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MANAGING THE “EXPECTATIONS GAP” IN INVESTOR PROTECTION: THE SEC AND THE POST-ENRON REFORM AGENDA

DONALD C. LANGEVOORT*

I. INTRODUCTION

As far as we know, the Enron story is one of artfully managed expectations. Company executives created high expectations among investors regarding the company's growth potential and their unique skill-set to reach it, producing for a time an extraordinarily high stock market valuation.\(^1\) Meanwhile, the economic reality was turning out to be more sobering. Increasingly aggressive, apparently fraudulent, steps were taken to report financial results and conditions that would not deflate investors' expectations in a way that would put the managers' jobs, compensation and perquisites—not to mention social status and self-esteem—immediately at risk. One can tell similar stories about other of this past year's financial reporting scandals, like WorldCom and Global Crossing.

I will return to this account later. For now, I simply want to note that issuers of securities are not the only possible creators of "expectations gaps." In the disclosure area, the term was coined to describe the difficulties the accounting profession faces with investor expectations that the audit process "assures" accurate reporting on the one hand, and the reality that audits are far from fail-safe on the other.\(^2\) But it applies more broadly to all of securities regulation. The rhetoric of securities regulation—much

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1. I am sure that the Enron story is still not fully understood. For now, I am taking my account from press reports, the so-called "Powers Report" (REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (Feb. 1, 2002) (on file with the author)) and Bill Bratton's excellent article on the subject (William W. Bratton, Enron and the Dark Side of Shareholder Value, 76 Tul. L. Rev. 1275, 1276 (2002)). In what follows, I will cite extensively from my own writings on Enron and securities law reform, not to be self-referential but simply to avoid repetition. More sustained treatment of many of the points made here can be found there. My most general, albeit pre-Enron, treatment of the appropriate relationship between securities law disclosure and corporate accountability is Donald C. Langevoort, Seeking Sunlight in Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability, 79 Wash. U. L.Q. 449, 453 (2001) [hereinafter Langevoort, Sunlight]. A good bit of what follows draws from ideas developed in that article.

of it generated by the Securities and Exchange Commission (SEC)—trum-
pests our commitment and success in creating strong marketplace integrity,
inviting deep investor trust in the transparency of the corporate system.³
The reality is also different here, as Enron and similar cases show. There
is still far too much obfuscation and concealment—and hence rent extrac-
tion—on the part of corporate managers, creating harmful stock price dist-
tortions with disturbing regularity.⁴ Naturally, the periodic discovery of
this brings about the question of how our celebrated system of securities
regulation might have failed. Hundreds of journalists, TV commentators
and members of Congress have asked, in one way or another, why the SEC
“let” Enron happen. Or were Enron and the others just exceptions that
prove the rule, the unavoidable handful of bad apples in a barrel of other-
wise sweet corporate fruit?

Though I doubt the latter, my paper will offer an answer that is more
sympathetic to the SEC than many other accounts. The expectations gap
is real: securities regulation is far from any assurance of corporate trans-
parency, delivering neither as much protection as many investors assume
nor as much as is optimal. Marketplace mechanisms, as Enron painfully
shows, do not always offer reliable correctives.⁵ My story, however, is not
one of a failure of administrative imagination or will. The United States
has under-funded the hard work of investor protection, holding back from
the system the resources it would take to substantially lessen the expecta-
tions gap, even if it can never be eliminated. Although no other country
invests more, either comparatively or in absolute terms, we still leave many
opportunities for the creation of investment illusions, which managers
guilfully exploit.

In theory, then, the remedy should be easy, and one could argue that
the recent Sarbanes-Oxley Act is exactly the right medicine. The Act calls
for investing in a far higher level of monitoring of corporate candor so
that the probability of identification and detection of corporate fraud rises

not by any means suggest that investor expectations have been manipulated, at
least not by the profession.

3. My views on the rhetorical function of securities regulation are set forth
extensively elsewhere. See, e.g., Donald C. Langevoort, Rereading Cady, Roberts: The
Ideology and Practice of Insider Trading Regulation, 99 COLUM. L. REV. 1319, 1327
(1999); Langevoort, Sunlight, supra note 1, at 486-90; Donald C. Langevoort, Tam-
ing the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation,

4. See Mark J. Roe, Rents and Their Corporate Consequences, 53 STAN. L. REV.
1463, 1477 (2001) (explaining consequences of higher rents for politics).

5. See Jeffrey N. Gordon, What Enron Means for the Management and Control of the
(2002) (explaining failure of accountant certification of financial statements in
Enron). I do believe that investors will learn from Enron and the other scandals,
and that norms of governance will improve for reasons quite apart from any new
regulation. For a view that these correctives are a superior response to costly re-
regulation, see Larry Ribstein, Market Versus Regulatory Responses to Corporate Fraud:
to a cost-efficient level, and it imposes serious penalties when wrongdoing is found. The Act’s mandates seek to eliminate the rents made available to corporate managers from being able to hide accurate economic performance.

Sarbanes-Oxley’s increased funding and new criminal threats are indeed an important step forward, but in broader terms, probably not enough to deliver anything approximating an optimal assurance of the credibility of issuer financial reporting. The SEC has lived nearly all its life in a world of chronically inadequate resources, for reasons that are complex but I suspect at least include the business community’s unwillingness to let go of the underlying rents. Perhaps the niggardly funding also reflects a reasonable suspicion that the bureaucracy has never expended its resources in an economically efficient fashion anyway and thus would not spend a major funding increase efficiently either. 6 That question touches on what is the most contentious academic debate in securities regulation, one well beyond the scope of this paper. Suffice it to say that, for any number of reasons, there will be no increase in SEC funding large enough to substantially eliminate the expectations gap. Sarbanes-Oxley only makes things marginally better.

This paper attends to both the politics and the substance of the post-Enron debate about appropriate investor expectations, with main attention to the role of the SEC. For substance, my goal is to shed some light on certain of the policy choices away from the distortion that occurs when these choices are viewed—as they have been for the last year—through a politically refracted lens.

We will never, however, get too far away from politics, and so let me make my main political point at the outset. The SEC’s role in investor protection inevitably brings it up against the affect-laden, socially constructed question of how much managerial autonomy, power and status a capitalist society ought to allow. The conservative view, of course, is that it should allow quite a lot. 7 Over-regulation is a threat to entrepreneurship and the bundle of rights that in their view legitimately attaches to economic success. To promote this vision and maintain a lean regulatory environment, conservatives must react aggressively to corporate scandals like Enron when they erupt. Denial is dangerous, so the best thing is the “bad apple” account. According to this story, only a very small number of managers act in so dysfunctional a way; the system remains socially benign.

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6. This, of course, is the view associated with conservative academic critics of centralized securities regulation, such as Roberta Romano. See, e.g., Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 YALE L.J. 2359, 2361 (1998); see also Paul G. Mahoney, The Exchange as a Regulator, 83 Va. L. Rev. 1438, 1457 (1997). For a direct application to the Enron scandals, see Ribstein, supra note 5.

Hence, the right response to scandal is tough enforcement. Hang the bad guys high, but otherwise permit business as usual.

On careful inspection, it should surprise no one that Republican SECs have been the more aggressive antifraud enforcers over the last few decades—the Shad/Ruder/Breeden 1980’s, when insider trading enforcement hit its apotheosis in the campaign against Wall Street insiders like Ivan Boesky and Michael Milken, is a good example. That sound and fury said to investors that a war was on to keep the system morally clean. Among other things, that in turn helped soften the risk of any political backlash that might otherwise have built about some of the more infectious economic threats that that decade’s favored deals, hostile corporate takeovers and leveraged buy-outs, were producing. That Republicans readily joined the pro-criminalization crusade leading to the adoption of Sarbanes-Oxley should surprise no one in light of this history. Had Harvey Pitt had more time as SEC chairman to pursue a post-Enron enforcement agenda, I suspect that he, too, would have turned out to be a very aggressive enforcer.

