
Four Years After Enron

Assessing the Financial-Market Regulatory Cleanup

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Last year was 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 fivefold.

Early in 2000, however, the air began to leak out of the bubble, and by the end of the year a widespread reduction of approximately 30 percent in the valuation of technology stocks had occurred. This market drop sharply affected other businesses that relied on Internet technology, causing several to fail outright, to slide out of control, or to engage in accounting gimmickry in order to shore up their profits. By December 2001, when Enron, the seventh-largest company in the United States and one of its leading “new economy” concept companies, filed for bankruptcy, the NASDAQ index had fallen 74 percent from its high of less than two years earlier. In 2001, 171 large corporate bankruptcies occurred, involving liabilities of \$230 billion, more than twice as many bankruptcies as in 2000, the previous record year. In July 2002, WorldCom, the country’s second-largest long-distance telecom company, with \$107 billion in assets, filed for bankruptcy after

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revealing massive accounting fraud. Throughout 2002, bankruptcies continued to occur, involving liabilities of \$338 billion, thus establishing a three-year period in which U.S. bankruptcies—the ultimate form of corporate failure—broke all previous records (Altman 2002).

In addition, instances of accounting failures in the form of “restatements” of prior audited financial results because of accounting errors nearly quadrupled to 616 cases in the four-year period 1998–2001 (Wu 2002). Restatements continued to occur in record numbers during 2002 and 2003, when 389 cases were reported (Huron Consulting Group 2003). As a consequence of these failures, there was an explosion of securities-fraud class-action lawsuits seeking damages from all involved officers, directors, and advisers of the companies. In all, 489 such suits were filed in 2001 (of which 312 were related to initial public offerings), and 259 more were filed 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 designed to limit substantially the number of such class-action lawsuits (Stanford Law School 2006). Many of these lawsuits were the consequence of stock prices that fell rapidly after sudden news of changed financial information.

The financial losses caused by these failures were considerable. Bank-loan write-offs for 2001–2002 were in the tens of billions of dollars. Publicly traded noninvestment-grade bond defaults for 2002 were (at par value) \$96.9 billion—the highest amount of such defaults then recorded—representing 12.8 percent of outstanding issues. In 2001, the default rate of these bonds was 9.8 percent, the highest since 1999. On the assumption that the bond defaults will result in recoveries (through bankruptcy or other workout arrangements) equal to the ten-year historical average of about 30 percent, the expected losses from loan write-offs and from bond defaults for the two-year period will be about \$100 billion (Altman 2004).

Equity-market losses in 2001–2002 attributable to fears of corporate failures caused by misgovernance were far greater: the S&P 500 peaked at 1,527 in March 2000 and then, reflecting the collapse of the technology bubble, fell steadily to 966 in September 2001, before recovering to nearly 1,200 by the end of the year. Even after clear signs of recovery in the economy and in corporate earnings were evident late in 2001, however, the Enron bankruptcy in December 2001 and other corporate surprises affected the market, and the S&P 500 index reversed direction and fell farther. 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 percent for the year (a loss of approximately \$4 trillion of market capitalization) and lower by more than 47 percent from its all-time high two and a half years earlier. For many industries suspected of accounting or governance shortcomings (for example, telecom, health care, energy services, and technology), share-price declines were even greater.

These losses were not sustained by the rich alone. In 2002, a survey conducted by the Investment Company Institute and the Securities Industry Association reported that 52.7 percent of American households owned equity investments either directly or in mutual or pension funds (2002, 48). Accordingly, the stock-market losses, the bankruptcies, and the revealed corporate misconduct associated with them became matters of great interest to the public media and to elected officials in Washington and the state capitals.

The corporate failures were publicized as being widespread, which they were indeed in the sense that record numbers of bankruptcies and corporate accounting restatements, involving more than six hundred companies, were reported during a three-year period—a great number of companies to be seen to have failed or acted badly (approximately 8 percent of all listed public companies in the United States). 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 rather of corporate mistakes and mismanagement in an environment of extraordinary risk taking. Of course, the vast majority of U.S. corporations did not fail and were not involved in scandals of any kind.

