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Reforming Regulation of Corporate Governance*

Kenneth Lehn

Abstract: Since the revelation of accounting scandals at Enron, Worldcom, and several other high profile companies (“Enron *et al*”) five years ago, there has been unprecedented public focus on U.S. corporate governance. A common view, articulated by many journalists, politicians and public pundits, is that these scandals were indicative of a crisis that eroded investor confidence in U.S. corporations. This paper makes the argument that the increase in resources allocated to securities enforcement and the substantial penalties meted out to executives convicted of accounting fraud have dramatically reduced the incentive to engage in Enron-like behavior.

About the Author: Kenneth Lehn is the Samuel A. McCullough Professor of Finance in the Katz School of Business at the University of Pittsburgh, where he teaches courses in financial economics. Professor Lehn also is an affiliated professor of law in the School of Law at the University of Pittsburgh. Professor Lehn’s research focuses on topics in corporate finance, including mergers and acquisitions, corporate governance, and capital structure.

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Reforming Regulation of Corporate Governance¹

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A. Introduction

Since the revelation of accounting scandals at Enron, Worldcom, and several other high profile companies (“Enron *et al*”) five years ago, there has been unprecedented public focus on U.S. corporate governance. A common view, articulated by many journalists, politicians and public pundits, is that these scandals were indicative of a crisis that eroded investor confidence in U.S. corporations. The “crisis of confidence” rationale was used to justify several policy changes, including, perhaps most prominently, the Sarbanes-Oxley Act, which was passed by Congress with unusual speed and signed into law by President Bush on July 30, 2002.

Sarbanes-Oxley is an historic piece of legislation, as the first major federal attempt to micromanage the internal governance procedures of U.S. corporations. Among other things, it requires (i) chief executive officers (“CEOs”) and chief financial officers (“CFOs”) to certify financial statements and other information, (ii) companies to file annual internal control reports that include evaluations of the effectiveness of the controls, and (iii) audit committees to comply with new regulations governing their composition and procedures. In addition, Sarbanes-Oxley tightened regulation of auditors and provided the SEC with expanded enforcement authority against auditors, officers, and directors.

Since its adoption, many policymakers on both sides of the aisle, including supporters of the legislation, have expressed skepticism about whether Sarbanes-Oxley and other regulations

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related to corporate governance are impairing innovation, entrepreneurship, and the competitiveness of U.S. corporations and financial markets.

For example, one year after Sarbanes-Oxley was signed into law, William Donaldson, then chairman of the Securities and Exchange Commission (“SEC”), stated that “I worry about the loss of risk-taking zeal. ... Sarbanes-Oxley unleashed batteries of lawyers across the country ... [the result is] a huge preoccupation with the dangers and risks of making the slightest mistake, as opposed to a reasonable approach to legitimate business risk.”² Similarly, in Congressional testimony in July 2003, Alan Greenspan, then chairman of the Federal Reserve Board, stated that “corporate executives and boards of directors are seemingly unclear, in the wake of the recent intense focus on corporate behavior, about how an increase in risk-taking on their part would be viewed by shareholders and regulators. As a result, business leaders have been quite circumspect about embarking on major new investment projects.”³

In an op-ed in the *Wall Street Journal* on November 1, 2006, New York Mayor Michael Bloomberg and Senator Charles Schumer stated that “Since [Sarbanes-Oxley] passage, auditing expenses for companies doing business in the U.S. have grown far beyond anything Congress had anticipated. ... There appears to be a worrisome trend of corporate leaders focusing inordinate time on compliance minutiae rather than innovative strategies for growth, for fear of facing personal financial penalties from overzealous regulators.”⁴ Mayor Bloomberg and Senator Schumer go on to say that they will seek to redefine a “balance of innovation and regulation” over the next several months.

² Adrian Michaels, “After a Year of U.S. Corporate Clean-Up, William Donaldson Calls for a Return to Risk-Taking,” *Financial Times.com*, July 24, 2003.

