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Recommended Citation

John F. Olson, *Looking beyond the Efficient Markets Hypothesis: A Comment on Professor Macey's Post-Enron Analysis*, 89 Cornell L. Rev. 527 (2004)

Available at: <http://scholarship.law.cornell.edu/clr/vol89/iss2/10>

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LOOKING BEYOND THE EFFICIENT MARKETS HYPOTHESIS: A COMMENT ON PROFESSOR MACEY'S POST-ENRON ANALYSIS

John F. Olson†

In his insightful article, Professor Macey makes some important observations about capital markets theory and disclosure policy based on his review of the collapse of Enron Corporation.¹ He also candidly acknowledges his growing doubts about the validity of the efficient capital markets hypothesis (ECMH), at least in its purest “strong” version, as a basis for disclosure policy,² and instead suggests that the famous “prisoners’ dilemma” is a better theoretical model on which to build a disclosure regime.³

It is certainly correct that the failure of Enron and other large enterprises, whose securities the market had vastly overvalued, exposed the limitations of the ECMH. Nonetheless, Professor Macey argues that the semi-strong ECMH remains analytically valid because the overvaluation of companies like Enron was based on intentionally misleading, or at least opaque, financial disclosures.⁴ But he concedes that even when clear signals of problems at Enron appeared—skeptical press articles, highly critical analysis published by noted “bear” analyst Jim Chanos, and finally the surprise resignation of Enron’s President, Jeffrey Skilling—the market failed to react as even the semi-strong ECMH would predict: the price of Enron stock did not drastically decline, and the majority of analysts confirmed their positive views of the Company’s prospects.⁵ Clearly, something inconsistent with the ECMH was at work.

Professor Macey attributes this inconsistency to the multiple failures of the traditional market monitors of corporate disclosure—investment banks and the analysts they employ, credit rating agencies, and, of course, Enron’s auditors.⁶ Quite correctly, he notes that each of these monitors has been co-opted to some extent by interests that

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¹ Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394 (2004).

² *Id.* at 417–20.

³ *Id.* at 414–17.

⁴ *Id.* at 397, 417–18.

⁵ *Id.* at 418–20.

⁶ *Id.* at 403–10.

conflict with objective reporting to the marketplace.⁷ For investment banks, the conflict was the desire not to offend important existing and potential corporate clients—Enron itself being among the most lucrative—for the firms' banking services.⁸ Moreover, this conflict was compounded by a compensation system for analysts based in large part on their roles in attracting banking business, rather than on their track records as predictors of market performance.⁹

Professor Macey perceives that the very power of the ratings issued by credit ratings agencies created their conflict, in that a downgrade has such a dramatic impact on access to and cost of capital for the corporation that credit raters exercise this power with great reluctance, and only after other signals to the market are so clear that they cannot be ignored.¹⁰

Professor Macey also makes particularly astute observations about the conflicts that auditors face. The problem is not that any single audit client is overly important to the accounting firm as a whole, but rather that a large client may be tremendously significant to the particular engagement partner and the team that performs the audit, and in some cases also to their branch office of the firm.¹¹ Enron was reportedly the largest client of Arthur Andersen's Houston office by a significant margin, and, perforce, the engagement partner was extremely powerful in that office and in the councils of the firm.¹² More recently, a similar relationship apparently existed between HealthSouth and the Birmingham, Alabama office of its auditor, Ernst & Young.¹³

The potential for such a relationship to cloud the objectivity of the auditing team and its lead partner does not depend on whether the team renders consulting services, or "pure" audit services, or other audit-related work. Rather, the loss of objectivity hinges on the im-

⁷ See *id.*

⁸ See *id.* at 404–05.

⁹ See *id.* at 409.

¹⁰ See *id.* at 406.

¹¹ See *id.* at 409–10.

¹² See Tom Fowler, *Andersen Battles To Clear Its Name*, HOUS. CHRON., Mar. 1, 2002, at 1; Kirstin Downey Grimsley, *Man of Texas Connections*, WASH. POST, Jan. 18, 2002, at E1.

