

## Searching for Rationality in A Perfect Storm

by Louis Lowenstein??

[D]espite all the academic studies of the influence of such variables as price, volume, seasonality, capitalization size, etc., upon stock performance, no interest has been evidenced in studying the methods of . . . value-oriented winners.

Warren E. Buffett, 1984<sup>1</sup>

In October 1991, there occurred off the coast of Massachusetts, a “perfect storm,” a tempest created by a rare combination of events, primarily an Arctic cold front colliding with a hurricane, that would create waves 30 meters (!) high and of course wreak havoc and death among the fishermen caught in its path.<sup>2</sup> In the late ‘90s, there was another perfect storm, a rare coincidence of events in our financial markets, which made it possible for corporate managements to scale new heights in compensation, and plum moral depths, without parallel -- and, like that nor’easter, at huge cost to the innocents caught in its grip.

The economy has bounced back, and stock prices have recovered a substantial piece of the \$7 trillion in losses they had suffered since March 2000. The scandals caught our eye more easily than reform; but behind the TV screens, government has responded at many levels and with remarkable vigor. Government has responded at many levels and with remarkable vigor, notably the Sarbanes-Oxley Act of 2002 (SOXA). Not since the first days of the Roosevelt Administration has there been such a comprehensive legislative and regulatory response.<sup>3</sup> But have we succeeded in putting the genie back in the bottle, or will we, as the public’s attention turns elsewhere – stocks were up over 25% in 2003 -- return to business as usual, dodging a new set of rules much as we had the earlier ones? Thus the key issue in the U.S. is whether we can restore a measure of credibility to corporate governance. There is a lot of tugging and pulling; in short the jury is still out.

By now, however, we have had enough time to see how academia has responded to these events, not just to the skullduggery, but to the bubble itself. For decades financial economists,

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<sup>1</sup>Simon H. Rifkind Professor Emeritus of Finance & Law, Columbia University.

and their law school colleagues, had built and refined elaborate models on the premise that the stock market is efficient, in the sense, first off, that new information is quickly impounded in the price of the relevant stocks – don't try to trade on new information, it's essentially too late – and, secondly and more importantly, that there is a good reason why every price is where it is. There are no bargains; while there are foolish investors, following the crowd or a whim or whatever, prices are promptly corrected by rational investors who will seize upon, arbitrage as the literature says, whatever discrepancies may occur. One might as well throw darts at the financial page to select which stocks to buy and which to sell.

But the late '90s saw the NASDAQ Composite index, for example, rise from 1201 in April 1997 to a high of 5048 to March 2000, and then fall back by even more to 1114 in October 2002. The rise and fall of the broader market index, the S&P 500, was less extreme, but still dramatic. [??? insert a footnote] Could it thus be true, as one major textbook in finance has said, that “every security's price equals its investment value *at all times*.”<sup>4</sup> (Emphasis added.) Many a model will, with a few tweaks here or there, seem useful for events towards the middle of the bell curve; only under more extreme or stressful circumstances could we see, for example, that [???] Ptolemy had it wrong, and Copernicus right. Because the late '90s were a period of great stress, indeed, they offer an exceptional opportunity to test the academic hypotheses.

For some years now, there has been an array of scholars taking a highly critical view of efficient market (EMT), a dissent known as behavioral finance. As two of the most highly regarded critics, Barberis and Thaler, wrote, “[b]ehavioral finance argues that some financial phenomena can plausibly be understood using models in which some agents are not fully rational.”<sup>5</sup> Agreeing that the traditional framework is appealingly simple – agents are rational, a security's price equals its “fundamental value,” i.e., the discounted sum of future cash flows – they accept the EMT thesis that “when attractive opportunities come to light, it is hard to believe they are not quickly exploited.”<sup>6</sup> Rather the argument is that some asset prices do not seem to reflect those values and short-selling and other mechanisms for correcting the mispricing may be beyond the ken of investors, because it is too risky, difficult to fashion, or as in the case of short-selling, made difficult by stock exchange restrictions or limitations on how mutual funds function. They have catalogued a range of deviations that appear to have been “brought about

by . . . traders who are not fully rational.”<sup>7</sup> Thus scholars have documented the existence of excessive volatility in stock prices, higher returns for small stocks than larger ones, and a herd mentality that exaggerates price movements in either direction, for all of which they have identified roots in personal or crowd psychology.

In its more passionate versions, EMT would argue against market regulation of almost any sort, even the rules prohibiting insider trading, because it would enable market prices to reflect nonpublic information more quickly). EMTers wholeheartedly endorsed hostile takeovers, no matter how skewed the bidder’s financing – and for a time there were a host of companies left staggering under unsustainable burdens of debt -- because the premium price being offered was ample evidence that the target company will henceforth be better managed, or put to a higher valued use. Markets know best, because rational traders make them such. Behavioral finance says simply, well, yes, but not as perfectly as one the EMT model suggests. It is not a different model, only one with defects at the margin.

For our purposes, both groups would agree that investors can do no better than to buy an index fund, in effect to buy the whole market. If “it is hard to believe [that mispriced stocks] are not quickly exploited,” then why waste time or money on research and, for investors why pay large management fees and transaction costs for a mutual fund when you can “buy the market” in a broad-based, low cost Vanguard index fund.

I would not have referred back, of course, except that what I noted then turned out to be reasonably prescient. Comparing the different cultures and values of institutional investors in the U.S. and our conceptual cousins in the U.K., I commented that the

“remarkably American emphasis on momentary stock prices, though it goes by the misnomer of **shareholder value**.” (emphasis added) Webster’s defines an investor as

‘individual or organization who commits capital to become a partner of a business enterprise.’ . . . Instead what we see are professionals who rely on pseudo-scientific technique of group rotation, chasing Malaysian stocks or whatever else has recently been showing the best returns, whether or not the financial reporting has any integrity. . . . The subtleties and nuances of a particular business utterly escape them.” (page 22)

Underlying this ephemeral notion of shareholder value, I said, were two dilemmas: First off, the utter scarcity of so-called relational or value investors capable of bringing thoughtful, well-informed oversight to their portfolio companies. A function of our highly liquid markets, the problem had long since been identified by Keynes and others. Secondly, there seemed to be no plausible way to induce investors to focus more on business prospects than on market movements.

