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Convergence and Competition in Rules
Governing Lawyers and Auditors

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Abstract

This Article examines problems (including information asymmetries, agency problems and cognitive biases) that auditors and lawyers (collectively, “gatekeepers”) confront when they evaluate and respond to risk, as well as the various ways in which gatekeeper regulation addresses these problems. Then, using the analytical framework of New Institutional Economics, this Article recognizes that “optimal” solutions to gatekeeper problems are far from certain. Better solutions are thus more likely to emerge from experimenting with different rules and observing outcomes from those rules. If auditors and lawyers are governed by different rules, a jurisdiction can simultaneously experiment with two different regulatory approaches for these two professions, and then make adjustments accordingly. Private actors also can signal which rules they prefer in a particular context by choosing whether to use, or to insist that other private actors use, auditors or lawyers for a particular task. Similarly, if rules for both professions vary among jurisdictions, jurisdictions can learn not only from their own experimentation but from the experimentation of other jurisdictions with different rules. Private actors can also signal their rule preferences by choosing the jurisdiction in which they want professional services to be performed. Improvements to gatekeeper regulation should follow from the observed results of this experimentation.

These purported benefits from regulatory competition could, however, be undermined if private actors are allowed unlimited choice among regulatory regimes (a “race to the bottom”). This article thus discusses the limits of regulatory competition, and mentions various strategies for reducing the likelihood of a race to the bottom. Finally, this article observes that, within a framework of controlled regulatory competition, market and social conditions may cause some rules governing auditors and lawyers to converge, as well as some rules governing both

professions in the United States and Europe to converge. Profession-specific and jurisdiction-specific differences, however, will probably remain, unless experimentation and observation demonstrate that a particular rule is clearly superior across professional and/or jurisdictional boundaries.



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IN RULES GOVERNING LAWYERS
AND LAWYERS**

***RICHARD W. PAINTER**

*Guy Raymond and Mildred Van Voorhis Jones Professor of Law, University of Illinois

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Richard W. Painter*

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I. INTRODUCTION

Ethics rules are becoming increasingly similar for auditors and securities lawyers. First, the Sarbanes-Oxley Act of 2002 (SOX) intensified federal regulation of auditors,¹ and put securities lawyers, formerly regulated almost entirely by the states, under the jurisdiction of the Securities Exchange Commission (SEC). Second, Congress and the SEC have enhanced the duties of both auditors and lawyers to investigate and disclose securities law violations and breaches of fiduciary duty.²

There are, however, differences between ethics rules for lawyers and auditors. The SEC appears to have backed off from an initial drive to impose auditor-like “reporting out” responsibilities on securities lawyers,³ and final SEC rules will probably require only “reporting up” by lawyers to client boards of directors.⁴

This adjustment would accommodate traditional differences between ethics rules for lawyers (whose principal duty is to clients) and ethics rules for auditors (whose principal duty is to investors). Furthermore, federal regulation is not as pervasive for lawyers as it is for auditors. Lawyers who represent persons other than issuers of securities, such as underwriters and corporate officers, are not covered by the SEC’s new SOX regulations, although they are still under the SEC’s Rule 102(e) jurisdiction. Although the SEC’s new lawyer rules in a few instances preempt conflicting state ethics rules, securities lawyers for the most part are still subject to state regulation. Auditor regulation, by contrast, is now heavily concentrated in the hands of the new Public Company Accounting Oversight Board (PCAOB) and the SEC.

Rules governing lawyers and auditors in the United States also are to some extent converging on rules in Europe, and vice versa. In the Sarbanes-Oxley Act, Congress borrowed some European rules for auditor regulation, such as mandatory audit partner rotation.⁵ The United States is also considering European principal-based accounting as

1. Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, § 101 [hereinafter SOX] (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.) (creating new accountant oversight board); §§ 102-109 (duties of the board and obligation of auditors to register with the board); §§ 201-209 (auditor independence rules and heightened disclosure requirements on auditors).

2. See, e.g., SOX, *supra* note 1, § 204 (requiring disclosures by auditors to a client’s audit committee); § 307 (requiring disclosure by lawyers representing issuer “up the ladder” to the client’s board of directors or a committee of independent directors if necessary). In 1995, Congress enacted Section 10A of the Exchange Act requiring auditors to detect and report illegal acts of public companies. The SEC has for decades also regulated auditors through its definition of auditor “independence” and under its Rule 102(e) for discipline of professionals practicing before the SEC. SEC regulation of securities lawyers before 2002, however, was sporadic and indeed quite rare.

3. For the Commission’s proposed Rules, see Exchange Act Release No. 33-8186; 34-47282 (proposed Nov. 21, 2002), available at <http://www.sec.gov>.

4. See 17 C.F.R. §§ 205, 240, and 249, adopted in Exchange Act Release No. 33-8185; 34-47276, *supra* note 3.

5. SOX, *supra* note 1, § 203 (requiring audit partner rotation); § 207 (directing the U.S. General Accounting Office to analyze the merits of requiring audit firm rotation and to report its analysis to Congress within one year).

an alternative to rules-based accounting.⁶ At the same time, jurisdictional convergence is being forced by the United States on Europe to the extent SOX and SEC rules under SOX apply to lawyers and auditors who practice abroad.⁷ This in turn has led to a barrage of comment letters from foreign law and accounting firms protesting the breadth of United States regulation.⁸ Even more significant, several of the largest multinational accounting firms have been forced to spin off European consulting and other non-audit service branches because of the Act's new rules on auditor independence.

The SEC has to some extent backed off from its initial drive to regulate foreign lawyers and auditors with a heavy hand. Many foreign securities lawyers, for example, are now exempt under the SEC's final SOX rules, whereas they would have been covered by the SEC's earlier proposed rules.⁹ The PCAOB may also accommodate different systems of regulating auditors in the United States and abroad, although the full extent of this accommodation has yet to be seen.

This Article examines problems (including information asymmetries, agency problems and cognitive biases) that auditors and lawyers (collectively, "gatekeepers") confront when they evaluate and respond to risk, as well as the various ways in which gatekeeper regulation addresses these problems. Then, using the analytical framework of New Institutional Economics, this Article recognizes that "optimal" solutions to gatekeeper problems are far from certain. Better solutions are thus more likely to emerge from experimenting with different rules and observing outcomes from those rules. If auditors and lawyers are governed by different rules, a jurisdiction can simultaneously experiment with two different regulatory approaches for these two professions, and then make adjustments accordingly. Private actors also can signal which rules they prefer in a particular context by choosing whether to use, or to insist that other private actors use, auditors or lawyers for a particular task. Similarly, if rules for both professions vary among jurisdictions, jurisdictions can learn not only from their own experimentation but from the experimentation of other jurisdictions with different rules. Private actors can also signal their rule preferences by choosing the jurisdiction in which they want professional services to be performed. Improvements to gatekeeper regulation should follow from the observed results of this experimentation.

Within this framework of professional and jurisdictional competition, market and

6. European companies generally use International Accounting Standards (IAS), which supposedly promote "standards based" instead of "rule based" accounting, but there is considerable pressure from U.S. investors for European companies to conform to U.S. Generally Accepted Accounting Principles (GAAP). At the same time, Congress has in the Sarbanes-Oxley Act ordered that a study be completed evaluating whether the United States should use standards based accounting. *See* SOX, *supra* note 1, § 108(d).

7. *See, e.g.*, SOX, *supra* note 1, § 106 (stating that accounting firms outside the United States that issue audit reports for companies subject to U.S. Securities laws are covered by the Act in the same manner as domestic accounting firms, subject to the exemptive authority of the SEC and the accounting oversight board).

8. *See, e.g.*, COMMENTS OF THE COUNCIL OF BARS AND LAW SOCIETIES OF THE EUROPEAN UNION (CCBE), Apr. 3, 2003 (File name: ccbe040303.htm); COMMENTS OF DR. DOMBEK, GERMAN FEDERAL BAR, Dec. 17, 2002 (File name: dombek1.htm); COMMENTS OF ALLEN & OVERY, FRESHFIELDS BRUCKHAUS DERINGER, HERBERT SMITH, LINKLATERS, LOVELLS, AND NORTON ROSE, Dec. 17, 2002 (File name: allenfresh1.htm); COMMENTS OF TOHRU MOTOBAYASHI, PRESIDENT, JAPAN FEDERATION OF BAR ASSOCIATIONS, Mar. 31, 2003 (File name: tmotobayashi1.htm); COMMENTS OF THE ISRAEL BAR ASSOCIATION (File name: ahertman1.htm), available at <http://www.sec.gov/proposed/s74502.shtml> (last visited Apr. 23, 2004).

9. *See* text accompanying note 87 *infra*.

social conditions may cause some rules governing auditors and lawyers, as well as some rules governing both professions in the United States and Europe, to converge. Profession-specific and jurisdiction-specific differences, however, will probably remain, unless experimentation and observation demonstrate that a particular rule is clearly superior across professional and/or jurisdictional boundaries.

There are, however, dangers from tolerating diverse approaches to public ordering if private ordering is allowed unlimited choice among public rules. First, regulatory “arbitrage” is possible if interchangeable professional services are governed by different rules. Lawyers thus can be asked to perform audit-like tasks, such as internal investigations of financial reporting practices, simply because someone with the power to choose prefers lawyers’ rules over auditors’ rules. Second, there can be arbitrage between rules of different jurisdictions. Lawyers or auditors in one jurisdiction thus can be asked to perform tasks more appropriately performed in another jurisdiction simply because someone prefers that an issuer hire gatekeepers subject to more lenient rules.

Market discipline penalizes excessive regulatory arbitrage if investors perceive what is going on and raise the cost of capital for issuers whose gatekeepers work under lax ethics rules. This market discipline is a theoretically appealing solution to regulatory arbitrage in the market for gatekeepers, just as market discipline is a theoretically appealing response to “race to the bottom” arguments in the market for issuers’ securities themselves.¹⁰ Market discipline may sometimes also be practical, although reliance solely on market solutions to regulatory arbitrage, at other times may not be realistic. If market sanctions do not materialize, the result can be a “race to the bottom” in which issuers “forum shop” for lax regulation of their lawyers and auditors. Legal restrictions establishing a uniform floor on gatekeeper regulation may minimize this problem, but there is a tradeoff here as well because the legal restrictions may also diminish the benefits of professional and jurisdictional competition.

Striking a balance between encouraging and constraining regulatory competition is, like designing specific rules for lawyers and auditors, an uncertain task in which optimal solutions may be unstable over time. This task is poorly informed by ideologically driven generalizations that either entirely condone or entirely condemn regulatory competition. It is better to rely instead on a learning process informed by empirical experimentation with arrangements that allow private ordering more or less room to maneuver within the confines of profession-specific and jurisdiction-specific rules established through public ordering. This Article discusses possible outcomes of this experimentation, as well as the small amount of empirical data collected so far. Both the U.S. and the EU, however, are at an early stage of experimenting with gatekeeper regulation and a great deal remains to be learned. The purpose of this Article is thus to suggest an analytical framework for the problem of regulating lawyers and auditors rather than to propose specific optimal solutions.

10. See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2361 (1998) (stating that the market approach to securities regulation should resemble the U.S. approach to state-regulated corporation law).

