

WST

# The Market Can Police Itself

By **Burton G. Malkiel** JUNE 28, 2002

We are witnessing today a complete disconnect between the stock market, which has been trading around Sept. 11 lows, and news of a healthy economy recovering from one of the mildest recessions in history. Is the market telling us that we will soon sink into another economic dip? I think not.

The stock market is reacting to accounting scandals of unprecedented magnitude: First came Enron, then Tyco, Global Crossing and Adelphia. Now WorldCom has joined the list with its admission that it overstated profits and cash flow by \$3.8 billion. As one trader put it. "When you walk into the kitchen and see a cockroach, you can be sure there are more around." At one annual meeting I recently attended, a stockholder opined that "everyone in corporate management in the U.S. is a crook." The large number of people attending the meeting applauded.

**Falling shares send a stronger signal than more regulations.**

the tack the Justice Department took when it decided to prosecute Arthur Andersen the firm, not individuals within Andersen.

### Act of Faith

Investing is an act of faith. We need faith not only in the long-term growth of the economy but also in our corporate executives and in the watchdog functions provided by boards of directors, auditors, and the financial community. There is no doubt that this faith has been shattered and is urgently in need of repair.

I have long believed that our securities markets are extraordinarily efficient. Stock prices generally reflect all relevant information about the economy and the individual companies in it. But I also recognize that sometimes markets go haywire, and when they do, they give the wrong signals to economic participants. This was certainly the case in Japan during the late 1980s when the bubble in land and stock prices led to enormous overbuilding. It was also the case in the U.S. in the late 1990s during the Internet-telecom bubble, when much unproductive investment was directed to nutty "New Economy" companies and to building telecom overcapacity.

Moreover, speculative manias, such as our recent stock market bubble, bring out the worst aspects of our system. The South Sea bubble of the 18th century led to a vast number of fraudulent new issues designed to meet the public's insatiable appetite for speculative vehicles. The speculative frenzy of the 1920s led to a degree of manipulation of the stock exchanges that set new records for unscrupulousness. And let there be no mistake that it was the extraordinary recent mania that encouraged the string of business scandals that have recently come to light.

Many businesses were managed not for the creation of long-run value but for the immediate gratification of speculators. When Wall Street's conflicted sell-side analysts looked for high short-term forecasted earnings to justify outlandishly high stock prices, many corporate managers willingly obliged. And if aggressive earnings targets proved hard to meet, "creative accounting" could be used so that not only the Street estimates but even the "whisper numbers" could be surpassed.

But remember: What ill gotten rewards the stock market has given during the times of irrational exuberance, it quickly takes away when sanity returns. The punishment given to transgressors is harsh and unforgiving. In case after case, companies as Enron, Adelphia, and WorldCom have become essentially worthless. No CEO can fail to realize that even a hint of accounting impropriety can send a stock plummeting. While markets occasionally make mistakes, they always correct and usually are quite effective monitors.

So what should we do now? Predictably, politicians are calling for nothing less than a complete overhaul of the system. There are, indeed, useful changes that can be made, and new bodies such as the proposed Independent Public Accountability Board may well do a better job at overseeing the accounting profession and minimizing conflicts of interest. But my reaction to many of the proposals floating around is similar to the slogan that "guns don't kill people, people do." The remedies that have the best chance for being truly effective are remedies that put responsibility for making improvements squarely where they belong. Let's hold people responsible—not institutions. Unfortunately, that's not

There is no way one can legislate accounting standards and there is no way to fix generally accepted accounting principles so that full transparency is assured. But perhaps the most useful thing we can do is to accept the suggestion of Treasury Secretary Paul O'Neill that CEOs should personally vouch for the veracity and fairness of their company's financial statements. Perhaps the independent chair of the firm's audit committee should sign the statement as well. If the firm's statements later prove to be misleading, the CEO should be held criminally liable.

As Judge Henry J. Friendly ruled over 30 years ago, that liability should hold even if the firm was in literal compliance with accounting regulations but the financial statements still created a materially misleading impression in the minds of shareholders. Thus, even if all of the Enron Special Purpose Entities met existing accounting rules for exclusion (which they did not), CEO Kenneth Lay could be prosecuted for creating the misleading impression that Enron was not highly leveraged. Moreover, corporate executives should reveal immediately whether they have bought or sold stock and should be made to give back any compensation that may have been gained from their transgression.

### Options

And whatever one's feelings about the appropriateness of executive compensation and whether stock options should be expensed on income statements, there is one reform that could clearly be of benefit: Require that executives who gain from the exercise of options hold onto their stock while still employed. Then executives would bear both the risk and reward of share-price movements, and the interests of executives and shareholders would be fully aligned.

The proposals of Richard Grasso, head of the New York Stock Exchange, to increase the proportion of "independent" directors are also useful. Boards cannot micromanage the companies they direct, but they can be more proactive. Similarly encouraging is the frank admission by Henry Paulson, CEO of Goldman Sachs, that Wall Street firms, including his own, need to better address the conflicts of interest affecting their research product.

But in the final analysis, the immediate punishment doled out by the market itself will be the most powerful deterrent to future corporate wrongdoing. And eventually the stock market will react to the increase in economic activity instead of the growth in corporate scandals.

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