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Jill E. Fisch

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INSTITUTIONAL COMPETITION TO REGULATE CORPORATIONS: A COMMENT ON MACEY

Jill E. Fisch[†]

INTRODUCTION

It is a pleasure to have the opportunity to comment on Professor Macey's paper. My remarks focus on an earlier draft of Professor Macey's paper and his oral remarks.¹ Professor Macey makes two basic points. First, he observes that crisis leads to regulatory change and identifies the Sarbanes-Oxley Act of 2002² as Congress' regulatory response to the recent corporate governance scandals. Second, he describes a type of competition among regulators in responding to the scandals, noting in particular the emergence of New York State Attorney General Eliot Spitzer as a key player in initiating enforcement activity. On this latter point, he predicts that the federal government will ultimately eliminate the ability of state regulators such as Spitzer to play a major role in corporate governance or securities regulation. Ultimately, the theme that encompasses both Professor Macey's oral remarks and the final version of his and Professor O'Hara's paper, is one of comparative institutional competence—identifying the institution best able to regulate corporate governance in today's world.

[†] Alpin J. Cameron Professor of Law and Director, Center for Corporate, Securities & Financial Law, Fordham Law School. Copyright 2005 Jill Fisch.

¹ *Positive Political Theory and Federal Usurpation of the Regulation of Corporate Governance: The Coming Pre-emption of the Martin Act*, 55 CASE W. RES. L. REV. 587 (2005). This commentary is based on that presentation, and not on the final paper that he has published as part of this volume.

² Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C. and 18 U.S.C.).

I. CRISIS GENERATES REGULATORY CHANGE

On the first point, Professor Macey is of course absolutely right—crisis does lead to regulation. Crisis is a particularly important factor in generating regulatory change with respect to business law. The clearest example we have of that is the stock market crash of 1929, which led Congress to enact the federal securities laws, the starting point of regulatory competition between the states and the federal government. Prior to the adoption of the Securities Act of 1933 and the Securities Exchange Act of 1934, the states regulated corporations through state corporation laws and blue sky laws, and the stock exchanges regulated corporations through listing standards.

The creation of the SEC itself is a byproduct of the federal securities laws. Congress specifically explained when it passed the federal securities laws that it was responding to national emergencies like the stock market crash and the Great Depression, and the burdens that these events put on the public, on the market, on the federal government, and so forth.³ More recent regulatory responses to crisis have included the Foreign Corrupt Practices Act, adopted after investigations revealed widespread use of bribes by U.S. corporations operating overseas,⁴ and the proliferation of state anti-takeover laws adopted in response to the growth in hostile tender offers in the 1980s.⁵

Why is crisis a substantial factor in producing regulatory change? One reason is that, from a public choice perspective, business is usually in a pretty good position to resist substantial new regulation. Crisis, at least in the short-term, upsets that balance. Corporate governance scandals—accounting, insider trading, excessive executive compensation packages—give business lobbyists a little less credibility. Crisis empowers members of the public that typically do not have significant political power. Crisis brings people with diverse interests together into interest groups. And, of course, crisis increases the political saliency of the regulatory issues involved—a factor that is par-

³ See Securities Exchange Act of 1934 § 2(4), 15 U.S.C. § 78b(4) (2000). As Congress stated in adopting the Act:

National Emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

Id.

⁴ 15 U.S.C. §§ 78m(b)(2)-(3), 78dd-1, 78dd-2, 78ff (2000).

⁵ See William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715 (1998) (describing timing and process by which states adopted antitakeover legislation).

ticularly important in that many issues involving business regulation generally have low political saliency.

If you look at the debate in Congress, leading up to the adoption of Sarbanes-Oxley, you see that the corporate governance crises had the effect of changing the different political dynamic. Professor Macey does not draw a particular normative conclusion about this change. Many corporate executives have criticized Sarbanes-Oxley as an overreaction—imposing substantial compliance costs on the vast majority of law-abiding corporations based on the wrongdoing of a few bad apples. Other commentators argue that self-dealing by corporate executives was widespread and that regulatory reforms were long overdue. In evaluating the consequences of regulatory reforms that respond to crises, one interesting question is whether the effect of those reforms will outlast public memory of the crises that generated them.

The recent corporate governance scandals did more than motivate regulatory reform; they shifted institutional participation in the regulatory process. Congress has taken a more significant role, removing certain corporate governance issues from state regulation and mandating specific governance initiatives by the SEC and the self regulatory organizations (SROs). At the same time, state regulators, particularly Attorney General Spitzer, have initiated enforcement actions with respect to securities issues that have typically been left to the SEC. It is this shift, and its effect on institutional competition, to which I turn in Part II.

