<sup>33</sup> requires the SEC to promulgate rules regarding disclosure of codes of ethics for to senior management.<sup>34</sup> The SEC's rules require that public corporations disclose whether the company has adopted a code of ethics that applies to the chief executive officer, chief financial officer, and principal accounting officer or controller.<sup>35</sup> If the corporation does not have such a code of ethics, it is required to explain why not.<sup>36</sup>

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<sup>31</sup> Z. Jill Barclift, *Codes of Ethics and State Fiduciary Duties: Where is the Line?*, 1 J. Bus. Entrepreneurship & L. 237, 250 (2008).

<sup>32</sup> 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).

<sup>33</sup> 15 U.S.C. § 7201, *et seq.* (2008).

<sup>34</sup> Section 406 of Sarbanes-Oxley refers to a code that only applies to senior financial officers: the principal financial officers, comptroller or principal accounting officer, or individuals performing these functions. See 15 U.S.C. 7264 (2008). The SEC rules added the "principal executive officer," reasoning that CEOs should be held to "at least the same standards of ethical conduct" as senior financial officers. See Newberg, *supra* note \_\_, at 277.

<sup>35</sup> 17 C.F.R. §229.406 (2008).

<sup>36</sup> *Id.* Newberg did not find a single instance of corporations electing not to disclose a code of ethics and providing an explanation why not. Newberg, *supra* note \_\_, 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 \_\_, Disclosure methods for codes of ethics.

The SEC elaborated on the disclosure requirements of Sarbanes-Oxley. First, the code itself must be disclosed, either (1) as an exhibit to the annual report, (2) by posting the code of ethics on its website, having indicated this in its annual report along with the corporation's internet address, or (3) by providing it to any person without charge upon request.<sup>37</sup> Thereafter, any amendments to the code, or waivers of the code for specific transactions or matters, must either be disclosed on a Form 8-K or, if the company has disclosed its intention to do so in its last annual report, it may disclose waivers and amendments to the code on its website.<sup>38</sup> NYSE Euronext and the NASDAQ have similar disclosure requirements for listed companies.<sup>39</sup>

The results have been underwhelming, to say the least. The waivers have received little attention in the business press or in legal and economic scholarship. A LexisNexis search revealed a single Business Wire story referencing a waiver, reporting a company press release that stated that a director of Patterson Companies, Inc. would resign from the board rather than seek a waiver to the company's code of ethics after his firm invested in a Patterson supplier.<sup>40</sup> 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. It does provide some evidence that the waiver requirement may be having some deterrent effect; rather than seek a waiver of conflict of interest, the director resigned.

### *C. Prior ethics waiver literature*

Little literature exists regarding waivers of ethics codes, and all of it merely speculates on Section 406's effects. Corporate ethics codes generally have been criticized as mere "window-dressing."<sup>41</sup> Several studies appear to

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<sup>37</sup> 17 C.F.R § 229.406.

<sup>38</sup> *Id.*

<sup>39</sup> 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 LISTED COMPANY MANUAL, § 303A.10. The NASDAQ merely requires that listed companies adopt a code of conduct that complies with the requirements of Sarbanes-Oxley and SEC regulations. NASDAQ MANUAL, Rule 4350(n).

<sup>40</sup> *Patterson Companies Reports Change in Board of Directors*, BUSINESS WIRE, July 29, 2005.

<sup>41</sup> See 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).

cast doubt on these codes' ability to change employee behavior.<sup>42</sup> Along with the generalized fear that ethics codes are mere "window-dressing," there is a more specific concern that the disclosure requirements of Sarbanes-Oxley have had the unintended effect of causing corporations to weaken their ethics codes.<sup>43</sup> Soon after passage there was speculation that the fact that all waivers for senior managers must now be disclosed might make it more likely that it will soften the language of the code, constricting the universe of prohibition, so that there will be less exposure for failure to disclose a waiver.<sup>44</sup> Indeed, a PLI publication counsels that "the less frequently a [c]ompany needs to grant waivers, the better."<sup>45</sup> 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.<sup>46</sup> For example, Wal-Mart, a corporation famous for its strict code of ethics, fired Julie Roehm for having a personal relationship with a subordinate and receiving gifts, "including liquor and lavish dinners," from suppliers.<sup>47</sup> She responded by suing the company, claiming that it applied a double standard and that Wal-Mart's CEO had also received gifts from vendors.<sup>48</sup> Companies might well conclude that a weaker code of ethics would lead to less liability. Thus, Section 406's goal of increasing transparency may be perversely

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<sup>42</sup> Krawiec, *supra* note \_\_, at 510 ("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 studies finding a significant relationship between ethics codes and employee behavior have methodological flaws. *Id.*

<sup>43</sup> See Notes, *supra* note \_\_, at 2135.

<sup>44</sup> *Id.* at 2135-37 ("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."). See also Manne, *supra* note \_\_, at 488.

<sup>45</sup> Russell J. Bruemmer & Leslie Sturtevant, *The Influence of Corporate Governance and Codes of Conduct on Effective Compliance Programs*, Practising Law Institute, 1418 PLI/CORP. 129, 147 (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.*

<sup>46</sup> Pitt & Groskaufmanis, *supra* note \_\_, at 1643.

<sup>47</sup> Bandler & McWilliams, *supra* note \_\_\_\_.

<sup>48</sup> *Id.*

undercut by the provisions of the Act itself: firms may rewrite codes of ethics to minimize the need for waivers<sup>49</sup>

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 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.<sup>50</sup> One of us has done preliminary work on waivers filed via 8-K, and this study grew out of that work.<sup>51</sup>

## ***D. Code disclosure***

First we examine disclosure of the codes of ethics themselves. We study 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) 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 in our study requires a written request to the company's secretary in order to obtain a copy of the code. Only five companies in our sample require a written request.

Thirty-three (16.5%) 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, by navigating the SEC website or rely on company websites that list SEC filings (for example,

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<sup>49</sup> Notes, *supra* note \_\_\_, at 2136. ("Companies will include only the bare minimum needed to comply with the SEC's suggested topics for a code, and the public filing of codes will not matter because investors will be unable to distinguish one vague, boilerplate code from another."); Manne, *supra* n. \_\_\_, at 488.

<sup>50</sup> See Mori, *supra* note \_\_\_, at 299 (2007).

<sup>51</sup> Usha Rodrigues, *From Loyalty to Conflict: Addressing Fiduciary Duty at the Officer Level*, 61 FLA. L. REV. 1 (2009).

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-K or 40-K.<sup>52</sup>

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

**Table II. Disclosure methods for codes of ethics**

Description	Number of Observations
<i>Panel A. Disclosure Method</i>	
Website	131
No Code of Ethics	21
10-K, 20-F, 40-F	33
False assertion of disclosure: could not find code on web	10
Request Sent to Company Secretary	5
Total	200
<i>Panel B. Missing Codes</i>	
False assertion of disclosure: could not find code on web	10
Failed or Disappeared	9
Merged	5
Still Publicly Listed	3
Stock De-listed	2
Reincorporated	2
Total	31

<sup>52</sup> There was one disclosure made via 20-F, and one disclosure made via 40-F. These are annual report equivalents for foreign private issuers.