Both problems, of course, played a critical role in the financial boom and crash of the ‘90s. But the reference to chasing Malaysian and other Southeast Asian stocks was inspired. In 1996 alone, the so-called Asian Tigers attracted \$93 billion of foreign capital even as their economies were slowing and were soon to collapse. “The simple fact is,” as James Wolfensohn, president of the World Bank said, “that very sophisticated banks loaned to Indonesian [and other] companies without any real knowledge of their financial condition.”<sup>8</sup>

So apart from my self-congratulations, what has changed since 1993? For one thing, we no longer need to waste time on efficient market theory which had for so long blinded scholars to the behavioral realities of the marketplace. As someone said, economists really should get out more often, and lo and behold Richard Thaler, Robert Schiller, and others have done just that. Thanks to them and the dramatic events of the late 1990s, a vast collection of academic modeling can be tossed into the dustbin. (Or so I had hoped. I am at a loss to explain why so many American scholars continue to squeeze the remarkably complex drama of the late 1990s into a

unidimensional model that ignores the systematic corruption and blatant deception.<sup>II</sup> Is there a “model” for fraud?)

More importantly, what happened is that the phrase “shareholder value” became the mantra, the justification for a period of unrestrained greed and corruption that tarnished essentially every aspect of American financial markets and corporate governance. Corporate managements were the driving force, but they enlisted – some might say, bribed – accountants, analysts, lawyers, bankers and others to aid and abet schemes which, whatever the facial characteristics, were fraudulent to their core. Every transaction, every CEO? Of course not, but the contagion was so systemic as to amount to a cultural collapse. Rules were suddenly meant to be broken. . . or so bent as to nullify their intent. Perhaps it was also part of a larger breakdown in the social compact. This high-voltage greed and fraud went far beyond anything, of course, I had imagined.

## **2. A perfect storm.**

Executive compensation in the U.S. has always been, relative to employee wages, much higher than in Europe or Japan. In 1990, however, Michael Jensen, who had long focused on the curative properties of stock markets and prices, wrote an article with Kevin Murphy, arguing that the quantity of dollars did not matter, and that managers should receive large, very large, stock option grants, to ensure that they identify with the interests of their shareholders.<sup>9</sup> With that simple move, we would eliminate the separation of ownership and control that, ever since Berle

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<sup>II</sup> Bebchuk & Fried, “Executive Compensation as an Agency Problem,” 17 J. Econ. Perspectives, 71-92 (2003) is a recent example.

and Means, had been seen to stalk our system of popular capitalism; henceforth managers would strive to enhance value **per share**, not just the size of the domain they ruled.

In fact the model was faulty; unlike shareholders, executives would take no risk – none. They would not exercise their options until such time as the options were “in the money,” i.e., the stock had risen above the exercise price; and taking advantage of a 1991 relaxation of SEC rules, they were free to sell immediately after they had bought. All the while, additional options would be issued, so that if perchance the stock dropped, new options at the lower prices would reward management merely for bringing the stock price back to the starting point.

Options had long been the vogue in Silicon Valley, where emerging companies used them to conserve cash and to attract talent; but in older companies the grants remained modest – a good perquisite but not much more. It was not until compensation consultants, spurred by the Jensen Murphy article and the market’s increasing vigor, seized on the concept that the scale of option grants took off.<sup>10</sup> In large American companies there is almost total reliance on these consultants. They come to board and compensation committee meetings armed with PowerPoint charts that highlight the “dismal” fact that the CEO’s pay is only in the 28<sup>th</sup> percentile of his (carefully selected) peer group, coupled with recommendations for cash and stock options, plus a host of pension and other benefits, that will put him in the upper quartile, where, to be sure, he belongs.<sup>c</sup> (The game of serial leapfrog will be obvious to the reader.)

It worked. “‘Pay for performance’ became the universal corollary to shareholder value.”<sup>11</sup> As the bull market unfolded, stock in one form or another took precedence in the executive pay package. The notion of excessive pay simply evaporated. With the bulls running on Wall Street, it mattered not that workers’ pay was stagnating<sup>a</sup> or that all in all, chief executives were now taking down over 400 times average employee salaries.<sup>12</sup> The connection to performance, often tenuous,

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<sup>III</sup> The compensation committees of NYSE-listed companies have now been given the authority to hire and fire any consultants. Deborah Solomon, “SEC Rules Limit Who Qualifies as ‘Independent,’” WSJ Nov. 5, 2003, A2, col. 4.

<sup>IV</sup> Congressional Budget Office data for the year 2000 show the greatest economic disparity between rich and poor since the CBO began collecting such data, in 1979. Lynnley Browning, “U.S. Income Gap Widening, Study Shows,” NY Times Sept. 25, 2003, C2.

“was sundered in the numerous cases in which failed CEOs were shown the door with tens of millions of dollars to ease their paths. Frank Newman of Bankers Trust (\$100 million), Jill Barad of Mattel (\$50 million), and Douglas Ivester of Coca-Cola ((\$25 million), were examples. It is hard to think of any other society in which failure pays so well.”<sup>13</sup>

In 1993, a perverse wind in the “perfect storm” developed in the usually obscure workings of the Financial Accounting Standards Board (FASB). The Board decided to consider whether the value of stock options should be treated as compensation expense, and therefore as a charge against corporate income. In principle, it seems clear. For example, if a company issued options to pay for inventory or a building, their value would be booked as part of the cost of those assets. The same treatment would seem to apply to stock options issued as compensation to employees or executives. No matter, there ensued a political firestorm, in which the angry protests of lobbyists and politicians forced the SEC and the FASB to back down. Henceforth, options would be treated as, well, nothing at all; even as managers’ thirst for options increased, it was decided that for accounting purposes options had no value, and hence would not be deducted from earnings. Actually, companies had the best of two worlds; they did treat options as a valuable tax deduction at the time of their exercise, so that the net effect was to increase reported earnings, not reduce them.

