A POX ON BOTH YOUR HOUSES: ENRON, SARBANES-OXLEY AND THE DEBATE CONCERNING THE RELATIVE EFFICACY OF MANDATORY VERSUS ENABLING RULES

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INTRODUCTION

Accurate and efficient pricing of securities is necessary in order to protect investors and to insure that scarce capital will be allocated efficiently within the real economy. The U.S. securities laws reflect the deeply imbedded assumption that timely, full, and complete corporate disclosure of material information is all that is required to achieve accurate and efficient pricing of securities.

This assumption is wrong. More is required. Specifically, for capital market pricing to function efficiently, there must be adequate “mechanisms of market efficiency” in place to ensure that available information about public companies is collected, processed, and transformed into trading strategies that efficiently move prices to accurate levels.

In other words, for capital markets to function efficiently, more than the mere transmission/supply of information is required. The “demand-side” of the market must also function in order for securities prices to be priced properly.

The main point of this Article is that the “demand-side” of U.S. capital markets is not functioning effectively, at least with respect to certain kinds of information. This, in my view, is the major lesson that should be taken from the recent spate of corporate debacles, most notably the collapse of the Enron Corporation. The “policy surprise” behind these scandals is not that there has been corruption inside so many U.S. companies. The “policy surprise” is that the vaunted U.S. capital markets did such a poor job in uncovering these scandals.

The poor performance of U.S. capital markets reveals that an unexamined and incorrect premise underlies U.S. securities law and policy. The faulty premise is that disclosure, and disclosure alone, is all that is necessary to

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The premise that disclosure alone is sufficient to protect investors was best, and most famously, articulated by Justice Brandeis in his observation that “[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman.” This disclosure philosophy is the bedrock principal on which all of U.S. securities law is based. This premise also serves as the unquestioned organizing principle behind all intellectual debate about securities law. The topic of this Symposium panel is a case in point. Scholars and policy-makers long have engaged in what has become known as the “mandatory versus voluntary disclosure debate” by asking whether or not companies should be able to “opt-into” whatever set of corporate law regulations they most prefer. The issue of whether or not mandatory disclosure is necessary for the protection of investors has been one of the most important debates in securities law over the years.

In recent years, the mandatory-enabling debate has powerfully reincarnated itself in the form of policy arguments favoring issuer choice among different regulatory regimes. This re-opened debate centers less on whether disclosure should be mandatory than on whether issuers should have a choice among competing regulatory regimes. Advocates of issuer choice argue that issuers should be able to choose the securities law regime of the federal government, any state, or any foreign country.

The Enron collapse demonstrates, however, that the “sunlight” that disclosure brings about is useful only if market mechanisms are in place that are capable of observing and interpreting the information that the “sunlight” brings into view. And this is true regardless of whether disclosures are made voluntarily or subject to a mandatory disclosure regime.

In other words, disclosure is a necessary but insufficient condition to accomplish the objective of ensuring that market prices are efficient. There must also be in place an adequate infrastructure to receive, analyze, and interpret the information that is disclosed so that such information quickly will be transformed into an effective trading strategy that will, in turn, cause securities prices to move to prices that reflect the potential risks and rewards associated with investing.

Using Enron as an object lesson in the things that can go wrong with public disclosures, the first part of this Article makes the argument that the capital market mechanisms that are supposed to insure accurate and efficient

2. LOUIS D. BRANDEIS, OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT 92 (1932) [hereinafter BRANDEIS].

share prices are not functioning properly. The second part of this Article discusses the reasons why this fundamental component in our system of corporate governance is not performing as well as it should. In the final section, I offer my views on whether there is anything in the debate over mandatory disclosure that can help us to resolve the current problems in the U.S. system of financial reporting.

I. ENRON, EARLY WARNING, AND CORPORATE GOVERNANCE

As noted above, for decades, there has been a debate in the U.S. between "market-oriented" scholars who take the view that mandatory disclosure is unnecessary because market forces provide plenty of incentives for firms voluntarily to disclose relevant information to the public, and "traditional" legal scholars who take the view that mandatory disclosure is required to ensure that investors receive all of the information necessary to make informed investment decisions. Recent events reveal a serious flaw in the arguments of both sides in this debate. Specifically, both sides embraced the erroneous view that once adequate disclosures were made (either voluntarily or because such disclosures were mandated), market forces, operating in the form of so-called "mechanisms of market efficiency," would move securities prices to their correct levels.

Unfortunately, these "mechanisms of market efficiency" are not functioning properly. Those who think that disclosure should be mandatory and those who think it should be voluntary have assumed, erroneously, as it turns out, that once disclosures were made, the market would take care of the rest. Disclosure is both irrelevant and meaningless unless somebody is acting upon the information being disclosed.

In the Enron collapse, the U.S. mandatory reporting system worked fairly well. While the disclosure system did not work perfectly, or even exceptionally well, Enron did make disclosures that should have led reasonable market participants to uncover grave problems within the company. Thus, the corporate governance problem that Enron unmasked was not a problem with the controversial U.S. system of mandatory disclosure. Rather, the problem was that the market did an astonishingly poor job of both interpreting Enron's disclosures and "decoding" the information contained in the trades conducted by Enron insiders.

5. BRANDEIS, supra note 2, at 92.
6. "Trade decoding occurs whenever uninformed traders glean trading information by directly observing the transactions of informed traders." Gilson & Kraakman, supra note 1, at 573; Myron S.
In this section of the Article, I wish to make two simple observations that appear to have gone completely unnoticed in the debates about disclosure rules in the wake of Enron.

A. Corporate Disclosures: “Receivers are as Important as Senders”

The first observation is that listening is as important, if not more important, than talking. In the disclosure context, this means that in order for an economy to have an adequate system of financial reporting, it is not enough that companies make disclosures of financial information. In addition, it is vital that there be set of financial intermediaries, who are at least as competent and sophisticated at receiving, processing, and interpreting financial information (and other information about company performance) as the companies are at delivering it. Enron’s collapse demonstrated the breakdown of both the infrastructure that generated information about corporate performance, as well as the infrastructure that was supposed to process and interpret that information.