¹³ See Jonathan Weil, *Did Ernst Miss Key Fraud Risks at HealthSouth?*, WALL ST. J., Apr. 10, 2003, at C1 ("HealthSouth had been the largest audit client of the accounting firm's Birmingham office, measured by HealthSouth's annual revenue and audit fees."); see also Carrie Johnson, *HealthSouth Executive Admits Inflating Profit*, WASH. POST, Mar. 27, 2003 at E1 ("[S]ince at least since 1996, [HealthSouth's CFO] provided top executives with HealthSouth's actual monthly and quarterly financial results. Then [he] and others allegedly directed the accounting staff to find ways to meet or exceed expectations of Wall Street analysts."); Jonathan Weil, *What Ernst Did for HealthSouth*, WALL ST. J., June 11, 2003, at C1 ("[T]he [misleading 'Pristine Audit'] program illustrates how Ernst had become an instrument of HealthSouth's marketing machine when it was supposed to be acting as the company's financial watchdog.").

PLICIT economic leverage the client enjoys with respect to the audit team, due to the significance of the client relationship to auditors' status and advancement in the accounting firm. These are important observations for regulatory policymakers because they suggest that the emphasis in recent SEC regulations¹⁴ and in the Sarbanes-Oxley Act¹⁵ on limiting the scope of services provided by the outside auditor, and requiring strict oversight by corporate audit committees, may well miss the mark. Audit partner rotation, or even rotation of audit firms, on a periodic basis may better bolster auditor independence.¹⁶

Finally, Professor Macey notes—with apparent sadness—that the monitoring potential of the market for corporate control was unsuccessful in limiting the financial abuses of the Enron era because market information was incomplete and share prices were therefore overvalued.¹⁷ Put differently, control contests did not effectively discipline corrupt or poor management because bad managers masked their deficient performance with bad disclosure.

All of these observations have valuable elements of truth, but I think something is missing from the analysis. Specifically, the psychology of investors, reflecting the temper of the times, played a much more important role in the failure of the disclosure system in the unanticipated collapse of Enron, WorldCom, and Global Crossing than is commonly acknowledged. Federal Reserve Board Chairman Alan Greenspan famously referred to this phenomenon as “irrational exuberance,” a phrase that aptly describes the widespread suspension of traditional equity valuation metrics that characterized the mid-1990s.¹⁸ While some analysts certainly contributed to this popular madness, there were also undeniable elements of herd mentality that drove investors to accept the most optimistic, nontraditional valuation approaches. In an irrational market, dominated by optimistic and incalculable concepts such as space on the geography of the computer screen, number of hits to a Web site, “first innovator advantage,” and the supposed synergistic value of alliances among a number of loss-making enterprises,¹⁹ it is hard to imagine any disclosure regime that

¹⁴ 17 C.F.R. §§ 210, 240, 249 & 274, Release Nos. 33-8183, 33-8183A (2003).

¹⁵ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, & 29 U.S.C.) [hereinafter Sarbanes-Oxley Act].

¹⁶ See *Testimony Concerning the Implementation of the Sarbanes-Oxley Act of 2002 Before the Sen. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. (2003) (testimony of William H. Donaldson, Chairman, Securities and Exchange Commission).

¹⁷ See Macey, *supra* note 1, at 419–20.

¹⁸ Alan Greenspan, *The Challenge of Central Banking in a Democratic Society*, Remarks at the Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research (Dec. 5, 1996), at <http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm>.

¹⁹ Such valuation terms were common parlance during the high-tech boom, employed when selling IPOs for money-losing companies.

could dampen irrational pricing of securities. In this regard, it is important to note that the “hot” IPO offerings of the late 1990s were made on the basis of prospectuses replete with dire black type warnings, not only about the present lack of profits but also about serious future risks and pitfalls of the enterprise. Yet these stark disclosures did not dampen investors’ enthusiasm or restrain overly optimistic market pricing, and at times it seemed that the more foreboding the risk warnings, the more popular the offering. I am aware of no evidence that companies that disclosed fewer risk factors had greater market valuations.

The fact is that markets are imperfect reflectors of even minimally sufficient disclosure because the reactions and decisions of investors are not always predictable or rational in relation to their access to information. Rather, the actions of market participants are heavily influenced by externalities that are not based on information about corporate financial performance, present or predicted. Often, such irrational investor behavior is instead based on less measurable public attitudes, emotional perceptions, and cyclical mood swings from relative public optimism to relative pessimism about the future. Cycles of “boom” confidence burn brightly for a few years and then decline to a darker view of economic prospects. These changes are only partly explained by objective changes in business performance.