As the stock market soared, it was clear that corporate chieftains wanted ever more stock options for themselves. Million-share awards became commonplace: Eisner of Disney received an 8 million share option in a single year, Silverman of Cendant 14 million, Ebbers of WorldCom megagrants five years running.<sup>14</sup> The boards of directors behaved like the well-cosseted lapdogs they in fact were<sup>b</sup>; there was precious little independent oversight. As Felix Rohatyn commented earlier this year, “I have begun to question the actual definition of an independent director. I don’t believe there is any such thing.”<sup>15</sup> Unlike the U.K., American companies rarely have an independent board chair, so that the CEO writes his own agenda.

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<sup>v</sup> Average director compensation at the 200 largest U.S. companies in 2001 was \$152,626. (Pearl Meyers & Partners, 2002, cited at Bebchuk & Fried, *supra*, 73.)

When Cendant's stock fell from 40 to 7, following the failure of a major acquisition engineered by the CEO, he received a new megagrant at the now depressed price.<sup>16</sup>

With tens, sometimes hundreds, of millions of dollars to be made from a rising stock price, the temptation to meet the market's expectations, to increase earnings in predictable fashion, becomes exquisite. By hook or crook. In reality, businesses do not grow, or earnings increase, in monotonic fashion. There are product cycles, unpredictable lapses, delays in product development, and whoa, the impact of competition; but by now CEOs knew the game was elsewhere. Gillette, like many others, kept promising Wall Street to expect earnings and sales increases of as much as 20% a year, clearly stretch figures for a mature business, and then would push product out the door at discount prices to meet its goals.<sup>17</sup> Gillette, in effect, was managing the razor business for Wall Street, not for its customers. Worse yet, mesmerized by the market and their own growing wealth,<sup>c</sup> CEOs began to pressure their chief financial officers to find, and their auditors to bless, the "earnings" needed to pump up their stock price so that they could unload their shares. "Pump and dump" was the key.

- The most respected, indeed the most highly valued, company of the era was General Electric. Over the twenty years of his stewardship, Jack Welch delivered the steadily increasing earnings, quarter by quarter, that investors craved. Some years ago, I wrote a column explaining how several "adjustments" – all quite visible to an analyst, but ignored by most – enabled GE to report higher, not lower, earnings for the prior year.<sup>d</sup> More recently, an accountant, using the Standard & Poor's excellent definition of core earnings, concluded that over a six-year period the earnings had been anywhere from 1% to 20% lower. And of course, the increases were not smooth, but lumpy.<sup>18</sup>

By 1998, the picture had become ugly enough that Chairman Arthur Levitt of the Securities and Exchange Commission gave a seminal speech excoriating the growing practice of,

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<sup>VI</sup> The ten highest-compensated executives in the U.S. had an average annual compensation in 1981 of \$3.45 million, in 1988 of \$19.8 million, in 2000 of \$154 million. Kevin Phillips, "How Wealth Defines Power," *The American Prospect* A8, A9 (Summer 2003). The year 2000 figures are, no doubt, inflated by the stock market bubble, but . . . .

as he politely put it, “managing earnings.” The most frequent distortions were in revenue recognition, which often meant keeping the books open for several weeks after a fiscal year close, or shipping unwanted merchandise to customers who had been assured they would not be billed. The SEC, recognizing that the problem was deep-rooted, prompted the creation of two panels, one focused on boards of directors and the other on accountants, looking in short to the two groups with statutory oversight duties and, conceptually at least, a degree of independence. (This author was on the so-called Panel on Audit Effectiveness, which for 20 months explored, with the benefit of a full-time staff, the growing failure of auditors to meet their responsibilities. The 200+ page report, issued in 2000, is a testimonial to the quiet virtues of laboring in the dark.)

Being the “old man” of these discussions, I can recall that in the 1960s, the then head of the New York Stock Exchange, speaking of a market bubble, lamented that he had seen it happen before, was seeing it happen again, and there didn’t seem to be anything he could do about it. There is a contagion, an excitement, at the prospect that each of us, all of us, if only we play the game, can get rich . . . very rich. With the pulse beating fast, no one cares that we are hour by hour simply repricing, passing along, the same shares. In the long run, share prices are merely the reflection of the underlying verity, but now, in the 1990s, with eyes focused on the stock quotes flashing across the TV screens in every bar and restaurant, the “long run” was not in anyone’s lexicon. No one was prepared to heed Levitt. We, and the “we” included the institutional investors, of course, simply wanted to know which stocks were rising, so as to seize the opportunity. Earnings, revenues, balance sheets, after a time none of it mattered. Dot.coms with no earnings, indeed scarcely any revenues, and often only dimly perceptible prospects would leap to billion-dollar values, on the novel theory that they would be the first to dominate some as yet non-existent market.

Applauding this mockery of intelligent investing were scholars who urged the public to buy the market, all of it, no matter what the price.<sup>19</sup>

### **3. Accounting is the key.**

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<sup>VII</sup> Invited to explain the “adjustments” to my finance class, the GE CFO instead discussed the

Disappoint Wall Street by a penny a share and the stock could sink 10-20 percent. Be careful, manage the earnings, that was the key to a healthy stock price. It's a truism that the earnings figure reflects a host of judgments that companies and their auditors make – about the value of inventories, reserves for bad debts and other contingencies, the number of new model 767 aircraft the company is likely to sell over the ensuing years, assumptions underlying the pension plan, and on and on. We say it's an art, not a science, because judgments – not just counting the boxes and such, but a host of valuations and estimates of future probabilities – are intrinsic to the process but largely **invisible to everyone but management and the auditor**. Computer risk models may highlight areas of likely concern, but only the time-consuming, tedious substantive checks on outstanding receivables and the like will provide the necessary assurance.