Inspired by low interest rates and rising stock prices, many companies in the 1990s committed themselves to high-growth strategies that could be sustained only by aggressive corporate actions and, in some cases, by “creative” accounting practices. Accountants at all five of the major auditing firms were cooperative and accommodating in these practices, despite being pledged to play an independent role, because of the consulting and other nonaudit fees they earned from large audit clients. According to a study of more than four thousand proxy statements filed with the Securities and Exchange Commission (SEC) between February and June 2001, nonaudit fees of the Big Five auditors represented two-thirds of total fees billed (Frankel, Johnson, and Nelson 2002). Banks, brokers, asset managers, and other intermediaries, enlarged by a decade of consolidation and deregulation, evolved into aggressive, multiline business platforms with considerable exposure to conflicts of interest, which all too often were resolved in their own favor (Levitt 2002, 130–35). 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 by interested parties) to its efforts to improve accounting and other market practices in the 1990s.

Public officials—including regulators, enforcement agencies, and legislatures—began to compete with each other in their common zeal to “clean up” the these perceived corporate excesses and abuses and to “restore confidence” in financial markets. During the four years after Enron’s failure, federal and state government officials expended a great deal of energy in pursuit of these objectives.

Cleanup Actions since Enron

Immediately after the Enron bankruptcy, congressional committees began investigations and consideration of legislative action. WorldCom's collapse accelerated these actions. In July 2002, President George W. Bush directed the Justice Department to establish the Corporate Fraud Task Force, which would include a variety of prosecutors, investigators, and technical experts. Within this group, a separate Enron Task Force was also appointed. Henceforth, Congress, the Justice Department, the SEC, and other enforcement agencies began an earnest effort to close in on those thought to be offenders.

- The Justice Department indicted Arthur Andersen, Enron's auditor, for obstructing justice in March 2002. By this time, an Arthur Andersen partner had confessed to inappropriate document shredding, which was alleged to have been the consequence of the firm's policy to destroy evidence that might be incriminating. Justice was also angered by Andersen's accommodating role in the Enron case, which according to Justice violated 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 U.S. Supreme Court, but the firm could not be revived at that point.
- A federal law to reform corporate accounting and governance, popularly known as the Sarbanes-Oxley Act, was enacted in July 2002. This act is 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 New York attorney general Eliot Spitzer) with leading securities firms, mutual-fund advisors, and insurance underwriters.
- Congress amended the Federal Sentencing Guidelines in November 2004. These guidelines, established by Congress in 1991, increased the penalties for "white-collar" offenses, making prison terms for offenders much longer and less subject to parole, and placed significant burdens on 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. The new standards include demonstration that preventive efforts are creating a "focus on ethics and organizational culture" and 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 U.S. Supreme Court, which changed them from "mandatory" to "advisory."
- Prosecutions of certain corporate officials began in 2002. Officials of some thirty-five major public companies had been charged with criminal activities by the end

of 2005. Several highly visible executives have been tried, convicted, and punished with long prison sentences, including Bernard Ebbers (WorldCom), who received twenty-five years in prison, John Rigas (Adelphia), fifteen years; Andrew Fastow (CFO of Enron), ten years; Denis Kozlowski (Tyco), eight years; and Scott Sullivan (CFO of WorldCom), five years. These executives have also been forced to turn over most of their remaining financial assets to the courts. Beginning in February 2006, two other high-profile executives, Ken Lay and Jeffrey Skilling of Enron, were put on trial.

Eliot Spitzer forced Sanford Weil of Citigroup and Maurice Greenberg of AIG, the powerful billionaire CEOs of two of America's most admired and successful financial corporations, to resign—Weill in October 2003 and Greenberg in June 2005—having threatened them that if they did not do so, he would bring charges against their firms. Weil resigned quietly, without relating his decision to Spitzer, but Greenberg denied all allegations and refused to cooperate with Spitzer's office, which had announced that it was considering criminal charges against him. Later, Spitzer announced that criminal charges would not be brought, but civil charges most likely would be.

Spitzer charged Richard Grasso, the former chief executive of the New York Stock Exchange (NYSE), and a former chairman of the NYSE's compensation committee with fraud (related to excessive compensation) in May 2004.

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

After all of this, it would seem that those responsible for the worst of the corporate abuses have been or soon will be fairly, if harshly, punished; that the financial-market and corporate governance systems have been reformed; and therefore that investors can have confidence in the markets again. These outcomes were the popularly supported goals articulated by regulators, legislators, and prosecutors when their respective interventions in the American business and financial marketplace began. Many would be inclined to say that for the most part the goals have been achieved.

