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on

Legislative Proposals to Examine Corporate Governance

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Chairman Crapo, Ranking Member Brown, and members of the Committee, I thank you for inviting me to testify. Effective corporate governance is a crucial foundation for economic growth, and by providing accountability and legitimacy to large-scale businesses, it is a core part of America's success story. I am honored to have been asked to participate. The Committee asked for comment on the role that law plays in corporate and shareholder disclosures and governance, and how they could be improved. After answering those questions, I comment on five of the seven bills that are the focus of today's hearing, although I am happy to take questions about any of the bills.

Background and Credentials

By way of background, prior to joining Harvard, I was a partner practicing securities and corporate law at one of the nation's most prestigious law firms, Wachtell Lipton Rosen & Katz. I drafted proxy statements, annual reports, and prospectuses, worked with SEC staff, managed shareholder meetings, and advised on most of the governance topics before the Committee. As an adviser, I had to assist boards respond to shareholder pressures in the absence of good information. In short, I have lived the experience of coping with disclosure obligations, as well as their absence.

At Harvard, I teach, research and write about corporate law and governance in both the law school and the business school, as well as in executive education sessions with directors, CEOs, and general counsels. I co-authored a foundational "core reading" on corporate governance designed for all MBAs.[1] I am on the SEC's Investor Advisory Committee, and I am also serving as a monitor for the DOJ and a compliance consultant to the SEC.

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[1] John C. Coates and Suraj Srinivasan, Corporate Governance, Core Reading, Harvard Business Publishing (2018 forthcoming).

General Remarks on Corporate Governance

Law -- and the subset of law known as regulation -- has always played an important role in corporate governance, and it continues to do so. Corporations are creatures of law; without an act of government, no corporation would exist. Initially, corporate charters included government-imposed terms that some would now label regulation, including terms about who is authorized to act for a company, how disputes among corporate officials are to be resolved, and the relative powers of investors, boards, officers, and other agents, including rights of access to information. The features of limited liability, legal personality (including the right to sue), and indefinite lifespan represent, in essence, economic subsidies – they facilitate capital formation and economic activity that would not occur without corporate law.

Today, reflecting a traditional embrace of separation of powers, those terms are set out in an array of locations. They include:

- **federal statutes** such as
  - the Foreign Corrupt Practices Act,
  - the Williams Act, and
  - the Investment Company Act of 1940,
- **SEC, DOL** and **IRS regulations**,
- **state corporate statutes**,
- **court decisions** interpreting purposefully vague standards of conduct,
- stock exchange **listing standards** (which function as regulation),
- corporate **charters** and **bylaws**,
- corporate governance **principles** and **codes of ethics** (which, once adopted, function like regulation in many respects),
- academic **treatises** (relied up on by courts on occasion), and,
- increasingly, **codes of best practices**, **stewardship codes**, **voting policies** and governance positions taken by large index funds, other mutual funds, pension funds and proxy advisors (which reflect and reinforce governance norms).

As this list suggests, law pervades corporate governance.

Most of these laws allow ample room for variation and experimentation. The U.S. has never imposed "one size fits all" regulation in corporate governance. The most contentious part of the Sarbanes-Oxley Act (section 404), for example, permits companies to comply or disclose.[2] Companies are not required to do what audit firms think is necessary for an effective control system, if companies are prepared to disclose the disagreement and live with the market consequences, which a substantial number of companies choose to do. Still, the law provides the basic framework within which governance is negotiated.

The core part of that framework – although not the only one – consists of disclosure obligations. Disclosure has many virtues. Disclosure enhances legitimacy. It assures the public generally that state-created and state–subsidized corporations such as Apple, AT&T, and Facebook, with their enormous power and resources, are also working in the public interest. Disclosure is necessary for accountability. It allows investors and enforcement officials to hold corporate agents responsible for theft, fraud, or violations of other laws. Disclosure provides a basis for lawmakers to evaluate whether current laws are doing what they are intended to do. These lawmakers include Congress, the SEC, and ultimately, in a democracy, the public. Is existing law, for example, minimizing the production of "externalities" – harms on third parties not in a position to protect themselves? Disclosure provides a foundation for improving law over time.

As an economic matter, disclosure enhances the best allocation of resources for sustained growth. Basic theorems of economics that undergird our nation's preference

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[2] John C. Coates, The Goals and Promise of the Sarbanes-Oxley Act, 21 J. Econ. Persp. 91 (Winter 2007); John C. Coates and Suraj Srinivasan, SOX After Ten Years: A Multidisciplinary Review, 28:3 Accounting Horizons 627 (2014).

for free trade commonly assume among other things those trading are on the same informational playing field (no "asymmetric information"). Disclosure helps move towards that ideal. While voluntary disclosure is common and valuable, well-designed disclosure laws also add value. They create standards, ensure comparability across companies, add enforcement tools, and greatly improve the credibility and reliability of the disclosures.