II. PROBLEMS IN EVALUATION AND RESPONSE TO RISK

A. Information Asymmetry

Information flow is important to evaluation of risk. Securities markets absorb issuers' business risks into security prices as investors learn, process and use information in trading decisions.¹¹ The timing and accuracy of an issuer's disclosure to securities markets,¹² however, depend on how quickly and completely information about business risk reaches persons who make disclosure decisions. Information often reaches the issuer's managers first, and then flows through to the issuer's auditors and lawyers. Sometimes, however, auditors or lawyers learn of business risks first and then inform managers. If underwriters are involved, the speed and accuracy with which information reaches them, and their lawyers, may also impact the timing and quality of the issuer's disclosure. At each step of the way, human beings are required to evaluate risk and then, in appropriate circumstances, respond by informing other human beings who inform still others until, it is hoped, the issuer discloses information to investors. A breakdown in the flow of information anywhere along this chain of human decision-making may significantly slow down the process by which information is disclosed to investors.

Although most information about an issuer reaches markets eventually, investors who receive it later than they are legally entitled to it may have a claim against the issuer, its managers, its underwriters, and perhaps even its auditors and lawyers. The possibility of such a claim—whether asserted by investors themselves or by the SEC—introduces a new kind of risk—legal risk. Legal risk, along with the issuer's business risk, is evaluated by all of the relevant decision makers at each step of the decision-making process (e.g. they ask not only "should this business risk be disclosed?", but also "what are the legal risks of not disclosing it?").

Timely and accurate disclosure to investors thus depends upon timely and accurate communication about business and legal risks among an issuer's internal constituents—employees, managers, and directors—and between these internal constituents and its outside gatekeepers—lawyers and auditors. Employees who conceal risk from managers, managers who do not inform gatekeepers about risk, and gatekeepers who do not disclose risk to an issuer's directors all can impede the issuer's disclosure to investors. Information asymmetry within an issuer or between an issuer and its gatekeepers is thus likely to cause information asymmetry between the issuer and its investors.

The Sarbanes-Oxley Act, through its corporate governance reforms, such as strengthened audit committee responsibility¹³ and whistleblower protection,¹⁴ seeks to

11. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (speaking on the widespread acceptance of the efficient capital market hypothesis).

12. Mechanisms besides the issuer's disclosure to investors also help information reach securities markets, although perhaps more slowly and in a manner which benefits some investors more than others. Analysts might discover information about an issuer and inform their clients who trade upon it. Managers or other agents of the issuer might trade on material nonpublic information. Managers or other agents of the issuer also might voluntarily disclose the information to some market participants. Although issuer disclosure to public investors is only one mechanism of market efficiency, it is one of the most important, and without it (as Enron aptly showed) market prices for securities are unlikely to be efficient.

13. See SOX, *supra* note 1, § 301 (standards for audit committees); Standards Relating to Listed Company

improve the quality of communication among an issuer's employees, officers, and directors. The Act also requires some of these internal constituents such as CEOs and CFOs to communicate information to investors through a certification process.¹⁵ Not everybody agrees that these provisions strengthen communication among the internal constituents of issuers or by issuers to investors.¹⁶ Issuers domiciled in foreign countries can find the provisions difficult to implement within corporate governance frameworks that Congress may not have contemplated at the time the Act became law.¹⁷ The Act's gatekeeper regulation provisions, which are the principal focus of this Article, similarly purport to improve the role of gatekeepers in the process by which information ultimately flows to investors. Here also, debate has ensued about whether the new regulations are effective and about whether they are suitable for gatekeepers domiciled outside the United States.

B. Agency Problems

Much of state corporate law is at its core a response to agency problems that arise from the separation of ownership from control in large public corporations.¹⁸ Corporate agents do not always do what is in the interest of shareholders.¹⁹ Although federal securities law distinguishes fiduciary problems from disclosure problems,²⁰ agents who breach their duties are not eager to disclose that fact, making it difficult to distinguish a breach of duty itself from the failure to disclose.²¹ Federal securities law after the Sarbanes-Oxley Act now takes the position that requiring disclosure is not enough, and that the SEC must also address agency problems within corporations that impede

Audit Committees, Sarbanes-Oxley Act, Exchange Act Release Nos. 33-8173, 34-47137, IC-25885, File No. S7-02-03, 2003 SEC LEXIS 38 at *114 (Jan. 8, 2003).

14. See SOX, *supra* note 1, § 806.

15. *Id.*, § 806.

16. See Larry Ribstein, *International Implications of Sarbanes-Oxley: Raising the Rent on U.S. Law*, 3 J. CORP. L. STUD. 299 (2003). SOX provisions that regulate various aspects of corporate governance are controversial because they are expensive to comply with, because they are so draconian that they arguably impede rather than enhance the flow of information within issuers and because they intrude on areas traditionally regulated by state corporate law. Although an analytical framework similar to that used in this Article could also be used to assess the corporate governance provisions of SOX, this Article will focus exclusively on regulation of the gatekeepers.

17. See Ribstein, *supra* note 16.

18. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 4 (1932) (discussing the implications of the separation of ownership from control of large corporations).

19. Generally, one might expect managers whose human capital is tied up in an issuer's business, and who own large amounts of its stock, to be more averse to business risk than shareholders who hold diversified portfolios. Stock options, on the other hand, increase managers preference for risk, and increased use of stock options as executive compensation in the 1990s thus may have led to riskier business strategies.

20. See generally *Santa Fe Indus. v. Green*, 430 U.S. 462, 474 (1977) (holding failure of fiduciary duty, without more, does not constitute material nondisclosure under the Securities Exchange Act).

21. No sooner was the *Santa Fe* decision handed down, then various circuit courts began to recognize a federal cause of action grounded in a failure to disclose a breach of fiduciary duty coupled with a lost state law remedy. See, e.g., *Healey v. Catalyst Recovery of Pennsylvania, Inc.*, 616 F.2d 641 (3d Cir. 1980) (echoing the holding in *Santa Fe*). For an excellent discussion of the interplay between federal securities law and state corporate governance law before the Sarbanes-Oxley Act, see Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859 (2003).

disclosure.²²

These agency problems are most likely to impede disclosure of bad news. Disclosure of bad news often reflects poorly on managers, who would prefer to try to fix a problem (or hope that market developments or improving economic conditions rescue them from a problem) before the problem is disclosed to investors. Managers also may hope that they can cash in stock options, sell shares at a profit or reap other rich rewards before bad news ultimately is disclosed (ideally after the managers have retired or moved on to other jobs).

Agency problems, however, do not end with managers. Every employee of the issuer has some incentives that diverge from the interests of shareholders, and gatekeepers are likely to have divergent interests of their own. Auditors and lawyers usually want to please particular managers who hire and compensate them, and may do so even at the expense of the issuer's shareholders. Whatever agency problems the issuer has with its own managers are thus likely to spread to its auditors and lawyers.

C. Cognitive Bias

Not all disclosure problems are grounded in information asymmetry or agency problems. Sometimes material risks are not disclosed simply because somebody in the decision-making chain honestly but mistakenly believes they are not material. At other times, somebody rightly or wrongly believes that the legal risks from not disclosing bad news are outweighed by the business risks the issuer will incur from disclosing its problems. Cognitive biases, the subject of a field sometimes labeled "behavioral economics,"²³ thus affect not only the way in which decision makers process information about risks but also their ultimate decisions about whether these risks should be disclosed. Unlike information asymmetry and agency problems, these cognitive biases have not received substantial attention from regulators (they are not mentioned in the legislative history of the Sarbanes-Oxley Act or in the releases accompanying the SEC rules thereunder), and only recently have they been addressed in academic literature.²⁴ Cognitive biases are nonetheless an important part of the problem.

Evaluation of risk, for example, may depend on the perceiver's frame of reference. Some psychological studies suggest that decision makers are risk averse when deciding between two alternatives that they perceive to result in a gain, but risk preferring when deciding between two alternatives that they perceive to result in a loss.²⁵ The "frame"

22. See Thompson & Sale, *supra* note 21, at 861 (discussing the Sarbanes-Oxley Act as "new evidence of the expanded role of federal law.>").

23. See, e.g., Russell Korobkin & Thomas S. Ulen, *Law and Behavioral Science*, 88 CAL. L. REV. 1051 (2000); Russell Korobkin & Chris Guthrie, *Psychology, Economics and Settlement*, 76 TEX. L. REV. 77 (1997); Donald Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship*, 51 VAND. L. REV. 1499 (1998). But see Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551, 1556-57 (1998) (criticizing over reliance on behavioral economics in legal scholarship). Cf. Christine Jolls et al., *Theories and Tropes: A Reply to Posner and Kelman*, 50 STAN. L. REV. 1593, 1599 (1998) (defending the growing importance of behavioral economics in legal scholarship).

24. See, e.g., the law review articles cited in *supra* note 23.

25. See, e.g., Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979); Daniel Kahneman & Amos Tversky, *Choices, Values and Frames*, 39 AM. PSYCHOLOGIST 341, 342-44 (1984); Amos Tversky & Daniel Kahneman, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 J. RISK & UNCERTAINTY 297 (1992). See also John C. Hershey &

that casts a decision as a choice between gains or a choice between losses affects the outcome.²⁶ Expertise in the subject matter does not mitigate this framing effect,²⁷ and this bias apparently influences judgments of risk (or evaluations) as well as decisions (or responses).²⁸

This framing effect could alter evaluation of, and response to, legal risks as well as business risks. Studies on framing of legal risks find, for example, that taxpayers who owe money are more likely to cheat on their taxes than taxpayers who expect a refund,²⁹ and that defense lawyers who are told that litigation is progressing worse than their clients' prior expectations, are more likely to cheat in discovery than defense lawyers whose clients are pleased with better than expected progress.³⁰ This same framing effect could induce managers of issuers, as well as auditors and lawyers, who perceive themselves as having something to lose from disclosing unfavorable information to investors, to take the risk of violating securities laws.

Issuers who perceive themselves to be in a gains frame thus are likely to be cautious about legal risk when making disclosure decisions. Lawyers and auditors for the issuer, if they also are in a gains frame (e.g. have nothing to lose from full disclosure) will probably be conservative as well. Indeed, many lawyers are risk averse.³¹ Prospect theory, however, predicts that these same actors are likely to underestimate risk and choose risk preferring responses when they slip into a loss frame. Missed earnings projections, liquidity problems that trigger default under debt covenants, and news of wrongdoing somewhere within an issuer's organization are examples of situations where an ethos of concealment can take over as the issuer becomes trapped in the "psychology of a cover up."³² This risk taking might be conscious, but decision makers can also conceal risk preferring behavior from themselves by adjusting their estimates of risk artificially downwards to make it appear that they are making risk neutral or risk averse

J.H. Schoemaker, *Risk Taking and Problem Context in the Domain of Losses: An Expected Utility Analysis*, 47 J. RISK INS. 111 (1980) (offering additional empirical support for Kahneman & Tversky's theory).

26. See Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 S. CAL. L. REV. 113, 124 (1996) (citing over a dozen studies confirming this cognitive bias in monetary gambles, life threatening choices, purchasing decisions, and other situations).

27. *Id.* at 124-25.

28. *Id.* at 125 and n.52 (citing studies analyzing the judged incidence of cheating and the judged quality of the taste of hamburger meat). "Prospect Theory" thus posits that plaintiffs are risk averse when weighing settlement offers against taking their chances in litigation for even larger potential gains, whereas defendants are risk preferring when weighing the certain costs of a settlement offer against taking their chances in litigation that could result in even larger potential losses. See *id.* at 128-30 (1996). See also Chris Guthrie, *Better Settle Than Sorry: The Regret Aversion Theory of Litigation Behavior*, 1999 U. ILL. L. REV. 43 (discussing Rachlinski's framing theory of litigation).

