

University of Pennsylvania Carey Law School

Penn Law: Legal Scholarship Repository

Faculty Scholarship at Penn Law

2004

The Role of Government in Corporate Governance

Cary Coglianese

University of Pennsylvania Carey Law School

Elizabeth K. Keating

Michael L. Michael

Thomas J. Healey

Follow this and additional works at: https://scholarship.law.upenn.edu/faculty_scholarship



Part of the [Antitrust and Trade Regulation Commons](#), [Business Administration, Management, and Operations Commons](#), [Business Law, Public Responsibility, and Ethics Commons](#), [Business Organizations Law Commons](#), [Economic Policy Commons](#), [Economics Commons](#), [Law and Economics Commons](#), [Legal Studies Commons](#), and the [Work, Economy and Organizations Commons](#)

Repository Citation

Coglianese, Cary; Keating, Elizabeth K.; Michael, Michael L.; and Healey, Thomas J., "The Role of Government in Corporate Governance" (2004). *Faculty Scholarship at Penn Law*. 1243.

https://scholarship.law.upenn.edu/faculty_scholarship/1243

This Article is brought to you for free and open access by Penn Law: Legal Scholarship Repository. It has been accepted for inclusion in Faculty Scholarship at Penn Law by an authorized administrator of Penn Law: Legal Scholarship Repository. For more information, please contact PennlawIR@law.upenn.edu.

THE ROLE OF GOVERNMENT IN CORPORATE GOVERNANCE

CARY COGLIANESE*
ELIZABETH K. KEATING**
MICHAEL L. MICHAEL***
THOMAS J. HEALEY****

Recent corporate scandals have led to public pressure to reform business practices and increase regulation. Of course, dishonesty, greed, and cover-ups are not new societal concerns. Indeed, much of the existing system of corporate regulation in the United States emerged in response to vagaries of the late 1920s and the subsequent stock market crash. What has changed in recent years, though, is the frequency and public salience of corporate scandals. As a measure of public attention, media coverage of corporate governance issues has increased sharply since the fall of 2001, when Enron declared dramatic third quarter losses. Over the past three years, stories on corporate governance increased by more than five

* Chair, Regulatory Policy Program and Associate Professor of Public Policy, John F. Kennedy School of Government, Harvard University. We gratefully acknowledge support from the Center for Business and Government's Corporate Social Responsibility Initiative, the Global Generations Policy Initiative, the New York Stock Exchange Foundation, and TIAA/CREF. We also appreciate research assistance from Ben Gerber and Gopal Raman, as well as helpful comments on an earlier draft from Marc Andersen, Paul Hodge, Bob Steel, Hope Steele, and Randy Young, as well as all the participants at a conference organized by the Regulatory Policy Program in May 2004. This article represents the authors' efforts to summarize and synthesize the perspectives expressed at that conference. The views expressed do not necessarily reflect those of its authors, the Regulatory Policy Program, the Center for Business and Government, the Kennedy School of Government, Harvard University, or any of the organizations supporting this project. Furthermore, although this article synthesizes the conference dialogue, it does not necessarily represent the views of all the participants nor should it be construed to represent a consensus statement or a shared set of recommendations.

** Assistant Professor of Public Policy, John F. Kennedy School of Government, Harvard University.

*** Senior Fellow, Center for Business and Government, John F. Kennedy School of Government, Harvard University.

**** Adjunct Lecturer and Senior Fellow, Center for Business and Government, John F. Kennedy School of Government, Harvard University.

times in the *Wall Street Journal* and more than ten times in *USA Today*, relative to the previous three years.¹

The public outcry over the recent scandals has made it clear that the status quo is no longer acceptable: the public is demanding accountability and responsibility in corporate behavior. It is widely believed that it will take more than just leadership by the corporate sector to restore public confidence in our capital markets and ensure their ongoing vitality. It will also take effective government action, in the form of reformed regulatory systems, improved auditing, and stepped up law enforcement.

Already policymakers have adopted numerous reforms. In 2002, Congress speedily passed the Sarbanes-Oxley Act,² imposing (among other things) new financial control and reporting requirements on publicly traded companies. The Securities and Exchange Commission ("SEC") and the self-regulatory organizations it oversees—both the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD")—have adopted new standards for public companies and securities dealers.³ The newly created Public Company Accounting Oversight Board ("PCAOB") is working to revamp oversight of auditors.⁴ Finally, state and federal en-

1. We compared the results of Westlaw searches for the three years prior to Enron's loss disclosure on October 16, 2001, with results for the three subsequent years. In the *Wall Street Journal* database, coverage increased from 314 stories containing the words "corporate governance" in the 1998-2001 period to 1,852 stories in the 2001-2004 period. In *USA Today*, hardly a newspaper noted for its financial coverage, the number of stories mentioning "corporate governance" increased from 22 to 256. Not surprisingly, the number of stories with the terms "corporate fraud" also increased—from 7 to 151 stories in the *Wall Street Journal*, and zero to 71 stories in *USA Today*.