## **b) Presence of code**

We find 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 of ethics. Ten companies state that their code of ethics is on their website, but we were unable to locate the code. In nine cases, we find 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 took their companies private, and therefore the regulations pertaining to publicly filed companies no longer pertained to them. Three remain publicly listed on the exchange, but do not have codes of ethics. According to EDGAR, one company has never made any filings with the SEC, while the second has not filed in more than a year.

## **2. Ease of discovery**

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

### **a) From document to document**

First, we examine 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 begin there.<sup>53</sup> If the 10-K refers investors to the proxy statement, there are two steps. If the proxy statement in turn refers investors to the company website, location requires three total steps. There is only one step if the company posts its code of ethics directly in the 10-K. When the 10-K refers the user directly to the website where the code of ethics was located, this takes "two steps" to locate. Finally, in some instances the 10-K would refer the user to a proxy statement, which would then direct the user to the company website for a copy of the code of ethics, and this takes "three steps." An overwhelming number of codes could be found in two steps.

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<sup>53</sup> The SEC's requirement that companies disclose their disclosure method in the 10-K presumes that investors would 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 Section b.

Number of Steps to Find Ethics Code	Number of Companies
1	33
2	96
3	35
Total	164 <sup>54</sup>

**b) From click to click**

Successful navigation to a company's website may not end the inquiry, however. A company can "bury" its code of ethics within the website, however, requiring investors to navigate through several pages before finally finding the codes. To measure this complexity, each webpage that an investor navigates in order to view the code of ethics is counted as a single "click."<sup>55</sup>

Number of Clicks to Find Ethics Code	Number of Companies
1	4
2	27
3	64
4	18
5	4

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<sup>54</sup> The total of 164 is derived from the original 200 minus 21 companies that have no code, 10 companies for which a code ultimately could not be located, and 5 companies which require one to write to the company secretary in order to receive the code.

<sup>55</sup> We presume that an investor interested in a companies code of ethics would know to click on a link titled "Investor Relations" (or similar) and then on "Corporate Governance," "Ethics," or a similar link.

6	2
7	1
No code found	10
Total:	130 <sup>56</sup>

In summary, we find that almost all companies disclose codes and they are generally easy to find, although a sizable minority to make them more difficult to find. Arguably the most troubling of our findings are the ten companies where we could not find a code of ethics, despite the companies' assertion that it had been disclosed. In these cases, the company may receive some benefit of appearing to have a code of ethics, but investors are likely unable to discover them.

## IV. Sample Waivers

In this section, we move to the heart of our findings: the disclosure of waivers granted from the codes of ethics. We first examine waiver location, and then discuss the lone waiver we found for the 200 sample firms over the four surveyed years. We then study the related-party transactions of the 200 sample firms reported in their year-end proxy statements, and cross-check to see if they fail to report waivers when required to do so. Finally, we discuss the unusual case of 3 Viacom waivers that, while not a part of the sample, raise a myriad of interesting issues.

### A. Location

Along with disclosing their code of ethics, companies must also indicate where waivers of the code will be located. 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.<sup>57</sup>

Forty-six companies, or 23% of the sample, do not specify the disclosure location of the waivers. The SEC's regulations require disclosure of

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<sup>56</sup> 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 takes one directly to a PDF containing the code of conduct.

<sup>57</sup> None of these companies chose to set out their code of ethics in their 10-Ks, however.

the intention to disclose waivers on a website, so silence presumably means disclosure will be by the default means, via 8-K.<sup>58</sup> Twenty-one companies, who did not have a code of ethics, are categorized as “not applicable.” The remaining 38 companies simply state that disclosure will be made by “some approved means” without indicating what means they will use. These last companies are arguably the most confusing to investors, who are now left with the possibility that the companies will use 8-Ks, company websites, or some other undefined disclosure mechanism that might be “approved” — by whom it is unclear: the company? The exchange? The SEC?

Disclosure via Website	92
8-K	3
Silent	46
Not Applicable	21
Some Approved Means	38
Total	200

### ***B. Single disclosed waiver***

Of our sample of 200 companies over four years, only one made a waiver disclosure. BioTime, Inc., a biotechnology firm, disclosed a waiver on October 12, 2007 on a Form 8-K filed with the SEC.<sup>59</sup> BioTime’s CEO, Dr. Michael West, had recently been hired from his position as President and

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<sup>58</sup> See 17 C.F.R. § 229.406(d) (2005): “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 registrant’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, disclose the registrant’s Internet address and such intention.”

<sup>59</sup> 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 remain on its board of directors until December 31, 2007. Advanced Cell Technology, Inc. is a potential competitor of BioTime in field of regenerative medicine and stem cell technology.” Biotime, Inc., Current Report (Form 8-K), at 7 (Oct. 10, 2007).

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, and the BioTime board granted a waiver to allow 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.

We characterize the lone sample waiver as relatively innocuous. 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. The consulting and board service components, the most troubling aspects of the waiver (because of the specter they raise of immediate conflict, a CEO “serving two masters”), lasted only three months and terminated at year end. The waiver, then, might offer some support for the idea that codes of ethics are diluted to the point that no significant information is disclosed, or that truly troubling behavior is being prevented.

### *C. Compliance assessment: related party transactions*

We provide several explanations for the glaring absence of waiver disclosure in our sample. First, companies might be extremely ethical, and may not engage in the kinds of transactions for which disclosure is required. Second, companies that might otherwise engage in unethical conduct may be dissuaded from such conduct by the prospect of SOX-required disclosure. Finally, the undesirable conduct still may be occurring, but not be being disclosed. The last case, of course, would be difficult to prove precisely because the required disclosure is not being made; there is no way for a researcher to know of undisclosed conduct precisely because it is undisclosed.

The overlap of different securities disclosure regulations provides us a rare chance to measure compliance with disclosure requirements. Item 404 of Regulation S-K requires disclosure in a company’s 10-K<sup>60</sup> 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.”<sup>61</sup> “Related persons” are defined as (a) a corporation’s current or nominated

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<sup>60</sup> Item 13 of the 10-K requirements require compliance with Item 404 of Regulation S-K. See 17 C.F.R. § 249.310 (2008).

