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STANDING UP TO WALL STREET (AND CONGRESS)

*Richard W. Painter**

TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW, WHAT YOU CAN DO TO FIGHT BACK. By *Arthur Levitt*. New York: Pantheon Books. 2002. Pp. x, 338. $24.95.

In 1992, Arthur Levitt co-chaired a fundraising dinner for William Clinton. The dinner raised $750,000 (p. 7). Clinton was elected President, and Levitt got the job he wanted: Chairman of the Securities and Exchange Commission. Levitt, a former Chairman of the American Stock Exchange and a connected Democrat, was well qualified for the job. His, however, became a pyrrhic victory when accountants, issuers, broker-dealers, and other special interests used their own political connections to frustrate just about everything he sought to do.

Levitt tells the story of his struggle against these well-funded interests in *Take on the Street*. One of his most troubling revelations is how little independence the Commission, a purportedly independent agency,[1] actually has in the face of political pressure from Congress. Combine that pressure with Congress's dependence on campaign contributions from industries regulated by the Commission and the recipe for regulatory capture is complete.

Levitt is right that investors are not represented as an interest group on Capital Hill.[2] Lack of investor representation, coupled with Congress's willingness to interfere with the work of the Commission, required Levitt to pick his battles carefully, and it is not always evident that he did so. Hindsight now provides Levitt with an opportunity to identify areas in which, despite the treacherous political waters of the 1990s, he could have been more effective in protecting investors. Rarely, however, does the book reassess Levitt's own priorities or

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1. *See* 44 U.S.C. § 3502(5) (2000) (including the Commission in the definition of "independent regulatory agencies").

2. P. 237 (stating that investors are "the most overlooked and underrepresented interest group in America").

approach. Instead, it concentrates on explaining why he pursued the regulatory agenda that he did.

Levitt's emphasis on self-justification is one of the book's weaknesses. Nonetheless, he gives investors helpful advice in plain English on everything from mutual funds to stock brokers and reading financial statements, in separate chapters devoted to each of these topics. Perhaps most importantly, Levitt also explains how he was so often frustrated in doing his job. Although academic work on regulatory capture theory is abundant,[3] a behind-the-scene account of how capture actually takes place is rare. An account as good as this one (complete with an Appendix publishing irate letters that Levitt received from members of Congress on behalf of the accounting industry) is a valuable contribution to the study of how regulatory agencies function in a political system influenced by the voice of regulated industries.

TAKING ON THE AUDITORS

In Chapter Five, Levitt discusses shortcomings he sees in the auditing profession. Chief among these are conflicts of interest when firms perform nonaudit services for audit clients. Levitt believes that nonaudit engagements, which sometimes generate fees several times higher than audit fees from the same clients, undermine auditors' independence from clients.[4] Some of these engagements also involve work (such as bookkeeping) that will later be reviewed in the audit, posing another conflict of interest.[5]

Levitt's view on these conflicts may be correct, although arguments in favor of nonaudit engagements are not explored, or adequately refuted, in his book. Audit firms are hardly independent to begin with, as audit fees are alone substantial and audit partners are often paid

3. *See, e.g.*, William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861 (1995). For general discussion of the theory of regulatory capture, see George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971), and Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976).

4. P. 138 (citing Dow Jones Newswire report that companies making up the S&P 500 paid their auditors $3.7 billion for nonaudit services in 2000, more than three times the $1.2 billion in audit fees paid by these same companies that year). In the case of some individual companies, the disparity between fees for audit and nonaudit services was much larger. Sprint Corp., for example, apparently paid Ernst & Young only $2.5 million for its audit and $64 million for consulting and other services. P. 138. "I have to wonder if any individual auditor, working on a $2.5 million audit contract, would have the guts to stand up to a CFO and question a dubious number in the books, thus possibly jeopardizing $64 million in business for the firm's consultants." P. 138.

5. "If an accountant keeps the books for a client, he can't turn around and vouch for the accuracy and completeness of those books." P. 118.

based on audit clients they bring in and keep.[6] Issuers' managers in turn have substantial influence over hiring and firing auditors, particularly before Congress turned this function over to issuers' audit committees in 2002.[7] Thus, the relevant inquiry is how much additional perverse incentive is created when fees from nonaudit services are added to the mix. The answer is not clear. Neither is it clear whether this added incentive for auditor malfeasance is outweighed by positive contributions to audit quality from having nonaudit services performed for the issuer by the audit firm.

Nonaudit engagements arguably could improve audit quality. First, there is informational advantage enjoyed by multidisciplinary audit firms. Providing nonaudit services, particularly legal and tax services, could help an audit firm see how a client puts together complex transactions. Assuming the auditor has not erected a communication barrier or "firewall" between its audit and nonaudit functions, problems initially detected by nonauditors could be brought to the attention of auditors.[8] The fact that auditors have broader disclosure obligations than other professionals, particularly lawyers, might increase the chances of public disclosure.[9]

Second, the auditor providing nonaudit services could be held to a higher legal standard of care because it should know more about a client than an auditor that provides only audit services.[10] Indeed, plaintiffs also could point to fees for nonaudit services as evidence of an additional motive for an auditor to misrepresent an issuer's financial statements.[11]

6. *See* Ken Brown & Ianthe Jeane Dugan, *Sad Account: Andersen's Fall from Grace Is a Tale of Greed and Miscues*, WALL ST. J., June 7, 2002 at A1; Cassell Bryan-Low, *Accounting Firms Face Backlash over the Tax Shelters They Sold*, WALL ST. J., Feb. 7, 2003, at A6.