Like all the rest of us, CEOs hate to get undressed in public; while on average they earn a grade of only B, or is it B-, each of them likes to believe that, given all the challenges he has overcome, he deserves an A report. It's simple human nature. That puts the auditor under ferocious pressure, which is why federal law has for 70 years required they be independent. Lawyers, too? No, only auditors.

I love markets; they do so many things so well. What happens, for example, to a failing company? In a strong market system, it is allowed to fail, thus keeping the losses to a minimum. Think of countries, and you know them well, where, long after any reasonable hope has vanished, governments continue to prop up banks and others, and in the end the mounting losses burden the entire economy.

In short, a well functioning market system provides a healthy dose of discipline. And they do other things well, too. Let me merely list them, as I suspect they are familiar:

- a. Low-cost, long-term capital for industry. Potentially lots of it, which is why companies seek to list their shares in London and New York.
- b. Liquidity for investors. The combination of permanent, equity capital for industry, together with liquidity for investors, is a unique strength of a market system.

c. The efficient allocation of capital. Even though we have seen huge sums foolishly invested in U.S. and European telecommunications companies, after a year or two the market turned away and the process stopped. Compare that with Japan, where politicians have steered capital to the real estate, retail and other poorly performing industries, and the lesson is clear.

d. Stock prices are an excellent measure of management performance **over time**. The old adage is, give me the power to see myself as others see me. Financial markets hold up to corporate managers a mirror, telling them, in stark terms, what the world thinks of their stewardship. Long speeches by prime ministers rarely catch the same attention.

Which leaves us, however, with two intractable facts: (1) While markets require a high degree of transparency, they do not by themselves create it. (2) The modern business corporation is typically a hugely complex enterprise, whose operations are often spread over many parts of the globe. Investors have no direct way to observe how well a company is doing, without that independent audit. As we say in the U.S., they cannot kick the tires. Neither can bankers, analysts, or any of us. And so we made an ultimately hollow Enron the seventh largest company in America. And Tyco, Global Crossing, WorldCom, and Lucent, and. . . and. . . . Enron's financials were opaque, dense, surely a warning to intelligent investors, such as the rare analyst at the pension fund for teachers, TIAA-CREF, who, seeking better data, was told abruptly by an Enron spokesperson "We're Enron; we don't need to have good accounting."<sup>20</sup> Of course, she was a buy-side analyst, not one working for an investment bank whose compensation would almost entirely depend on her ability to bring in the financing transactions that are the core of their business.

- In Project Nahanni, the name of a Canadian national park known for its wolves, Enron borrowed money from Citigroup to buy Treasury bills, then sold those bills and within days reimbursed Citigroup at an above-market interest rate. Why? The bank had assured Enron that the \$500 million it received could be reported as **operating cash flow**, thus "reassuring" investors, analysts and the like.<sup>21</sup>
- In 1999, Enron persuaded Merrill Lynch to purchase power-generating barges moored off the coast of Nigeria for \$28 million, subject to a secret side agreement to reverse the transaction, at a profit to Merrill, within six months. Enron booked \$12 million in bogus

profits.<sup>22</sup> On completion of the round-trip, Merrill had indeed “earned” a \$775,000 fee.

By the time of Enron’s collapse, the company had piled up \$38 billion in debt, but thanks to transactions such as these, only \$13 billion appeared on the balance sheet.<sup>23</sup>

The bankers, of course, knew full well what they were doing. Thus, one Merrill executive’s note: “Reputational risk, i.e., aid/abet Enron income stmt manipulation.”<sup>24</sup> Or a Chase banker: “Enron loves these deals, as they are able to hide funded debt. . . .”<sup>25</sup> Or a Citi banker, “E gets money that gives them c[ash] flow but does not show up on the books as big D Debt.”<sup>26</sup> And of course the auditors. Through all of these palpable frauds, Enron’s auditors, Arthur Andersen, never blinked. Having seen their consulting wing, Andersen Consulting – now known as Accenture -- break away, they were far too eager to build a consulting business anew.

As the Panel on Audit Effectiveness saw, the decline of the accounting profession had been underway for 20 years, roughly since the firms began to see auditing, not as a public trust, but rather as providing an unparalleled (indeed, legally mandated) opportunity to gather consulting and other profitable work worldwide from the very management from whom they purported to be independent. Consulting in its various forms soared from 30% to about 75% of firms’ revenues and a still higher percentage of profits. That is why the press now routinely refers to accounting as an industry, not a profession.

Audit work came to be seen as a low margin business, and a low-wage line of work. Cut the hours, use drones instead of MBAs, keep the fees low. It’s not where the money is. Columbia, Harvard and like B-Schools simply do not train accountants; true they teach accounting, but only for those going to Wall Street and the like.<sup>e</sup> Accounting as a profession has been left to Ill. State, Case Western and other less prestigious schools. The Panel looked at audit standards (weak), discipline (nonexistent), peer reviews (a joke), and particularly independence (shattered) as accountants often “audited” the very tax schemes they had concocted.

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<sup>VIII</sup> As recently as February 28, 2003, the “Columbia Daily Spectator” carried an advertisement from the state accounting society: “if you’re looking for an exciting profession with opportunities. . . consider becoming a CPA. . . average starting salary of \$35,000.” In NY City ?? To restore credibility to auditing, we need to pay credible salaries.

The Panel reported that it might take a major blowup to effect real change. Be careful what you wish for! By 2002, \$7 trillion in market value had been erased, some by the collapse of the bubble, some by the collapse of the frauds.<sup>27</sup> In the 4 years ended 2001 over 700 companies, many of them major, restated earnings.

Every link in the chain broke. Institutional investors, security analysts, audit committees, political leaders, investment and commercial bankers, and oh yes, the lawyers who crafted all those hollow transactions devoid of any proper purpose. In short, a broad cultural failure—AOL, Adelphia, Sunbeam, Global Crossing, WorldCom, Enron, Health South, CMS, the list seems endless. As political analyst Kevin Phillips recently noted, financial corruption seems to be an inevitable consequence of the psychologies unleashed as a long bull market feeds a culture of money and greed.<sup>28</sup> Executive insatiability drove the process, earnings manipulation provided the sought-after cover, and sleepy boards of directors supplied the necessary nod of approval. Fiduciary duty, conflict of interest? Sorry, they dropped out of our lexicon.

