Four Years after Enron

Assessing the Financial Market Regulatory Clean Up

By Roy C. Smith and Ingo Walter*

Abstract

This paper assesses the efforts to "clean up" financial markets and corporate governance practices in the wake of the bankruptcies and scandals of the early 2000s. It begins by reviewing what actually happened during that period, what damages ensued and the responses of government enforcement agencies and policy makers, then assesses the impact of the various actions that followed and their effectiveness. The paper then looks at these actions in an historical context, examining the possibilities of imbalances of power between market insiders and ordinary investors that provide an uneven market environment. Finally, it discusses actions that might be taken to have a greater impact on leveling the uneven market, and what might be expected in the way of altered governance practices for the future.

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This year is the tenth anniversary of the beginning of the tech bubble in the stock market that began after the commercialization of the Internet and through it the development of a "new economy" led by "dot.coms" and other Internet enabled companies. These developments drove a tremendous stock market expansion from 1995 until the end of the 1990s, during which the NASDAQ index increased five-fold.

Early in 2000, however, the air began to leak out of the bubble, and by year end there was a widespread reduction in valuation of technology stocks of about 30%. This market drop sharply affected other businesses that relied on Internet technology, causing several to fail outright, or to slide out of control or to engage in account gimmickry in order to shore up their profits. In By December 2001, when Enron, the seventh largest company in America and one of its leading "new-economy" concept companies, filed for bankruptcy, the NASDAQ index had fallen 74% from its high of less than two years earlier. In 2001 there were 171 large corporate bankruptcies involving liabilities of $230 billion, more than twice the level in 2000, the previous record year for bankruptcies. In July 2002, WorldCom, the countries second largest long-distance telecom company with $107 billion in assets filed for bankruptcy after revealing recent instances of

accounting fraud. Throughout 2002 bankruptcies involving liabilities of $338 billion occurred, thus establishing a three-year period in which American bankruptcies – the ultimate form of corporate failure – broke all previous records.[1]

In addition, instances of accounting failures (in the form of “restatements” of prior audited financial results due to accounting errors) nearly quadrupled in the four-year period 1998-2001 to 616 cases.[2] Restatements continued to occur at a record level during 2002, when 330 cases were reported, 22% more than in 2001. As a consequence of these failures, federal securities-fraud class-action lawsuits seeking damages from officers, directors and advisers of the companies involved exploded. 489 such suits were filed in 2001 (of which 312 were related to initial public offerings) and 259 more in 2002, as compared to an average of 194 filings per year during the three years prior to passage of the Private Litigation Reform Act of 1995, a bill that was designed to substantially limit the number of such class action lawsuits.[3] Many of these lawsuits were the consequence of stock prices that fell rapidly, causing losses (damages) to investors, when such stock price declines followed sudden news of changed financial information

The financial losses caused by these failures were disproportionate. Bank-loan write offs for 2001-2002 were in the tens of billions of dollars. Publicly traded non-investment grade bond defaults for 2002 were (at par value) $96.9 billion -- the highest level of such defaults then recorded -- representing 12.8% of all such outstanding issues. In 2001 the default rate of these bonds was 9.8%, the

highest then since 1999. On the assumption that the bond defaults will result in recoveries (through bankruptcy or other work-out arrangements) equal to the ten-year historical average of about 30%, then the expected losses from loan write offs and from bond defaults for the two year period would be about $100 billion.

Equity market losses in 2001-2002 attributable to fears of corporate failures due to misgovernance were far greater: the S&P 500 peaked at 1527 in March, 2000 and then, reflecting the end of the technology bubble (which affected NASDAQ listed stocks much more), fell steadily to 966 in September, 2001, but then recovered by year-end 2001 to nearly 1200. But, even after clear signs of recovery in the economy and in corporate earnings were evident early in 2002, the influences of the Enron bankruptcy in December 2001 and other corporate surprises affected the market and the S&P 500 index reversed direction and fell further. Unlike the periods following recovery from previous recessions, the stock market continued to sag, with the S&P 500 index reaching a five-year low of 798 on July 23, 2002, down 33% for the year (reflecting a loss of about $4 trillion of market capitalization), and lower by more than 47% from its all-time high two and a half years earlier. For many industries suspected of accounting or governance shortcomings (e.g., telecom, health care, energy services and technology), share price declines were even greater. As a consequence of these failures, federal securities-fraud class-action lawsuits seeking damages from officers, directors and advisers of the companies involved exploded. 489 such suits were filed in 2001 (of which 312 were related to initial public offerings) and 259 more in 2002.[4] Many of these lawsuits were the

consequence of stock prices that fell rapidly, causing losses (damages) to investors, when such stock price declines followed sudden news of changed financial information.