29. Rachlinski, *supra* note 26, at 124, and n.50 (citing Henry S.J. Robben et al., *Decision Frame and Opportunity as Determinants of Tax Cheating: An International Experimental Study*, 11 J. ECON. PSYCHOL. 341 (1990)).

30. See *id.* at 124.

31. See Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375, 377 (1997) (discussing risk aversion of lawyers). Agency problems also explain part of this risk aversion. See text accompanying notes 18-22 *supra*.

32. This author is currently working on a broader project under this title exploring the phenomenon of concealment in a loss frame. This author is thus far persuaded that disclosure problems in many corporate issuers are in part due to this problem.

decisions when in fact they are not.³³ Poorly calculated cover ups arose in many of the most recent corporate scandals, ranging from document destruction at Arthur Anderson after the Enron fiasco to Martha Stewart's lies to federal investigators when, if she had kept her mouth shut, she probably would have escaped prosecution because the other evidence against her was so weak. Prospect theory helps explain why such seemingly irrational cover ups occur so often.

Cognitive biases other than framing also can affect evaluation of risk and risk preferring responses in disclosure decisions.³⁴ Many of these biases tilt toward underestimation of an issuer's business risks or the legal risks of nondisclosure. "Cognitive conservatism and decision simplification" can lead decision makers to develop simplified explanations of occurrences, or "schemas," that resist evidence of change, a tendency that is exacerbated in group settings where stress comes from challenging commonly held beliefs.³⁵ "Overoptimism" often arises from the tendency of organizations to promote an optimistic viewpoint in order to promote hard work and long-term commitment by employees, even though this viewpoint deflects or rationalizes evidence of negative developments.³⁶ When there is sufficient ambiguity to allow it, people sometimes infer "self serving facts" that do not threaten their self esteem or career prospects.³⁷ Finally, once a decision maker commits to a particular response to risk, the decisionmaker may adhere consistently to that response ("commitment bias") even if later confronted with evidence that the commitment was a bad choice.³⁸ A particular way

33. See Rachlinski, *supra* note 26, at 134-35 (discussing how subjects in litigation settlement negotiation simulation studies overestimate their chances of winning and therefore perceive their own risk preferring reservation prices to be risk averse); *id.* (citing George Loewenstein et al., *Self-Serving Assessments of Fairness and Pretrial Bargaining*, 22 J. LEGAL STUD. 135 (1993) (study of overconfidence in evaluation of litigation prospects)).

34. See Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997) [hereinafter Langevoort, *Organized Illusions*] (identifying the "social cognitions and norm structures within organizations that 'loose coupling' between regular activities and instrumental rationality for reasons that go beyond managerial opportunism"); Donald C. Langevoort, *Where Were the Lawyers?: A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 101-11 (1993) (positing that lawyers may not be good monitors of their clients' conduct because, having agreed to represent a client, they are motivated by biases—such as commitment, overoptimism and cognitive conservatism in processing new information that contradicts existing schema—to see the client's activities as permissible and thus to ignore red flags).

35. Langevoort, *Organized Illusions*, *supra* note 34, at 135-39 and nn.114, 118, citing Dennis A. Gioia, *Pinto Fires and Personal Ethics: A Script Analysis of Missed Opportunities*, 11 J. BUS. ETHICS 379 (1992) (discussion of how Ford Motor's product recall personnel missed danger signs associated with the Pinto's on-road performance because of a "normalcy" schema); and Sara Kiesler & Lee Sproull, *Managerial Response to Changing Environments: Perspectives on Problem Sensing from Social Cognition*, 27 ADMIN. SCI. Q. 548, 549 (1982) (discussing aspirational level comparisons in problem situations).

36. Langevoort, *Organized Illusions*, *supra* note 34, at 139-41 and nn.133, 135 (citing MARTIN E.P. SELIGMAN, *LEARNED OPTIMISM* 100-12 (1991)); see also Edward J. Zajac & Max H. Bazerman, *Blind Spots for Industry and Competitor Analysis: Implications for Interfirm (Mis)perceptions for Strategic Decisions*, 16 ACAD. MGMT. REV. 37 (1991) (discussing the two major areas of strategy research—industry analysis and competitor analysis).

37. See Langevoort, *Organized Illusions*, *supra* note 34, at 143-46 (citing Dennis A. Gioia, *Self-Serving Bias as a Self-Sensemaking Strategy in Explicit vs. Tacit Impression Management*, in *IMPRESSION MANAGEMENT IN THE ORGANIZATION* 219, 230-33 (Robert A. Giacalone and Paul Rosenfeld eds., 1989)).

38. See Langevoort, *supra* note 34 at 142-43, n.142 (citing Barry M. Staw, *The Escalation of Commitment to a Course of Action*, 6 ACAD. MGMT. REV. 577 (1981)).

of accounting for a transaction, for example, once used by an issuer and blessed by its auditors, may be difficult for the issuer's managers and auditors to retreat from, even if later evidence emerges suggesting that the accounting treatment was wrong.

A few biases, however, can tilt in the opposite direction. "Defensive pessimism," for example, can cause agents of the issuer, including its auditors and lawyers, to overemphasize the possibility of negative outcomes.³⁹ "Commitment bias" can cause auditors and lawyers to carry a conservative approach used for one client over to another client, even if the second client wants a more aggressive approach. Accounting rules (including much of GAAP) could be described as "schemas" that promote conservatism, even in situations where more aggressive treatment might be allowed.

The overall effect of cognitive biases on an issuer's disclosure depends on how these various biases affect agents acting for the issuer and how these agents interact with each other. Legal rules can make a difference. Legal rules that shift responsibility for evaluation of, or response to, risk away from one group of decision makers (for example an issuer's managers) to other decision makers (for example auditors or outside directors) may change evaluation and response to risk if these decision makers are subject to different cognitive biases. Specific scenarios that trigger cognitive biases can be identified and legal rules can then shift decision-making responsibility in those scenarios away from persons vulnerable to biases that discourage disclosure. Rules that require gatekeeper consultation with independent directors in "loss frames" such as ongoing securities law violations, for example, shift decision-making power away from corporate officers most vulnerable to the cover-up mentality. Legal rules can also overcome "commitment bias" and "self serving bias" by requiring an issuer in certain scenarios to obtain second opinions from new auditors or lawyers, or by requiring rotation of auditors or lawyers on a periodic basis.

III. OBSTACLES TO REGULATING GATEKEEPER EVALUATION AND RESPONSE TO RISK

A. Gatekeeper Regulation is Pointless if it Chokes Off the Flow of Information to Gatekeepers

Lawyers and auditors, because of their expertise and ability to gather information, often know more about an issuer's business risks and legal risks than the issuer's outside directors (who get information secondhand from managers and focus mostly on "big picture" issues at periodic board meetings). Usually, however, lawyers and auditors know less about an issuer's risks than managers and other employees who know this information firsthand and transmit it to the gatekeepers. Gatekeeper regulation—even if it improves gatekeeper response to risk—is thus probably not desirable if it substantially impairs information flow to gatekeepers. There is no use requiring gatekeepers to disclose, or otherwise respond to, risks they will never learn about in the first place.

Some ethics rules for gatekeepers are designed to encourage managers and other employees to communicate openly with gatekeepers. For example, the gatekeeper has a

39. See Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375, 377 (1997) at 423-26 (discussing "defensive pessimism").

duty to keep clients' confidence,⁴⁰ as well as a duty to avoid representing other clients with conflicting interests who could take advantage of client information.⁴¹ Other ethics rules facilitate two-way discussion between gatekeepers and an issuer's employees, for example the general duties to provide competent representation⁴² and to keep a client informed.⁴³

Other ethics rules—even if they improve gatekeeper response to risk—can impair the flow of information about risk from issuers to gatekeepers. For example, managers might hide information from auditors who are required to notify outside directors of disclosure problems, and might be even more likely to hide information from auditors who are required to notify the SEC.⁴⁴ Auditor rotation requirements and restrictions on non-audit services, also may reduce auditors' exposure to information about issuers' businesses, making it more difficult to learn about risk. Lawyer up-the-ladder reporting rules,⁴⁵ and particularly lawyer "noisy withdrawal" rules⁴⁶ arguably may decrease the flow of information about risk between managers and lawyers. Any improvement in gatekeeper response to risk that comes from these rules has to be weighed against potential reduction in gatekeeper information and consequent impairment of gatekeeper evaluation of risk.

As illustrated in the following diagram, a hypothetical gatekeeper G will only disclose or otherwise appropriately respond to risk if G finds out about the risk in the first place, and G then responds, or causes some other agent of the issuer to respond, appropriately. Both knowledge and response are required. The percentage (Z) of an issuer's undisclosed risks that G appropriately responds to (or causes someone else to appropriately respond to) is thus a product of the percentage (Y) of undisclosed risks that G finds out about in the first place and the percentage (X) of incidents in which G, when aware of a risk, will appropriately respond (or cause someone else to appropriately respond). More stringent gatekeeper regulation is designed to increase X, but arguably does so at the expense of Y. The impact of a regulation on disclosure (Z) thus depends on

40. See, e.g., MODEL RULES OF PROF'L CONDUCT R. 1.6 (2002) (requiring preservation of client confidences with certain limited exceptions); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA), CODE OF PROF'L CONDUCT [hereinafter AICPA CODE] R. 301 (1995) (prohibiting disclosure of client confidential information, subject to disclosure requirements connected with an audit under Rules 202 and 203).

41. See, e.g., MODEL RULES OF PROF'L CONDUCT R. 1.7, 1.9, 1.10 (2002) (prohibiting certain client conflicts); see also AICPA CODE R. 102 (requiring accountants to maintain a practice clear of conflicts of interest).

42. See, e.g., MODEL RULES OF PROF'L CONDUCT R. 1.1 (2002) (duty of competence).

43. See, e.g., MODEL RULES OF PROF'L CONDUCT R. 1.4 (2002) (duty to communicate with clients).

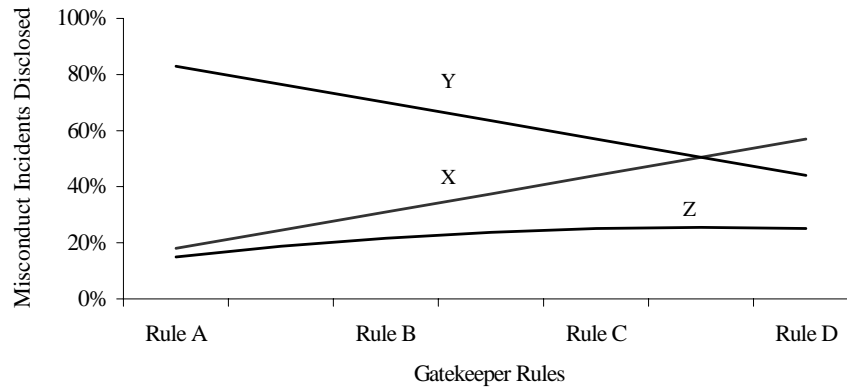
44. See Securities Exchange Act of 1934 § 10A, 15 U.S.C. § 78a et seq. (2003).