This simultaneous breakdown in the systems of developing/sending and receiving/interpreting disclosures of corporate information is particularly troubling in the context of the debate about whether such disclosure should be mandatory or voluntary. On the one hand, the system of developing and sending the information is a mandatory system. As is well known, the Securities Act of 1933, the Securities Exchange Act of 1934, and particularly the rules promulgated thereunder, such as SEC Rule 10b-5 and Regulation FD, constitute an elaborate system of mandatory disclosure that, until recently, was viewed as the envy of the world. The failure of this system does not reflect well on the efficacy of mandatory disclosure systems.

On the other hand, the system of receiving and interpreting disclosures of corporate information is a voluntary, market-driven regime. Just as government-mandated command-and-control systems exist for producing information about public companies, competition among rival financial intermediaries is supposed to insure that such information is properly analyzed and reflected in firms’ share prices. The economics of this free-market arrangement are simple: the financial markets offer massive gains to intermediaries who can interpret public disclosures and translate that information into effective trading strategies. To the extent that the disclosures

Scholes, The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices, 45 J. Bus. 179 (1972) (showing that trading changes share prices by releasing information into the market, rather than by putting “price pressure” on stocks through changes in the supply or demand for shares).
produced by the mandatory rules indicate that current securities prices do not accurately reflect the present value to securities holders of owning such securities, profits from risk arbitrage are possible. The profits associated with buying under-priced securities and selling over-priced securities should, in theory, provide ample incentives for financial intermediaries to invest in interpreting the information disclosed by public companies.

Thus, my first simple observation is that the recent string of corporate debacles, led by Enron, should be a humbling episode, not only for those who believe in the efficacy of the current system of mandatory reporting but also for those who champion the efficacy of a more laissez-faire approach. Of course, one might argue that, regardless of how efficient the market intermediaries who receive corporate information are, they will fail in their efforts if the information they receive from corporations is tainted by fraud, either in the form of outright misrepresentations or in the form of omissions of important information that is necessary to gain a full understanding of the financial condition of the company being analyzed. However, as I will show in the following section of this Article, I think that it is clear, at least in the case of Enron, that despite the failure in the quality of the (mandatory) reporting generated by Enron, the company’s problems could have been discovered by diligent intermediaries much earlier.

B. Corporate Governance and Culture: Greed Is Not Always Good

My second simple observation relates to the likely incidence of fraud in the financial systems. The recent, seemingly unremitting, series of financial scandals, which includes, among others, Adelphia, Enron, Global Crossing, Tyco, WorldCom, and Xerox might lead some to believe that no companies can be trusted because all of corporate America is crooked. Unfortunately, this perspective is not only wrong, but it also takes attention away from what I believe is a much more important and interesting issue. It seems pretty clear that most corporate executives and directors are honest. The interesting and important question: is why are they honest? There are at least two competing hypotheses.

The first possible explanation for the generally high levels of honesty in corporat:: America is that the vaunted—and enormously expensive—system of checks and balances that comprises the U.S. system of corporate governance usually prevents managers from going astray. This system of corporate governance is comprised of a number of well-paid components, including corporate boards of directors, audit committees on boards, outside accounting firms, law firms, state and federal securities regulators, stock exchanges, financial analysts, commercial lenders, credit rating agencies, the
Financial Accounting Standards Board (FASB), hedge funds and miscellaneous other short-sellers. Unfortunately, one of the object lessons in the Enron collapse is that every component in this complex corporate governance infrastructure is fundamentally broken. If but one of these components had worked properly, Enron would not have been able to deceive the investing public in the way that it did. But Enron’s board of directors and its audit committee turned a blind eye to the financial shenanigans perpetrated by Enron’s Chief Financial Officer, Andrew Fastow, and others. The audit engagement team from Arthur Andersen, led by David Duncan, and the company’s outside counsel, were completely captured by Enron. As a result, they failed to provide the independent, “gatekeeper” function that investors were told they were entitled to expect.

Similarly, lenders appeared to be more concerned with keeping Enron’s business than with conducting the due diligence that would have revealed problems at Enron. FASB was apparently captured by the accounting profession. Over time, those responsible for developing basic accounting principles lost sight of (or gave up on attaining) the goal of developing accounting rules that required companies to provide an accurate overall assessment of their financial condition. Instead, the accounting rules for public companies morphed into a set of highly technical provisions more likely to obfuscate than to illuminate the true financial condition of reporting companies.

Hedge funds and other likely short sellers missed a bonanza in failing to identify Enron’s problems in a timely way. Similarly, the credit rating agencies also failed to recognize Enron’s troubles, despite their privileged access to non-public, material information about the companies to whom they provide credit ratings. Strikingly, there is absolutely no reason to believe that the financial intermediaries that interacted with Enron were any different than their competitors. The law firm, the accounting firm, the directors, the regulators, and the financial intermediaries responsible for monitoring Enron were not pathological outliers on the U.S. corporate governance. They were typical.

In other words, in my view, the story of the rise and fall of Enron suggests that the billions spent on legally mandated corporate governance systems and regulatory infrastructure in the U.S. may be largely a dead weight social loss. Investors pay dearly for such systems and infrastructure but do not receive the safeguards and other protections they are told they might receive. Rather, the meaningful protection for investors is largely religious, sociological, and cultural. There are strong religious, sociological, and cultural norms against lying, cheating, and stealing. People care a lot about how they are perceived. Corporate managers and directors, in particular, have made significant
investments in reputation. These factors cause officers and directors to be honest. Accordingly, the generally high levels of honesty in the way that business is conducted in the U.S. is attributable to the fact that most (though clearly not all) top managers and directors have developed a strong taste for honesty and forthrightness.

The critical question is how much more honesty do corporate governance regulations generate beyond that which is attributable to religiously, culturally, and sociologically induced incentive structures. At the margin, the U.S. system of mandatory corporate governance regulations appears to contribute little, or nothing. It seems clear that, in its current form, the costs of this system are not worth the benefits. Take for example, the (mandatory) provision in U.S. law that requires public companies to produce financial statements that have been audited by independent accounting firms.\(^7\) This requirement is based on the premise that independent accounting firms are unlikely to permit their clients to make material misrepresentations of their financial condition. Independent accounting firms are thought to be unlikely to permit (or acquiesce in) fraud because it is not in their economic interests to do so. The gains from participating with a client in any such fraud are, in theory, greatly outweighed by the losses to the accounting firm’s reputation that would follow from being implicated in a fraudulent accounting scheme.