Other Consequences of the Cleanup

The interventions, however, have also had other consequences:

- More than 10,000 public companies now must each expend millions annually to comply with the many new checklist 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 the 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.¹ In addition to the direct costs, compliance requires many hours of time by corporate officers and directors, diverting them from managing their businesses, and it may also reduce their tolerance for risk taking.² Such costs no doubt are considerable, but represent only a small fraction (0.1 percent) of the market capitalization of the country's stock markets. In contrast, Sarbanes-Oxley's benefits are difficult to assess: most of the powers the law created were already vested in the SEC, though not necessarily enforced effectively. The law requires a great deal of new compliance effort, but there is no assurance that Enron and WorldCom would not have failed had these requirements been in place when these companies were engaged in the actions that ultimately triggered charges of fraud and concealment against them.

- The costs of financial intermediation (public offerings, bank loans, market making, securities research, and mutual funds) have also risen as a result of the \$1.5 billion Spitzer/SEC settlement with Wall Street firms, which also involves annual compliance costs of approximately \$1 billion 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.
- As a result of the Spitzer/SEC Wall Street settlement (combined with pressures to reduce "soft dollar" rebates for research), research budgets at the seven largest Wall Street firms have fallen by 40 percent since 2000 (Der Hovanesian 2005). The reduction has resulted in many companies' being dropped from coverage by Wall Street financial analysts. We estimate that more than half of the listed companies in the United States are now unable to attract research coverage, which is generally thought to be necessary to support investment by institutional investors. Many of these companies may also 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.
- State and federal prosecutors' eagerness to bring charges against companies and executives has resulted in difficulties in proving the charges in court. The conviction of Arthur Andersen³ was overturned by the U.S. Supreme Court because of

1. Cost estimates vary widely: Korn Ferry International, the executive search firm, has estimated costs in the area of \$5 billion for the Fortune 500 companies; Financial Executive International's estimate is \$1 billion for 217 companies. Assuming an average of \$2 million per company for ten thousand companies, the total would come to \$20 billion (Korn Ferry International 2006).

2. Ironically, Sarbanes-Oxley has proven to be a godsend for the accounting industry, which feared significant hardship following the loss of consulting revenues, also mandated by Sarbanes-Oxley.

inappropriate instruction of jurors, a problem that may also apply to the obstruction-of-justice conviction of CSFB executive Frank Quattrone, which is currently under appeal. Richard Scrushy, CEO of HealthSouth, was acquitted of charges that were very similar (and supported by similar testimony of other senior executives) to those brought against WorldCom's Ebbers, who 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 as prosecutors wish them to. How the prosecutors will fare in the long-delayed trials of Enron's Lay and Skilling remains to be seen.

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 a trial and to get the matters out of the public eye. In such settlements, the defendant never admits guilt, and the record is sealed, so there is no indication of what actually happened or what laws, if any, were broken and how. As a result, settlements are not very useful in signaling how laws will be applied in the future.

- In the one and only case brought to trial by Spitzer, Theodore Sihpol, a junior executive of Bank of America, was acquitted of most of the charges of fraud related to late trading of mutual funds because the jury was not persuaded that Sihpol's actions were actually illegal under New York law. This result may encourage others charged by Spitzer, such as former NYSE CEO Grasso, to force the prosecutor to prove charges against them to a jury, rather than to settle the cases as all of the charged corporations have done.
- These legal actions and the accompanying class-action suits have collected billions of dollars for the government bodies and plaintiff groups bringing the suits. Investors who experienced 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, and accountants—to pay for their actions as accessories. These intermediaries have been punished in five different ways for their roles in allegedly assisting corporations accused of fraud: (1) by losses from loans extended to those 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 of their own stocks, and (5) by the cost of extensive additional legal and compliance measures needed to ensure conformance with new regulations and new standards for business conduct imposed on them. Cumulatively, these burdens have been substantial for the corporate financial intermediaries involved; some might say the burdens have been excessive and unfair relative to what the intermediaries are alleged to have done.
- 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 their firms are to be in assisting aggressive corporations; they may well fear that the penalties associated with charges of misconduct will substantially outweigh the benefits. Some of the largest banks involved in the Enron and WorldCom litigation saw their stock prices decline in 2004–2005 relative to their peers, possibly because investors have become reluctant to pay full price for their stock if the bank's performance is to be overshadowed by uncertainties regarding possible draconian punishments for doing business with the wrong clients in the future. This situation might lead one or more of the large financial intermediaries to change business strategies 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, still do not constitute a significant percentage of American gross domestic product. However, the cost of capital in the United States will rise by an 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 function as public companies may be more restricted. In the aggregate, these costs and effects may reduce national economic growth and the rate of productivity increase, which in turn may adversely affect American prosperity and the future value of the country's many publicly traded corporations.