Disclosure laws are also among the least intrusive and costly forms of regulation. They are not a panacea. They have costs, although those costs are often overestimated. Generally, those costs fall – often dramatically – over time.[3] But disclosure is a mild and often clearly socially efficient means to address specific problems. This is especially true when disclosure is compared to mandatory conduct rules, structural laws such as activity bans (even if coupled with exemptions), state ownership, or political governance. The public has a tendency to demand legal change in response to crises, market crashes or corporate scandals. Those responses can be prescriptive, especially if the behavior involved took place in the dark. Disclosure reduces paranoia, and moderates reactions.

Even if information disclosed is not readily understood by the public, or even by most investors, the role of sunlight in deterring misconduct is too well known to elaborate. Disclosures can be processed by analysts, who can then provide summaries and recommendations to others. For example, as I have written about with Glenn Hubbard -- who served as Chairman for President George W. Bush's Council of Economic Advisors and who currently Co-Chairs the Committee on Capital Markets

[3] See Coates and Srinivasan, supra note 2; see also John C. Coates, Towards Better Cost-Benefit Analysis: An Essay on Regulatory Management, 78 Law and Contemporary Problems 1 (2015); John C. Coates, Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications, 124 Yale Law Journal 882 (2014-2015).

Regulation -- the Investment Company Act is one of the most successful disclosure laws of all time.[4] It requires disclosure of much information that few investors ever learn about directly. But the disclosures are consumed, analyzed and simplified by financial advisors and intermediaries such as Morningstar. The U.S. has the most successful fund industry in the world, thanks in significant part to mandatory disclosure laws.

Three Specific Bills

I turn now to five of the bills before the Committee.

Cybersecurity Disclosure Act (S. 536)

I support the Cybersecurity Disclosure Act (S. 536). On the basic issue of cyber-risk, I will not detail here what I expect the Committee already knows: cyber-attacks are more frequent and consequential each year; they are producing more and more harms to the public and investors; and, as SEC Chair Jay Clayton testified, they are not well understood by American investors.[5]

What I will emphasize is that cyber-risk is, among the many kinds of risks that companies face, nearly unique. Cyber-risk is intense, ever-changing and growing. But unlike other kinds of risks, cyber-risk is general to all companies. Only basic financial risks affect more companies. In fact, while there are some sectors (retail, financial services, and telecom) where cyber-risk is most acute, it is hard to identify any major public companies that are not faced with significant cyber-risks. This is why cyber-risk

[4] John C. Coates and R. Glenn Hubbard, Competition in the Mutual Fund Industry: Evidence and Implications for Policy, 33 J. Corp. L. 151 (2008); see also John C. Coates, Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis, 1 J. Legal Anal. 591 (Summer 2009).

[5] John McCrank, *SEC Chief Says Cyber-Crime Risks are Substantial, Systemic*, Reuters, September 5, 2017, http://www.reuters.com/article/us-sec-enforcement/sec-chief-says-cyber-crime-risks-are-substantial-systemic-idUSKCN1BH094.

warrants special public policy attention, and why a modest disclosure law aimed at cyber-risk is not a slippery slope to overly-burdensome disclosures about all kinds of risks.

S. 536 is well designed. It does not attempt to second-guess SEC guidance and rules regarding disclosures generally, or even as to cyber-risk overall. The bill simply asks publicly traded companies to disclose whether a cybersecurity expert is on the board of directors, and if not, why one is not necessary. To be clear, the bill does not require every publicly traded company to have a cybersecurity expert on its board. Publicly traded companies will still decide for themselves how to tailor their resources to their cybersecurity needs and disclose what they have decided. Some companies may choose to hire outside cyber consultants. Some may choose to boost cybersecurity expertise on staff. And some may decide to have a cybersecurity expert on the board of directors.

The disclosure required would typically amount to a sentence or two. The disclosure would be contained in a particular type of document – annual proxy statements – that are among the documents that I know from experience are regularly and carefully read by boards of directors. Proxy statements are how directors are re-elected each year. They describe the directors themselves, what committees they are on, and how they function as a board. Being human, directors tend to read things about themselves more carefully than other disclosures. Given this, the bill would gently remind boards to take direct responsibility for cybersecurity, by focusing them on board-level resources regarding cyber-risk, and through that reminder, on cyber-resources more generally.