Unfortunately a combination of factors, including: (a) the consolidation of the accounting industry into a highly concentrated cartel-like structure; (b) the elimination of accounting firm partners’ incentives to monitor their firms due to the transformation of accounting firms from general partnerships to limited liability partnerships; and (c) the organization of accounting firms into audit teams comprised of auditors who serve only one corporate client, led to the demise of the public accounting firm as a gatekeeper.\(^8\)

In a variety of other ways that have recently played themselves out on the public stage, many other elements of the U.S. system of corporate governance became corrupted, at least temporarily. Anthropology in the form of cultural studies, and not economics in the form of systems of incentives, protected the U.S. investing public from plunder at the hands of the managers and directors to whom it entrusted its fortunes during that time-frame. The scariest lesson of Enron, then, is that if managers ever come actually to believe the lie that “Greed is Good,” the U.S. will be in real trouble.


\(^8\) See id. at 1176-78.
Fraud is not easy to detect. Thus, before concluding that the U.S. system of corporate governance has truly failed, it is worth asking whether it would have been possible to glean the true financial condition of Enron from the admittedly flawed public disclosures that the company made prior to its collapse.

Today, lots of people point to defects in Enron's financial disclosures that, they claim, they could have detected had they bothered to study the company prior to its bankruptcy filing. Typical of the "know-it-all" approach are statements by Ramu Thiagarajan, who is engaged in "Stock-Selection Research" at Mellon Capital Management. Thiagarajan told the New York Times that he spotted trouble at Enron "10 months before it blew up." He also stated that "[t]here were quite a few red flags on the financials: gross margins were declining, interest coverage was getting worse, [and] return on sales was deteriorating." Hindsight is 20-20, and these statements are rendered far less impressive by the fact that they were made in October, 2002, a full year after Enron's bankruptcy filing and only after the information had been firmly incorporated into Enron's share price.

On the other hand, there is strong contemporaneous evidence that even amateur observers, as long as they were independent, were able to detect the problems in Enron much earlier than the collapse of the company. Here I adduce evidence from three sources: (a) Enron's own tax accounting, which, presented the company's financial condition far more accurately than its corrupted GAAP/SEC reporting; (b) investigations by business school students at Cornell's Johnson Graduate School of Business in 1998 that indicated a high probability that Enron was manipulating its earnings long before any other analysts or investigators uncovered wrong-doing at Enron; and (c) reports by the public press, particularly the Texas edition of the Wall Street Journal.

10. Id.
C. Enron’s Tax Accounting

During the years that Enron was reporting massive earnings and return on equity, it was not paying any taxes. The reason that the company wasn’t paying taxes was that it did not have any income. As Victor Fleischer has observed in TAX NOTES, the key to the discrepancy between Enron’s earnings from a tax perspective and Enron’s earnings from an SEC/GAAP perspective lies in the vaunted, off-balance sheet Special Purpose Entities (SPEs) which were limited partnership arrangements that Enron used to book fictitious earnings and move debt off of its balance sheet.

Under these arrangements, Enron would create an SPE and “buy” 97 percent of the equity in the entity in exchange for giving the entity some illiquid asset of highly uncertain value that Enron wanted to clear off its balance sheet. For SEC/GAAP purposes, this arrangement would permit Enron to move the asset off its balance sheet and even show a profit on its sale, so long as 3 percent of the equity in the SPE was owned by independent, outside investors. Even better, the SPEs generally would borrow money from outside lenders and channel the loan proceeds back to Enron, thereby improving Enron’s cash position.

The tax system specifies a much more sound basis for dealing with these transactions than GAAP. As Professor Fleischer observes, tax accounting did not permit Enron to recognize a gain on these transactions:

For tax purposes it’s basically a non-event. As well it should be. From an economic perspective, Enron’s position has changed very little regarding the asset—it still carries virtually all of the opportunity for gain and risk of loss. So the tax system concludes that we should wait and see what the asset is really worth before requiring the payment of tax. If and when the partners exit the investment by selling to a third party, that’s when the tax system recognizes a true event, the income flows through to the partners and the partners pay the tax.

What is truly perplexing here is the fact that no financial analyst, hedge fund operator, or other securities market intermediary thought that the

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14. Id. at 1046 (emphasis in original). Technically, I.R.C. Section 721 makes Enron’s contribution of property to the partnership/SPE in exchange for a partnership interest a non-recognition event.
discrepancy between Enron's tax reporting and its SEC/GAAP reporting raised any red flags. Apparently, to the extent that people observed the discrepancy, they simply presumed that the SEC/GAAP reporting provided a more accurate depiction of Enron's financial condition than the company's reporting to the IRS. But the SEC/GAAP accounting appears to be flawed to its core because Enron is able to realize a gain for the sale of an asset, despite the fact that the company remained financially "on the hook" for the asset.15

D. Business School Students

On May 5, 1998, students at Cornell's Johnson Graduate School of Management, using publicly available data, published an investment report on Enron. This report indicated significant problems in Enron far earlier than professional investors and other financial intermediaries did.16 The report recommended that investors sell Enron stock, based, among other things, on the recognition that the net income available to common stock had fallen by 85% during the prior year. Even more tantalizing, by employing the multivariable Beneish Model17 for detecting earnings manipulation using publicly reported accounting data, the MBA students found that Enron, "may be manipulating earnings," based primarily on suspicious growth in sales figures.18 Subsequent to Enron's collapse, accountants, utilizing the Beneish

15. See id. at 1046.
18. The Beneish Model uses accounting measures to generate a statistical model that identifies earnings manipulation in financial reporting. The Model finds indications of earnings manipulation whenever management violates GAAP in order to artificially increase the firm's financial performance as compared to the firm's performance under GAAP. The Model uses financial statement data to capture both the effects of manipulations and the preconditions for manipulation that may prompt firms to engage in manipulation.

