Testimony of

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Introduction

A consensus appears to exist that greater use should be made of the criminal law in combating securities fraud and accounting irregularities. Not only has the President and the Chairman of the SEC announced their views that the perpetrators of fraud must be brought to justice, but Senator Leahy and the Senate Judiciary Committee have drafted a bill that in my judgment would usefully simplify the prosecution of securities fraud and obstruction of justice cases.1 In this light, I will not replow ground that has already been covered and will focus today only on issues of implementation: How do we appropriately adjust the criminal law to deter "cooking the books"? No time will be spent defending the propositions that securities fraud and accounting irregularities are morally wrong or constitute major societal problems, because I sense that on this topic I would be preaching to the choir in appearing before you today.

My focus will be on the sentencing stage because the Senate Judiciary Committee has already addressed the substantive criminal law in adopting the Leahy Bill (S. 2673, Title VII). As a brief word of background, I should indicate that my areas of legal specialization include (1) securities regulation and corporate governance, and (2) white collar crime and sentencing. Increasingly, these two areas of law appear to be merging. With regard to the former area, I have served as a Reporter to the American Law Institute for its Restatement-like project, PRINCIPLES OF CORPORATE GOVERNANCE: Principles and Recommendations (1992), am a co-author of the most widely used casebook on Securities Regulation (Jennings, Marsh, Coffee & Seligman, SECURITIES REGULATION: Cases and Materials (8th ed. 1998)) and of several other books on corporate law, have served as a member of the Legal Advisory Boards to both the New York Stock Exchange and Nasdaq, and was a member of the SEC's Advisory Committee on Capital Formation and the Regulatory Process. With regard to the sentencing and white collar crime fields, I served as a Reporter to the American Bar Association for its Standards on Sentencing Alternatives and Procedures in connection with its Minimum Standards for Criminal Justice Project, have been a member of a National Academy of Sciences Panel that reviewed the empirical research on sentencing, and have served as a consultant for, and as a member of an Advisory Committee to, the United States Sentencing Commission with regard to its organizational sentencing guidelines and its proposed environmental sentencing guidelines. I have also written extensively on white collar crime and taught a course on this subject with United States District Judge Jed Rakoff for the last decade.

II. Recommendations for Individual Defendants

How do we best deter economic crime? The consensus of criminologists is that likelihood of apprehension is far more important than the severity of punishment. For example, Professor Daniel Nagin, a criminologist at Carnegie Mellon University, told a symposium hosted by the United States Sentencing Commission in 2000 that research on tax compliance indicated that: "[C]ompliance is nearly perfect when detection risk is very certain, and compliance is nearly zero when detection risk is negligible."2

He added:
"The flip side of this conclusion... is that draconian penalties are unlikely to be an effective substitute for a more-difficult-to-achieve alternative of effective detection and prosecution. For example, a penalty of 25 years of imprisonment with a probability of .01 is unlikely to be as effective a deterrent as a 2.5 year of punishment but with a probability of .1"3

Criminologists have consistently held this view at least since the days of Cesare Beccaria in the 18th Century, and modern empirical research has confirmed it.
From a policy perspective, this means that the passage of tough mandatory sentences that impose exemplary sentences on white collar offenders will do less to achieve deterrence than investment in enforcement and detection. On this basis, my first recommendation would be the following, which is, I believe, fully consistent with the American Bar Association's Minimum Standards for Criminal Justice:
RECOMMENDATION ONE: Avoid Mandatory Minimum Sentences. They Are An Election-year Solution to Crime. Fair, but Certain, Punishment Works Far Better.