<sup>61</sup> See SEC Item 404, 17 C.F.R. § 228.404 (2008).

directors and executive officers, and their immediate family,<sup>62</sup> 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.<sup>63</sup> Related party transactions must be disclosed annually on Form 10-K or a proxy statement,<sup>64</sup> in contrast to waivers of a company's code of ethics, which must be disclosed within four business days on a Form 8-K or, if the company has chosen this method of reporting, on the company's website.<sup>65</sup>

The fit is not perfect. Not all related party transactions fall within Section 406's purview. Item 404 applies to all transactions over \$120,000 between the corporation and a relatively large set of corporate insiders. Section 406 applies only to senior officers: the CEO, CFO, CAO, or officers performing similar duties. Thus, we reviewed all reported related party transactions for the sample companies from 2002-2007. 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, *none of these transactions were disclosed as waivers.*

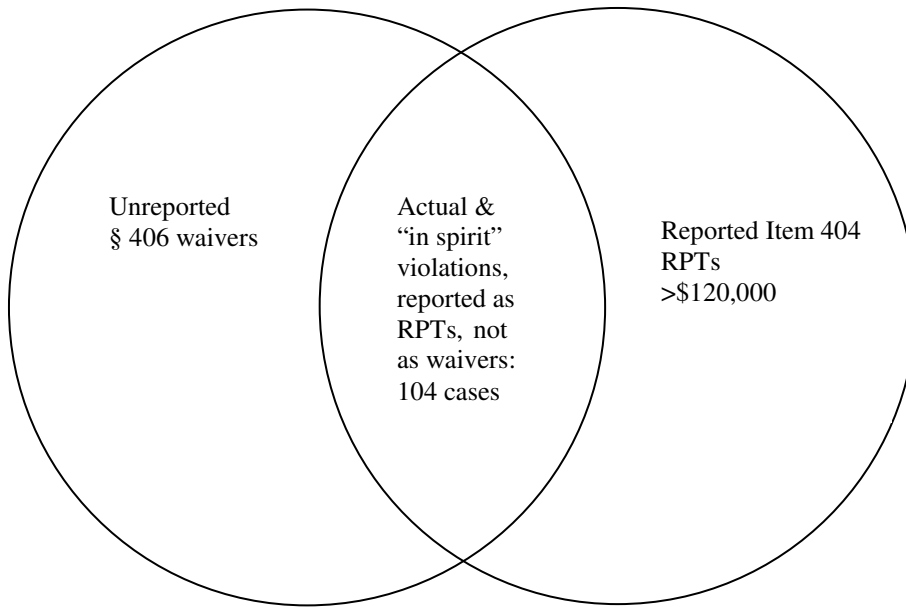
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<sup>62</sup> Defined as "any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law of such director, executive officer or nominee for director, and any person (other than a tenant or employee) sharing the household of such director, executive officer or nominee for director." *Id.*

<sup>63</sup> See Instructions to SEC Item 404, 17 C.F.R. § 228.404(a) (2008); SEC Item 403, 17 C.F.R. § 228.403 (2008).

<sup>64</sup> 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 after 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 on their proxy statements. See Nowack, *supra* note \_\_, at 387 ("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.").

<sup>65</sup> See General Instruction B.1 to Form 8-K, 7 C.F.R. § 249.308 (2008).



**Figure 1**

Still, one might think, “no harm, no foul.” Although the Section 406 transactions are not being labeled as waivers, at least they are being disclosed, as Congress intended. But there’s a difference between immediate disclosure and eventual disclosure. In the universe of ethical issues, ethics-minded stockholders would presumably want to know about related party transactions<sup>66</sup>—one of the starkest conflicts of interest within a corporation—immediately. Indeed, Section 406 requires near-real-time 8-K or website disclosure, presumably because investors want to know about waivers from the code of ethics almost immediately. Item 404, in contrast, presumes that investors want to know about related party transactions, but only requires that disclosure of that information *once a year, in the 10-K*. So by not reporting transactions as conflict waivers, companies are delaying disclosure by months—as many as eleven months, if the transaction is made directly after the 10-K filing.

Furthermore, proxy statements contain much more information than just related party transactions. Among other information, they typically contain information on stock option plans, biographies of directors, executive officers, promoters and control persons, executive compensation, stock holdings of large shareholders and management, and accounting fees and services. Thus, proxy disclosure is “covert” disclosure: companies may attempt to “bury” negative information amidst a sea of information. If investors have a large amount of information to process, and if they have

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<sup>66</sup> That is, when the company completes a transaction with a director, officer or one of their family members.

limits to their attention, then disclosing information in a noisy setting may distract investors from otherwise pertinent information.<sup>67</sup> There is some evidence that such behavior occurs with a firm's accounting disclosure and reporting choices.<sup>68</sup>

### 1. Actual violations

Out of 200 companies, 15 companies actually violated Sarbanes-Oxley.<sup>69</sup> The total number of actual violations for all companies was 30. The number of actual violations is as follows:

Type of Transaction	Number of Transactions
Asset Sales	5
Family Hires	12
Leases	7
Loans	3
Other	1
Products	2
Total	30

"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 raise issues because of the conflict of interest when determining the terms of

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<sup>67</sup> For more on this phenomenon, see DANIEL KAHNEMAN, *ATTENTION AND EFFORT* (1973).

<sup>68</sup> David Hirshleifer & Siew H. Teoh, *Limited Attention, Information Disclosure, and Financial Reporting*, 36 J. ACCT. & ECON. 337, 337-386 (2003).

<sup>69</sup> Sometimes firms disclose related party transactions that occurred in prior years. Therefore, a single transaction might be disclosed on 3 successive proxy statements. We have counted a single transaction as one violation of Rule 406, on the theory that Rule 406 is a one-time disclosure requirement. However, if the transaction is "on-going" (i.e., a multi-year loan or an interlocking director position), we do not treat each subsequent disclosure as another violation. In other words, we presume that Rule 406 is focused on getting information to the market quickly and Schedule 14-A is more focused on providing a snapshot of the related party transactions a company currently (or in the recent past) has engaged in.

the sale. In one example of an asset sale, the company sold a condo it owned to its COO.<sup>70</sup>

“Family hires” occur when a company hires a member of an officer’s family for a position within the company. These hires present conflicts because the terms of the employment agreement may seem unduly favorable or the family member may appear to be (or actually be) unqualified for the position. In a typical example of a family hire, a company hired its President’s son and his brother. The son was employed as a representative, while the brother was hired as the Director of Production Technology.<sup>71</sup>

In the category of “leases,” the corporation usually either leases property, either real or personal, to or from an officer of the corporation. In one example, the company leased a branch in Alabama from a corporation in which the President and CEO of the company owned a minority interest and was president.<sup>72</sup>

Many corporations make loans to their officers. Making loans can be problematic if the loans are made in terms unfavorable to the corporation; they also reduce ready cash flow for the corporation.<sup>73</sup> Loans can also include situations in which an officer or director makes a loan to the corporation, although these appear to be less problematic as long as the rates charged are at or below market. Several companies did not disclose the amount of the loans given or who the loan was given to, but rather made a blanket disclosure that loans to executive officers were made “on substantially the same terms...as those prevailing at the time for comparable transactions with other persons.”<sup>74</sup> In another example of loans, several officers personally guaranteed a loan that was made to the company and in one instance, an officer made a personal loan to the company of \$100,000.<sup>75</sup>

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<sup>70</sup> See Semitool, Inc., Proxy (Form 14A), at 11 (Jan. 21, 2005).