These losses were not just felt by the rich. In 2002, a survey conducted by the Investment Company Institute and the Securities Industry Association reported that 52.7% of American households owned equity investments.[5] Accordingly, the stock market losses, the bankruptcies and the corporate misconduct associated with them became of great interest to the public media and to elected officials in Washington and in state capitols.

The corporate failures were publicized as being wide-spread. They were in the sense that record levels of bankruptcies and corporate accounting restatements were reported that involved over 600 companies during a three year period. This is a large number of companies to be seen to have failed or acted badly (about 8% of all listed public companies in the US). However, most of these failures were not the result of malfeasance or violations of law (officers and directors of fewer than fifty public corporations were involved in criminal charges), but of corporate mistakes and mismanagement inside an environment of greater than usual risk-taking. And, of course, by far the greatest percentage of corporation did not fail nor were involved in scandals of any kind.

However, inspired by the easy-money market bubble, many companies in the 1990s committed themselves to high-growth strategies that could only be sustained by aggressive corporate actions and “creative” accounting practices. Accountants were cooperative and accommodating, despite being pledged to a

role of independence, because of lucrative consulting fees available from large audit clients. Banks, brokers, asset managers and other intermediaries, enlarged by a decade of consolidation and deregulation, evolved into multi-line business platforms with considerable exposure to conflicts of interest, which, all too often, were resolved in their own favor. And even the SEC, the regulatory body responsible for financial markets and practices, had quietly sunk into ineffectiveness in the face of powerful resistance in Congress (resulting from lobbying and political contributions) to its efforts to improve accounting and other market practices in the 1990s. [6]

Once motivated by a common desire to address corporate excesses and abuses, public officials, including regulators, enforcement agencies and legislatures, began to compete with each other in their zeal to “clean up” the mess and to “restore confidence” in financial markets. During the four years after Enron a great deal of energy was expended by government officials in doing this.

Clean Up Actions since Enron

Immediately after the Enron bankruptcy, committees of Congress began investigations and consideration of legislative action. These actions were accelerated with the collapse of WorldCom. In July 2002, President Bush directed the Justice Department to establish a Corporate Fraud Task Force to include a variety of prosecutors, investigators and technical experts. Within this group a separate Enron Task Force was also appointed. Henceforth, the SEC

and other enforcement agencies began an earnest effort to close in on those thought to be offenders.

-- March 2002. The Justice Department chose to indict the firm of Arthur Andersen, Enron's auditor, for obstructing justice. By this time certain Andersen partners had confessed to inappropriate document shredding, which was alleged to have been the consequence of a firm policy to destroy evidence that might be incriminating. Justice was also angered by Andersen's role in the Enron case, which it believed was in violation of a consent decree extracted earlier in a fraud case involving Waste Management Corporation. In June 2002 Andersen was convicted of the charges, and as a result, immediately went out of business. In May, 2005 Andersen's conviction was overturned by the US Supreme Court though the firm was not, at the time, revivable.

-- July 2002. A new federal omnibus accounting and corporate governance reform and improvement law, Sarbanes-Oxley, was passed and signed by the President. This was the most comprehensive and extensive federal securities legislation since the 1930s, requiring the SEC to draft numerous new "rules" to provide for its implementation.

-- Beginning in April, 2003, more than $5 billion was collected from the financial services industry in a series of out-of-court settlements (orchestrated for the most part by NY State Attorney General Eliot Spitzer) with leading securities firms, mutual fund advisors, and insurance underwriters.

-- The Federal Sentencing Guidelines were amended in November 2004. These guidelines, established by Congress in 1991 to increase penalties for "white-collar" offenses (making prison terms for white collar offenders much longer and less subject to parole) and to place significant burdens upon employers to cooperate with enforcement officials in order to avoid prosecution. The amended guidelines raised significantly the standards that corporations must meet to avoid indictment in criminal situations involving their employees. These standards included the need to demonstrate preventive efforts to provide a "focus on ethics and organizational culture," and the ability to show that officers and directors understand and accept greater responsibility for assuring corporate compliance with these standards. However, the constitutionality of the sentencing guidelines was questioned in 2005 by the US Supreme Court, which reduced them from "mandatory" to "advisory."

