MANAGER UNETHICAL BEHAVIOR DURING THE NEW ECONOMY BUBBLE

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ABSTRACT:
This paper investigates factors that brought about the surge in manager unethical behavior within the US economy. Key structural causes are the weak internal control, perverse incentives related to managers’ compensation, conflicts of interest within in the banking and auditing sectors. Unethical behavior was further enhanced by the large economic noise specific to the IT bubble, which emerged in the late nineties against the background of increased deregulation in the goods and financial markets. The US administration opposed to the proliferation of CEO unethical behavior the Sarbanes-Oxley Act of 2002; we argue why some of its provisions might be taken one step further.

Key-Words:
- Unethical behavior,
- CEOs
- Financial deregulation
- Activism
- Sarbanes-Oxely Act.

RESUME:

Mots-clés:
- Comportement non-éthique
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- Loi Sarbanes-Oxley

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1. Introduction. The Internet bubble and US corporate scandals of the nineties*

After ten years of continuous growth, in 2001 the American economy ran into a period of deep trouble. GDP growth almost vanished and unemployment rose by almost two percentage points in one year. Over the same period, shareholders lost some 7000 billion dollars, in what appears to have been the worst stock market decline since the Great Depression. Everybody now agrees that a speculative bubble took off in the late nineties, when abnormal growth was supported by overconfident expectations about the long-lasting high returns to be generated by the new information technologies. This ‘Internet bubble’ burst in March 2001.

The situation would have not been so critical if the collapse of so many stock prices had simply reflected normal readjustment to their fundamental value; but then the US economic outlook became really bleak when a wave of corporate scandals surfaced, filling newspaper front pages with several cases of outrageous misconduct by chief executive officers (CEOs) and/or chief financial officers (CFOs) at leading US companies. William H. Donaldson, President of the US Securities and Exchange Commission, describes the problem in concise terms: ‘Starting with the unfolding of the Enron story in October 2001, it became apparent that the boom years had been accompanied by fraud, other misconduct and serious erosion in business principles’ (Donaldson, 2003a).

It subsequently emerged from the legal investigations into typical cases such as Enron, WorldCom, Global Crossing, Tyco, Qwest, Adelphia, etc., that on the eve of the crisis, several large companies’ CEOs had produced false financial statements with the complicity of corrupt auditors, and reaped personal gains from the resulting short-term overvaluation of their companies by massively selling their shares just before the firm's collapse. Sometimes, the motives for information manipulation were more subtle: either to ‘win time’ for a distressed company, or to use overvalued shares to pay for the target company in a takeover. In all cases, once revealed, these frauds entailed major costs in terms of reputation, that have ultimately been passed on to shareholders and stakeholders. ‘Creative accounting’ and ‘earnings manipulation’ were basic ingredients of all the corporate scandals (Carson, 2003; Lev, 2003). This variety of manager misconduct can be interpreted as an extreme development of the basic conflict of interest between an agent and the principal, as put forward by traditional corporate governance literature (Alchian and Demsetz, 1972; Jensen and Meckling, 1976). Conflicts of interest may take place whenever an economic agent in charge of a public mission derives a private benefit from his job; in many cases, his private interest may conflict with the public interest at large. While conflicts of interest between managers and shareholders are nothing new, the Internet bubble period proved to be a fertile ground for fraud, which is an extreme development of such conflicts (Demski, 2003; Donaldson 2003a; 2003b; Healy and Palepu, 2003).

Some broad figures give a better idea of the scale of the problem. To fight corporate crime, the United States set up a Corporate Fraud Task Force in July 2002 within the Department of Justice. In the course of one year, this public body charged 354 defendants.

with some type of corporate fraud in connection with 169 cases; it has already obtained over 250 corporate fraud convictions or guilty pleas, including guilty pleas or convictions concerning at least 25 former CEOs. From October 1st through June 30th, 2003, the Securities and Exchange Commission (SEC) filed 443 enforcement actions, 137 of which involved financial fraud on reporting. Eleven companies were suspended from trading, and the assets of 30 companies were frozen. The SEC filed almost 50% more financial fraud and reporting cases in 2003 than in the previous fiscal year. Of course, while these absolute numbers are alarming, they seem less so when weighed against the total 15000 US public companies under the SEC’s supervision. The most important stylized fact was not the total number of cases, which is relatively small, but the unusual surge in wrongdoings.

The US economy was deeply affected by these corporate scandals. Managerial abuses brought about a wave of public distrust and criticism, directed at everything from CEOs’ individual behavior to shareholder capitalism as a whole. An opinion poll in July 2002 by the Harvard Business School and the Pew Research Center showed that only 23% of Americans would trust bosses of large companies (yet 75% trusted people who run small businesses). The loss of trust in the main institutions of capitalism such as publicly traded companies and the financial market exacerbated the economic crisis by adversely affecting investment, since it increased the cost of raising capital. As a signal of distrust, for more than three years following the stock market collapse, the market for initial public offerings has been almost nonexistent.