³ Testimony of Chairman Alan Greenspan before the Committee on Financial Services, U.S. House of Representatives, July 15, 2003.

⁴ Michael Bloomberg and Charles Schumer, “To Save New York, Learn from London,” *Wall Street Journal*, November 1, 2006.

As recently as November 2006 in a speech to the Economic Club of New York, Treasury Secretary Paulson called for a reassessment of the regulatory “reforms” adopted after the corporate scandals, arguing that regulation, including Sarbanes-Oxley, and securities litigation is chasing capital from the U.S. to foreign financial markets. As possible evidence of this, 24 of the 25 largest worldwide initial public offerings (“IPOs”) last year listed in foreign markets, suggesting that U.S. financial markets are no longer the preferred venue for large IPOs. Secretary Paulsen went on to state that “When it comes to regulation, balance is key. ... Excessive regulation slows innovation, imposes needless costs on investors, and stifles competitiveness and job creation. At the same time, we should not engage in a regulatory race to the bottom, seeking to eliminate necessary safeguards for investors in a quest to reduce costs.”⁵

Hence, there is a growing consensus that changes to Sarbanes-Oxley and our approach to regulation of corporate governance is necessary. In a recent interview with *SDA-Asia*, Alan Greenspan joked that “Sarbanes-Oxley passed both houses with almost unanimous votes. Any bill that goes through Congress with that sort of vote cannot be good.” Dr. Greenspan predicted the 110th Congress will make changes to Sarbanes-Oxley, as some key Democrats, including Congressman Barney Frank, chairman of the House Financial Services Committee, and Senator Schumer favor such reform. In addition, in December 2006, the SEC will consider proposed changes to controversial Section 404 of Sarbanes-Oxley, which concerns the audits of companies’ internal financial controls.

As policymakers consider regulatory reform in this area, they should consider a different model for regulating corporate governance. Instead of trying to micromanage corporate governance with a “one size fits all” approach, as Sarbanes-Oxley does to a large degree,

⁵ Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of U.S. Capital Markets, Economic Club of New York, New York, NY, November 20, 2006.

policymakers should focus on affecting the expected costs and benefits of accounting fraud such that it is irrational for executives to commit this fraud. As I argue below, the expected costs of accounting fraud increased substantially since 2001, which greatly reduces the incentive to commit “Enron-like” fraud. This change in incentives is likely to be far more effective in deterring fraud than the costly, cumbersome provisions of Sarbanes-Oxley. In my opinion, Congress should repeal those parts of Sarbanes-Oxley that micromanage corporate governance procedures and focus on policy variables that affect the expected costs and benefits of accounting fraud.

B. No Evidence Of A “Crisis of Confidence” After Enron

A popular rationale for Sarbanes-Oxley at the time of its passage is that Enron *et al* had caused a “crisis of confidence” in U.S. corporations that made investors reluctant to invest in U.S. companies. This, in turn, it was argued, was a major reason for the substantial decline in U.S. stock prices around the time the Enron scandal was revealed in October 2001. Sarbanes-Oxley, it was argued, would restore investor confidence in the integrity of U.S. corporations.

A close look at stock price movements during this time period contradicts this view.

First, the decline in U.S. stock prices during the period around the revelation of Enron *et al* was comparable to the decline in stock prices in other developed countries that did not experience high-profile accounting/governance scandals. For example, the S&P 500, a broad-based U.S. stock market index, declined by 29% from its peak on March 24, 2000 to October 15, 2001, the date of the first public revelation of the Enron scandal. The corresponding decline in the U.K.’s FTSE Index was similar, at 25%, even though the U.K. had not been besieged with headline-grabbing corporate scandals. The corresponding declines in Germany’s DAX index, France’s CAC index, and Japan’s Nikkei index over this period were even larger, at 43%, 34%,

and 48%, respectively (see Exhibit 1). Hence, it is hard to infer from these data that the large decline in U.S. stock prices during this period was related to concerns about widespread accounting problems among U.S. companies.

