THE SECURITIES EXCHANGE ACT IS A MATERIAL GIRL, LIVING IN A MATERIAL WORLD: A RESPONSE TO BEBCHUK AND JACKSON'S "SHINING LIGHT ON CORPORATE POLITICAL SPENDING"

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"But they can't see the light, that's right
Cause the boy with the cold hard cash
Is always mister right, cause we are
Living in a material world
And I am a Material Girl"

Madonna
Material Girl

ABSTRACT

This Article responds to a piece by Lucian Bebchuk and Robert Jackson, "Shining Light of Corporate Political Spending," which argues in favor of a rulemaking petition submitted by the authors to initiate a mandatory rule pursuant to the Securities Exchange Act requiring companies to disclose political expenditures, including contributions to politically active non-profits. This Article explores the economic cost-benefit analysis requirements that constrain SEC rulemaking and argues that when making a mandatory disclosure rule the SEC must demonstrate that the subject of the disclosure is material to investors. It shows how Bebchuk and Jackson have not made a sufficient case that corporate political expenditures meet that materiality threshold, nor that a mandatory disclosure rule would meet the SEC's cost-benefit analysis requirements. This is true particularly in light of how a mandatory disclosure rule risks inhibiting corporate freedom of speech.

I. COST BENEFIT ANALYSIS IN RULEMAKING UNDER THE SECURITIES EXCHANGE ACT

In a recent article in the *Georgetown Law Journal* entitled "Shining Light on Corporate Political Spending," Professors Lucian Bebchuk and Robert Jackson offer a comprehensive argument in support of their rulemaking petition urging the SEC to adopt a requirement that publicly trade firms

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disclose corporate political expenditures.[1] When it conducts a rulemaking "in the public interest," the SEC is required by statute to consider the impact of a rule on investor protection as well as efficiency, competition and capital formation.[2] This section will offer some initial observations about what those four variables mean in order to shed light on which of Bebchuk and Jackson's arguments will be relevant in the SEC's consideration of their rulemaking proposal.

Before exploring the various arguments that Bebchuk and Jackson urge in favor of their rule, a review of recent cases interpreting the provision, legislative history of the provision, and the SEC's own recent interpretive guidance explaining its understanding of the economic analysis requirements will help develop a framework to consider the relevance of Bebchuk and Jackson's arguments. While legislative history and judicial interpretation of the economic analysis standard is the primary source for interpreting the standard, the SEC's own interpretation of its mandate provides secondary precedential value. The SEC staff recently promulgated guidance interpreting that requirement.

The SEC guidance interprets its requirement as identifying the reason for the rulemaking, describing the baseline against which the costs and benefits of the proposed change should be measured, considering reasonable alternatives to the proposal, and measuring the likely economic impact of the proposal and its reasonable alternatives.[3] The SEC guidance describes a typical justification for a rule as a "response to a market failure that market participants cannot solve because of collective action problems."

The requirement that the SEC consider the impact of rules on efficiency, competition and capital formation in rulemaking pursuant to the Securities Exchange Act of 1934 was adopted under the National Securities Markets Improvement Act of 1996 (NSMIA).[4] In a statement on the House floor introducing that legislation, Congressman Tom Bliley "the National Securities Markets Improvement Act will require the SEC to conduct meaningful cost-benefit analysis of proposed rulemakings that directly affects all securities issuers. Under this new provision, the SEC must weigh the cost of every rule they propose against the burden those rules would impose on the engine of our economy. This provision is simply common sense: meaningful regulation should not impose unnecessary burdens and costs."[5] The House Committee report on the Securities Amendments of 1996 notes, "The

[1] *See* Lucian A. Bebchuk & Robert J. Jackson, *Shining Light on Corporate Political Spending*, 101 Geo. L.J. 923 (2013).

[2] 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c).

[3] *See* Memorandum from the Div. of Risk, Strategy and Fin. Innovation and the Off. of the Gen. Counsel, U.S. Sec. & Exch. Comm'n, on Current Guidance on Economic Analysis in SEC Rulemakings 1 (Mar. 16, 2012), http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf [hereinafter SEC Economic Analysis Guidance].

[4] National Securities Markets Improvement Act of 1996, Publ. L. No. 104-290, § 106, 110 Stat. 3416, 3424–25.

[5] 142 Cong. Rec. H12047 (1996).

Committee expects that the Commission will engage in rigorous analysis pursuant to this section. Such analysis will be necessary to the Congress in connection with its review of major rules pursuant to the terms of the Small Business Regulatory Enforcement Fairness Act of 1996."[6]

The Act referenced by NSMIA provides a role for the White House Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA) as an arbiter of agency rules, and thus the SEC's use of OMB circulars defining cost-benefit analysis as a starting point for its understanding of the economic analysis requirement is appropriate. The OMB's guidance however has changed dramatically since 1996, with the most recent circular taking a far more inclusive view for those costs and benefits that can be counted. The SEC's guidance references Circular A-4,[7] dated September 17, 2003, as its guide for cost-benefit analysis, but that was not in effect in 1996 when the three part standard was passed.[8] Since OMB Circular A-4 was not in place at the time NSMIA was adopted, it cannot be considered part of the legislative intent of the three-part standard.

In 1996 the OMB's guidance was in the form of a "best practices document."[9] The most significant change in that guidance was the later addition, post-NSMIA, of an observation that agencies should be permitted to consider whether new rules "protect privacy, permit more personal freedom," further "other democratic aspirations" and other "social purposes."[10] Since those new dimensions to cost-benefit analysis were not a part of the materials referenced by the adopting legislation, but were instead a significant expansion of the cost-benefit analysis conducted by the federal government after the new economic analysis legislation was adopted, the SEC's guidance on this point is in error.