The progressive voice in securities regulation is different. It wants to focus attention on the concentration and abuse of economic power and is comfortable drawing starker lines of conflict between managerial and investor interests and in recognizing that those two interests do not themselves coincide with the public interest. Disclosure has a social virtue in spreading disinfectant on the world of wealth and power, not just an informational role. This view chafes at the artificial distinction long drawn between federal and state spheres of authority, wishing to extend the federal presence to a full range of matters touching on managerial accountability and corporate governance. To the progressive, Enron is a story about arrogance and abuse, and a call for wide-ranging reforms designed to reduce the rents from corporate stewardship. Individual enforcement cases, though certainly important, are hardly enough, and too easily distract from deeper needs.

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12. See Langevoort, Sunlight, supra note 1, at 450-53.
The foregoing explains much about the post-Enron reform efforts. The initial Republican agenda was hardly real institutional reform at all, except timidly in the accounting area. As typical, it relied on the fire and brimstone of enforcement to respond to the increased level of social discontent, until it subsided. The Democratic agenda more willingly tapped into that discontent, but still faced a difficult implementation problem. In fact, there are relatively few moderate, cost-efficient strategies, especially in a world of chronic under-investment in securities enforcement, that are likely to make a compelling difference with respect to abuses of managerial power. Real reform is either fairly radical (attacking matters like conflicts of interest and excessive executive compensation directly), very expensive (extraordinary funding increases for monitoring and enforcement, empowering aggressive private securities litigation, etc.), or both. Given the current political and budgetary landscape, neither is practicable. To me, the Democratic reform proposals came closer to touching on some of the real problems in the world of corporate behavior, but in ways that by themselves still will not change all that much. They are best seen as a shot across the bow, perhaps saving the heavier ammunition for a time when they hold a stronger political hand. Sarbanes-Oxley did some very good things, especially in the accounting and auditing area, but in the end—and notwithstanding the Sturm und Drang rhetoric—it is still fairly moderate legislation.

My primary focus here, however, is on the SEC’s place in the reform efforts. The investor protection mission of the Commission naturally tilts it slightly in the progressive direction; it is hard to devote so much time and attention to instances of investor harm without perceiving the fairly widespread presence of managerial arrogance and selfishness. Republican SEC chairmen are inclined to moderate this, but I suspect that even they usually leave office with a stronger, if unspoken, sense of the venality of large segments of the business community than they had when they took office.

To understand the SEC’s behavior in carrying out its dramaturgical role, it is important to return to the expectations gap. The SEC is in an awkward position vis-à-vis the investing public. On one hand, it has to un-

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14. In fairness, of course, it bears emphasis that there are many reasonably public-spirited business people. And in Enron’s aftermath, I suspect there are greater numbers of executives who want meaningful changes if only to extinguish the shadow that hangs over all companies, including their own, today.
derscore its own importance as "the investor's champion," and for that there has to be a visible enemy—typically, self-serving managers who lie or cheat. At the same time, it cannot portray the risk of investing as so severe that investors actually become discouraged and drop out of the markets. Any significant reduction in the depth and liquidity of the markets would both reduce the scope of the Commission's stature and authority (if not eliminate much of its reason for being) and invite the inference that it was to blame for not doing its job beforehand. Hence, the risks of investing must always be portrayed as moderate and, with serious bureaucratic intervention, manageable. In the end, in other words, the Commission must promote the viability and attractiveness of broad individual participation in the stock markets, the ultimate capitalist tool. This is a strong check on too much drift in the progressive direction. Only if the SEC stays in the middle ground—which may require some artful management of investor expectations of its own—is it in a position to bargain effectively for the additional scarce resources in a not-terribly-friendly political environment necessarily to do its job better.

My sense is that most SEC chairmen, commissioners and senior staff in recent memory have had a high level of commitment to this mission. They have invested their professional identities in the task. They may disagree about matters of ideology and style, but whatever their specific objectives, they have all confronted the resource problem and hence faced the core negotiation dilemma. To gain those resources, there are a limited number of strategies. One is to appeal for support aggressively to investors (or even the non-investing public) to counter the more organized and focused efforts of the business community. While essential to some degree, this has natural difficulties: investors are diffusely organized, especially individual ones, and are fickle in their preferences. During bull markets, their demand for investor protection is limited. Institutional investors are a more powerful group, but politically difficult. They pose threats to individual investors in many respects (e.g., the agency cost

15. See Langevoort, Animal Spirits, supra note 3, at 175.

16. At the risk of speculating here a bit too much, I suspect that one of the underestimated elements of administrative behavior is the psychology of commitment (the process underlying cognitive dissonance). A highly successful person, no matter what his or her "priors," who voluntarily undertakes the task of SEC chairman or commissioner is bound to become more biased in favor of investor interests. No SEC chairman wants to leave a legacy of undermining the very interests central to that role. I would add this to the list of reasons Republican chairmen are often very aggressive antifraud enforcers: this offsets any cognitive discomfort created by following through on deregulatory reform agendas. In other words, I do not mean to suggest anything necessarily disingenuous by my earlier suggestion that the conservative view is toward aggressive enforcement. For an interesting exploration of some of the deregulation that was occurring during the 1980's, see Mark A. Sargent, The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform, 68 WASH. U. L.Q. 225, 227 (1990).
problems embedded in mutual fund structures\(^{17}\) and will refuse to ally themselves politically with the Commission in other areas if the Commission is too aggressive in their domain. So, too, with other organized groups who have self-interests in promoting high expectations of investor protection, such as the broker-dealer industry, the accountants and the securities bar.

In sum, whatever the ideological leanings of the sitting commissioners, the SEC has to make substantial regulatory compromises in order to protect or enhance its claim for resources. It frequently avoids debilitating opposition either by muting its regulation or offering a trade of concession in one area for aggressiveness in another. To me, what has occasionally been described as the agency's "captive" behavior is not surrender but pragmatic negotiation—reforms such as shelf registration or Rule 144A, whatever their underlying merits, are devices to cement political alliances in aid of the SEC's core objectives.\(^{18}\)

If that is right, then the prevailing strategies of securities regulation will often be politically driven rather than substantively ideal, even putting aside the problem of scarce resources. In turn, the scholar's task becomes one of separating substance from politics and critiquing the prevailing regulatory regime on its merits alone (i.e., the net of real costs and benefits to the public). In Enron's aftermath, our search will be primarily for places where the current law might have been unduly weak for reasons having to do with political compromise rather than simple lack of enforcement or surveillance resources. Obviously, weakness is not the only possibility. Over-regulation is also possible at the behest of a particular interest group (particularly lawyers)\(^ {19}\) or because of bureaucratic inertia.\(^ {20}\) But if our search is for regulatory deficiencies apart from a gross lack of enforcement resources that might have contributed to Enron and related scandals, that should be our focus.

As such, I want to write about some of the reforms that touch on the SEC's work, as well as make a few suggestions of my own. (I will be very selective here: many more ideas have already been adopted into law than I have the time or inclination to write about, much less those still being fashioned). What kinds of changes in the disclosure, fraud and enforcement regime might \textit{really} make a difference in preventing future Enrons? What changes might do more harm than good? And which of the changes


\(^{19}\) See Jonathan R. Macey, \textit{Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty}, 15 Cardozo L. Rev. 909, 914 (1994) (noting that over-regulation occurs when agency "expands their regulatory turf... in areas that Congress intended to leave unregulated").