All scholars in social sciences would agree that what can be called ‘ethical behavior’ plays an important role in the well-functioning of capitalist economies: given that their resource allocation system builds on voluntary exchange between individuals, positive social externalities such as trust, loyalty and truth-telling are needed to oil the economic machinery (inter alia: Arrow, 1974; McKean, 1975; Becker, 1976; Hirshleifer, 1977; Noreen, 1988; Brickley et al., 2002). The wave of corporate scandals that marked the turn of the century, mostly in the US but also in Western Europe, were a forceful reminder that in the realm of trust and honesty, capitalism comes with its own limits. In his celebrated work, Arrow (1974) pointed out that nothing guarantees that contemporary capitalist economies can produce sufficient amounts of trust and the other positive social externalities. If the notorious cases of managerial abuses are interpreted as a shortage of honesty and loyalty, the recent US experience seems to validate his viewpoint.

The main aim of this paper is to emphasize the economic and institutional factors that supported development of dishonest managerial behavior in the US during the Internet bubble years (1995-2001). It will be argued that more managers crossed the honesty border because incentives to behave well had, for some reason, been attenuated. Somehow, the US had deregulated dishonesty. Our policy recommendations build on the reverse argument: to prevent managers from following further dishonest strategies, new regulations should make those strategies impossible, ineffective or much more expensive.

Changes in regulation and the economic environment only partially explain managerial misconduct. At the corporate level, the company-specific culture probably played an important role in encouraging or blocking unethical behavior. As noted by Sims and Brinkmann (2003, p.246) who analyzed the Enron case in depth, “the company culture of individualism, innovation, and aggressive cleverness left Enron without compassionate, responsible leadership”. It may also be surmised that every individual has his own stance on ethical behavior; while many managers are concerned about ethics, some are not. Many

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would agree with Watley and May, (2003) and Sims and Brinkmann, (2003) that dishonest behavior is a characteristic of bad management. But while bad regulations can be changed without delay, changing a corporate culture or an individual ethical stance can take many years. In order to focus on elements that are under the control of policymakers, this chapter will leave the major cultural or individual dimensions out of the picture.

The paper is organized as follows. The next section analyses changes in the US economic and financial structure that paved the way for dishonest in depth managerial behavior during the Internet bubble. Section 3 comments on the US policy response to this phenomenon and draws some recommendations for further reform. The final section presents the conclusion.

2. Key factors explaining the surge in dishonest managerial behavior

2.1 A broad picture of the US economic environment

The US economy features both a mature financial market and a powerful sector of publicly traded companies. These two major institutions are not independent: publicly traded companies need an efficient capital market for financing, and financing instruments issued by publicly traded companies (corporate bonds and shares) are essential ‘commodities’ in the financial market. The quality of the financial instruments traded on the market, and the quality of the transactions themselves depends on the existing corporate governance structures. Last but not least, the information disclosure rules and the financial information system have an impact on the allocative efficiency of the financial market.

Since the focus here is on conflicts of interest between managers and shareholders, the relevant field of analysis is the publicly traded companies sector. Most of them are large companies. While large companies contribute only about half of the total US economy in terms of GDP, their influence on the rest of the economy cannot be underestimated given their coverage of the essential sectors (water and energy distribution, transportation, telecommunications, electronics and engineering, etc), their leading role in innovation, and their position as client for many small companies. According to the US Census Bureau, in 2000, the 17000 companies with 500 employees and more (0.3% of the total number of companies) accounted for about 55% of the annual payroll and 50% of total employment. Large companies finance themselves by reinvesting profits, through bank loans and issuing shares and bonds. A distinctive feature of the US economic system is the prevalence of this third financing channel. More precisely, contrary to the Continental European model, where many large companies are still private (non-listed) and where bank loans represent the main external source of funding, in the Anglo-Saxon model, the capital market (where companies sell bonds and shares) provides the bulk of new business finance resources. This leads to major differences between the incentive systems at work in the two zones, and calls for a specific form of regulation.

On the savings side, in the nineties, one American out of two held shares, either directly or through various types of investment funds. The development of a dispersed shareholder base was backed by several structural changes. The population aging problem

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3 Other chapters of this book – for instance those written by Antonio Argandoña and Nicoletta Ferro – cover these important topics.
increased the amount of savings and pension funds emerged as major players in the capital market. Mutual funds, those important vehicles for ‘popular’ capitalism, made share ownership accessible to many small investors.

The emergence of new financial instruments such as derivative products brought further momentum to the development of the capital market. New markets have emerged, now connected to economic risks that a few years ago were beyond the realm of the financial sphere, for instance natural catastrophes or climate change. The creation of hedge funds, those lightly regulated investment vehicles, allows (wealthy) private investors to participate in financial transactions reserved in the past for expert institutional traders (leverage investments, short-selling of assets and so on).

This widening and deepening of the financial market occurred against a background of additional deregulation in the goods markets: the state was pulling out of many traditional sectors, for instance transportation, energy and telecommunications. Even in sectors traditionally controlled by the state (e.g. the defense industry), the government increasingly resorted to managed competition.

Technical progress, mainly in the information technologies, is changing the way people communicate, organize business and trade. In the goods markets, price information can easily reach buyers in this Internet era; since search costs are lowered, spatial differentiation attenuates and local market power declines: as a result, many goods markets are tending to move closer to a situation of perfect competition, to the benefit of consumers. In the financial sphere, trade orders travel at the speed of light, and many financial markets quote prices in real time. Yet all practitioners will agree that information in financial markets is far from perfect; this happens because the traded ‘commodity’ is a claim on future resources. But future resources can only be contingent on the state of affairs at the time the claim is due, making them random variables. When trading future claims, people have to form expectations about their value, but these expectations involve a high degree of subjectivity in the choice of the relevant probabilities. In this specific context, many economists have pointed out that rumors, herding behavior, inside trading and expectation bubbles may all explain why at some given time the transaction price of an asset can drift away from its fundamental value.4

In particular, privileged traders have the ability to influence prices, either because they are big (i.e. they trade large volumes) and/or because they have a high reputation. In recent years, managers have discovered that the way they communicate about their company’s performances also has considerable influence on share prices. Since they have significant control over the outgoing information flow, they may be tempted to use their ‘market power’ in the corporate information market in order to achieve self-interested objectives (Besancenot and Vranceanu, 2004).