The SEC's guidance accurately describes the need for the Commission to weigh the costs and benefits of new rules against significant alternatives to the rule.[11] In this case that would include the status quo, in which firms are able to voluntarily adopt policies which either eschew participation in the political process or provide for itemized disclosure about firm expenditures. Shareholders are similarly permitted to adopt bylaws that provide for the same, and shareholders can infer from a lack of board voluntary disclosure or from a lack of a board-adopted bylaw on political expenditures that the company wishes to retain freedom of action in this area. The SEC guidance also correctly observes that the baseline against which the SEC must consider a new rule includes "both the economic attributes of the relevant mar-

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[6] H.R. REP. NO. 104-622, at 39 (1996) (Conf. Rep.).

[7] *See* OFF. OF MGMT. & BUDGET, EXEC. OFF. OF THE PRESIDENT, OMB CIRCULAR NO. A-4, REGULATORY ANALYSIS (2003).

[8] SEC Economic Analysis Guidance, *supra* note 3, at 4.

[9] *See Economic Analysis of Federal Regulations Under Executive Order 12866*, THE WHITE HOUSE (Jan. 11, 1996), http://www.whitehouse.gov/omb/inforeg_riaguide (last visited May 5, 2013) (describing the interagency report referenced as a "best practices" document).

[10] *See* SEC Economic Analysis Guidance, *supra* note 3, at 5.

[11] *See id.* at 4.

ket and the existing regulatory structure, including (where relevant) state law."[12] This means that the SEC will need to consider the presence of an alternative regulatory scheme in this area, at the Federal Elections Commission (FEC), and the existence of state law bylaws and charter amendments which permit extensive disclosure and permit companies to adopt binding agreements with shareholders to provide for more extensive disclosure or to agree not to make political expenditures.

The most recent legal challenge to an SEC rule under the three-part economic analysis requirement was *Business Roundtable v. SEC*,[13] a case which affords some useful guidance to ensure the SEC complies with its statutory obligations should it undertake Bebchuk and Jackson's recommendation. For instance, the court admonished the SEC in that case for five separate flaws in its rulemaking, including that it "inconsistently and opportunistically framed the costs and benefits of the rule, failed adequately to quantify the certain costs or explain why those costs could not be quantified, neglected to support its predictive judgments, contradicted itself, and failed to respond to substantial problems raised by commenters."[14]

In *Business Roundtable*, the court gave particular focus to empirical literature, focusing of stock price event studies and studies of comparative excess earnings at firms.[15] The D.C. Circuit showed that it would be skeptical of a rule based on mixed empirical literature, which also may characterize much of the prior literature on the link between firm returns and political involvement. The court also gave particular weight to the argument that, in corporate governance-based rulemaking that serves to empower the shareholder base, the SEC must cautiously consider the prospect that certain shareholders may use that power to advance goals which conflict with those of long term wealth maximization.[16]

In particular, the D.C. Circuit showed agreement with the concern many commenters articulated that,

> investors with a special interest, such as unions and state and local governments whose interests in jobs may well be greater than their interest in share value, [and] can be expected to pursue self-interested objectives rather than the goal of maximizing shareholder value, and will likely cause companies to incur costs even when their nominee is unlikely to be elected[17]

Larry Ribstein has argued that the central purpose behind the effort to regulate corporate political speech through the securities laws is to burden it such

[12] *See id.* at 7.
[13] Business Roundtable v. SEC, 647 F.3d. 1144 (D.C. Cir. 2011).
[14] *See id.* at 1148–49.
[15] *See id.* at 1150–51.
[16] *See id.* at 1152.
[17] *See id.*

that it could eventually be silenced.[18] Similarly, Bradley Smith argues that the subtext of this issue is an attempt by union investors to limit corporate political activity and obtain an advantage for their preferred candidates.[19]

Should any SEC rule in this area also cover investment companies, the SEC must also consider whether rules developed in the context of publicly traded companies are well advised in the unique context of the investment management industry.[20] In *American Equity Investment Life Insurance Company v. SEC*,[21] the D.C. Circuit held that the SEC must "determine whether, under the existing regime, sufficient protections existed to enable investors to make informed investment decisions and sellers to make suitable recommendations to investors."[22] Thus, the D.C. Circuit also appreciates that a good cost-benefit analysis needs to compare proposed mandatory rules against market processes that develop to remedy short-term market failure.

With those guiding principles to cost-benefit analysis of securities regulation in mind, this article will next consider what special principles might apply in the context of a mandatory corporate finance disclosure rulemaking pursuant to the Securities Exchange Act of 1934.[23]

II. Materiality is a Vital Component to Cost-Benefit Analysis of a Mandatory Disclosure Rule

In pursuing a rulemaking in the public interest the SEC is arguably required to determine that a rule requiring disclosure satisfies the same materiality test as that which constrains actions under SEC Rule 10b-5. Rule 10b-5, which addresses fraud, was intended to work in tandem with the affirmative disclosure rules the agency was empowered to adopt pursuant to the Securities Exchange Act of 1934. Thus, disclosure items that issuers are mandated to provide, but about which deceptive disclosure would not be actionable under 10b-5, would frustrate the purpose of the Exchange Act. Put another way, how can disclosure that the SEC is unable to demonstrate as material ever further the purposes of investor protection or capital formation?

While there is no express statutory requirement that disclosure regulations meet a materiality test, it is unclear how mandatory disclosure of immaterial items would ever survive the kind of cost-benefit analysis contemplated by the NSMIA three-part standard. If a rule does not provide

[18] Larry E. Ribstein, *The First Amendment and Corporate Governance*, 27 Ga. St. U. L. Rev. 4 (2011).