\(^{20}\) See Langevoort, \textit{Bureaucracy, supra} note 13, at 531.
being talked about are largely window dressing, designed just to manage investor expectations a bit further?

II. IDENTIFYING THE UNDERLYING PROBLEM

The question of why managers mislead investors is one that I have written about at length, as have others, and thus it is not worth repeating here. But there are a few more subtle points that touch directly on the Enron story, and help address the question of whether Enron (and WorldCom, Xerox, Sunbeam, Cendant, Waste Management, et al.) are outliers in a world of generally high corporate candor or examples different from standard corporate practice only in degree—a question of immense importance to devising the right regulatory strategies. At the risk of digression, I want to explore this account in some detail, dividing the discussion by focusing on the two elements that underlie the lawyers’ usual way of proving a circumstantial case, motive and opportunity.

A. Motive and Rationalization

Lacking the data to answer this empirically, we must resort to some underlying theory. Economic analysis provides the most straightforward possibility. Two extraordinary developments of the last two decades are (a) the explosive growth in executive compensation, especially in the form of incentive compensation and (b) the more frequent turnover of senior management personnel, including the CEO, for failing to satisfy investor expectations. Together, this means CEOs and their closest associates can expect incredible rewards for each year control is maintained, but that control is very much at risk if expectations drop in the face of reality. The motive, then, is to make the large promises necessary to gain the job and excite investors, and then delay any appreciation of the truth once adversity is encountered so that the period of wealth can be extended, if only by a matter of a year or two (or even a few months) before any adverse reckoning.

I do not mean to suggest that CEOs or other senior officials who succumb to pressure are always deliberate in their obfuscation. Their hubris

and capacity for rationalization enable them to perceive as justified what is often just enriching. Indeed, I suspect that this brings us to an unappreciated aspect of the scandals. Return to the mid and late 1990's, when the economy and the stock market were vibrant. Everyone agrees that this is when the seeds of the current tragedies were sown. The standard story—to which Alan Greenspan has given the title “infectious greed”—is that the ramping up of executive compensation with generous stock options made CEO's and CFO's obsessed with high stock prices, which they were willing to inflate by hook or by crook. No doubt there is some truth to this, but it misses a deeper tale.

In the minds of many new age business people back then, the conventions of accounting were under a thick cloud of doubt with respect both to their accuracy and relevance. Accounting is a practice built on an ethic of conservatism to provide standardized treatment of the financial performance of a business. Its principles were formed in an era of bricks and mortar industry, when discrete inventory moved off shelves and into customers' possession for simple cash or credit. As every beginning accounting student is taught, this never, even then, quite captured economic reality and always requires a good bit of subjective judgment. But for a long time, it worked well enough within the norms and mores of the American economy.

The high-tech and knowledge-sector booms of the 1980's and 90's helped change that view. Orthodox accounting does not apply well at all to intangibles like human and intellectual capital, or to new style methods of creating and selling products and services. It paints an unrealistic picture in many ways, understating the value of those companies that cannot demonstrate the tangibles in terms of assets and recognizable revenue compared to those that can. That frustrated the innovators. They were convinced that their business models held the real economic value in America's future, but conventional accounting ignored that truth and shackled their ability to attract more and more capital. After all, investors still seemed to obsess on announcements of steadily ascending quarterly earnings per share, which are nothing but accounting artifacts.


What was an enlightened financial executive to think then? If old-style accounting was unfair, then “aggressive” accounting—taking the judgment calls to their limits—was a legitimate way of fighting back. If a few rules actually got broken, it was not so bad either. The shackles needed to come off. It is hard to consider what you are doing fraudulent if you do not think that following the rules conveys much truth either.  

It worked. An irrationally exuberant market cared little about heavy financial cosmetics even though—as Arthur Levitt pointedly reminded investors during his term as SEC chairman—the makeup was concealing more and more of what should be seen. Innovators thrived with the freedom to paint more vibrant portraits of their companies’ underlying economics than old teachings would allow. And nearly everyone was getting away with it, which did two things. First, the absence of any serious crackdown bolstered the impression the system was willing to tolerate their philosophy—the opposite of the expressive function that aggressive enforcement of the law can play. That encouraged further rationalization, which when coupled with the positive feedback (higher stock prices) from the practices, emboldened them to become even more aggressive. Second, the evolving norm pressured even those competitors not caught up in the postmodern spirit to follow suit.

They had help, of course. A new wave of leaders in the accounting profession, seeking new sources of revenue so that they could be wealthy too, developed strategies for pushing the limits of the old rules, first as tax avoidance, then importing the same tactics into financial cosmetics. They were pleased to be part of the creative destruction of their own faith. Investment bankers had deals to sell, especially complex synthetic financing techniques by which assets, liabilities and risk could be moved in, out and around the company in a blur. They, too, were willing converts to new age accounting, as were many lawyers who benefited from the work that came with the financial frenzy.

In this setting, restraint crumbled, and therein came the problem. By now, the norm in many places was that if the financial, legal and accounting people could “get comfortable” with some rationalization of the rules (that is, not cringe or laugh), do it. Investors will thank you eventually. Transparency dimmed even more. With the dimming of transparency, in

turn, came a loss of accountability—the executives were now free to take bigger risks selected from an ever more sophisticated menu of financial engineering techniques than could be hidden from investors' view. Their egos and their greed got the better of them.

Accounting may be treated as passé, but economics is not, and the executives' self-defined, socially constructed brilliance was not quite up to tougher market conditions. The real economic returns were in doubt, and the executives were locked into inflated expectations. In some of these instances, what may have started as postmodern accounting turned into real fraud as insiders acted like most human beings caught in traps of their own making, trying desperately to hide the truth for a little while longer, waiting for some last-minute stroke of fortune. For most, it never came.

This process of rationalization and self-serving inference is not purely an individual one by any means. Corporate cultures exacerbate certain biases, especially ones built on optimism or illusions of control. Enron was in many ways the organizational embodiment of a belief system that rationalized to the extreme, made all the worse by the flattery and adulation the press, other business people and investors lavished on it for so long.

B. Opportunity

Motive alone is not enough; deception requires opportunity as well. Some of what follows addresses that question—compromises in the aggressiveness of auditors, deficiencies in antifraud enforcement and private litigation, etc. To that we must assign a good bit of responsibility to investors who demand unreasonable levels of earnings growth and then believe management's numbers too readily notwithstanding the obvious motive to cheat, abetted by the investment professionals and journalists inclined to celebrate management's self-serving stories rather than doubt them. Indeed, investors' irrational obsession with short-term performance metrics serves to give the rationalizing manager further excuse to mislead them in the name of protecting their strategic vision for underlying business from the vagaries of exuberance. And the more some executives fall prey to temptation, others will follow simply because the first group has set a norm that would be risky for any competitor to ignore.

Opportunity also is enhanced by financial innovation. Complicated derivatives and hedging strategies create the ability to shift risk in ways that

32. See Langevoort, Organized Illusions, supra note 21, at 139-41.
33. See Langevoort, Sunlight, supra note 1, at 484. The idea that managers deserve substantial autonomy in the face of the irrational tendencies of the marketplace received an important judicial stamp of approval in Paramount Communications Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990).
34. On the problems in this area, see Henry T.C. Hu, Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism, 102 Yale L.J. 1457, 1465 (1993); Partnoy, supra note 31, at 250.
are not apparent to investors. The same is true of off-books “special purpose entities.” All of these are perfectly legitimate tools in most contexts, but increase the range of creative possibility for obscuring economic reality. (Many of these techniques were learned and honed, I suspect, as tax avoidance strategies and then imported into the world of financial reporting—a point that will be taken up below). I will venture a guess that one commonality among many of the financial frauds recently exposed was a fairly charismatic outward-oriented CEO with at best a dim understanding of complex financial engineering, who delegated more and more power to a CFO with the implicit understanding of “don’t ask, don’t tell” about how the numbers needed to satisfy the CEO’s “vision” were being produced.  

