11/2/2011

Ms. Elizabeth M. Murphy

Secretary

Securities and Exchange Commission

100 F Street, Northeast

Washington, D.C. 20549

A Cost-Benefit Analysis of Corporate Political Spending Disclosure

By Susan R. Holmberg, Ph.D.

I. Executive Summary

This report provides a cost-benefit analysis of a potential rule promulgated by the SEC that would require public corporations to disclose corporate political spending. Using existing evidence on both the dynamics of corporate political spending and the costs and benefits of SEC mandatory disclosure in general as well as employing agency theory, an economic framework that highlights the asymmetric interests and knowledge between corporate managers and shareholders, I conclude that the range of potential benefits of corporate political spending disclosure—to shareholders and the market—vastly outweigh the possible costs of compliance to public corporations.

II. Introduction

This paper is an economic analysis of the costs and benefits of SEC File No. 4-637, a Securities and Exchange Commission petition to require public companies to disclose to shareholders the use of corporate resources for political activities. This report will do the following: 1) describe the various forms of corporate political spending; 2) define and support the use of agency theory as the economic framework best suited to identify the costs and benefits of the proposed corporate political spending disclosure rule; 3) map agency theory onto corporate political spending and illustrate the ways in which such activity generates monitoring costs; 4) highlight the main tenets of the debate on the costs and benefits of SEC mandatory disclosure in general; and 5) use the existing evidence from the above discussions to identify and compare the costs and benefits of political spending disclosure. I then conclude that the range of economic benefits of this disclosure rule would greatly outweigh the nominal costs imposed on corporations for compliance.

III. Corporate Political Activity

Prior to the Supreme Court's *Citizens United v. Federal Election Commission* decision in 2010, corporate political activity (CPA) had included the following tactics: direct lobbying of lawmakers; donating soft-money to political parties, which was legal until 2002's Bipartisan Campaign Reform Act (BCRA a.k.a McCain-Feingold); spending through affiliated corporate political action committees (PACs a.k.a. Separate Segregated Funds or SSFs); and grassroots lobbying to encourage the public to engage on a particular issue (Hillman et al. 2004).

Citizens United v. FEC added another tool into the corporate political chest: the ability to spend corporate treasury funds on two types of political ads: 1) independent expenditures which expressly advocate for the election or defeat of a candidate and 2) electioneering communications as defined by BCRA, which are colloquially known as broadcast "sham issue ads."

Before *Citizens United*, corporations had been barred from making these expenditures in federal elections, but after *Citizens United* they were freed to spend an unlimited amount on both categories of political ads. *Citizens United* also changed the law in 22 states that had similar corporate expenditure bans. Because of pre-existing disclosure loopholes, companies can hide this new political spending from the investing public (Torres-Spelliscy 2011 and Aprill 2011).[1]

Why do corporations engage in political spending activity? Is CPA effective? Which parties does it benefit and what are the broader impacts? The following sections present the basic structure of the principal-agency framework and draws from existing

[1] Corporations often combine CPA tactics. For example, Ansolabehere et al. (2004) finds that 86% of all contributions come from firms who have both lobbyists and political action committees. Schuler et al. (2002) show evidence that firms tend to mix contributions and lobbying (contributions are what purchase the lobbying access).

research evidence to unpack some of CPA's properties and its impacts on corporate players.

IV. Agency Theory

Agency theory is an extremely well-developed economic framework for understanding the complex dynamics of corporate governance in general. It predicts conflicts of interest between managers (agents) and shareholders (principals) based on the fact that a) their goals are not perfectly aligned and b) problems of asymmetric information exist between them (see Jensen and Meckling 1976, Fama 1980, and Eisenhardt 1989).[2] In regards to the former, rather than maximizing corporate profits, manager-agents seek to maximize an objective utility function that would include salary and benefits as well as qualitative factors like power and prestige, all subject to a given profit constraint. In terms of the latter, asymmetric information—a kind of market failure—arises when the agent has more information or expertise than the principal. These two factors, combined with the fact that, in some situations, managers are more insulated from risk, constitute a problem called moral hazard. Furthermore, because of the moral hazard problems inherent in a situation with conflicting objectives, asymmetric information, and insulation from risk, principal-shareholders must be able to monitor the actions of firms' agent-managers, which imposes direct costs (hiring an external auditor) and/or indirect costs (shareholders' opportunity costs) (Eisenhardt 1989 and Johnson and Greening 1999).

