Technological Evolution and the Devolution of Corporate Financial Reporting

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TECHNOLOGICAL EVOLUTION AND THE DEVOLUTION OF CORPORATE FINANCIAL REPORTING

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INTRODUCTION

Technology's fingerprints are found all over the recent financial reporting scandals involving Enron, WorldCom, Tyco, Global Crossing and the like. The firms caught up in the scandals were disproportionately either in the technology sector or were technology-driven competitors in related product markets. They were especially attractive as investments to a generation of investors using on-line brokerage accounts and financial websites—an information-rich environment that promised to empower the retail trader vis-à-vis the dominating mutual funds, hedge funds, and pension plans.

Just as important, many of these firms were innovators in how they used technology in both financing and conducting their businesses. Enron is now the best-studied example,1 with massive utilization of structured finance techniques and derivatives to create an "asset lite" strategy wherein both assets and liabilities were quickly moved one step outside the formal boundaries of the firm to numerous affiliated special purpose entities.2 These financing techniques themselves would be impossible without sophisticated technology that enabled Enron to become more an energy-based investment bank than a traditional supplier of natural resources. And even business-to-business relationships structured by many of these firms were innovative, with firms using information and communications technology to create more embedded relationships with customers and suppliers characterized by "just in time" production and delivery.

My claim is that the technology link to the recent disclosure scandals is no coincidence.3 To be sure, cheating tempts all who seek...

1. For a good overview from an economic and accounting perspective, see Paul M. Healy & Krishna G. Palepu, The Fall of Enron, 17 J. ECON. PERSP. 3 (2003).
3. For a pre-scandal paper drawing the connection between technological evolution and...
wealth, in whatever line of business they find themselves. I want to show, however, how the rapid pace of innovation at a number of levels offered motive, opportunity, and rationalization for a downshift in financial reporting norms, which in turn made outright fraud more probable.

Understanding the root causes of the scandals is important because of the need for care in choosing a response. The popular story of the scandals, born out of a great deal of frustration and anger, is one of corporate greed—misreporting as a stark form of corruption and hence "evil." While greed certainly had a role, the misreporting was far more complicated and ambiguous, both in terms of underlying motivation and its impact on investors. Technology's multiple dimensions set in motion a feedback loop in which many managers came to believe that aggressive reporting—close to the line and perhaps over it—was both necessary and justifiable. During most of the 1990s, the SEC and the courts did relatively little in response—even though the practices were becoming more and more notorious—thereby sending a message of tacit acquiescence. Putting aside the most egregious cases, the story may thus be more of mixed signals and situational pressures run amok than anything unusually corrupt about the dispositions of the managers involved. As Warren Buffett said in 1997, well before the scandals ever emerged, the inclination to engage in deceptive earnings management had made it "very tough to cleanse the system ... because you don't have good guys and bad guys anymore."

If that is so, then the right reaction is probably not moral outrage and the right regulatory response is not necessarily the broad-brush criminalization threatened by the Sarbanes-Oxley Act of 2002. This

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5. Sarbanes-Oxley does much more than criminalize. I do not mean to be critical of the Act's overall thrust, especially as it addresses conflict of interest problems in corporate governance, accounting, investment banking, and the provision of legal services. See, e.g., Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It
is not to trivialize or to excuse financial misreporting: it causes serious harm and requires a potent remedy. And in some of the cases—Enron, for example—the misconduct went way out of bounds. The point is simply that choosing the right forum for adjudication and remedy requires a more nuanced analysis of what happened and why, not the lumping of all the scandals together into an undifferentiated mass. That story begins with the state of technology and innovation in the 1990s.

I. TECHNOLOGY'S FIRST DIMENSION: THE ISSUERS THEMSELVES

Enron, we know, was an energy business that transformed itself into an investment bank making markets in energy trading, broadband, and many other synthetic assets—an extraordinarily sophisticated, technology-based task. WorldCom was one of the major players in telecommunications, and Global Crossing was an innovator in the trans-oceanic communications business. Adelphia, Xerox, AOL-Time Warner and so many others fit the same mold.

What could a firm's product line have to do with either the motive or opportunity to manage earnings or other financial metrics? I shall explore some of the connections in more detail below, including the simple fact that retail investors became fascinated with stocks that had a technology-based story. At a higher level of generality, however, an important common thread was the perception that cutthroat competition was necessary to grow. There was a strong sense during the 1990s that the Internet and related technological changes provided a short window of opportunity for firms to achieve the scale necessary to be a winner (or survivor) in newly redefined product lines. Many competitors would not survive if they did not fight for growth. Those that succeeded would be lavishly rewarded in something resembling a winner-take-all tournament. “Eat or be eaten” was a common incantation. As a result, both hope and fear—


6. \text{For a thorough review, see FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS (2003); see also Healy & Palepu, supra note 1.}\n
7. \text{See Eli Ofek & Michael Richardson, DotCom Mania: The Rise and Fall of Internet Stock Prices, 58 J. FIN. 1113 (2003).}
two of the most profound motivators in human and organizational psychology—were strongly at work.

The connection to financial misreporting here is two-fold, and the duality is important. Growth is financed in the capital markets, either through infusions of capital (IPOs, borrowings, etc.) or through stock-for-stock acquisitions of existing or potential competitors. The higher the perceived valuation of the company, the more it could accelerate its growth through equity-based financing; the more solid its balance sheet and cash flow, the more it could leverage itself in the debt market and avoid default on existing debt. More indirectly, reported measures of strong growth could be of value in other markets, including the attraction of high-quality employees and the gaining of customers. The latter deserves special note. In a market where many firms are likely to disappear quickly, customers naturally seek out the most likely survivors to establish dependable relationships. Firms that demonstrate strong earnings and revenue growth are most likely to survive, which can in turn become a self-fulfilling prophecy. The more firms can convince customers to make long-term commitments, the more they gain resources enabling them to be around for the long term. Of course, once the motivation to demonstrate strong revenue and earnings is seen, the temptation to create illusions of success is equally clear.

The other connection is managerial motivation. Growth in highly competitive markets is difficult and takes a highly motivated management team. Conservatism, much less sloth, is deadly. Beginning in the late 1980s, firms rapidly increased the use of incentive pay for executives and other key employees as the primary component of their compensation packages. Stock options, in particular, came to dominate in technology-based industries, gradually migrating into many other market segments where

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9. On the connection between debt covenants and the incentive to manage or misreport earnings, see Patricia Dechow et al., Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC, 13 CONTEMP. ACCT. RES. 1, 21 (1996); see also Thomas Fields et al., Empirical Research on Accounting Choice, 31 J. ACCT. & ECON. 255 § 4.2.2 (2001).

growth pressures were increasing. Though not well acknowledged at the time, this trend produced an obvious agency-cost problem because executives could cash out their stock in the near-term stock market.\footnote{11} We could expect them, therefore, to focus obsessively on the immediate stock price—and perhaps manipulate it if they could—with less attention to the long term.