A Faustian bargain results: the CFO with more arrogance and brains than good judgment begins to take risks, encouraged by skilled salespeople from the investment banks. When the risks go bad, he faces either being honest and losing all the power and status, or taking even more risks, including stepping outside the law, in the hope that good fortune will return. Frankly, it is human nature to do the latter.  

While regulation has to respond to any given form of innovation, the pace can be pernicious. We know that regulation—whether in the form of disclosure rules from the SEC or accounting principles issued by the Financial Accounting Standards Board—is slow to develop, and can be the subject of political interference. In the meantime, the dimly understood and often elastic interim principles leave ample room for opportunism without any compelling appreciation of impropriety—exactly the circumstance that creates all the more opportunity for deception. One of the disturbing features of all the recent scandals is that every single form of accounting, no matter how dubious, had some justification put forward after the story broke. While outsiders might not be convinced, one can see how a motivated insider might well have convinced himself—in a leap of self-deception of the sort noted earlier—that there was a “reasonable basis” for the accounting.  

35. At the very least, this describes Enron (Lay and the combination of Skilling and Fastow) and WorldCom (Ebbers and Sullivan). On the propensities of charismatic business executives with respect to candor (or lack thereof) see Michael Maccoby, Narcissistic Leaders, HARV. BUS. REV., Jan.-Feb. 2000, at 68, 69.  

36. Psychologists point out that people take much larger risks to keep what they have than to gain something they do not (“loss aversion”). For further elaboration on the psychology of Enron-like environments—with an emphasis on the personality profiles of people who make it to the top of highly competitive corporations, see Donald C. Langevoort, The Organizational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron, 70 GEO. WASH. L. REV. 968 (2002).  

37. This, in turn, leads to the famous slippery slope. Each form of aggressive accounting that is not caught invites something a step more aggressive. Psychologists interested in organizational wrongdoing identify this as a standard account for the gradual descent into serious wrongdoing. See, e.g., John M. Darley, How Organizations Socialize Individuals into Evildoing, in Codes of Conduct 13 (David M. Messick & Ann E. Tenbrunsel eds., 1996).
Based on all of this, I think a strong circumstantial case is made that there was a serious problem in financial reporting and disclosure, so that there is basis for the fear that Enron and like cases are aberrational only in size and severity. If so, we should take seriously the question of whether the law is up to the task of deterrence.

III. POST-ENRON REFORM: SUBSTANCE OR WINDOW DRESSING?

As noted earlier, the debate that has divided the policy community after Enron was fairly well defined. The conservative position is that the financial reporting scandals are violations of laws and regulations currently on the books, so that relatively few significant changes in the regulatory structure are necessary. The response should be one of stepped-up enforcement, not deep reform. The more progressive view was that the venality that has led to these abuses is the product of commonplace conflicts of interest and undue concentration of power, which must be targeted broadly. Sarbanes-Oxley reflects some of both positions, albeit limiting the real structural change to the field of accounting and auditing. In what follows, I do not intend to analyze deeply all the reforms, with their considerable technical detail. Rather, I want to take a more impressionistic look at a few of the issues that go closest to the heart of the SEC’s work.

A. The Disclosure Regime

One of the curious sleights of hand that has occurred since Enron has been the SEC’s promotion of “real-time disclosure” as a response to the scandals. In fact, real-time disclosure—that is, accelerating the timetable for disclosure of key information—was already in the works as a key regulatory objective.\(^\text{38}\) I have for some time urged the movement away from the 10-K/10-Q periodic reporting regime in favor of a continuous duty to update the issuer’s electronic EDGAR file, albeit with appropriate, well-defined nondisclosure privileges for sensitive information and a specific timetable for when certain kinds of hard-to-gather data needs to be refreshed.\(^\text{39}\) So I am pleased by the efforts to add substantially to the “8-K” list of immediately reportable events, which is a back-door way of getting roughly to the same point.\(^\text{40}\) However, with a few exceptions such as the

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reporting of conflict of interest transactions with the issuer (e.g., Kenneth Lay’s stock transactions), we have to admit that there are few places where the simple acceleration of disclosure would have made much of a difference in these recent scandals.

This might be different were the SEC to employ a more aggressive strategy than just a “prompt” disclosure after the fact, focusing instead on disclosure of plans and intentions to engage in certain kinds of activities before they occur. For instance, it would be of substantial benefit to investors to know that an executive intends to buy or sell company stock before that transaction takes place; so, too, with significant conflict of interest transactions.\(^{41}\) There is an interesting rule-making authority question here; plainly, the current periodic disclosure system set forth in Section 13(a) (and even more clearly the insider trading reporting regime set forth in Section 16(a)) contemplates after-the-fact disclosure, even though Sarbanes-Oxley accelerated that disclosure). But as recent Regulation FD shows, there is some elasticity here, at least under 13(a). The legal standard authorizes the SEC to require reports designed to “keep reasonably current” the initial disclosure mandated upon attaining public company status.\(^{42}\) It is well within the realm of reasonableness to say that a proposed transaction is the kind of information needed to update the file; if so, there is leeway here. Indeed, disclosure of proposed transactions is already specifically required in various places in Regulation S-K (e.g., Item 404(a)). This is an idea the SEC probably ought to pursue.

Turning to the substance of disclosure, we should remember the two separate, if related, purposes to the mandatory disclosure regime. One is to allow investors to make informed valuation decisions—in other words, what are the securities worth compared to their current price?\(^{43}\) The other is an agency cost idea: disclosure designed to reduce the opportunities of insiders to extract rents at investor expense.\(^{44}\) These are inseparable insofar as a valuation decision is impossible without an assessment of the risk that incumbent management will divert to itself the otherwise expected stream of earnings. Here we see clearly why, so long as it is disclosure that we are talking about, there is no persuasive federalism-based


\(^{41}\) See Jesse M. Fried, Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure, 71 S. Cal. L. Rev. 303, 348-64 (1998). Fried would make this the exclusive form of insider trading regulation for high-ranking executives, a proposal with which I do not agree.


\(^{44}\) Paul Mahoney persuasively argues that this was the primary purpose behind the disclosure regime when it was adopted. See Paul G. Mahoney, Mandatory Disclosure as a Solution to Agency Problems, 62 U. Chi. L. Rev. 1047, 1051-54 (1995).
reason to keep the SEC away from corporate governance matters. Management integrity, or fear of mismanagement, is a legitimate concern that is part and parcel of the valuation process as well as the shareholder franchise protected by the proxy rules.

Are the mandatory disclosures found in Regulation S-K up to this task? Let us take first the disclosures related to potentially disloyal senior management, a significant part of the Enron story. Here we do find a few gaps, though nothing major. Andrew Fastow's nondisclosure of the amount of his interest in the affiliated partnerships, described in the Powers Report, probably violated Item 404(a) notwithstanding the purported defense that it was "impracticable" to calculate precisely. Certainly, a fair reading of the rule calls for a reasonable estimate even when precision is impossible. A somewhat bigger gap is the nondisclosure of the interest of Fastow's subordinate, Michael Kopper, in the Chewco partnership, created explicitly for the purpose of avoiding disclosure (Item 404 demands disclosure only of conflict transactions by directors and executive officers; Kopper was chosen because he was a step below). It would probably be wise to expand these disclosure requirements to conflict transactions with any insider, so long as the amounts in question exceed a fairly high materiality threshold. But here again, we are dealing with something not necessarily at the heart of the fraud. The fact of the insider interest was disclosed, just not the details regarding the unusually large profits the insiders were receiving.