-- Prosecutions of corporate officials began 2002-2005. Officials of about thirty-five major public companies were charged with criminal activities. Several high visibility executives have been tried, convicted and punished with lengthy prison sentences– including Bernie Ebbers (WorldCom) who received 25 years in prison, John Rigas (Adelphia) 15 years, Andrew Fastow, CFO of Enron, 10 years, Denis Kozlowski (Tyco) 8 years, and Scott Sullivan CFO of WorldCom, 5 years.[7] These executives have also been forced to turn over most of their remaining financial assets to the courts. Two other high profile executives, Ken Lay and Jeffrey Skilling of Enron await trial in early 2006.

-- Sanford Weil of Citigroup and Maurice Greenberg of AIG, the powerful, billionaire CEOs of two of America's most admired and successful financial corporations, were forced to resign by Mr. Spitzer – Weill in October 2003 and Greenberg in June 2005 -- who otherwise threatened to bring charges against their firms. Mr. Weil resigned quietly without relating his decision to Mr. Spitzer, but Mr. Greenberg has denied all allegations and refused to cooperate with Mr. Spitzer's office and accordingly is believed to face charges in the future.

-- The former head of the New York Stock Exchange and a former chairman of its compensation committee were charged with fraud (excessive compensation) by Mr. Spitzer in May 2004.

-- The plaintiff's bar has been especially active with class action suits against banks, investment banks and accountants from which settlements aggregating more than $14 billion were agreed by mid-year 2005. In the WorldCom and Enron cases, the plaintiff (a NY State pension fund), has insisted on the personal, uninsured participation in the financial settlement by the independent members of the boards of directors of the corporations,

After all of this, it would seem that those responsible for the worst corporate abuses have been (or will be) fairly (if harshly) punished, the financial market and corporate governance systems have been reformed and investors, indeed, can have confidence in the markets again. These were the popularly supported goals articulated by regulators, legislators and prosecutors when their

combined, interventions in the American business and financial marketplace began. Many would be inclined to say that the goals have for the most part been achieved.

Other Consequences of the Clean Up

The interventions, however, have left other consequences behind:

-- More than 10,000 public companies now must each expend millions annually to comply with the many new check-list compliance requirements imposed by Sarbanes-Oxley, the SEC and the stock exchanges. The average initial cost of such compliance efforts, according to a 2005 study of 217 companies with average revenues of $5 billion by Financial Executives International, was $4.36 million, with smaller companies paying more per dollar of revenue than larger ones. In aggregate, some estimates of the overall front-end cost of Sarbanes-Oxley are as high as $20 billion, with perhaps $5 to $10 billion in annual follow on costs.[8] In addition to the direct costs, compliance requires many hours of time of corporate officers and directors that divert them from managing their businesses, and may also reduce their tolerance for risk-taking. [9] Such cost estimates are considerable, but represent only a small fraction (0.1%) of the market capitalization of the country's sock markets. The benefits of Sarbanes-Oxley are difficult to assess – most of the powers created by the law were already vested in the SEC, but not necessarily enforced effectively by it. The law requires a great deal of new compliance effort, but there is no assurance that had these been in place at the time Enron or WorldCom, which were accused of fraud and concealment, that the companies would not have failed as they did.

-- The costs of financial intermediation (public offerings, bank loans, market-making, securities research and mutual funds) have also risen as a result of the Spitzer/SEC settlements involving an initial $1.5 billion cost and possibly another $1.0 billion per year in annual compliance costs for five years. These costs, though incurred by banks and brokers, are likely to be passed on to the users of American financial markets, which were already substantially regulated before Enron.

-- More than half of the listed companies in America will be unable to expect research coverage by Wall Street financial analysts, which have reduced coverage of companies by about 20%, and many will find the

ongoing cost of being public companies to be a drag on their prospects and therefore may consider withdrawing from the public market, or alternatively, repositioning their securities in the increasingly robust Euro-securities market.