The Beneish Model contains nine variables that are each presumed positively to affect the likelihood of manipulations: (1) Days Sales in Receivables (DSRI); (2) Days Sales in Inventory (DSINV) (a large increase in days' sales in receivables or a large increase in inventory raises the likelihood that receivables and inventory, and thus earnings and sales, are inflated); (3) Asset Quality Inventory (AQI) (an increase in asset realization risk analysis indicates an increased propensity to capitalize and thus defer costs); (4) Sales Growth Index (SGI) (computed by dividing the current period's sales by the last period's, SGI is considered to be the first indication in a slowdown of the firm's performance); (5) Gross Margin Index (GMI) (determines whether gross margins have deteriorated, a negative signal about the firm's prospects which can lead the firm to manipulate earnings); (6) Sales General and Administrative Expenses Index (SGAI) (changes in SGA expenses relative to sales); (7) Depreciation Index (DEPI) (changes in the rate of depreciation of assets); and (8) Leverage Index (LVGI) (change in the company's leverage (total debt to total assets); (9) Working
Model in retrospect, found earnings quality problems at Enron for every year since 1995 and the significant probability of earnings manipulation as early as 1996 due to problems in revenues, margins, asset quality, and sales. The question of course, is: why were none of the bona-fide and highly incentivized professionals utilizing the Beneish Model, or other methodologies, to uncover the financial problems at Enron?

E. Enron, the Financial Press and Market Efficiency

One of the most stunning aspects of the Enron collapse is the fact that Enron’s problems were uncovered by the financial press before they were uncovered by financial intermediaries. This is surprising because the intermediaries’ economic returns for uncovering financial fraud (which come in the form of arbitrage and other trading gains) would appear to be dramatically higher than the economic returns to the financial press (who are paid fixed salaries and generally prohibited from trading in advance of their stories). In particular, the now-defunct Texas edition of the WALL STREET JOURNAL beat Enron’s board of directors and audit committee, the credit rating agencies following Enron, Arthur Andersen (Enron’s accounting firm), stock market analysts, and most interestingly, short-sellers and hedge fund operators in the race to identify the problems within Enron.

Jim Chanos, the well-known analyst who began carefully to scrutinize Enron’s financial statements in September 2000, started trading at the height of Enron’s success. Chanos decided that Enron, which currently was trading at 60 times earnings, was vastly overvalued. Chanos believed that the Company should trade more like a hedge fund than an energy company because it relied on trading for more than 80% of its earnings. Chanos reasoned that there were lots of other, better performing hedge funds, whose shares were priced attractively relative to Enron’s. Moreover, using publicly available documents, Chanos calculated that Enron was earning only 7 percent on capital, as compared with an average cost of capital of 10 percent.


22. Id.
Interestingly, it appears that Chanos got the inspiration to look more closely into Enron by reading a September 2000 article in the (now defunct) Texas edition of the WALL STREET JOURNAL.\(^{23}\) This article raised questions about the quality of the earnings at Enron and a number of other companies with large energy trading departments. The article pointed out that investors may not realize that Enron's large reported profits were in the form of large, unrealized, noncash gains. Changes in market conditions could wipe out these profits. For example, the article pointed out that Enron had "booked $747 million in unrealized gains from risk-management activities during the second quarter [of 2000], more than the company's total $609 million in earnings before taxes and interest."\(^{24}\) In other words, if these unrealized gains had not been reported, Enron would have suffered a loss for the quarter instead of the 26% increase in earnings it actually reported.\(^{25}\)

Enron's financials did not reveal that two-thirds of the company's debt was not disclosed on the company's balance sheet. However, Enron's Annual Reports (on Form 10-K) and Quarterly Reports (on Form 10-Q) revealed that an unnamed "senior officer" of Enron was in charge of limited partnerships that had engaged in a large number of transactions with the Company, all of which had the effect of removing assets from Enron's books and providing Enron with revenue.\(^{26}\) For this reason, in February, 2001, when Enron was trading at around $80 per share, Chanos chose Enron as one of the two stocks he identified at his firm's annual "Bears in Hibernation" meeting in Miami.\(^{27}\) Chanos's original inspiration for his profitable trading strategy, however, was the WALL STREET JOURNAL.

II. PROBLEMS IN THE U.S. SYSTEM OF FINANCIAL REPORTING

Clearly, the problem at Enron was that the firms, individuals, and institutions that were supposed to have been monitoring the company were not performing in accordance with the market's or society's hopes and expectations. There are two structural constraints that financial engineers and policy-makers face when they design a system of corporate governance: the problem of "capture" and the problem of access to high-quality information.

The "capture" problem arises when a monitor becomes too close to the managers of the firm it is supposed to be monitoring. This problem stems...
from the fact that, for monitors to be effective, they must be objective.\textsuperscript{28} Unfortunately, monitors that become too close to the firm they are supposed to monitor risk losing their objectivity.

The solution to the problem of "capture" that plagues "proximate" monitors is to have monitors maintain their distance from the firms they are monitoring and hence retain their objectivity. But this characteristic of objectivity presents its own, unique structural problems for those who wish to design an effective system of corporate governance. Put simply, it is not enough for monitors merely to be objective. To be successful, monitors must have high quality information about the companies they are covering in order to monitor them effectively. But paradoxically, with distance comes not only the positive characteristic of objectivity but also the negative characteristic of low-quality information.

Thus, from an engineering and design perspective, there is a basic trade-off between proximity and objectivity in corporate governance. Proximate monitors are unlikely to be objective because of their susceptibility to capture. Objective monitors are unlikely to have sufficiently timely, reliable information about what is going on within the companies they are monitoring because their distance from the decision-making process necessarily denies them access to real-time information about corporate decisions as such decisions are being made.

In designing an effective system of corporate governance, it is critical to be aware of the trade-off between proximity and objectivity. The problem, of course, is that as monitors become more proximate, they tend to lose their objectivity, and as monitors become more objective, they tend to lose the high-quality, real-time information that comes only to those in close proximity to the issuer whose results they are trying to analyze.

From this perspective, the U.S. system and the European systems of corporate governance have always appeared to be a study in contrasts. The European system is characterized by relatively high proportions of insiders on boards, as well as by extensive patterns of cross-shareholdings among large institutional investors. In this system, monitors appear to be quite close (proximate) to management, but often lack objectivity. By contrast, the U.S. system is characterized by relatively high proportions of outside directors, as well as by systems of independent monitors, such as hedge funds and the market for corporate control. These outside monitors do not have access to high quality inside information, nor do they participate in the internal

decision-making processes within firms to the extent that European investor-owners do. But these U.S. outsiders were at least thought to be unbiased and objective.

The problem, which has become excruciatingly obvious in retrospect, is that over time, the supposedly independent outside monitors that characterized the U.S. system of corporate governance have become captured, conflicted, or co-opted by the firms for which they were supposed to act as gatekeepers. Those who were not financially conflicted, including journalists and business school students, performed well. However, as discussed above, lawyers and accountants, who were supposed to be objective and independent, became co-opted. Analysts apparently traded strong ratings for issuers (along with their own reputations) in exchange for the prospect of earning generous bonuses for helping their own firms garner business from issuers, who, in turn, supplied such business in exchange for optimistic ratings from analysts.