In short, no board would have to change its composition in response, and it preserves flexibility for companies to respond to cyber threats in a tailored and cost-effective way. It would not require disclosure of sensitive or proprietary information, and so would not increase the risk of cyber-attacks. It would be extremely low cost – the board is already required under SEC rules and guidance to disclose its role in risk oversight, including oversight of material cyber-risks. The bill would simply flip the switch on whether the topic needs to be explicitly addressed in proxy statements, so boards could not fail to engage the issue, as, unfortunately, many still do, despite SEC guidance and numerous high-profile examples of cyber-attacks.

8-K Trading Gap Act

I also favor the 8-K Trading Gap Act, with one suggested modification. Current rules permit insiders to game disclosure rules and reap unwarranted windfalls by trading in company stock in the window between the moment a material "current event" requiring disclosure occurs, and the moment that the disclosure is actually made. Such trading may already violate SEC Rule 10b-5. But enforcement of Rule 10b-5 – an intentionally broad anti-fraud standard – is restrained by available SEC resources and the magnitude of expected recoveries in private litigation. The proposed bill would enact a bright-line ban on such trading. It would have relatively modest effects on non-fraudulent trading, as the trading could occur after a company makes required disclosure, the timing of which is within the company's control. It also exempts trades under pre-committed 10b-5-1 trading plans, further allowing insiders to achieve liquidity and diversification on a fair basis that does not disadvantage other investors.

The one suggestion I would make is to lengthen the "covered period" as defined in the bill by one trading day. Information takes some time to be reflected in market prices. Forms 8-K can be filed late in a day. The market and public investors generally should have one full trading day to digest the information in a Form 8-K before having to worry that insiders are on the other side of the trade. While I would still favor the bill without this modification, this modest change would more effectively accomplish its purposes, without imposing unnecessary costs on insiders or companies.

Proxy Advisor Regulation Act (H.R. 4015)

The third bill on which I offer comment is formally titled the "Corporate Governance Reform and Transparency Act of 2017," but in the spirit of fair disclosure, it should be renamed the "Proxy Advisor Regulation Act," because that is in fact what it is – a bill to regulate proxy advisors – and its current title provides no useful information as to its contents. Proxy advisors are indeed the sole target of the bill. In general, as a background fact, no one is required by law or regulation to consult a proxy advisor. To my knowledge, there are no regulatory or legal barriers to entry for new entrants to compete with the existing advisors. Of course, there is the usual requirement in a market economy that someone offer better services at a lower cost.

As a result, on the substance of the bill, I find myself puzzled. The bill states that its goals are to "to improve the quality of proxy advisory firms," and to "foster accountability, transparency, responsiveness, and competition in the proxy advisory firm industry." Those are worthy goals.

The puzzle is why these goals are important as a target of regulation in the proxy advisory industry, and how the bill is meant to accomplish those goals. I am unaware of a clamor from investors for regulation of proxy advisors. Usually evidence of market failure is a pre-requisite for regulation – here, that would presumably consist of evidence of the inability of investor-clients of advisory firms to obtain information by directly asking for it. Alternatively, disclosure laws may be needed for comparability or enforcement purposes. There are so few proxy advisors, and their recommendations are under such constant scrutiny, that it seems unclear at best how those goals would be advanced by new regulations enforced by the SEC.

It is also a puzzle how its provisions could possibly pass a cost/benefit test to accomplish those goals, even if one thought the bill could accomplish those goals. Some parts of the bill – e.g., the requirement to have an ombudsman and a compliance officer – seem worthy in the abstract, but have the distinct characteristic of "one size fits all." That is usually not a phrase of praise in the corporate governance arena.[6] Would a new entrant in the proxy advisory services market need a full time ombudsman or compliance officer? If not, then that requirement would deter rather than enhance competition.

A ban on modifying recommendations based on whether companies buy other services from the advisor also seems like a worthy specific goal. Is it best addressed in a federal statute? The conduct so prohibited on its face sounds like garden-variety fraud or deceptive sales practices, something the states are long used to regulating in a variety of areas. Are the pension funds and other clients of proxy advisors not capable of enlisting state attorneys general or other enforcement allies if they suspect systematic deception of that kind? They seem able to protect their own interests from fraud or quasi-fraud with existing laws in other areas of their business.