Crime, it has been said by a friend (who I believe has no personal experience), is about opportunity. As we in the U.S. made banks more open, more inviting, we “invited” more bank robberies. In the parts of town where the opportunities are limited, there may only be street games of three-card monte or drugs. But in corporate America, seeing that the primary watchdogs had become household pets, managers found unparalleled opportunities. And like any sensible con artist, they seized them.

Of all the external gatekeepers, we depend most on the auditor. Which is why it is a government mandate. The nub of the problem is that accountants have two very different clients for their work: (a) management for the lucrative IT consulting services and the like, and (b) the board, the shareholders, lenders and the public generally for the audit, which is a report on the performance of **that very same management**. If they are not independent, the process fails. Even the directors have nowhere else to turn. And with almost three-fourths of their revenue coming from elsewhere, with intense pressure to bless sham transactions, to redefine the Gregorian calendar as having 380 days, not just 365 – e.g., Sunbeam -- the auditors ability to “just say no” had dried up.

While managerial greed was the driver for so much what we have seen, the contagion spread beyond even their reach. The mutual fund industry, which had seemed unscathed, has now become embroiled in several important scandals. Fund managers have bribed brokerage firms to recommend their funds to clients, no matter what the performance of those funds. Worse yet, banks allowed hedge funds, such as Canary Capital, to steal from investors in the banks' own mutual funds by permitting them to trade mutual fund shares at prices at variance with the underlying values. [[see "bank of america infra note 9/28\_\_] And still worse, specialists at the New York Stock Exchange, some of them affiliates of major Wall Street firms, injected their personal trades ahead of customers' orders, at a cost to investors estimated by the SEC at over \$150 million, all in just a three-year period.<sup>29</sup> The Exchange knew, but seemed essentially indifferent. Meanwhile the board of directors of the Exchange, which included representatives of all but one of the five offending firms,<sup>30</sup> approved deferred compensation of \$140 million to the chairman of the Exchange, Richard A. Grasso, a testimonial of sorts to his diligent oversight of the trading floor. In short, not every failure could be laid at the doorstep of corporate America, though palpably it was the same failed culture operating throughout.

Having boasted of my predictive powers, let me now confess, as Mats has reminded me, that as recently as 1998, I wrote that the U.S. had developed its "financial reporting and disclosure system to a degree not known anywhere else, not even in England."<sup>31</sup> By dint of great foresight I tucked that essay into an obscure volume intended for an audience in New Zealand, so that but for our zealous host it might have gone unnoticed. Sic transit. . . .

#### **4. Sarbanes-Oxley and more.**

Not since the first days of the Roosevelt Administration has there been such a comprehensive legislative and regulatory response.<sup>32</sup> At first Congress wavered, but as the huge frauds at WorldCom broke, so did the resistance, and the result was a wide-ranging bill, Sarbanes-Oxley Act of 2002 (SOXA). Some of the more salient aspects are to: impose significant new and accelerated disclosure requirements on public companies -- require the CEO

and CFO personally to certify their company's financial statements -- increase the responsibilities of audit committees and the independence of boards -- impose strict limitations on non-audit services for audit clients -- establish a new Public Company Accounting Oversight Board (PCAOB), with independent funding – subject directors and officers to trading blackouts - - and increase criminal penalties for violations. Also included was a requirement of up-the-ladder reporting by lawyers of securities law and fiduciary duty violations, a provision added in the wee hours before passage, and before the lobbyists knew what was afoot. The public's outrage and pocketbook losses overwhelmed the hesitancy of the White House; and while the Administration fumbled for a bit, Congress then gave the SEC the much needed additional funding.

Congress was shutting down the opportunities, both directly and more importantly for the years ahead, by reinforcing the independence of the potential watchdogs, notably directors, auditors and lawyers, and of course the potential penalties. Closing down one of the Big Five, Arthur Andersen, was itself a powerful message. Financial skullduggery is never-ending; only the tricks change. The structures put in place in the 1930s worked well for decades; the new structure seems well designed to eliminate not just the special purpose entities, the broadband swapping and the like abused by Enron and the rest, but hopefully whatever our fertile imaginations might produce next. The window for reform is always narrow; fortunately, Congress seized the moment.

Since Sarbanes-Oxley, there have been a number of criminal indictments, civil proceedings, and SEC and NYSE rules implementing the Act directly and in many instances going well beyond it. But the clear focus has been on accounting. Yes, accounting, the quintessence of boring, banal work, performed by Dickensian fellows wearing green eyeshades, had captured the attention of the Congress, the regulatory bodies, indeed the press and society generally. Only a short time before, who would have guessed that Congress would enact a law dealing explicitly with off-balance sheet transactions? Or that boards of directors would be scouring the countryside looking for audit committee candidates with the requisite level of expertise? Or that the public's attention would be riveted to the tales of how some twenty

telecom and energy companies, guided by Arthur Andersen, boosted their reported revenues by some \$15 billion by swapping one set of broadband leases for another?<sup>33</sup> As Arthur Levitt told me, he had never thought he would be spending so much of his years as SEC chairman dealing with accounting.

What also emerges is that in one fashion or another, the federal government has done what many of us had hoped for, but not envisaged in our lifetimes (or at least not in mine), adoption of nationwide rules for the governance of public corporations, and for the two professions, law and accounting, the oversight of which had been left to the far too haphazard, at best indifferent supervision of the states. Even executive greed, the core issue, came under federally sponsored regulation, by virtue of new stock exchange and NASDAQ rules giving shareholders the right to approve stock option plans, and stripping brokerage firms of their right to befriend corporate clients by voting “street-name,” i.e., customers’, stock in favor of such plans.<sup>34</sup> Ahead of the curve as usual, Michael Jensen had, as early as 2001, become an outright critic of the culture he had helped to spawn, expressed in a paper graphically entitled “Paying People to Lie.”<sup>35</sup>

## **5. Two Steps Forward and One Back?**

SOXA did not in a simple flash of Congressional fervor restore ethical and moral standards. In the little more than a year since its enactment, what have we seen? In a word, swirling cross-currents.