The problem with credit rating agencies is that these agencies become "captured" by issuers, not because they are beholden to the issuers for business, but because issuers make it impossible for rating agencies to downgrade them. This is because for many, if not most, publicly traded companies, being downgraded by one of the credit rating agencies makes bankruptcy a foregone conclusion by signaling that the company can no longer raise the debt necessary to support its operations. In other words, when a company such as Enron receives a downgrade from a credit rating agency, it can no longer receive the credit it needs to finance its operations. Suppliers and trading counter-parties demand payment in advance, and the firm collapses because its creditors cut off the firm's liquidity. In many other corporations, including Enron, the company's public debt goes into technical default whenever the debt is downgraded below a certain rating level, usually investment-grade. In this situation, a downgrade can cause bankruptcy directly, by literally causing the company to be in default on its debt obligations and triggering repayment of hundreds of millions of dollars of debt.

Because a downgrade by a rating agency is like a corporate nuclear bomb, the credit rating agencies are extremely reluctant to use their power. This, in turn, undermines the efficacy of credit ratings as a corporate governance device. In the case of Enron, the value of the Corporation's $250 million in rated Senior Unsecured debt had declined from $0.90 cents on the dollar to $0.35 cents on the dollar in the month preceding the downgrade. In other words, the market had rejected the notion that Enron's debt was investment grade before the credit rating agencies got around to downgrading the company. The credit ratings agencies were unwilling to downgrade Enron's
debt below investment-grade status because such a downgrade would have triggered Enron’s debt covenants, thereby making the principal and interest on such debt due immediately. In other words credit rating agencies had become victims of their own success.

In the Enron post-mortem, no corporate governance institution is of greater interest to the mandatory disclosure debate than the firm’s board of directors. On paper, the Enron board appeared to be both competent and independent. The audit committee was led by Robert Jaedicke, a giant in the field of academic accounting and a model of independence. At the time of his board services, Jaedicke resided in California and was Professor of Accounting Emeritus and former Dean of the Graduate School of Business at Stanford University. Other board members had equally impressive credentials. Among them were a former Chairman of the Executive Committee of Gulf & Western Industries, a former Chairman of the U.S. Commodity Futures Trading Commission, and the former United Kingdom Secretary of State for Energy.29

Despite that wealth of experience, these directors did little or nothing for Enron’s shareholders.30 From the “proximity-objectivity” perspective presented here, the Enron collapse raises the issue of whether it is even possible for public companies to organize boards of directors that, unlike the Enron board, are impervious to capture by management. The problem is that boards, by definition, exist in a space that is proximate to management. In the ordinary course of events, prospective board members are asked by a representative of the company (a manager, a head-hunter, or a sitting board member) to serve on the company’s board. The very act of accepting an offer to stand for a seat on a corporate board is often, in a very real sense, an endorsement of the quality and integrity of incumbent management. Once on a board, directors inevitably become closely aligned with management. Directors decide whether to retain managers. And, of course the decision to retain a particular management team constitutes an endorsement of management’s practices. When managers bring issues to the board for their approval, such approval constitutes further co-option of the board. In other words, over time, even the most independent director becomes aligned with managers. Management failure inevitably is a bad reflection on the board that has endorsed the continued employment of the management team. This is especially true when a board has been in place during a management

30. Id.
transition and is thus directly responsible for not only retaining management but also for identifying, selecting, and recruiting the managers. On the basis of considerable support from the field of social psychology, I have observed previously:

[O]nce boards of directors have been in place for a while, they are likely to embrace management’s perspective. More specifically, after a decision is made and defended by a board, it will affect future decisions such that those decisions will comport with earlier actions. For example, studies of the decision-making process that contributed to the escalation of the Vietnam War showed that leaders paid more attention to new information that was compatible with the earlier decisions. They tended to ignore information that contradicted those earlier assumptions. As one researcher observed, “there was a tendency, when actions were out of line with ideas for decision-makers to align their actions.” Once ideas and beliefs become ingrained in the mind of a board of directors, the possibility of altering those beliefs decreases substantially. As Tom Gilovich has argued, “beliefs are like possessions, and when someone challenges our beliefs, it is as if someone criticized our possessions.”

The nature of proximity makes the probability of director capture extremely high. The question whether it is reasonable, in light of this analysis and recent experience, to rely on even the most well-meaning boards of directors as a source of independence from management is subject to considerable doubt.

A. The Mechanisms of Market Efficiency Revisited

Proximate monitors cannot always be trusted because of their susceptibility to capture. Certain ostensibly objective monitors (like outside accountants and outside counsel to the company) are highly susceptible to capture because of their sustained interaction with the management of the firms they are supposed to monitor. But one group of objective monitors, market trading professionals, do not have interactions with the firms they are supposed to monitor. This group is thought to be crucial to making securities markets efficient. A full accounting of Enron’s collapse must consider why this group failed so miserably to detect the problems at Enron in a timely fashion.

Market professionals are thought to be the critical "mechanism" of market efficiency. These market professionals, who constitute the "dominant minority of informed traders," is comprised of:

the community of market professionals, such as arbitrageurs, researchers, brokers and portfolio managers, who devote their careers to acquiring information and honing evaluative skills. The trading volume in most securities that these professionals control, directly or indirectly, seems sufficient to assure the market's rapid assimilation into price of most routine information.\(^\text{32}\)

The list in the above block quotation should be expanded to include hedge funds,\(^\text{33}\) which have become a major market force in recent years.\(^\text{34}\) While some of these market professionals, particularly analysts, were subject to acute conflicts of interest that caused them to be "captured" by issuers such as Enron, there were hundreds, if not thousands of market professionals, including professional short-sellers\(^\text{35}\) and managers of hedge funds, who were not subject to capture by Enron because they had no connection with Enron whatsoever.

A critical question is, therefore: where were these independent market professionals during the Enron collapse? The question is intriguing because these market professionals left billions of dollars in potential trading profits "on the table" by failing to recognize the acute problems at Enron and transform this realization into a profitable trading strategy. Why did market

\(^{32}\) Gilson & Kraakmen, supra note 1, at 571.