Against this background of deregulation in the financial and goods markets, a mix of institutional and economic factors joined forces to set off a proliferation of dishonest managerial behavior during the late nineties. The first factor can be termed **cyclical**, as it is closely connected to the economic boom; it provided the ground layer for the others factors to become active. The other factors may be called **structural**, to emphasize their relative independence of the macroeconomic outlook.

### 2.2. The cyclical factor

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4 See Stiglitz and Greenwald (1991) for an analysis of the economic functions of contemporary financial institutions with special emphasis on the imperfect information issue.
Economic history shows that many ‘affairs’ have come to light at the end of every period of exuberant growth driven by overoptimistic expectations, to mention only the railroads or the electricity episodes (Malkiel, 1973; Kindelberger, 1978). In a ‘bubblish’ environment, the gap between the market value and the fundamental value of selected commodities and financial assets widens sharply, so that prices no longer convey relevant information. Borrowing the physicist's vocabulary, we say that the ‘noise’ of the system increases. In such an environment, decision-makers have more difficulties in extracting the relevant signals. Periods where economic agents believe that large profits can be obtained in a short period of time, and behave accordingly, are supportive for unethical managerial behavior for at least three reasons.

Firstly, in a ‘bubblish’ environment shareholders must process a large amount of information; in particular, they may be blinded by the ongoing rise in the share price (becoming victims of a kind of price illusion). This makes it easier for dishonest managers to hide their actions. As the probability of being caught decreases, the expected cost of fraud declines and more managers may be tempted to increase their own wealth by fraudulent means.

Secondly, ‘good conduct’ is a relative concept: in general, people believe they are behaving well when they are doing what their peers do. To take a basic example, if in a given country all drivers drive slowly, within the legal speed limit, individuals internalize this norm and derive some satisfaction from driving like everybody else, i.e. slowly. If everybody drives fast, the individual will be satisfied if driving fast too. Both situations are stable Nash equilibria, but the second is socially dominated, since it comes with an increased number of lethal road accidents. In the business world, if all managers were concerned with sustainable corporate development, a “ruthless” outlier would never get enough support for his action; conversely, in a world where all managers are obsessed with heuristically-given, excessive targets (like a yearly 15% profit rate), anyone who speaks seriously about environmental protection or corporate social responsibility will only be marginalized.

Thirdly, and this relates to the above point, the task of the external authorities in charge of policing deviant behavior is much more difficult in a ‘noisy’ environment. These public bodies use comparisons (benchmarking) as their main method of controlling managerial performances and actions. In a favorable equilibrium, if someone deviates, the authorities can easily detect and correct the deviation. In the unfavorable equilibrium where all drivers drive fast, how can the police helicopter observe all those exceeding the speed limit? Detection technology exists, but can be expensive.

The risk with economic bubbles such as the Internet bubble is that they replace social norms assigning a significant role to ‘hard work’ and responsibility with norms where easy short-term gains seem both possible and consistent with the common good. In general, people come to realize the absurdity of such a situation only after the bubble has burst. Unfortunately, once a social norm has collapsed, the costs of reinstating it can be quite considerable.

We turn now our attention to those structural factors that contributed to the increase in unethical managerial behavior. Emphasis is set on information manipulation, whither internal control, perverse incentives related to option-based compensation, and corruption of auditors and financial analysts.

2.3. Information manipulation and “creative accounting”

Most of the CEOs’ frauds during the Internet bubble period consisted of information manipulation causing abnormal stock prices. Many managers carried out such actions with total disregard for shareholders and/or stakeholders' goals, pursuing a short-term objective of
large personal gain, for instance by selling shares just before the company collapsed. Sometimes motives were subtler than straightforward personal gain. Some financial misstatements were intended to keep share prices up during a take-over (generally by way of exchange of shares). While incumbent shareholders (and the CEO) may have gained from such action, the target company's shareholders were robbed. In one notorious example from early 1997, the management team of Boeing, the US airplane maker, deliberately omitted to report abnormal costs due to late delivery and other production difficulties, in order to shore up the share price before the take-over of a rival, McDonnell-Douglas; they then reported losses of 2.6 billion dollars three months after the share exchange.\(^5\) In other cases, fraudulent behavior by the CEO aimed at ‘winning time’ for a distressed company facing difficulties in its relations with clients and suppliers. Even though personal gain was not necessarily the main goal of this manipulation, clearly such unethical behavior can only penalize shareholders and stakeholders in the long run, since nobody would wish to deal with a company whose management has a reputation as liars.