<sup>71</sup> See Energy Conversion Devices, Inc., Proxy (Form 14A), at 40 (Oct. 29, 2007). The employment of the son and brother was terminated in 2007, the year of the disclosure.

<sup>72</sup> See Charter Fin. Corp., Proxy (Form 14A), at 21 (Jan. 28, 2004).

<sup>73</sup> Section 402 of Sarbanes-Oxley prohibits loans to executives. See 15 U.S.C. § 78m (2008) (“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 if the loans in this sample have been structured to avoid violation of Section 402, or if they are violating the provision.

<sup>74</sup> See, e.g., Carver Bancorp, Proxy (Form 14A), at 20 (July 29, 2004); Charter Fin. Corp., Proxy (Form 14A), at 21 (Jan. 28, 2004).

<sup>75</sup> See Transcend Services, Inc., Proxy (Form 14A), at 15 (Mar. 31, 2006).

The “products” category encompasses instances in which the firm purchases products from or sells products to another firm in which one of their executive officers has a substantial interest. In one example of products, Backyard Burger, Inc. purchased certain food products from Michael Enterprises, Inc. The President of Michael Enterprises is the CEO and Chairman of Backyard Burgers.<sup>76</sup>

## **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. Incredibly, most of the surveyed companies do not ban “related party transactions” in their code of ethics.<sup>77</sup> Section 406, remember, only requires reporting of waivers to a company’s particular code of ethics. If the code is “diluted” so that it fails to prohibit related party transactions, then no waiver is needed. Although these related party transactions occur frequently, by virtue of omission of the category from the code of ethics, the companies can avoid mandatory near-real-time disclosure of these transactions via their websites or 8-Ks, instead delaying disclosure until the 10-K filing.

A close reading of the Act suggests that this tactic may be illegitimate, however. Section 406(c) of the Act defines “code of ethics” to mean “such standards as are reasonably designed 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.”<sup>78</sup>  
[Emphasis added]

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<sup>76</sup> See Backyard Burgers, Inc., Proxy (Form 14A), at 15 (Apr. 19, 2004).

<sup>77</sup> Only thirty companies include related party transactions within their code of ethics.

<sup>78</sup> 15 U.S.C. § 7264 (2008). 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).

We argue that by omitting related party transactions from their codes of ethics, these companies are at least arguably in violation of Section 406(c)(1), because their codes are not “reasonably designed” to promote “ethical handling of actual or apparent conflicts of interest between personal and professional relationships.”<sup>79</sup> At the very least, we can say that these codes violate the intention, or “spirit” of Section 406’s disclosure requirements. After all, as discussed in Part III, 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.

Indeed, 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 counterparty becomes related to the firm and (2) when a transaction entails the handing down of executive positions to family members.<sup>80</sup> Also, it has been found that firms that engage in related party transactions are more likely to manage earnings, allegedly to mask any expropriation occurring through the related party transaction.<sup>81</sup> Finally, there is some evidence that Chinese firms acquire (sell) assets from related parties at prices that are higher (lower) than similar deals that are arms-length transactions.<sup>82</sup> Thus, there is a basis for believing that it is the onus of the firm to convey the rationale for such transactions.

### **3. “In spirit” violations**

Incredibly, despite the fact that Section 406 was a specific response to Enron’s board-approved related party transactions, many companies omit

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<sup>79</sup> Ironically, the SEC first proposed rules separately requiring that ethics codes address related-party, but eliminated the 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.” Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5110, 5118 (Jan. 31, 2003).

<sup>80</sup> See Shawn Thomas & Michael Ryngaert, Related Party Transactions: Their Origins and Wealth Effects (Sept. 20, 2007) (on file with author at University of Pittsburgh).

<sup>81</sup> See Elizabeth Gordon & Elaine Henry, Related Party Transactions and Earnings Management (Nov. 2, 2005) (on file with author at Rutgers University).

<sup>82</sup> See Steven Yan-Leung Cheung, Yuehua Qi, Raghavendra Rau, & Aris Stouraitis, *Buy High, Sell low: How Listed Firms Price Assets in Related Party Transactions*, J. BANKING & FIN. (forthcoming 2009).

these transactions entirely from their codes of ethics. One could plausibly argue that these companies hurt only themselves, because the market will internalize the weakness of their codes of ethics, and discount the stock accordingly. But for our purposes, the significance of these “in spirit” violations is that they show how easily and routinely companies can evade the intent of regulation when it is couched in terms of disclosure.

In 74 instances, the company has reported a related party transaction, but their code of ethics does not prohibit the transaction. Unfettered by the constraint, the companies were free to delay reporting these transactions until their annual 10-K filings, rather than filing a waiver to the codes of ethics within 4 business days after the transaction. This we term an “in-spirit violation,” because while the nondisclosure of a waiver does not violate Sarbanes-Oxley, it violates the spirit of the Act by permitting transactions involving conflicts of interest at the highest levels of the corporate organization: the CEO, CAO, CFO and similar officers.<sup>83</sup> Out of 200 companies, 45 violated the spirit of the Sarbanes-Oxley Act.

The total number of in spirit violations for all companies was 74. The types of transactions are broken down into asset sales, family hires, interlocking positions, leases, loans, products, and services.

Asset sales usually involve the sale of assets to or from a related party.<sup>84</sup> In one example of an “in spirit” asset sale violation, the Atlantic Tele Network Inc.’s board of directors authorized the sale of all of its remaining assets in the corporation’s business in Haiti, including an office building and 13 tower sites, to its Chairman. The Chairman was also the father of Atlantic Tele Network’s Chief Executive Officer.<sup>85</sup> Because Atlantic Tele Network’s code of ethics did not prohibit related party transactions, it was able to delay disclosure of the sale for almost a full year.<sup>86</sup>

Family hires typically involve hiring the family member of an officer or the company in which the family member worked or that the family member owned.<sup>87</sup> In one example of a more direct family hire, the corporation hired its Co-CEO and Co-President’s stepson to act as the

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<sup>83</sup> For this discussion we leave to one side the question whether The Act actually permits omitting related-party transactions from codes of ethics.

<sup>84</sup> See also *supra* notes \_\_ and accompanying text.

<sup>85</sup> See Atlantic Tele Network Inc., Proxy (Form 14A), at 30 (Apr. 30, 2007).

<sup>86</sup> The transaction occurred in May 2006, and the disclosure was filed in April 2007. See *id.*

<sup>87</sup> See also *supra* notes \_\_ and accompanying text.