In the aftermath of Enron and the like, this second story has come to dominate, and many of the Sarbanes-Oxley reforms operate on the premise that these scandals simply demonstrated the severity of the agency-cost problem. The popular account was about executive selfishness and greed to the detriment of the firm's shareholders. My suspicion, however, is that while both accounts are important, it is actually the first that takes precedence.\footnote{12} An important force that was driving the managers in Enron and WorldCom to create illusions of growth was that any disclosure of weaknesses or problems (shortfalls in customer orders, increases in costs or liabilities, etc.) would have translated into an advantage for the firms' competitors and a potentially lethal loss of competitive edge in the product or capital marketplace.

That these illusions also directly increased the managers' own wealth is far from trivial—basic psychology teaches that executive inference is heavily self-serving\footnote{13}—but hard to disentangle from the connection to financial misreporting. The fact that so many of the executives in these scandals sold only portions of their portfolios

\begin{itemize}
\item \footnote{12} See Baruch Lev, \textit{Corporate Earnings: Facts and Fiction}, 17 \textit{J. ECON. PERSP.} 27, 36 (2003):
\begin{quote}
While the image of managers who feather their own nests attracts an understandably large share of attention ... my sense is that the more common reason for earnings manipulation is that managers, forever the optimists, are trying to "weather out the storm"—that is, to continue operations with adequate funding and customer/supplier support until better times come.
\end{quote}
\item \footnote{13} See, e.g., George Loewenstein, \textit{Behavioral Decision Theory and Business Ethics: Skewed Trade-offs Between Self and Other}, in \textit{CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS} 214, 221 (David M. Messick & Ann E. Tenbrunsel eds., 1996).
\end{itemize}
before the collapse of their stock prices strongly suggests that the frauds that occurred were not primarily about personal wealth maximization. Executives were betting that the illusions could indeed become self-fulfilling—that the immediate competitive gains from shading the truth would more than compensate for any harms flowing from a loss of credibility were the truth eventually to be discovered. Many of these bets were predictably overly optimistic. Most, however, were probably made with the sense that, at the time, they were aggressively consistent with the firm’s interests.

II. TECHNOLOGY’S SECOND DIMENSION: THE RISE OF THE UNSTABLE RETAIL INVESTOR

The second place where technology played an important causal role in the financial scandals was in the mechanisms of investment. The unfixing of brokerage commission rates in the 1970s led to the rise of the discount broker, who cut commission fees by reducing the broker’s role in the provision of customized investment advice. The broker’s self-interest, however, was still in active trading by the customer, hence the search was on for low-cost ways of prompting customer demand. By the 1990s, the Internet offered the ideal mechanism, permitting inexpensive, rapid execution without any costly broker involvement yet providing a rich display of investment-related information that—if portrayed in the right way—could entice the investor to trade with greater and greater frequency. Soon on-line trading became the norm for the active retail investor, growing with exceptional speed. By the first quarter of 2000, some twenty percent of all trading was being generated by on-line accounts.
This phenomenon was fed not only by the on-line brokerage firms such as E-trade but by the financial media as well. Financial websites delivered greater streams of data and cable television followed suit. A number of cable networks devoted their programming during trading hours completely to market and issuer information, making celebrities of executives, analysts, and their own reporters. The connection between cable coverage and on-line trading is clear. A study by Busse and Green of a popular show on CNBC showed that stocks mentioned favorably, on average, had a forty-one basis point positive abnormal return in the first minute of an interview that was favorable to the issuer and sixty-two basis points within fifteen minutes. Retail investors were competing with market professionals to gain an edge via rapid-fire trading.

The growing influence of retail investors in daily trading—especially those focused on the technology sector—suggests that prices may have become more volatile and noisy as a result. Putting aside for a moment the wisdom of professional traders, recent studies of retail investor behavior demonstrate marked tendencies to trade on “pseudo-news” rather than careful fundamental analysis, resulting in a tendency toward trend-chasing and overreaction to highly salient bits of information. The deepest study of actual on-line trading in accounts at a large discount brokerage firm during the 1990s showed that on-line traders demonstrated considerable overconfidence, trading at higher and higher velocity in response to positive market news with little regard for the fact that even their discounted brokerage fees were eating up their returns. At times the evidence is comical. During the 1990s, MCI

17. Jeffrey A. Busse & T. Clifton Green, Market Efficiency in Real Time, 65 J. FIN. ECON. 415, 421 (2002). To be sure, this effect dissipated quickly, and Busse and Green do not put it forth as evidence of inefficiency. The point is simply to illustrate the potential for influencing prices on a more sustained basis.
18. See Ofek & Richardson, supra note 7.
(coincidentally, the company that became WorldCom) was a fast-growing company. Its ticker symbol was MCIC; a small closed-end investment company, Massmutual Corporate Investors, had claimed the symbol MCI. With regularity, the release of positive news by the big MCI would lead to a statistically significant run-up in the price of Massmutual shares simply because investors were mistakenly buying its stock because of the confusing ticker symbols.  

It appears that increasing retail investor involvement in the daily trading markets contributed to a nontrivial reduction in market efficiency, at least in the technology sector. The increasing influence of the so-called noise traders made it more likely that markets would be hyper-sensitive to some kinds of information that are, in the proper context, relatively insignificant, while being insensitive to other kinds of information that may be more relevant to the company's long-term prospects. Consequently, on-line trading began to flourish roughly at the same time that companies became so fearful of falling short of analyst earnings estimates even by a penny.

If this correlation between investor overreaction and earnings management is accurate, the first two technology stories connect. As I have shown, issuers were under increasing pressure to create favorable impressions in the capital markets and avoid negative surprises. Noise trading made the markets more easily manipulable, as issuers learned what kinds of disclosures would excite investors—and gain favorable attention on outlets like CNBC—and what had to be avoided. The disclosure and financial reporting script was rewritten for a more emotional, less sophisticated audience. This was also the time, it turns out, when some sell-side

23. See Ofek & Richardson, supra note 7.
24. The evidence here is admittedly circumstantial. One study has shown that firms with relatively greater institutional ownership are more likely to work hard to meet or exceed expectations—i.e., engage in careful earnings management. See Dawn A. Matsumoto, Management's Incentives to Avoid Negative Earnings Surprises, 77 ACCT. REV. 483, 489 (2002). That would suggest that earnings management is targeted at active institutional traders; however, it is at least plausible that the institutional traders are engaging in momentum strategies premised on predictions of overreaction by retail investors.
investment analysts were allegedly being enlisted to assist issuers in their reporting "spin" instead of offering unbiased advice.  