How can managers push up share prices? Managers are better informed about the company status than anyone else, be they employees, investment bankers or auditing firms. Sometimes, top executives lie by describing the company's outlook in excessively rosy terms; at other times, all they have to do to keep prices up is to hide a relevant piece of information. Of all the various techniques for manipulating investors’ expectations, one was particularly extensively used during the last crisis. Managers understood that the easiest way to keep the company share price up is to report high earnings. As shown by theoretical and empirical analyses, for various reasons, investors tend to highly rate companies reporting high earnings, and vice-versa.\(^6\) Based on a survey of 31 countries, Leutz, Nanda and Wysoki (2003) argued that earnings manipulation is positively correlated with managers’ benefits.

How can managers manipulate earnings? Under the US accounting standards — Generally Accepted Accounting Principles, or GAAP — companies use accrual accounting, that is: “attempts to record financial effects on an entity of transactions … in the periods in which those transactions … occur rather than only in the period when the cash is received or paid by the entity” (FASB 1985, SFAC 6, para. 139). As emphasized by Xie et. al. (2003), the principle of accrual accounting gives managers great discretion in reporting earnings over a given period. The scope for ‘creative accounting’, that is the capacity of dishonest managers to push the existing accounting standard to its limit, increased with the emergence of new financial instruments: derivatives, offshore markets, new debt instruments, and so on.

During the boom period, many companies systematically understated liabilities and/or inflated assets. For instance, WorldCom management deliberately reported ordinary expenses of seven billion dollars as an investment. Enron set up “special vehicles” – read outside units working as affiliates in all respects except in their name – and sold them gas against a promise to buy it back one year later; it then reported the revenues but not the liabilities. Quest Communications improperly counted more than one billion dollars as revenues in the 1999-2001 period; in particular, the company booked the revenues on fiber optic sales before delivering the product to customers. Computer Associates also booked more than two billion dollars in revenues through accounting sleight-of-hand that involved backdating of contracts. Some companies had recourse to “swap” trades that both parties recorded as revenue (e.g. Dynegy, Quest, Global Crossing). Many other manipulations took the form of mis-estimating

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5 In November 2003, Boeing fired its CFO, Mike Sears, for communicating with a US Air Force acquisition official about her future employment with the company while she was in charge of purchases of tanker aircraft for the Pentagon and was processing Boeing and Airbus’ offers. The CEO, Phil Condit, had to resign soon afterwards. See Business Week, Mai 20, 2002; The Economist, November 29th, 2003; WSJ, December 2nd, 2003 and November 14th, 2004.

6 As pointed out by Zhang (2000), the relationship between share value and earnings may not be linear.
reserves and provisions (see Lev, 2003; Stiglitz, 2003; Healy and Palepu, 2003; Sims and Brinkmann, 2003).

Boards of directors clearly failed in their mission of monitoring the financial statements provided by the CEOs and CFOs. While no empirical relationship between earnings manipulation and the overall structure of boards has been put forward, Xie et al. (2003) point to the essential monitoring role played by the audit committee. In an empirical study covering 110 US companies over three years, they show that earnings manipulation (what they call “earnings management”) is less likely to occur in companies whose audit committees include more independent outside directors, and directors with corporate experience.

When a manager succeeds in manipulating investors’ expectations by issuing a false signal and thus pushes up the share price for a limited period, the result is not a zero sum game where some shareholders lose (those who keep their shares) and some win (those who sell the shares before the truth comes out). One of the capital market’s main roles is to provide information about the economic position of a given company; evolutions in its share price provide early signals for investors and boards, which must implement corrections in the company’s strategy and management. If these corrections are timely, adjustments are smooth; otherwise, adjustments happen in jumps, which are always costly (especially if the firm is filing for bankruptcy).

2.4. Whither internal control

In general, publicly traded companies are governed by a board of directors; in the US this is a legal requirement for incorporation. The board must oversee top management's actions on behalf of the shareholders. According to the Conference Board's annual survey, boards have on average nine members, meet about six times per year and each member receives basic compensation within the range of 10000 to 70000 dollars (Demski, 2003). Some of the members come from within the company, while others are outsiders.

The conflict of interest between directors and the CEO is nothing new: while directors aim at building and maintaining a reputation as honest experts, CEOs have incentives to “capture” them, so as to protect their positions and extract greater benefits (Hermalin and Weisbach, 2003). The situation is clearly described by William H. Donaldson, the SEC Chairman (since December 2002):

Over the past decade or more, at too many companies, the chief executive position has steadily increased in power and influence. In some cases the CEO had become more of a monarch than a manager. Many boards have become gradually more deferential to the opinions, judgements and decisions of the CEO and senior management team. This deference has been an obstacle to directors’ ability to satisfy the responsibility that the owners – the shareholders – have delegated and entrusted to them. (Donaldson, 2003b, pp. 17)

That managers are taking control over boards is obvious to anyone who observes CEOs’ compensation over a long period. A first spectacular jump occurred in the period 1980-1985; over those few years, the CEO compensation per dollar of profit doubled. In the nineties, this tendency was even more pronounced. The average real compensation for the 500 S&P CEOs leapt from 3.5 million dollars in 1992 to 14.7 million in 2000. The fall in average incomes was fairly limited during the crisis, since it was still as high as 9.4 million dollars in
Bebchuck et al. (2002) were among the first to suggest that in the Internet years, entrenched CEOs set out to "capture" boards of directors and grant themselves large pay increases at the expense of shareholders. Arthur Levitt, a former and influential President of the Securities and Exchange Commission, wrote that ‘unseemly excessive compensation and separation packages are a consequence of boards falling victim to a seduction by the CEO’ (Levitt, 2004, pp. A7). Perel (2003, p. 384) points out that many directors are ‘ill-qualified to proffer opinions on executive compensation’; hence, many boards will decide on top executive compensation based on the advice of external consultants, most often hired by … the same top executives. In an empirical analysis, Core at al. (1999) found that companies with weaker governance tend to pay their CEOs more.8