7. *See* Sarbanes-Oxley Act of 2002, H.R. 3763, 107th Cong. § 202 (2002) (codified in scattered sections of 15 U.S.C.) (amending § 10A(m) of the Exchange Act to provide that audit committees shall be responsible for retention, compensation, and oversight of outside auditors); Securities Exchange Act of 1934, 15 U.S.C. 78 (2000) (codified as amended at 15 U.S.C. §§ 78a-78mm) (2002)).

8. *See* Richard W. Painter, *Lawyers' Rules, Auditors' Rules and the Psychology of Concealment*, 84 MINN. L. REV. 1399, 1426-36 (2000) (discussing informational synergies from multidisciplinary practice that could improve audit quality).

9. *Id.* at 1430.

10. The auditor thus might have more difficulty proving a due-diligence defense under § 11 of the Securities Act or disproving a claim of recklessness under § 10(b) of the Exchange Act.

11. Pleading specific facts that infer a defendant's motive to deceive is critical to surviving a motion to dismiss fraud claims under § 10(b) of the Exchange Act, 15 U.S.C. § 78j (2000), and § 21D(b) of the Exchange Act, 15 U.S.C. § 78u3 (requirement for pleading state of mind). *See In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 268-69 (2d Cir. 1993) (requiring "strong inference" of scienter through either (1) facts establishing a motive and opportunity to commit fraud; or (2) facts constituting circumstantial evidence of either reckless or conscious behavior).

Definitive resolution of the debate over nonaudit services thus requires answers to difficult questions that Levitt does not address: How much do nonaudit engagements increase the likelihood that auditors will cut corners to please lucrative clients, and are these perverse incentives outweighed by benefits to audit quality from nonaudit engagements?[12] Levitt points out that many failed audits in recent years involved clients that obtained nonaudit services from their auditors (pp. 138-39). His anecdotal evidence, however, comes from a relatively small sample of less than a dozen firms. This hardly proves cause and effect. The case that nonaudit services are a serious threat to audit quality should be more rigorously tested by statistical comparison of audits by audit-only firms with audits by firms that also provide nonaudit services to the same issuer. A statistically significant difference in incidents of earnings restatements or other problems with audits between these two groups would provide firmer support for Levitt's intuitively appealing argument against allowing audit firms to provide nonaudit services for audit clients.[13]

The Commission required issuers to publicly disclose nonaudit fees paid in proxy statements filed after February 5, 2001, and several empirical studies use this newly public information to measure the impact of nonaudit fees on audit quality. Results of these studies, however, are inconclusive. One 2001 study found significant negative market reaction to proxy statements filed by issuers reporting higher than expected nonaudit fees, a measure perhaps of what the market thinks of audit quality.[14] The study also found some evidence that issuers that

12. In addition to the ways in which nonaudit services could improve audit quality, there arguably are economies of scale and synergies that could be realized when issuers obtain audit and nonaudit services from one provider. For example, time spent by both auditors and nonaudit service providers familiarizing themselves with a client's business and management could be reduced when audits and other services are provided by the same firm. To the extent such cost savings are passed on to investors, they too are relevant to the question of whether auditor provision of nonaudit services helps or harms investors.

13. This author is aware of only one such study that looks for a correlation between earnings restatements and nonaudit services. This is also the only study that this author is aware of that examines "confidential" data from the time period prior to 2000 (data concerning nonaudit fees for the period after 2000 is publicly available). *See* William R. Kinney, Jr. et al., Auditor Independence and Non-audit services: What do Restatements Suggest? (May 14, 2003) (unpublished manuscript, on file with author) (using detailed fee data — obtained by the study's authors after negotiating a confidentiality agreement with the seven largest auditing firms in the United States — on 432 registrants that announced restatements from 1995-2000 and 512 similar registrants without restatements). This study found little evidence of positive association between issuer restatements and audit-firm fees for either financial-information systems or internal-audit services. However, the study found some evidence of positive correlation between "other" services fees and restatements, except for a negative correlation between tax services and restatements. By contrast, most empirical studies in this area look for a correlation between nonaudit services and an indicator of audit quality other than restatements. *See* studies cited *infra* notes 14-17.

14. RICHARD M. FRANKEL ET AL., AUDITOR INDEPENDENCE AND EARNINGS QUALITY (Stanford Graduate School of Business Research Paper No. 1696R, July 2001).

bought more nonaudit services from their auditors were more likely to engage in earnings management, a practice which is difficult to measure but that can be approximated by examining how often an issuer just meets or beats earnings benchmarks or reports large income-increasing or income-decreasing discretionary accruals.[15] Other studies, however, show no effect of nonaudit fees on other measures of audit quality, such as the willingness of the auditor to send a "going concern" opinion letter to an issuer that questions the issuer's ability to stay in business.[16] Absent more empirical evidence confirming Levitt's concern about nonaudit fees, it is not at all certain that his enormous battle with the accounting industry over this issue was a worthwhile expenditure of political capital (p. 138).