That said, I would put somewhere on the SEC's reform agenda a fresh look at Subpart IV of Regulation S-K generally as a whole. Much attention has been given to executive compensation question, which probably calls for more disclosure than really is necessary. Of course, it is important to revise the accounting rules so that options and other non-cash benefits are treated in an economically realistic fashion on the income statement—and hence in earnings per share. But that is a question of accounting versus descriptive treatment, at least as applied to executives within the scope of Item 402. What I would eventually like to see is a reworking of other portions of the rule so that it creates an express duty to disclose the full range of facts and circumstances in situations where senior managers materially place their interests ahead of the corporation's, or otherwise engage in materially unlawful activity. Take, for example, Enron's alleged manipulation of the California energy markets. If this was illegal, it (almost certainly) was material. Yet, as I have also explored elsewhere, locating a duty to disclose this sort of matter is often—though not inevita-

45. See Langevoort, Sunlight, supra note 1, at 474-75.
47. Both the level of detail and the board-generated discussion have a boilerplate quality that I think could profitably be simplified.
48. Here, a good example of something not currently covered by Reg S-K is the systematic diversion of corporate opportunities to an affiliated venture.
bly—difficult. To be sure, I am not proposing a foolish-sounding requirement in the expectation that companies will actually disclose their illegal conduct at the time it occurs. Expressing the duty simply anticipates that investors are often misled by the nondisclosure and suffer considerable harm. Thus it should be explicitly within the purview of the federal securities laws.

The main focus of disclosure is the issuer’s business and prospects, rather than management’s stewardship per se. Here again, the question is what additional forms of disclosure might have been helpful to investors in Enron-like situations. My sense, based on the available facts, is that there were ample violations of the current legal rules, which naturally leads to the possibility that no reforms would be efficacious—the issuer bent on violating the current rules would surely have violated any new ones as well. While that is certainly well taken, the response is two-fold. First, disclosure requirements that are too vague or open-ended invite, as noted earlier, “violation by rationalization”—seeing if a possible argument can be devised to justify noncompliance, which quickly can lead down a slippery slope. The clearer the rules are, the less room there is for this. Second, more focused disclosure requirements may lead to more careful attention by persons not directly involved in the wrongdoing, the so-called gatekeepers.

The primary issue here, in the abstract at least, is the divergence between reported results on the balance sheet, income statement and cash flow statement and “economic reality.” While I have no doubt that many GAAP rules deserve refinement or change in order to produce more reliable numbers, I recognize that the very nature of accounting makes capturing economic reality with precision impracticable. The reasons are familiar ones. Accounting looks backwards, while investment analysis is forward looking. Accounting rests on principles of conservatism and the need to quantify, while economic reality often involves non-quantifiable risks and opportunities. And as noted earlier, the rules of accounting can never quite change as fast as the pace of financial innovation.

If so, can investors be apprised of material differences known to the company? That, of course, is what the Management Discussion and Analysis (MD&A) portion of mandatory disclosure is supposed to be about. I think the SEC is correct in the points made in a series of interpretive releases this past year that nearly all of the kinds of concealment that Enron did violate the current MD&A requirements, whether or not GAAP was technically complied with in the underlying reporting. In other words, a

49. See Langevoort, Sunlight, supra note 1, at 457-68.

50. The reasons are familiar at least to those with some knowledge of accounting, something too many lawyers lack. See Elliott J. Weiss, Teaching Accounting and Valuation in the Basic Corporation Law Course, 19 CARDozo L. REV. 679, 682-83 (1997).

fair reading of the requirements regarding known trends and uncertainties would suggest, for example, that Enron’s use of its own stock as a guarantee of certain contingent liabilities should have been disclosed in the MD&A regardless of the proper accounting treatment or footnote disclosure.

However, one cannot read the current MD&A instructions without a sense that they miss the point in a number of respects, failing on grounds of obscurity if not misdirection. The underlying issue is a profound one: to what extent does the issuer have a duty to disclose forward-looking information in its possession that would lead investors to see that reported results are not a good indicator of even the near-term future, if not longer-term prospects? Carefully trying to avoid an overbroad duty, the MD&A fails to make sufficiently principled distinctions and hence collapses into a muddle. Although there are many flaws in the execution, the primary one is the emphasis on “known” trends and uncertainties. What does that mean, in distinction to all forward-looking information material to the financial condition of the issuer? In 1989, the Commission tried to answer that question by saying that the requirement applies only to events “reasonably likely” to occur (though it gave no helpful guidance even on what that particular phrase means). And there we see the difficulty in terms of “rationalized nondisclosure.” Management can take big risks (e.g., the use of Enron stock as a contingent guarantee) and hide them on the assumption—which it may actually believe, aided by a bit of self-deception—that the downside is not “reasonably likely” to happen.

My sense is that the MD&A needs a complete overhaul, beginning with a jettisoning of the “reasonably likely” location in favor of the more traditional materiality standard. As a result of Sarbanes-Oxley, this is happening piecemeal; what I am suggesting is a more coherent re-conceptualization. The fear here, of course, is that this opens the floodgates to disclosure of the full range speculative possibilities about the issuer’s prospects, making the MD&A unwieldy and useless. In response, I would refine the focus of the MD&A. To me, what investors really want and need is a warning of material future risks—not just their possibility (as boilerplate


52. The familiar concerns here are that too broad a duty creates too much disclosure, and that forward-looking information usually has embedded in it the kinds of proprietary data that reasonable investors would not want their companies to divulge.

53. For a related criticism, see Kitch, supra note 43, at 799-816.


risk disclosure tends to do), but a discussion of their probability and magnitude from management's perspective as well.\textsuperscript{56} They deserve a flashing yellow light when future risks edge into the realm of materiality. Thus, in the end I would prefer to restyle the MD&A into a "risk discussion and analysis" requirement based simply on materiality, which in turn I would make—as Congress suggested in Sarbanes-Oxley—part of the "real time," not just periodic, disclosure requirement.\textsuperscript{57} This would make it far harder to hide risks, as Enron seemingly did, on the grounds that even if the magnitude of the impact might potentially be severe, the possibility was unlikely to occur.

B. Targeting Insiders: Officer and Director Responsibilities

While much of the inadequate deterrence in the financial reporting area stems from the under-funding of the SEC, there are a few ways in which the Commission contributed to the problem. One, historically at least, was through a combination of settling its enforcement cases with relatively low penalties and allowing most, if not all, of the costs of settlement or judgment to be borne by the issuer (and hence its innocent shareholders) rather than the insiders who engineered the wrongdoing. This, of course, gave insiders the impression that they had relatively little to lose in personal wealth from risking a securities law violation. To me, the most important change in the past year has been a refocusing of attention on deterring the insiders most likely responsible for financial fraud.