II. COMPETITION AMONG REGULATORS

Competition among regulators is an ongoing theme in corporate law. Since the adoption of the federal securities laws in the 1930s, the federal government and the states have shared the responsibility for regulating corporations. Well before the 1930s, the states competed with each other for regulatory authority through the mechanism of charter competition. New Jersey was the early leader in that competition, but was subsequently displaced by Delaware. Delaware remains the dominant supplier of state corporate law to date, despite some efforts by states such as Nevada to attract charter business away from Delaware.

Thus, institutional competition to regulate corporations is not a new theme. Mark Roe has written about the delicate balance between federal level regulation, by the SEC and Congress, and state regula-

tion.⁶ Roe argues that, because Congress has the power to preempt state level regulation, Congress can effectively compete with the states even without formal legislation, because the prospect of such legislation constrains state regulatory discretion. Essentially, as Roe explains, Delaware and other states cannot depart too far from the federal ideal, or Congress will push back.

The Spitzer investigations and enforcement actions represent the opposite side of Mark Roe's analysis—the push back from the states in response to perceived inadequacies in federal enforcement activity with respect to misconduct typically regulated by the SEC and the SROs. First, Spitzer investigated conflicts of interest among research analysts, uncovering extensive problems among large Wall Street Investment Banks and ultimately engineering a \$1.4 billion global settlement with ten of the banks.⁷ Subsequently Spitzer uncovered widespread practices of late trading and market timing in the mutual fund industry.⁸ Spitzer's enforcement actions addressed issues about which federal regulators were aware, but nevertheless had failed to act. Indeed, at the same time that the SEC is moving to extend its regulation of the mutual fund industry and impose some of the same restrictions on hedge funds, Spitzer's actions suggest serious deficiencies in mutual fund regulation.

Spitzer's actions have, in turn, generated a federal pushback, although perhaps not of the type envisioned by Roe. In addition to having the effect of embarrassing federal regulators, the Spitzer investigations have been quite unpleasant for securities firms who are currently seeking to have Congress curb Spitzer's enthusiasm for cleaning up the securities markets. There is actually legislation on the table, such as H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act, that limit Spitzer's ability to compete with the SEC to regulate misconduct in the securities industry.

Professor Macey tells this story and offers the prediction that Congress will reduce or eliminate institutional competition from state regulators like Spitzer through legislation. The scope of current institutional competition goes quite a bit further, however. Spitzer has also entered into a turf war with the SEC and the federal government on the dual issues of self-regulation in the securities industry and ex-

⁶ Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

⁷ Press Release, Office of New York State Attorney General Eliot Spitzer, *SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices* (December 20, 2002), available at http://www.oag.state.ny.us/press/2002/dec/dec20b_02.html.

⁸ Press Release, Office of New York State Attorney General Eliot Spitzer, *State Investigation Reveals Mutual Fund Fraud* (September 3, 2003), available at http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html.

ecutive compensation, addressing both with his litigation challenging former NYSE CEO Richard Grasso's compensation package.⁹

There are two ways to look at Spitzer's actions here. First, on the subject of self-regulation, the New York Stock Exchange and the NASD have traditionally had extensive regulatory authority, subject to SEC oversight. This means that even though the big broker dealers have extensive operations on Wall Street, and have a substantial impact on the economic condition of New York, the NYSE CEO and Board have substantially greater regulatory power over them than state regulators such as Spitzer. Moreover, although the SEC ostensibly supervises self-regulation, there are areas such as market regulation in which that supervision has been extremely light.¹⁰ Spitzer's lawsuit can be seen as a reassertion of authority over a key New York State industry. Indeed, although Grasso argued that a federal court should hear the case because of the SEC's role overseeing the stock exchange, that argument was rejected by a federal judge who sent the case back to state court.¹¹

Alternatively, by challenging Grasso's pay package, Spitzer may be trying to stake out a role in regulating executive compensation. Although the regulation of executive compensation is traditionally considered a component of state corporate law, most of the major regulatory initiatives have occurred at the federal level.¹² The SEC has sought to address excessive executive compensation through disclosure requirements. Similarly, Congress has restricted the amount and form of executive compensation through provisions in the internal revenue code. These regulatory efforts have been widely criticized as ineffective; indeed, some commentators argue that these efforts have exacerbated the problem.¹³ Grasso has responded through

⁹ See Complaint, *People v. Grasso* (N.Y. Sup. Ct., filed May 24, 2004), available at http://www.oag.state.ny.us/press/2004/may/may24a_04_attach.pdf.