Company's Vice President of Franchise Development at a salary of about \$86,000 per year.<sup>88</sup>

"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, at times, be conflicting. In one example of interlocking positions, Atlantic Tele Network acquired a significant minority interest in, and provided funds to, LighTrade, Inc. ATN's CEO was also an officer of LighTrade, Inc.<sup>89</sup>

Leases are when a corporation leases property from an officer.<sup>90</sup> In another example of a lease, the company leased a private aircraft from its Chairman and CEO for roughly \$30,000 per month.<sup>91</sup> In another example of a lease agreement, 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.<sup>92</sup>

Loans involve making a loan to a related party.<sup>93</sup> In one example of loans, the corporation loaned its new Chief Financial and Information Officer, as part of his employment agreement, an amount of money necessary to pay off a loan by his former employer.<sup>94</sup> In another example of loans, the corporation loaned its CEO and Chairman, who had retired that year, two million dollars for the sole purpose of purchasing the company's stock.<sup>95</sup>

Products involve the sale of products by a company controlled by an officer, or a party related to an, to the corporation.<sup>96</sup> In one example of products, the corporation purchased food related products from another

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<sup>88</sup> See California Pizza Kitchen, Inc., Proxy (Form 14A), at 20 (May 1, 2006).

<sup>89</sup> See Atlantic Tele Network, Proxy (Form 14A), at 17 (Apr. 18, 2006).

<sup>90</sup> See also *supra* notes \_\_ and accompanying text.

<sup>91</sup> See K2 Inc., Proxy (Form 14A), at 12 (Apr. 12, 2007).

<sup>92</sup> See Granite City Food & Brewery, Inc., Proxy (Form 14A), at 35 (Sept. 25, 2007).

<sup>93</sup> See also *supra* notes \_\_ and accompanying text.

<sup>94</sup> See Beverly Enters. Inc., Proxy (Form 14A), at 38 (May 11, 2004).

<sup>95</sup> See Borgwarner, Inc., Proxy (Form 14A), at 18 (Mar. 22, 2004).

<sup>96</sup> See also *supra* note \_\_ and accompanying text.

company. The corporation's President and CEO was also president and majority shareholder of the second company who made the sales.<sup>97</sup>

### **"In Spirit" Violations**

Type of Transaction	Number of Transactions (Excluding Actual Violations)
Asset Sales	12
Family Hires	11
Interlocking Positions	8
Leases	7
Loans	19
Products	3
Services	10
Other	4
Total	74

## **4. Alternate explanations for our findings**

Madoka Mori suggests an alternate explanation for the dearth of ethics waivers. In a prior study focusing solely on waivers filed with the SEC from 2004-2006 (ignoring because of difficulty of study the website disclosure possibility), she found only 26 waivers. 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, she instead focuses on what she terms a "hypertechnical" definition of the term "waiver." As she explains, 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." She posits that companies have arguably avoided the need to disclose waivers by adopting codes that provide for "approvals, permissions, or authorizations."<sup>98</sup> The argument goes that the

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<sup>97</sup> See Backyard Burger, Inc., Proxy (Form 14A), at 15 (Apr. 19, 2004).

<sup>98</sup> Mori, *supra* note \_\_, at 305-06.

company could reason that if the code itself allows for approval for deviations from the code, then granting the approval is not a “departure,” and thus need not be disclosed.<sup>99</sup> She therefore suggests amending Form 8-K’s instructions to require disclosure “approvals” of conflict-of-interest activities.

We do not agree that Mori’s theory is a plausible excuse for not disclosing waivers. As Mori herself points out, the chairmen of Enron’s audit committee and finance committee tried a similar argumentative sleight-of-hand before the Senate when they testified that there was no waiver of Enron’s code of conduct when it “approved” the related party transactions with Fastow.<sup>100</sup> Nevertheless, the Senate Report rejected the Enron officials’ proffered sophistry and characterized the behavior as a waiver.<sup>101</sup>

Still, it may be that the 30 companies we find with actual violations are relying on Mori’s “approval” interpretation of the securities laws to evade disclosure. Her explanation does not help the “in spirit” violators who failed to forbid any related party transactions in their codes of ethics. To make yet another interpretive argument, it may even be that they rely on the materiality language of the instructions to argue that the transactions were not “material” departures from the code. 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 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.

At a more fundamental level, as we will discuss further in our Conclusions section, we believe that these overly-legalistic interpretations of the law amount to the same thing. Whether companies attempt to evade the reach of the ethics waiver provision by arguing that their so-called “code” does not forbid related party transactions, or they have not departed from their code in approving a transaction (Mori’s hypothesis), or that a departure from the code is not “material,” the point is that companies appear to be routinely allowing their senior offices to engage in conflicting interest transactions without immediately disclosing them to the market, as required by securities law.

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<sup>99</sup> *Id.* at 306.

<sup>100</sup> *Id.* at 306 n.20.

<sup>101</sup> *Id.* at 299.

## 5. Immediate disclosure not identified as ethics waiver

Our findings present twin problems of disclosure delayed and mislabeled: transactions that should be disclosed on Form 8-Ks within 4 business days after occurrence, and identified as waivers, are instead not disclosed until the year-end proxy statement, and are buried amongst other information. But if other SEC rules required 8-K disclosure of related party transactions, the problem of disclosure delay, at least, would not exist.

In fact, 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, “*Any 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.*”<sup>102</sup> Thus some subset of our related party transactions were, or should have been, disclosed within four business days in 8-Ks as material definitive agreements, as well as being disclosed as ethics waivers. See Fig. 2.

Of our 104 total violations, only 11 were in fact disclosed via 8-K as material definitive agreements; 10 were in spirit violations, and 1 was an actual violation.<sup>103</sup> So we are left with 93 related party transactions that were disclosed in the year-end proxy and should have been disclosed as waivers immediately. Of those 93, 64 are in spirit violations, and 29 are actual violations of Section 406.<sup>104</sup>

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<sup>102</sup> See Instructions to Form 8-K, 7 C.F.R. § 249.308 (2008) [emphasis added].

<sup>103</sup> 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 do not treat it was adequate disclosure of the nature of the transaction.

<sup>104</sup> Research into the possibility of this 8-K disclosure is complicated by the fact that most of the related party transactions disclosed in the year-end proxies are not dated; in fact, only 38 are.