In sum, both the motive and the opportunity to create sustained illusions in the markets increased during the 1990s. This, in turn, had an effect on the psyches of corporate executives. The financial reporting process commands respect when disclosure of material information leads to a measured, rational response. When pseudo-news excites or depresses, and much important detail and perspective seems simply to be ignored, managers can readily become cynical about disclosure and reporting, seeing it as little more than a game. This conception of disclosure can easily lead them to trivialize the substance of mandatory disclosure, resulting in managers giving themselves implicit permission to skew the facts without substantial guilt, so long as they think that the firm and its long-term shareholders benefit from the spin. It is easy to think that an investment marketplace that acts with more exuberance than prudence neither wants nor deserves disclosure in strict conformity to the rules. That rationalization contributed mightily to the devolution of reporting norms.

25. See, e.g., Roni Michaely & Kent L. Womack, Conflict of Interest and the Credibility of Underwriter Analyst Recommendations, 12 REV. FIN. STUD. 653, 657-60 (1999). This development, of course, became the basis for major reform efforts, as evidenced in the Sarbanes-Oxley Act and its aggressive enforcement led by New York Attorney General Elliot Spitzer. For a legal analysis, see Jill E. Fisch & Hillary A. Sale, The Securities Analyst as Agent: Rethinking the Regulation of Analysts, 88 IOWA L. REV. 1035 (2003).


27. Until recently, at least, the foregoing discussion would quickly be met by the claim that noise traders cannot have a sustained impact on market prices because the smart money would arbitrage away the distance between the price and fundamental value. There is no doubt that arbitrage can and does work under some circumstances, but there is a growing acceptance that it does so very imperfectly. See, e.g., Andrei Shleifer & Robert W. Vishny, The Limits of Arbitrage, 52 J. FIN. 35, 47-49 (1997). Constraint on short-selling is one main reason. The other is that while there can be consensus among sophisticated traders that a price is too high or too low, the question of when the noise will dissipate is fraught with uncertainty. That risk leads to underinvestment in corrective trading.

Enron has provided a good illustration, because many professionally advised pension funds and mutual funds were significant losers, buying Enron stock very late in the process (after warning signs were becoming more vivid) and holding too long. The explanations are varied, but many scholars focus on the herd-like behavior of portfolio managers—behavior that is a rational temptation given compensation arrangements in this field. See, e.g., Paul A. Gompers & Andrew Metrick, Institutional Investors and Equity Prices, 116 Q.J. ECON. 229, 257 (2001); Russ Wermers, Mutual Fund Herding and the Impact on Stock Prices, 54 J. FIN. 581, 583-86
III. TECHNOLOGY'S THIRD DIMENSION: BREAKING THE TRADITIONAL BOUNDARIES OF THE FIRM

A. Derivatives and Synthetics

The fall of Enron, in particular, has focused much attention on the extensive use of structured finance techniques and derivatives financing in the structure of the modern corporation. Structured finance is the less technology-driven development of the two, though modern information technology is essential to it in important respects. Assets and liabilities can be transferred to a related entity for financing purposes such that investors need only be concerned with the financial condition of that entity, presumably leading to a more favorable evaluation. The accounting treatment—on which Enron slipped—permits the transferred assets and liabilities to be separated from the originating company's balance sheet and income statement. Derivatives are more clearly a product of technological innovation: highly complex, customized contractual arrangements for allocating the risk of almost anything between the counterparties. In Enron, the potency came from their combination. The special purpose entities entered into extraordinarily complicated risk allocation contracts with Enron that were pegged to a variety of measures, including Enron's own stock price.

From a financial reporting standpoint, several points deserve attention. First, the fact that each derivative is customized makes

(1999). Portfolio managers are much more concerned with not lagging behind their peers than with outperforming them, because the penalty/reward structure is asymmetric. If Enron has been doing well lately, the herd will be inclined to stay with the momentum and feed additional money into it, thereby accelerating the momentum in the short run. In the face of this phenomenon, managers are reluctant to defect from the group by selling for fear that the momentum will continue and they will be left behind. The effect is to feed the influence of the noise traders rather than to counteract it.


29. Frank Partnoy suggests that the Special Purpose Entities (SPEs) by themselves would have been harmless without the derivatives element. See PARTNOY, supra note 6, at 373-92, 397-99; Frank Partnoy, A Revisionist View of Enron and the Sudden Death of "May," 48 VILL. L. REV. 1245, 1249-62 (2003).
valuation difficult individually and impossible in the aggregate. The contingencies written into the arrangements are mind-numbingly intricate. Depending on how events play out, there are endless possible end-states. And when these instruments are bundled into the firm's portfolio, they interact in countless possible ways. This uncertainty tempts financial executives who would prefer to hide the level of risk assumed by the firm, because even a sophisticated, dedicated investment analyst is unlikely to try to untangle the complexity.\textsuperscript{30} A firm, like Enron, that aggressively wants to leverage its capital structure can do so opaquely. In an efficient market the mystery itself would be penalized to reflect the outside world's risk of uncertainty.\textsuperscript{31} Yet in the 1990s, at least, the market did not react that way.

Derivatives also blur—perhaps even make meaningless—the line between debt and equity. They are not equity securities because they involve obligations to pay. The complex set of contingencies typically built into them, however, permits the assumption of risk well beyond that ordinarily identified with debt. They fit nowhere particularly well, either on the balance sheet or the income statement. Users of the financial statements who rely too heavily on simple metrics like solvency or earnings per share are endangered.

In terms of the dimension described earlier, derivatives are part of the opportunity story—a firm wanting to create an illusion to gain access to capital or other resources can obscure its liabilities and risks far more easily by using them extensively. (Of course, so can executives whose motives are more selfish.) Likewise, the more insiders feel the need to gamble their way out of difficulty, the more they can do so without triggering the traditional financial metrics that signal trouble when more conventional techniques are used.


\textsuperscript{31} This is a classic “lemons” problem, as described by George Akerlof. See George A. Akerlof, \textit{The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism}, 84 Q.J. Econ. 488 (1970).
B. Business-to-Business Relationships

The derivatives story behind Enron and some of the other financial scandals is well-known. Many of the scandals, however, have less to do with synthetic financial instruments and more to do with conventional accounting questions like revenue recognition and capitalization versus expensing. Here, the technology link is more subtle but quite profound.

There has been a so-called "revolution" in business-to-business relationships at both ends of the production process. The relationship between firms and their suppliers has become much closer than the old-style market sale transaction. "Just in time" delivery systems emphasize supplier investment in firm-specific knowledge and close communication so that fluctuations in demand can be handled seamlessly. As many have noted, this revolution blurs the traditional boundaries of the firm. The "make or buy" decision that has long characterized the firm means less when external suppliers form supple long-term relationships with the company. These long-term relationships represent a decision somewhere in between "make" or "buy." So, too, do customer relationships, which simply reflect this same dynamic a few steps down the line.