The literature supporting the moral hazard problems that arise out of the principal-agent framework is convincing. Bebchuk and Fried (2004) link weaker shareholder rights with higher CEO pay and Yermack (2006) finds a negative relationship between perquisites of major company CEOs and average shareholder returns. According to Coates (2010), "observable corporate governance provisions consistently predict the degree to which faithless managers divert shareholder wealth for their own ends, destroy corporate wealth, and reduce public welfare" (2). Coffee (1984) states that managers "have strong incentives to withhold adverse information and to undertake preemptive buyouts of their own firm, which are facilitated by withholding positive information"

[2] Controlling shareholders, who have the ability to divert corporate resources, are also sometimes characterized as agents (Ferrell 2007-2008).

(752). Of course, in light of cases like the Enron Corporation accounting scandal, one does not have to delve deeply into academic research to comprehend the moral hazard problems prevalent in corporate governance. The following section highlights some of the ways CPA conforms to the principal-agent scenario, which thereby produces serious moral hazard problems for companies who engage in political spending and for their investors.

V. CPA Agency Problems

The economic literature suggests that there are two primary reasons why corporations engage in CPA. One ready explanation is they do it to maximize profit for the company. As a "political investment" (Hadani 2011), corporations are expecting a "return," particularly in the following forms: reduced trade barriers, earmarks, government contracts, reduced or easier regulatory inspections, favorable rate regulation, and lower tax rates (Coates 2010).

There is a tremendous amount of literature that evaluates whether CPA actually achieves the aforementioned firm-level outcomes, and the results are not consistent. For example, Cooper et al. (2010), Bonardi et al. (2006), and Dean et al. (1998) all find evidence of a positive impact of CPA on firm-level outcomes while Aggarwal et al. (2011), Coates (2010), Ansolabehere et al. (2004), Igan et al (2009), Milyo (1999), and Banker et al. (1997) have all found negative outcomes. These conflicting results suggest that CPA creates uncertainty and risk for shareholders that are well-beyond what typically accompanies economic investment activities.

The second explanation, which is gaining ground in the economics literature, is that corporate managers spend in politics for their own self-aggrandizement, at the expense of the company. In the CPA context, there is considerable potential for personal advantages to corporate executives, particularly prestige, a future political career, and star power (Hart 2004) or to help political allies (Aggarwal et al. 2011).

To complicate matters, in CPA settings, asymmetric information between managers and shareholders is ubiquitous. Corporate executives know precisely how much money is being spent on politics while neither CPA's process nor strategic outcomes is at all transparent to shareholders or the investing public (Fisch 2006 and

Butler and Ribstein 1995). Unlike economic production, the market does not signal the "production" of CPA. In other words, if a closed-door meeting between a corporate lobbyist and a policymaker goes badly, that failure will not be broadcast nor will it be reflected in the company's stock price. This lack of transparency makes it extraordinarily difficult, maybe impossible, for millions of dispersed shareholders to monitor—and hold accountable—the actions of managers who might not have the skills to be effective at achieving their strategic goals (Hart 2004) or are motivated by their personal gain, at the expense of shareholders.

All three of these factors—the considerable ambiguity about CPA outcomes, the potential personal rewards to managers of political spending, and the lack of transparency (asymmetric information) in both CPA processes and goals—renders CPA a moral hazard situation that is extremely risky for shareholders.[3]

The recent body of evidence strongly supports this conclusion. For example, Coates (2010) finds that when shareholder rights are weak and, thus, there is little transparency, corporations engage in more CPA. Hadani (2011) also found that when there is no monitoring, firms were more likely to engage in political spending. Aggarwal et al. (2011) report that worse corporate governance is correlated with larger donation sums and that a lack of transparency allows for CPA to serve as a form of private benefits for corporate managers. A recent study by Schepers and Gardberg (2011) also found that, on average, the corporations that spend the most tend to disclose less than companies with more moderate CPA.

Furthermore, shareholders are well aware of, and concerned with, the agency problems of CPA. Hadani (2011) finds that institutional investors (large ones in particular) tend to oppose CPA and also cites a Mason-Dixon shareholder poll that 85% of respondents felt that a lack of CPA monitoring had allowed for management to act in ways that were in conflict with shareholder preferences.