The SEC's main innovation—codified and expanded, somewhat confusingly, in two different places in Sarbanes-Oxley—is the requirement that both the CEO and CFO "certify" that the 10-K and 10-Q are accurate in all material respects as of the date of filing and "fairly present" the financial condition and operations of the issuer.\textsuperscript{58} Technically, this is not much of a departure given the previous signature requirements;\textsuperscript{59} the

\textsuperscript{56} Here, it is worth repeating the teaching—too often ignored in practice—that "[t]o warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit." Huddleston v. Herman & McLean, 640 F.2d 534, 544 (5th Cir. 1981), aff'd in part, rev'd in part, 459 U.S. 375 (1983). Disclosing the possibility of a risk is minimally important; what investors need is a reasonable assessment of its probability. See Donald C. Langevoort, Disclosures That "Bespeak Caution", 49 Bus. LAW. 481, 492-99 (1994). This is one reason that the statutory safe harbor for forward-looking information is conceptually incoherent: it only insists on the "meaningful" identification of risk, and even then does not insist on disclosure of all the significant risks known to management in order to immunize even a deliberate lie.


\textsuperscript{59} Before the change, both the CEO and the CFO, among others, signed the 10-K; the CFO or chief accounting officer signed the 10-Q.
Ninth Circuit held a few years ago that being a signatory of an SEC filing creates primary liability with respect to any falsity of which the signer is aware. Even without a signature, reaching executives who have a hand in either structuring the underlying transaction or formulating the disclosure with awareness of its falsity is not all that difficult, on an aiding and abetting theory if nothing else. Also, Rules 13b2-1 and -2 impose explicit liability on managers who introduce false information in one way or another into the corporate reporting and internal controls systems. While the new certification requirement is beneficial, one should not advertise certification in and of itself as a revolutionary change.

One thing the certification requirement clearly does is place more emphasis than ever on what it means to say that the financial statements "fairly present" the financial condition and operations of the issuer. We shall turn to this question later in discussing the responsibilities of auditors, where similar language has long been employed. My sense is that "accounting reality" and "economic reality" are two distinct concepts, posing a profound intellectual challenge to the executive forced to certify. To me, the right bridge here is to turn the MD&A into a narrative that comprehensively discusses the differences known to management, which as noted above would require some revisions to the instructions to that line-item. Until then, awkwardness will remain.

Significantly, the certification requirements avoid imposing an explicit duty to investigate. Hence, the predictable organizational response may simply be to increase the incentive to isolate the CEO and CFO from the wrongdoing in the firm—the familiar "plausible deniability" or "don't ask, don't tell" scenarios. Where the CEO lacks knowledge or awareness

60. Howard v. Everex Systems, Inc., 228 F.3d 1057, 1061-63 (9th Cir. 2000).
61. See Donald C. Langevoort, Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment, 63 LAW & CONTEMP. PROBS. 45, 54 (Summer 2000). I think that simply structuring a transaction in such a way as to mislead auditors or others involved in the preparation of disclosure is aiding and abetting, even if the person is not personally involved in the actual preparation of the disclosures. Notably, aiding and abetting has long carried with it the risk of criminal prosecution.
62. Rule 13b2-1 bars any person from falsifying any of the issuer's books and records. Rule 13b2-2 bars any officer or director from making any false statement to an accountant involved in an audit or the preparation of an SEC filing. For an application, see SEC v. Anderson, Litig. Release 17521, 2002 SEC LEXIS 1331 (N.D. Cal., May 20, 2002).
63. The Sarbanes-Oxley formulation is confusing in many respects. Among other things, the new criminal provision (section 906) requires certification that the report containing the financials "fairly present" the condition and operations of the issuer. The "civil" certification, which is put under the rule-making authority of the SEC, speaks in terms of the financials themselves "fairly presenting" those conditions and results. The latter is the more troubling conceptually; the criminal provision works acceptably if the MD&A becomes the vehicle for describing the differences between economics and accounting.
64. See Langevoort, Organized Illusions, supra note 21, at 128. For a classic exposition in light of the post-Watergate scandals of the 1970's, see John C. Coffee,
of the improprieties, the SEC's task is much more difficult—and certification by itself does no good. The open questions are two-fold. First, how elastic is the state of mind standard? One of the to-be-explored connections here is how similar certification language that has long been in place in health care and government contract regulation has been interpreted, and whether this analogy will stick as imported into securities law. The second is whether adding to the requirement a certification that goes to the quality of the "disclosure controls and procedures" in place will actually improve information flow sufficiently to overcome the organizational tendency to suppress bad news. It is simply too early to predict the answers.

If liability in an SEC proceeding is clear enough, then the remaining issue is one of the severities of the civil sanctions. In 1990, Congress gave the SEC deterrence power via the introduction of civil penalty liability for all securities law violations, and by making it possible for the SEC to seek a bar order preventing any person from further service as an officer or director of a publicly traded corporation. 65 Unfortunately, each of these remedies had serious limitations. The civil penalty amounts are smaller than they should be compared to the gravity of many financial frauds. 66 And the Second Circuit has held that the officer-director bar is available only in "recidivist" kinds of cases. 67 This is an area where Sarbanes-Oxley made a useful contribution. My sense is that the new statutory language should be read in a way that presumes the propriety of a bar order from any finding of serious, intentional securities fraud.

Much credit goes to the SEC for its willingness to expand the scope of disgorgement sought in serious financial fraud cases, another step clarified in Sarbanes-Oxley. 68 In some ways, it is surprising that the Commission had not long ago taken the position—ample justifiable even then—that executives complicit in financial fraud forfeit their right to any special compensation they made during the time in question that might reasonably be tied to the wrongdoing. Given that incentive compensation and bonuses tied to stock price performance is commonplace, the money at

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66. For instance, even the highest penalty "tier" allows, per violation, a penalty of only $100,000 for a natural person. As a result, the magnitude of executive compensation these days is hardly all that much, even if multiplied to reflect the presence of more than one violation by the wrongdoer.

67. See SEC v. Patel, 61 F.3d 137, 142 (2d Cir. 1995) (finding that "[a]lthough it is not essential for a lifetime ban that there be past securities law violations, we think that it is essential, in the absence of such violations, that a district court articulate a factual basis for a finding of the likelihood of recurrence").

stake here should be large.\textsuperscript{69} And happily, disgorgement is not the kind of thing normally protected by insurance or indemnification.\textsuperscript{70}

C. Outside Directors and Audit Committees

As noted earlier, each of the recent scandals falls into one familiar pattern: the outside directors inevitably claim that they were as much the victims of deceit as investors. And I suspect they are being truthful in disclaiming knowledge; that certainly was the conclusion of the Powers report with respect to Enron’s outside directors.

The natural response is to ask whether something more should be done to make directors more diligent in their monitoring. For reasons I have explained elsewhere, I am skeptical that increasing the threat of liability for outside directors is a wise idea—it too easily misconceives the role of the outside director and introduces a chill that redirects attention away from the handful of things outsiders do well.\textsuperscript{71} I share the view of Ed Rock and Michael Wachter, among others, who argue that norms rather than law ought to be the main drivers of directorial diligence.\textsuperscript{72}

My inclination is instead to refocus on information flow to the board as a precursor to good disclosure to investors. I do not think it accidental that bad disclosure and board ignorance are positively correlated. The prevailing assumption in much of the academic literature and business press is that CEOs see the board as a group whose expectations have to be managed as much as those of investors and other stakeholders.\textsuperscript{73} With the

\textsuperscript{69} As under current law, there is no reason to insist on a high level of precision in determining the extent of the unjust enrichment: doubts are held against the wrongdoer. \textit{See} SEC v. First City Fin. Corp., 890 F.2d 1215, 1216 (D.C. Cir. 1989). It is unclear what the new provision in Sarbanes-Oxley that requires disgorgement of certain compensation and stock sale profits gained prior to a restatement of accounting reports if it can be shown that the restatement was the product of “misconduct” will accomplish. In part it depends on whose misconduct we are talking about.