The result is that many of the historic conventions of financial reporting have rapidly become much more artificial. Here,

32. For a good overview of revenue recognition fraud issues, see Manning Gilbert Warren III, Revenue Recognition and Corporate Counsel, 56 SMU L. REV. 885, 909-22 (2003).
35. In addition to this trend, technology has an impact in terms of the relative value of intangible (i.e., intellectual) property as compared to other assets. Accounting's historic reluctance to allow firms to claim the full value of these intangibles effectively hides them from view and implicitly penalizes firms whose value resides in the intangibles vis-a-vis those whose assets are more tangible. See MARGARET M. BLAIR & STEVEN M.H. WALLMAN, UNSEEN WEALTH: REPORT OF THE BROOKINGS TASK FORCE ON INTANGIBLES 7-10, 23-31 (2001); ROBERT G. ECCLES ET AL., THE VALUE REPORTING REVOLUTION: MOVING BEYOND THE EARNINGS GAME 221-24 (2001); see also Steven M.H. Wallman, The Future of Accounting and Disclosure in an Evolving World: The Need for Dramatic Change, 9 ACCT. HORIZONS 81, 84-86 (1995). A feeling
WorldCom offers an example. The main form of accounting fraud alleged against WorldCom was the improper capitalization of $3.8 billion in line costs (i.e., what WorldCom was paying for access to lines built and operated by third parties). By all accounts, generally accepted accounting principles (GAAP) require expensing these costs, which would reduce earnings. WorldCom improperly capitalized them instead and thus showed higher earnings.

While the rules may be clear enough, the economic reality is far less so. WorldCom officials appeared to justify their misreporting on grounds that these particular line costs would generate predictable revenue over a definable period, just like a capital investment. If so, then expensing would also be misleading. Imagine that a company enters into a long-term contract to purchase line capacity, which creates a sense of security that enables the other firm to invest in building or expansion of that capacity. The economics are much the same as if the firm was building the capacity itself, which would permit capitalization and thus favorable income statement treatment. By choosing an economically similar route that does not involve the formalities of internalization, a harsher result ensues.

Now, consider this from the standpoint of the executive making the “make or buy” decision who believes that, simply from a business standpoint, the deal with the third party makes better sense. The technology of business relationships increasingly makes that kind of partnering feasible without taking on costly new employees, facilities, and so on. But to return to the first dimension, assume also that this is a fast-growing firm seeking the maximum advantage in access to capital, customers, and the like. The

that this penalization was unfair would also contribute to a sense that the prevailing norms were illegitimate.


accounting penalty may be intolerable if it creates a competitive disadvantage, even if the economic distinctions are minimal.

The executive will feel immense pressure to gain both the economic and accounting edges. More importantly, if he or she manipulates the accounting decision to capitalize even though GAAP forbids it, there is unlikely to be much guilt. The convention is purely artificial, penalizing legitimate economic choices without reason other than to maintain old-fashioned distinctions in the rules. 38

Under these circumstances, some will adhere to the rules and others will not. Psychologists teach that compliance with the law, at least when there is a relatively low probability of detection, is heavily influenced by perceptions of the legitimacy of the rules. 39 I strongly suspect that over the course of the 1990s, as the boundaries of the firm became less distinct with respect to both suppliers and customers, executives who had so much to lose from any given accounting treatment came to disdain the artificiality of the accounting rules as they applied to these areas. As that disdain developed into a sense that orthodox accounting was penalizing good business decisions, accounting's legitimacy was diminished, and the rate of manipulation and noncompliance rose. High-tech firms—whose emphasis on intangible assets already puts them at a disadvantage under prevailing norms of financial reporting 40—were especially likely to chafe under these constraints. And as noncompliance increased, the pressure grew for competitors to do the same, lest they put themselves hopelessly behind the more

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40. See supra note 35. The treatment of research and development expenditures, which in many cases require expensing rather than capitalization, is another example of penalization that many high-tech firms face. See, e.g., Baruch Lev & Theodore Sougiannis, Penetrating the Book-to-Market Black Box: The R&D Effect, 26 J. BUS. FIN. & ACCT. 419, 435-42 (1999); Lev, supra note 12, at 30-33. My sense, in part, is that the vehemence with which many high-tech firms fought to avoid the requirement that executive stock options be expensed was not simply selfish but also a product of the belief that they were already being disadvantaged and that expensing options would simply push them further backwards.
aggressive firms. Conservative accounting had become a loser's game. Financial reporting norms devolved for this reason, too.

IV. THE FEEDBACK LOOP

A. Testing the Limits

The three important lessons from the foregoing can be summarized:

(1) The incentive to misreport was as much, and maybe more, a product of competitive fear as it was a product of personal greed. Managers in fast-changing, technology-based markets became convinced that earnings aggressive management—and perhaps some cheating—was a survival tactic. Although there was, no doubt, much rationalization and self-serving inference used in developing this tactic, the basic fear was rational.

(2) The stock market provided greater opportunity for cheating by shifting its focus away from careful fundamental analysis to indicators of short-term price movement—a "sound bite" culture. Greater retail participation in daily trading was an important force in this trend.

(3) Innovation in business strategies made the lines drawn in the historic norms of financial reporting increasingly artificial and outdated. Playing conservatively by the accounting rules were seen as conforming to a regime in which fairness and utility were questionable as a reflection of economic reality. In the eyes of many managers, financial reporting had lost its relevance and legitimacy.

These three factors combined into a feedback loop. Managers were pressured to push the limits of the prevailing norms. For a long time no one seriously pushed back. The market responded positively; indeed, it increased its expectations of performance so that exceeding expectations became that much more difficult, requiring all the more aggressiveness. The auditing profession was acquiescent, we

41. See William H. Beaver, What We Have Learned from the Recent Corporate Scandals That We Did Not Already Know, 8 STAN. J.L. BUS. & FIN. 155, 163 (2002) (emphasizing the connection between high growth rates and targets and the pressure to engage in earnings or revenue deception).
are told, because of conflicts of interest in the generation of non-audit fees. Such conflicts of interests are no doubt part of the story, but there is probably more to it. As the accounting norms themselves became more complicated and subjective, the ability to confidently say "no" to a client diminished.42 I suspect that many accountants were also coming to share managers' views about the contemporary relevance of accounting principles,43 which also led to a loss of faith that there were cognizable lines that management should not be allowed to cross.

Nor did the legal system push back. Through most of the 1990s, the SEC was quiet about overly aggressive financial reporting, coming to the subject with too little, too late.44 The explanation here is a mix of limited resources and politics.45 Especially during the height of the bull market in technology stocks, executives from the high-tech industry held immense political power, securing major reform of private securities litigation and beating back initiatives such as mandatory expensing of stock options.46 Challenging conduct that these executives saw as a competitive necessity was bound to be a costly, and probably losing, battle. Hence, the implicit regulatory message was one of ambivalence, born of vain hope that the markets would take note and call the companies to task. SEC Chairman Arthur Levitt's prescient speech in 1998 about accounting

42. See Max H. Bazerman et al., The Impossibility of Auditor Independence, 38 SLOAN MGMT. REV. 89, 93 (1997); Mark W. Nelson & William R. Kinney, Jr., The Effect of Ambiguity on Loss Contingency Reporting Judgments, 72 ACCT. REV. 257, 269-72 (1997); Mark W. Nelson et al., Evidence from Auditors about Managers' and Auditors' Earnings Management Decisions, 77 ACCT. REV. 175, 189-98 (Supp. 2002). The opposite problem also occurred. Under pressure from a variety of sources, some GAAP rules were changed to be more mechanical. That, too, made it impossible for the auditor to resist if the company was literally in compliance, even if the economic substance made no sense. For a useful discussion of these changes, see Paul M. Healy & Krishna G. Palepu, How the Quest for Efficiency Corroded the Market, HARV. BUS. REV., July 2003, at 76, 78-80.