2. Sarbanes Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C.) [hereinafter Sarbanes-Oxley Act].

3. See NASD Manual Rule 4350 (2003), available at http://cchwallstreet.com/nasd/nasviewer.asp?SelectedNode=4&FileName=/nasd/nasd_rules/RulesoftheAssociation_mg.xml#chp_1_4; NYSE Listed Company Manual § 303A (2003), available at <http://www.nyse.com/listed/p1020656067970.html?displayPage=%2Fabout%2F1045516490394.html>

4. See William J. McDonough, Chairman Public Company Accounting Oversight Board, Speech at the Fourth Annual A.A. Sommer, Jr. Lecture on Corporate, Securities & Financial Law, 9 FORDHAM J. CORP. & FIN. L., 583, 595-97 (2004); see also PCAOB, BRIEFING PAPER: PROPOSED AUDITING STANDARD ON CONFORMING AMENDMENTS TO PCAOB INTERIM STANDARD RESULT-

forcement officials have responded by aggressively pursuing a number of highly publicized prosecutions against corporate leaders and others accused of violating financial rules.⁵

These responses make clear that the governance of corporations has become a central item on the public policy agenda. The recent scandals themselves demonstrate that lax regulatory institutions, standards, and enforcement can have huge implications for the economy and for the public.⁶ Of course, government responses to scandals should be well considered and effective. Regulatory reforms that over-react or that address symptoms while ignoring underlying causes can be costly and counterproductive. The task of government is to restore corporate integrity and market confidence without stifling the dynamism that underlies a strong economy.

To address this challenge, the Center for Business and Government and its Regulatory Policy Program organized a conference in May 2004 to explore the role of government in corporate governance. The conference brought together government officials, business leaders, and academic researchers

ING FROM THE ADOPTION OF PCAOB AUDITING STANDARD NO. 2, (2004), *available at* http://www.pcaobus.org/Rules_of_the_Board/Documents/BriefingPaper-0040308-2.pdf.

5. *See, e.g.*, Press Release, Office of New York State Attorney General Elliot Spitzer, Spitzer Announces Market-Timing Settlement with Banc One Advisors Corporation (July 29, 2004), *available at* http://www.oag.state.ny.us/press/2004/jun/jun29d_04.html; Press Release, Office of New York State Attorney General Elliot Spitzer, Spitzer, S.E.C. Reach Largest Mutual Fund Settlement Ever (Mar. 15, 2004), *available at* http://www.oag.state.ny.us/press/2004/mar/mar15c_04.html; *see also* SECURITIES & EXCHANGE COMMISSION, SEC 2003 ANNUAL REPORT, ENFORCEMENT (2003), *at* <http://www.sec.gov/pdf/annrep03/ar03enforce.pdf>; Press Release, Office of the Secretary of the Commonwealth, Secretary Galvin Charges Managers of Three Hedge Funds for Targeting Unsophisticated Investors (Aug. 13, 2003), *available at* <http://www.sec.state.ma.us/sct/sctpdf/hedgefundpressrel.pdf>.

6. *See* Lynne L. Dallas, *A Preliminary Inquiry into the Responsibility of Corporations and their Officers and Directors for Corporate Climate: the Psychology of Enron's Demise*, 35 RUTGERS L.J. 1, 1 (2003) (“[T]he reverberating effects of Enron’s demise undermined confidence in U.S. stock markets.”); *see also* Douglas L. Keene & Rita R. Handrich, *The Enron Effect: Uncertainty, Mistrust, and Cynicism*, ATLA Winter 2003 Convention Reference Materials, Advocacy Track: Communicating with the Jury—Repackaging Your Message (Feb. 2003) (“The wave of corporate meltdowns epitomized by the Enron scandal has had the effect of eroding the faith workers place in our country’s business institutions.”).

to discuss three fundamental public policy challenges raised by recent corporate abuses.

First, the recent corporate crisis has brought into relief the challenge of *who should regulate*. Currently, the government shares regulatory authority and oversight with various nongovernmental, self-regulatory institutions. Self-regulation has been prominent in the operation of securities markets as well as in the oversight of the accounting and legal professions. Are these existing self-regulatory arrangements sufficient? Should government change its oversight of self-regulatory institutions? Or should government assume a greater and more direct role in regulating?

In addition to choosing who will regulate, recent scandals have highlighted the challenge of deciding *how to regulate*. Most broadly, regulators face a choice between principles and rules. Should regulatory standards articulate broad goals and purposes; guiding behavior through the adherence to general principles? Or should regulations take the form of specific rules that tell companies and their lawyers and auditors exactly what is acceptable and unacceptable? Rules have their virtues, and they have been widely used, but they also may allow corporate actors to find ways to comply with the letter of the law while circumventing its spirit.

Finally, regulators face the challenges of deciding *how to enforce* the rules or principles they have adopted. Is more aggressive enforcement needed? Should enforcement officials target just individual perpetrators, or should they also go after the corporations in which they work? When should regulators pursue criminal (as opposed to civil) sanctions? Furthermore, since both the state and federal governments have jurisdiction over publicly traded corporations, enforcement officials must constructively deal with jurisdictional competition.

These three major policy challenges framed the deliberations at the conference held at the John F. Kennedy School of Government. This article summarizes that discussion and is organized in three parts: (1) government regulation versus self-regulation, (2) the design of regulatory standards, and (3) regulatory enforcement.