--The eagerness of state and federal prosecutors to bring charges against companies and executives has resulted in difficulties in proving the charges in court – the conviction of Arthur Andersen was overturned by the US Supreme Court because of inappropriate instructions of jurors, a problem that may also apply to the conviction of a CSFB executive (Frank Quattrone) which is currently under appeal. Richard Scrushy, CEO of HealthSouth, was acquitted of charges that were very similar to (and supported by similar testimony of other senior executives) those brought against WorldCom's Bernie Ebbers, who, on the other hand, received a virtual life sentence for his actions. It took two trials to convict Dennis Kozlowski of misappropriating company funds, indicating that even in so-called clear-cut cases, the jurors may not see things – or understand them -- as prosecutors wish them to. How the prosecutors will fare with the long-delayed but coming trials of Ken Lay and Jeffrey Skilling of Enron is yet to be seen.

-- In the one and only case brought to trial by New York State Attorney General Eliot Spitzer, Theodore Sihpol, a junior executive of Bank of America, was acquitted of most of the charges of fraud related to late-trading at mutual funds because the jury was not persuaded that the actions taken by Mr. Sihpol were actually illegal under NY law. This result may encourage others charged by Spitzer, such as former NYSE CEO Richard Grasso, to force the NY Attorney General to prove charges against them to a jury, rather than to settle them as all of the corporate "targets" have done.

--- All of the charges of alleged corporate misconduct brought by Spitzer were settled by the corporations involved to avoid the considerable risk and expense of trial, and in order to get the matter behind them. In such settlements, the defendant never admits guilt, and the record is sealed so there is no indication as to what actually happened in the situation or what laws were broken and how. As a result, settlements are not very useful in signaling how the law should be applied in the future.

-- These legal actions, and the class action suits that have accompanied them, have collected billions of dollars for the government bodies and plaintiff groups bringing the suits. Individual investors experiencing the

losses caused by corporate malfeasance have recovered relatively little of it, and the worst of such offenders such as Enron and WorldCom have been bankrupted, leaving others, principally their banks, brokers, accountants and other intermediaries to pay for their actions as accessories. These intermediaries have been punished for their roles in allegedly assisting corporations accused of fraud in five different ways (1) by losses from loans extended to these companies, (2) by the financial penalties and settlements they have agreed to, (3) by the class-action litigation that has almost always followed, (4) by the loss of market value in their own stocks, and (5) by the cost of extensive additional legal and compliance measures needed to insure conformance with new regulations and business conduct standards imposed on them. Cumulatively, these burdens have been substantial for the corporate financial intermediaries involved -- some might say they have been excessive and unfair relative to what was alleged to have been done by them. The aggregate burden of these punishments has fallen heavily on the shareholders and employees of the intermediaries and affected their abilities to offer low cost services to financial market users. In the long run, the boards of directors of these intermediaries must decide how active the firms are to be in assisting aggressive corporations in the future for fear that the penalties associated with charges of misconduct may substantially outweigh the benefits. Such corporations would find investors reluctant to pay full price for their stock if overshadowed by a range of uncertainties regarding possible draconian punishments for doing business with the wrong clients. This could change business strategies of the one or more of the large financial intermediaries considerably.

-- The economic costs to the country of the various losses, penalties, class-action settlements, and added compliance costs since the fall of Enron, as large as they are in aggregate, have not constituted a significant percentage of American GDP. However, the cost of capital in the US will rise by some amount yet to be determined as a result of new regulations and compliance requirements, and the access to capital markets by large, dynamic and aggressive corporations and by smaller corporations seeking to become public companies may be more restricted. In aggregate these costs and effects could lead to a reduction in the national economic growth rate and rate of productivity increases, which in turn could adversely affect American prosperity and the future value of its many publicly-traded corporations.

Such consequences of meeting the goal of restoring confidence in financial markets may not be what was expected when the goal to clean up the

system was originally undertaken. We may have satisfied a sense of public outrage that followed a revelation of greed and misconduct, but if the cost of doing so was to adversely affect the prospects for economic growth in the country, and to obscure rather than clarify regulatory standards for the future, in an effort to prevent a small percentage of otherwise fully regulated American companies from committing fraud, then perhaps the cost was excessive. Especially as we have left untreated certain important defects in the system that can surface again at a later time.

The Clean Up and American Regulatory Tradition

In the American tradition, the objectives of regulatory policy makers have been to seek the optimal balance of fair but free market activity at the lowest cost. Before 1925, there was no financial market regulation which may not have been necessary because of the relatively small participation in markets by unsophisticated retail investors. After 1925, mutual funds came to be sold actively as the roaring stock market of the time attracted retail investors seeking to share in the potential for capital gains. After the stock market crash in 1929, in which all investors lost considerable money on their investments, a new regulatory regime represented in the Securities Acts of 1933 and 1934 was imposed. The new regime was based on required disclosure (including financial information audited by independent auditors), to be enforced through the courts by the new, fully empowered SEC. A well informed market, the theory held,

would essentially regulate itself by the continuous adjustment of prices and the checks and balances imposed by the large number of market participants.