43. See ECCLES ET AL., supra note 35, at 103-08.

44. Note that the SEC's view that GAAP compliance is not a complete defense to a fraud claim resurrected a case, United States v. Simon, 425 F.2d 796 (2d Cir. 1969), that was largely forgotten until after the scandals. See note 64 infra. One would be hard pressed to find that kind of claim aggressively pursued or even threatened by the Commission during the 1990s. The same is true of many other legal positions taken in response to allegations of firms' fraudulent conduct.

45. See Langevoort, supra note 26.

46. For a recounting of the politics associated with these issues, see JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 714-41 (3d ed. 2003).
gimmicks was far more of a wake-up call directed to investors than a signal that a wave of tough enforcement actions was immediately forthcoming.

As a result, managers gradually learned from experience that additional steps in the direction of lower-quality financial reporting paid off without serious penalty. If neither the auditors nor the government was taking reporting seriously, why should they? The feedback loop then became a vicious cycle. The most aggressive executives pushed harder and harder. Enron was sufficiently proud of its regulatory arbitrage that it tried to market its creative accounting services to others. The very fact that it did this so brazenly shows that executives had little sense at this point that their conduct was seriously wrongful. In turn, less aggressive managers conformed. And inevitably some of this aggressiveness crossed over the line to starker forms of fraud. If no one is pushing back, why stop, especially when it is so easy to rationalize the cheating as utilitarian? As the cheating became more pronounced and business downturns occurred, the slippery slope became steeper as some managers realized that they had crossed the line and deliberately took more aggressive steps either to cover up the fraud or to gamble their way out of it. The important thing to remember, however, is how many situational forces combined to make the slope so wet.

47. Securities and Exchange Commission Chairman Arthur Levitt, The "Numbers Game," Address at the New York University Center for Law and Business (Sept. 28, 1998), at http://www.sec.gov/news/speecharchives/1998/spch220.txt. To its credit, the SEC's action, once it began to take the issue seriously, was on the mark, though still not particularly heavy-handed. A key step was the promulgation of Staff Accounting Bulletin 99, which defined materiality for reporting purposes in terms of measures likely to influence investors regardless of quantitative significance. For an application of the materiality standard, see Ganino v. Citizens Util. Co., 228 F.3d 154, 161-68 (2d Cir. 2000).

48. Congress and the judiciary also contributed by making accounting-based "fraud on the market" lawsuits harder to bring. Although a good bit of this effort was in the form of protection to accounting firms and other "gatekeepers," see John C. Coffee, Jr., Understanding Enron: "It's About the Gatekeepers, Stupid," 57 BUS. LAW. 1403, 1409-10 (2002), courts both before and after the Private Securities Litigation Reform Act showed a strong willingness to dismiss cases on the ground that insufficient evidence of scienter was proffered even though the violation of GAAP was clear. See, e.g., In re K-Tel Sec. Litig., 300 F.3d 881 (8th Cir. 2002); Grossman v. Novell, Inc., 120 F.3d 1112 (10th Cir. 1997); Provenz v. Miller, 102 F.3d 1478 (9th Cir. 1996).
B. Evaluating the Harm

That many of the financial reporting scandals were the product of strong situational forces is no excuse, especially to the extent that they caused severe harm. The harm, however, is more difficult to assess than most people think. Popular portrayals often cite the drop in stock price values from their highs as measures of what investors lost. That view, of course, is wrong—the inflated valuations were illusions, and investors who were smart or lucky enough to have sold at or near the highs were simply gaining at some uninformed buyer's expense. The harm came to those who bought at inflated prices and held until it was too late. It is also easy to overestimate the net cost to investors, though surely it was significant. For every unfortunate buyer there was an innocent lucky seller, except to the extent of sales by insiders or others with inside information. Although that fact is scant comfort to the particular buyers in question, it suggests that much of the effect of the fraud was in the form of pocket-shifting. The shareholder group most severely harmed was the set of undiversified investors—such as Enron employees with too much invested in that particular stock49—who bought and held. Less likely to be harmed were active, diversified traders.

Indeed, in many ways scandals like Enron were as much frauds on debtholders as on holders of common stock. Designed in large part to make the company's credit rating appear more solid than it really was, and thus to facilitate access to a fluid supply of money, these schemes were intended to benefit equity holders, albeit with the infusion of a higher level of risk. Securities fraud also harms competitor firms—those who would have gotten more business or better market valuations if fairly compared to their peers, rather than looking inferior because other firms in the industry are cooking the books—which, in turn, leads to capital misallocation.50 There is a comparative dimension to this harm, however, because once aggressive reporting becomes the norm in an industry, the relative prejudice is lessened. As Judge Posner put it in a related context, in


a setting where puffery is the order of the day, the unvarnished truth becomes misleading.\textsuperscript{51}

Finally, there is the matter of comparative fault. It is hard to disentangle the portion of an inflated stock price that is tied to the misreporting from that simply caused by the market's exuberance. I suspect that many of the fraud cases occurred where the firm in question hit a streak of good fortune that generated an excess of investor enthusiasm and a stock price run-up without any serious misreporting. The situational pressures came from the desire to avoid negative surprises that would trigger an overreaction on the downside. In measuring the harm, the question is how much of the inflation would have occurred regardless of any fraud (i.e., was simply the product of investor exuberance) and how much was directly attributable to the misreporting. That question is not easily answered, either—certainly not simply by looking at the deflation that occurred once panic set in.\textsuperscript{52}

\section*{V. EFFECTIVE REGULATORY REFORM}

\subsection*{A. The Starting Point}

The likely efficacy of the regulatory reform stimulated by Sarbanes-Oxley can be measured against the foregoing. Technological innovation is accelerating. There is no reason to believe that the pressures or the innovations described earlier will change. Thus, we can expect managers to be operating under those constraints for the foreseeable future. Market efficiency is more episodic. I am not willing to predict that the "retailization" of daily trading activity will be a permanent part of the capital markets; we could just as well see a return toward institutionalization if retail investors learn that active trading leads, on average, to inferior returns. History, however, teaches that investor sentiment, and carelessness, is cyclical and that there will be future periods of opportunity when the other pressures result in issuer-generated illusions that too easily become impounded in market price.