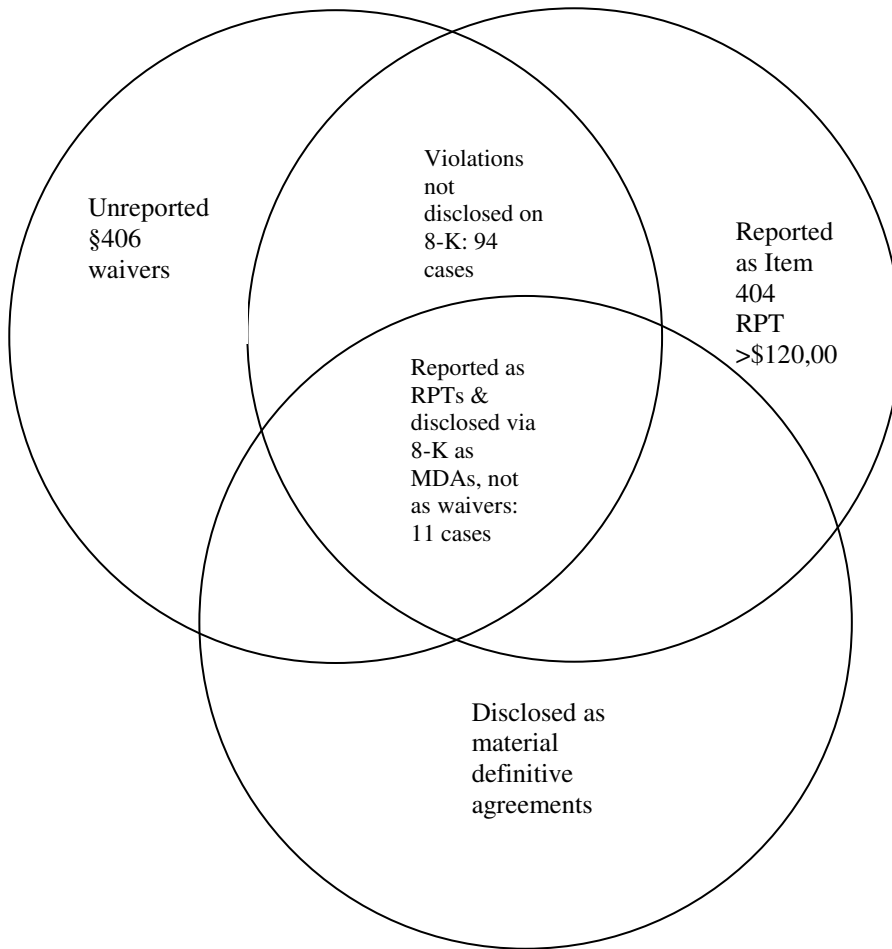


Figure 2

## 6. Timing of disclosure

We presume that disclosure of related party transactions in 10-Ks annual reports instead of via 8-K waiver causes a delay. But if companies were disclosing 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 4 business days after the transaction).

We also looked at when companies chose to disclose their related party transactions. For twenty-two companies, we could not tell whether the disclosure was made before or after the transaction. Only four companies 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 before the transaction occurred and some after.

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.

#### ***D. The curious case of Viacom***

Outside of our sample, during the course of research we discovered three waivers filed by Viacom via website. Of course, these cannot count as part of the sample, but they are positive proof that companies do use their websites to disclose waivers. Moreover, they offer a window into the misleading behavior a website disclosure option makes possible, even at a Fortune 500 company.

First, some background: prior to the waivers in question, Sumner Redstone, Viacom's Chairman and CEO, controlled 70.8% of Viacom's votes via control of a corporation, National Amusements' ownership of class A shares.<sup>105</sup> Importantly, the common stock of Viacom was divided into two classes. Class A shares entitle the owner to one vote per share, and class B shares are non-voting shares. Viacom announced that it was instituting a stock repurchase program. There is nothing unusual about this, on its own. Stock repurchase programs are common ways for companies to invest excess capital by buying up shares. In general, on the announcement of such programs the firm's shares will increase in value due to the market believing that a firm will only undertake such a program if the firm's shares are undervalued.<sup>106</sup> These repurchases, then, result in an essentially tax-free distribution to shareholders since capital gains can be indefinitely deferred.

Viacom disclosed an October 28, 2004 agreement with National Amusements, Inc., on [www.cbcorporation.com](http://www.cbcorporation.com).<sup>107</sup> Viacom made 2 similar agreements, and received 2 corresponding waivers, in 2005 and 2007.<sup>108</sup> The

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<sup>105</sup> See Viacom, Inc., Proxy (Form 14A), at \_\_ (Oct. 28, 2004). Both National Amusements and NAIRI, Inc., a wholly-owned subsidiary of National Amusements, owned shares of Viacom. Because both are controlled by Redstone, we treat them as a single entity for purposes of this discussion.

<sup>106</sup> See Clifford Stephens & Michael Weisbach, *Actual Share Repurchases in Open-Market Repurchase Programs*, 53 J. FINANCE 313 (2008).

<sup>107</sup> See Viacom, Inc., Waiver of Conflict of Interest, [http://www.cbcorporation.com/assets/documents/waivers\[1\].pdf](http://www.cbcorporation.com/assets/documents/waivers[1].pdf) (Oct. 29, 2004). Viacom spun off into CBS Corporation and Viacom; the 2004 agreement is on the surviving company website, CBS Corporation.

<sup>108</sup> In 2005, Viacom spun off into CBS Corporation and Viacom; the 2005 agreement and 2007 agreements are disclosed on the spin-off company, Viacom's site. See Viacom.com, Waiver of Conflict of Interest,

agreements are identical in nature. Each is between National Amusements (the entity controlled by Redstone) and Viacom, and the intention of the agreements is to allow National Amusements to participate in Viacom's repurchase program of common stock.<sup>109</sup> The three agreements allow National Amusements (essentially, Mr. Redstone) to participate in the repurchase program by allowing its Viacom class B shares (not class A shares) to be bought by Viacom, in tandem with shares purchased on the open market. The agreements state that they are "intended to maintain their percentage equity ownership in Viacom, which would otherwise increase as a result of purchases made by Viacom pursuant to the stock purchase program."<sup>110</sup> In essence, this statement means that Mr. Redstone's total holding in both class A and B shares should remain constant throughout the program.

It is important to note that the announced repurchase programs include the repurchase of both classes of shares, but the agreement only stipulates that Mr. Redstone's class B shares be repurchased. There are two stories we can tell about these agreements, one benign and one malign. In the benign version, the agreement is meant to do no more than what it states, maintain National Amusement's (and through it, Sumner Redstone's) ownership percentage; without the agreements, he would increase ownership of the company by mere virtue of the decrease in the number of outstanding shares. Indeed, technically his equity ownership percentage remains about the same.

Still, a more sinister, and believable, story would describe the stock purchase plan and accompanying National Amusements/Viacom agreements as orchestrating a consolidation of Mr. Redstone's control with, at best, no outlay of cash. As seen in the accompanying table, the transactions appear to have the effect of allowing Sumner Redstone to simultaneously take cash out of Viacom and gain more control of the firm.

As seen in Table XX, Redstone's total equity ownership changes very little from 2003, before the repurchase program is announced, to 2008.<sup>111</sup>

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[http://www.viacom.com/investorrelations/Investor\\_Relations\\_Docs/New\\_Viacom\\_BCS\\_Waiver.pdf](http://www.viacom.com/investorrelations/Investor_Relations_Docs/New_Viacom_BCS_Waiver.pdf) (Jan. 1, 2006).

<sup>109</sup> A \$3 billion program was introduced in 2004 and a \$4 billion program was introduced in 2007.