Furthermore, Levitt does not discuss other approaches that might be more effective in improving audit quality. For example, the SEC could have allowed auditors to provide nonaudit services to audit clients, but only on the condition that (i) auditors communicate on a regular basis with employees performing nonaudit services for the same client; (ii) all information known to nonaudit employees in the audit firm be imputed to the auditors for purposes of civil and criminal liability; (iii) the audit firm rotates the audit partner with principal responsibility for each client's account;[17] and (iv) perhaps most impor-

15. *Id. But see* Hollis Ashbaugh et al., Do Non-Audit Services Compromise Auditor Independence? Further Evidence (Apr. 18, 2002) (unpublished manuscript, on file with author) (finding no such correlation between issuers' positive discretionary accruals and the ratio of audit to nonaudit fees in a study that controlled for the issuers' prior performance, a factor that can itself be related to income increasing accruals); J. Kenneth Reynolds et al., Professional Service Fees and Auditor Objectivity (2002) (unpublished manuscript, on file with author) (observing that the correlation between aggregate levels of discretionary accruals and the ratio of consulting fees to audit fees disappears when controlling for high-growth issuers). Other studies also have not detected a relationship between audit firms' fees and evidence of earnings management. *See, e.g.*, Hyeesoo Chung & Sanjay Kallapur, Client Importance, Non-Audit Services, and Abnormal Accruals (Aug. 2002) (unpublished manuscript, on file with author) (finding no statistically significant association between abnormal accruals by issuers and "client importance" measures such as the ratio of both audit and nonaudit fees to the audit firm's total U.S. revenues or to the revenues of a particular office of the audit firm).

16. *See, e.g.*, Mark L. Defond et al., *Do Non-Audit Service Fees Impair Auditor Independence? Evidence from Going Concern Audit Opinions*, 40 J. ACCT. RES. 1243 (2002) (finding no significant correlation between the auditor's willingness to issue a going concern opinion with respect to an issuer and either total fees or audit fees paid by the issuer to its audit firm). The results of this study could be harmonized with those of FRANKEL ET AL., *supra* note 14, by hypothesizing that auditors are induced by nonaudit fees to cut small corners for issuers, as shown by earnings management strategies, but that nonaudit fees will not discourage an auditor from acting appropriately to address a serious problem, such as issuer insolvency, in which the auditor's own liability is significantly enhanced.

17. This condition is now imposed by the Sarbanes-Oxley Act of 2002, § 203, amending § 10A of the Exchange Act. The Act also orders a study to be conducted as to whether audit firm rotation should also be required. *See* § 207. At least one empirical study, however, has found that the size of an issuer's earnings accruals is inversely related to the length of the auditor-client relationship. This would suggest that mandatory auditor rotation could actually harm audit quality. *See* James Myers et al., Exploring the Term of the Auditor-Client

tant, that the audit committee of an issuer rather than the issuer's senior management be responsible for hiring and firing the auditor.[18] Such approaches might have increased the likelihood that information gained from nonaudit services actually informed the audit.

Whatever the merits of his position on nonaudit engagements, Levitt is right that the way in which the accountants fought their battle with the Commission over this issue raises questions about the Commission's ability to preserve its own independence from the industries it regulates. The barrage of letters that Levitt received from Members of Congress urging him to back off on auditor independence (and the similar letter from Kenneth Lay, the CEO of Enron, praising nonaudit and audit services performed by Arthur Andersen)[19] is deeply troubling. Here, in the Appendix to Levitt's book, one sees the power of Congress being brought to bear on a purportedly independent agency, as well as Congress's eagerness to respond to demands that regulated industries make on the political process.[20]

TAKING ON THE ANALYSTS

Conflicts of interest affecting stock market research were obvious by the time Levitt became Chairman of the Commission in 1993.[21] After fixed commissions were abolished in 1975 and the profitability of brokerage operations declined, broker-dealers earned lower returns on reputational capital tied to research and recommendations in stocks.[22] The enormous profitability of underwriting and trading operations in the 1990s, on the other hand, encouraged broker-dealers to sacrifice their reputation on the research side if necessary to attract investment banking business and to favor their own traders over brokerage customers. In some instances, this is exactly what happened.[23]

Relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation? (June 2002) (unpublished manuscript, on file with author).

18. This condition is also now imposed by the Sarbanes-Oxley Act of 2002, § 201, amending § 10A of the Exchange Act.

19. *See* Appendix at 299-300 (letter dated September 20, 2000 from Kenneth L. Lay, Chairman and Chief Executive Officer, Enron Corporation to Arthur Levitt, Chairman, Securities Exchange Commission (stating that "for the past several years, Enron has successfully utilized its independent audit firm's expertise and professional skepticism to help improve the overall control environment within the company")).

20. These aspects of the capture problem are discussed more extensively under the heading "Taking on Congress" in this Review.

21. "The problem was apparent as far back as the 1960s." P. 69.

22. "During the past two decades, the economics of Wall Street had shifted away from retail sales to arranging initial public offerings, which brought in billions of dollars of profit during the runaway bull market." P. 65.

23. *See* p. 66.

During the bull market of the 1990s, analysts' buy recommendations not surprisingly outnumbered sell recommendations by huge proportions.[24] Investment-banking clients were almost never downgraded, even if the firm's trading desk knew, perhaps from confidential emails from analysts, that the stock was to be avoided.[25] Industry relationships reinforced this behavior because issuers had substantial influence over their investment bankers, who they could always replace with a competitor, and investment bankers in turn had substantial influence over the work of analysts in their firms, even how much analysts got paid.

Rather than addressing these structural problems that encouraged analysts to mislead investors, however, the Commission focused most of its efforts on a related problem: analysts' informational advantage over ordinary investors from private communications with issuers. The Commission sought in Regulation Fair Disclosure ("Regulation FD")[26] to prevent analysts from receiving preferential access to nonpublic information from issuers, and thus to prevent analysts' firms from trading on that information or allowing favored customers to trade on that information, before it is disseminated to the public.[27] Such access to inside information creates yet one more incentive for analysts to shade their reports in order to preserve their relationship with issuer management.[28] Removing analysts' informational advantage, however, does not remove other incentives (such as investment-banking business) that analysts and their firms have to shade reports to please issuer management. Regulation FD was thus only a partial answer to misleading analysts' recommendations.