\textsuperscript{51} Eisenstadt v. Centel Corp., 113 F.3d 738, 746 (7th Cir. 1997) ("Where puffing is the order of the day, literal truth can be profoundly misleading, as senders and recipients of letters of recommendation well know.").

\textsuperscript{52} See Langevoort, supra note 20, at 182-86.
Therefore, regulation has to be designed carefully in light of these realities and should not reflect a simplistic impression of what happened to give rise to the scandals. Take, for example, the increased independence requirements for audit committee members and board members generally.\textsuperscript{53} The prevailing impression that financial misreporting was about executive greed and the self-serving desire to facilitate option exercises at the expense of the company's long-run interests easily justifies the effort to shift more power to outsiders. Implicitly—and explicitly, perhaps, in the SEC's recent efforts to allow large shareholders greater voice in nominating directors\textsuperscript{54}—the idea is to have directors whose interests are more closely aligned with those of investors. If much of financial misreporting is competitive rather than selfish, however, we cannot expect such directors to interfere to any great extent. At best, they might moderate managerial over-optimism, but even this is not clear.\textsuperscript{55} Ironically, the scenario where independent directors are more likely to check this kind of behavior is where they are less interested in the returns to investors being generated by the company and thus more sensitive to their own liability risks. Directors who attend to nonshareholder constituencies—a group that plays an underestimated role in corporate governance\textsuperscript{56}—could fall into this category of those more likely to seek legal compliance even in the face of strong competitive pressures. That is a very


\textsuperscript{56} Governmental authorities, in particular, are an important nonshareholder constituency for directors who have close connections with them. See generally Anup Agrawal & Charles R. Knoeber, Do Some Outside Directors Play a Political Role?, 44 J.L. & Econ. 179 (2001) (pointing out that many directors are valuable to the boards on which they serve primarily for their political connections). This point connects to debates about shareholder primacy—undue attention to shareholder interests, especially when measured in short-term results, is not the same thing as the best interests of either the firm itself or society as a whole. See, e.g., Margaret M. Blair, Directors' Duties in a Post-Enron World: Why Language Matters, 38 Wake Forest L. Rev. 885, 891-95 (2003); Bratton, supra note 2, at 1326-28, 1359-60.
different direction from most of the reform strategies we observe, which have bought heavily into the managerial selfishness story.

B. The Philosophy of Financial Reporting

Much of Sarbanes-Oxley's reforms are intended to restore both integrity and primacy to financial results as reported in accord with generally accepted accounting principles. The process by which GAAP is created is made more independent from the industry.57 A new Public Company Accounting Oversight Board has been created to oversee and monitor auditor behavior.58 Conflicts of interest within auditing firms have been lessened.59 The hope is that accounting rules will be less management-oriented and more inclined toward investor protection. In turn, issuers are barred from reporting financial results outside of GAAP without engaging in a cumbersome process of disclaimer and reconciliation.60

Whether this will work is unclear. If I am right about the pressures on the reporting process just described, technology-driven innovations are sure to overwhelm a system that is based on rules rather than principles.61 The more concrete the tests,62 the more effort will be devoted to finding sophisticated mechanisms to run ahead of them. It is doubtful that any regulatory body has the capacity—in terms of resources or expertise—to keep pace with this sort of innovation. Moreover, the accounting profession is still biased in the direction of rules that are complex and manipulable, because that increases the need for and value of their expertise and

62. See Benjamin S. Neuhausen & Reva B. Steinberg, New Consolidation Rules for VIEs—Formerly Known as SPEs, INSIGHTS, Apr. 2003, at 19, 20 (discussing the 3% equity requirement for SPEs, which has been revised to 10%).
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generates substantial returns in areas such as tax advisory services, which are expressly permitted under Sarbanes-Oxley.

As a result, reliance on GAAP is necessary but not sufficient. Notably, senior executives will have to certify that the company's financial reports are not only compliant but "fairly present ... the financial condition and results of operations of the issuer." We are told that this certification requirement will be a centerpiece of securities law enforcement, both civil and criminal. More generally, the SEC has also brought back to life an old accounting case, United States v. Simon, which held that GAAP compliance is not a defense to accounting fraud; reports can apparently be both compliant and false and misleading. The SEC has also reinterpreted the Management Discussion and Analysis requirement to be the primary bridge between reported results and economic reality so that issuers risk being in violation if they conceal whatever is creating the difference.

Lurking herein is a problem to which lawyers have paid too little attention: what, precisely, is the right baseline for financial reporting? This is not just another way of asking the important question of whether the accounting rules should be tilted toward principles rather than rules, wherein we have to decide how much subjective discretion should be afforded those responsible for preparing or auditing the financial statements. In light of technological innovation, I think principles are plainly preferable to rules, even if this increases the resources that must be devoted to ex post

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64. 425 F.2d 796, 805-06, 808-09 (2d Cir. 1969). For a critique of broad readings of Simon, see Christian J. Mixter, United States v. Simon and the New Certification Provisions, 76 St. John's L. Rev. 699, 703-05, 708-13 (2002). Read carefully, it is not clear that Simon is necessarily about the issue cited—though dicta in the case certainly can be so read. My explanation of the case—which involved nondisclosure of certain insider transactions—is that the accountants aided and abetted the insiders' fraud by certifying the financials as GAAP compliant when apparently they were aware of the self-dealing scheme.
enforcement.\textsuperscript{67} Even in a principles-based world, however, the question is: what principles?

Take, for example, one of the fundamental principles on which accounting has long been based: conservatism.\textsuperscript{68} Caution should rule in the face of uncertainty—hence, the bias is usually to overstate costs (or losses) and understate income (or gains). Many more specific accounting rules are bright-line efforts to impose this same bias on financial results. Should conservatism be a guiding principle in a post-Enron world?

While many people instinctively say "of course"—especially with the recent scandals in mind—remember that conservatism nearly assures reporting inaccuracy. Imagine, for example, the CEO asked to certify that financials that have been prepared conservatively "fairly present" the financial condition and results of operations of the firm. If, by fairly present, we mean "reflect economic reality," then they almost surely do not—because they are probably too conservative. Indeed, if the story we told earlier is right, there are likely numerous places where either conservatism or some cognate accounting rule or principle results in an artificial representation of the firm's condition that is significantly distinct from economic reality.\textsuperscript{69} And that is with faithful, indeed slavish, adherence to GAAP.

This is hardly a novel insight. For years now the accounting profession has been debating the role of "fair value" accounting in which the objective of all prevailing rules and principles is to

\textsuperscript{67} As Professor Bratton has pointed out, a principles-based regime depends on a strong enforcer, given management's temptations to construe ambiguous, subjective principles in its favor. If the accounting profession is not sufficiently reformed, then only aggressive enforcement will do. See William W. Bratton, \textit{Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents}, 48 \textit{Vill. L. Rev.} 1023 (2003) (arguing that tough enforcement is necessary if Sarbanes-Oxley is to have its intended effect). On the tendency of accountants to see ambiguous rules in self-serving terms, see Max H. Bazerman et al., \textit{Why Good Accountants Do Bad Audits}, \textit{Harv. Bus. Rev.}, Nov. 2002, at 97, 98-99.