[19] Bradley A. Smith, *Another Union Attack on Corporate Speech*, Wall St. J., Nov. 10, 2011, at A21.

[20] *See Business Roundtable*, 647 F.3d. at 1154–55 (D.C. Cir. 2011).

[21] 613 F.3d 166 (D.C. Cir. 2009).

[22] *See id.* at 179.

[23] It should be noted that many of the principles explored by this Article may also apply in the context of many rules adopted pursuant to the Securities Act of 1933, and also to many rules considered under other statutes.

material benefit to shareholders, and has significant costs associated with it, it would seem unlikely the SEC could determine that the rule furthered the goals of investor protection, efficiency, competition and capital formation. Materiality will thus be an important lodestar in cost-benefit analysis of mandatory disclosures under the Securities Exchange Act of 1934. Regardless of whether the SEC is required to demonstrate materiality in all disclosure rules, materiality is an important component of that determination at the very least. The cases interpreting this issue have shown a particular focus on the import of information for prospective investors, and insisted where possible that empirical studies be used to demonstrate the materiality of an item.[24]

The SEC's guidance on materiality, Staff Accounting Bulletin No. 99, describes two approaches the SEC takes to determining materiality.[25] First, they consider the quantitative materiality of an item using its size in comparison to a relevant company specific variable. For instance, they would consider disclosures about company expenditures in relation to total expenditures or company market capitalization. The Staff bulletin also indicates that misstatements may be considered in relation to the degree to which a misstatement distorts a reporting item.[26] While the relevant ratio, and the relevant denominator, for a materiality calculation is subject to some degree of professional judgment, the general rule of thumb is that an item representing a misstatement of less than 5% of an item will not be considered quantitatively material.[27]

A second method to determine quantitative materiality is to consider the extent to which a disclosure has impacted, or can be expected to impact, stock prices in a statistically significant manner.[28] The SEC's interpretation on that issue merely codifies existing interpretations of Section 10b-5 of the Securities Exchange Act in various Courts of Appeal.

The SEC interpretation of materiality also describes a second approach, qualitative materiality, to supplement quantitative materiality and include items that, though relatively small, may still be "viewed by the reasonable investor as altering the total mix of information made available."[29] In describing the types of items the SEC considers qualitatively material, the SEC describes financial items that could be used to hide much larger financial impropriety, such as "whether a misstatement changes a loss into in-

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[24] *See, e.g.*, *In re* Merck & Co., Inc. Sec. Litig., 432 F.3d 261 (3d Cir. 2005).
[25] *See* SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 13,1999).
[26] *See id.* at 45,151.
[27] *See id.*
[28] *See id.* at 45,151–53.
[29] SEC Staff Acounting Bulletin No. 99, 64 Fed. Reg. 45,151 (quoting TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

come or vice versa,"[30] "whether the misstatement involves concealment of an unlawful transaction."[31]

Bebchuk and Jackson describe executive compensation disclosure as an item similar to their focus in the rulemaking petition, where the SEC has determined that mandatory disclosures should be required on the grounds that interests of shareholders and managers are conflicted and transparency is useful, despite mandating disclosure of amounts that are not material.[32] But that area is distinct from this issue, as it was still grounded in arguments about the materiality of compensation. Though Bebchuk and Jackson cite to language that the SEC requires disclosure of executive compensation even for items that are not "financially significant,"[33] the reference is clearly to a lack of quantitative materiality rather than qualitative materiality.

The SEC's interpretative release on materiality specifically focuses on executive compensation as a key example of qualitative materiality.[34] Executive compensation that might be quantitatively immaterial may nonetheless impact the way the executive runs the company, and serve as a link to future items that are quantitatively material. Executive compensation therefore meets the test of qualitative materiality. As we will explore in the next section, Bebchuk and Jackson have yet to demonstrate that political expenditures are qualitatively material.

Bebchuk and Jackson point to the legislative history of the Securities Exchange Act of 1934 and note that the SEC was given "complete discretion" to determine what types of additional disclosures investors should receive."[35] Yet, as this article has already noted, a subsequent statute limits that discretion significantly in the National Securities Markets Improvement Act of 1996, which required that the SEC effectively conduct a cost-benefit analysis of new rules using market based estimates of costs and benefits.[36]

In conducting a proper cost-benefit analysis, some have argued that using measures of willingness to pay in estimating benefits to consumers (or here investors) is considered more useful than using survey data or other expressions of consumer welfare that are not bounded by a budget constraint and subject to potential survey bias.[37] The relevant OMB guidance in place at the time the SEC's three part economic analysis statutory requirement was adopted shows a marked preference for using data generated from market transactions to estimate the value of benefits for those benefits directly

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[30] SEC Staff Acounting Bulletin No. 99, 64 Fed. Reg. at 45,152.

[31] *Id.*

[32] *See* Bebchuk & Jackson, *supra* note 1, at 944.

[33] *Id.* at 956.

[34] *See* SEC Staff Acounting Bulletin No. 99, 64 Fed. Reg. at 45,152.

[35] *See* Bebchuk & Jackson, *supra* note 1, at 929–30.

[36] *See* National Securities Markets Improvement Act § 106.