I. SELF-REGULATION

For the past century, self-regulatory institutions have played a central role in policing both corporate behavior and the behavior of the professionals involved in corporate transactions. Since the 1930s, the nation's securities laws have expressly authorized self-regulatory organizations, such as the NYSE or the NASD, to assume primary responsibility for rulemaking and enforcement of securities violations.⁷ In addition, the actions of corporate accountants, corporate lawyers, and financial advisors have been subject to oversight by self-regulatory bodies.⁸

In light of the recent series of corporate scandals, it is reasonable to ask whether the current structure of self-regulation is adequate. However, deciding who should regulate corporate behavior and securities transactions is not merely a choice between either government or self-regulation.⁹ Rather, it is a question of when and how self-regulation should be used. What are the conditions under which self-regulation is appro-

7. Polly Nyquist, *Failure to Engage: The Regulation of Proprietary Trading Systems*, 13 YALE L. & POL'Y REV. 281, 290-292 (1995); Securities Exchange Act of 1934 § 6(b)(1), 15 U.S.C.A. § 78f (noting that for national securities exchanges, "the rules of the exchange [must be] designed to prevent fraudulent and manipulative acts and practices."); Securities Exchange Act of 1934 § 15A(b)(1), 15 U.S.C.A. § 78o-3 (addressing registration and self-regulation of national securities associations).

8. Some financial advisors have been subject to oversight by NASD or the exchanges. See, e.g., Press Release, NASD Regulation, Inc., NASD Charges H&R Block Financial Advisors With Fraud in Sale of Enron Bonds to Hundreds of Customers (Nov. 8, 2004), available at http://www.nasd.com/stellent/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_012056&ssSourceNodeId=553; Richard Spinale, Exchange Hearing Panel Decision 04-160 (New York Stock Exchange Oct. 5, 2004), available at <http://www.nyse.com/pdfs/04-160.pdf>; In the Matter of Lawrence Berman, American Stock Exchange (Nov. 2004), available at http://www.amex.com/at/amex/regulation/discipline/2004/Berman_Decision_110204.pdf. Lawyers and accountants have their own self-regulatory overseers.

9. For a discussion of different allocations of regulatory authority, see Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 THEOR. INQUIRIES IN LAW 4 (2001), available at <http://www.law.harvard.edu/faculty/hjackson/pdfs/2001.Jackson.Centralization.Theoretical.Inquiries.pdf>; Securities & Exchange Commission, Concept Release Concerning Self-Regulation, Release No. 34-50700 (Nov. 18, 2004), available at <http://sec.gov/rules/concept/34-50700.htm>.

priate? And when it is appropriate, how should self-regulation be structured to maximize its advantages and minimize its disadvantages?

The Advantages and Disadvantages of Self-Regulation

To some, the term *self-regulation* is an oxymoron, or something akin to the fox guarding the chicken. But self-regulation offers a number of potential advantages in the realm of corporate regulation. Conference participants highlighted at least five potential advantages of self-regulation:

1. *Proximity.* Self-regulatory organizations are, by definition, closer to the industry being regulated. This close proximity means that self-regulatory organizations will generally have more detailed and current information about the industry, something that is especially helpful in rapidly changing sectors. By comparison, government regulators are often playing “catch up.” Being closer to the action, self-regulators are better situated to identify potential problems more quickly.

2. *Flexibility.* Self-regulatory organizations can act with greater flexibility than government regulators. They are not subject to the same kinds of procedural and due process hurdles that government is, nor do they face the same political constraints. Governmental regulators do not relish dealing with politically unpopular or extremely complex issues, so these issues can be delegated to self-regulatory bodies.

3. *Compliance.* Self-regulation may generate a higher level of compliance. The greater the involvement of industry in setting the rules, the more those rules may appear reasonable to individual firms. Self-regulation may also generate rules that solve the regulatory problem in ways more sensitive to industry practices and constraints, and hence it may be easier for firms to comply with them.

4. *Collective Interests of Industry.* Self-regulation can harness the collective interests of the industry. This may be another way that self-regulation promotes compliance, as competitors can effectively “police” each other.

5. *Resources.* Self-regulatory bodies may have a better ability to secure needed resources. In addition, when regulatory funding is self-directed, the legislature cannot cut it off or use it as a leverage point over the self-regulatory body.

Although self-regulation has these important advantages, it also has some noteworthy drawbacks. Self-regulation possesses at least five potential disadvantages:

1. *Conflicts of Interest.* The very proximity that can help the self-regulator acquire useful information can be a disadvantage because of conflicts of interest. Knowing an industry better does not mean that a regulator will have the proper incentives to regulate it more effectively. There is also the possibility that self-regulation will be used by older, more established entities simply to keep out newer market entrants.

2. *Inadequate Sanctions.* The greater flexibility afforded self-regulatory organizations also means they may have the discretion to mete out only modest sanctions against even serious violators. Conference participants noted several instances of self-regulatory organizations imposing small sanctions for egregious malfeasance.

3. *Underenforcement.* Self-regulators' conflicts of interest and flexibility may also make it more likely that compliance with rules will be insufficiently monitored. If industry's interests are at variance with society's interests, then enforcement with self-regulation might be less than optimal for the overall good of society.

4. *Global Competition.* In a global marketplace, an industry's collective interest can be defined by competition with foreign markets. If foreign markets are not equally burdened with regulation, then aggressive self-regulation could put domestic firms at a serious disadvantage, providing yet another reason to question whether self-regulators will make socially optimal decisions.

5. *Insufficient Resources.* Although the funding of self-regulatory bodies may not be susceptible to the whims of legislatures, underlying conflicts of interest could leave self-regulatory bodies with less than sufficient funding.