45. Professor Kraakman argues that "whistleblowing leaves all regulatory targets at the mercy of their private monitors" and creates for clients "a powerful incentive to withhold information from potential whistleblowers." Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. L. ECON. & ORG. 53, 60 (1986). But see Richard W. Painter, *Toward A Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 GEO. WASH. L. REV. 221 (1995) (pointing out that whistleblowing rules on balance enhance disclosure for at least some combinations of lawyers and clients, and proposing that lawyers and clients should thus be allowed to agree ex-ante that the lawyers will blow the whistle on illegal acts, a commitment likely to be viewed favorably by regulators, transaction participants, and investors).

46. See discussion of the SEC's proposed "noisy withdrawal" rule for lawyers at text accompanying notes 3-7 *supra*.

relative changes to Y and X that result from the regulation:

FIGURE 1



$$X\% \times Y\% = Z\%$$

In Figure 1, Rules A through D could, for example, be whistleblowing rules for lawyers (e.g., A = reporting up optional, reporting out prohibited; B = reporting up optional, reporting out optional; C = reporting up required, reporting out optional; D = reporting up required, reporting out required).⁴⁷ Alternatively, they could be rules regulating non-audit services by auditors for audit clients (e.g., A = all non-audit services permitted; B = some, but not all, non-audit services permitted; C = all non-audit services prohibited; and D = all non-audit services prohibited for both audit clients and other clients of the auditor). A through D could also be rules requiring auditor rotation (e.g. A = no rotation required; B = audit partner rotation required every five years; C = audit partner rotation required every year; and D = audit firm rotation required every year). The tradeoff for each of these sets of rules is empirically different (and the tradeoff is empirically different for one set of rules depending on the particular issuer and gatekeeper involved), but the problem is analytically the same.

Figure 1 is relatively agnostic between gatekeeper rules A through D because curves X, Y and Z in Figure 1 are drawn almost symmetrically assuming that, as rules become progressively more strict, improvements in X (gatekeeper disclosure and response to risk) are almost exactly offset by deterioration in Y (gatekeeper information about risk). In short, gatekeepers under Rule D may be highly likely to respond to those risks they are

47. In this scenario, Rule A would parallel the ABA's former Model Rules 1.13 and 1.6 (prior to August 2003 amendments); Rule B, the rule in the majority of states which permit reporting out as well as reporting up but require neither; Rule C, the regime now imposed by the SEC's § 307 and rules thereunder which require reporting up and make reporting out optional (preempting state rules to the contrary); and Rule D the combination of the SEC's rules with rules in the minority of states (which the SEC has expressly not preempted) that would require reporting out if reporting up is unsuccessful. See Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 GEO. WASH. L. REV. 221 (1995).

aware of but are also highly unlikely to be aware of many risks because their evaluation of risk is impaired by poor information. At the opposite extreme, Rule A maximizes gatekeeper access to information, but does little to assure that agency problems or cognitive biases do not prevent the gatekeepers from responding appropriately. Rules B and C lie somewhere in the middle. Overall gatekeeper response (Z) in this particular diagram is relatively unaffected by the choice between A, B, C or D.

Such, however, is not always the case. For each specific set of rules the tradeoff between gatekeeper information about risk and response to risk is different; lines X and Y are sloped differently, and not necessarily in the symmetrical fashion depicted in Figure 1. Changing assumptions about how Rules A through D affect variables X and Y thus changes the slope of line Z. A stricter Rule C or D that dramatically improves gatekeeper response to risk (because variable X is elastic) without significantly impairing gatekeeper information about risk (because variable Y is inelastic) should improve overall gatekeeper response to risk (Z). Policymakers should choose such a rule, if they can identify it, and if other costs of the rule do not exceed the value of improved gatekeeper response (Z). A stricter rule should be avoided, however, if it does little to improve gatekeeper response, while dramatically impairing gatekeeper information (e.g. X is inelastic and Y is elastic).

Debates over tradeoffs in gatekeeper regulation thus are often about the relative slopes of curves X and Y for each set of progressively stricter gatekeeper rules (A, B, etc.). These can be lawyer and auditor whistleblowing rules, rules restricting fees for non-audit services, auditor rotation rules or other rules. Proponents of strict regulation argue that a proposed rule C or D will benefit investors because it is a necessary and effective way to get gatekeepers to respond to known risks (a sharp increase in X),⁴⁸ whereas gatekeepers and their lobbyists (whether the ABA or the AICPA) often insist that strictly regulated gatekeepers will have difficulty gathering information about their clients (a precipitous drop in curve Y). Gatekeepers and their lobbyists also sometimes argue that gatekeepers, when they do learn of risks, almost always appropriately respond and, in any event, are unlikely to change their response because of stricter regulation (they argue that curve X is both high and inelastic).

One variable not portrayed in Figure 1, and often overlooked by opponents of strict gatekeeper regulation, is the absolute number of undisclosed risks there are to begin with (Z in Figure 1 is a percentage of this absolute number). If stricter gatekeeper regulation discourages internal constituents of an issuer from concealing risks to begin with, the total number of undisclosed risks against which percentage Z is multiplied is not constant across Rules A, B, C, and D. Rule C and particularly Rule D may discourage the issuer from concealing at least some risks from investors because the issuer knows that the gatekeeper, if it discovers the concealed risk, will have to respond. Even if Z is relatively unimpressive for Rule C or D, under this scenario the stricter disclosure rule could result in more overall disclosure to investors.

Whatever the optimal tradeoff between gatekeeper response to risk and gatekeeper information about risk, that tradeoff may differ depending on the issuer and the

48. See, e.g., Letter from Richard W. Painter, University of Illinois et al. to Harvey Pitt, Chairman, Securities and Exchange Commission (Mar. 7, 2002), available at <http://www.abanet.org/buslaw/corporateresponsibility/pitt.pdf> (last visited Mar. 23, 2004).

gatekeeper involved. It is for this reason that this author initially suggested that private ordering should be used to choose lawyer disclosure rules (lawyers and clients should be allowed, for example, to choose ex-ante their own rules for lawyer whistleblowing).⁴⁹ Private ordering might also help design rules in other areas (for example, shareholders could demand that issuers not hire audit firms for non-audit services or that an issuer's audit firm be rotated periodically). Private ordering has, however, suffered from market failures (including information asymmetry between shareholders and managers, transaction costs and shareholders' bounded rationality). Focal points for gatekeeper behavior and managers' and shareholders' expectations of gatekeeper behavior sometimes emerged not from an objective search by informed private actors for efficient tradeoffs between competing priorities, but rather from the rhetoric of powerful gatekeeper trade organizations such as the AICPA and ABA which elevated in the public consciousness their own self interested model of professional services. Mantras such as "one stop shopping" in the case of auditors and the "sanctity of client confidences" in the case of lawyers dominated public discussion of gatekeepers' roles throughout much of the 1990s. Critics of existing regulation, including this author, responded to these perceived failures in private ordering by proposing that public ordering assume a more aggressive role in regulating gatekeepers.

The Sarbanes-Oxley Act thus responds to perceived market failure by imposing its own rules on gatekeepers, but does so mostly based on only a rough estimate, if that, of how each rule is likely to affect the overall disclosure induced by gatekeepers (curve Z in Figure 1) or is likely to affect the overall amount of information that issuers' managers do not disclose to begin with. It is for this reason perhaps that Congress spoke mostly in generalities in the Act and left a significant amount of detail up to the SEC. Whatever rules the SEC promulgates (some of which are discussed in more detail in Section IV below), it is not apparent that those rules will strike the right balance between gatekeeper response to risk and gatekeeper information about risk. It is even less apparent that the SEC will devise rules that strike the right balance not only in the U.S. but also for lawyers and auditors in foreign countries. Experimentation with different rules in different jurisdictions (some choosing Rule A or B and some Rule C or D) may be the best way for regulators in all jurisdictions to discover the best resolution of this tradeoff for their own lawyers and auditors.

B. Gatekeeper Regulation Can Ameliorate, but Cannot Solve, Gatekeeper Agency Problems

Agency problems can cause gatekeepers to poorly evaluate risk (for example, by ignoring information) or to fail to respond appropriately. These agency problems often grow out of stockholder-manager agency problems because gatekeepers, hired and compensated by managers, are likely to be responsive to those managers—even if their instructions are contrary to the interests of the issuer and its shareholders. In worst case scenarios, an issuer's managers are able to "bribe" all or most of its gatekeepers with lucrative fees into ignoring risks. Ethics rules for gatekeepers try to control this agency problem,⁵⁰ but are not always effective.⁵¹ Self regulatory organizations and government

49. See Painter, *supra* note 47.

50. See, e.g., MODEL RULES OF PROF'L CONDUCT R. 1.13 (organization as client) (requiring lawyer

regulators also have addressed agency problems by attacking particular arrangements that maximize the risk of gatekeeper defection. AICPA rules, for example, bar auditors from charging contingent fees,⁵² AICPA and SEC rules prohibit auditors from having an ownership interest in their clients,⁵³ and the new Sarbanes-Oxley Act rules bar many types of non-audit services.⁵⁴

Entirely apart from their relationship with the issuer and its managers, gatekeepers face agency problems within their own professional services firms.⁵⁵ Even if a gatekeeper firm overcomes perverse monetary incentives and wants to limit its own risk exposure from excessive deference to client managers, individual partners in the firm may still be interested in getting and keeping a lucrative but risky client—even if it harms the firm as a whole. Some gatekeeper regulations (e.g., the new audit partner rotation rules under the Sarbanes-Oxley Act⁵⁶) are designed to mitigate gatekeepers' intra-firm agency problems. For the most part, however, these problems can only be corrected through structural changes within the gatekeeper firms themselves (e.g., risk management departments in audit firms, ethics committees in law firms, and reforms to compensation systems).

On the positive side, gatekeepers may not be as prone to agency problems as an issuer's managers, particularly if the gatekeepers' payoffs are different from those of managers. Gatekeepers often do not benefit as much as managers benefit when risk taking turns out to be profitable, yet gatekeepers pay a cost as high or higher than managers pay for undisclosed risk taking that turns out to be harmful. For example, if concealment of earnings shortfalls from investors keeps an issuer's stock price temporarily high, managers will claim most of the credit and get most of the rewards for their deception (particularly if they own stock options). If, however, things go wrong and the shortfalls are later exposed and investors lose money, the auditors may shoulder much of the blame and incur much of the liability in subsequent lawsuits. Gatekeepers involved in corporate scandals also face loss of reputation, the very asset that allows gatekeepers to

representing an organization to do what is in the best interests of the organization, not its managers).

51. See discussion at text accompanying notes 77-79 *infra* of concern about the vague language in Model Rule 1.13 which led eventually to enactment of more precise federal requirements concerning ethical obligations of securities lawyers.

52. Auditors who certify an issuer's books and records may not be compensated by contingent fees. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA) CODE OF PROF'L ETHICS, § 302, R. 302.01. The AICPA Rule defines a contingent fee as "a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service."

53. Such an ownership interest destroys the independence of an accountant with respect to the client. See Codification of Financial Reporting Policies § 602.02(b), 4, Fed. Sec. L. Rep. (CCH) ¶ 73,258, at 62,886 (1988); AICPA Codification of Statements on Auditing Standards ("SAS") No. 1, AU § 220.03 ("An auditor with a substantial financial interest in a company might be unbiased in expressing his opinion on the financial statements of the company, but the public would be reluctant to believe that he was unbiased."). See also Exchange Act Release Nos. 33-7870, 34-42994, 35-27193, *supra* note 3 (proposing clarification of SEC rules on ownership interests in clients held by partners of auditing firms).