It was with Regulation FD that the Commission, despite its well intentioned effort to even the playing field between analysts and ordinary investors, may have had the wrong priorities. Analysts' privileged access to inside information was a problem. A still greater problem, however, was that information given to investors by some analysts, even absent inside information, was wrong, and probably intentionally so. It was the misinformation given by analysts to investors that fed the market bubble of the late 1990s, not the fact that investors did not

24. *See* p. 73 (reporting that in March 2000, there were ninety-two buy recommendations for every sell recommendation).

25. P. 65 (discussing investigation in which New York Attorney General Eliot Spitzer subpoenaed internal emails from analysts at Merrill Lynch that had described stock recommended by these analysts as "a piece of junk," "crap," and "a dog").

26. 17 C.F.R. §§ 243.100-243.103 (2001).

27. "Mutual funds and pension funds were getting far better information, and a lot earlier, than retail investors." P. 8.

28. Some issuer CEO's and finance chiefs "were trading important information about earnings and product development with selected analysts, who in return were writing glowing reports." P. 8

get information soon enough. Combating this misinformation should have been the Commission's priority.

There is also at least some evidence that Regulation FD delays rather than accelerates dissemination of information to markets by encouraging issuers to delay communication with analysts until they are willing to make a public announcement.[29] Regulation FD, on the other hand, seems fair because it requires issuers to let their own shareholders know information at the same time they tell analysts. Because fairness is important to investor confidence, Regulation FD may have been justified despite its costs. Nonetheless, the Commission, in pushing this controversial Rule, spent political capital that could have been spent addressing structural problems that induced some analysts to lie to investors in research reports even when they did not possess material nonpublic information about an issuer.

Although Levitt sought to address these structural problems by pressuring the National Association of Securities Dealers ("NASD") to strengthen ethics rules for analysts, he did so late in the his term, after the market bubble had already begun to burst.[30] The SEC talked about the possibility of regulating analysts if the NASD would not,[31] but the SEC did not propose rules of its own. Not until passage of the Sarbanes-Oxley Act of 2002 did federal regulation address analysts' conflicts of interest.[32] Moreover, the SEC never required brokerage firms to disclose this problem to ordinary investors, for example, by disclosing that analysts' reports are "sales literature,"[33] something that

29. *See, e.g.*, Richard M. Frankel et al., An Empirical Investigation of Pre-Earnings Announcement Quiet Periods (Feb. 2002) (unpublished manuscript, on file with author) (observing a substantial increase in the number of issuer self-imposed "quiet periods" after Regulation FD; that quiet-period issuers have characteristics indicative of higher litigation risk; and that trading volume in these issuers' stocks is higher before earnings announcements, but lower afterwards).

30. P. 67 (describing December 2000 phone call from NASD President Mary Schapiro informing Levitt that the NASD's members could not agree on a new code of conduct for securities analysts that Levitt had fourteen months earlier asked the NASD to come up with).

31. P. 67 (reporting that Levitt, in the December 2000 phone call with Schapiro, insisted that the NASD regulate and threatened, "If you don't do it, we will.").

32. Section 501 of the Sarbanes-Oxley Act of 2002 added § 15D of the Exchange Act, which requires the Commission to promulgate rules designed to address conflicts of interest in securities analysts' reports within one year of the Act's passage. These rules must, among other things, restrict the involvement of investment-banking employees of the broker-dealer in approval of research reports, supervising or compensating analysts, as well as prohibit the broker-dealer from retaliating against an analyst as a result of recommendations. *See* 15 U.S.C. § 15D(a). The Commission is also required to promulgate rules requiring securities analysts to disclose in public appearances and in research reports their own conflicts of interest. *See* § 15D(b).

33. *See* Robert P. Sieland, Note, *Caveat Emptor! After All the Regulatory Hoopla, Securities Analysts Remain Conflicted on Wall Street*, 2003 U. ILL. L. REV. 531 (recognizing that conflicts of interest persist for securities analysts even after the Sarbanes-Oxley Act and proposing that all analysts' reports generated within broker-dealers be labeled "sales literature" to alert investors to these conflicts).

sophisticated investors already knew.[34] In hindsight, the Commission should have directed the same energy that it spent battling broker-dealers over Regulation FD toward an initiative early in Levitt's term to curtail the misleadingly optimistic analysts' reports that Levitt knew all along were a factor in the market's unrealistic valuation of equities in the 1990s (p. 71).

TAKING ON THE LAWYERS

Levitt's book also omits an important issue in the debate over the Sarbanes-Oxley Act of 2002: corporate lawyers who knowingly assist clients with defrauding investors or at a minimum look the other way when clients commit fraud.[35] The last time the Commission sought to define standards of professional responsibility for securities lawyers through disciplinary proceedings was in 1981.[36] The Commission soon thereafter made a point of reassuring lawyers that it would not again seek to impose sanctions on lawyers absent judicial or bar association findings of violations.[37] The Commission under Levitt continued what it had been doing about securities lawyers' ethics since the early 1980s: nothing.

A few commentators urged Levitt's Commission to clarify its stance on lawyer disclosure of corporate fraud, asking for an imposition of an up-the-ladder reporting requirement requiring lawyers to communicate with client boards of directors about securities law violations.[38] The Commission, however, continued to stay away from lawyers. Finally, after the Enron and Worldcom fiascoes, forty law professors wrote Levitt's successor Harvey Pitt in March 2002 seeking

34. Pp. 74-77 (subchapter titled "Everybody Knew — Except You").

35. See Sarbanes-Oxley Act, § 307 and legislative history of § 307 discussed in text accompanying notes 38-41, *infra*.

36. *See In re* William R. Carter, Exchange Act Release No. 34-17597, 22 SEC Docket No. 292 (Feb. 28, 1981), 1981 WL 384414.