And the final puzzle is why its sponsors and supporters believe that a federal statute and mandatory regulation would do more to accomplish these goals as applied to proxy advisory firms than they would as applied to public company boards of directors,

[6] Cf. Society for Corporate Governance, Inc., Statement on Corporate Governance ("the Society is skeptical of one-size-fits-all governance prescriptions").

who routinely face conflicts of interest, or index fund advisors, who routinely make voting decisions on behalf of others without publishing their methodologies.

To be clear, I am open minded about what well-designed regulation can accomplish. Indeed, as outlined above, well-designed disclosure laws can achieve a great deal, including accountability, transparency, responsiveness, and (in some contexts) competition. But this bill is not limited to disclosure, and it is not clear that the disclosures it requires are well-suited to its goals, or are the least costly means of accomplishing the same objectives. Substantially more evidence should be in hand before mandating new regulations of this kind. I am unaware of any reliable economic evidence that would suggest that the net benefits of the bill would exceed its costs, which would be substantial.

Take, for example, the requirement that a proxy advisory firm be required to register with the SEC for simply providing proxy advice. Registration requirements are not to be mandated lightly. They impose more burdens on new entrants than on incumbents. They therefore also risk reducing competition, not increasing it.

One element of the registration form that the SEC would not have authority to drop under the bill is a requirement that the proxy firm disclose "the procedures and methodologies that the applicant uses in developing proxy voting recommendations," and the SEC would be required to make that information publicly available. Since procedures and methodologies are essentially trade secrets, the bill would destroy existing or new proxy firms' ability to protect their intellectual property. New competitors will have no way to recover investments in research and development of better procedures or methods. How would such a requirement make the industry more competitive?

I would not want to reject out of hand the idea that some regulation of proxy advisors might be warranted – particularly concerning conflicts of interests. I could imagine that some light touch disclosure rules, informational barrier requirements, or back-up enforcement might help alleviate concerns that the concentrated market for proxy advice was susceptive of abuse through that channel. If the SEC believes it lacks resources or authority to hold hearings and ultimately develop such a regulatory approach, there might be a clear need for federal legislation. Absent that, I would recommend – in the language of academic publishing – a "revise and resubmit" decision on this bill.

Fair Investment Opportunities for Professional Experts Act (S. 2756)

This bill does three things. First, it substantially removes discretion from the SEC to alter the definition of "accredited investor" based on net worth and income, by moving the current definition into a statute and out of a rule. Second, it inflation-adjusts the current definition. Third, it directs the SEC to consider education, job, or professional experience (among other things) in potentially expanding the definition.

On the overall topic of how to define "accredited investor" and why it matters, I commend to this Committee the advice of the SEC's Investor Advisory Committee.[7] That advice was developed before I joined that Committee, but it is good advice, it was carefully considered, and it is advice that I endorse. I also commend to this Committee the research conducted by the SEC's Division of Economic and Risk Analysis, which lays out many consequences of different policy choices available here.[8] I note, finally,

[7] See https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-advisor-accredited-definition.pdf.
[8] See https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf.

that the SEC is required to review the definition of accredited investor every four years under the Dodd-Frank Act.[9]

Based on that information, I conclude that the second and third effects are good ideas. The first is not. The current net worth and income thresholds have been eroded by inflation for thirty years. They are, as a result, too low.[10] To lock them into the statute now would durably expose a large number of financially vulnerable Americans to the heightened fraud risk that unregistered offerings create.

While inflation-adjusting the thresholds is a good idea, doing so would be a good idea to do so in a statute only if the current levels were a reasonable proxy for financial resilience, literacy, and sophistication. It is a good idea to add the financially educated and financial professionals to the pool of potential private-placement investors. Net worth and income have always been imperfect proxies for sophistication. It is also a good idea to delegate to the SEC, as the bill does, the precise way in which education and experience should play into a broadened definition. Some consideration should be given to ways that the definition could assure that even educated or experienced investors have financial resources to absorb losses that routinely accompany investment.

<u>Expanding Access to Capital for Rural Job Creators Act (S. 2953)</u>

I favor having the SEC receive advice about the interests of small businesses based in rural areas. In an era of increasing distrust and distance between rural and urban parts of this country, fostering more communication and understanding across an array of policy areas is increasingly important. Small businesses in rural areas are less likely to be able to raise capital in conventional ways than other businesses. Although rural area

[9] Dodd-Frank Act, section 413(b)(2).
[10] John Coates and Robert Pozen, Bill to Help Businesses Raise Capital Goes Too Far, Wash. Post (Mar. 12, 2012).

population is declining, relative to cities and suburbs, rural areas remain home to sixty million Americans, and a greater share of rural workers have jobs in small businesses than other areas.