[3] A theoretical argument against the moral hazard problems of CPA is the "Wall Street Rule," which states that if the shareholder is in conflict with corporate management, it is more efficient (less costly) to sell corporate shares than demand behavioral change (Joo 2001). However, there are two factors that invalidate the Wall Street Rule: 1) institutional investor or controlling investors are not able to easily sell all their shares (Han et al. 1999) and 2) the transparency that the Rule presumes does not, in fact, exist in the CPA context.

VI. The Costs and Benefits of SEC Mandatory Disclosure Regulation

In order to effectively highlight the potential costs and benefits of the SEC File No. 4-637 petition to develop rules to require public companies to disclose to shareholders the use of corporate resources for political activities, it is useful to discuss some of the economic research and debates on the costs and benefits of SEC mandated corporate disclosure in general.

The economic impacts of SEC disclosure regulation are intensely debated in the literature. Arguments against mandatory disclosure claim that requiring corporate disclosure is unnecessary, as the market will compel firms to disclose information (Grossman and Hart 1980 and Easterbrook and Fischel 1984). However, that conclusion is based on perfect symmetry of interests and information between managers and shareholders, which, as is well-established in the economics literature, is a fairly weak assumption.

Researchers also argue that mandatory disclosure rules impose competitive costs, i.e. they would be forced to share proprietary information with their competitors (Ferrell 2007-2008). Finally, there is evidence that disclosure rules can sometimes be costlier for smaller companies (Bushee and Leuz 2005).

Arguments supporting mandatory disclosure include several factors that would foster market efficiency. For example, it would lower the cost of capital (Ferrell 2007-2008); in terms of principal-agent problems, mandatory disclosure can also compel managers to focus more narrowly on the maximization of shareholder value (rather than their own utility maximization) (Greenstone et al. 2005); and firms previously filing with the SEC experience positive stock returns and permanent increases in liquidity, suggesting positive externalities from disclosure regulation (Bushee and Leuz 2005).

VII. The Costs and Benefits of Corporate Political Spending Disclosure

How do these economic arguments apply to SEC disclosure in the CPA context? In terms of costs, there are a few commonly identified categories to consider.

First, compliance costs of CPA disclosure should be nominal. Lobbying and other political contributions are not tax deductible as regular business expenses for tax reporting purposes under Internal Revenue Code § 162(e). Thus, in order for a politically active company to file accurate IRS returns it must already keep track of their CPA. The new rule envisioned by SEC File No. 4-637 would merely make this internal accounting of CPA available for the investing public. So long as the reporting categories chosen by the SEC in the new disclosure rule mirror the categories that the IRS lists as non-deductible political expenditures under § 162(e), the cost of compliance may be as little as the hours it would require an employee to copy and paste data from an internal file into a public one. Furthermore if the new SEC rule adds to an existing reporting requirement such as filings currently made by companies on Form 10-K or Form 10-Q, then there would be minimal additional production or mailing costs for reporting companies. Rather, companies would merely add a few lines of text to disclosures that they are already legally required to give to their investors.

The second issue is the aforementioned problem of firm size. Bushee and Leuz (2005) document that disclosure requirements result in higher costs for smaller companies. This can be explained by lower production costs of information for bigger companies, i.e. economies of scale (Jensen and Meckling 1976). However, considering that the accounting process for CPA disclosure to the SEC would be as simple as making internal accounting records public, there is no reason to expect that smaller companies would bear a larger burden from a disclosure requirement than larger companies. In other words, neither type of firm is expected to experience a noticeable increase in accounting costs.

The third issue to consider is the potential competitive costs to corporations, which should not be problematic. Companies already often match competitors' political contributions and CPA tends to concentrate by industry (Grier et al. 1994), which suggests that corporate political spending is not proprietary information that could potentially be threatened by mandatory disclosure.[4]

[4] One might wonder how competitors could discover information about CPA when shareholders cannot. One possible channel is through politicians, who both know whether a given corporation has spent money supporting or lobbying them and have an incentive to use that information strategically to extract support from that corporations' competitors. Another possible channel is politically active trade groups, whose representatives have information about corporate contributions to the groups as well as political spending more broadly.