<sup>110</sup> Waiver of Conflict of Interest, available at: [www.viacom.com](http://www.viacom.com/investorrelations/Investor_Relations_Docs/New_Viacom_BCS_Waiver.pdf) at [http://www.viacom.com/investorrelations/Investor\\_Relations\\_Docs/New\\_Viacom\\_BCS\\_Waiver.pdf](http://www.viacom.com/investorrelations/Investor_Relations_Docs/New_Viacom_BCS_Waiver.pdf).

<sup>111</sup> Viacom spun off CBS Corp. between the 2005 and 2006 proxy statements, thus drastically changing the shares outstanding in the table.

However, Mr. Redstone increases his control of the firm (via class A shares) by about 12% while simultaneously reducing his non-voting shares from 6.4% to 4.6% of the total shares. A repurchasing story is easy to tell from this table. From 2004 to 2008 Viacom repurchased both class A and class B shares. However, Mr. Redstone only sold back to the firm the non-voting class B shares and no class A shares. Thus, Mr. Redstone increased his wealth by selling class B shares (seen in the reduction of relative and absolute share ownership decreases) and increased his control over Viacom by simply allowing the firm to repurchase all class A shares except his (seen in the static number of outstanding class A shares and the increasing percent ownership of class A shares).

**Table XX 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 shares	69.4%	70.8%	71.2%	72.3%	79.1%	81.6%
Redstone's % B 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%

Yet rather than telling the market: "I'm increasing my voting control of the company and taking money out for my wholly-owned subsidiary," the waiver is worded as merely a way to effect the company's stock purchase plan and not increase his ownership percentage. While technically true (because his total equity ownership does not increase), the waivers create a false implication that his real voting control will not go up, when in fact it does.

No matter which view you take of these actions, Viacom's disclosure choices are interesting, to say the least. As noted, all three waivers were filed on the companies' websites (the 2007 one filed as an "update" to the 2005 one, so it appears from the website that only one waiver was disclosed, even

though there are 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, but under the heading of “entry into a material definitive agreement”—they were not identified as conflict waivers. So although the company disclosed the agreements to the market real-time via an 8-K, the agreements was only flagged as requiring conflict waivers in website disclosure, not in SEC filings.

The Viacom waivers, then are interesting on at least two fronts. First, they show an example of a waiver disclosed on a website; despite the fact that almost half of our sample (45%) 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 the agreement as a “material definitive agreement,” thus providing near-real-time disclosure via 8-K. But it chose to avoid the taint of labeling the transaction as an ethics issue. Of course, the information was disclosed to the market; efficient market believers would argue that the markets are quite capable of assimilating relevant information and that the lack of the label “ethics waiver” is insignificant. Avoiding an 8-K disclosure of ethics waivers seems to have mattered to Viacom, however, at least so much so that it chose a convoluted path of double disclosure (website and 8-K) that avoided identifying the transaction’s questionable ethical component in the filing it made with the SEC. An alternative explanation 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.

We are unaware of other disclosures that the SEC permits companies to make on websites rather than via SEC filings. The Viacom example points out the difficulties of this regime. No regulation requires companies to leave the waivers posted for any length of time, nor is there guidance as to how to label waivers: Viacom is able to make two waivers look like one by adding its 2007 waiver as an “update” to the 2005 one. In fact, as of March 2009, it seems impossible to navigate to find the disclosed waiver, 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, a centralized, permanent record would exist. Website disclosure seems to presume that investors would continually monitor a company’s investor relations site, on the lookout for disclosure of an ethics waiver. As it is, we have confusion and incomplete disclosure.

## **V. All conflict waivers filed with SEC**

### ***A. Methodology***

In addition to researching a random sample of 200 companies, we also use a subscription-based search engine, 10k Wizard, to search the SEC's EDGAR filings. We search 8-K and 8-K/A forms under Item 5.05 and the terms "code", "ethics" and "waiver." Because many 8-K filings reference Item 5.05 only to state that it was "not applicable," we screen out the term "applicable." This data set does not comprise all waivers filed, however, because companies can also file waivers on their websites. Nevertheless, given that there is 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 V, we classify waivers into six different categories. The most numerous, wealth transfers, contains 11 observations. This category contains waivers in which there is a transfer of wealth from the firm to one of its officers or directors. This takes three main forms: (1) the firm acquiring another firm owned by a manager or director, (2) the firm undertaking a real estate transaction (*i.e.*, leasing or buying) in which the real estate is owned by a manager or director of the firm, and (3) the firm buying a service or product from a company in which a manager or director directly benefits from in a monetary fashion. In a typical real estate transaction, the corporation disclosed amendments made to a current lease arrangement between the corporation's headquarters and its Chief Executive Officer.<sup>112</sup> 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.<sup>113</sup>

The category with the second most numerous observations is interlocking positions. Interlocking positions occur when an officer or director holds one or more positions that may cause a conflict with his or her status as an officer or director. In one example of "interlocking positions," Wheeling Pittsburg Corp. authorized its CEO and its President to act as

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<sup>112</sup> See Hauppauge Digital, Inc., Current Report (Form 8-K), at 2 (Oct. 18, 2006).

<sup>113</sup> See Marvell Tech. Group, Current Report (Form 8-K), at 2 (Aug. 11, 2005).

minority owners, directors and executive officers of a company who competed with the corporation in a few, narrowly defined ventures.<sup>114</sup>

We classify five waivers as disclosing related party transactions. This category includes those incidents where the corporation does business with another company controlled by a party related to an officer or director of the corporation. In one example of a related party transaction, IVAX Corp. waived the code of ethics in favor of a consulting agreement with a company controlled by the CEO's nephew, and a services agreement with the same CEO's son.<sup>115</sup>

There are also five waivers we classify as blackout transactions. These waivers include instances in which the corporation allows an officer or director to purchase or sell stocks during a period when such sales are usually prohibited - blackout periods. In one example, 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.<sup>116</sup>

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.<sup>117</sup>

Finally, there are four waivers that do not fit into a specific category, and we classify these as "other." In one case, Tivo, Inc filed a waiver that allowed a board member to sit on more boards than that allowed within the firm's code of ethics (a maximum of two board seats).<sup>118</sup> In a waiver that involved the CFO accusing the CEO of abuse of power, Hooper Holmes filed a waiver granting the CEO a reprieve from his poor judgment of obtaining company reimbursement for \$23,000 of personal expenses, which the company deemed immaterial. Another waiver filed by GIII Apparel allowed two of its directors to acquire an interest in a customer. Finally,

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<sup>114</sup> See Wheeling Pittsburgh Corp., Current Report (Form 8-K), at 4 (Dec. 6, 2006).

<sup>115</sup> IVAX Corp. disclosed the agreement with the nephew on two occasions. See IVAX Corp., Current Report (Form 8-K), at 2 (Oct. 12, 2004) (providing for 18 month term of agreement); IVAX Corp., Current Report (Form 8-K), at 2 (Sept. 11, 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 3 (Feb. 8, 2005).