Also in 1934, a seminal legal opinion was published by Judge Learned Hand of the US Second Court of Appeals in a tax related matter (*Helvering v. Gregory*) in which he said "nobody owes any public duty to pay more [taxes] than the law demands." This idea, extended beyond taxes, became a central one in American administrative law: One does not have to comply with the law more than the law precisely requires. Or, in other words, companies are not prohibited from doing their best to maximize their own results as long as they stay within the limits of the law. When it is uncertain what the limits of the law may be in a particular case, the company is not obliged to interpret the law in a manner most favorable to the government. The company's interpretation of the law may be contested, and a law suit needed to resolve the matter, but nonetheless, companies are free to risk being contested if they want to. In our more modern terms, Enron, for example, may have chosen to interpret accounting rules related to off-balance sheet subsidiaries in a manner most favorable to it (though in its view still within the law), recognizing that the issue might be challenged by the government if it did so. But if Enron, arguing that it was a different kind of innovative, "new economy" company for which old-fashioned accounting principles were no longer appropriate, was not challenged by either its own independent auditors, outside legal counsel or the SEC, which it was not, then its own interpretation would prevail. If it were challenged, its policies might have to be changed, and results restated (and possibly some penalties incurred), but

simply being challenged should not in itself be a crime, as long as the company did not use fraud or deception to persuade its accountants or others to accept its interpretation.[10]

This line of reasoning fit very well into aggressive corporate growth strategies aimed at maximizing shareholder value that were widely adopted during the 1980s and 1990s. During this twenty-year period the market capitalization of US equity securities increased fourteen-fold, or at an annualized rate of growth of nearly 15%, a rate never sustained for such a long time before. Great fortunes were made by many investors and corporate officers and directors during this period. Shareholders wanted their companies to grow, and selected directors who would choose and provide incentives to managers who would adopt dynamic, aggressive policies to do so. Managers pushed for large acquisitions, compensation practices and accounting policies that could best help them in their task, without, in many cases, fully describing the risk inherent in such policies. But the policies were rewarded by stock price appreciation, and deemed to be successful. Indeed, management compensation incentives reached their all time peak about the same time as the stock market did.

There was a lot of growth in the 1980s and 1990s, only a small portion of which was affected by fraud, and the fraud was detected and addressed without the benefit of the corporate governance procedures required by Sarbanes Oxley. As happens during bubbles – we had four during the twentieth century -- a lot of things can go wrong while under the spell of rising markets and easy pickings: the accounting industry may have become too compliant with client wishes,

mutual fund managers may have accepted improper trades, and underwriters over-hyped Internet IPOs and provided insincere research, but the power to enforce the laws prohibiting such abuses was already vested in the SEC. After Enron, the market adjusted securities prices to reflect concerns over false accounting and other suspected wrongdoing, but the public appeared to want even stronger measures so, after the failure of WorldCom in 2002, Congress was able to pass a quickly cobbled together Sarbanes-Oxley Act, a comprehensive federal law embracing accounting and corporate governance issues but lacking a central theory and duplicating some existing powers and authorities. Eliot Spitzer’s large scale settlement with the leading underwriting firms and with several mutual fund management companies came next, followed by settlements with class actions litigants. The cost of these several actions will tax future growth but perhaps will do little to avoid future problems if the central question of the period is not addressed in the reform measures to be taken. And the central question is “where was the SEC and the other checks and balances in the system when the abuses were taking place?”

Weakened Checks and Balances

Corporations are creations of state law which imposes fiduciary duties on their directors and principle officers. The principle securities laws of the United States are federal, and the SEC which is empowered to enforce them, is not permitted to act in matters of state law, where the fiduciary duties of officers and directors are found. As a result, the SEC chose not to pursue the officers and

directors of companies like Enron for violation of fiduciary duties (though conceivably it might have done so relying upon the interstate commerce clause of the US Constitution to justify it), leaving such prosecutions instead to the state courts, or, in the case of criminal actions, to the Justice Department which would be restricted to bringing charges of fraud under federal law, often a more difficult set of charges to prove than fiduciary misconduct. The chairman and four commissioners of the SEC are appointed by the President, with two of the commissioners being required to be from the opposition party. Even the most earnest and capable of SEC chairmen have found the political limitations of the job to be formidable. As a result, much of the power of the SEC has either been delegated to self-regulatory bodies such as the Financial Accounting Standards Board (responsible for Generally Accepted Accounting Principles) or the New York Stock Exchange, or it must depend on adequate funding from Congress to be applied. During the Bush administration three supposedly "business-friendly" SEC chairmen have served, though with each of the first two being replaced before their terms expired by the President.