\(^{33}\) A hedge fund is a private investment fund (usually held by affluent individuals and institutions) that utilizes aggressive investment strategies, including some that are off-limits to publicly traded investment funds, such as mutual funds. Hedge funds engage in practices such as selling short, leverage, program trading, swaps, arbitrage, and derivatives. Hedge funds are limited by law to fewer than 100 investors. Hedge fund participants usually invest a minimum of $1 million. "The general partner usually receives performance-based compensation." Hedge Funds Defined, at http://www.sophiaorange.com/hedge_funds_defined.htm (last visited Mar. 20, 2003).

\(^{34}\) There are an estimated 5,000 hedge funds active in the U.S., with between $400 and $500 billion under management. Hedge funds are the fastest growing sector of the financial services industry, with growth of approximately 20% annually. Michael Plunkett, SVP-Hedge Funds, June 13, 2002, at http://www.instinet.com/ir/management_presentations/investor_day/plunkett.061202.pdf (last visited Mar. 20, 2003).

\(^{35}\) Short selling is the sale of a security that the seller does not own (and has not contracted to buy) at the time of the sale. Traders who "sell short" must borrow the security that they have sold from their broker in order to make delivery to the purchaser. Short sellers must then pay their broker interest on the securities borrowed. Short sellers can profit when the price of the security they have sold and borrowed drops after the sale, allowing the seller to purchase the security necessary to repay the lender at a lesser cost than the value of the shares at the time they were borrowed (a process known as "covering"). The profit equals the difference between the sales price and the sum of: (a) the cost of the security purchased; (b) the interest payments on the stock borrowed by the short seller; (c) taxes on the gain received in the short selling; and (d) transaction costs.
professionals not make profits by short-selling Enron when its shares were overvalued?

One fascinating characteristic of securities markets (which casts considerable doubt on the validity of the theory that securities markets are universally efficient) is that in the real world, "[r]emarkably few shares are in fact sold short."36 Using data from the New York Stock Exchange, where Enron's stock was traded prior to its collapse, Professor Robert Shiller reports that short sellers accounted for only between .14 percent and 1.91 percent of all shares from 1977-2000.37 And Dechow, Hutton, Meulbroek, and Sloan report that less than two percent of all stocks had short interest greater than five percent of shares outstanding during the period 1976-1993.38 As Professor Shiller has observed:

[G]iven the obviously large difference of opinion about and difference of public attention to different stocks, it is hard to see how such a small amount of short selling could offset the effect on stock price of the extra demand of investors who develop an irrational fixation on certain stocks.39

Restrictions on short-selling "could be a fatal flaw in the basic efficient markets theory."40 One major difference between buying securities and selling securities short is that investors enjoy a limit on the extent of their liability when they buy, but face (theoretically) infinite exposure when they sell short, because there is no (theoretical) limit on the price to which a security might rise, and thus no limitation (again, in theory) on the price at which a short seller might be forced to cover. Simple risk aversion will, therefore, keep investors away from short selling.

Because of the perceived risk of short-selling problems, regulators "have established strict rules to monitor short-selling activities due to this special risk return profile of short-selling."41 Further, many institutional investors and corporate insiders are prevented by contract from short-selling.42

Utilizing Kahneman and Tversky’s prospect theory,43 and evidence of the

37. Id. at 101.
40. Id. at 98.
41. Zhang, supra note 11, at 7.
42. Id.
43. Daniel Kahneman & Amos Tversky, Prospect Theory: An Analysis of Decision Under Risk,
acute “pain of regret,” Professor Shiller has posited that because individuals become more upset by losses than they become pleased by gains, short-sellers tend to lose disproportionate amounts of money short selling because they are reluctant to cover their losses.

It also seems clear that short-selling is subtly discouraged. There is a social stigma attached to it. The general public—and policy-makers have exhibited a consistent hostility to short sellers (on whom the stock market crash of 1929 was blamed). And short-selling is regulated in the form of the “up-tick” rule, which makes it illegal to sell-short when the stock is falling—specifically, when the last trade price is lower than the immediately preceding price. This rule has particular force in cases like Enron, when the stock starts to fall dramatically. Regulators probably scrutinize short-selling to a greater extent than they scrutinize other trading activity.

Needless to say, the tax code does not help short sellers. Ironically, the interest that short sellers must pay on the stock they borrow is not deductible when the short seller loses money because the Internal Revenue Code requires that interest payments, to be deductible, must be offset against a corresponding gain. When the underlying shares rise in price, and the short seller loses money, there is no gain against which the short seller can offset his losses. In addition, the tax rules are written so as to make most profits on short selling short-term capital gains, rather than more advantageous long-term capital gains, regardless of the length of time that a trader keeps open her short position. This tax consequence occurs because the timing for capital gains purposes is calculated by measuring the (usually short) time period between the date on which the short seller buys shares to cover her “short” and the date on which she then delivers the purchased shares to the firm that loaned her the shares. It would make more economic sense and encourage short-selling if the period were instead calculated by measuring the (generally far longer) time period between the date on which the short seller initially sells the shares that she borrowed from her broker and the date on which the short seller buys the shares to repay them to her broker.

46. I.R.C. § 163(d) (West 2003).
47. I.R.C. § 1233 (West 2003). Generally, a gain or loss is not realized until the property is delivered to close the short sale. The holding period is determined by the amount of time the property
To the extent that short-selling is relatively rare and costly, bubbles and financial fraud will be more likely. The largest ray of hope that the future will be brighter is contained in the Commodity Futures Modernization Act of 2000, which made single-stock futures contracts legal for the first time in twenty years.

Single stock futures contracts are futures contracts on an eligible underlying equity interest. The contract is an agreement to sell shares in a particular issue of common stock at a designated date in the future, the maturity date.

Single stock futures contracts eliminate some, but not all, of the problems associated with short selling. In particular, traders do not need to pay interest on borrowed stock when they trade in futures, nor do the need to worry about where to borrow the stock they are shorting. This means that traders can keep positions open far longer. The ability to sustain a pessimistic trading position for a prolonged time frame is important when there are long periods of time that a security is mispriced. This sustainability is probably the most important reason why single stock futures contracts may be more effective in dealing with “irrational exuberance” than short-selling.

Finally, while single stock futures contracts will be subject to short term capital gains taxes regardless of how long they are held, they are not subject to the up-tick rule. Thus, sophisticated intermediaries likely would have traded Enron futures contracts if such futures contracts had been available prior to the collapse of the company.