<sup>116</sup> See Nat'l Coal Corp., Current Report (Form 8-K), at 2 (Apr. 3, 2007).

<sup>117</sup> See Am. Capital Strategies, Current Report (Form 8-K), at 2 (Dec. 21, 2006).

<sup>118</sup> See Tivo, Inc., Current Report (Form 8-K), at 2 (Feb. 15, 2005).

Overstock.com filed a waiver allowing one director to make a personal loan to another director. 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 ethics waivers

**Table V. Waivers**

This table shows the number of observations of each type of waiver found. In Panel A, we classify waivers in the first column and report the number of each type in the second column. In the remaining columns, we report 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 report the CAR for the three days around the filing date only in Panel B.

*Placebo Ethics*

Type of Waiver	Observations	CAR – file date	CAR – report date	CAR – event date
<i>Panel A</i>				
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 <sup>119</sup>	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]
<i>Panel B</i>				
Simultaneous disclosure	19	-2.3%* [14]		
Lone disclosure	17	1.3% [16]		

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

### *C. Price Evidence on Waivers*

For the 29 firms that file waivers, we examine the abnormal return to the firm's shareholders around the filing of the 8-K that contains the waiver to the firm's ethics code. We were unable to find price data for firms on five

<sup>119</sup> One waiver did not disclose what was being waived, other than that a waiver was occurring.

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 V. Thus, we report only one abnormal return associated with these two waivers. This process leaves 30 waivers for the analysis.

The abnormal return we examine is the cumulative abnormal return (CAR) to the firm from the 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 report 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 sub-category, we find that no sub-category is significantly different from zero at 5% significance or less.

We also examine returns around the date the 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-run our analysis from column three using this new, report date. We find that both the entire sample CAR, and the sub-sample CARs, are not different from zero. So, it appears either that there is not leakage of information, and, if there is, that the information is not important to shareholders.

For 25 firms, the 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. So, we also examine 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.

Finally, we examine transactions based on whether there is simultaneous disclosure of another event (*e.g.*, a simultaneous merger announcement alongside a waiver of a particular director of the bidder owning stock in the target) or not. 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 V, 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 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 an 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.

The wide range of issues filed as waivers to the code of ethics, 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 response that one could conclude from our findings is that the code of ethics is either great 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. Moreover 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.<sup>120</sup>

Thus, according to this filing, the board deems certain behaviors unethical, *i.e.* directors sitting on boards of potential competitors. The current chairman clearly violates Global's code of ethics, but because he violated the ethical code *prior* to adopting the code, his behavior is by definition acceptable. Though this statement by the board is illogical, at best, the board goes on to waive this behavior anyway. This example, one of only 36 waivers filed, underscores the seemingly nonsensical, but costly, busywork that requiring a corporate code of ethics represents.

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<sup>120</sup> Global Tech. & Tele., Inc., Proxy (Form 14A), at 2 (11/8/2006) (announcing ethics code and providing for waiver).

## **VI. Conclusions**

### ***A. Ethics disclosure***

Our findings suggest that the current regime is a bad one, long on costly and burdensome disclosure 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.

More fundamentally, we suggest eliminating the code of ethics waiver requirements entirely. The ability of companies to "game the system" by creating their code has allowed for weak codes and empty disclosures. The tiny minority of companies that disclose waivers generally save them for innocuous transactions, except when they are bundled with other information. They delay the more unsavory related party transactions and disclose them in year end proxies, where they can be buried amongst the noise of other year end 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, miniscule compared to a company of a market capitalization of billions of dollars. But these transactions are significant not for their actual cost to the firm, but for what they represent: the signal that agency costs may be severe, and that the firm's officers may be putting their own interests above the shareholders, more intent on looting the company than fulfilling their fiduciary duties.

### ***B. Website disclosure***

Selfishly, of course, as researchers we dislike website disclosure because it makes research much more difficult (arguably this type of research makes markets more efficient and provides another layer of monitoring of management). The SEC provides a reliable, consolidated database for study. In contrast, website disclosure is unpredictable, and there is no requirement that companies keep the disclosure public; indeed, Viacom has now made it impossible to navigate to the waivers we discuss from its Investor Relations page. When a company files with the SEC, in contrast, the information is

available forever. It is nearly impossible for investors to monitor this type of disclosure, unless they visit the company's website daily.

The Viacom waivers illustrate the perils of permitting website disclosure in general. Viacom was able to pick and choose which information it would disclose where. To the SEC, it disclosed a material definitive transaction, and only by website did it disclose the required ethics waiver. Further, if Viacom is at all representative, companies can misleadingly file waivers as "updates," making it seem as if there is one waiver when there are really several.

We conclude that website disclosure is a bad idea, period. It makes it harder to find information, and provides no real benefit to companies (except to give them opportunities to downplay questionable transactions). We are unaware of any other areas where the SEC permits website disclosure. The experiment should end here.

### *C. The limits of transparency*

Our study shows that requiring disclosure can only do so much. Why depends on whether one views companies as attempting in good faith to comply with the laws, or not. Under a "malign" view, companies manipulate the law to disclose as little as possible. Whether companies rely on an overly narrow definition of "waiver," as Mori posits, on the notion of "material departure", or as we maintain, they game the system by failing to include conflicts of interest in their codes of ethics, companies are evading the clear intent of the law. We characterize the ethics waiver requirements as "soft" disclosure: at best, easy for companies to get wrong, at worst easily manipulable. "Hard" disclosure, where a company is told to disclose related party transactions of over \$120,000, appears to work much better. Otherwise companies can bend the rules to duck or delay incriminating disclosures whenever possible.

Under a "benign" view, in contrast, companies' failure to disclose ethics waivers may be an honest mistake. Related party transaction regulation has been around for decades, and companies have established mechanisms for reporting it, and for training insiders through the chain of command in identifying and reporting them.

It is commonplace to speak of the costs and burdens imposed by securities regulation, and particularly by Sarbanes-Oxley.<sup>121</sup> Complying with codes of ethics disclosure requirements does not seem at first blush to be particularly onerous or costly; a company must merely file a Form 8-K or, if it has opted for website disclosure, merely post a document to its website. But if one believes the benign story above, companies may not be complying

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<sup>121</sup> See *supra* note \_\_\_ and accompanying text.

because they have not set up systems to monitor their high-level officers' conduct and raise red flags when the ethics code is violated. Under the benign theory, apparently without such monitoring, ethics codes are meaningless. Even well-intentioned companies might go astray if they are unaware of new disclosure obligations. This hypothesis has resonance for today's crisis. Educating all of the appropriate individuals within an organization, developing controls and systems for disclosure, may be a difficult but crucial step in implementing successful disclosure regulations.

Our findings thus 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. Fewer but more finely-tuned "hard" disclosure requirements are the answer.