The United States Sentencing Commission was, of course, created by Congress to reduce sentencing disparities and ensure fair and certain punishment. The Sentencing Commission has long promulgated sentencing guidelines for economic crimes, including Guideline §2B1.1 which applies to offenses involving "fraud and deceit." This will be the guideline that typically applies to securities fraud cases, but, as next discussed, it needs revision to deal adequately with accounting fraud cases. Essentially, this guideline starts at Base Offense Level 6 and then further increases the "Base Offense Level" in direct proportion to the loss caused by the crime, starting at the $5,000 level and enhancing the offense level by up to 26 levels (if the loss exceeds $100,000,000). In addition, Guideline §2B 1.1 also increases the Base Offense Level by two levels if more than ten (but less than 50) victims are involved and by four levels if more than 50 victims were involved. A variety of other offense level enhancements are also authorized if specific additional factors are present; for example, if the defendant derived more than $1,000,000 in gross proceeds from a financial institution or if the defendant "substantially jeopardized the safety and soundness of a financial institution," the base offense level rises by two and four levels, respectively.
While I have long believed that the Commission's guidelines tend to take an overly mechanical approach to the determination of offense severity, the foregoing guideline illustrates the limitations inherent in this approach in a particularly revealing way. First, let's begin with the definition of the "loss" in a case where corporate executives are convicted of securities fraud for "cooking the books." Assume that no defendant engaged in insider trading and that the company did not sell securities to the market during this period. Yet, when the earnings overstatement is revealed, the company's stock price drops 50% over the next two days for a total loss (in terms of market capitalization) of $2 billion dollars.4 Does this count as a "loss" for purposes of §2B 1.1? The definition of "loss" in Application Note 2 to §2B 1.1 looks to the "reasonably foreseeable pecuniary harm" that the defendant "reasonably should have known was a potential result of the offense." The problem here is that a chief financial officer who overstates earnings by even two cents a share can trigger a vehement reduction in the firm's stock price by an angry market when an earnings restatement is later announced. But this stock price reduction could sometimes be small and sometimes large; it is seldom predictable. Moreover, in civil litigation, courts do not necessarily assume that the full stock price reduction was attributable to the earnings

restatement; rather, they require the plaintiff to prove "loss causation." For example, a court might often find that much of the stock price decline on a given date was attributable to new macro-economic news reaching the market or to industry conditions that also affected the firm's competitors. Accordingly, the sheer stock market decline is not necessarily an accurate proxy for the "reasonably foreseeable pecuniary harm." In this light, it seems apparent that this guideline was really drafted to deal with the very different case in which the fraudulent stock promoter obtains funds from deceived investors. But this does not happen in many (and probably most) "accounting irregularities" cases where the loss falls on shareholders who purchased in the secondary market, not from the defendant promoters.

My point then is simply that the existing guidelines for fraud offenses (i.e., §2B 1.1) does not mesh well with "accounting irregularity" cases. This point is reinforced when we consider the enhancement for the number of "victims" in such a case. Who are the victims? If all shareholders are the victims, the earlier noted "50 or more" victim enhancement will be triggered in every case. But some shareholders bought at a very low price at the outset of the corporation's history and have thus experienced no real economic loss. One cannot easily determine the number of shareholders who have suffered a net economic loss (although I admit that it will usually be well in excess of 50). If the corporation is instead seen as the victim, then there is only one victim, and the "number of victims" test is nullified.

Similarly, the special enhancement for deriving funds from a financial institution seems to produce an indefensible result in such a case, because it does apply when the corporation sells its bonds to a bank, but not when it sells equity to proverbial widows and orphans. All this leads to my second recommendation:

RECOMMENDATION TWO. Congress Should Instruct the Sentencing Commission to Develop a Special Guideline for Securities Fraud Cases Involving Accounting Irregularities.

Such a new guideline needs to take a broader perspective on the social harm involved in corporate overstatements of earnings and understatement of liabilities. The premise of §2B 1.1 is that the loss is visited exclusively on the specific victims of the defendants who give them cash or property for overvalued stock. That rationale may fit the classic Ponzi scheme well enough (which was the type of case that used to be criminally prosecuted), but not an Enron or a Worldcom. In these cases, the broader social injury needs to be recognized; that is, the victims are not just the shareholders of Enron, but shareholders in all other public corporations whose share prices have also been discounted because investors no longer trust the credibility of reported financial results. Indeed, viewed more generally, the victims include not only investors, but employees, creditors, other stakeholders, and citizens generally - - all of who suffer a loss when securities fraud erodes investor confidence and thereby produces an increase in the cost of capital.