What we are trying to do is change a systemically perverse culture. American International General (AIG), the nation’s largest commercial insurer, recently conceded that “mistakes” were made writing a backdated, bogus insurance policy, and issuing a misleading audit letter, all in order to help a client overstate its earnings by more than half. AIG, whose own disclosures have long been suspect,<sup>36</sup> tried to deny corporate responsibility, until confronted with subpoenas, at which point it produced a marketing paper designed to sell these very same

bogus policies and counseling that some aspects of the policies should be concealed. AIG, agreed to pay a \$10 million fine.<sup>37</sup> The problems run deep within the core of how some major companies function and how they see their goals.

Rules and enforcement proceedings clearly help, but they are only the stepping stones. Some recent polls suggest that both in the financial community and in the country as a whole, the expectation is that we will, in time, revert to “business as usual,” meaning corruption. [Atlantic oct. ‘03] Indeed, evidence of executive excess continues to unfold. According to one survey, total take-home pay for CEOs at one hundred of the largest companies grew by an average of 14% in the year 2002, despite the slumping economy and job losses.<sup>38</sup> Among the CEOs reaping big increases, even while their companies suffered, was William Harrison of J.P. Morgan Chase, whose pay rose by 80% to \$17 million. Think how well he would have fared if the bank had not played a key role in the Enron debacle.

A number of criminal proceedings are underway, but thus far many of them have focused on the seemingly easy cases of destruction of records, i.e., obstruction of justice. As of this writing, in October 2003, Dennis Kozlowski of Tyco, Richard Scrushy of HealthSouth, and John Rigas of Adelphia, are among the few high-profile CEOs to be indicted. Despite their companies’ bald and hugely costly deceptions – and the seemingly strong evidence of their involvement – neither Bernard Ebbers of WorldCom, Kenneth Lay and Jeffrey Skilling of Enron, Richard Scrushy of HealthSouth, nor Gary Winnick of Global Crossing, have as yet been charged under federal law.<sup>39</sup> It is, however, a matter of public record that at least some are “under investigation.”<sup>40</sup> Were some of them too far removed from the scene to know what was happening? Doubtful, even in the case of Lay, admittedly not a hands-on manager. When a well informed executive in the finance department warned him that Enron’s accounting was a house of cards, Lay referred the letter to the very same law firm that had crafted fictional transactions. The firm, Vinson & Elkins, “reassured” by the Arthur Andersen partner in charge of Enron, promptly issued a report that no further investigation was warranted.<sup>41</sup> Winnick of Global Crossing, ignoring an even more graphic signal of imminent danger, continued to sell stock while his company issued misleading reports.<sup>42</sup>

With each revelation of still another corrupt practice, we would like to think that the worst is over. In some cases, the disclosures are new, but at least the events took place in years past. But too often we see ongoing evidence of the very same crony capitalism SOXA sought to curb. Three examples stand out.

- Freddie Mac is the government chartered company created to provide low-cost home mortgages. Although publicly traded, it enjoys enormous competitive advantages under the tax and securities laws, as well as an implicit government guarantee of its debt. It is seen as a public service corporation, and yet it distorted its earnings by over \$7.6 billion pretax.<sup>43</sup> There has for years been a large sign outside its Virginia headquarters, “Steady Freddie,” openly acknowledging what management saw as its mission, to deliver the steady earnings that investors crave. Its (now former) CEO took down a \$5 million salary – hardly what its quasi-governmental role would have suggested, but then it didn’t see itself as such.
- Bank of America, eager to expand its private banking business, successfully courted Edward Stern, the head of the hedge fund Canary Capital, by allowing his fund to use late-breaking news to trade shares of mutual funds managed by the bank after the close of business, illegally backdating the transaction slips when needed. The other fund investors could buy/sell only at the next day’s closing price. What’s striking is that so many people within the bank had to know that Canary was literally stealing from other fund investors, and yet a supervisor could happily hail the relationship with Stern as “a tremendous example of leveraging the franchise.”<sup>44</sup> They knew, but they didn’t care.
- While no law was broken, what struck the country as perhaps the most jarring failure took place at the New York Stock Exchange, where in the summer of 2003, the board announced its new policy of transparency by disclosing that the chairman, Richard A. Grasso, was about to cash in \$140 million of deferred compensation and retirement benefits. The board seemed genuinely puzzled that the SEC chairman, William Donaldson -- himself a former chairman of the exchange -- was angry. The exchange is in large measure a de facto monopoly; a so-called self-regulatory organization (SRO), it is responsible to the SEC and the public at large for setting standards for the trading practices as well as the corporate governance of the listed companies. As mentioned earlier, Grasso’s pay was thus fixed by the very traders and bankers he was charged with regulating. Cronyism at its worst – or for Grasso, opportunity at its best – the sum included a \$5 million bonus for his acknowledged success in reopening trading

in the wake of 9/11; his colleagues, while aware of the sacrifices of those who fought the flames and perished there, expressed their appreciation in the only currency they knew. After some delay, the exchange disclosed that Grasso was entitled to a still further \$48 million, which he graciously waived, having decided apparently that if his colleagues could overlook such a modest sum, so would he.<sup>45</sup> The principals were unable to sense how out of touch they were with the society at large.<sup>46</sup> No, Grasso would of course not resign, but of course he did. The head of the compensation committee, the former New York State Comptroller, H. Carl McCall, seemed perplexed by the outcry; he thought he could “now be the reformer on the board that I wanted to be.”<sup>47</sup> No such luck, Carl; eight days later, he, too, resigned.<sup>f</sup>

As Mats and Rolf know, my favorite dictum is “you manage what you measure,” meaning that once we had disclosure of Grasso’s pay, the game was up. It was only while it was kept from public view that it could soar out of sight. And just to underscore the point, the same was true of GE, WorldCom and the rest. Financial transparency is the key.