54. See text accompanying notes 63-69 *infra* (discussing these rules).

55. For an excellent discussion of these agency problems within auditing firms, see Jonathan Macey & Hillary Sale, *The Demise of Professionalism in the Accounting Profession: Preliminary Observations on Commodification, Independence and Governance*, 48 VILL. L. REV. 1167 (2003).

56. See text accompanying notes 70-73 *infra* (discussing these rules).

sell their services to issuers in the first place. These “market reputation” and “litigation” corrections for gatekeeper agency problems may be as effective as, if not more effective than, regulation.

Gatekeeper regulation, however, can take advantage of the fact that agency problems affect issuers and gatekeepers differently by reallocating responsibility for evaluating and responding to risk. In situations where an issuer’s managers are more prone to agency problems than gatekeepers, responsibility for evaluation of risk can be shifted to the gatekeepers. This, for example, is a rationale behind requiring financial statements that have been prepared under the supervision of an issuer’s chief financial officer to then be certified by an independent auditor. In situations where gatekeepers themselves are prone to agency problems, regulation can require the gatekeepers to disclose information to the issuer’s independent directors who may not be as prone to agency problems and who thus may be more likely to respond appropriately. The Sarbanes-Oxley Act thus requires certain disclosures by auditors to the issuer’s audit committee and by lawyers to the issuer’s directors. Finally, responsibility for evaluating and responding to risk can be shifted from one gatekeeper to another gatekeeper less prone to agency problems. Provisions in the SEC’s lawyer regulations that encourage issuers to obtain a separate opinion from outside counsel⁵⁷ accomplish this objective if the lawyer providing the opinion has weaker ties to the issuer’s managers than the lawyer originally making the report.

Another way of overcoming gatekeepers’ agency problems is to remove or mitigate the incentives that managers create for gatekeepers not to evaluate appropriately or respond to risk. Auditor independence rules under the Sarbanes-Oxley Act thus bar audit firms from receiving fees from audit clients for at least some non-audit services. The Act also provides that audit committees—not managers—shall hire, fire, and determine the compensation of auditors. These rules could go even further by requiring rotation of audit firms so future audit fees can no longer be used to reward complicity in concealment. Similarly, lawyers should be prohibited from receiving contingent fees in corporate transactions (this author has suggested that the SEC prohibit arrangements such as the \$35 million contingent fee paid by Time-Warner to its outside counsel for closing what turned out to be a disastrous merger with AOL).⁵⁸

Regulations furthermore can impose on gatekeepers a legal duty to appropriately respond to risk despite the temptation not to do so. The securities laws have long made auditors liable for materially misleading audited financial statements. In 1995, Congress added Section 10A of the Exchange Act, which requires an auditor to take steps to detect and then to disclose certain violations of law to the SEC. The SEC has also proposed a rule that would require a lawyer to make a “noisy withdrawal” from representing an issuer that persists with illegal conduct, in effect alerting the SEC to the problem. As pointed out above in the discussion of Figure 1, some of these rules, even if they reduce the harmful effect that agency problems have on gatekeeper response to risk, might also

57. See text accompanying notes 81-87 *infra* (discussing these rules).

58. See The Role of Attorneys in Corporate Governance, Subcommittee on Capital Markets, Insurance & Government Sponsored Enterprises, House Committee on Financial Services, 108th Cong. (2004), available at <http://financialservices.house.gov/media/pdf/020404rp.pdf> (last visited Mar. 24, 2004) (testimony of Professor Richard W. Painter on the SEC’s adopted and proposed rules on professional conduct of corporate attorneys) (urging that the SEC prohibit such contingent fee arrangements in connection with securities transactions).

have the unfortunate effect of reducing the gatekeeper's access to information.

One reason agency problems are so hard to generalize about is that they are often particular to the organizational framework of the issuer or of the gatekeeper's own professional services firm. A solution to an agency problem for one issuer, or for one gatekeeper, may make the problem worse for another. For this reason, private ordering (solutions devised by issuers and other market participants themselves) may more easily address agency problems than public ordering through regulation. Where private ordering fails, and public ordering must be used, it is unlikely that regulations that work in one jurisdiction will work in another jurisdiction where the organizational framework of both issuer firms and gatekeeper firms is different and the corresponding agency problems are different as well. Jurisdictional diversity informed by experimentation with different approaches may be the best approach to agency problems that are very difficult to solve.

C. Gatekeeper Regulation Has Made Little Overt Effort to Address Cognitive Bias

Issuers, gatekeepers, and regulators intuitively are probably aware of cognitive bias. As pointed out in the foregoing discussion of cognitive bias, some reporting requirements and responsibility shifting arrangements between issuers and gatekeepers, although they were probably designed to overcome agency problems, also minimize perverse effects of cognitive biases. On the other hand, there have been few systematic attempts by regulators to understand how cognitive biases affect issuers or gatekeepers and how gatekeeper regulation can best take into account these biases. This is an area in which analysis of gatekeeper regulation, and of regulation generally, could be much improved.

Regulators should first recognize and address circumstances in which gatekeepers are less affected by cognitive biases than are issuers' managers. A missed earnings projection, for example, is usually a "loss frame" situation for managers, who thus might underestimate the risk of manipulating earnings to conceal the missed projection. The auditors, on the other hand, are probably not in a "loss frame" (missed earnings projections usually are not blamed on auditors), and they might evaluate risks from earnings manipulation more conservatively. Regulators thus could improve disclosure by increasing the role of auditors in disclosure decisions when the issuer has reported earnings within a close range of earnings projections previously made by its managers. For example, the issuer's audit committee could be required to intensify its review of the financial statements by taking extra procedural steps such as detailed inquiry into each disagreement between the issuer's managers and auditors. The issuer could also be required in this situation to conform the issuer's financial statements to recommendations made by the auditor, even if those recommendations are not conditions for the auditor to issue an unqualified opinion. Alternatively, in this situation the audit committee could be required to explain to shareholders in a separate disclosure statement its reasons in each instance for deferring to management instead of to the auditors.⁵⁹ Similarly, accounting

59. The Sarbanes-Oxley Act arguably reduces the impact of managers' cognitive bias on issuers' disclosure decisions because it makes audit committees stronger and more independent and also enhances auditors' duties to communicate with audit committees. See SOX, *supra* note 1, § 204. The point made here in this article is that regulators could accomplish even more if they were to identify specific situations where, because of cognitive biases, such shifting of responsibility for evaluation and response to risk away from managers toward auditors and audit committees is most appropriate.

treatments that turn on managers' evaluation of their own business projects should be identified as being vulnerable to "self serving bias" and "commitment bias." In these and other instances in which managers are particularly likely to be making biased decisions, the issuer could be required to give special deference to auditors' recommendations. The amount of deference required could be commensurate with the intensity of the bias that is likely to affect managers in a given situation.

In other situations, however, regulators should recognize that both managers and gatekeepers may be affected by a bias (such as a loss frame or commitment bias) or the gatekeeper may be more severely affected than the managers because the gatekeeper's previous decisions have caused a problem.⁶⁰ Commitment bias could affect an auditor's evaluation and response to risk, for example, if inaccuracies are found in audited financial statements for a prior period and the same auditor now advises the issuer on whether or not to restate earnings. The auditor will not want to admit that it was wrong. Lawyers who are representing the issuer in litigation, and who have told the issuer that it is likely to prevail, may be unwilling to admit later that the issuer could lose. If so, the lawyers' communications about the case to the issuer, and to its auditors, are likely to be misleading. In these and similar situations, regulators could require the issuer to rely more heavily on its audit committee to assess the likelihood of prevailing in litigation and how it should be accounted for. Alternatively, the issuer could be encouraged to obtain a second opinion from another gatekeeper not prone to the same bias.⁶¹ An issuer rotating audit firms, or at least audit partners, also might reduce its exposure to auditors' loss frames and commitment biases (although auditor rotation also has its problems because the new audit firm's self serving bias might lead it to find unjustified fault with the earlier audit).

Another approach is to use gatekeepers as a conduit for transmitting information about risk from persons within the issuer's organization who are most often affected by cognitive biases (usually its officers and other employees) to other persons who are not as seriously affected by these same biases (usually independent directors, but sometimes the issuer's general counsel). Section 307 of the Sarbanes-Oxley Act, for example, may help overcome the effect of cognitive biases by requiring an issuer's lawyers to report information about securities law violations and fiduciary breaches to the issuer's general counsel and then to its directors. However, neither Section 307 nor the SEC's rules thereunder took the additional step of identifying specific situations (e.g., those in which managers are most likely to be affected by loss frames, commitment bias, self serving bias, overoptimism, or other biases) and then imposing heightened duties on the lawyers in those situations to communicate information to the issuer's directors. The criteria for up-the-ladder reporting—"evidence" of a "securities law violation, breach of fiduciary duty or other similar violation"—is instead extremely general.

60. For discussion of the various cognitive biases that can affect audit quality, see Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, 80 HARV. BUS. REV. 97 (2002); and Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133 (2000).

61. The second opinion provider still might have a self-serving bias that leads the second opinion provider to believe and say exactly what the issuer's management wants to hear, or what makes the first opinion provider look bad by comparison. For discussion of both advantages and disadvantages of second legal opinions, see Michael Klausner, Geoffrey Miller & Richard W. Painter, *Second Opinions in Litigation*, 84 VA. L. REV. 1411 (1998).

Regulators thus have made little effort to identify specific scenarios likely to subject issuers and/or their gatekeepers to cognitive biases that discourage disclosure. These scenarios might include rapid earnings expansion, corporate acquisitions, missed earnings projections, high debt load, and the prospect of restated financials. Some of these scenarios place the issuer and some of its gatekeepers in a potential “loss frame” where anything less than stellar performance is a letdown. Other scenarios can trigger “overoptimism,” “self-serving bias” or “commitment bias.”⁶² Instead of approaching gatekeeper regulation through the lens of generalization, regulators could, using a more tailored approach, identify these and other scenarios where cognitive biases are most likely to impede disclosure, and then design regulations to combat the relevant biases in each scenario.

Cognitive biases, however, are similar to agency problems in that they vary with the role of individual decisionmakers within the issuer or within the gatekeeper’s own professional services firm. A solution to a cognitive bias that works for one issuer, or for one gatekeeper, may not work for another. Private ordering is arguably the preferred approach to cognitive biases, as it arguably is the preferred approach to agency problems, because private parties are well positioned to recognize when relevant decision makers are vulnerable to cognitive biases. Market failures, however, demonstrate that private ordering does not always work and that public ordering should probably have some role. Regulations that address cognitive biases in one jurisdiction, however, may not work in another jurisdiction where decision makers have different roles within their organizations and different cognitive biases as a result. A single regulator, whether the SEC or any other, is thus unlikely to design regulations that overcome cognitive biases affecting issuers and gatekeepers in all, or even most other jurisdictions. Regulators also have little experience consciously confronting cognitive biases, making jurisdictional diversity in this area of regulation that much more important.