In a notorious example of lack of transparency and weak board control, the former NYSE chairman Richard Grasso obtained from the board, whose members were in general appointed by him, secret compensation of 48 million dollars on top of his declared 140 million dollars. When in September 2003 the authorities uncovered this hidden amount, the chairman was forced to resign and the board began a restructuring process.9

2.5. The problem with stock-option based compensation

As emphasized by Carson (2003, pp. 392), ‘terms of employment and compensation schemes can create incentives for unethical conduct’ and ‘rules, decision procedures and schemes for reward and compensation all need to be scrutinized for the incentive they create’. Let us follow his advice and take a closer look at the US executive compensation system.

In 1994, the US enacted Section 162(m) of the Internal Revenue Code, which capped corporate tax deductibility of compensations awarded to the five highest-paid executives at one million dollars per executive, unless the additional income qualified as performance-based pay. Unsurprisingly, after this regulatory change was implemented, many large companies set their managers' salary right at the upper limit, and then awarded them more in performance-related compensation. There are many ways to relate pay to performance, the traditional methods being bonuses based on profits or other quantitative targets (market share, customer satisfaction, innovation, etc.), and shares that can be sold at a later time. In practice, stock options became the preferred form of incentive pay.

In general, a call option gives the holder the right to buy a share prior to an ‘expiration time’ at an ‘exercise price’ fixed at the time the option is issued.10 In most compensation schemes, the exercise price is equal to the market price at the issue date, and managers may convert a quarter of the total stock option grant at the end of every year over a five-year period. In many cases, when the manager decides to exercise his options, the company will issue new shares. This means the value of each individual share is diluted, since the company's market value is distributed between a higher number of shares.

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8 A caveat is put forward by Hermalin and Weisbach (2003): highly successful CEOs may command both high compensation and low monitoring by the board. Murphy and Zabojnik (2004) suggest that, to some extent, the increase in wages may be explained by increased competition between firms to attract good managers.
9 None of the new board members will belong to institutions regulated by the NYSE, as was the case with the former board. See: “John Reeds modest proposal”, The Economist, November 22nd, 2003. See also the next chapter.
10 Holders of ‘American options’ may exercise the option at any time prior to expiration, whereas ‘European options’ can be exercised only at the pre-determined expiration time.
Is this option worth anything? It certainly is for the executive concerned. He does not know what the exact price of the share will be at the time of exercise, but he has an idea of the statistical distribution of the future price. He knows that if the share price goes up, he will benefit from the spread between the exercise price and the market price, while in the worst of cases, if the share price goes down, he will lose nothing. As a consequence, his expectations about the future gain can only be positive. For the company on the other hand, any compensation scheme including the value of a stock-option grant is a cost with manager labor input that affects corporate profit.

From a US tax standpoint, the spread between the market and exercise prices is considered as an expense and can be deducted from the company’s taxable earnings. But strange as it may seem, US accounting rules in force in the late nineties did not require that stock option grants to managers and employees should be recorded as an expense; if stock-option pay expenses had been recorded as such, US companies' earnings per share would have been 14% lower than reported in the nineties (Botosan and Plumlee, 2001). The US accounting rules merely required the estimated market value (or “fair” value) of the stock-option grant to be reported in a footnote to the annual financial statement! So, paradoxical though it may be, the massive recourse to stock option grants enabled companies to pay lower corporate taxes, while simultaneously declaring higher accounting earnings.

The main thrust of the argument against expensing stock option grants emphasizes that the traditional Black and Scholes (1973) option pricing model, which is extensively utilized for valuing publicly traded options, cannot apply to option-based compensation, since it takes no account of vesting periods (the option cannot be exercised immediately), non-transferability, the possibility of early exercise, shifts in earnings distribution that the option grant itself may entail, variable stock volatility, and so on. This argument remains unconvincing: theoretical research in the field is well-developed and more powerful models, able to take these specificities into account, can and have been designed (e.g. Huddart, 1994; Hemmer et al., 1994; Cuny and Jorion, 1995). The US regulatory board in charge of accounting standard-setting, the Financial Accounting Standards Board (FASB), has long acknowledged that satisfactory methods exist; FASB Statement No.123 (December 1995) recommended that companies should utilize fair value methods for assessing the cost of stock-based compensation. The general idea was that although no perfect evaluation method was available, a rough estimate was better than no estimate at all. But companies did not follow this sensible advice.

The only group of people that could benefit from this obvious shortage of transparency was the executives (Carson, 2003; Hall and Murphy, 2003; Levitt, 2004; Stiglitz, 2003). As pointed out by Guay et al. (2003, pp. 408) the lack of transparency specific to un-expensed options helped top managers ‘to justify awarding themselves excessively lucrative pay packages’. It does appear to be easier to convince boards to grant a manager a million-dollar pay increase in the form of an option plan (since no expense is recorded, and annual earnings are not affected) than in a million-dollar cash bonus.