Such consequences of meeting the goal of restoring confidence in financial markets may not be what was intended when the measures to clean up the system were originally undertaken. These measures may have satisfied a sense of public outrage that followed a revelation of greed and misconduct, but if a cost of the clean up is to affect adversely the prospects for economic growth 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 is excessive, especially inasmuch as the clean-up effort has left untreated certain important defects in the system that may surface again later.

The Cleanup and American Regulatory Tradition

In the American tradition, regulatory policymakers at their best have sought the optimum balance of fair but free market activity at the lowest cost. Before 1925, there was no financial-market regulation, and none may have been necessary because of the relatively small participation in markets by unsophisticated retail investors. After 1925, however, mutual funds began to be sold actively to retail investors who sought to share in the opportunity for capital gains in the roaring stock market. In the wake of the stock-market crash from 1929 to 1932, in which

all investors lost considerable money on their investments, a new regulatory regime based on the federal securities acts of 1933 and 1934 was imposed. The new regime required disclosures, including financial information audited by independent auditors, and was 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 by the checks and balances of the large number of market participants.

Also in 1934, in a seminal legal opinion in a tax-related case (*Helvering v. Gregory*, 69 F. 2d 809), Judge Learned Hand of the U.S. Second Court of Appeals wrote that “nobody owes any public duty to pay more [taxes] than the law demands.” This idea, extended beyond taxes, became central to U.S. administrative law: one does not have to comply with the law any more than the law precisely requires. In other words, companies are not prohibited from doing their best to maximize their own results so long as they stay within the limits of the law. When those limits are uncertain, as they may be in a particular case, the company is not obliged to interpret the law in the manner most favorable to the government. The company’s interpretation may be contested, and a lawsuit may be needed to resolve the matter, yet companies are free to risk being contested if they want to do so. Enron, for example, may have chosen to interpret accounting rules related to off-balance-sheet subsidiaries in the manner most favorable to the company, though in its view still within the law, recognizing that the government might raise a challenge if it did so. If Enron, arguing that it was a different kind of innovative, “new economy” company for which old-fashioned accounting principles were inappropriate, was not challenged by its own independent auditors, outside legal counsel, or the SEC (which it was not), then its own interpretation would prevail. If it was challenged, its policies might have to be changed and its financial results restated (and possibly some penalties incurred), but a challenge would not in itself imply the commission of a crime, as long as the company did not use fraud or deception to persuade its accountants or others to accept its interpretation.³

This line of reasoning meshed well with the 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 U.S. equity securities increased fourteenfold or at an annualized rate of growth of nearly 15 percent, a rate never sustained for such a long time previously. Many investors and corporate officers and directors made great fortunes. Shareholders wanted their companies to grow, and they selected directors who would choose and provide incentives to managers who would adopt dynamic, aggressive policies to achieve that objective. Managers pushed for large acquisitions, compensation practices, and accounting

3. What makes the Lay/Skilling cases so difficult for the prosecutors (as opposed to the case of Enron’s CFO Fastow, 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 disclosed, though minimally.

policies that could best help them in their task—without, in many cases, fully describing the risk inherent in such policies. For several years, the policies were rewarded by stock-price appreciation and were deemed to be successful. Indeed, management-compensation incentives reached their all-time peak about the same time that the stock market did.