While it is the high profile criminal cases that catch the reader’s eye, largely off the screen the SEC working directly, and pushing the SROs indirectly, has been using a host of regulatory changes and 600 enforcement proceedings in the last fiscal year<sup>48</sup> to change that culture, or as Chairman Donaldson put it, their DNA.<sup>49</sup> To be sure, attitudes and expectations do not change overnight. Witness the fact that no sooner had Morgan Stanley agreed to pay \$125 million to settle an enforcement action arising out of charges that the firm had paid other firms to provide favorable, ostensibly independent “research” reports for the firm’s stock offerings, than the firm’s CEO issued a business-as-usual statement that Morgan Stanley had done nothing to concern the retail investor.<sup>50</sup> Similarly, when the FASB issued its Interpretation No. 46, an interim effort to deal with the special-purpose entities so abused by Enron, and still widely used elsewhere, it was met with the vociferous protest that to recognize the “new” assets and liabilities might well cause

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<sup>IX</sup> Lest the reader regard Grasso’s pay as aberrational, note that the two Executive Vice-Presidents each received about \$13 million in pay over the latest five years, and is due more than \$22 million in retirement benefits. “NYSE’s 23 Top Executives Owed \$128 million in Deferred Payments,” SRLR, Oct. 20, 2003, 1736.

companies to be in default under their loan covenants. By virtue of the long-practiced abuses, companies had forgotten that this was, indeed, how loan agreements should work. (As I write, the confusion over FIN 46 has caused the FASB to postpone its effective date, until the calendar year-end reports, so the deed is not yet done.)<sup>51</sup>

According to a poll, two-thirds of professional money managers remain deeply skeptical whether the recent governance changes are likely to prevent future accounting scandals.<sup>52</sup> The skepticism is plausible, given the sordid history and the reality that the reforms are recent, many of them not yet effective, and at best will only take hold over a period of years. Looked at less charitably, how would those mutual fund managers have time to know? They were turning over their portfolios at the breathtaking annual rate of 110% in 2002.<sup>53</sup> Nor would the funds' investors, who were redeeming their shares at a 45% annual rate.<sup>54</sup> Indeed, turnover in NYSE-listed stocks averaged 125% last year, the highest in almost a century.<sup>55</sup> So much for patient study and informed shareholding.<sup>56</sup>

In short, not one money manager in ten is likely to have noticed the major implications in the announcement by William J. McDonough (formerly head of the Federal Reserve Bank of New York), now head of the new PCAOB, that henceforth the Board will set audit standards, not the industry which, despite its sorry history, had so energetically sought to keep control.<sup>57</sup> True, the process of staffing the Board has been moving slowly.<sup>58</sup> True, too, there are troublesome signs that, given the history of low fees for the basic audit, the Big Four firms still see a need to game the rules, by promoting exotic tax schemes, for example, thus raising the specter of firms continuing to audit their own work. Here, too, the PCAOB, whose budget is a hefty \$68 million for 2003, and subject to SEC approval \$103 million for 2004,<sup>59</sup> responded with a not very subtle warning. Telling the Senate Finance Committee in September, 2003, that he found the Big Four's selling faulty tax shelters and hiding them from government auditors "immensely and morally repugnant," McDonough added, "If they do not save themselves, we will save them and it will not be pleasant."<sup>60</sup>

By contrast, the FASB seems almost becalmed. Thanks to incessant lobbying from Silicon Valley, a new standard for stock option accounting is not likely to be issued for a year, if then. An even more leisurely pace afflicts the creation of a new rule for revenue recognition, the

issue highlighted by Chairman Levitt in 1998, and still the most common abuse. The underlying reality is that companies have for some years now been gaming these and other rules, and then lobbying intensely to preserve their creative distortions. Political pressure is applied not just in the U.S., but in the EU as well.<sup>61</sup> Who would have guessed that accounting would become a political football? The somewhat better news is that we may soon have enhanced disclosure requirements for pension fund liabilities and some other projects being worked on in collaboration with the International Accounting Standards Board. And the still better news is the election of the highly regarded Robert Denham as chairman of the Financial Accounting Foundation, the group directly responsible for oversight, funding and appointments for the FASB. While chairman of the SEC, Arthur Levitt, Jr., had waged a battle to recapture control of the Foundation from corporate America, and Denham's election augurs well for what Levitt was trying to do.

The task is daunting. While all the gatekeepers failed, the ultimate failure was in thee and me. We were delighted with how “steadily” and predictably Freddie and GE delivered the earnings increases we sought, no matter that, at least in the case of GE, the footnotes belied the tale. How likely are we then to persuade Americans that, instead of staring at CNBC's market quotes and trivial news, they should be reading annual reports and footnotes? Or analysts to stop catering to investors' worst impulses and to focus, not on the next quarter's earnings, but on long-term prospects? Or executives to stop catering to these myopic impulses. In short, the underlying issues raised ten years ago are still with us.

It is well beyond the scope of this essay to describe all the remedial steps taken thus far,<sup>62</sup> but one very recent initiative illustrates how energetically the Commission has seized the initiative, as well as the political forces muddying the waters. In October, the SEC proposed rules to provide investors with direct access to company proxy statements so as to permit them, under carefully circumscribed conditions, to vote for shareholder-designated nominees to boards of directors. Remember, under the so-called “internal affairs” doctrine, it has for over a hundred years been left almost entirely to the jealously guarded domain of the states – effectively Delaware – to determine how boards are elected, candidates are nominated, and the like. And the proxy statement has of course been under the exclusive control of management, subject to the typically benign oversight of the board. Ninety-nine percent of board elections are uncontested.