37. *See* Edward F. Greene, Lawyer Disciplinary Proceedings Before the Securities and Exchange Commission, Remarks to the New York County Lawyers' Association, January. 18, 1982, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 83,089 (Jan. 18, 1982) (statement by SEC General Counsel Greene that in his view the SEC should not institute proceedings against lawyers under Rule 102(e), absent a prior judicial finding of a securities law violation); Securities Act Release No. 6783, 1988 WL 278442, at 24631 (July 13, 1988) (reaffirming that Rule 102(e) charges should not be brought absent prior determination by a court or bar association that the attorney's conduct was unethical or a violation of securities laws).

38. *See* Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225 (1996) [hereinafter Painter & Duggan, *Corporate Fraud*] (proposing SEC rules, or alternatively an amendment to the Exchange Act, requiring up-the-ladder reporting by issuer's counsel either to the issuer's full board of directors or to a committee of the issuer's board designated by the issuer in advance); *see also* Richard W. Painter, *Rules Lawyers Play By*, 76 N.Y.U. L. REV. 665, 719 (2001).

a Commission rule requiring issuers' lawyers to report unrectified securities law violations to client boards of directors.[39] The Commission responded by acknowledging strong opposition from within the organized bar to Commission regulation of lawyers and by suggesting that Congress could step into this arena if it wanted.[40] Congress took up this invitation in the Sarbanes-Oxley Act of 2002 and mandated that the Commission promulgate professional responsibility rules for lawyers representing issuers before the Commission, including the up-the-ladder reporting requirement.[41] The Commission promulgated its rules in January 2003,[42] but even these rules were watered down from the Commission's November 2002 proposals that had drawn the predictable ire of lawyers subject to those rules.[43]

Although these legislative and rulemaking initiatives began after publication of Levitt's book, lawyers' professional responsibility was an important issue before and during Levitt's tenure at the Commission.[44] The Commission's role in regulating securities lawyers, however, goes unmentioned in his book. The Commission's failure for over two decades to assure the integrity of the lawyers who practice before it was an example of how, even without interference from Congress, the Commission could quickly back down in the face of pressure from an interest group that it had, briefly in the late 1970s, sought to regulate. Indeed, in this instance it was Congress, in the sea change of political opinion after the Enron and Worldcom scandals, that stood up to the ABA and other bar associations and told the Commission that lawyer regulation was required.

As Chairman of the Commission, however, Levitt did address lawyers' ethics in one important area (also not mentioned in his book): "pay to play" arrangements in which municipal bond lawyers or

39. Letter from Richard W. Painter et al., to Harvey Pitt, Chairman, Securities and Exchange Commission (Mar. 7, 2002) (on file with author).

40. Letter from David M. Becker, General Counsel, Securities and Exchange Commission, to Richard W. Painter (Mar. 28, 2002) (on file with author) (citing Painter & Duggan, *Corporate Fraud*, *supra* note 38, for the proposition that Congress rather than the Commission should take the first step toward federal regulation of securities lawyers).

41. *See* Sarbanes-Oxley Act, § 307, 15 U.S.C. § 7245 (2002).

42. *See* 17 C.F.R. §§ 205, 240 and 249, adopted in Release No. 33-8185; 34-47276. For the Commission's proposed Rules, see Release No. 33-8186; 34-47282, *available at* http://www.sec.gov, proposing 17 C.F.R Parts 205, 240 and 249.

43. *See* http://www.sec.gov (containing several dozen comment letters from around the world, mostly from securities lawyers and bar associations, on the Commission's proposed rules under § 307). The Commission in its final rules responded to these comment letters by narrowing many of the definitions in the proposed rules. The Commission, for example, more narrowly defined which lawyers "practice before the Commission" and are thereby covered by the rules, and the definition of what constitutes "evidence of a material violation" sufficient to trigger lawyer reporting obligations.

44. *See* Painter & Duggan, *Corporate Fraud*, *supra* note 38; *In re* William R. Carter, Exchange Act Release No. 34-17597, 22 SEC Docket No. 292 (Feb. 28, 1981), 1981 WL 384414.

plaintiffs' lawyers make campaign contributions to state officials and are then appointed as counsel for state bond underwritings or for state pension funds having the lead plaintiffs' role in securities class action suits.[45] The Commission should perhaps have followed through by discouraging municipal-bond issuers from retaining bond counsel that made campaign contributions, and by filing amicus briefs in class actions asking courts to disqualify counsel who had made campaign contributions to state officials who manage the pension funds serving as lead plaintiff. The ABA, however, fought the SEC on this issue, and, unfortunately, the SEC did not stand its ground.[46] The ABA was allowed to substitute its own rule that is highly subjective and unenforceable.[47]

TAKING ON MANAGEMENT

Accountants, broker-dealers, lawyers, and other gatekeepers could have done more to prevent financial fraud during the 1990s, but managers at issuer corporations were usually the primary culprits. Compensation tied to stock price may have given managers more incentives to commit fraud, and directors may have provided inadequate oversight of managers' activities. Although state corporation law, not federal securities law, governs compensation of managers and governance of corporations, it would be interesting to hear Levitt's view of whether state corporate law failed, and if so, what should be done about it.