The expected benefits of mandatory disclosure of corporate political spending would be substantial. Disclosure would help to mitigate the moral hazard problems inherent in CPA by diminishing the monitoring costs for shareholders, allowing them to make more informed investment decisions. It would also create incentives for managers to focus on the kinds of CPA that would maximize shareholder wealth rather than their own self-interest. Finally, it would offer the same kinds of positive externalities that corporations, which already share required information, enjoy from mandatory disclosure. All of these impacts would have significant benefits for market competition and economic efficiency.

In summary, it is indisputable that an SEC rule requiring companies to disclose their corporate political spending would result in only a nominal set of compliance costs to corporations engaged in political activities while creating a wide range of benefits to the economy, particularly by: generating positive externalities for corporations that are already in compliance; offsetting the large monitoring costs from a lack of transparency in corporate political spending borne by existing shareholders; providing potential investors with key information with which to make rational investment decisions; and creating incentives for self-interested corporate managers to more effectively maximize shareholder wealth.

VIII. Conclusion

This report draws from robust economic methodology and the existing body of empirical research evidence to highlight the relative costs and benefits derived from a mandatory disclosure of corporate political spending.

Corporate political spending includes a range of tactics—direct lobbying of lawmakers, soft-money, PAC activity, and grassroots lobbying. Since the Supreme Court's *Citizens United v. Federal Election Commission* decision in 2010, corporations have also had the ability to spend corporate treasury funds on two kinds of political ads: 1) those advocating for election or defeat of a candidate and 2) "sham issue ads."

Deciphering the CPA context using agency theory demonstrates that CPA generates significant moral hazard problems. Agency self-interest, asymmetric information (i.e. lack of transparency), and ambiguous evidence on the strategic impacts result in moral hazard problems that render CPA extraordinarily risky for shareholders and the investing public.

When I consider, based on the evidence in the economic literature, what the impacts of a potential SEC rule requiring CPA disclosure would be, I conclude that the benefits would vastly outweigh the costs. By observing current patterns of CPA, I predict that compliance costs to corporations would be nominal. For example, the accounting costs would be marginal as CPA is already recorded for tax purposes; small and large companies alike would face minimal compliance costs; and CPA is not proprietary information and, thus, no competitive costs are expected.

Furthermore, the benefits of CPA disclosure would be substantial. This rule would help to correct the market failures that currently exist in CPA by creating incentives for managers to focus less on their personal gains and more on maximizing shareholder wealth; by providing shareholders with key information with which to make rational investment decisions; and generating positive externalities for corporations that already disclose their CPA to shareholders. In other words, requiring corporations to disclose their political donations would substantially improve the efficiency of capital markets, which is why I urge the SEC to promulgate a rule requiring corporate political disclosure for publicly traded companies.

/s/Susan Holmberg, PhD

Susan R. Holmberg holds a PhD in Economics from the University of Massachusetts, Amherst. She is the Program Director at the Center for Popular Economics, an organization that teaches economics literacy to the general public. Her economic research focuses primarily on international development and trade issues.

Contact Information:
Susan Holmberg
[redacted]

IX. References

Aggarwal, Rajesh K., Meschke, Felix, and Tracy Wang. *Corporate Political Donations: Investment or Agency?* Working Paper: 2011.

Ansolabehere, Stephen, Snyder, James M., and Michiko Ueda. "Did Firms Profit from Soft Money?" *Election Law Journal* 3.2 (2004): 193-199.

Aprill, Ellen P. *Regulating the Political Speech of Noncharitable Exempt Organizations After Citizens United*. Loyola Law School Los Angeles Legal Studies Working Paper 57: Dec. 2010.

Banker, Rajiv D., Das, Somnath, and Chin S. Ou. "Shareholder Wealth Effects of Legislative Events: The Case of Airline Deregulation." *Public Choice* 91 (1997): 301-331.

Bebchuk, Lucian A., and Jesse Fried. *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* Cambridge, Massachusetts: Harvard University Press (2004).

Bonardi, Jean-Philippe, Holburn, Guy L.F., and Richard G. Vanden Bergh. "Nonmarket Strategy Performance: Evidence from U.S. Electric Utilities." *Academy of Management Journal* 49 (2006): 1209-1228.

Bushee, Brian J., and Christian Leuz. "Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board." *Journal of Accounting and Economics* 30.2 (June 2005): 233-264.

Butler, H.N., and L.E. Ribstein *The Corporation and the Constitution* Washington, DC: AEI Press (1995).

Coates, John C. "Corporate Governance and Corporate Political Activity: What Effect Will Citizens United Have on Shareholder Wealth?" Working Paper: 2010.