[37] *See* Brookshire et al, *Valuing Public Goods: A Comparison of Survey and Hedonic Approaches*, 72 Am. Econ. Rev. 165 (1982).

traded in markets, which directly encompasses publicly traded securities.[38] In calculating costs, the relevant OMB guidance urged considering the opportunity costs of benefits foregone such as losses in consumer or producer surplus.[39] Thus Bebchuk and Jackson's focus in the following section on

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[38] The following is a discussion of opportunity cost and willingness to pay from the OMB's 1996 guidance on Executive Order 12866:

> The concept of "opportunity cost" is the appropriate construct for valuing both benefits and costs. The principle of "willingness-to-pay" captures the notion of opportunity cost by providing an aggregate measure of what individuals are willing to forgo to enjoy a particular benefit. Market transactions provide the richest data base for estimating benefits based on willingness-to-pay, as long as the goods and services affected by a potential regulation are traded in markets. It is more difficult to estimate benefits where market transactions are difficult to monitor or markets do not exist. Regulatory analysts in these cases need to develop appropriate proxies that simulate market exchange. Indeed, the analytical process of deriving benefit estimates by simulating markets may suggest alternative regulatory strategies that create such markets.
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> Either willingness-to-pay (WTP) or willingness-to-accept (WTA) can provide an appropriate measure of benefits, depending on the allocation of property rights. The common preference for WTP over WTA measures is based on the empirical difficulties in estimating the latter.
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> Estimates of willingness-to-pay based on observable and replicable behavior deserve the greatest level of confidence. Greater uncertainty attends benefit estimates that are neither derived from market transactions nor based on behavior that is observable or replicable.

See Benefit Estimates, Economic Analysis of Federal Regulations Under Executive Order 12866, *supra* note 7.

[39] The following is a discussion of opportunity costs from the OMB's 1996 guidance on Executive Order 12866:

> The preferred measure of cost is the "opportunity cost" of the resources used or the benefits forgone as a result of the regulatory action. Opportunity costs include, but are not limited to, private-sector compliance costs and government administrative costs. Opportunity costs also include losses in consumers' or producers' surpluses, discomfort or inconvenience, and loss of time. These effects should be incorporated in the analysis and given a monetary value wherever possible. (Producers' surplus is the difference between the amount a producer is paid for a unit of a good and the minimum amount the producer would accept to supply that unit. It is measured by the area between the price and the supply curve for that unit. Consumers' surplus is the difference between what a consumer pays for a unit of a good and the maximum amount the consumer would be willing to pay for that unit. It is measured by the distance between the price and the demand curve for that unit.)
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> The opportunity cost of an alternative also incorporates the value of the benefits forgone as a consequence of that alternative. For example, the opportunity cost of banning a product (e.g., a drug, food additive, or hazardous chemical) is the forgone net benefit of that product, taking into account the mitigating effects of potential substitutes. As another example, even if a resource required by regulation does not have to be paid for because it is already owned by the regulated firm, the use of that resource to meet the regulatory requirement has an opportunity cost equal to the net benefit it would have provided in the absence of the requirement. Any such forgone benefits should be monetized wherever possible and either added to the costs or subtracted from the benefits of that alternative. Any costs that are averted as a result of an alternative should be monetized wherever possible and either added to the benefits or subtracted from the costs of that alternative.

See Cost Estimates, Economic Analysis of Federal Regulations Under Executive Order 12866, *supra* note 7.

various indicia of shareholder interest which do not derive from market processes are not relevant in the necessary cost-benefit analysis.

With the appreciation that materiality to investors is a binding constraint on disclosure rulemaking, with materiality measured as the size of an item in relation to the company's activities or determine as small items that may indicate much larger financial problems at a company, it becomes clearer that many of the arguments Bebchuk and Jackson offer in support of their proposal would not be relevant in the SEC's cost-benefit analysis of their petition.

III. The Lack of Benefits from Political Expenditure Disclosure

Bebchuk and Jackson argue that the frequency and outcome of shareholder proposal votes concerning political expenditure disclosure is relevant to this discussion.[40] They are, however, incorrect in arguing that the frequency and outcome of such votes bears on the materiality of political expenditure disclosures. These results are akin to surveys, which are disfavored in cost-benefit analysis, as they do not indicate any price discount shareholders demand for firms that do engage in political expenditures.

Bebchuk and Jackson also cite to polling data of shareholder assertions about political transparency,[41] but that data is even less relevant in a cost-benefit analysis since polling answers are even less constrained by market processes than engagement in the shareholder proposal process. Similarly, views expressed by shareholder organizations are equally irrelevant as such.[42] Comment letters from those organizations which provide reliable data about costs and benefits to the cost-benefit analysis would certainly be relevant to the extent they are reliable, but mere expressions of interest in a rulemaking by shareholder groups would not be relevant.

Expressions of consumer welfare that do not derive from a market process are clearly disfavored in the type of cost-benefit analysis contemplated by the statutory economic analysis standard. A more useful indicator of shareholder materiality would focus on the stock price effects of political expenditure disclosure, such as possible differences in IPO premia that can be linked to differences in the level of political expenditure disclosure or stock price effects of changes in firm policies about political expenditure.

These types of indicia would not be the end of the analysis of course, as one would need to determine why government regulation is more effective than private market processes at obtaining an efficient level of disclosure, but it would at least provide the type of market based price data that the SEC is required to review in a disclosure rulemaking.

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[40] *See* Bebchuk & Jackson, *supra* note 1, at 938.
[41] *Id.* at 940.
[42] *See id.* at 941.

If they were to demonstrate data on how much investors are willing to expend in self-funded shareholder proposals (not through the relatively inexpensive 14a-8 shareholder proposal process), that data may provide some relevant market-based indicia of how much shareholders value this form of disclosure. Even then, however, those values would need to be discounted to reflect the possibility that conflicted shareholders may be motivated in that activity by the conflicted goals described in *Business Roundtable v. SEC*.[43]

Bebchuk and Jackson argue "The SEC has long recognized that shareholder proposals can serve as an important indicator of investor interest in such matters."[44] Though that may be true, it does not mean that the SEC has done so appropriately, or that such evidence would support the SEC in fulfilling its statutory obligations under the three-part economic analysis standard.