The implications, the potential pressure on managements to consider a genuine “shareholder value,” are breathtaking; the 100 largest managers of pension and mutual funds now control 56% of all U.S. stocks.<sup>63</sup> Predictably, the Business Roundtable, an association of CEOs, immediately attacked, and while all five SEC commissioners voted to release the proposal, two promptly expressed reservations.<sup>64</sup>

So what are the key issues that Rolf and Mats would have us look for in the ensuing years? We need to remake a corrupt culture that contaminated every sector of corporate and financial America. Some might argue that major failures such as these are endemic to a capitalist, market economy, or perhaps simply a reflection of the American utilitarian obsession with success. While I disagree, I do not underestimate the difficulty. There is an Aristotelian concept of the unity of the virtues, which describes the virtues – justice, courage, temperance, generosity, and kindness – as being of a piece in any given individual.<sup>65</sup> Without all, there would be none.

Much the same is true here. Jack Bogle, the founder of the Vanguard mutual fund group, may have had it right when he said our society “is measuring the *wrong* bottom line: form over substance, prestige over virtue, money over achievement, charisma over character, the ephemeral over the enduring.”<sup>66</sup> Does he overstate the problem? I don’t think so. What else should we think as we read a Citibank executive, Steve Bailie’s, email saying that Bacchus, a year-2000 Enron partnership would enable Enron to write “up the asset in question from a basis of about \$100 MM to as high as \$250 MM, thereby *creating earnings*.”<sup>67</sup> (Ital added) Or that more than 30% (sic) of the mutual fund companies surveyed by the SEC had given favored customers the nonpublic information they would need to place “advantageous” trades – translation: steal from investors.<sup>68</sup> Or that, or that. . . .

Among the gatekeepers, first and foremost are the corporate boards on the inside and the auditors on the outside. (Only they have the power and the duty to oversee, fund, insist upon, produce, credible financial statements. By comparison, the rest are bit players.) Sarbanes-Oxley and the SEC have zeroed in on both. The DNA of the others, analysts, and bankers are important, but they will not matter without good boards and audits. Indeed, the inverse of the Aristotelian model surely applies: corruption breeds cynicism which in turn breeds corrupt practices throughout. It’s also clear, of course, that to achieve a renewed sense of fiduciary responsibility

in boards and accountants, we need vigorous enforcement. Specifically, we need to send some of those high-profile figures to jail, and we need some really large-dollar civil judgments in the host of pending civil suits.<sup>8</sup> SOXA is remarkably good; but rules alone will never do.

The likelihood of success would be greater if the problems were not so inherently intractable. We can legislate independence requirements for directors, but independence in fact is beyond our reach. As those of us who have been on boards know so well, there is a collegiality factor that subtly but almost surely blunts one's judgment until the problems become truly inescapable. My mother's dictum of a stitch in time saves nine is right-on; but too often even the one director who can weave the catalytic "stitch" seems hard to find. Then, too, auditing is, as we have said, inherently judgmental. The saving grace is that investors and boards need only a "fair presentation," as the formula goes, not precision, which would in any event be illusory.

As between the two, my view is that if boards are forced to confront the unpleasant realities revealed by a good audit, they are then likely to wake up. I would be tempted to say that of the two factors, accounting is the key. (We all like to think that which is our special purview is also what matters most.) But it's a discussion that goes nowhere; we need both. The prospect is for sharply enhanced audits – the Big Four will eventually realize that auditing is how they will have to earn their keep; audit fees will increase, and shareholders, and audit committees, should be pleased, nay thrilled, at that. Sarbanes-Oxley and related rules have imposed an array of new requirements designed to improve audits, to wit: (a) that audit committees have significant expertise, (b) that they be more independent than ever, [c] that the auditors will be hired by and report to the audit committee not management, and (d) that the audit committee report directly to shareholders in the proxy material. All these and more suggest that we will see a new level of board vigor and oversight. And auditing is a fine place to start.

I will be happy to review just how well all this turns out, when we meet again in 2013. In the meantime, on to the Festival of Santa Lucia.

December 11, 2003

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<sup>x</sup> During the 1990s, partly by new legislation, partly by a Supreme Court decision, auditors in particular became far less vulnerable to suit. See Cent. Bk of Denver; Pvt. Sec. Litig. Reform Act; Uniform Stds. Act.

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  3. But see, e.g., Lawrence A. Cunningham, "The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)," 35 *Conn. L. Rev.* 915 (Congress failed to legislate rules for option accounting, and should have given direct responsibility for accounting and audit regulation to the SEC); Douglas M. Branson, "Enron—When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?," 48 *Villan. L. Rev.* 989 (2003 (Sarbanes-Oxley damages federalism, stifles informed risk-taking))
  4. William F. Sharpe, "Investments," (3d ed. 1985), p. \_\_\_, cited at "Minding the Store," 45.
  5. Nicholas Barberis & Richard Thaler, "A Survey of Behavioral Finance" Sept. 2002 (Abstract) (forthcoming in the *Handbook of the Economics of Finance*).
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  13. *Origins*, 52; the disease of rewarding failure is a problem in the U.K. as well. "Fat cats feeding," *The Economist*, Oct. 11, 2003, at 64.
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  16. *Origins*, at 50.
  17. Claudia H. Deutsch, "For Mighty Gillette, These Are the Faces of War," *NY Times*, Oct. 12, 2003, Sec. 3, p. 1, 11.
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  22. Kurt Eichenwald, "Merrill Reaches Deal With U.S. in Enron Affair," NY Times, Sept. 18, 2003, C1 (per the indictment of three Merrill executives).
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  25. *Id.* at 81.
  26. *Ibid.*
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  28. Phillips, *supra*, fn. b, @9.
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  32. But see, e.g., Lawrence A. Cunningham, "The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)," 35 *Conn. L. Rev.* 915 (Congress failed to legislate rules for option accounting, and should have given direct responsibility for accounting and audit regulation to the SEC); Douglas M. Branson, "Enron—When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?," 48 *Villan. L. Rev.* 989 (2003 (Sarbanes-Oxley damages federalism, stifles informed risk-taking)
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