Clearly, self-regulation has both advantages and disadvantages. It is neither an inherently good nor inherently bad way to regulate corporate conduct. The challenge, then, is to find the situations in which self-regulation is the most appropriate model. After that, the challenge becomes finding optimal ways of designing self-regulatory institutions.

Designing Self-Regulatory Institutions

Even if existing self-regulatory institutions receive some of the blame for recent scandals, it does not follow that self-regulation should be abandoned entirely. Instead, the solution may be to change the internal governance structures of self-regulatory institutions, grant them new powers or increase their resources, or modify the degree and type of government oversight they receive.

Self-regulatory organizations can be designed in different ways.¹⁰ Some self-regulatory bodies are stronger and more effective than others. At the weakest end of the spectrum lies a voluntary industry code of conduct for which compliance is voluntary and the industry has little or no enforcement capability. For example, the Association of Investment Management and Research (now known as the CFA Institute) simply has the power to revoke the ability of its members to refer to themselves as “chartered financial analysts.”¹¹ At the other end of the spectrum lie self-regulatory bodies with greater powers both to make and to enforce binding rules. The traditional securities self-regulatory organizations, such as NYSE and NASD, develop extensive sets of rules and can bar those who violate these rules altogether from participating in the securities markets.¹² In between these poles lie organizations such as state bar associations that possess little regulatory authority but have the power to disbar or exclude, as well as self-regulatory bodies such as the Financial Accounting Standards Board (“FASB”) that have the power to adopt rules but relatively little ability to enforce them.¹³

In addition, some self-regulatory bodies are more closely connected with the industry’s self-interest than others. Institutions that share responsibilities for both creating markets and regulating them will face an inherent conflict—whether real

10. Margo Priest, *The Privatization of Regulation: Five Models of Self-Regulation*, 29 OTTAWA L. REV. 233 (1997).

11. See Bylaws of the CFA Institute § 3.10(a)(1) (2004), available at <http://www.cfainstitute.org/memberservices/pdf/cfainstitutearticlesandbylaws2004finalversion2.pdf>.

12. NASD Manual Rule 8310, available at http://cchwallstreet.com/nasd/nasdviewer.asp?SelectedNode=2&FileName=/nasd/nasd_rules/RulesoftheAssociation_mg.xml#chp_1_2; NYSE Rule 476.

13. See generally Financial Accounting Standards Board Information, at <http://www.fasb.org>.

or perceived—that is absent from institutions that keep regulatory functions separate from market operations. The NASD and, more recently, the NYSE have taken steps to make their regulatory functions independent of their market operations, precisely to keep the regulatory side of their organizations less conflicted.¹⁴

Finally, self-regulatory organizations can vary in terms of the amount of government oversight they receive. Some self-regulatory institutions are entirely separate from the government, while others, such as the NYSE and NASD, are overseen by the SEC.¹⁵ Government oversight can help overcome some of the limitations of self-regulation, counteracting potential bias while still securing the advantages of self-regulation. Government officials need not know as much as the self-regulators do about the industry, since they are not the principal regulators; they simply need to be able to assess the quality and seriousness of a self-regulatory organization's rulemaking and enforcement behavior. Moreover, by effectively delegating authority to self-regulatory institutions for routine regulatory functions, government agencies can then utilize their resources for detecting and responding to major rule violations and monitoring for systemic problems.

Looking Ahead

Despite the criticism self-regulatory institutions have received in recent years, self-regulation seems here to stay. But self-regulation is changing. Institutions such as the NYSE are undergoing significant structural changes, and the self-regulatory approach to overseeing the accounting industry is being revamped. An important task for the government in the future will be to monitor how well these changes work.

II.

RULES VERSUS PRINCIPLES

Whether the regulatory body is governmental or self-regulatory, it must decide whether to adopt principles or rules. In

14. National Association of Securities Dealers, *Report of the NASD Select Committee on Structure and Governance to the NASD Board of Governors* (1995); William Power, *NASD Board Approves Restructuring of Association and Nasdaq Stock Market*, WALL ST. J., Nov. 20, 1995, at B2.

15. See also *supra* note 7 and accompanying text.

response to recent corporate scandals, many have suggested that the current U.S. regulatory system is too focused on rules.¹⁶ Although rules can be simple, they also can provide an easy target for manipulation. Some observers, including the SEC, advocate a more principles-based approach to regulation that stresses goals and objectives rather than the particular methods of achieving those ends.¹⁷

Current policy responses to the recent corporate scandals exhibit a tension between rules and principles. The most notable legislative change has been the passage of the Sarbanes-Oxley Act, which has imposed numerous new and detailed rules on corporations.¹⁸ At the same time, the primary accounting standard setter, FASB, has been criticized for relying too much on detailed rules to determine the appropriate accounting treatment and, as a result, has recently explored a more conceptual or principles-guided approach to accounting standards.¹⁹

The Strengths and Weaknesses of Rules

In the United States, regulators and industry players often seek refuge in rules. Indeed, industry participants often lobby for a rules-based environment to avoid the unpredictability of later enforcement. Rules are typically thought to be simpler and easier to follow than principles, demarcating a clear line between acceptable and unacceptable behavior. Rules also reduce discretion on the part of individual managers or auditors, making it less likely that their judgments will be motivated by a desire to achieve personal gain at the expense of investors or the public. The seminal work in this area is the

16. Matthew A. Melone, *United States Accounting Standards—Rules or Principles?*, 58 U. MIAMI L. REV. 1161, 1161-62 (2004) (noting that in the wake of recent corporate scandals numerous arguments have been advanced in favor of a shift to principles-based accounting standards).