As Frank Easterbrook has pointed out, sophisticated “intermediaries sold approximately $10 billion in Enron credit-risk derivatives” which were written to pay off only when the issuer defaulted. This reflects an astonishing amount of pessimism about Enron on the part of sophisticated...
investors. It seems reasonable to surmise that if single stock futures contracts had been legal at the time that the Enron bubble was inflating, sales of such futures contracts might have moved market prices to their efficient levels.

The market response to Enron was extremely disappointing. Professor Shiller's explanations that short-selling is relatively costly, and even somewhat terrifying psychologically, do not account for the failure of arbitrageurs, hedge funds, and other professional investors to profit from trading on the Enron "bubble." The assumption that sophisticated traders can decode opaque, complicated, or obscure financial reporting is very much in doubt. This, in turn, creates a significant hole in the theory of market efficiency.

Such holes, however, are likely to be temporary, due to the massive economic gains available to those able to step in and fill them. In other words, the obscure nature of Enron's financial reporting does not explain why there was such a delay in uncovering the problems at Enron. After all, the more obscure and indecipherable the financial reporting, the greater the potential arbitrage gains to those who are first to solve a financial puzzle.

III. THE MANDATORY-ENABLING DEBATE: SOME WORDS ABOUT SARBANES-OXLEY

The preceding analysis can provide some insight into the debate between those who believe in mandatory regimes for disclosure of corporate information and those who believe that the operative legal regime should be enabling in order to facilitate regulatory competition and private-sector innovation. Unfortunately, recent experience does not provide much basis to support either a mandatory or an enabling corporate law regime. On the supply side, Enron rose and fell in the context of one of the world's strictest regimes of mandatory disclosure and reporting. The system failed miserably in Enron, and that failure appears to be pervasive rather than isolated.

On the demand side, the largely unregulated participants in the capital markets (market professionals such as hedge funds and other financial intermediaries) would have profited in myriad ways from providing early warning of Enron's collapse, but they also failed miserably.

Thus, the history of Enron should not provide comfort either to those who champion strict regimes of mandatory disclosure or to those who champion a free-market system.

Rather, I think that the critical lesson to be learned from the collapse of Enron is this: rather than focusing on the question whether a particular regulation is mandatory or enabling, government regulators and policy analysts should focus their efforts on facilitating those market processes that
promote true objectivity among outside monitors and towards generating better and more accurate information for internal monitors.

Many of the provisions of Sarbanes-Oxley reflect these concerns; however, the statute takes a largely supply-side perspective in that it focuses on regulating the production of information. The statute does very little to improve the environment on the demand-side for information, despite the fact that Enron and its “progeny” represent a much more significant failure on the demand-side of the market for information than on the supply-side of this market. On the other hand, it seems clear that improvements in the competitiveness of the capital markets, particularly by doing more to encourage short-selling, hold far greater promise for reducing managers’ ability to defraud investors than tightening regulations on the supply side.

In my view, the best way to improve the demand-side of the market would be to give tax and other financial incentives to short-sellers and those who trade single stock futures. Such legislation would have positive effects on the capital market far beyond the modest financial incentives that such provisions would provide. This is because the provisions would reflect a major “sea change” in attitudes about the social benefits of short-selling and would thereby reduce the social stigma associated with such activity.

The Sarbanes-Oxley Act regulates the conduct of corporate officers and directors, as well as lawyers and accountants who perform services for public companies. The Act also significantly expands the scope of criminal and civil liability for corporate officers and directors. Significantly, however, the Act does not expand the scope, content, or format of corporate disclosure already mandated by U.S. securities laws. Instead, the provisions of Sarbanes-Oxley are designed to remedy perceived deficiencies in the market processes by which public corporations interact with the investing public. This point is seen most clearly in the manner in which Sarbanes-Oxley addresses the (contractual) relationship between reporting companies and their audit firms.

The Act, in essence, requires that accounting firms contract for their services not with management, but with the audit committees of the boards of

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53. While much of Sarbanes-Oxley is consistent with the “contract-enhancing” framework discussed in this Article, the Act does contain some mandatory provisions, such as Public Law 107-204 § 401(a), amending Section 13 of the Securities Exchange Act of 1934 (15 U.S.C. § 78m), which requires the SEC to issue rules that require public companies to disclose all material off-balance sheet transactions, arrangements, obligations, and other relationships between the company and unconsolidated entities or other persons which may have a material effect on the company’s financial condition. While this provision is mandatory, it is clearly designed to remedy failures in the contracting process between auditors and their public company clients, as well as failures in the system of mandatory disclosure. It is impossible to imagine that a company contracting in good faith for the provision of auditing services would not contract for the disclosure of off-balance sheet transactions that may have a material effect on the company’s financial condition.
directors of the companies they propose to audit. This change in the nature of the contracting process between auditors and audit clients is effectuated by Section 301 of Sarbanes-Oxley, which stipulates that the audit committees of public companies "shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer (including resolution of disagreements between management and the auditor regarding financial reporting) . . . ."54

The power of the audit committees of U.S. public companies is further bolstered by the provisions in Sarbanes-Oxley that require any accounting firm auditing a public company to timely report to the company's audit committee:

(1) all critical accounting policies and practices to be used; (2) all alternative treatments of financial information within [GAAP] that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the . . . accounting firm; and (3) other material written communications between the registered public accounting firm and the management of the issuer . . . . 55

Sarbanes-Oxley also requires that audit committees set up procedures for handling complaints from "whistleblowers" within the company56 and for engaging independent legal counsel and other advisors to carry out its duties.57

Perhaps the most famous provisions of Sarbanes-Oxley are the new rules relating to "Corporate Responsibility for Financial Reports."58 These rules require the principal executive officer (CEO), and the principal financial

(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and
(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

officer (CFO), of a public company to certify that he or she has reviewed each quarterly or annual report filed with the SEC and attest that, to his or her knowledge, the report does not contain any material false statements or omissions and "fairly presents in all material respects the financial condition and results of operations of the [company] as of, and for, the periods presented in the report." CEOs and CFOs must also certify that they "have evaluated the effectiveness of the [company's] internal controls" and "presented . . . their conclusions about the effectiveness of [such] controls."59

The Act imposes criminal sanctions in the form of fines up to $1 million and/or up to ten years imprisonment for knowingly making false certifications.60