Most states employ a version of the "business judgment rule" in which the court is to give the benefit of the doubt to corporate boards which act legally and in good faith. That is, the court will accept the assumption that a business decision made by a board that acts in accordance with its fiduciary duties of care and loyalty was a valid business decision that may not be second-guessed. As recently as August 2005, the Delaware Chancery Court found in favor of the directors of the Walt Disney Corporation who had been charged by shareholders

with breach of fiduciary duty in the case of the hiring and firing of a former president, Michael Ovitz. The court found that as passive, slipshod and disinterested as the Disney board may have been in performing its duties (and the court found that there was much fault to be found), the board's disputed conduct had not risen to the level of bad faith, and therefore the business judgment of the board in the Ovitz case could not be questioned.

If for some reason, however, the good faith test of the business judgment rule was not met in a case such as Enron, and/or individual directors should be convicted of fraud under federal law, then the directors involved (assuming they had not committed "gross negligence") could look first to the company (and its shareholders) to indemnify them against any legal expense or judgment against them, and should the company be unable to meet such an expense, then to insurance policies paid for by the company to back up the indemnification. So, short of committing gross negligence, individual corporate directors (further protected by the business judgment rule) have been able to expect not to be personally liable for their actions and decisions.

Being so protected, directors (who benefit in various ways by their directorships) cannot be blamed for lapsing into a state of uncritical support for management, or for generally being unwilling to appear aggressive in their crucial role as on-the-scene representative of the shareholders.[11] This problem of diffident directors appears in all corporate organizations that operate in financial markets – including among directors of mutual funds, banks, brokerages and

insurance firms – all of whom are part of the interacting forces in the market that provide its checks and balances.

Altogether, there is substantial asymmetry between the powerful incentives offered to achieve increases in shareholder value through aggressive corporate actions and the natural restraining forces of fiduciary duties applicable to individual officers and directors. This asymmetry has always been difficult to manage and largely explains the continuing outbreak of corporate failures and scandals over time (despite efforts to improve corporate governance procedures going back at least two decades) but it has not been altered by any of the legislative or enforcement actions taken since the collapse of Enron four years ago.

The Tilt in the Market

This asymmetry in effect creates a tilt in the market to favor those in positions of control and influence over those without it. A modest tilt may be tolerable, but a larger one can be very dangerous to the economic system, as recent years have indicated. One remedy would be to force companies through regulation to adopt more conservative competitive policies that would involve less risk of compliance failure. Such a remedy would, however, surely constrain innovation, risk-taking and growth-oriented competitive strategies that the country depends on for its economic growth. Another approach would be to find ways to stiffen the fiduciary liabilities of corporate officials and of financial intermediaries and agents, so as to encourage them to discipline management and their own

employees more effectively. Though this should be done, and could be, it is very likely to be resisted strenuously by those bearing the fiduciary liabilities and these individuals are powerful and influential people.

If neither of these remedies are likely to occur, which appears to be the case, then the best remaining solution is to assist the market to sharpen its abilities to sort out dangerous investments from solid ones, by encouraging independent investors, accountants, analysts, and market-makers from being conflicted by business interests of their own that are placed ahead of the interests of their clients. Once the market understands that a corporation's strategy is risky or controversial or too close to regulatory intervention, then its stock price should suffer, which tends to deflate the strategy. But to restore a crisp, self-policing quality to the market means restoring the respect for the independent firm whose business is not conflicted by too many products and services. This must start with the accountants (as Sarbanes Oxley requires) so that the market can rely on the financial information being disclosed being accurate. Regulators must appreciate the natural lassitude of so-called "independent" directors, and find ways to prick them into performing their fiduciary duties more alertly and skeptically. Surely after the shocks experienced by the market in 2000-2003, investors can expect the market to straighten out and sharpened up, but the task is to keep it that way well into the next iteration of the "new economy."