17. Securities & Exchange Commission, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (2003), available at <http://www.sec.gov/news/studies/principlesbased-stand.htm> (staff report recommending a more principles-based approach to accounting standards).

18. See *supra* note 2.

19. FASB, Proposal: Principles-Based Approach to U.S. Standard Setting (Oct. 21, 2002), available at http://www.fasb.org/proposals/principles-based_approach.pdf.

book *Playing by the Rules*, by Frederick Schauer of the John F. Kennedy School of Government, which analyzes the nature of rules-based decision making.²⁰

Despite the virtues of rules, in practice rules can be more complex—and, hence, more murky—than principles. As lawmakers try to address every conceivable eventuality, the rulebook becomes harder to understand and harder to follow. The tax code, for example, is heavily rules-based, and problems often arise when corporations undertake new types of transactions not covered by the code.²¹ Determining the appropriate tax treatment can sometimes be quite difficult, leaving auditors with *de facto* discretion and creating the need for additional rules to clarify inconsistencies or close gaps. Moreover, even simple and clear rules can be manipulated. An effective planner can use the exact wording of the rule to structure transactions in ways that comply with the letter of the law but circumvent its underlying purpose.²²

Recent Innovations in Regulatory Design

Since rules and principles each have their strengths and weaknesses, regulators sometimes try to combine them both in hybrid systems of regulation. Examples include recently adopted international standards governing the computation of risk-adjusted bank capital and the SEC's standards on calculating the fair value of mutual funds.²³ Both sets of regulations rely on principles that the industry must follow in developing and deploying complex econometric models to assess their own compliance.

20. FREDERICK SCHAUER, *PLAYING BY THE RULES: A PHILOSOPHICAL EXAMINATION OF RULE-BASED DECISION-MAKING IN LAW AND IN LIFE* (1991).

21. See generally Noel B. Cunningham and James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1 (2004).

22. See, e.g., Cass R. Sunstein, *Problems With Rules*, 83 CAL. L. REV. 953, 995 (1995) ("Because rules have clear edges, they allow people to 'evade' them by engaging in conduct that is technically exempted but that creates the same or analogous harms.").

23. BASEL COMMITTEE, *BASEL II: INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK* (June 2004), available at <http://www.bis.org/publ/bcbs107.htm> [hereinafter *BASEL*]; SEC Division of Investment Management, April 2001 Letter to the ICI Regarding Valuation Issues, available at <http://www.sec.gov/divisions/investment/guidance/tyle043001.htm>.

The international banking community is facing the implementation of a new capital adequacy framework, known as Basel II.²⁴ Although the underlying document is lengthy and complicated, the framework is based on risk-management principles and relies heavily on the parties with access to the best information. In this case, the regulated financial institutions are deemed to have the best information. Accordingly, Basel II recognizes that banks are responsible for computing their own bank capital and for determining the appropriate level of bank capital (within certain specified limits).²⁵ The role of the regulator is then to supervise the private parties after the fact. It is yet to be seen how well this innovative approach will work. The success of Basel II will probably rest on the ability of regulators to assess the sophisticated econometric models that banks develop and, hence, the willingness of member governments to invest in hiring and educating capable regulators.

In the case of the SEC's mutual fund standards, the issue is how to value fund shares each day.²⁶ The appropriate valuation of shares is not clear-cut, as some mutual fund holdings are illiquid while others may change in value in domestic after-hours trading or trading on markets around the world occurring after the 4:00 p.m. market close in the United States. The SEC's fair value standard is principles-based in that it stipulates that a mutual fund has an obligation to determine the "fair" value of the shares.²⁷ As with the banking example, the regulation relies upon the party with access to the best information to determine the appropriate value. Historically, most mutual funds have chosen to use the close of business prices to determine the fair value of the shares, although a few firms rely on a separate pricing model to value shares when there has been a substantial move in prices since the close of business.²⁸ As

24. See generally BASEL, *supra* note 23.

25. *Id.* at 14, 150, 181, 183, 195.

26. See, e.g., Statement of Paul F. Roye to Open Meeting of SEC (Dec. 3, 2003), available at <http://www.sec.gov/news/speech/spch120303pfr.htm>.

27. See SEC Staff Letter to Investment Company Institute (Dec. 30, 2001), available at <http://www.sec.gov/divisions/investment/guidance/tyl043001.htm>; see also Investment Company Act of 1940, 15 U.S.C. § 80(a)(2)(a)(41)(B).

28. For background on the mutual fund industry, see ROBERT C. POZEN, THE MUTUAL FUND BUSINESS (2d ed. 2002).

with the new Basel II standards, it remains to be seen how well this approach will work.