\textsuperscript{69} For a good discussion of the advantages and disadvantages of GAAP as a generator of "quality" earnings, see Stephen H. Penman, \textit{The Quality of Financial Statements: Perspectives from the Recent Stock Market Bubble}, 17 \textit{Acct. Horizons} 77 (Supp. 2003).
present the performance of the firm in a fair and unbiased fashion.\(^70\)

Best estimates of current valuations ("mark to market")\(^71\) substitute for historic cost and other artificial measures. The argument for fair value, of course, is that the conservatism bias in accounting effectively limits managers' ability to portray accurately the firm's financial condition, which is not necessarily in the shareholders' best interests. After all, the securities laws are built on investors' need for accurate information. Any reporting rule, such as accounting standards that deal with expensing versus capitalization, that fails to capture economic reality with a high enough level of sensitivity risks communicating misleading information to investors, distorting rather than aiding inter-firm comparisons. This risk is one reason why accounting scholars often point out that earnings management creates potential benefits for investors as well as imposing obvious costs.\(^72\)

We saw that frustration with the artificial norms of reporting may have motivated the inclination to test limits and become cynical about the relevance of GAAP reporting, especially in the high-tech sector.\(^73\) Some of those who began to manage earnings and other financial results were fair value revolutionaries, engaging in acts of GAAP disobedience after convincing themselves that their reports were a fairer representation of the information to which investors should be paying attention. A number of investigations—including WorldCom\(^74\) and recently, Freddie Mac\(^75\)—have noted that management responsible for the violations justified their violations on precisely these grounds.

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\(^71\) Id.


\(^73\) A survey of executives has demonstrated that while most believe their companies to be undervalued in the market, the perception is strongest among high-tech managers. See Eccles ET AL., supra note 35, at 48.

\(^74\) See supra text accompanying notes 36-38.

\(^75\) See Patrick Barta et al., *Behind Freddie Mac's Troubles: A Strategy to Take on More Risk*, WALL ST. J., Sept. 22, 2003, at A1, A12 ("Some Freddie Mac officials who were involved in the matter privately say they believed the maneuvers actually gave a truer picture of the business.... The Baker Botts report confirmed this motivation.").
The conservatism bias, however, has compelling virtues that make it hard to reject. It counters managers' natural bias toward optimism—thus offering a more credible anchor from which future earnings can be estimated—and constrains managerial opportunism.\(^76\) When there is no reliable market, mark-to-market accounting invites highly skewed estimates, as happened in Enron. Knowing that assets are real and that movements of funds and property are properly recorded, even if in accord with artificial rules, is a good way of keeping managers honest in their stewardship of the company. Moreover, financial statements play multiple roles. From the standpoint of a creditor of the firm, conservatism and artificial rules make ample sense: because there is only downside risk and no upside participation, conservatism operates as a useful buffer in conveying warnings about potential solvency problems. That accounting principles were born at a time when bank lending and other forms of debt financing dominated corporate financial activity plausibly explains the strength of the bias.

The equity holder with a relatively short-term investment horizon—interested in the upside as well as the downside—is in a more ambiguous position, however, because there is a clear trade-off between accuracy and verifiability.\(^77\) My suspicion is that we have another piece of the story here. The 1980s and 1990s brought the flourishing of an equity culture and the significant acceleration of portfolio turnover by both institutional and retail investors. Managers, too, took on this perspective as their compensation packages became more heavily equity-based and liquidity-oriented. With an equity bias, accounting discipline was viewed as especially rigid and confining. In turn, this rigidity exacerbated broader concerns. Another strong complaint against GAAP is that it penalizes "knowledge"-based firms by excluding measures of intellectual and human capital, wherein real comparative advantages lie. Conventionally computed earnings are also misleading for

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76. See, e.g., Penman, supra note 69, at 81-93.
77. See, e.g., William W. Bratton, Shareholder Value and Auditor Independence, 53 DUKE L.J. 439, 453 & n.53 (2003); Watts, supra note 68, at 3-4.
78. Investors with a very short-term horizon who trade on volatility may well prefer aggressive accounting to the extent that they believe they can game the system. See Bratton, supra note 77, at 462.
that reason.\textsuperscript{79} We miss something if we forget that the era of accounting scandals occurred at a time when so many people thought that GAAP was in many ways archaic. They were—and still are—probably right.

My point here is not to take a position on the relative merits of conservatism and the various approaches to fair-value accounting. Instead, I am simply offering context. Much of Sarbanes-Oxley—not to mention media attention to the scandals—operates as if GAAP is a form of religious orthodoxy from which departures can properly be labeled heresy, making earnings management patently sinful. The truth is far murkier, however. As a leading accounting scholar, Baruch Lev, has observed, "[t]he extent to which GAAP fulfills its mission—the dissemination of quality financial information, and earnings in particular, to facilitate investors' valuations and the monitoring of management—has frequently been challenged, but never more hotly than in the last couple of years."\textsuperscript{80}

So long as the underlying philosophy of financial reporting is doubted, a strong norm of compliance is unlikely to emerge. Moreover, in light of these doubts, even material, intentional accounting violations are likely to run along a lengthy continuum of wrongfulness.\textsuperscript{81} From the standpoint of investors, at least, a violation that takes the report farther away from the underlying economics is far more serious than one that takes it closer—and both kinds of cases are likely to arise with some frequency.

Most importantly, what this means is that over-deterrence can have significant costs. Imagine, for example, that the upshot of the certification requirement for senior executives is to make them virtual guarantors of GAAP compliance, at the risk of criminal prosecution for defection. Assume further that this requirement works as intended and that executives obsess on compliance. In a regime where conservatism is the dominant philosophy, there is likely to be an excess of caution, so that reports move further away

\textsuperscript{79} See, e.g., Thomas A. Stewart, Accounting Gets Radical, FORTUNE, Apr. 16, 2001, at 184-86; see also supra note 35.

\textsuperscript{80} Lev, supra note 12, at 32.

\textsuperscript{81} For a provocative claim about why some degree of earnings management is a distinct social good, see Anil Arya et al., Are Unmanaged Earnings Always Better for Shareholders?, 17 ACCT. HORIZONS 111 (Supp. 2003).
from economic reality. Because it is too dangerous to push against the norms, the value of the underlying information is reduced.

I am not necessarily predicting this result because the technology-driven pressures toward “competitive” financial reporting are so strong. What I am suggesting instead is that many executives are likely to be caught in the middle of these forces, making the cases that arise as a result very hard. Many of the recent reforms move the rock and the hard place closer together. The rule that makes non-GAAP disclosures far more difficult is an example, because it chills the issuer's use of one of the methods of communicating a different story about economic reality. Regulation FD (Fair Disclosure)—the ban on private communications of material nonpublic information—however well-justified on other grounds, closes another avenue to telling the non-GAAP story.