\textsuperscript{70} Though outside the scope of this SEC-oriented paper, the step-up in the criminal law treatment of securities law violations is one of the most notable accomplishments of Sarbanes-Oxley. Time will tell whether criminal prosecutions for securities fraud become common enough so that the “law on the books” threat becomes a real one. Very little in the legislation makes it easier for prosecutors to demonstrate knowing or intentional fraud beyond a reasonable doubt, which has long been the reason for preferring civil to criminal enforcement.

\textsuperscript{71} \textit{See} Donald C. Langevoort, \textit{The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability}, 89 Geo. L.J. 797, 812 (2001) (asserting that increased monitoring of CEO by outsiders can foster mistrust and effectively chill communication).


\textsuperscript{73} \textit{See}, e.g., Jay W. Lorsch \& Elizabeth McIver, \textit{Pawns or Potentates: The Reality of America’s Corporate Boards} 88 (1989) (suggesting that natural bias of CEOs may cause some to inadvertently or deliberately shape agendas and select data in ways that influence board decisions); James Westphal, \textit{Board Games: How

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commonplace scatological reference to how truffle pigs are kept and fed, they are given only the information senior management wants them to have. The underlying image is an arms-length type negotiation between the managers and the board, with an imbalance of bargaining power.

Maybe so. But it is at least worth noting that this kind of posture by senior management, however commonplace, is a breach of fiduciary duty. Though underdeveloped, the common law is quite clear that agents and other fiduciaries owe a duty of utmost candor to their superiors, a duty not only to tell the whole truth but also to volunteer all information needed for the superior to make informed decisions. And the board is the superior in any corporation. While I think the case is easy to make under current law that any executive who fails to inform the board of the truth about the company at least aids and abets any resulting misreporting, I am concerned that the working norms and assumptions in too many companies about candor with the board still miss this point. To make the point clearer, the SEC could adopt a rule (or revise Rule 13b2-2) to provide that any executive officer who is aware that the issuer's financial reports are or are likely to be materially false or misleading has an affirmative duty to notify the board of that fact.

One of the most interesting steps taken in Sarbanes-Oxley is the requirement that the audit committee of the board take control over the retention and compensation of the company's auditors. That this was not already ordinary practice is a testament to a breakdown of corporate governance norms—if a primary purpose of an audit was to look over the shoulders of the company's financial managers, it is foolish to put those managers in charge of choosing the auditor. Of course it should be the

CEO's Adapt to Increases in Structural Board Independence from Management, 43 Admin. Sci. Q. 511, 517 (1998) ("CEOs may use persuasion or integration tactics with these directors to maintain mutual agreement and compatibility in their relationship to the board.").

74. I am currently working on a paper entitled, Agency Law Inside the Corporation: Problems of Candor and Knowledge, which will explore this issue more deeply. At state law, the duty of candor has evolved to recognize this principle clearly, yet struggles with the separate question of how this applies to the duty of corporate executives to company shareholders. See, e.g., Lynch v. Vickers Energy Corp., 383 A.2d 278, 279 (Del. 1977) (raising issue of duty owed to shareholders by corporate executives). As the law has evolved in Delaware, at least, a line is drawn between a duty when the shareholders are being asked to vote or otherwise act, as opposed to remaining passive. See Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) (establishing that Delaware corporate directors have fiduciary duty to disclose fully when board seeks shareholder action). The law under 10b-5 is in accord. See Chiarella v. United States, 445 U.S. 222, 234 (1980); see also Langevoort, Sunlight, supra note 1, at 466-68. Whatever these difficulties, there is no limitation on the duty when the disclosure is to the board, rather than the shareholders. The only possible defense is that the board waived its interest in the information, which should be a relatively rare occurrence.

75. Sarbanes-Oxley does require the CEO and CFO, as part of the "civil" certification responsibilities, to pass on information involving fraud on the part of managers with responsibility for internal controls of the issuer. Notoriously, lawyers will be subject to an explicit duty to report to the board.
audit committee. It is tempting at first to applaud this step, but then the problem immediately comes to mind: if the board was not willing on its own to claim this responsibility, will compliance with the new law simply be an empty formality, with the audit committee still taking direction from the managers? Here, I am somewhat optimistic. If one believes that norms are what drive most of director behavior, then the fact that, prior to Sarbanes-Oxley, it was normal to put control over the audit in the CFO's hands was a strong constraint. Any board that defected from the norm risked sending a signal that it did not trust the CFO or that it suspected some serious problem. Now, the new law provides cover to any such step, making it possible that we will see a shift in norms to the more rational posture.

This solution will fail, however, if either of two conditions occurs. One, obviously, is that board lacks any desire to operate independently and gives de facto control back to the managers. The other is that the managers deprive the newly emboldened auditors of access to enough information to make judgments. The next section will touch on one response to this—changing the nature of the audit so that the auditors have to do more independent investigation. Another response goes to the issues discussed above. The insiders' fiduciary obligation of candor should extend not only to the board but those who work for the board—i.e., the auditors. Sarbanes-Oxley gives the SEC the authority to adopt rules on managerial interaction with auditors, rules that should say not only that it is unlawful to mislead the auditors, but that managers have an affirmative duty to provide auditors with all material facts necessary and appropriate to the conduct of the audit.76

D. Aiding and Abetting and Private Litigation

Of all the subjects we have considered, private rights of action are most outside the control of the SEC, being mainly the province of the courts and (lately) Congress.77 However, they are closely connected to the SEC's work. Unless there is a vastly enlarged SEC, private actions inevitably must serve as an enforcement substitute for deterrence purposes, as well as their more traditional role as an avenue for appropriate compensation of victims. This paper is not the place to revisit the debates of 1995 over what reforms should or should not be adopted with respect to private securities litigation. The current system, both before and after reform,

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bears so little resemblance to the ideal that I would be tempted simply to
start anew in crafting the appropriate rules. 78

Here, I want to focus simply on two areas where private actions touch
closely on the integrity of the financial reporting process. If private ac-
tions are to be a useful deterrence supplement to SEC enforcement,
then—just like the SEC—they have to be able to reach not only issuers but
also the human beings and firms that actually engineer the fraud. Here,
we come to the Supreme Court's Central Bank of Denver v. First Interstate
Bank 79 case, barring private aiding and abetting liability under Rule 10b-5
and, presumably, some other kinds of secondary agency-based or vicarious
theories of liability. Imagine that a second-in-command financial officer
devises some fraudulent accounting scheme, in which some investment-
banking firm plays a key role in structuring the transaction. Both the
manager and the investment bank should be liable, surely. But, as is well
known, many lower courts have followed Central Bank to an illogical con-
closure, demanding that the fraud be visibly attributable to the person or
firm before "primary" liability attaches. 80 Behind the scenes, actors gain
immunity for that reason alone, even if they are the primary authors or
architects of the fraud. 81 Other courts disagree, but it has created a mess.
Central Bank should be overruled legislatively, leaving to other winnowing
mechanisms the task of assuring that secondary actors are not named as
defendants when they had no responsibility for the fraud at all.