One of Levitt's predecessors as Chairman of the Commission, William Cary, believed strongly that state corporate law in the 1960s and 1970s was racing to the bottom from investors' vantage point, and Cary initiated an important academic debate with his proposal for federalization of corporate law.[48] Levitt could have revived this debate by specifically pointing out which areas of corporate law, if any, he

45. *See* Arthur Levitt, Lawyers and Ethics: The Problem of Pay-to-Play, Remarks at the U.S. Securities and Exchange Commission Fixed Income Daily Conference on Municipal Finance (June 26, 1997), *available at* 1997 WL 353221 (S.E.C.); Michael Stanton, *Levitt Says SEC May Act if Lawyers, Issuers Don't Curb Pay to Play*, BOND BUYER, Apr. 18, 1996, at 3.

46. *See generally* Jon B. Jordan, *The Regulation of "Pay-to-Play" and the Influence of Political Contributions in the Municipal Securities Industry*, 1999 COLUM. BUS. L. REV. 489 (describing Levitt's confrontation with the ABA and other bar associations over this issue).

47. *See* MODEL RULES OF PROF'L CONDUCT R. 7.6 (2003) (providing that "[a] lawyer or law firm shall not accept a government legal engagement or an appointment by a judge if the lawyer or law firm makes a political contribution or solicits political contributions for the purpose of obtaining or being considered for that type of legal engagement or appointment").

48. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974). *But see* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (arguing that Delaware corporate law maximizes rather than minimizes shareholder welfare).

believed should be subject to federal regulation. For the most part, Levitt does not engage this topic, even though as his book was going to press, Congress was enacting the Sarbanes-Oxley Act of 2002, the broadest federal encroachment into corporate governance in decades.

One very significant issue is management compensation. Stock options and other compensation packages that tie managers' pay to stock prices gave managers more incentive than they already had to conceal earnings shortfalls and other problems in order to temporarily inflate issuer stock prices. Nonetheless, stock options and manager compensation were for the most part untouched by the Sarbanes-Oxley Act.[49] Levitt points out instances where shareholders object because too many stock options are granted or options are exercisable at ridiculously low prices (pp. 212-13, 218-19), and the Commission is now deliberating over proposals from the stock exchanges that would require shareholder approval of employee stock options.[50] Meanwhile, the Financial Accounting Standards Board is still deliberating over whether issuers should be required to treat stock options as an expense at the time they are granted,[51] an issue about which the Commission did little during Levitt's tenure.[52]

Implicit in these debates is the assumption that issuers should grant their executives stock options in the first place. Perhaps options are desirable because the incentive they give managers to enhance corporate performance outweighs the incentive options give managers to overcompensate themselves and to lie about performance. While this may be true, it is not obvious. Readers would have benefited from hearing Levitt's view on whether options should be used at all, and whether the Commission, the stock exchanges, state corporate law, or issuers themselves should decide when options are to be granted, and how they are to be accounted for.

By contrast, the oversight functions of corporate boards, and particularly audit committees, are extensively regulated in the Sarbanes-Oxley Act.[53] It is here that the Act intrudes most broadly

49. The Act does, however, provide that an issuer's chief executive officer and chief financial officer must forfeit bonuses and profits from trades in securities of the issuer during periods in which the issuer is required to restate its earnings "as a result of misconduct." Sarbanes-Oxley Act § 304, 15 U.S.C. § 7243 (2002).

50. Gretchen Morgenson, *Plan Restricting Stock Options Stalls at S.E.C.*, N.Y. TIMES, Mar. 13, 2003, at A1.

51. *See*, Arden Dale, *Accounting Body to Consider Classification of Stock Options*, WALL ST. J., Mar. 13, 2003, at C9 (reporting that the Financial Accounting Standards Board voted to add to its agenda the issue of whether to require companies to count employee stock options as a compensation expense).

52. *See* pp. 107-11 (discussing Levitt's caving in to pressure from Congress and refusing to back up FASB on its proposed rule that would require issuers to account for options as an expense when granted).

53. *See, e.g.*, Sarbanes-Oxley Act § 301, amending § 10A of the Exchange Act, to add subsection (m) requiring the Commission to direct the national securities exchanges to pro-

into matters traditionally governed under state corporate law, triggering debate over whether this intrusion was really necessary,[54] and if so, whether it went far enough. Levitt discusses corporate audit committees' lack of independence in Chapter Eight of his book, as well as his own partially successful effort as Chairman to persuade the stock exchanges to reform audit committees.[55] Such initiatives, however, pale in comparison to the sweeping regulation in the Sarbanes-Oxley Act, and it would be helpful to know if Levitt believes federal legislation of corporate governance was required, or whether his more conservative approach of working through the stock exchanges ultimately would have been successful.

TAKING ON THE LITIGATION SYSTEM

Although the Commission has long viewed private rights of action as a necessary supplement to its own enforcement powers, Levitt led a lukewarm effort to fight retrenchment of private plaintiffs' rights in two rounds of amendments to the securities laws in 1995 and 1998. Levitt's book barely mentions this important legislation, thus sidestepping a major issue in the debate over investor protection in the 1990s.

Even if Levitt had taken a more aggressive stance against legislative retrenchment of civil litigation, his task would have been made difficult by Congress's hostility to plaintiffs and the poor public image of the plaintiffs' bar. One prominent class action lawyer publicly stated that he "has no clients,"[56] reinforcing defendants' arguments that class action litigation enriched lawyers more than it protected investors. Plaintiffs' lawyers contributed to their political allies, mostly Democrats, but could not match the political contributions of defendants who carefully nurtured relationships in both parties. Plaintiffs'

hibit listing of securities of any issuer that does not meet requirements specified in that subsection (m) concerning membership on directors' audit committees, duties of audit committees, and audit committee procedures for, among other things, receiving anonymous information from employees of the issuer and engaging independent counsel.