This last point cannot be overemphasized: securities fraud has macro-economic consequences. It injures not only investors, but the public generally by raising the cost of capital for all corporations and thereby retarding economic growth, increasing interest rates, and producing inevitable layoffs.

So what should be done? Although Congress itself should not write sentencing guidelines, Congress could instruct the Sentencing Commission to consider these broader public injuries and report back, within say one year, with a revised guideline for this special context. For example, such a guideline could sensibly look to the amount of the earnings restatement and also the number of quarterly reports that were misstated in considering the impact on public confidence.

In addition to fines, a federal court can also order disgorgement of profits obtained from the crime. In "accounting fraud" cases, the real motive underlying the crime may be the desire to receive stock options or other bonuses based on presumed superior performance. Or, the motive could be the desire to maximize the value of stock options that were earlier awarded by inflating the stock price. Either way, the Sentencing Commission needs to consider when the disgorgement sanction should include executive compensation that was received or that earned an enhanced valued during the period of the fraud. Admittedly, this will involve some subtle distinctions.

Recommendation Three: Instruct the Sentencing Commission to Determine and Report When and to What Extent Executive Compensation Awarded During a Period in Which Earnings Were Overstated Should Be Deemed Subject to Disgorgement.

III. Corporate Defendants

In some securities fraud cases, the corporation itself may be prosecuted, and the Sentencing Commission has special organizational sentencing guidelines applicable to corporate defendants.5 These organizational guidelines contain a special sentencing credit against any fine if the corporation has established and maintained an effective compliance program to detect and prevent violations of law.6 The actual content of such an effective compliance program has long been the suspect of reasonable debate and disagreement (and this author was among those who participated in their initial drafting). Yet, this topic seriously needs re-examination in light of the Enron debacle. For example, Enron shows the importance and social value of whistle-blowers (as Worldcom may also). A model corporate compliance plan might well include procedures by which potential whistle-blowers were alerted as to how to report suspected violations of law to the broad - - and on an anonymous basis. Indeed, procedures could be mandated in these guidelines under which at least certain serious violations of law (including securities fraud) could be reported directly to the Audit Committee on a confidential basis. Again, all the elements in a model compliance plan need not be established by Congress at this stage, but this is a timely topic that has received little recent attention, and needs re-examination. Accordingly, I recommend:

RECOMMENDATION FOUR: Require the United States Sentencing Commission to Review and Determine If Compliance Plans Are an Effective Deterrent to Organizational Crime and If They Justify the Sentencing Credits That Are Currently Awarded. Also, Specific Attention Should Be Given to the Possible Need for Greater Protection in Them for Whistle-blowers.

The President and others have suggested the need to restrict improper loans or payments to corporate executives. In addition, following a corporate conviction, it may become apparent that the corporation has strong legal claims against present or former officers or directors. Sometimes, the corporation may be reluctant to assert these claims. One means by which to address this problem is through the use of corporate probation. Corporate probation is already an authorized sanction (in addition to fines and other penalties), but it could be expanded by making the appointment of a corporate monitor an authorized probation condition. Such a monitor could be authorized in an appropriate case to sue in the corporation's right and place for a corporate recovery from the former officers or directors. Essentially, this proposal assures a more objective and independent evaluation of the legal strength of the corporation's claims, and it is a parallel to the independent counsel statute in the public sector.

RECOMMENDATION FIVE: Instruct the Sentencing Commission to Evaluate and Report on

the Potential Utility of Corporate Probation as a Means by Which to (a) Correct Failures in Corporate Governance at the Defendant Organization, and (b) Recover Amounts or Damages Due to the Defendant.