The Case of Financial Accounting

Another area undergoing regulatory re-design is corporate financial accounting. The requirements for corporate financial accounting were initially established after the stock market crash in 1929.²⁹ At that time, corporate financial statements were not always audited, and accounting followed industry practice rather than authoritative rules.³⁰ The poor quality of financial reporting was thought to be a significant factor leading to the stock market run-up and collapse.³¹ In response, Congress passed legislation that required the accounting industry to disclose regular financial statements that have been audited by external parties.³²

Outside investors require financial and accounting information that is both reliable and has been verified by auditors who are independent of management. Traditionally, accounting and auditing practices in the United States have been governed by detailed rules.³³ However, as recent scandals have shown, transactions can be structured to circumvent the rules. Enron's extensive use of special purpose entities, for example, enabled the company to avoid reporting consolidated information about high levels of debt.³⁴

In the wake of these scandals, some observers have proposed an alternative, hybrid approach to financial accounting standards, one that asserts an overarching principle that relevant and useful information should be reported.³⁵ A move to

29. Stephen A. Zeff, *How the U.S. Accounting Profession Got Where It is Today: Part I*, 17 ACCOUNTING HORIZONS 189, 189-205 (Sept. 2003).

30. George O. May, *Corporate Publicity and the Auditor*, 42 JOURNAL OF ACCOUNTANCY 321, 321-26 (Nov. 1926).

31. ROSS L. WATTS AND JEROLD L. ZIMMERMAN, *POSITIVE ACCOUNTING: THEORY* (1986).

32. See generally Securities Act of 1933, 15 U.S.C. § 77; Securities Exchange Act of 1934, 15 U.S.C. § 77a *et. seq.*

33. See Melone, *supra* note 16, at 1162.

34. Edmund L. Jenkins, *The FASB's Role in Serving the Public: A Response to the Enron Collapse* (Mar. 14, 2002), available at http://www.fasb.org/news/fasb_role.pdf

35. See Katherine Schipper, *Principles-Based Accounting Standards*, 17 ACCOUNTING HORIZONS 61 (Mar. 2003); AAA Financial Accounting Standards Committee, *Evaluating Concepts-Based vs. Rules-Based Approaches to Standard*

a more principles-based system of accounting standards, however, will face several important challenges.

First, many accountants are not sufficiently trained to make the requisite business-based judgment calls. Hence, under a principles-based system, many accountants could need to undergo significant training to acquire new skills. Second, corporate executives are encouraged, principally through compensation arrangements, to maximize shareholder value in the near term. For principles-based standards to be effective, the economic incentives that can lead managers to disclose unreliable or biased information would still need to be addressed. A restructuring of executive compensation contracts may be needed.³⁶ Third, in the absence of clear rules, company accountants may need to exercise a higher degree of professional resolve when results they are charged with presenting accurately conflict with corporate executives' interests.³⁷ Outside auditors may similarly need to show greater resolve when faced with client statements that are inconsistent with broad accounting principles.³⁸ Showing such resolve may be particularly challenging, since auditors and accountants may be less able to predict how regulators or courts will apply these principles in particular contexts.³⁹

Setting, 17 ACCOUNTING HORIZONS 73 (Mar. 2003); Mark W. Nelson, *Behavioral Evidence on the Effects of Principles- and Rules-Based Standards*, 17 ACCOUNTING HORIZONS 91 (Mar. 2003).

36. For a lucid analysis of executive compensation more generally, see LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

37. On the general pressures facing company accountants, see William E. Shafer, *Ethical Pressure, Organizational-Professional Conflict, and Related Work Outcomes Among Management Accountants*, 38 J. BUS. ETHICS 263 (2002).

38. See Scott A. Taub, *Speech Before the 2003 Thirty-First AICPA National Conference on Current SEC Developments* (Dec. 11, 2003) (suggesting that "auditors need to get more comfortable telling clients that certain accounting treatments are unacceptable, even in the absence of literature that specifically says so").

39. Of course, the status quo is not always an easy one for the auditor in the face of an aggressive management. As Roman Weil has noted, in a rules-based system, management can always challenge the auditor by demanding, "Show me where it says I can't." Roman Weil, *Fundamental Causes of the Accounting Debacle at Enron: Show Me Where It Says I Can't*, Summary of Testimony Presented to the House Committee on Energy and Commerce (Feb. 6, 2002), available at <http://www.sec.gov/rules/proposed/s74002/r1weill.htm>

In the end, notwithstanding the problems with rules-based accounting, businesses, auditors, and regulators may well continue to welcome rules. With the business environment in the United States seeming ever more litigious, corporate leaders may resist movement toward principles and continue to favor rules as a way of reducing uncertainty and avoiding costly litigation.

Looking Ahead

Just as the proper balance between government regulation and self-regulation is likely to vary by situation, so too no single spot on the continuum between principles and rules is likely to apply in all circumstances. Both ends of the spectrum have their strengths and weaknesses. Finding the point in the range that is appropriate for a given particular issue will remain a persistent challenge. A move to a more principles-based approach to accounting in the United States will prove especially challenging in the absence of greater political support.

III. ENFORCEMENT

Enforcement connects in important ways to both of the issues we have discussed. Whether the regulator is a government agency or a self-regulatory organization, its rules or principles must be enforced. As Voltaire argued, "It is well to kill from time to time an admiral to encourage the others."⁴⁰ In this same vein, recent prosecutions have had life-altering effects on both individuals and organizations. Jamie Olis of Dynegy, for example, was sentenced to twenty-four years in prison for accounting fraud.⁴¹ Arthur Andersen LLP was effectively put out of business after being convicted of obstruction of justice.⁴²

40. Voltaire, *Candide*, in *CANDIDE, ZADIG AND SELECTED STORIES* 78-79 (Donald Frame, trans. 1961).

41. Simon Romero, *Ex-Executive of Dynegy Is Sentenced To 24 Years*, N.Y. TIMES, Mar. 26, 2004, at C2.

42. See generally Kathleen F. Brickey, *Andersen's Fall from Grace*, 81 WASH. U. L. Q. 917 (2003); see also Jennifer M. Niece & Gregory M. Trompeter, *The Demise of Arthur Andersen's One-Firm Concept: A Case-Study in Corporate Governance*, 109 BUS. & SOC'Y REV. 183 (2004).