But that probably will not occur, and hence the SEC has to step in
with its explicit statutory authority. Reading the various press accounts of
Enron, I have a strong suspicion (though not the facts to be sure) that
much of the fraud was engineered by Enron insiders with substantial help
from investment bankers and others who gave not only technical assist-
ance in deal structuring and financing but actively marketed strategies of
evasion under circumstances where there was enough awareness of En-
ron's desire to mislead to satisfy at least the recklessness test. If so, then
one of the strongest tests of the SEC's political will in responding to the
mess will be how aggressively it pursues that matter, and whether it will

78. Among other things, I would turn the measure of damages to something
more approximating a "penalty" scheme. For some of my views here, see Donald
639, 660 (1996); see also Janet Cooper Alexander, Rethinking Damages in Securities
80. See, e.g., Ziemba v. Cascade Int'l Inc., 256 F.3d 1194, 1203 (11th Cir.
2001); Wright v. Ernst & Young LLP, 152 F.3d 169, 178 (2d Cir. 1998). For a
critique, see Jill Fisch, The Scope of Private Securities Litigation: In Search of Liability
81. I favor the "co-author" locution. See Donald C. Langevoort, Words from on
High About Rule 10b-5: Chiarella's Past, Central Bank's Future, 20 Del. J. Corp. L.
865, 892 (1995). That phrasing was utilized in Klein v. Boyd, which was subse-
cuently vacated pending rehearing, and finally rendered moot by settlement. See
1998).
insist on penalties sufficient to take away far more than the profits the banks earned from these practices.

The other private litigation doctrine I want to focus on is subtler, having to do with the extent to which private plaintiffs can effectively enforce violations of the SEC's disclosure standards. There is a largely ignored body of law dealing largely with the MD&A requirement in 10b-5 cases. A fair number of courts—though not all—have refused to allow private plaintiffs to seek damages for nondisclosure of events even if the nondisclosure was a violation of Item 303. Enforcement of Item 303, these courts essentially say, is for the SEC only, not private rights of action.

That is odd, and wrong. It is well established that a false filing with the SEC gives rise to liability—in other words, investors are entitled to rely on 10-K's and 10-Q's and bring an action when misled. It strikes me that a false or misleading response to Item 303 should fall into the same category—investors should be entitled to rely on the issuer's narrative as a truthful and complete response to the instructions just as they rely on any other portion of the filing. The courts' suggestion that the MD&A does not create a duty to speak for antifraud purposes, as opposed to SEC enforcement, is neither logical nor sensible, and undermines the private action's role in supplementing the Commission's enforcement work.

This view can easily have a significant impact. For example, one of the interesting aspects of the Enron class action has to do with alleged violations of the proxy rules and other disclosure requirements regarding Fastow's conflicts of interest. Assume, as seems to be the case, that Enron's disclosure was in violation of Item 404 because it did not give enough detail about the extent of compensation, etc. Assume also that this was a material violation—i.e., the omitted details were significant. Here, at least under the foregoing view, plaintiffs might well have difficulty going forward with the claim. The difficulty is that Enron disclosed enough about the entities and the affiliations so that any reader might not have been misled. The reader would have been bothered, to be sure, by the opaqueness of the footnote disclosure and the narratives. But the reasonable reader response would be to accept simply that the company has not been candid, and not rely at all on what was said without further elaboration. It might be seen as reckless, in other words, for the reader to assume that large payouts were not being made to insiders in the face of the patently incomplete disclosure. Without good justification for reliance on a mistaken impression, the 10b-5 cause of action might fail.

82. See, e.g., In re Burlington Coat Factory, 114 F.3d 1410, 1419 (3d Cir. 1997). For a discussion of Item 303's coverage of management's discussion and analysis of the financial condition and results of operations, see Gulati, supra note 22, at 725-27. For a more expansive reading, see In re Scholastic Corp. Sec. Litig., 252 F.3d 63, 70 (2d Cir. 2001).

83. In contrast, seeing the line item requirements as establishing an affirmative duty to disclose would allow the inference, common in nondisclosure cases, that reliance could be presumed upon a showing of the materiality of the omission. See, e.g., Affiliated Ute Citizens v. United States, 406 U.S. 128, 131 (1972).
IV. Conclusion

One of the standard media questions after Sarbanes-Oxley and the flurry of certifications to the SEC and criminal indictments is whether investing is now "safe" from misconduct (or even more foolishly, whether we can now expect the stock market to go back up). That brings us back to the expectations gap. New rules that are not enforced effectively become part of the problem—they exacerbate the gap, rather than help reduce it. Sarbanes-Oxley's funding increase will surely lead to some step-up in the level of enforcement by the SEC, but it is unlikely that we will have reached an optimal level even once the skilled enforcers are hired and trained (which will take a while). In other words, I still have doubts about whether we will see sufficiently sustained, aggressive enforcement, especially of the hard-to-prove requirements, at the level necessary to cause executives to perceive that a securities law violation is not a risk worth taking, no matter how much money or status is involved. That is especially so if you think that executives have a tendency to rationalize in the face of greed or fear and fail to perceive risk accurately as a result. I am especially skeptical that we will see enough criminal enforcement for the *in terrorem* effect to be real, at least once this round of political attention subsides.\(^4\)

Thus, the ultimate response to the residual risk of managerial opportunism in financial reporting remains in private hands. Realizing that a considerable risk remains does not mean investors should not invest: it does, however, argue for careful diversification and reduced expectations. As has been suggested repeatedly over the past few months, it argues for realism about growth stocks. On average, stocks grow at a pace with the economy and increases in productivity. Any company that promises that it can grow faster than that bears a heavy burden of proof about how and why. Intellectual property and a unique internal skill-set may provide an answer, but we should be suspicious of that—job market mobility means that companies have little assurance that whatever special talents they may have for a time will still be there next year. Enron gives us the perfect objective lesson that what may seem to be extraordinary talent may really

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This assumes, of course, that there was reliance on the document containing the omission. It is arguable, however, that even if the logic I criticized is rejected, there should be no recovery in my Item 404 example set forth in Part III, Section D. Having put the reader on notice that the facts are being withheld, the justification for any reliance might disappear. Cf. Jensen v. Kimble, 1 F.3d 1073, 1077 (10th Cir. 1993) (finding no fraud-based cause of action for breach of disclosure duty when victim is put on notice that facts are being withheld).

\(^4\) For a further discussion of executives' reactions to and consequent likely success of Sarbanes-Oxley, see *supra* notes 58-70 and accompanying text. Partly because of my doubts about the level of enforcement of the laws relating to financial fraud, I am less pessimistic than people such as Larry Ribstein who fear that there will be such a chilling effect from the new regime that investors will be worse off than they were previously. See Ribstein, *supra* note 5. I do concede that any increased accountability does have some unquantifiable adverse effect on internal trust and motivation within the firm.
be some combination of luck and cheating. Growth by serial acquisitions should be equally suspect, given the evidence of the last decade. In sum, investors need to ratchet down their investment expectations—a message Wall Street's retail side hardly wants to embrace, and investors themselves resist.

As Henry Hu has shown, the SEC is in a difficult position with respect to investor education in the face of all this. The underlying message—if stated accurately—is that stocks are more risky than many investors expect for reasons that include (but are hardly limited to) managerial abuse and that investors by and large lack the time, skill, data and judgment to evaluate risk and return on individual stocks. They should therefore diversify broadly and passively, or leave investment analysis to professionals—who, unfortunately, charge dearly for their services and too often deliver disappointing results. Those cautionary messages are inconsistent, however, with the overarching theme of individual investor empowerment on which the Commission’s own political fortunes largely rest. The SEC wants to persuade successive generations of retail investors that everything is controllable (and largely under control), because that is why it gets its funding and power. It is tempted to rationalize, too, and so we cannot seem to escape the expectations gap. Post-Enron reforms or not, the SEC will long be trying to muddle through the delicate task of trying to persuade investors that the issuers are honest enough to justify broad and confident public participation without committing its own version of a fraud on the market.


86. See Langevoort, Animal Spirits, supra note 5, at 175 (“[T]he SEC's . . . message of empowerment [of individual investors] may contribute not simply to investor confidence, but to overconfidence.”).