IV. REGULATING THE GATEKEEPERS

As pointed out in the discussion accompanying Figure 1 above, regulating gatekeepers can be a balancing act between assuring that gatekeepers have information critical to evaluation of risk and improving gatekeeper response to risk. Many of the aforementioned rules that maximize gatekeeper information (such as lawyer confidentiality rules) may encourage inadequate response to risk. Furthermore, many of the rules that maximize gatekeeper response to risk (such as auditor rotation rules) may reduce the amount of client information available to gatekeepers and impede evaluation of risk. Finding the right balance between these two priorities can be difficult and uncertain. Introducing agency costs and cognitive biases into the problem brings yet more

62. A “loss frame” scenario, for example, is likely when an issuer is rapidly expanding, because the issuer’s officers and directors, and possibly even its gatekeepers, may believe themselves to have a vested interest in the issuer’s projected growth. Any slowdown in growth becomes a loss that nobody wants to own up to. “Overoptimism” in turn may feed growth projections which become increasingly unrealistic. A “loss frame” scenario can also arise in the aftermath of a recent corporate acquisition in which various constituents of the issuer, including its gatekeepers, may have underestimated the costs of integration or personnel changes. “Self-serving bias” and “commitment bias” may reinforce an unwillingness to admit that the acquisition could have been a mistake. Concealment of problems with the acquisition thus seems to be the best alternative. An issuer’s aggressive use of leverage can create yet another “loss frame” scenario, particularly if a liquidity crisis ensues.

uncertainty about optimal rules.

These tradeoffs are apparent in controversies over audit firms' provision of non-audit services to audit clients, auditor rotation and retention procedures, and professional responsibility rules for securities lawyers. In each case, Congress, in 2002, responded to breakdowns in private ordering by enacting rules designed to improve gatekeeper response to risk. Multidisciplinary practice for auditors, close relationships between auditors and senior managers, and client confidentiality rules for lawyers were sacrificed to reach this objective. Much of the debate over these new statutory provisions, and the rules that follow therefrom, is over whether gatekeeper evaluation of risk has been compromised as well.

A. Regulating Auditor Response to Risk

1. Non-Audit Engagements

Non-audit engagements are now restricted, but not completely banned, under the Sarbanes-Oxley Act,⁶³ because they allegedly exacerbate agency problems. Fees for non-audit engagements are sometimes several times the audit fees from the same clients, and may undermine auditors' independence from managers.⁶⁴ Some non-audit engagements also involve tasks (such as bookkeeping) that will later be reviewed in the audit, posing another conflict of interest.⁶⁵ Arguably, these conflicts of interest make it less likely that auditors will appropriately respond to risk.

Audit firms, however, are hardly independent to begin with, as audit fees alone are substantial. Furthermore, non-audit engagements may improve the flow of information to the auditor. Providing legal and tax services, for example, could help an audit firm see how a client puts together complex transactions. Problems initially detected by non-auditors could be brought to the attention of auditors,⁶⁶ thereby improving the auditors' evaluation of risk.

The SEC required issuers to publicly disclose non-audit fees paid in proxy statements filed after February 5, 2001, and several empirical studies use this information to measure the impact of non-audit fees on audit quality. Results of these studies, however, are inconclusive. One 2001 study found significant negative market reaction to proxy statements filed by issuers reporting higher than expected audit fees, a measure

63. See SOX, *supra* note 1, § 208 (prohibiting certain types of non-audit services and authorizing the SEC and PCAOB to regulate others).

64. ARTHUR LEVITT, TAKE ON THE STREET 138 (2002) (citing Dow Jones Newswire report that companies making up the S&P 500 paid their auditors \$3.7 billion for nonaudit services in 2000, more than three times the \$1.2 billion in audit fees paid by these same companies that year). In the case of some individual companies, the disparity between fees for audit and non-audit services was much larger. Sprint Corp., for example, apparently paid Ernst & Young only \$2.5 million for its audit and \$64 million for consulting and other services. *Id.* at 138.

65. "If an accountant keeps the books for a client, he can't turn around and vouch for the accuracy and completeness of those books." *Id.* at 118.

66. See Richard W. Painter, *Lawyers' Rules, Auditors' Rules and the Psychology of Concealment*, 84 MINN. L. REV. 1426-36 (2000) (discussing informational synergies from multidisciplinary practice that could improve audit quality).

perhaps of what the market thinks of audit quality if not of audit quality itself.⁶⁷ This study also found some evidence that issuers that bought more non-audit services from their auditors were more likely to engage in earnings management—a practice that is difficult to measure, but can be approximated by examining how often an issuer just meets or beats earnings benchmarks or reports large income increasing or income decreasing discretionary accruals.⁶⁸ Other studies, however, show no effect of non-audit fees on other measures of audit quality, such as the willingness of the auditor to send a “going concern” opinion letter to an issuer questioning its ability to stay in business.⁶⁹

It appears from these studies that regulation of non-audit services is unlikely to bring either a sharp drop or a sharp rise in total disclosure caused by auditors (curve Z in Figure 1). Improved auditor response to problems may be offset by reduced auditor information. In addition, there are economies of scale and synergies that could be realized when issuers obtain audit and non-audit services from one provider. All of these factors have to be taken into consideration when policy makers decide whether barring auditors from providing non-audit services to audit clients induces sufficient improvement in auditor response to risk to justify the costs of the regulation. The answer to this question is not at all clear, suggesting that continued experimentation with different approaches to regulating non-audit engagements is desirable.

Meanwhile, quite the opposite has happened. Non-U.S. issuers that sell or list securities in the United States are required to retain auditors that comply with most U.S. auditor independence regulations. In response, large worldwide auditing firms have been forced to spin off consulting and other non-audit-service branches in Europe as well as in the United States. Issuers willing to forgo access to U.S. markets in order to avoid U.S. auditor independence rules are apparently too few in number to generate enough business for non-audit service providers to be able to continue working as part of many large audit firms. Unless U.S. regulation becomes more flexible in its extraterritorial reach, there is

67. RICHARD M. FRANKEL ET AL., AUDITOR INDEPENDENCE AND EARNINGS QUALITY (Stanford Graduate School of Business Research Paper Series 2001).

68. *Id.* But see HOLLIS ASHBAUGH ET AL., DO NON-AUDIT SERVICES COMPROMISE AUDITOR INDEPENDENCE? FURTHER EVIDENCE (Working Paper 2002) (no correlation found between issuers' positive discretionary accruals and the ratio of audit to non-audit fees in a study that controlled for the issuers' prior performance, a factor that can itself be related to income increasing accruals); J. KENNETH REYNOLDS ET AL., PROFESSIONAL SERVICE FEES AND AUDITOR OBJECTIVITY (Working Paper 2002) (observing that the correlation between aggregate levels of discretionary accruals and the ratio of consulting fees to audit fees disappears when controlling for high growth issuers). Other studies also have not detected a relationship between audit firms' fees and evidence of earnings management. See, e.g., HYEESOO CHUNG & SANJAY KALLAPUR, CLIENT IMPORTANCE, NON-AUDIT SERVICES, AND ABNORMAL ACCRUALS (Working Paper 2002) (finding no statistically significant association between abnormal accruals by issuers and “client importance” measures such as the ratio of both audit and non-audit fees to the audit firm's total U.S. revenues or to the revenues of a particular office of the audit firm).

69. See, e.g., Mark L. Defond et al., *Do Non-Audit Service Fees Impair Auditor Independence? Evidence from Going Concern Audit Opinions*, 40 J. OF ACCT. RES. 1243 (2002) (finding no significant correlation between the auditor's willingness to issue a going concern opinion with respect to an issuer and either total fees or audit fees paid by the issuer to its audit firm). The results of this study could be harmonized with those of the FRANKEL ET AL. study, *supra* note 67, by hypothesizing that auditors are induced by non-audit fees to cut small corners for issuers, as shown by earnings management strategies, but that non-audit fees will not discourage an auditor from acting appropriately to address a serious problem, such as issuer insolvency, in which the auditor's own liability is significantly enhanced.

little prospect of conducting parallel experiments on each side of the Atlantic, with the United States prohibiting most nonaudit services for audit clients and some Member States of the European Union being more flexible. Particularly in view of the mixed empirical evidence on this issue available thus far, this attempt to foist U.S. rules on auditors in Europe and elsewhere could be a mistake.

2. Auditor Rotation Rules

Regulators also seek to improve auditor response to risk with rules requiring rotation either of the audit firm (the practical effect of rules in some European countries where shareholders are allowed to choose the auditor)⁷⁰ or of the audit partner (the new U.S. rule).⁷¹ Recent developments thus show some convergence between the American and the European approach to this issue, as the United States moves away from a model in which an issuer's managers dominate auditor selection and compensation, and Congress considers going one step further, requiring audit firm rotation as well.⁷² Regulators who impose such rules presumably believe that a new audit firm or audit partner is better equipped than the old to overcome the agency problems and cognitive biases that interfere with audit quality.

Once again, it is not at all certain that these rules actually improve auditor response to risk, nor is it certain how much these rules impair the flow of information from the issuer to the auditor. At least one empirical study has found that the size of an issuer's earnings accruals (a sign that auditors are tolerating earnings management by clients) is inversely related to the length of the auditor-client relationship,⁷³ suggesting that stable auditor-client relationships are beneficial and that mandatory auditor rotation actually could harm audit quality. Clearly, more experimentation with different types of auditor rotation rules is required to ascertain which, if any, of these rules have benefits to audit quality that outweigh their costs.

3. Auditor Retention Rules

Another apparent way to address agency problems that could impair audit quality is to take control over auditor retention away from managers. The Sarbanes-Oxley Act requires that an auditor be retained by an audit committee of the independent directors of the issuer, rather than by the managers of the issuer.⁷⁴ The United States thus has converged to some extent with the European approach that also distances managers from the auditor selection process. Differences remain, however, between the United States and those countries that provide for "statutory auditors" hired not by the issuer's

70. In some European jurisdictions, "statutory auditors" are not only rotated but hired by the shareholders, not managers, and are directly accountable to the shareholders. *See, e.g.,* Sital Kalantry, *Do As Foreigners Do*, NAT'L L.J., Sept. 9, 2002, at A19 (stating the benefits of statutory auditors).

71. *See* SOX, *supra* note 1, § 203 (amending Section 10A of the Exchange Act to require rotation of audit partners).

72. *Id.* § 207 (ordering a study of whether audit firm rotation should also be required).

73. *See* JAMES MYERS ET AL., EXPLORING THE TERM OF THE AUDITOR-CLIENT RELATIONSHIP AND THE QUALITY OF EARNINGS: A CASE FOR MANDATORY AUDITOR ROTATION? (Working Paper 2002).

74. *See* SOX, *supra* note 1, § 301 (2002) (amending Section 10A(m) of the Exchange Act to provide that audit committees shall be responsible for retention, compensation, and oversight of outside auditors).

directors, but by its shareholders.⁷⁵ In other countries, such as Germany, issuer supervisory boards (which by statute must include a certain number of the issuer's employees) have responsibility for selecting and supervising auditors, making it difficult to comply with the Sarbanes-Oxley requirement that auditors be selected by an audit committee consisting solely of independent directors.⁷⁶

Both the new American approach and existing European approaches, while different, have the same potential cost—they could distance auditors from managers, and arguably could impede the flow of information to auditors (see Figure 1). Here, however, the information asymmetry argument is weaker because transferring auditor hiring, firing, and compensation decisions from managers to outside directors is unlikely in itself to significantly interfere with auditor access to information. Managers are still allowed ample opportunity to communicate with auditors. The long experiment in the United States with auditors selected and supervised almost solely by managers also seems to have yielded unsatisfactory results, at least in recent years. Still, continued experimentation is needed to determine which type of auditor retention rules (the new American rules under Sarbanes-Oxley, one of the various European rules, or some third alternative) would be most beneficial and least costly to the issuer.

B. Regulating Lawyer Response to Risk

In Section 307 of the Sarbanes-Oxley Act, Congress imposed new rules on securities lawyers in response to concern about lawyers who knowingly or negligently fail to take appropriate remedial action when clients commit fraud. The way in which Congress and then the SEC dealt with this problem—by more tightly regulating lawyers' response to risk—caused widespread concern about whether the regulations would also impair lawyers' ability to evaluate risk by impeding lawyers' access to information from their clients.