Enforcement not only has major consequences for individual and corporate violators, but it also can affect the overall credibility of a regulatory system. Enforcement actions send a message to the broader public. They both deter bad actors and level the competitive playing field. That said, greater enforcement is not always better, for taken too far it can dampen socially valuable risk-taking. As with any important policy tool, regulators need to know when and how to pursue enforcement actions, especially criminal prosecutions.

The Role and Limits of Criminal Sanctions

When employees' life-long pensions disappear in the wake of corporate fraud, white-collar crimes can no longer be seen as truly victimless. For the purpose of enforcement, then, one important issue is whether victims of white-collar crime are harmed more or less than victims of street crime. Some argue that employees who lose their jobs or retirement savings deserve to see the government give more than a mere wrist slapping to executives who caused their losses.⁴³ Others would question the fairness of a system that imposes a twenty-four-year sentence on someone convicted of accounting fraud when defendants convicted of criminal homicide often spend less time than that in jail.⁴⁴

Whether fair or not, criminal sanctions certainly can be effective in deterring corporate misconduct. Corporations, as profit-making enterprises, are accustomed to balancing risk and reward. The threat of a civil penalty may not be adequate to deter misbehavior if corporate officials simply view potential fines as "a cost of doing business." On the other hand, more severe sanctions, such as imprisonment or being put out of business, materially change the calculus. The possibility of going to jail does tend to catch the attention of corporate officials, and is often (though not always) enough to derail further contemplation of illegal conduct. Criminal law also em-

43. See, e.g., Damien Cave, *Lock Up the Analysts and Throw Away the Key*, SALON (May 17, 2002), available at: <http://www.salon.com/tech/feature/2002/05/20/analysts>.

44. Kathryn Keneally, *Some of the Distortions to Justice Caused by the Sentencing Guidelines*, CHAMPION MAGAZINE (Nat'l Ass'n of Criminal Defense Lawyers) (Aug. 2004), available at <http://www.nacdl.org/public.nsf/0/4a779f54d2fbe1ce85256f17006bc605?OpenDocument>.

powers other law-abiding individuals — whether the board of directors, senior management, or other professionals — to stand up to less well intentioned colleagues or, at a minimum, to resist going along with misconduct.

Yet criminal law is no panacea. First, many of the agencies that regulate business conduct lack the authority to impose criminal sanctions. For example, even though the SEC, the PCAOB, and the Office of the Secretary of the Commonwealth of Massachusetts play key roles in overseeing important corporate activities, none are authorized to seek or impose criminal sanctions. Second, criminal sanctions such as fines and imprisonment cannot provide restitution to shareholders, employees, vendors, or others injured by corporate misconduct. Third, not everyone will be deterred by the threat of criminal prosecution, as some people are prepared to accept a short prison sentence rather than pay back personal or corporate profits. Finally, criminal sanctions may raise the stakes so high that they unintentionally chill legitimate and economically beneficial conduct. For these reasons, effective enforcement is likely to depend on the continued use of civil penalties combined with the selective use of criminal sanctions.

The Organization as Defendant

Many of the strategic decisions facing prosecutorial and civil enforcement staff will be the same whether sanctions are criminal or civil. One of these decisions involves against whom to file an enforcement action. Enforcement officials can pursue just the individuals who actually engaged in the underlying offense, they can name managers or the board of directors for failing to supervise properly, or they can even go after the corporation itself.

One conference participant noted that major scandals foster a “lynch-mob mentality” that drives both the public and enforcement officials to want to pursue the people at the top, regardless of whether they have done something warranting punishment.⁴⁵ Prosecutorial discretion, however, ultimately requires a reasonable balancing of both individual fairness and public policy considerations. Charging the corporation,

45. In order to facilitate open dialogue, the workshop discussion was conducted on a not-for-attribution basis, so statements are not identified in this article with the name of any specific participant.

for example, may do much to deter others in an industry, but it may also negatively affect many people beyond those who violated the law. This concern is especially palpable in the case of a criminal indictment, as shown by the demise of Arthur Andersen; however, it is also relevant in civil cases since large punitive fines may put a company on the brink of financial ruin.

In deciding whether to charge the corporate entity, enforcement officials should consider the nature of the underlying conduct in relation to the overall operations of the business. It is easier to justify criminal or civil sanctions against the organization when the organization—and not merely the bad employee—benefits from the misconduct. For example, an antitrust violation by which a company increases its profits is a better candidate for an organizational prosecution than a case of embezzlement by an employee that benefits the employee only (and in which the company is itself a victim).

Another factor to consider is whether a corporation has systemically failed to supervise its officers and employees. Companies' boards and senior management are responsible for the overall culture of the organization. They must put in place procedures, training, and monitoring that are reasonably designed to prevent and detect violations of regulations. Recent legislative developments require that public companies implement such steps, including (1) a code of ethics,⁴⁶ (2) certification of financial information by the chief executive officer and chief financial officer,⁴⁷ and (3) procedures that empower and protect employees who may wish to report misconduct.⁴⁸ Isolated misconduct that occurs despite these safeguards, and of which management was actually unaware, generally would not give rise to proceedings against the company, or even against senior management.