Perhaps even more revealing is the pattern of stock prices from October 15, 2001, the date the Enron scandal was first revealed publicly, to July 30, 2002, the day President Bush signed Sarbanes-Oxley into law. During this period, the S&P 500 fell 16%, reflecting a general decline in U.S. stock prices. Some advocates of Sarbanes-Oxley cited declining U.S. stock prices as evidence that investors had lost confidence in U.S. companies. Yet, the corresponding declines in the U.K., German, and French indices were the same or greater at 16%, 19%, and 19%, respectively, even though these countries did not experience a comparable amount of angst over corporate scandals during this period (see Exhibit 2). Only Japan had an appreciably smaller decline in stock prices over the period (-5%).

The evidence strongly suggests that factors other than a loss of investor confidence in U.S. companies accounted for the decline in U.S. stock prices around the time of the Enron scandal. If so, then the major purported benefit of Sarbanes-Oxley, restoring investor confidence in U.S. companies, was negligible. This evidence suggests that a fundamental premise on which Sarbanes-Oxley was justified is just not true.

C. Diagnosing the Cause of the Corporate Scandals

In order to prescribe an appropriate remedy for a policy problem, it is important to properly diagnose the reason for the problem. Unfortunately, the hurried nature with which Sarbanes-Oxley was passed did not allow for a reasoned diagnosis of the problems that led to the scandals.

A common view among advocates of Sarbanes-Oxley at the time of its passage was that the “greed” of U.S. business executives led to the proliferation of high profile scandals in 2001 and 2002. However, the “greed theory” is not a satisfactory explanation of why these scandals occurred when they occurred.

Economists generally assume that people in all walks of life, not just business, prefer “more” to “less,” and that this desire does not swing widely over time. Furthermore, accounting fraud is not a new phenomenon – cases of accounting fraud go back to the inception of business enterprise. During the past thirty years alone, the SEC has brought hundreds of cases of accounting fraud, including dozens during the stock market boom of the late 1990s when some investors and the media were less engaged in the topic.

If not an outburst of greed, what, then, explains the presumed increase in accounting fraud in the early part of the millennium? Professor Gary Becker, the Nobel- prize winning economist at the University of Chicago, developed an economic theory of crime that suggests an answer.

Under Professor Becker’s theory, crime, or in this case, accounting fraud, can be viewed as an act governed by rational behavior. Whatever their ethical predispositions, executives are more likely to commit fraud as the expected costs of fraud decline relative to the expected benefits of fraud. Conceptually, the expected costs are simply the probability the fraud is detected times the penalty incurred if the fraud is detected. Hence, if there is a 10% chance that the fraud is detected, and the penalty if detected is 10 years in prison, then the expected prison sentence before a fraud is committed is one year (i.e., 10% times 10 years).

There is good reason to believe that the probability of detecting accounting fraud, and, therefore, the expected costs of accounting fraud, declined during the 1990s. If so, it is

predictable that there would have been an increased incidence of accounting fraud during this period.

First, U.S. securities markets grew substantially during the 1990s, at a rate that far outpaced the growth in resources at the SEC, the federal agency chiefly responsible for ferreting out accounting fraud. As one measure of this, the value of publicly traded companies on the New York Stock Exchange (“NYSE”) and Nasdaq increased more than five-fold during the 1990s, from \$3.1 trillion in 1990 to \$16.1 trillion in 2000. During the same time, the SEC’s budget increased a little more than twofold, from \$162 million in 1990 to \$372 million in 2000 (see Exhibit 3).

As U.S. securities markets grew more rapidly than the SEC, the probability the SEC would identify and prosecute accounting fraud declined, thereby lowering the expected cost of committing fraud. At the margin, this made fraud more rational, resulting in a higher incidence of accounting fraud.

