Capitalism Will Clean Itself Up
by
Roy C Smith and Ingo Walter
(Professors of Finance, Stern School of Business)

More financial wealth in America was created in the last two decades of the 20th Century than at any other time or place in the history of the world. A stupendous stock market boom boosted the value of financial assets at twice the rate of the economy's nominal growth. Many boats rose in this extraordinary tide. As the new millennium dawned, nearly half of American households were participants in the stock market. Conspicuous consumption, private philanthropy, and political activism all followed the market’s boom. It was a great time and American corporations and financial markets became the wonders of the modern world.

But the early years of the new millennium have seen an ebbing of the stock market tide. Although the Dow Jones index is off only about 13% from its all-time high, the NASDAQ index (containing most of the computer and telecom names) is down by more than 50%. And, the falling tide not only lowered the boats, but also revealed a lot of rocks and slime that were overlooked on the way up. The sudden collapse of Enron (and some other companies) revealed a dark underside to American corporate governance. Though management could be innovative, aggressive and glib (all useful qualities), it could also be misleading, dishonest and corrupt. Enron, for example, was able to contaminate all those who chose to fatten at its corporate trough – its directors, auditors, bankers, analysts, rating agencies, lawyers and political friends.

Enron, however, was hardly alone in its accounting fiddles and dubious management practices. The list is as long as the trail of shareholder litigation and failed audits by the “big five” accounting firms. But Enron did much to sharpen sensitivity to financial shenanigans, so investors today are looking much more skeptically at all companies, including some of the country’s most respected firms. The growing concern about the integrity of American corporations dovetails with this year's publication of top executives' compensation awards, with plenty of examples of management self-enrichment despite declining earnings and eroding stock prices.

How can this be, after so many years of attention to principles of good “corporate governance” and pontificating to others about the superiority of the American capital market-dominated system? In a recent address at New York University Alan Greenspan, Chairman of the Federal Reserve, said there are “hardly any independent directors left” on corporate boards, adding that our system has become CEO-dominant and difficult to restrain, and that mechanisms supposedly binding the interests of managers and shareholders sometimes do just the opposite.
In the old days, corporate directors like banker J. Pierpont Morgan (as a representative of bond investors, not stockholders) imposed restraint on management and owners of large corporations. Companies feeling the Morgan presence often traded at higher stock prices than companies without it. But as corporations evolved into public companies financed in capital markets by fragmented shareholders and equally fragmented debt-holders, most of the power of restrain reverted to the managers themselves. In recent years, CEOs have been able to select boards supportive of their management, and have rewarded them for their loyalty. For CEOs determined to accomplish their goals, reservations on the part of outside directors (if any) have had little influence.

Such a system inevitably must pay a price for lapses in effective governance. Managers may be allowed too easily to commit their companies to strategic mistakes. The methods used to compensate management have become absurd. They are paid to sign-up, paid to stay, even paid to go -- often at eye-popping rates that bear no relation to the results achieved, while stock options are handed out with little accountability or regard for their dilutive effects -- and then sometimes are repriced when they turn out to be temporarily worthless. Worse, smoke and mirrors appear to make implausible things seem to work, misreported accounting numbers obscure true performance and risks, and deals are encouraged just for the sake of showing dynamic acquisitive behavior (or maybe to increase the size of the CEO’s corporate platform, fame and personal fortune). Government can and does react to some of the worst offenses, but standards of proof are high in criminal cases and not all of them are addressed.

But the pendulum inevitably swings back, and market forces emerge to cleanse the system. In a rising market, even those who are victimized fail to see many of the clues that things are seriously wrong. Reactions are delayed until a serious crack in the system opens. But when it finally comes, the market can extract a terrible price for unacceptable conduct. Enron’s stockholders lost all of their investment in a company that a year before had been worth well over $50 billion. Bank lenders and bondholders will have to forfeit nearly the same amount. Enron employees and pensioners with significant voluntary holdings in the company’s stock – some who might have been middle management whistleblowers but weren’t – lost their hard-earned retirement assets. Officers and directors have already taken heavy financial losses and forever have lost their good names – and there will be further losses as whatever is left of their fortunes is depleted by the many civil lawsuits they yet must deal with. Enron’s auditor, Arthur Andersen, is already a ruined hulk, whether it legally survives or not, and its partners will have lost a lifetime’s earnings retained in the firm. Most recently the shareholders’ lawyers have added nine of Enron’s bankers and two of its law firms to a growing list of defendants. Finally Enron’s equity and credit analysts have been embarrassed by their incompetence in finding catastrophic trouble, and face a future in which their recommendations are likely to be considered
suspect, ignored or scorned. Those involved will not soon wish to repeat their experiences.

The forces redressing the cumulative weaknesses in American corporate governance, however, do not stop at Enron. All of America’s 8,000 publicly traded companies will have to pay more for auditing services, and much more for officers and directors liability insurance. Stock prices of companies whose accounts come under suspicion will sag below their peers, and borrowed money will carry higher interest rates, punishing their cost of capital and competitive performance in the marketplace. Accounting rules will tighten and make it more difficult to overstate reality. The cleansing will take place because the market finally wants it to, and the market will get what it wants.

For critics of the American system of CEO-dominated corporate governance, correction by market forces may seem clumsy, awkward, uneven and unreliable. But it works, as no other system can, though admittedly its fury is released only after the damage is done. Most alternatives work against the market. This one works with the market to extract retribution, when enough is enough.