¹⁰ See, e.g., Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315, 315 (1985) (arguing that SEC has failed to take significant steps to deregulate the securities markets despite an explicit congressional mandate that it do so).

¹¹ Associated Press, *Update 4: Grasso Lawsuit Sent to State Court*, Dec. 10, 2004, available at <http://www.forbes.com/associatedpress/feeds/ap/2004/12/10/ap1703935.html>. Federal District Court Judge Gerald Lynch held that "[p]ermitting a state government to enforce the corporate governance norms under which an exchange or self-regulating organization is established violates no policy embodied in the federal securities laws." *Id.*

¹² See, e.g., Jill E. Fisch, *Teaching Corporate Governance Through Shareholder Litigation*, 34 GA. L. REV. 745, 761-63 (2000) (describing federal and state regulation of executive compensation).

¹³ E.g., Donald C. Langevoort, Commentary, *Stakeholder Values, Disclosure, and Materiality*, 48 CATH. U. L. REV. 93, 96-97 (1998).

a different route, using an obscure provision of state not-for-profit law.¹⁴

The *Grasso* litigation is another example of the kind of dynamic that Professor Macey is talking about—institutional competition among regulators to address corporate governance issues. Arguably both SRO supervision and executive compensation are areas in which one could criticize the level of SEC enforcement activity, and Spitzer's lawsuits represent exactly that type of challenge.

The state level pushback extends beyond Attorney General Spitzer. On the specific subject of executive compensation, we see a response by the Delaware courts in the *Disney* case.¹⁵ After years of giving limited scrutiny to claims that executive compensation is excessive, courts in Delaware have seized upon the duty of good faith as a potential mechanism for increasing their oversight of the compensation process.

A broader example is in the area of securities litigation. Over the past ten years, Congress has taken securities litigation away from the states, largely in response to claims of excessive or frivolous litigation.¹⁶ The Private Securities Litigation Reform Act ("PSLRA") imposed a heightened pleading standard and other substantive and procedural barriers to private civil claims for federal securities fraud.¹⁷ When investors sought to bypass the restrictions of the PSLRA by litigating in state court, Congress passed the Securities Litigation Uniform Standards Act, which preempted most state court claims for securities fraud.¹⁸ At the same time, commentators have argued that federal securities litigation has developed into the primary mechanism for regulating corporate governance.¹⁹

Now states are pushing back against the federalization of securities fraud. We see an increasing use by plaintiffs of state "holders" litigation, in which plaintiffs recast their claims as breaches of fiduciary duty and then, relying on a narrow carve-out in the PSLRA, bring

¹⁴ N.Y. NOT-FOR-PROFIT-CORP. LAW § 202(a)(12) (McKinney 1998). This section authorizes non-profit corporations to pay only "reasonable compensation" that is "commensurate with services performed."

¹⁵ *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003).

¹⁶ See Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1305 (1999) (describing the evolution away from States' securities litigation power).

¹⁷ Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. (1998)).

¹⁸ Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.).

¹⁹ Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 860-61 (2003).

those claims in state court.²⁰ “Holders” litigation offers a mechanism for recapturing some control over corporate governance at the state level in state courts.

III. PUBLIC CHOICE AND INSTITUTIONAL CHOICE

Professor Macey goes on to evaluate this institutional competition, relying heavily on a public choice analysis of the SEC. He has, of course, written extensively in this area,²¹ and as he sees it, institutional competition is largely about interest groups and rent seeking. With respect to the SEC, Professor Macey is particularly concerned about agency capture. He identifies the revolving door between the SEC and the securities industry. Potentially more significant is the role of the powerful investment banks. Corporate America has typically been very successful in constraining SEC regulatory initiatives. The Business Roundtable successfully litigated to overturn the SEC’s one share, one vote rule.²² The Chamber of Commerce is challenging the SEC’s independence requirements for mutual fund boards.²³ Corporate opposition has, to date, blocked the SEC’s proposal to allow direct shareholder nomination of directors. Similarly, with respect to analyst conflicts of interest, mutual fund trading practices, and so forth, Professor Macey identifies the risk that the SEC’s views will be dominated by the powerful investment bank interest group. He concludes from this that, in the long run, Spitzer’s enforcement efforts are doomed. They are doomed because they represent state intrusions into the SEC’s turf, a turf on which investment banks have traditionally been better protected from aggressive regulation.

But the story is a bit more complex. First, from an interest group perspective, it is a mistake to focus exclusively on investment banks. The key factor in the current regulatory environment is that the corporate governance scandals have destabilized the political dynamic, increasing the power of a variety of other interest groups, including shareholders, corporations, trial lawyers, and employees. A prime

²⁰ See, e.g., *Small v Fritz Cos.*, 65 P.3d 1255 (Cal. 2003) (recognizing a state law claim for “holders” of securities who were induced not to trade because of alleged fraud).