This leads to consideration of Professor Macey’s suggestion that the classic prisoners’ dilemma may offer an effective analytical basis for disclosure policy.²⁰ He posits that, while the best result for the market and all its participants occurs when all companies pursue a policy of full and accurate disclosure, any one corporate participant can benefit, at least temporarily, by pursuing a policy of misleading disclosure, as Enron did.²¹ He correctly observes that this “bad” advantage is available to a defector company only so long as most market participants make, and are perceived by investors to make, “good” disclosure.²² The problem with this theory of corporate behavior is that any defector advantage from “bad” disclosure is, at best, temporary. Moreover, once the defector is unmasked, the consequences for the company and its managers are so severe that intentional “bad” disclosure is not, in fact, a rational choice.

Furthermore, the prisoners’ dilemma has limitations of its own. As Robert Axelrod observes:

Of course, the abstract formulation of the problem of cooperation as a [p]risoners’ [d]ilemma puts aside many vital features that make any actual interaction unique. Examples of what is left out by this

²⁰ See Macey, *supra* note 1, at 414–17.

²¹ See *id.* at 414–15.

²² *Id.* at 415.

formal abstraction include the possibility of verbal communication, the direct influence of third parties, the problems of implementing a choice, and the uncertainty about what the other player actually did on the preceding move. . . . It is clear that the list of potentially relevant factors that have been left out could be extended almost indefinitely. Certainly, no intelligent person should make an important choice without trying to take such complicating factors into account.²³

Thus, even those who find the prisoners' dilemma construct most useful for predicting human behavior recognize that it is a simplified analytical tool that omits many factors that may impact behavior.

Professor Macey appears to suggest that increasing the "punishment"—presumably, civil and criminal penalties—for false or misleading disclosures will assure that the prisoners' dilemma effect does not tempt some companies to "bad" disclosure.²⁴ However, there is no evidence that ratcheting up penalties for disclosure violations has in fact reduced their incidence.

Because failure to completely and accurately disclose will cost the company more in the long run, the prisoners' dilemma scenario posited by Professor Macey should be revised to more closely resemble the original prisoners' dilemma construct. As Professor Macey acknowledges in describing the original prisoners' dilemma, "no matter what the other prisoner does, a suspect can improve his own position by confessing"²⁵ Why cannot the same be said for corporations and their disclosures? Specifically, because any benefit from nondisclosure is temporary and will ultimately lead to more severe consequences for the corporation that makes "bad" disclosure, it follows that corporations can only improve their positions by fully disclosing.

Take, for example, Professor Macey's hypothetical involving Enron and his imaginary "Exron."²⁶ If both companies disclose truthfully, their shares will drop from \$100 a share to \$50 a share. On the other hand, if neither company discloses, then their shares will drop to \$30.²⁷ Although in Professor Macey's prisoners' dilemma, Enron can apparently maintain its share price at \$100 while Exron's share price drops to \$25 from its disclosure, this hypothetical belies the fact that Enron's shares eventually will also drop to \$30. Because nondisclosure benefits evaporate when a firm's dishonesty is revealed, any share price stability Enron achieves from its nondisclosure is fleeting. True to life, once the extent of Enron's wrongdoing became public in

²³ ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* 19 (1984).

²⁴ See Macey, *supra* note 1, at 415.

²⁵ *Id.* at 414 n.103.

²⁶ See *id.* at 414–15.

²⁷ *Id.* at 415.

2001, investors treated the company harshly, ultimately leading to bankruptcy.

One also observes in Professor Macey's corporate prisoners' dilemma a problem generally applicable to whichever firm makes its disclosure decision first. Namely, the first to disclose may face greater consequences as compared to other companies that have not disclosed. Professor Macey concedes, though, that nondisclosing firms will ultimately bear declines in their share prices as well. In the hypothetical, if Enron had disclosed along with Exxon, Enron's share price would drop to \$50.²⁸ However, the hypothetical fails to capture the fact that after Exxon discloses and experiences its drop in stock price, Enron's share price drops to \$30 shortly thereafter—\$20 further than it would have if Enron had disclosed initially. Ultimately, Enron suffers more from nondisclosure than if it had disclosed. Thus, there seems to be as much incentive for corporations to disclose as for prisoners in the original prisoners' dilemma to confess.

Such "first mover" problems with corporate disclosure may be tempered by the fact that the bad acts of one firm will result in punishment for all similarly situated firms. As Professor Macey remarks, after the Enron debacle, firms unrelated to Enron, but engaged in businesses like Enron's, were punished for Enron's wrongdoing because investors began to distrust all similar firms.²⁹ Thus, although Professor Macey calls for more regulations to ensure punishment sufficient to deter nondisclosure, it seems that the market already punishes firms for failing to promptly and accurately disclose negative information. Furthermore, when too many firms opt for nondisclosure and public confidence ebbs, even "innocent" firms may share in this market punishment.