No system of enforcement will achieve the right balance if it ignores the ambiguity and debate surrounding the threshold question of what constitutes a “good” financial report in the first place. Passing judgment on often ambiguous conduct and its net of social benefits and harms is an extraordinarily difficult task—not the easy, Sentencing Guidelines-like formula that we have been led to think it is. Hence, we should turn to the process of enforcement and adjudication to see if it is up to the task of disentangling the good guys from the bad in settings where the distinctions involve so many different shades of gray.

VI. A Fresh Look at the Enforcement and Remedies

If the foregoing is right, then post-Sarbanes-Oxley securities regulation has to accept the permanence of innovation and respond

82. Nor would such a regime be politically stable. Cf. John C. Coates IV, Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis, 41 VA. J. INT'L L. 531, 561-64 (2001) (advocating the use of a model that takes into account the ability of executives to "capture" government enforcement mechanisms in the disclosure area). Strong deterrence is expensive and difficult, making it likely that prosecutions would be fairly random and episodic. The fear of unfairly being singled out for criminal-like punishment would likely trigger a political backlash from managers—perhaps justifiably—that would quietly seek to disable the enforcement system.

83. See supra note 60.

accordingly. So long as there remains a disconnection between GAAP and economic reality, there will be intense pressures on the system and a large amount of managerial conduct that will test the limits of the rules. Accepting arguendo that this gap cannot be eliminated without introducing so much subjectivity that the system loses its grounding (and becomes far less useful for creditor protection or for supervising management's stewardship over assets), the best solution is care and moderation in its application.

Securities regulation, then, has to be flexibly responsive to technological change. This approach requires an enforcement system capable of responding quickly to police line-challenging conduct and an adjudicatory system capable of evaluating the nature of any misconduct and of applying a remedy. On the assumption that proportionality is in the long-term interest of investors, the question becomes what kind of adjudicatory system best delivers proportionate results. Again, the task of the adjudicator is to untangle the complicated reporting mess and determine what the motivations were, how bad the misconduct was in context, and what the right remedy is in light of the factual findings. That task is extremely hard, and it is doubtful that the federal courts have the patience and business expertise to make these judgments with consistent accuracy. Indeed, business expertise is lacking in the judicial system, with the exception of the Delaware judiciary, which uniquely has both the incentives and opportunity to learn from experience and become skilled at these tasks.

This reality suggests to me that the federal securities adjudicatory process should be made, as much as possible, an administrative rather than judicial process. Use of administrative law courts is the norm in banking and other financial services regulation and in the SEC's supervision of securities professionals. 85 Administrative proceedings in those areas can be used to fine, censure, and bar subjects from continued involvement in the industry—a powerful set of penalties.

Securities regulation has not, however, internalized the adjudicatory process with respect to public company wrongdoing. That task was left to the judicial process. To be sure, there have

long been administrative remedies that force issuers to correct their filings, and in 1990, Congress added cease-and-desist authority to the Commission's in-house toolkit. But this expansion of authority did not have any significant punitive capacity. In Sarbanes-Oxley, however, there was a little-noticed change that has begun a revision here—allowing the SEC to use cease-and-desist proceedings to bar officers and directors involved in securities misconduct from further service in that capacity with any public company. The Commission can now bring a financial misreporting case internally that is designed not simply to expose the conduct but also to punish the executives involved. More recently, the SEC has asked Congress to add to this authority the ability to impose fines on the executives and the companies. Were the remedial package complete, the administrative proceeding could be the mechanism of choice for the adjudication of financial misreporting cases, creating the possibility that the administrative law judges could over time gain the expertise in this area comparable to the Delaware chancery.

If administrative law judges were indeed given the opportunity to develop such an expertise, the change in corporate and securities law might be profound. Internalizing corporate misreporting and fraud cases would permit administrative law judges and the SEC not only to find the facts but also to develop law, subject to (presumably deferential) appellate oversight by the courts. In other words, there would be a shift that would permit the Commission to have a greater voice in evaluating conduct going to the core of financial disclosure and in a wide range of matters touching on corporate governance. There is no meaningful line between the spheres of governance and transparency; they overlap greatly. Recall that one of the great innovations in corporate law—the prohibition against insider trading—was set in motion by the SEC by using its lawmak-

86. Id. at 865-73.
89. A truly complete system would include equitable relief beyond the accounting and disgorgement specifically authorized under Section 21C(e), though it would probably be acceptable to require judicial assistance in granting this sort of remedy.
ing ability in bringing its first case against a stockbroker. By finding open-market insider trading to be a fraud—notwithstanding a nearly universal assumption to the contrary at that time—the Commission federalized a form of perceived managerial opportunism. Broadening the scope of the Commission's authority to do the same to the full range of undisclosed executive misconduct would expand the Commission's lawmaking ability considerably.

That proposal no doubt frightens many and seems to be an assault on federalism. Indeed, efforts have been made in the bills dealing with penalty authority to create a direct right of appeal to a federal district court from the administrative law judge’s imposition of a penalty, which would substantially reduce the full Commission's ability to make law. My sense is that the net of risks and benefits from administrative adjudication makes internalization attractive over a variety of dimensions. It is the one system likely to deliver the consistent, expert, and proportionate response to financial misconduct and, thus, the most stable balance in investor protection. Enlarging the SEC's adjudicatory power makes it less likely that future scandals will lead to the kind of heavy-handed reaction implicit in portions of Sarbanes-Oxley.

CONCLUSION

Technological innovation poses a problem for all forms of regulation, not just securities. Regulatory lag is inevitable when the pace of change is fast and the subject complicated. When that kind of lag is coupled with a loss of restraint by the class of persons to be protected, as occurred in securities regulation in the 1990s, opportunism is almost certain.

In 2003, by virtue of hindsight, that opportunism looks particularly venal and corrupt. A serious attempt to remember what it was like five years or so ago, however, changes the picture. A survival-of-the-fittest contest was going on in a variety of product markets, with the sense that the winners would take much, if not nearly all.


Aggressiveness was celebrated, and investors were enthusiastic to place their bets on who would prevail. It turns out that many firms inflated their prospects in search of capital and customers out of some mixture of greed and fear. For some, the bubble burst completely.

The purpose of securities regulation is to restrain the worst kind of insider opportunism and make transparent as much about issuers as is practicable.93 We have to look hard at each of the so-called scandals to find out the extent to which the misreporting was driven by executive selfishness to misappropriate value from investors. To this extent, harsh remedial intervention is needed. But if we find more of an excess of competitive zeal in a time of extraordinary normative uncertainty—aided by the market's own exuberance and the law's ambivalent signals—the response should be more measured. Lumping all the rule-breaking into a single tale of corporate evil makes for bad justice and bad policy.

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