Frank Easterbrook and Daniel Fischel's seminal work on the mandatory disclosure system provides a useful guide to determine the types of benefits that might justify a mandatory financial disclosure.[45] They urged caution in rushing to judgment on instituting mandatory disclosure, as even in instances where items could be deemed financially significant there may be sufficient incentives in the competition for capital for firms to voluntarily disclose the information.[46]

In the absence of mandatory disclosure, many firms have instituted voluntary disclosure policies about their political contributions. Shareholders will be able to infer from a lack of disclosure that companies might be engaging in political expenditures, which substantial minorities of the public may find objectionable, and can divest of those companies. Other critics of *Citizens United*[47] argue that divestment is an inadequate remedy out of a misguided concern for current shareholders.[48] But that ignores the dynamic effect of the divestment threat—if it becomes powerful enough, then the threat that capital formation will be more difficult in the future provides an incentive for managers to disclose and to bind to future disclosure.[49]

Even in instances where corporate competition for investment capital does not lead firms to voluntary provide an optimal level of disclosure, Easterbrook and Fischel describe four methods whereby market solutions can evolve to solve failures in the market for investment capital.[50] They note that informational intermediaries can specialize in processing information and provide both monitoring and bonding services, more informed traders not subject to collective action constraints will move the price of a stock to

[43] 647 F.3d 1144, 1152 (D.C. Cir. 2011).

[44] Bebchuk & Jackson, *supra* note 1, at 938.

[45] Frank Easterbrook & Daniel Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669 (1984).

[46] *Id.* at 714–15.

[47] Citizens United v. Fed. Election Comm'n, 558 U.S. 310 (2010).

[48] *See, e.g.*, Elizabeth Pollman, *Citizens Not United: The Lack of Stockholder Voluntariness in Corporate Political Speech*, 119 Yale L.J. Online 53 (2009).

[49] *See* Easterbrook & Fischel, *supra* note 45, at 690.

[50] *See id.* at 687–91.

reflect any costs to account for inefficient and otherwise hidden activity, stock exchanges can promulgate listing rules to maintain market integrity to keep trading volume, and therefore fee revenue for exchange members, at higher levels, and states of incorporation can compete to provide optimal governance mechanisms.[51]

A discussion about a mandatory rule in the political expenditure area must include evidence that these types of market-based solutions are ineffective. Such an argument would be particularly difficult. First, it would appear that market-based indices have been innovatively designed to rate the effectiveness of firm disclosure about political expenditures. For instance, the Center for Political Accountability and the Zicklin Center offer yearly reports that provide indexed comparisons of publicly traded firms on the basis of their disclosures about political expenditures, serving as the kind of informational intermediary Easterbrook and Fischel anticipated.[52] The fact that the index is not a fee-based service might indicate that investors place little value on the information, but it is available nevertheless. Furthermore, that fact that the index gauges relative levels of disclosure with little difficulty may indicate that the benefits of standardization and comparability and other third party effects Easterbrook and Fischel submit as potential reasons for mandatory disclosure are not present in this type of item.[53]

In support of their argument that political expenditures at firms are a material (or at least significant) expense, Bebchuk and Jackson describe how political expenditures by trade associations amount to large sums of money, and many publicly traded companies sit on the boards of directors of these organizations.[54] The fact that corporate political expenditures may be a significant share of all political expenditures, or that corporate influence is a significant influence on the political process, are all irrelevant for a rulemaking under the Securities Exchange Act of 1934. The only relevant determination for a finding of materiality is how large the political expenditure is at a company in relation to financial metrics at the company, such as company size, total expenditures at the company, or total expenditures at a particular subsidiary of the company.[55]

Bebchuk and Jackson describe donations to the U.S. Chamber of Commerce, for instance, on the order of $500,000 by various publicly traded companies like Chevron or Prudential Financial.[56] They argue that since the Chamber of Commerce is a powerful participant in political expenditures, and these donations afford them significant influence over the Chamber of

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[51] *See id.*

[52] *See* CTR. POLITICAL ACCTOUNTABILITY & ZICKLIN CTR. BUS. ETHICS RESEARCH, THE 2012 CPA-ZICKLIN INDEX OF CORPORATE POLITICAL ACCOUNTABILITY AND DISCLOSURE (2012), http://www.politicalaccountability.net/index.php?ht=d/sp/i/6904/pid/6904.

[53] *See* Easterbrook & Fischel, *supra* note 45, at 700.

[54] *See* Bebchuk & Jackson, *supra* note 1, at 930–33.

[55] *Cf.* Litwin v. Blackstone Grp., L.P., 634 F.3d 706 (2d Cir. 2011).

[56] *See* Bebchuk & Jackson, *supra* note 1, at 934.

Commerce, they may be material to the average investor.[57] Whether or not donations of the magnitude they describe may be material to the Chamber of Commerce, and whether those donations afford material influence over the political process, are both irrelevant for the purposes of a disclosure rulemaking under the Exchange Act. What counts is whether the amounts are material in relation to the company, and at Chevron or Exxon an expenditure of $500,000, for which there is no indication of misreporting or misconduct pursuant to the concept of qualitative materiality, would clearly not meet either the quantitative or qualitative materiality threshold.