²¹ E.g., Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 242-44 (1986) (describing how the public can control special interest legislation through institutional mechanisms such as constitutions); Jonathan R. Macey, *Public Choice: The Theory of the Firm and the Theory of Market Exchange*, 74 CORNELL L. REV. 43, 45-47 (1988) (describing an economic theory of legislation in which “politicians maximize the aggregate political support they receive from all interest groups”).

²² *Bus. Roundtable v. SEC*, 905 F.2d 406, 416-17 (D.C. Cir. 1990).

²³ See Andrew Countryman, *Mutual Fund Independence Regulation Challenged*, CHI. TRIB., Sept. 3, 2004, at 1 (describing the litigation).

example is the way in which employee pension losses in Enron has caused a dramatic re-evaluation of the fiduciary obligations of pension fund managers.

If the political arena functions more or less as market, the empowerment of other interest groups increases the competition for political advantage. Some of the groups that have taken a heightened interest in corporate governance are groups that already enjoy a significant amount of political influence, such as the AARP and labor union pension funds. Their empowerment and attention should reduce the ability of investment banks to use their political power to generate or maintain rents.

Second, and this relates to the previous discussion of institutional competition, the effect of interest group competition must also be evaluated on a comparative basis. In particular, one has to question whether state regulators can conceivably pose a meaningful threat in the long run, considering the political power of the investment banking and U.S. business interests. It should virtually always be easier for an industry, such as the financial services industry, to capture the state level of regulation than to capture the Congress and the SEC.

We saw an example of this with respect to state anti-takeover regulation. Although corporate interest groups pushed hard in Congress for federal legislation restricting hostile takeovers, they were largely unsuccessful. In contrast, state legislatures passed extensive anti-takeover regulation.²⁴ Indeed, Ohio has some notable and distinctive statutory anti-takeover provisions, including an explicit rejection of Delaware's heightened standard of review for management defensive actions.²⁵

Similarly, the financial services industry must have considerably more political power in New York State than in Congress where other competing interest groups have a fair amount of political capital. As Spitzer prepares to run for governor, he will also be increasingly aware of the economic power of the Wall Street banks. As with takeovers, a congressional response to state regulation is likely to be more costly from a public choice perspective than state level action.

On the normative side, the question that Professor Macey's public choice analysis puts on the table is the question of comparative institutional competence. From a normative perspective, who is the right regulator? Will Congress, the SEC, the SROs, or the states do the best job in improving corporate governance and reducing the potential for future misconduct? Of course, this question requires us to make

²⁴ See Carney, *supra* note 5.

²⁵ OHIO REV. CODE ANN. § 1701.59(C) (2004).

some hard decisions, both about our objectives and about the most suitable method of achieving those objectives. On the goal side—should regulators place the greatest emphasis on efficiency, on uniformity, on freedom of contract, on the protection of small investors, or something else? On the methodology side, how are these goals best obtained? The SEC has traditionally emphasized transparency and disclosure. State courts, particularly the Delaware courts, have focused on process and independence. The SROs, especially the New York Stock Exchange, pay the most attention to market structure. In Sarbanes-Oxley, Congress places a premium on financial accounting.

These institutional differences highlight an additional benefit of institutional competition—specialization. The presence of multiple regulators creates a broader scope of regulation while maintaining the high level of expertise required by the capital markets. Indeed, the very dispersion of regulatory responses to the corporate governance scandals offers a powerful reason to reject the search for the ideal institution to anoint as the dominant regulator. Only time will allow us to identify which institution has responded most effectively, but by maintaining regulatory competition, we increase the likelihood of an effective response.

CONCLUSION

In examining the varied regulatory responses to the corporate governance scandals and, in particular, the turf war between Attorney General Spitzer and the SEC, Professor Macey focuses on institutional choice. For him, the scandals highlight questions about the SEC's vulnerabilities as a regulator and suggest that, because those vulnerabilities are the product of interest group influence, they are likely to dominate the temporary political instability generated by the recent crisis.

This comment suggests that crises create instability not just within interest group competition but within the balance of authority among competing institutional regulators. In business regulation, this instability is particularly effective in overcoming a substantial status quo bias. The resulting regulatory competition offers valuable experimentation and innovation with respect to potential regulatory solutions and, ultimately, a powerful defense to the broad allocation of regulatory authority among competing institutions such as Congress, the SEC, the NYSE, and the states.