This author urged the SEC in the 1990s to clarify its stance on lawyer disclosure of corporate fraud, including imposition of an up-the-ladder reporting requirement that lawyers communicate with client boards of directors about securities law violations.⁷⁷ After the Enron and Worldcom fiascos, forty law professors wrote SEC Chairman Harvey Pitt in March 2002, seeking a SEC rule requiring issuers' lawyers to report unrectified securities law violations to client boards of directors.⁷⁸ The SEC responded by acknowledging strong opposition from within the organized bar to SEC regulation of lawyers and by suggesting that Congress could enact such a rule if it wanted to.⁷⁹

75. See *supra* note 70.

76. See Ribstein, *supra* note 16.

77. See Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225 (1996) (proposing SEC rules, or alternatively an amendment to the Exchange Act, requiring up-the-ladder reporting by issuer's counsel either to the issuer's full board of directors or to a committee of the issuer's board designated by the issuer in advance). See also Richard W. Painter, *Rules Lawyers Play By*, 76 N.Y.U. L. REV. 665, 719 (2001) (discussing this and similar proposals).

78. Letter from Richard W. Painter et al. to Harvey Pitt, Chairman, Securities and Exchange Commission (March 7, 2002) (on file with author).

79. Letter from David Becker, Securities and Exchange Commission General Counsel, to Richard W. Painter (Mar. 28, 2002) (on file with author) (citing Painter & Duggan, *supra* note 77 for the proposition that Congress rather than the Commission should take the first step toward federal regulation of securities lawyers).

Congress then responded in Section 307 by requiring the SEC to promulgate professional responsibility rules for lawyers representing issuers before the SEC, including the up-the-ladder reporting requirement.⁸⁰

The SEC promulgated proposed rules in November 2002⁸¹ and more narrowly defined final rules in January 2003.⁸² In addition to more precisely defining specifics of the “reporting up” obligation set forth by Congress in Section 307, the SEC’s final rules preempt the few states that would prohibit a lawyer from “reporting out” issuer violations. These rules substituted a rule that would permit, but not require, disclosure by a lawyer to regulators when substantial financial harm is likely to result from an issuer’s violations (the SEC specifically stated that its rules did not preempt ethics rules in the few states that would require “reporting out”).⁸³ The SEC’s final rules also allow for a certain degree of private ordering by allowing the issuer to establish a “Qualified Legal Compliance Committee” (QLCC) and directing that its lawyers report to that committee instead of to the full board of directors.⁸⁴

One of the most controversial provisions in the proposed rules, however, would require a “noisy withdrawal” by the lawyer in the event the directors of a client issuer refused to take appropriate remedial action in response to a violation. This provision, if adopted in the final version of the rules, has the most potential to impair the flow of information to the lawyer. Requiring too much by way of lawyer response to risk in this instance thus might diminish the likelihood that the lawyer learns about the risk in the first place.

In this respect, American and European approaches appear to be diverging. To the extent that the SEC seeks to require a noisy withdrawal, this would go significantly beyond what is required in many European jurisdictions and even beyond what is allowed in some.⁸⁵ A flood of comment letters from European firms objected to this requirement (and to some other aspects of the SEC’s rules). Commentators also objected to the SEC’s view in its proposed rules that a large number of foreign transactional lawyers are

80. See SOX, *supra* note 1, § 307 (codified in 15 U.S.C. § 7245 (2002) (requiring the SEC to promulgate rules of professional responsibility for lawyers representing issuers before the SEC, including the rule requiring reporting up to client boards of directors of securities law violations, breaches of fiduciary duty and other similar violations).

81. For the Commission’s proposed Rules, see Exchange Act Release No. 33-8186; 34-47282, *supra* note 3.

82. See 17 C.F.R. §§ 205, 240 and 249, adopted in Exchange Act Release No. 33-8185; 34-47276, *supra* note 3.

83. Four states—New Jersey, Florida, Virginia, and Wisconsin—now require a lawyer to disclose information necessary to prevent a client’s crime. See Exchange Act Release for § 307 Rules, *supra* note 3 (discussing rules in these states). The majority of states allow such disclosure. A minority forbid it. *Id.*

84. See 17 C.F.R. § 205.3 (2004). See also Painter & Duggan, *supra* note 77 (suggesting that a federal reporting up requirement for lawyers should allow the issuer to redirect lawyer reporting to a committee of independent directors so long as this direction is made before the reportable conduct occurs).

85. See COMMENTS OF THE COUNCIL OF BARS AND LAW SOCIETIES OF THE EUROPEAN UNION (CCBE), *supra* note 8; COMMENTS OF DR. DOMBEK, GERMAN FEDERAL BAR, AND COMMENTS OF ALLEN & OVERY, FRESHFIELDS BRUCKHAUS DERINGER, HERBERT SMITH, LINKLATERS, LOVELLS, AND NORTON ROSE, *supra* note 8. The Freshfields comment letter describes in Appendix A specific provisions of attorney ethics rules in England, Germany, France, Italy, the Netherlands, Hong Kong and Singapore that potentially conflict with the SEC’s proposed “noisy withdrawal” requirement, although generally not with Section 307’s up-the-ladder reporting requirement.

practicing before the SEC and are therefore subject to its rules.⁸⁶ The SEC's final rules, however, retreated from this broad jurisdictional reach,⁸⁷ and the SEC may retreat from the noisy withdrawal requirement as well.

Unlike the numerous, although often inconclusive, empirical studies on the relationship between audit quality and either non-audit services or auditor rotation, no empirical work addresses claims of either proponents or opponents of lawyer disclosure rules such as those set forth in Section 307. Many commentators, including this author, believe strongly that requiring lawyers to report known violations up-the-ladder to issuer boards of directors will result in more overall disclosure caused by lawyers (curve Z in Figure 1), as well as give clients the incentive to reduce the absolute number of disclosure lapses to begin with.⁸⁸ The proposed noisy withdrawal requirement (which would correspond to a Rule C or D in Figure 1) is significantly more problematic. Still, however, the final shape of the SEC's rules under Section 307, and the effect of those rules on lawyer evaluation of risk and response to risk remain uncertain. Once the SEC's final rules are promulgated, observation of how these rules work in practice may lead to further adjustments in the rules.

In the meantime, it is highly doubtful that the SEC should aggressively impose its rules on foreign lawyers, particularly those that do not provide extensive advice to clients on compliance with U.S. securities laws. "Optimal" solutions to problems in lawyer regulation are far from certain and are likely to differ across international boundaries. Better solutions are thus more likely to emerge from experimenting with different rules and observing outcomes. Experimentation is facilitated by allowing different jurisdictions to impose different rules, so private actors can choose the location in which they want legal services to be performed. Each jurisdiction can then change its rules after observing results from this experimentation.

It is theoretically possible that exemptions for non-U.S. lawyers from Section 307 rules will drive issuers who want to avoid these rules to hire non-U.S. lawyers instead of U.S. lawyers. Such fears of a jurisdictional "race to the bottom" are, however, exaggerated. First, U.S. securities lawyers are usually best positioned to represent clients in connection with disclosures made to U.S. investors. Most issuers therefore will be reluctant to hire non-U.S. lawyers simply in order to avoid the SEC rules. Second, the SEC rules allow an issuer to avoid many of the rules' most stringent requirements by setting up a QLCC and directing the lawyer to report to the QLCC. Hiring non-U.S. counsel in order to get around the SEC rules thus is unnecessary. Third, directors and managers who cause an issuer to hire non-U.S. counsel simply to avoid the SEC rules would have to explain their actions to shareholders and, in the event of litigation, to a

86. *See id.* and accompanying text.

87. *See* <http://www.sec.gov>, containing several dozen comment letters from around the world, mostly from securities lawyers and bar associations, on the Commission's proposed rules under Section 307 (some of which are cited in *supra* note 8. The Commission, in its final rules, responded to these comment letters by narrowing many of the definitions in the proposed rules, including that of which lawyers "practice before the Commission" and are thereby covered by the rules and the definition of what constitutes "evidence of a material violation" sufficient to trigger lawyer reporting obligations.

88. *See* Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Ethical and Legal Issues*, 58 *BUS. LAW.* 143, 178 (2002); Susan P. Koniak, *When the Hurlyburly's Done: The Bar's Struggle with the SEC*, 103 *COLUM. L. REV.* 1236 (2003).

court. Fourth, exemption from Section 307 rules does not exempt non-U.S. lawyers from U.S. sanctions if they violate or cause a client to violate U.S. securities laws, or engage in obstruction of justice, for example by destroying documents. Finally, most non-U.S. jurisdictions impose their own rules on securities lawyers, including rules that prohibit lawyers from assisting fraud. Many of these jurisdictions may be stricter than the U.S. in penalizing attorney complicity in client fraud.

The argument that the SEC should allow non-U.S. lawyers to be regulated for the most part by non-U.S. ethics rules thus withstands the criticism that this accommodation will drive regulatory competition to the lowest common denominator. The advantages of not applying Section 307 rules aggressively beyond U.S. borders also outweigh the mostly theoretical possibilities suggested by the “race to the bottom” thesis.

V. THE NEW INSTITUTIONAL ECONOMICS PERSPECTIVE ON REGULATION OF AUDITORS AND LAWYERS

A. *New Institutional Economics*

New Institutional Economics⁸⁹ looks less to efficiency of rules in isolation and more to effectiveness of “institutions,” or combinations of formal and informal rules and sanctions.⁹⁰ Because preferred definitions of “efficiency”⁹¹ change as social and economic circumstances change, the search for static equilibria is less important than looking for an effective evolutionary process, out of which new institutional arrangements emerge to solve problems.⁹²

Of principal concern is the way in which institutions adjust on two levels (private ordering by regulated economic actors and public ordering by policy makers) to imperfect information, bounded rationality, and agency problems. New Institutional Economics recognizes that learning about these limitations on rational decision-making occurs by experimenting with different rules. Each of these rules is likely to be imperfect for a variety of reasons including government actors’ bounded rationality, imperfect

89. For further discussion of New Institutional Economics, see Ronald Coase, *The New Institutional Economics*, 140 J. OF INSTITUTIONAL & THEORETICAL ECON. 229, 229-31 (1984); Terence W. Hutchison, *Institutional Economics Old and New*, 140 J. OF INSTITUTIONAL & THEORETICAL ECON. 20, 20-29 (1984); Douglas C. North, *The New Institutional Economics*, 142 J. OF INSTITUTIONAL & THEORETICAL ECON. 230, 230-37 (1986); OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (New York 1985); Christian Kirchner, *Formen innerstaatlicher Interaktionsregeln für wirtschaftliche Prozesse*, in Korff, W. et al. (ed.), *Handbuch der Wirtschaftsethik*, Bd. 2, at 127-85 (1999). This author is grateful to Christian Kirchner for valuable insights into the application of New Institutional Economics to regulatory policy.

90. EIRIK G. FURUBOTN & RUDOLF RICHTER, *INSTITUTIONS AND ECONOMIC THEORY: THE CONTRIBUTION OF THE NEW INSTITUTIONAL ECONOMICS* 6 (Ann Arbor 1997). See also Christian Kirchner & Richard Painter, *The Economics of Germany’s Shop Closing Hours Regulation*, 17 EUR. J. L. & ECON. (forthcoming 2004) (discussing the New Institutional Economics analytical framework and applying it to regulation of shop closing hours).