For all these reasons, the volume of option-based revenues kept on increasing. In the nineties, nearly 80% of the rise in CEO pay took the form of stock options; given this dynamic, in the bubble years the share of option-based compensation represented as much as 60% to 70% of CEOs’ total compensation (Perel, 2003). Proponents claim that they provide an efficient mechanism for aligning manager and shareholder interests, and retaining good managers and staff in young companies that face cash shortages. Do massive stock option grants entail any risks? The answer to that question must bring both the compensation structure and the manager's decision horizon into the picture.

Let us consider the case of the manager of a company whose fundamentals are weak, and whose market value is being driven upwards by the bubble. Of course, the CEO knows
that at some time in the future the game will be up. If most of its compensation consists of pending shares or options to become exercisable in the near future, the rational strategy for the manager will be to push up the share price as high as possible, cash the options, and watch the company collapse. This may have been the case at Enron, whose "Old Economy" background (gas distribution) was shrinking, while the bulk of its earnings came from its risky dotcom branch, trading gas and energy. Kenneth Lay, the Enron CEO, cashed 120 million dollars in options a few weeks before the company went bankrupt, while employees were prevented from selling Enron shares (mostly components of their retirement plans). In the same vein, Gary Winnick, the CEO of Global Crossing, also made more than 130 million dollars by selling shares during the few weeks immediately before the company’s bankruptcy.

Studying a poll of 600 companies listed with the SEC, Rosner (2003) shows that fragile firms with no obvious signs of distress prior to bankruptcy were more likely to succeed in reporting overstated earnings in their financial statements than firms considered as fragile ex ante.

This logic may also explain why the majority of “Old Economy” firms were not affected by this type of opportunistic behavior. If the manager knows that his company is robust, and that once the bubble bursts its value will realign with fundamentals, will he behave in the same way? Probably not. If he has to choose between a large one-off gain followed by job termination and the discounted value of future benefits on the job, the incentives to cheat are less powerful.

2.6. Corrupt auditors and financial analysts

Accounting information would not have been so easy to manipulate without the complicity of corrupt auditors. Accounting firms were also greedy. They all carried out auditing and consulting activities, and most of them provided both services to the same client. In November 2000, alerted by the increasing signals that conflicts of interest were probably under way, the SEC made every endeavor to pass a rule that would have prohibited accounting firms from providing consulting services to their audit clients; but in the face of strong opposition from both audit firms and their clients, the SEC had to scale back its proposal (Palmrose and Saul, 2001). This failed regulation is an indicator of the global mood in the ‘bubblish’ US environment at the time, where common sense was completely overtaken by almost generalized opportunistic behavior. After the crises, the SEC’s worst fears were validated.

The case of Andersen, one of what were five audit firms with a global network, is probably the most significant example of dishonest accounting firms. The name of this now-defunct company was linked with almost all the notorious corporate scandals. In June 2002, after five weeks of evidence and ten days of deliberation, a jury found Andersen guilty of obstructing the course of justice in the Enron case. David Duncan, the leading Andersen partner in charge of auditing Enron, pleaded guilty to the charge of shredding thousands of documents. How could Andersen have been ‘independent in fact and appearance’ as required by the law, when more than half of its billion-dollar-a-week bills to Enron concerned non-audit services? (Demski, 2003).

Many other audit firms, including the other four major firms, allowed varying degrees of significant scope for abusive interpretation of the accounting rules, or even outright fraud. For instance, on September 25th, 2003, Thomas Trauger, a former auditor with Ernst and Young, was arrested for his alleged participation in the destruction of audit working documents during the audit of NextCard. Then, memorably, in early 2002 Deloitte&Touche reviewed the auditing practices of Andersen and concluded that the firm complied with the
best standards. The accounting profession's reputation is likely to remain tarnished for a long time.

Beside boards and accounting firms, the financial status of public companies comes under close scrutiny from security analysts at banks, investment funds and rating agencies such as Moody’s, Standard & Poor’s or Fitch. Company management put tremendous pressure on these people too. Traditionally, analysts who advised their clients to buy the shares of a given company used to benefit from all the firm’s favors, while those who advised to “sell” were persecuted quite openly (for instance, being prevented from attending general shareholders' meetings, among other tactics). Rating agencies only downgraded Enron’s bonds on November 28th, 2001, when the company was nearly bankrupt.

Companies obtained new means of putting the pressure on bank security analysts in 1999, when the Gramm-Leach-Bliley Act on Brokers Rules put an end to the Glass-Steagall Act of 1933. This had been introduced in the aftermath of the Great Depression, when 11000 of the US' 40000 banks went out of business, causing major disruption to the financial system and huge social pain for those who had seen their lifetime savings vanish. It set out a clear separation of financial intermediaries' investment activities and commercial activities. The generally accepted rationale for this law was well expressed in the brief filed by the First National City Bank (1970) in support of the Comptroller of the Currency:

...three well-defined evils were found to flow from the combination of investment and commercial banking: (i) banks were investing their own assets in securities with consequent risk to commercial and savings deposits; (ii) unsound loans were made in order to shore up the price of securities or the financial position of companies in which a bank had invested its own assets; (iii) a commercial bank's financial interest in the ownership, price, or distribution of securities inevitably tempted bank officials to press their banking customers into investing in securities which the bank itself was under pressure to sell because of its own pecuniary stake in the transaction. (FNCB, 1970, pp. 40-42)\(^{11}\)