Consequently, a great deal of corporate growth occurred in the 1980s and 990s, and only a small portion of it was affected by fraud. The fraud that did occur was detected and dealt with without the benefit of the corporate governance procedures that Sarbanes-Oxley now requires. During financial-market bubbles—four of which developed in the twentieth century—much can go wrong under the spell of rising markets and easy money. In the 1980s and 1990s, the accounting industry may have become too compliant with client wishes, mutual-fund managers may have been too willing to accept improper trades, and underwriters may have hyped Internet initial public offerings (IPOs) and provided insincere research, but the power to enforce the laws prohibiting such abuses was already sufficient and fully vested in the SEC. After Enron, although the market rapidly adjusted securities prices to reflect concerns about false accounting and other suspected wrongdoing, the public appeared to want even stronger, more punitive measures. So, after WorldCom’s failure in 2002, Congress quickly passed the Sarbanes-Oxley Act, which pertains to a variety of accounting and corporate governance issues, but lacks a central theory and duplicates some existing powers and authorities. Spitzer’s large-scale settlement with the leading underwriting firms and with several mutual-fund management companies came next, followed by settlements with class-action litigants. Although the cost of these actions has served as punishment for a large group of market participants, it is unlikely that the reform elements of the measures taken will do much to prevent future problems because they fail to deal with the central question posed by the most troubling elements at issue: Where were the SEC and the system’s other checks and balances when the abuses were taking place?

Weakened Checks and Balances

In the United States, corporations are created by state law, which imposes fiduciary duties on their directors and principle officers. However, the principal securities laws are federal, and the SEC is not permitted to act in matters of state law. As a result, the SEC did not pursue the officers and directors of companies such as Enron for violations of fiduciary duties, instead leaving such prosecutions to state enforcement officials. Also, the SEC is not empowered to bring criminal actions. Such actions must be undertaken by the U.S. Justice Department, which is restricted to bringing charges under federal law.

The SEC’s chairman and four commissioners are appointed by the president, and two of the commissioners are required to belong to the opposition party. The SEC’s enforcement actions require adequate funding by Congress. The chairman

must satisfy both the congressional committees charged with oversight of the SEC and the president's administration, which aspires to have good relations with corporate contributors. Even the most earnest and capable of SEC chairmen have found the job's political limitations to be formidable. As a result, much of the SEC's power has been delegated to self-regulatory bodies, such as the Financial Accounting Standards Board (responsible for Generally Accepted Accounting Principles) and the National Association of Securities Dealers (NASD), or left to be administered with the consent of congressional committee chairmen. Thus, the SEC's power to take bold actions in anticipation of problems is significantly restricted. During the Bush administration, three supposedly "business-friendly" SEC chairmen have served, although the first two (Harvey Pitt and William Donaldson) were replaced by the president before their terms expired. These chairmen often found it difficult simultaneously to manage the media coverage of complex securities issues and to gather the support of their fellow commissioners and the other political players involved. They were criticized both for failing to enforce the rules forcefully enough and for enforcing them too harshly.

Most states employ a version of the "business judgment rule," according to which the courts are to give the benefit of the doubt to corporate boards that act legally and in good faith. In other words, the courts 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 and 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 hiring and firing of former president Michael Ovitz. The court found that however passive, slipshod, and disinterested the Disney board may have been in performing its duties (and the court determined that much fault could be found), the board's disputed conduct had not risen to the level of bad faith, and therefore its business judgment in the Ovitz case could not be questioned.

Further, should a company or its officers or directors be convicted of an offense, then the officers and directors involved (assuming they have not exhibited "gross negligence") may look first to the company (and its shareholders) to indemnify them against any legal expense or judgment against them. Such indemnification has become standard for public companies to offer to its directors as a means to induce them to serve. Should the company be unable to meet an indemnification expense because of bankruptcy, for example, then the directors can rely on insurance policies paid for by the company to back up its indemnification. So individual corporate directors have expected that, absent gross negligence, they would not be held personally liable for their actions and decisions.

Protected by the business judgment rule, indemnification, and insurance, directors (who benefit in various ways by their directorships) can scarcely be blamed for their lapse into uncritical support for management or for their general

unwillingness to appear aggressive in their crucial role as the shareholders' on-site representatives. The problem of diffident directors appears in all corporate organizations that operate in financial markets, including banks, brokerages, mutual funds, and insurance firms, all of which are part of the market's interacting checks and balances.

Altogether, a substantial asymmetry has existed between the powerful incentives offered to achieve increases in shareholder value through aggressive corporate actions and the weak restraining forces of the corporation's officers and directors' fiduciary duties. This asymmetry has always been difficult to manage and in large part explains the continuing outbreak of corporate failures and scandals over time, despite efforts that go back at least two decades to improve corporate governance procedures. It has not been altered by any of the legislative or enforcement actions taken since the collapse of Enron. However, three private lawsuits—shareholder suits against the boards of Enron, WorldCom, and Hollinger—have resulted in recent settlements in which some independent directors have been required to contribute personal funds to the settlement payments. In the past, independent directors had only rarely been required to contribute to such settlements. Still, the recent cases are unusual because they were brought at the insistence of the plaintiffs, state pension funds administered by elected officials.