Coffee, John C. "Market Failure and the Economic Case for a Mandatory Disclosure System." *Virginia Law Review* 70.4 (1984): 717-753.

Cooper, Michael J., Gulen, Huseyin, and Alexei V. Ovtchinnikov. "Corporate Political Contributions and Stock Returns." *Journal of Finance* 65.2 (2010): 687-724.

Dean T.J., Vryza, M., and G.E. Fryxell. "Do Corporate PACs Restrict Competition?" *Business and Society* 37 (1998): 135-52.

Easterbrook, Frank H., and Daniel R. Fischel. "Mandatory Disclosure and the Protection of Investors." *Virginia Law Review* 70.4 (May 1984): 669-71.

Eisenhardt, Kathleen M. “Agency Theory: An Assessment and Review.” *The Academy of Management Review* 14.1 (1989): 57-74.

Fama, Eugene F. “Agency Problems and the Theory of the Firm.” *Journal of Political Economy* 88.2J (1980): 288-306.

Ferrell, Allen. “The Case for Mandatory Disclosure in Securities Regulation around the World.” *Brooklyn Journal of Corporate, Financial, and Commercial Law* 81 (2007-2008).

Fisch, Jill E. “The ‘Bad Man’ Goes to Washington: The Effect of Political Influence on Corporate Duty.” *Fordham Law Review* 75.3 (2006): 1593-1613.

Greenstone, Michael, Oyer, Paul, and Annette Vissing-Jorgensen. “Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments.” *Quarterly Journal of Economics* 121 (2006): 399-460.

Grier KB, Munger, M.C., and B.E. Roberts. “The Determinants of Industry Political Activity: 1980-1986.” *American Political Science Review* 88 (1994): 911-26.

Grossman, S.J., and O.D. Hart. “Disclosure Laws and Takeover Bids,” *The Journal of Finance* 35.2 (May 1980): 323-334.

Hadani, Michael. “Institutional Ownership Monitoring and Corporate Political Activity: Governance Implications.” *Journal of Business Research* (2011): 1-7.

Han, Ki C., Lee, Suk Hun, and David Y. Suk. “Institutional Shareholders and Dividends.” Journal of Financial and Strategic Decisions 12.1 (Spring 1999): 53-62.

Hart, David M. “‘Business’ is Not an Interest Group: On the Study of Companies in American National Politics.” *Annual Review of Political Science* 7 (2004): 47-69.

Hillman, Amy J., Keim, Gerald D., and Douglas Schuler. “Corporate Political Activity: A Review and Research Agenda.” *Journal of Management* 30.6 (2004): 837-857.

Igan, D., Mishra, P. and T. Tressel. *A Fistful of Dollars: Lobbying and the Financial Crisis.* IMF. Working Paper: 2009.

Jensen, Michael C., and William H. Meckling 1976. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *Journal of Financial Economics* 3 (4) 305-360.

Johnson R.A., and D.W. Greening. “The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance.” *Academy of Management Journal* 42 (1999): 376-983.

Joo, Thomas W. “The Modern Corporation and Campaign Finance; Incorporating Milyo, Jeffrey. “The Political Economy of Campaign Finance.” *The Independent Review* III.4 (Spring 1999): 537-547.

Milyo, Jeffrey. “The Political Economy of Campaign Finance.” *The Independent Review* III.4 (Spring 1999): 537-547.

Schuler, D., Rehbein, K., and R. Cramer. “Pursuing Strategic Advantage Through Political Means: a Multivariate Approach.” *Academy of Management Journal 45* (2002): 659-672.

Schepers, Donald H., and Naomi A. Gardberg. “Baruch Index of Corporate Political Disclosure.” CUNY Baruch College: Zicklin School of Business (2011).

Schuler, D., K. Rehbein, and R. Cramer. “Pursuing Strategic Advantage Through Political Means: a Multivariate Approach.” *Academy of Management Journal 45* (2002): 659-672.

Torres-Spelliscy, Ciara*.* “Hiding Behind the Tax Code, the Dark Election of 2010 and Why Tax-Exempt Entities Should Be Subject to Robust Federal Campaign Finance Disclosure Laws.” *Nexus: Chapman’s Journal of Law and Policy* 16 (2011): 59.

Yermack, David. “Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns.” *Journal of Financial Economics* 80 (2006): 211-242.