54. *See, e.g.*, Larry E. Ribstein, *International Implications of Sarbanes-Oxley: Raising the Rent on U.S. Law*, 3 J. CORP. L. STUD. (forthcoming 2003) (arguing that the Sarbanes-Oxley Act went too far, particularly in its interference with corporate governance norms that traditionally vary depending on the state or country of incorporation); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2003).

55. *See* pp. 204-35 (chapter entitled "Corporate Governance and the Culture of Seduction" discussing shortcomings in corporate governance and more specifically of the SEC's efforts to integrate audit committee reform into stock exchange listing requirements).

56. William P. Barrett, *I Have No Clients*, FORBES, Oct. 11, 1993, at 52 (quoting William S. Lerach (internal quotation marks omitted)).

lawyers thus lost their legislative battles in 1995 and 1998, and the debate continues over whether investors lost as well.[57]

The Private Securities Litigation Reform Act of 1995 ("PSLRA") changed private securities litigation more than any statute since the 1930s. The 1995 Act imposed new procedural hurdles, including heightened pleading standards and a stay on discovery pending resolution of a defendant's motion to dismiss. The 1995 Act also included a "safe harbor" against fraud claims for forward-looking statements, as well as new, pro-defendant formulas for calculating damages. Defendants other than the issuers (such as auditors) in most cases were made only liable for a portion of the shareholders' damages according to a proportionate-liability formula linked to a defendant's share of blame for the violation.[58] The combined effect of all of these provisions was to make it more difficult for plaintiffs to win securities fraud suits and, when plaintiffs do win, to reduce liability. Whatever the merits of this legislation, particularly in cutting back on frivolous suits, it may have reduced the deterrent effect of civil litigation by reducing the expected cost of violating securities laws.

In retrospect, someone needed to speak out on Capitol Hill, not for defendants or for plaintiffs' lawyers, but for investors. Levitt tried to do so,[59] and the Commission micromanaged some important compromises concerning the wording of the 1995 Act.[60] The Commission did not, however, propose a clear alternative agenda that prioritized investors over lawyers and defendants. For example, the

57. Many scholars believed that the 1995 Reform Act made litigation on behalf of plaintiffs too difficult. *See, e.g.*, John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. L. 975, 995 (1996) (the 1995 Reform Act favors defendants "at virtually every juncture."); Joel Seligman, *The Private Securities Reform Act of 1995*, 38 ARIZ. L. REV. 717 (1996); Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711 (1996). Others were concerned that the PSLRA had not gone far enough, and that litigation was merely shifting to state courts. *See, e.g.*, Joseph A. Grundfest & Michael A. Perino, *The Pentium Papers: A Case Study of Collective Institutional Investor Activism in Litigation*, 38 ARIZ. L. REV. 559 (1996).

58. These provisions are incorporated in Securities Act § 27 (Private Securities Litigation) and § 27A (Application of Safe Harbor for Forward Looking Statements), and in Exchange Act, § 21D (Private Securities Litigation) and § 21E (Application of Safe Harbor for Forward Looking Statements).

59. P. 13 ("The vast and growing number of individual investors, however, lacked focus, direction, or leadership to make much of an impression on Washington policy makers. I often wondered how to empower this expanding group . . . .").

60. *See, e.g.*, *Securities Litigation Reform Proposals: Hearings on S. 240, S. 667, and H.R. 1058 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong. 247, 249 (1995) (statement of Arthur Levitt, Chairman, U.S Securities and Exchange Commission) (expressing Levitt's concern that the Senate Bill contained language setting forth a pleading standard that was too high, and that the Act failed to define the standard of recklessness sufficient to sustain an action under § 10(b) of the Exchange Act); *Id.* at 231, 235-36 (stating that Chairman Levitt favored the Second Circuit's pleading standard for scienter). The Commission was also very much involved with Congress's drafting of the Act's safe harbor for forward looking statements.

Commission could have strongly endorsed reforms that curtailed procedural and ethical abuses by plaintiffs' lawyers without curtailing substantive rights of plaintiffs themselves. The F.R.C.P. Rule 11 provisions of the 1995 Act its limitations on excessive counsel fees, its settlement disclosure requirements, and its lead counsel provisions — all should have received strong Commission support at the outset.[61]

Changes to pleading, discovery, and damages formulas, including the Act's proportionate liability scheme, were more problematic in that they directly obstructed plaintiffs' remedies and thus decreased the expected penalty for fraud.[62] Arguably, the proportionate liability scheme encouraged auditors and other collateral participants to worry less about fraud liability, with adverse consequences in Enron and other matters.[63] Also, perhaps the Commission should have insisted that it, not Congress and the various lobbyists influencing Congress, design the safe harbor for forward looking statements. Finally, although the Commission was given some additional enforcement powers in the 1995 Act,[64] the Commission should have insisted on more extensive enforcement powers and a more adequate budget, in return for Commission endorsement of the 1995 Act.

The Commission instead appears to have spent much of its energy reacting to initiatives in Congress. With nobody making a clear case that investor protection is different from lawyer protection, the battle over the 1995 Act was easy to portray as one between plaintiffs' lawyers and defendants,[65] neither of whom could claim the moral high

61. Other provisions of the 1995 Act targeted at abuses by plaintiffs' lawyers include those barring the use of repeat "professional plaintiffs"; barring lawyers from giving financial incentives to lead plaintiffs; prohibiting sealed settlements that conceal attorneys' fees and other information about a settlement; and barring attorneys from receiving a disproportionate share of settlement awards. It can always be argued that measures designed to curb plaintiffs' lawyers ultimately hurt plaintiffs by discouraging lawyers from filing suits. Perhaps at the margins this is true, but regulation of lawyer conduct generally deters the least meritorious suits and encourages lawyers to share a more significant percentage of damage awards with investors. Compared with measures that directly impair plaintiffs' procedural and substantive legal rights, regulation of lawyer conduct should cure abuses in class action litigation at lower cost to investors.