It also is likely that the changing mix of assets in the U.S. economy during the 1990s made it more difficult to detect accounting fraud, thereby resulting in a higher incidence of fraud. During the past twenty years, intangible assets such as research and development, human capital, and growth options have become a more important part of the U.S. economy, and tangible assets have become less important. Throughout the 1990s, there was enormous growth in firms with mostly intangible assets, such as telecommunications, software, and dot.com firms. Compared with firms that have mostly “bricks and mortar” (e.g., steel, textiles, food), these firms are more difficult to value, their managers are more difficult to monitor, and their accounting data is more difficult to verify.

As a result, the probability of detecting accounting fraud is almost certainly more difficult in firms with largely intangible assets. As a result, accounting fraud is more likely in these firms. Dean Mason Gerety of Northern Arizona University and I found some support for this hypothesis in a paper published in 1997.⁶ Anecdotally, many of the prominent cases of accounting fraud occurred in firms with large amounts of intangible assets, such as Worldcom, Qwest, and Adelphia. As firms with mostly intangible assets accounted for a larger proportion of the public market, it is not surprising that there was a corresponding increase in accounting fraud.

A third reason why the incidence of accounting fraud may have grown in the 1990s is that the sizeable increase in the use of executive stock options may have increased the expected benefits of committing fraud. Overall, stock options do more good than harm, as they can be used to align incentives of managers with stockholders. However, stock options also can increase incentives for accounting fraud. If a manager expects the fraud to artificially inflate his company's stock price, and if he views the expected gains from his options position to exceed the expected costs of fraud, then, holding ethical constraints constant, he is more likely to commit fraud. At the margin, the growth in executive stock option grants during the 1990s probably increased the incentive to commit accounting fraud, even if, on balance, stock options serve the interests of stockholders.

If my diagnosis is correct, that the proximate cause of the accounting scandals five years ago was a change in the expected costs and benefits of fraud, then the appropriate policy response is to change that the cost-benefit calculus in such a way that Enron-like fraud becomes

⁶ Mason Gerety and Kenneth Lehn, "The Causes and Consequences of Accounting Fraud," *Managerial and Decision Economics*, 1997, pp. 587-599.

irrational. As I discuss in the next section, Congress, the SEC, and state attorneys general effectively have done this since 2001.

D. The Expected Costs of Accounting Fraud have Increased Substantially Since Enron

The two variables that determine the expected costs of fraud, the probability of detection and the penalty incurred if detected, have both increased significantly since the revelation of Enron *et al* five years ago. As a result, the incentive to commit accounting fraud is far lower today than it was five years ago.

The probability of detection has undoubtedly increased since 2001. Sarbanes-Oxley immediately authorized increased funding of \$20 million for the SEC, enabling it to add 100 people to its enforcement staff. Since then, the SEC budget has grown substantially, to \$888 million in 2006, an increase over its level in 2000. The budget for the SEC's division of enforcement in 2006 is \$336.7 million, almost as large as the entire SEC budget in 2000. In addition to the increase in the SEC's overall budget and the budget for its enforcement activities, state attorneys general, perhaps represented most prominently by Elliot Spitzer, have become more vigilant in their efforts to fight state securities fraud. This also has increased the probability of detection.

The penalties imposed on those caught committing fraud also have increased substantially since 2001. Recently, Jeffrey Skilling of Enron and Bernard Ebbers of Worldcom received prison sentences of 24 years and 25 years, respectively, meaning that both will live most of their remaining life in prison. In addition, the remaining \$60 million of Skilling's personal assets will be liquidated to compensate the alleged victims of his fraud. Other than his house and \$50,000, all of Ebber's \$45 million of personal assets will be liquidated for the same reason. In addition to these high profile individuals, dozens of lower level executives have been

sentenced to prison or face prison sentences related to accounting fraud, resulting in ruination of their lives and personal finances.

In addition, the indictment of Enron's auditor, Arthur Andersen, resulted in the demise of the firm, causing great financial loss to hundreds of Arthur Andersen partners, most of whom had no culpability in the Enron scandal. This event also has increased the expected costs of accounting fraud, such that the incentive for committing this fraud is considerably less than it was in 2001.