Corporate PACs spend an average of one million dollars per company.[58] Even the leading advocate for corporate governance restrictions admits that these are not material expenses.[59] Even though lobbying expenditures by firms far exceed political contributions, they still tend to be quite small relative to the size of the firm. Hill et al. show that at the typical publicly traded companies lobbying expense amounts to $385,000.[60] For political expenditures pre-*Citizens United* the amount was even lower, at $65,000 per election cycle per company.[61] Based on traditional concepts of materiality in the securities laws, this amount would not be considered material.

Bebchuk and Jackson also admit that a great deal of information about political expenditures is available in the public domain, but argue that the information is difficult for investors to obtain and to assemble.[62] To the extent that the information Bebchuk and Jackson wish to see disclosed on the corporate financial statements are already available in the public domain, however, this fact actually cuts against a finding that they are material. Information is material only to the extent that it alters the "total mix of information made available" and once information is already available in the market it is assumed that it is incorporated into stock prices. For the purposes of the securities laws, materiality is voided where information has been capitalized into stock prices even though most investors don't actually have the information at their fingertips.

The securities disclosure system is built on a presumption that publicly available information will be incorporated into stock prices in an efficient

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[57] *See id.* at 931.

[58] Ciara Torres-Spelliscy, *Corporate Political Spending & Shareholders' Rights: Why the U.S. Should Adopt the British Approach*, *in* Risk Management and Corporate Governance 391, 396 (Abol Jalilvand & A.G. Malliaris, eds., 2011) (quoting Press Release, Campaign Fin. Inst., Party Conventions' Financiers Have Spent Nearly $1.5 billion on Federal Campaign Contributions and Lobbying Since 2005 (Aug. 20, 2008), *available at* http://www.cfinst.org/press/PReleases/08-08-20/Conventions_Financiers_Spent_Nearly_1_5_billion_Since_2005.aspx.).

[59] *Id.* at 400.

[60] Matthew D. Hill et al., Determinants and Effects of Corporate Lobbying 16 (Jan. 19, 2011) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1420224.

[61] Michael J. Cooper et al., *Corporate Political Contributions and Stock Returns*, 65 J. Fin. 687, 689 (2010).

[62] *See* Bebchuk & Jackson, *supra* note 1, at 935–37.

market, the fraud-on-the-market presumption of reliance is one variant on that theme.[63] One of the two standard definitions of materiality used by courts in securities litigation recognizes that fact in the articulation that information will only be deemed material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available."[64] That formulation assumes that investors have at their disposal all information made available, even though it may be difficult to find or assemble.

Thus even if political expenditure information is otherwise material, the fact that much of the relevant information is already available in the public domain would argue against the materiality of mandatory disclosure. The fact that the relevant information may be difficult to assemble or process does not matter, as the presumption of efficient markets only needs a few informed or specialized traders whose trading will allow the price to reflect the value of the information.[65] Thus the only benefits that would be relevant in this calculation would be any benefits attributed to the marginal difference between information presently available and that made available by the new rule.

Bebchuk and Jackson argue that one of the potential costs that mandatory disclosure can eliminate (thus categorized as a benefit) is the risk that investors will invest in companies whose political expenditures do not match the political preferences of the investors.[66] But satisfying investor political preferences is not an objective of the federal securities laws, mandatory disclosure under the Exchange Act is always anchored in the requirement that the mandatory reporting item, whether directly or indirectly, have a material impact on company value. It may be the case that corporate interior decorations, the location of a new company factory, or meals provided in the company cafeteria all reflect the preferences of the CEO rather than the company's best interest or the preferences of its shareholders, but the question remains whether those expenditures have a material impact on the company's finances. To the extent that decisions reflecting executive's preferences over the needs of the company violate their obligations to the company, those matters are left to state law fiduciary suits via the Supreme Court's internal affairs doctrine.[67]

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[63] *See* Basic, Inc. v. Levinson, 485 U.S. 224, 241–42 (1988) (citing Peil v. Speiser, 806 F.2d 1154, 1160–61 (3d Cir. 1986)) (establishing the fraud-on-the-market presumption).

[64] *See Basic, Inc.*, 485 U.S. at 231–32.

[65] *See In Re* Merck & Co., Inc., 432 F.3d 261, 269 (3d Cir. 2005) (holding that "the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm's stock" even though the information publicly available required independent analysis and calculation).

[66] *See* Bebchuk & Jackson, *supra* note 1, at 943–44.

[67] Edgar v. MITE Corp., 457 U.S. 624, 645 (1982). In the state of Delaware, for instance, the law governing interested transactions by executives and board members is quite robust.

In a prior piece Bebchuk and Jackson also argue that their proposals are justified by the possibility that minority shareholders will be forced to subsidize positions they do not believe in,[68] but there are a wide variety of expenditures by companies that might just as easily implicate deeply held social beliefs, from energy exploration to healthcare, offshoring to urban development methods. If companies had to get shareholder approval for every one of them, companies could not function.[69] Shareholders have the option to invest in funds that only themselves take positions in companies that have political expenditure and other social welfare objectives as part of their governing documents if they choose.

Bebchuk and Jackson also argue that political expenditures have "expressive significance" for shareholders,[70] but those concerns are irrelevant in a rulemaking under the Exchange Act to the extent they do not impact stock prices or other variables relevant to the three part economic analysis standard. Bebchuk and Jackson urge that the SEC has required disclosure of non-material items on similar grounds in the past,[71] but that does not mean such a rule was a legitimate exercise of its regulatory authority, particularly after the NSMIA of 1996 and the *Business Roundtable* case of 2011.