All these evils came back to haunt the economy of the late nineties, once the Glass-Steagall Act was on the verge of being abrogated. Banks rushed to underwrite bonds issued by star companies, while also having to advise the public whether or not to buy shares in these firms. The conflict of interest was more than obvious. In a typical example, WorldCom issued five billion bonds with Citibank as the legal underwriter. The same bank also granted Bernie Ebbers, WorldCom's CEO, a 400 million-dollar loan with WorldCom shares as collateral. Let us assume that the bank got hold of some information about the company's true financial position. Would it disclose it? Jack B. Grumman, financial analyst at Salmon Smith Barney, a Citibank partner, maintained his recommendation to buy WorldCom shares and even issued a forecast of a 100% increase in the share price, only three months before the company's bankruptcy (Stiglitz, 2003). In 2002, investigations by New York Attorney General Eliot Spitzer showed that Merrill Lynch analysts were doctoring their reports to win business for their banks' investment arms.\(^{12}\)

To sum up, many factors contributed to the surge in dishonest managerial behavior during the Internet bubble years. At that time, increased ‘noise’ in the economy lowered the probability of the existing supervision system detecting deviant action. There are also many signs suggesting that the detection system itself, where boards of directors play the central

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\(^{11}\) See: www.cftech.com/BrainBank/specialreports/GlassSteagall.html.

role, was gradually ‘captured’ by the managers. CEOs succeeded in granting themselves ever increasing compensation packages, mostly in the form of stock options. This reinforced incentives for short-term planning, which proved to be an extremely dangerous practice in the context of the most fragile companies. Finally, by blocking the early signals that a slide in share prices might have conveyed, managers prevented timely error correction (any adjustment would probably have involved the loss of their jobs) and made bankruptcy inevitable.

3. **New activism and the way ahead**

To restore trust after the crisis, the US administration threw itself energetically into developing business regulations, with the aim of strengthening corporate surveillance, fighting fraudulent accounting practices and enhancing the effectiveness of the legal system in this field.

On July 9th, 2002, a **Corporate Fraud Task Force** including US Attorneys, the FBI and the SEC was set up to oversee the investigation and prosecution of financial fraud, accounting fraud and other corporate criminal activity, and to provide enhanced inter-agency coordination of regulatory and criminal investigations. The **Sarbanes-Oxley Act**, signed in July 2002, was designed to tighten up supervision of the practices of the accounting profession, strengthen auditor independence rules, increase the accountability of executive officers and board directors, enhance the timeliness and quality of financial reports of public companies, and protect employees’ retirement plans from insider trading. 13 Both the SEC and the new law require the CEOs and CFOs of large public companies to personally certify the accuracy and fairness of their companies’ public filings.

The increased effectiveness of the US anti-fraud agencies helped them address more complex and insidious cases than the more trivial early frauds; notorious examples are the mutual funds scandal, where over fifteen large US mutual funds came under scrutiny for illegal practices, and the foreign exchange rate fraud. The list of top executives indicted for fraud grew longer every day (see the Corporate Task Fraud website). 14 Some of them have already been convicted and sentenced to jail terms and fines. Changes in the federal sentencing guidelines in 2001 and 2003 significantly raised the penalties for fraud; economically damaging frauds are now on the same level as armed robberies, and prison sentences of over 20 years are not unusual. 15

All in all, the legal system has significantly stepped up both its effectiveness and toughness in dealing with corporate crime. But when it comes to dealing with the economic factors that contributed to the proliferation of dishonest manager behaviour in the Internet bubble years, the US Administration has taken a comparatively soft stance on post-bubble reform.

The valuation of stock-based compensation became one of the most controversial issues in recent accounting history (Guay et al. 2003). Although many US companies unilaterally decided after the 2001 troubles to adopt fair value methods of expensing stock-option pay, the FASB did not make it mandatory. In December 2002, the FASB issued Statement No. 148, **Accounting for Stock-Based Compensation – Transition and Disclosure**, as an amendment to Statement No. 123 of December 1995. The document made only minor changes to existing regulations, mainly improving the quality of information available in the

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14 See www.usdoj.gov/dag/cftf/.

footnote to the yearly financial statements referred to earlier, and asking that this information should also be disclosed in the quarterly statements. But the FASB is pushing the reform further, and the chances of seeing it implemented improved in 2004; the Exposure Draft Share-Based Payment (March 31st, 2004) advocates the mandatory expensing of stock-option grants; companies may choose one of several accepted evaluation methods. It remains to be seen whether the industrial lobby from the west coast high-tech companies will manage to block this reform too.\footnote{See FASB Project Update Equity-Based Compensation, www.fasb.org/project/equity-based_comp.shtml, and US warned over options reform, Financial Times, July 1st, 2004. In Europe, companies using the International Accounting Standards will have to start expensing stock options from January 2005.}

During the Internet bubble years, many boards of directors were actually “captured” by the CEO and failed in their chief mission of monitoring the manager. After 2001, many companies spontaneously undertook a process of reviewing and ‘cleaning up’ their governance systems. While everybody agrees that directors should not fall under the manager’s influence, the question of how independence can be enforced is still open to debate. It is generally assumed that outsiders are more impervious than insiders to managers’ charms. This is not necessarily true; for instance, if the manager has a say in recruiting a new board member, that board member may want to support the manager in troubled times (the ‘gift exchange’ principle, where one good turn deserves another). This uncertainty would explain why no new regulation addressed this important issue. In a notable exception, Section 301 of the Sarbanes-Oxley Act marks a singular step in the right direction: it stipulates that all boards of directors’ audit committees should be made up of independent members of the board. The audit committee is important since it supervises the relationship between the company and the auditing firm.