Rather than further increasing penalties and prescriptions, the best remedy for fraudulent disclosure practices remains the discipline of the marketplace, which exacts real economic penalties for failures of corporate candor. Since the fall of Enron, the capital markets have placed a new premium on corporate reputations for integrity and financial reporting transparency. Witness, for example, the significant efforts of General Electric recently to respond to criticisms about the complexity and opacity of its financial reports by releasing additional, more detailed disclosures and increasing its communications with analysts.³⁰ Also noteworthy is the rapid growth of rating systems to measure corporate governance quality, which focus in part on percep-

²⁸ *Id.*

²⁹ *See id.* at 414, 416.

³⁰ *See* Keith H. Hammonds, *GE (Re) Does the Numbers*, FASTCOMPANY, May 2003, available at <http://pf.fastcompany.com/magazine/70/realitycheck.html>.

tions of corporate candor and clarity of financial reporting.³¹ These changes reflect a dampening of exuberant and irrational public expectations that has refocused the markets on measurable performance, understandable disclosure, and, most importantly, more reasonable expectations. New regulations governing analyst conflicts of interest,³² as well as the new certification requirements and increased penalties imposed on chief executive and chief financial officers,³³ may reduce the risk that “bad” information will lead to future irrational market decisions. However, the real solution lies not in these changes but in renewed public skepticism and investor demands for better disclosure, reflected in price punishment for those companies deemed to lack candid and transparent disclosure practices.

Investors get the market they deserve. If investors—particularly institutional investors³⁴—demand clear and complete disclosure as the price of capital, such disclosure will be forthcoming. Investors who exercise appropriate skepticism about optimistic predictions and unorthodox valuation approaches will prevent such irrational projections from influencing the marketplace. Managers rewarded for transparency and measurable fundamental performance, rather than for short-term stock price increases, will manage accordingly. If all this is true, then the most important post-Enron reform of the past two years may not be the much-heralded Sarbanes-Oxley Act, but rather the new rules adopted at the very end of former SEC Chairman Harvey Pitt’s tenure that will require mutual fund managers to make public their proxy voting decisions for portfolio securities.³⁵ These rules transfer responsibility for disciplining apparently dishonest corporate managers to investment management company intermediaries who control large pools of capital. If the SEC adopts a rule giving large, long-term investors direct access to management proxy statements to promote the investors’ own candidates, the ability of large holders to monitor management behavior will be enhanced even further.³⁶

³¹ See Matthew Brown, *Companies Must Seek To Avoid the “Junk” Governance Rating*, 11 CORP. GOVERNANCE ADVISOR 28 (2003) (“This increasing investor focus on governance also is now resulting in a proliferation of published rating systems or metrics that rank, analyze, and compare the relative corporate governance practices of public companies.”).

³² See NASD and NYSE Rulemaking, Securities and Exchange Commission Release No. 34-48252 (July 29, 2003).

³³ See Sarbanes-Oxley Act, *supra* note 15, §§ 302, 404, 906.

³⁴ See Stewart Pinkerton, *Reforming the Boardroom: How Deep Is the Ethics Crisis?*, FORBES, July 24, 2003, available at <http://www.forbes.com/2003/07/24/cz-sp-0723ethics.html>.

³⁵ 17 C.F.R. § 275.206(4)-(6) (2003) and Securities and Exchange Act Release No. 33-8188 (Jan. 31, 2003).

³⁶ Security Holder Director Nominations, Securities and Exchange Act Release No. 34-48626 (Oct. 14, 2003), available at <http://www.sec.gov/rules/proposed/34-48626.htm>; SEC Division of Corporation Finance, Staff Report: Review of the Proxy Process Regarding

Chastened by the recent wave of fizzling corporate performance after overly optimistic financial projections, institutional investment managers will likely follow a more rational and measured approach, at least for the next few years. With the ability to directly influence the election of directors and the obligation to divulge how they vote the shares they hold, one can expect investment managers to be more active in disciplining corporate managers who do not adopt open and candid disclosure practices. Put differently, large institutional equity market participants will better monitor and motivate good corporate disclosure practices because they, too, will be subject to enhanced expectations regarding their conduct as monitors, and they will have additional tools to influence boards of directors and, through them, corporate managers.