E. "One Size Fits All" Regulation is the Wrong Approach

The large increase in the expected costs of accounting fraud has almost undoubtedly gone a long way towards deterring the Enron-like behavior that resulted in the adoption of Sarbanes-Oxley. As policymakers consider revisions to the law in the ensuing months, they should consider repealing those aspects of Sarbanes-Oxley that impose internal governance procedures on firms.

The inherent problem with prescribing "good governance" standards on all firms through legislation or regulation is that there are not universal governance standards that are good for all firms. In reality, optimal governance structure and procedures vary significantly across firms and industries.

The pressure on the SEC to relieve small firms from the onerous requirements of Section 404 of Sarbanes-Oxley illustrates the fallacy of "one size fits all" regulation. The high fixed costs of complying with Section 404 are greater than any benefit investors in small firms, if not all firms, could conceivably derive from this provision of Sarbanes-Oxley. Hence, the SEC is considering exemptions for firms below a certain size. But identifying the appropriate size for this cutoff and quantifying other variables that might affect the costs and benefits of this

provision on a firm-by-firm basis is prohibitively costly, if not impossible. Furthermore, if complying with this section of Sarbanes-Oxley was efficient, then firms should have a private incentive to voluntarily comply with the law. Perhaps as an alternative to outright repeal of Section 404, Congress should consider allowing firms to “opt in” (or “opt out”) of Section 404.

Similarly, regulations that attempt to prescribe “good” board structures are inherently plagued by the fact that a “good” (i.e., value-maximizing) board structure for one firm may be a “bad” (i.e., value-reducing) board structure for another firm. Consider the issue of independent directors. Corporate governance activists often argue that board independence is universally good. Yet, historically, one finds systematic differences in the independence of boards across companies.

Historically, boards have been more independent in mature industries (e.g., food processing, textiles, steel) than in younger, high-growth industries, such as software and biotech. There is a good economic reason for this pattern. In young, high-growth firms, it is more difficult for outsiders to assess the value of companies and monitor the managers. Hence, adding more independent directors to the board of a high growth company is likely to add costs that exceed any countervailing benefit. Perhaps the largest cost is the cost of additional management time as managers, instead of managing the company, need to spend more time providing information to the independent directors. Regulation of board size and structure is likely to impose costs on firms, especially high growth firms, without sufficient countervailing benefit.

The danger with the “one size fits all” provisions of Sarbanes-Oxley is that it has moved the U.S. in the direction of codifying corporate governance. One of the strengths of the U.S. economic system, and others that derive from the U.K. common law tradition is that we generally do not codify corporate behavior. Different firms are allowed to experiment with,

among other things, different governance structures and procedures, subject to enforcement of antifraud laws and regulations. Codifying corporate governance, i.e., restricting choice, imposes substantial costs on firms, especially those operating in innovative, high growth industries where nimbleness and flexibility are important.

Conclusion

Congress has the opportunity to correct a mistake it made when it hurriedly passed Sarbanes-Oxley in 2002. The federal government is very effective at establishing incentives, but largely ineffective at micromanaging the internal governance procedures of U.S. firms that vary greatly in terms of size and industry characteristics. This paper makes the argument that the increase in resources allocated to securities enforcement and the substantial penalties meted out to executives convicted of accounting fraud have dramatically reduced the incentive to engage in Enron-like behavior. In light of this, Congress should repeal the “one size fits all” provisions of Sarbanes-Oxley, which are unlikely to be effective remedies for high profile corporate scandals.

Exhibit 1
Percent Change in Major Stock Indices in the U.S., U.K., Germany,
France, and Japan,
March 24, 2000 to October 15, 2001