Federal versus State Law Enforcement

Corporate actors face the threat of enforcement by multiple regulators. When the SEC was created in 1934, states already had jurisdiction over securities matters and they con-

46. Sarbanes-Oxley Act, *supra* note 2, § 406.

47. *Id.* § 404.

48. *Id.* § 1107.

tinue to retain much authority.⁴⁹ State and federal prosecutors also co-exist with self-regulators such as the NYSE and the NASD. The existence of multiple regulators has often been justified in part on the premise that competition among enforcement agencies results in optimal deterrence.⁵⁰

The deterrent value of multiple enforcers depends, however, in part on regulations being clear and consistent across jurisdictions. Variations across jurisdictions only give companies opportunities to exploit the differences. Moreover, if the existence of multiple enforcers creates a patchwork of inconsistent, sometimes even incompatible, legal rulings, this can be counterproductive for businesses engaged in interstate or international commerce.

Even when rules are clear and universally accepted, the presence of multiple enforcement authorities can create problems. Political factors may motivate enforcement agencies to insist on being “at the table” in dealing with a major crisis. Or different agencies may compete against each other to see which can impose the toughest sanctions. Competition motivated by a desire to score political points can hinder the overall objective of enforcement, either by overly complicating resolution of enforcement actions or by misallocating scarce resources so that other important regulatory problems go neglected.

Finally, it may be difficult to maintain the proper balance between enforcement at the federal, state, and self-regulatory levels when one regulator is perceived—rightly or wrongly—as lax or ineffective. Others will rush in to fill the perceived vacuum. For example, the recent mutual fund lawsuits filed by New York, Massachusetts, and other states against broker-dealers and investment advisers took aim at conduct that tradition-

49. JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 42-50 (1995).

50. See Roberta S. Karmel, *Appropriateness of Regulation at the Federal or State Level: Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 *BROOKLYN J. INT'L L.* 495 (2003) (noting that “[s]ome scholars believe that competition among financial regulators is beneficial and results in an optimum level of regulatory intrusion upon private business interests”).

ally fell within the SEC's province.⁵¹ Those who believe the SEC was insufficiently interested in pursuing leads about improper conduct in the mutual funds industry may well conclude that the state litigation shows the value of enforcement competition. Yet, taken too far, it is also possible that such competition will waste resources and generate inconsistent rulings across jurisdictions.⁵²

Looking Ahead

The existence of multiple enforcers, each facing choices about whether to pursue criminal or civil penalties against either individuals or organizations, makes regulatory enforcement a complicated enterprise. Competition among enforcement jurisdictions certainly can increase deterrence. However, in the future, continued efforts at coordination among enforcement officials are likely to be needed to allocate limited enforcement resources sensibly and to ensure fairness and consistency in the overall regulatory system.

IV.

CONCLUSION

The crisis of confidence in America's capital markets, sparked by the corporate scandals of the past several years, has generated widespread debate over proposals for regulatory changes. Underlying these discussions are fundamental policy issues about the role of government in corporate governance. Although these policy issues are sometimes framed as simple dichotomies—for example, government regulation versus self-regulation, principles versus rules, or criminal versus civil penalties—the choices government faces are in fact neither simple nor dichotomous.

What, then, is the role of government in corporate governance? It is undoubtedly not any single role, but different roles—that of policymaker, enforcer, and overseer—in different situations. Accordingly, there is still another fundamental

51. William H. Donaldson, SEC Chairman, Speech at NASAA Conference (Sept. 14, 2003), available at <http://www.sec.gov/news/speech/spch091403whd.htm>.

52. For a concise analysis of federal-state coordination, see John C. Coffee, *Competitive Federalism: The Rise of the State Attorney General*, 230 N.Y.L.J. 5 (Sept. 18, 2003).

role for government to undertake: the role of analyst, seeking to identify the conditions under which to deploy different configurations of regulatory institutions, standards, and enforcement practices. Given the range of policy issues raised by corporate governance, and the variety of industries and firms involved, government decision makers will need to understand thoroughly the effects that different regulatory actions can have in terms of a range of policy criteria.

On the issue of self-regulation, this means, among other things, considering the effectiveness of self-regulatory organizations as policymakers as well as their effectiveness as enforcers. It also calls for careful evaluation of the recent structural changes in self-regulatory organizations. What impact will these changes have on the credibility and effectiveness of self-regulation?

On the issue of regulatory design, decision makers need to understand better what makes different degrees of specificity and generality “right” for particular types of regulatory problems. They also need to assess whether certain hybrid systems can overcome some of the limitations of rules or principles alone.

Finally, on the issue of enforcement, state and federal officials should analyze why some individuals and organizations adhere responsibly to regulatory standards—and why others do not. Such analysis would help enhance government’s ability pursue optimal enforcement, instead of under- or over-enforcement.

The steps that government has already taken, and will undoubtedly continue to take in the wake of the recent scandals, will affect both the integrity and productivity of the American economy. The success of these efforts will be made more likely with careful attention to the kinds of issues summarized in this article, and with further constructive discussion among the many constituencies affected by the multiple roles that government plays in corporate governance.