As required by the Sarbanes-Oxley Act, a Public Company Accounting Oversight Board was set up in January 2003, to ‘oversee the audit of public companies subject to the securities law…’ (Section 101). This Board, an independent non-profit organisation financed by compulsory contributions from all listed companies and security issuers, has wide-ranging inspection and rule-making authority over all auditing firms.\footnote{See Testimony before the United States Senate, by William J. McDonough, Chairman of the PCAOB at: www.pcaobus.org/transcripts/McDonough_11-20-03.asp.} In an economic context where more than half of the American people hold shares and trade in shares is highly decentralized, providing accurate information about the financial position of listed companies should be seen as a public good. This information is needed by a myriad of shareholders; they should be considered the legitimate clients of the accounting firms. So far such a market for information – with direct trade in information between shareholders and accounting firms – has not emerged spontaneously. Mancur Olson’s (1971) theory on collective action perhaps provides an answer to this coordination failure: the market cannot emerge, since no single small consumer would pay for the production of information, and all consumers have an incentive to free-ride on the collective production of information. One possible solution would be to let the government organize the production of high quality financial information. If, on behalf of shareholders, a government agency became the main client of auditing firms, it could then set up some form of managed competition between auditors (as has happened in the US defence sector).

Section 201 of the Sarbanes-Oxley Act prohibits auditing firms from providing a wide range of consulting services to their clients for at least 180 days after the end of the audit process. However, that implies that only six months after an audit, any auditor could be hired on a consulting contract by the same client. It will be interesting to see how frequently such dubious situations emerge in the future. Conflicts of interest can be ruled out only if the law imposes strict separation of audit and consulting firms. To comply with the law, in 2003, the
"big four" auditing firms split from their legal advisory arms and terminated their partnerships with major law firms.

The 2001 crisis differed from the Great Depression with respect to the relatively good financial position of the banking sector (the amount of bad loans was moderate). With some cynicism, it can be surmised that the US were lucky that the bubble burst no later than 2001, only two years after the abrogation of the Glass-Steagall Act. By allowing banks to carry out brokerage activities, the Gramm-Leach-Bliley Act of 1999 left the door wide open for conflicts of interest between same-bank commercial and investment activities, and an increasing number of abuses have been recorded since. By strengthening the independence of research analysts relative to officials involved in investment activities, the Section 501 of the Sarbanes-Oxley Act makes a timid step in the right direction. In the same vein, on July 29, 2003 the Securities and Exchange Commission approved rules proposed by the New York Stock Exchange to specify the period over which a member firm engaged in a public offering of a security or as an underwriter or a dealer cannot publish research on this security. The rules also require analysts and members to disclose any conflicts of interest; in particular, they must provide information on whether in the past they had received any compensation from the issuer that is the subject of the research report.\(^\text{18}\)

However, the current system of regulations is so complex it is hardly surprising that ‘innovative’ bankers find ways to circumvent it. The only sensible policy choice would be to reinstate a modern version of the Glass-Steagall Act imposing a clear separation of commercial and investment activities. Some may criticize this recommendation, pointing to the experience of Germany, where such conflicts of interest do not occur systematically and despite the lack of separation between investment and commercial/savings activities; but it must be borne in mind that the capital market is much less developed in Germany than in the United States. Relying more on banks to finance the corporate sector may provide a workable alternative to a highly regulated capital market.

4. Conclusion

The US corporate scandals of the early 2000s have provided a forceful reminder of a basic principle of economic analysis: when weak internal corporate control allows managers to set up policies that diverge significantly from shareholders’ interests, corrections are ultimately brought about by external forces in the financial and goods markets. While these market-driven adjustments are necessary, they may be extremely brutal and may come with heavy social costs: firms go bust, growth is hampered and millions of employees may lose their jobs.

Most abuses were carried out by managers in companies with weak fundamentals, and most of them were related one way or another to speculation on the Internet and telecommunications markets. Managerial misconduct consisted essentially of manipulating investors’ expectations, through artificially inflated earnings by means of false financial statements or other forms of fraudulent accounting. They successfully avoided early detection with the complicity of corrupt accounting firms and excessively tolerant financial analysts, and by taking advantage of the wave of naïve public faith in the New Economy saga. As shown by the US experience, the economic cost of reneging on ethical principles can be extremely high. Managers come to focus on short-term performances, and recourse to

\(^{18}\) In 2003, ten major US security firms agreed to pay 1.4 billion dollars to settle regulators’ accusation that their analysts wrote too favorable reports in order to win underwriting assignments (Wall Street Journal, November 23, 2004).
unethical actions – even those not motivated by hopes of personal gain – can only damage a firm’s reputation and precipitate corporate collapse.

The best policymakers can do to avoid future corporate scandals is to make dishonest behaviour a very expensive or ineffective strategy for managers. Of course, this presupposes the existence of an efficient legal system able to detect and sanction abuses. This system cannot work properly without clear economic rules. Those rules cannot be minimalist; it would be a mistake to believe that in the absence of external constraints, the resulting equilibrium will necessarily be optimal. The recent corporate scandals in the US provide support for Arrow’s (1974) claim that without proper regulation, the capitalist economy would produce an insufficient amount of positive social externalities such as trust, loyalty and honesty.

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