91. A solution could be deemed “efficient” because it is Pareto-efficient, because it passes the Kaldor-Hicks test, or because it meets some other agreed upon criteria. Once again, the focus of New Institutional Economics is not on analyzing specific rules under these various definitions of efficiency but on recognizing that rules can be efficient under any of these definitions at one moment in time but, if implemented through a rigid institutional framework with a slow learning process, can be a failure tomorrow.

92. FURUBOTN & RICHTER, *supra* note 90, at 7.

information, and responsiveness to interest groups rather than to general welfare. Solutions that appear optimal when adopted often are not optimal, but better solutions will likely emerge from continued experimentation and adjustment on the basis of observed results. By contrast, an institutional framework that, because of rigidity or adherence to abstract principles, fails to encourage learning through experimentation, risks disadvantaging everyone as time goes on.

One way of encouraging experimentation is to prioritize jurisdictional competition over universal rules. Jurisdictions learn more when they observe their chosen rules compete with other rules in different jurisdictions. Jurisdictional competition thus has an important role in the process of institutional design.⁹³ By contrast, once power to dictate rules is delegated to a single agency with extraterritorial reach, an international organization or an agreed upon process for harmonizing rules in all jurisdictions, the central rulemaking authority may be slow to overcome changing market conditions, bounded rationality, imperfect information or interest group politics.

At the same time, jurisdictional competition has its limits as a desirable institutional framework for rule design. If jurisdictions do not compete to design rules that meet a general welfare test for efficiency, but instead compete to accommodate the interests of a subset of actors, and if other actors—whether because of imperfect information, bounded rationality, collective action problems, or other reasons—fail to respond by withdrawing investment from jurisdictions that choose inefficient rules, jurisdictional competition will only drive rules to the lowest common denominator. The policymaker's task is thus to distinguish institutional frameworks in which efficient rules are likely to emerge from jurisdictional competition (a "race to the top")⁹⁴ from those in which inefficient interest-group driven rules are the likely result (a "race to the bottom").⁹⁵ As pointed out above, the "race to the bottom" argument is sometimes exaggerated, but it is at other times valid and should be taken seriously.

B. The Relevance of New Institutional Economics to Regulation of Auditors and Lawyers

Many general observations from New Institutional Economics have particular significance for regulation of auditors and securities lawyers. First, rulemakers have imperfect information, particularly about subjects as complex as information asymmetries, agency problems and cognitive biases that affect auditors and securities lawyers. Whatever rules these rulemakers choose thus may not be the optimal rules.

93. Much has been written about the value of jurisdictional competition in American corporate law. *See, e.g.,* ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993); FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991). On regulatory competition in European corporate law, see W. Kerber & K. Heine, *European Corporate Laws, Regulatory Competition and Path Dependence*, 13 *EUR. J.L. & ECON.* 47, 47-71 (2002). Jurisdictional competition has also been suggested as a superior approach to securities regulation that the European Union in particular might want to consider when deciding whether to enact a centralized securities code. *See* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *YALE L.J.* 2359, 2361 (1998).

94. *See* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. LEGAL STUD.* 251, 254-62 (1977) (arguing that Delaware corporate law maximizes rather than minimizes shareholder welfare).

95. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *YALE L.J.* 663, 666 (1974) ("The entire function of state corporate law has been reduced to reflecting the preferences of the managers of the largest corporations.").

Second, optimal rules can change over time, particularly when rapidly changing financial markets require institutions to adjust quickly to new information. For example, institutional frameworks, such as the United States securities laws, may have to change to be efficient in a global economy. Accounting firms and corporate law firms are also different from their predecessor firms and their functions may be different than they were when lawyers and auditors began developing a framework for their own regulation. Arguments in favor of particular rules based on historical precedent are thus of limited value.⁹⁶ Third, the amount of money involved makes it certain that interest group politics will influence regulation of gatekeepers in financial transactions. Whatever rules were previously chosen, interest groups probably influenced the choice, perhaps at the expense of the general welfare. Today, these rules may be even less efficient from the vantage point of general welfare and may not even be desirable from the vantage point of the interest groups that originally wanted them.

New Institutional Economics's recognition that experimentation is a learning tool suggests that rules for lawyers and auditors should not be forced to converge to a point where lawyers' and auditors' disclosure obligations are indistinguishable. As pointed out above (see Figure 1), it is uncertain where the optimal tradeoff is between imposing disclosure and other response obligations on gatekeepers and sacrificing gatekeeper access to information about issuers. Results from various resolutions of this tradeoff are best observed by allowing lawyers and accountants to be governed by different disclosure rules (for example, requiring auditors to disclose securities law violations to the SEC but requiring lawyers only to disclose to the issuer's directors). These two professions may, as a result, have access to different amounts of information about issuer risk, and may respond to that risk in different ways. This in turn allows issuers, investors and regulators to learn from observing these differences whether auditors' or lawyers' rules produce superior gatekeepers and in which particular circumstances.

The New Institutional Economics also suggests that jurisdictional competition, in which countries experiment with different rules for gatekeepers, is probably a good thing. For such experimentation to work, countries would have to refrain, in most circumstances, from using jurisdiction over securities sold within their borders or listed on their exchanges as a pretext to regulate services provided by foreign lawyers and auditors. Rules could compete for favor as jurisdictions choose rules for auditors and lawyers practicing within their borders, issuers choose their auditors and lawyers, and investors take into account the applicable jurisdiction's rules when evaluating the risk involved with work performed by auditors and lawyers for a particular issuer.

96. For example, rhetoric about client confidentiality being a "core value" of the legal profession is unhelpful in debate over how confidentiality should be balanced against other obligations of securities lawyers. Much of this rhetoric is rooted in historical traditions from criminal defense practice rather than modern securities law. Equally unhelpful is rhetoric of "professional independence" used to categorically deny that the SEC should have jurisdiction over securities lawyers. One comment letter to the SEC went so far as to complain that new SEC rules for securities lawyers threatened an independence of the bar exemplified by John Adams's defense of accused British soldiers after the Boston Massacre. Letter from Edward Fleischman, New York City to Jonathan G. Katz, Secretary of the Commission, Securities and Exchange Commission (Nov. 25, 2002), available at <http://www.sec.gov/rules/proposed/s74502/ehfleischman1.htm> (last visited Mar. 23, 2004). The connection between defending British soldiers after the Boston Massacre and securities work for Enron is tenuous at best. It is also not clear how such analogies inform the task of designing an institutional framework that sufficiently adjusts to current conditions so it can efficiently regulate the securities bar.

Within this framework of jurisdictional competition, complete convergence of American and European rules for auditor and lawyer regulation would probably be undesirable, at least for the time being. Experimentation with diverging rules, by contrast, would expedite the learning process. Rulemakers, for example, would learn more about the desirable balance between strict regulation that improves gatekeeper response to risk (the direction the United States has moved with the Sarbanes-Oxley Act) and more relaxed regulation that may improve evaluation of risk by enhancing auditors' and lawyers' access to information. Experimentation also may reveal which specific rules are most likely to achieve the desired balance. For example, some European jurisdictions seek to assure auditor independence, and thus improve auditor response to risk, by requiring issuers (or allowing shareholders to require issuers) to rotate auditors every few years. It remains to be seen, however, whether auditor rotation is needed or whether the American approach of requiring only audit partner rotation (after the Sarbanes-Oxley Act) will sufficiently improve auditor response to risk without compromising the audit firm's familiarity with the issuer. Experimentation with these different rules in the United States and Europe should facilitate evolution of more efficient rules in both jurisdictions. These rules may naturally converge or, if different institutional conditions lead to different rules, they may continue to diverge.

It is true that policymakers should remain vigilant about the dangers of a race to the bottom in which issuers forum shop by obtaining legal and auditing services in jurisdictions with rules that cater to managers' interests (for example managers' desire to conceal accounting or legal problems from investors). Lawyers and auditors in jurisdictions with stricter rules could lose business to lawyers and auditors in jurisdictions with less regulation. Such a race to the bottom can be avoided, or at least mitigated, however, with a number of strategies. First, jurisdictions could agree upon universally applicable minimum rules beneath which competitive federalism cannot go. Nowhere, for example, should lawyers or auditors be allowed to assist in client fraud. Second, a single large jurisdiction such as the United States or the European Union could carve out specific contexts from jurisdictional competition by making those contexts subject to the rules of that single jurisdiction. For example, lawyers who advise issuers about compliance with United States securities laws could be subject to SEC rules regardless of where they practice, whereas foreign lawyers who merely draft documents used in United States securities filings could remain subject only to rules of their home jurisdictions. This is exactly the approach of the SEC's final rules for securities lawyers,⁹⁷ although the SEC's earlier proposed rules had sought to impose SEC jurisdiction over all lawyers who participated in preparing disclosure documents.⁹⁸ The SEC could consider liberalizing its rules somewhat further by exempting foreign lawyers who advise clients on U.S. laws other than securities law and could possibly also exempt lawyers who give only general

97. See 17 C.F.R. §§ 205, 240, 249, adopted in Exchange Act Release No. 33-8185; 34-47276, *supra* note 3. The final rules more narrowly define "practicing before the Commission," to exclude a "non-appearing foreign attorney" which is in turn defined as a foreign lawyer who does not give advice on United States securities laws without the benefit of United States co-counsel. 17 C.F.R. § 205.2(j). Even for lawyers who do practice before the Commission, there is an exception under which a lawyer need not "comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law." 17 C.F.R. § 205.6(d).

98. Exchange Act Release No. 33-8186; 34-47282, *supra* note 3 (setting forth proposed rules).

advice concerning U.S. securities laws (for example, that a Securities Act registration statement must be filed before the sale of securities). This last exemption might actually decrease the number of securities law violations because, without it, foreign lawyers might be unwilling to say anything to their clients about U.S. securities laws. In each instance, experimentation and observation would inform the evolutionary development of a regulatory framework that curtails abuses of jurisdictional competition (a race to the bottom) while preserving as much as possible the benefits of jurisdictional competition (a race to the top).

Finally, the skepticism of New Institutional Economics toward static regulatory frameworks is particularly germane to regulation of professional services. Traditional regulatory bodies do not always understand securities markets or securities law, in which case a shift in regulatory responsibility may be needed. State lawyer disciplinary bodies, for example, are not accustomed to dealing with cases involving corporate lawyers and they routinely neglect this area in their enforcement (apparently, not a single lawyer involved in the savings and loan crisis of the early 1990s was disciplined by a state bar association). After similar allegations arose in Enron, Congress wisely refused to defer to a state regulatory apparatus that, in the securities practice context, simply was not working.

VI. CONCLUSION

The United States, with the Sarbanes-Oxley Act of 2002, has embarked on a new course in regulating gatekeepers. Actual results from experimentation with these new rules remain uncertain. Until we know more about the effects these new rules will have on gatekeeper evaluation and response to risk, the United States should be reticent about imposing these rules on foreign lawyers and auditors merely because they represent issuers that sell securities in the United States. Regulators should also avoid imposing the same disclosure obligations on lawyers and auditors. While lawyers should be required to tell client corporation directors about evidence of securities law violations or breaches of fiduciary duty, lawyers probably should not be required like auditors to report this same information to the SEC. Continued experimentation with different rules, within a framework of jurisdictional and professional competition, is preferable to imposing one-size-fits-all rules on lawyers and auditors in all jurisdictions.