Winkler describes the foundation for campaign finance limitations on corporate political speech as grounded in agency cost justifications, in other words, companies should be limited in their ability to donate to protect shareholders from residual losses through donations designed to serve the executives' personal political preferences.[72] *Citizens United* rejects the agency cost justification for campaign finance limitations on corporations.[73] It makes reference to shareholders being able to use the tools of shareholder democracy to alleviate any concerns about corporate political activity in dicta,[74] but it clearly does not reference any need to reform corporate governance rules to achieve that purpose. If courts reject this justification in the campaign finance context, it is unlikely they will accept them in this context.

Bebchuk and Jackson also note that the *Citizen's United* case observed that shareholders upset with corporate expenditures in politics could rely on the "procedures of corporate democracy."[75] This observation in dicta does not however urge fundamental changes to those procedures or a requirement for enhanced disclosure in this area. What Bebchuk and Jackson have missed is that a lack of disclosure about political expenditures reveals a great

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[68] Lucian A. Bebchuk & Robert J. Jackson, *Corporate Political Speech: Who Decides?*, 124 Harv. L. Rev. 83, 90–91 (2010).

[69] *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. L. Rev. 547 (2003).

[70] *See* Bebchuk & Jackson, *supra* note 1, at 943–44.

[71] *See id.*

[72] Adam Winkler, *"Other People's Money": Corporations, Agency Costs, and Campaign Finance Law*, 92 Geo. L.J. 871, 934 (2004).

[73] Jeremy G. Mallory, *Still Other People's Money*, 47 Cal. W. L. Rev. 1, 35 (2010).

[74] Citizens United v. Fed. Election Comm'n, 558 U.S. 310, 370–71 (2010).

[75] *See* Bebchuk & Jackson, *supra* note 1, at 944–45.

deal of information, particular when considered in conjunction with the increasing amounts of voluntary disclosure Bebchuk and Jackson describe as currently occurring.[76]

Bebchuk and Jackson urge that, though they argue that stock price impact of political expenditure disclosure is not required to initiate a mandatory disclosure rule,[77] there is a body of literature supporting the notion that political expenditures are harmful to companies.[78] They admit that the literature is mixed however,[79] and Business Roundtable v. SEC warns against grounding a mandatory disclosure rule on mixed empirical evidence.[80]

Some of the literature Bebchuk and Jackson cite also suffers from a few key flaws as well.[81] Studies of soft-money spending, for instance, do not necessarily capture the effects of entirely different forms of political engagement like independent expenditures through intermediary groups. Further, like in many other corporate governance debates, studies will only be useful to the extent they control for the specter of endogeneity problems.

For instance, if one were to find an association between firm legal expenses and excess negative returns, one may be tempted to conclude that the legal expenses caused the abnormal losses. Yet both may instead be a function of some other firm variable. Further, a disclosure rule which required companies to itemize their legal expenditures might generate collateral damage for the firm, as potential litigants could better determine the settlement value of strike suits. In much the same way, it would appear that mandatory political expenditure disclosure would do little to improve shareholder returns and may in fact actually harm them, as firms who feel the need to engage in political expenditures may simply be subject to higher levels of political risk in the first place.

Further, empirical inquiry in this area will need to prove relevant for a materiality inquiry, for instance a finding that firm political expenditures do not impact firm profits or shareholder returns would not demonstrate the materiality of those expenditures, and would serve as evidence that they are in fact immaterial.

Bebchuk and Jackson argue that since the SEC has grounded disclosure rules in the past, as in the areas of corporate social responsibility or climate change disclosure, on the expressed desires of a minority of shareholders and in the absence of a stock price materiality inquiry, it may do so again in this instance.[82] Yet that does not mean the SEC fulfilled its obligation to conduct cost-benefit analysis under the NSMIA in those instances, particu-

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[76] *See* Bebchuk & Jackson, *supra* note 1, at 945–48.
[77] *Cf. id.* at 943–44.
[78] *Id.* at 947.
[79] *See* Bebchuk & Jackson, *supra* note 1, at 947.
[80] Business Roundtable, 647 F.3d. 1144, 1150–51 (D.C. Cir. 2011).
[81] *See* Bebchuk & Jackson, *supra* note 1, at 947.
[82] *Cf. id.* at 943–44.

larly in light of the *Business Roundtable* case, and those rules may remain in place solely because no litigant has sought to challenge it yet.

It is beyond the scope of this reply to determine the empirical impact of political expenditures at companies, merely to observe that this will be the most critical component of a proper cost-benefit analysis by the SEC if it goes forward with a rule on this issue. The D.C. Circuit has strongly favored empirical analysis, and particularly the stock price effects of rules or the items included in rules, in reviewing the SEC's compliance with this statutory requirement, most recently in the case of *Business Roundtable v. SEC*.[83]

IV. Clear Costs to Mandatory Political Expenditure Disclosure

Easterbrook and Fischel urged that on the cost side of the equation for a mandatory disclosure, the most significant costs would always be indirect costs, or reductions in the level of beneficial activity.[84] In this case that type of cost will be evidenced in a reduction in corporate political expenditures, political expenditures that may afford significant benefits to the firm, because of the risk that public disclosure of those expenditures may result in negative publicity with particular interest groups of suppliers, consumers, or government regulators or politicians with power over the firm.

In a prior article Bebchuk and Jackson also argue that "existing laws permit corporate political spending to be channeled through intermediaries in a manner that obscured the source and magnitude of the funds, and companies doing so will have little reason to fear a backlash."[85] One of the only direct anecdotal examples of corporate political donations harming company value reveals that the disclosure of the donation itself was the source of harm to the company, and not the underlying and legal expenditure, so in that sense the room currently allowed by law for anonymity in disclosures actually helps to protect the company. Mandatory disclosure in financial statements could then directly harm the company and its shareholders. A disclosure of political expenditures by companies may itself be the cause of company losses, rather than the expenditures themselves.