The Tilt in the Market

The asymmetry in effect creates a tilt in the market to favor those in positions of control and influence, as opposed to others. A modest tilt may be tolerable, but a larger one can jeopardize the economic system, as recent events have shown. One remedy might be to force companies, through regulation, to adopt more conservative competitive policies that would involve less risk of compliance failure. Such a remedy, however, would surely constrain the innovation, risk-taking, and growth-oriented competitive strategies that the country depends on for its economic growth. Another approach might 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 their companies' management and employees more effectively. Although this action perhaps should be taken, it almost certainly would be resisted strenuously by those bearing the fiduciary liabilities, and these individuals are powerful and politically influential people.

If neither of these remedies is likely to be embraced, as appears to be the case, then the best remaining solution is to help the market sharpen its abilities to sort out dangerous investments from solid ones, by deflecting independent investors, accountants, analysts, and market makers from conflicts in which their own business interests receive priority over their clients' interests. Once the market understands that a corporation's strategy is too risky or controversial or too close to regulatory

intervention, then its stock price should suffer, which will tend to discourage adoption of that strategy.

Restoring a crisp, self-policing quality to the market requires restoring respect for the independent firm whose business is not placed into conflicts by its providing too many products and services. This action must start with the accountants (as Sarbanes-Oxley has appropriately done), so that the market can rely on the accuracy of the financial information disclosed. Regulators must be aware of the natural lassitude of the so-called independent directors of institutional investors and intermediaries and find ways to prod them into performing their fiduciary duties more alertly and skeptically. After the shocks the market experienced between 2000 and 2003, investors should expect the market to straighten out and sharpen up, but the task is to keep it that way well into the next iteration of a new economy.

Free-Market Capitalism in a Democracy

We fool ourselves if we think that a government regulatory regime by itself will eliminate all the problems that appear in free and active financial markets. We make ourselves even greater fools if we think that increasing regulation indefinitely serves our interests. Excessive regulation causes as much harm as insufficient regulation. The Sarbanes-Oxley Act and the SEC may have pushed regulation somewhat too far. If so, time will tell, and the act can be amended or the SEC can reinterpret the requirements for its enforcement. The same may be true of the activities of state and federal prosecutors and class-action litigants. The most important lesson of the recent period of corporate excesses may be one that the supporters of unfettered capitalism in the United States should have learned already: capitalism must be understood by the whole country, not just by the capitalists, if it is to be beneficial. If capitalism is seen (rightly or wrongly) to be abusive, then it will be ended or reformed. Indeed, free-market supporters must realize that abuse can be expected to have its retribution in a democratic society and that such retribution is likely to be swift, harsh, and possibly unfair when it comes. Thus, in the service of everyone's interest, abuses should be prevented.

For this understanding to develop, capitalists themselves should attempt to contribute to a consensus that good business is fair business. Regulators should strive to ensure that the information that market participants process is as timely and accurate as possible and that conflicts of interest, which lay behind many of the abuses of the late 1990s, have been neutralized by their identification and disclosure. Then, the regulators should allow market forces to react. The market may decide that dangerous investments include the securities of firms with too many conflicts or of firms that are too big to control the conflicts they have. If so, such firms' market prices and business strategies are likely to change.

Institutional investors, which now own approximately two-thirds of all stocks traded in the United States, must play a leading role in defending the market from

corporate or other abuses. For this initiative to be taken, regulators and enforcement agencies must use their powers to insist on the proper performance of the fiduciary duties that corporate directors and the directors of institutional investors and intermediaries have in common. The performance of these duties cannot be treated as the weak sister of the achievement of corporate goals. A powerful signal by the SEC and important state agencies that ways will be found to ensure that officers and directors take their fiduciary duties seriously would help in various ways: by causing independent directors to be more concerned about their own liabilities, by increasing the officers and directors' insurance rates, and by spurring greater interest in corporate governance by public-sector institutional investors, such as state pension funds. Altogether, these fiduciary concerns can begin to constitute a market force of their own. The sooner market participants recognize the value of returning to an untitled marketplace, the sooner Sarbanes-Oxley will be amended to remove expensive and unnecessary provisions.

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