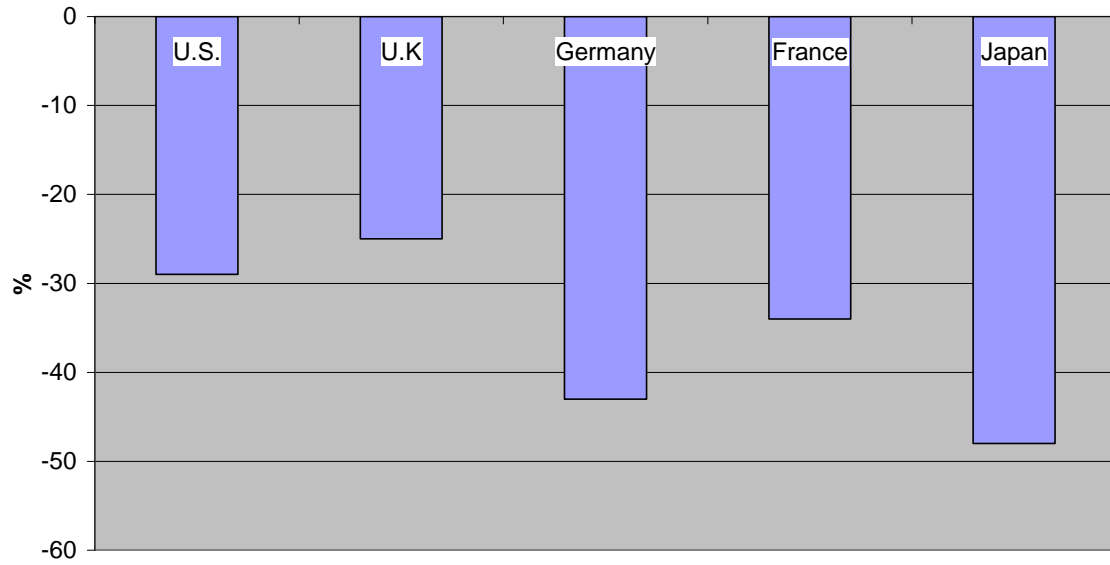


Exhibit 2
Percent Change in Major Stock Indices in the U.S., U.K., Germany, France, and Japan
October 15, 2001 to July 30, 2002

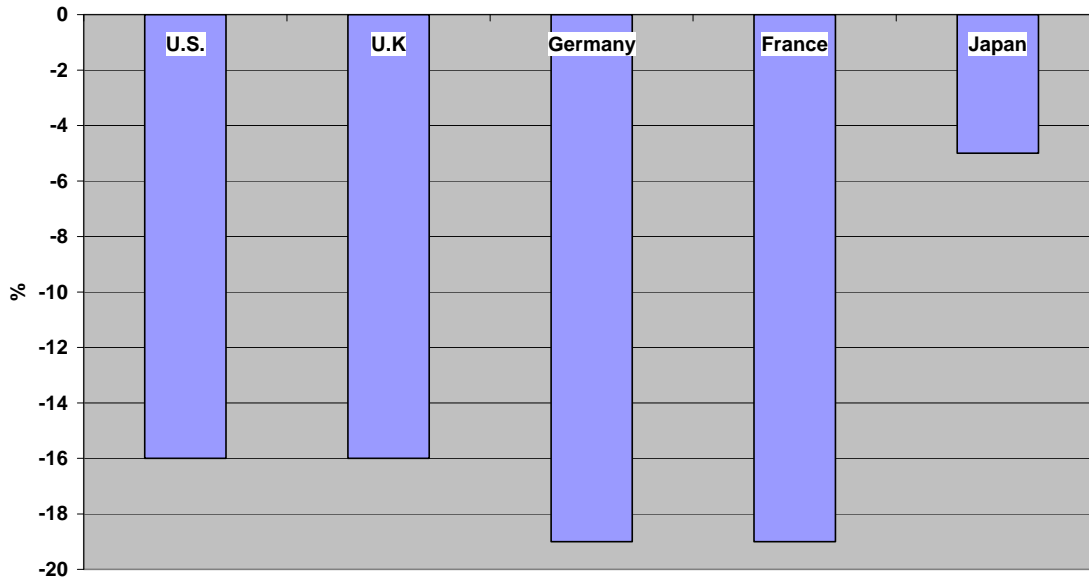


Exhibit 3
SEC Budget and Value of NYSE and NASDAQ Listed Firms, 1990 and 2000