Bebchuk and Jackson argue "There is no reason to expect that disclosure will undermine directors' and executives' ability to pursue political spending that shareholders want."[86] And yet in fact that has already happened. In the case of Target stores, Target made a political expenditure to a group, which supported an intermediary group called Minnesota Forward, which then supported a candidate who was against gay marriage.[87] Neither Target nor Minnesota Forward supported that position, and the intermediary

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[83] *See Business Roundtable*, 647 F.3d at 1148–49.

[84] *See* Easterbrook & Fischel, *supra* note 45, at 708.

[85] Bebchuk & Jackson, *supra* note 68, at 93.

[86] *See* Bebchuk & Jackson, *supra* note 1, at 960.

[87] Brody Mullins & Ann Zimmerman, *Target Discovers Downside to Political Contributions*, Wall St. J., Aug. 7, 2010, at A2.

group Minnesota Forward was solely focused on economic policies that might make Minnesota a friendlier environment for economic growth.[88]

Nevertheless a boycott against Target was later organized, and Target was successfully urged to apologize for the donation.[89] Thus it was not the political donation that harmed the company, but the disclosure of the political donation that did so. This will form one of the principal costs to the mandatory disclosure rule that Bebchuk and Jackson put forward. Bebchuk and Jackson urge that mandatory disclosure will only deter political expenditures that are inconsistent with shareholder interests.[90] What they fail to appreciate is that the real risk here is not necessarily shareholder reaction to mandatory disclosure, but the reaction of customers or government officials to the expenditure.

Companies are in a better position to determine whether their political expenditures might subject them to collateral damage with the various constituents of the company, including customers, suppliers, or regulators and government officials. They would be better equipped to determine whether it is better to make these expenditures anonymously through intermediary groups, and whether it is best to refrain from disclosing them on the company financial statements. The case of Target Stores is instructive, and in estimating costs the D.C. Circuit has also suggested the relevance of measuring costs at individual firms and then using that as a basis to extrapolate cost estimates to the wider industry.[91]

Another clear cost to the proposal is that it may deter the evolution of private market solutions to any market failure in this area. State law for instance provides a ready method for companies to bind to disclosure, or for shareholders to initiate disclosure requirements. Company bylaws, charter amendments, or company policies can be tailored to specific company needs, but in face of a mandatory rule freedom of action will likely be limited.

Sitkoff argues "corporations probably supported the enactment of the Tillman Act as a means of protecting themselves for extortive threats by political leaders seeking campaign contributions."[92] Any yet companies can just as easily commit not to donate individually by placing provisions prohibiting the practice into their charters, which require approval by both the board and the shareholders, severely restricting a company's ability to make donations without a delay of many months and an affirmative vote of shareholders. If this were a valuable provision, one would see it included in the charters of new companies at the time of their initial public offerings.

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[88] *Id.*

[89] *Id.*

[90] *See* Bebchuk & Jackson, *supra* note 1, at 960.

[91] *See* Chamber of Commerce of the United States of America v. SEC, 412 F.3d 133, 144 (2005).

[92] Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. Chi. L. Rev. 1103, 1131 (2002).

However, such measures have been markedly absent from IPO firm charters. In the SEC's mandatory proxy access rule companies and their shareholders were not permitted to adopt higher ownership thresholds or ownership holding periods to trigger a federal proxy access right, and any mandatory rule on this issue is likely to be similarly inflexible.

Bebchuk and Jackson would likely not agree that this cost argument is valid, since they argue that private ordering will ultimately prove ineffective anyway. If they are wrong however, it is a legitimate cost that should be considered. Bebchuk and Jackson argue against a private ordering approach for four reasons. One is that they feel the level of disclosure is insufficient, and that some firms who voluntarily disclose information do not provide the specific recipients of the expenditures.[93] Bebchuk and Jackson still have not demonstrated however that identifying the recipients of expenditures has material importance to shareholders independent of their magnitude.

They also urge that there is substantial variation in disclosure, which makes comparability difficult across firms.[94] But any challenges in comparability across firm expenditures are nowhere near the scale of standardization benefits provided by the inordinately more complex financial valuation methods included in Generally Accepted Accounting Principles. In any event, new and innovative methods to compare firm political disclosure are already available as, for example, in the Zicklin index referenced previously.

Bebchuk and Jackson also urge that investors should not be required to make demands for disclosure at thousands of firms individually,[95] but that argument misses that if political expenditure disclosure does have a positive impact on stock prices, firms will initiate disclosure themselves in the absence of some market failure. Bebchuk and Jackson also urge that those companies that do not voluntarily disclose political expenditures are the companies most likely to make them,[96] but that argument actually cuts against their thesis. If that is true, then silence will send a clear signal to investors, which they will then be able to incorporate into the stock's price.

Conclusion

Bebchuk and Jackson present a well-argued and forceful case against corporate political expenditures, and at the very least they demonstrate that the greater social debate over corporate political expenditures will continue to be a lively endeavor. Nevertheless, many of the arguments that Bebchuk and Jackson offer in support of their rulemaking petition are not relevant to the cost-benefit analysis that the SEC is required to perform under NSMIA. If the SEC moves forward with their rulemaking petition, it is highly likely

[93] Bebchuk & Jackson, *supra* note 1, at 947.
[94] *Id.* at 948.
[95] *Id.*
[96] *Id.* at 949.

that petition will be either vacated or remanded by the D.C. Circuit and face the same fate as the proxy access proposal remanded in *Business Roundtable*.