Free-Market Capitalism in a Democracy

We fool ourselves if we think that a government regulatory regime will eliminate by itself all the problems that appear in free and active financial markets. And we make ourselves even greater fools if we think that increasing regulation beyond its economically optimal point is in our interests. Excessive regulation is as harmful as insufficient regulation. Sarbanes Oxley may have pushed regulation a bit too far, if so, time will tell and the act can either be amended or the SEC can re-interpret it. The same may be true of the activities of state and federal prosecutors and of class action litigants. The most important lesson of the recent period of corporate excess may be the one that should have already been learned by the supporters of unfettered capitalism in the United States – that capitalism must be understood by the whole country, not just by the capitalists, to be good for it, and if capitalism is seen to be abusive (rightly or wrongly), then it will be ended or reformed. Indeed free-market supporters such as the authors must realize that abuse can be expected to have its retribution in a democratic society, and that retribution is likely to be swift, harsh and possibly unfair when it finally comes. Thus, abuses should be prevented.

For this understanding to develop, capitalists themselves should attempt to contribute to a national consensus that good business is fair business, and the emphasis must be placed by investors and by regulators to insure that the information being processed by market forces is as timely and accurate as it is supposed to be, and that conflicts of interest, which lay behind many of the abuses of the late 1990s, must be neutralized by their identification and disclosure, and then by allowing market forces to react to the information. The

market may decide that firms with too many conflicts, or firms that are too big to control the conflicts they have, may be dangerous to invest in. If so, the market prices and business strategies of such firms are likely to change.

Equally, regulators and enforcement agencies should use their powers to insist on the proper performance of the fiduciary duties that corporate directors, institutional investors and intermediaries have in common. The importance of these duties cannot be left in second place behind corporate goal achievement. A powerful signal by the SEC and some important state agencies that ways will be found to insure that fiduciary duties are taken seriously by officers and directors will show itself in various useful ways – by causing independent directors to be more concerned about their own liabilities, by increased officer and directors insurance rates, and by continuing interest in corporate governance by public sector institutional investors, such as state pension funds. In aggregate these fiduciary concerns can begin to constitute a market force of their own.

The sooner market participants recognize the value of returning to an untilted marketplace, the sooner may be the time when Sarbanes-Oxley might be amended to remove expensive but unnecessary provisions.

Endnotes:

[1] Edward Altman, "Bankruptcy and Default Statistics," working paper, New York University Stern School, August 31, 2002

[2] Min Wu, "Earnings Restatements: A Capital Market Perspective," Stern School of Business Working Paper, Jan. 2002.

[3] Source: Stanford Law School Class Action Website

[4] Source: Stanford Law School Class Action Website

[5] Investment Company Institute and Securities Industry Association, "Equity Ownership in America, Washington, DC, September 2002.

[6] Arthur Levitt, former SEC Chairman, testimony to Senate Committee on Government Affairs, January 24, 2002, and *Take on the Street*, New York, Pantheon Books, 2002, pp. 130-135..

[7] At the time of Kozlowski's sentencing, a New Jersey man was sentenced to 8 years in prison for beating his wife to death in a rage.

[8] Cost estimates are quite varied –Korn Ferry, the executive search firms has estimated costs in the area of $5 billion for the Fortune 500 companies; the Financial Executive International estimate is $1 billion for 217 companies. Assuming an average of $2 million per company for 10,000 companies would be $20 billion.

[9] Ironically, Sarbanes-Oxley has proven to be a god-send to the accounting industry that feared significant hardship following the loss of consulting revenues, also mandated by Sarbanes-Oxley.

[10] What makes the Lay/Skilling cases so difficult for the prosecutors (as opposed to the Fastow case – Enron's CFO – which dealt with unauthorized skimming from subsidiaries) is that the accounting treatment followed was, except for a few minor exceptions, consistent with Generally Accepted Accounting Principles, had been approved by Arthur Andersen and outside legal counsel, and was appropriately (if minimally) disclosed.

[11] However, a spectacular bankruptcy case can result in class action suits brought by public officials (state pension trustees, etc.) that pursue "social justice" as well as monetary compensation, and, as occurred in the WorldCom case, resulting in members of the board of directors being required to contribute personally to the settlement without the ability to be reimbursed by indemnification or insurance funds. This case was very rare, but once a precedent is established by one such case, corporate directors will be concerned that others may be expected to follow.