Other provisions of Sarbanes-Oxley, which are designed to restore the integrity of the public company audit process, make it unlawful for any person "to fraudulently influence, coerce, manipulate, or mislead" any accountant performing an audit of a company's financial statements "for the purpose of rendering the financial statements materially misleading."61 Audit firms also are forbidden from performing audit services for a public company if the company's chief executive officer, controller, chief financial officer, chief accounting officer, or similarly situated corporate official was employed by the accounting firm and participated in an audit of the company "during the one-year period preceding the date of the initiation of the audit."62

From the "mandatory-enabling" perspective of this Article, perhaps the most interesting provision of Sarbanes-Oxley concerns auditor rotation. The statute forbids accounting firms from providing audit services to public companies if the "lead" or "coordinating audit partner" or "the audit partner responsible for reviewing the audit, has performed audit services for the [company] in each of the [five] 5 previous fiscal years."63 Like the provisions of Sarbanes-Oxley that forbid auditors from providing certain consulting and other ancillary services to clients,64 the obvious intent of this statutory

provision is to minimize the "capture" of audit firms by the issuing companies they are supposed to be auditing. Whether this provision will make things better or worse, however, remains to be seen.\textsuperscript{65} It is possible, for example, that auditors will now feel stronger pressures to capitulate to clients' wishes because the auditor-rotation rules will lead to new intra-firm rivalries among accountants, as new accountants compete for higher client satisfaction survey results than their predecessors.

The contractual relationship between lawyers and public companies was also fundamentally altered by Sarbanes-Oxley. The Act requires the SEC to articulate minimum standards of conduct for lawyers who practice or appear before the SEC in the representation of public company issuers.\textsuperscript{66} The statute requires the SEC to develop rules that obligate lawyers "to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent [of the company], to the chief legal counsel or the chief executive officer of the company" (or similarly situated officer).\textsuperscript{67} If the CEO or Chief legal counsel does not properly respond, the lawyer will be required to "report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of [independent] directors . . . , or to the board of directors" of the company.\textsuperscript{68}

The Sarbanes-Oxley provisions just discussed were designed to correct severe distortions that appear to have developed in the contracting process between corporations and their outside advisors, who ostensibly served as "gatekeepers" for these companies. In particular, these provisions regulate the most basic aspect of the contracting process by clarifying "who is contracting with whom" when a company retains an outside lawyer or accountant to represent it in interactions with the SEC and in the public disclosure process. Prior to Sarbanes-Oxley, accountants and lawyers, for all practical purposes, frequently contracted with management. While the corporation's shareholders paid the bills, it was the managers who gave the outside advisors their marching orders and decided whether these outside advisors would be retained or awarded additional business.

Gradually these peculiarities in the contracting process distorted the relationships between corporate clients and their lawyers and accountants to


\textsuperscript{65. See Macey & Sale, supra note 7, at 1185-86 (arguing that auditors will still be pressured by clients "in order to protect their own status within the firm.").}


the degree that lawyers and accountants were often no longer acting as gatekeepers, but as aiders and abettors, and perhaps even as primary actors in the misdeeds of their clients.\textsuperscript{69} Sarbanes-Oxley attempts to cure this deficiency in the contracting process by placing new professional obligations on lawyers and by designating the public company's audit committee, rather than its incumbent management, as the primary counter-party in the contractual relationship between audit companies and their clients.

Thus, Sarbanes-Oxley is best viewed as a mechanism for addressing problems in the contracting process that had developed over time between public companies and the professional gatekeepers who were supposed to safeguard the interests of the investing public and other stakeholders in these firms. In this context, it is important to consider whether the legislation was needed, or whether it was likely (or even possible) for firms to have addressed these problems on their own. Certainly, even without Sarbanes-Oxley, firms could have delegated to audit committees rather than management, the responsibility for selecting, evaluating and paying for audit firms. And Sarbanes-Oxley was not needed to empower lawyers to report fraud up the corporate chain of command to responsible independent directors. Nor was Sarbanes-Oxley required to protect whistleblowers, nor even to cause companies to disclose off-balance sheet items that could have a material effect on their financial condition. Companies, at least in theory, could have done all of this themselves.

Firms could have done these things, but they did not. Professional advisors are rational economic actors, and like other rational economic actors, they respond to incentives. When incumbent management was the client, and management happened to be corrupt, it seems that the gatekeepers also became corrupted, or at least compliant. Thus, we came to a bizarre crossroads, where companies with honest management were served by honest gatekeepers, while companies with dishonest management were served by professionals who lacked sufficient incentives to fulfill their roles as gatekeepers.

Public companies were not going to solve the contracting problem. After all, monitors and gatekeepers are needed in public companies precisely because shareholders in such companies face collective action problems (such as free-riding and rational ignorance) that make it difficult for shareholders effectively to monitor management, much less to contemplate

\textsuperscript{69} For an extended discussion of the role of the gatekeepers in the collapse of Enron, see In re Enron Corporation Securities, Derivative & ERISA Litigation, 235 F. Supp.2d 549 (S.D. Tex. 2002).
the intricacies of the contracting process that goes on between the corporation and its auditors and lawyers.

CONCLUSION

Even the most ardent proponents of free-market solutions recognize that some centralized, societal force is necessary to facilitate the contracting process. At a minimum, for example, the state, (or something like it) is required to enforce the terms of agreements between parties. And law-and-economics scholars also have made it clear that legal rules are useful, particularly in the corporate context, as a means to reduce transaction costs. The provisions of Sarbanes-Oxley discussed in this Article may or may not be effective in improving confidence in public companies and their financial reports, but these provisions clearly restore a semblance of sanity to the contracting process between companies and their outside auditors.

This Article has developed the argument that the problems in U.S. corporate governance reflect problems with mandatory rules, particularly mandatory reporting rules, as well as problems with enabling, contractual rules, particularly with the market-based system for receiving and analyzing the information that companies disclose.

Sarbanes-Oxley was a measured and appropriate response to the abject failures in U.S. corporate governance typified by Enron. These failures were not merely failures in the system of mandatory reporting, though it is clear that mandatory rules did not serve us well. Rather, the corporate governance crisis in America, with Enron as its poster child, represents a failure of both our system of mandatory rules, and of the contracting processes, which, together, constitute the infrastructure of the U.S. corporate governance system.