62. *See* Securities Act § 27 and Exchange Act § 21 D (containing these provisions).

63. *See* John C. Coffee, Jr., *Understanding Enron: "Its About the Gatekeepers, Stupid,"* 57 BUS. L. 1403, 1410 (2002) (stating that "the new standard of proportionate liability protected [auditors] far more than it did most corporate defendants" and that "although auditors are still sued today, the settlement value of cases against auditors has gone way down"). On the other hand, Arthur Andersen's fate should send a powerful message to the accounting industry that proportionate liability will not save an auditor from collapse, particularly in cases that involve large investor losses and potential criminal conduct.

64. The most significant of these was the Commission's power to bring actions against aiders and abettors. *See* Exchange Act § 20, added by § 104 of the 1995 Act. The Supreme Court a few years earlier had held that private plaintiffs could not sue aiders and abettors under § 10(b) of the Exchange Act. *See* Cent. Bank of Denver v. First Interstate Bank, 511 U.S. 164 (1994).

65. *See* H.R. CONF. REP. NO. 104-369, at 31 (1995) (stating that before enactment of the 1995 Act, Congress heard testimony concerning various abuses by the plaintiff's bar).

ground. Even the President's veto message, which emphasized his objections to the Act's mandatory Rule 11 provisions,[66] showed where his loyalties lay, giving the Act's proponents yet another argument for an override.[67] Little was done to compensate for the potential decrease in private enforcement by broadening Commission powers, and nothing was done to adequately fund the Commission's enforcement budget.

In 1998, plaintiffs lost another battle, this time over preemption of class actions for securities fraud under state law. Congress had specifically preserved state private rights of action when it enacted the Exchange Act in 1934.[68] Moreover, Congress did not create express private rights of action for securities fraud that it might have created had it chosen instead to preempt state law. Federal courts subsequently implied a private right of action under section 10(b) of the Exchange Act, but the Supreme Court has been hostile to it.[69] The one check on excessively pro-defendant federal case law under section 10(b), or on further statutory restrictions on plaintiffs similar to those in the 1995 Act, was availability of class actions in state courts under state law.

Defendants argued, however, that plaintiffs' lawyers were using state litigation as an end-run around the 1995 Act.[70] Among other abuses, state litigation was purportedly being used to obtain discovery that was stayed pending resolution of a defendants' motion to dismiss

66. *See* Private Securities Litigation Reform Act of 1995 — Veto Message from the President of the United States, H.R. DOC. NO. 104-150 (1995) (stating that "Specifically, I object to the following elements of this bill... Third, restore the Rule 11 language to that of the Senate bill."), *reprinted in* 141 CONG. REC. H15,214-06 (1995). FRCP Rule 11, among other things, allows sanctions against lawyers for frivolous pleadings. The 1995 Act makes these sanctions mandatory in securities cases. *See* Securities Act § 27 and Exchange Act § 21D.

67. On December 20, 1995, the House voted to override the veto by a vote of 319-100, and on December 22 the Senate voted to override the veto by a vote of 68-30. 141 CONG. REC. H15,223 (1995); 141 CONG. REC. S19180 (1995).

68. *See* § 16 of the Securities Act, 15 U.S.C. § 77p (1996) ("The rights and remedies provided by this Act shall be in addition to any and all other rights and remedies that may exist at law or in equity."); § 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a) (1996) ("The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity.").

69. *See, e.g.*, Marine Bank v. Weaver, 455 U.S. 551, 556 (1982) ("[W]e are satisfied that Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud."); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738, n.9 (1975) (stating that the Court's seemingly arbitrary restriction on lawsuits under § 10(b) of the Exchange Act by plaintiffs who did not buy or sell the securities in question is "attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law").

70. *See* Grundfest & Perino, *supra* note 57; Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 302-14 (1998) (reciting statistics showing an increase in state court filings after the PSLRA); *see also* 144 CONG. REC. S4781 (daily ed. May 13, 1998) (floor debate on S. 1260) (statement of Sen. Alfonse D'Amato) ("The problem to which I refer is a loophole that strike lawyers have found in the 1995 [Reform Act] . . . .").

under the 1995 Act.[71] Congress could have enacted legislation narrowly targeting actual abuses (for example, allowing a federal court to stay discovery in state proceedings), but instead used the sledge hammer of preemption, forcing almost all class actions involving misrepresentation in connection with the purchase or sale of nationally traded securities into federal court.[72] It did not matter that there were only thirty-nine state class action suits in 1997,[73] and that three-quarters of these were brought by California investors in California courts against California defendants (many in the Silicon Valley).[74] It did not matter that this "problem," if there was one, may have been more appropriately resolved in Sacramento than in Washington, and that many of the politicians supporting preemption were generally states' rights advocates. What mattered was that Silicon Valley wanted this legislation and wanted it badly.[75] While plaintiffs' lawyers put up a fight, they were not fighting for something that was particularly important to them, because there was so little state-court litigation to begin with. The bill quickly won broad bipartisan support in Congress,[76] and this time the signature of the President.

Once again, the Commission put up a half-hearted fight to preserve private rights of action.[77] Levitt (who does not mention this controversy in his book) was up for reconfirmation at the time, putting him in a difficult position. Congressional opponents of preemption also were perceived to be in the pocket of plaintiffs' lawyers, strengthening arguments that reform was needed because lawyers were profiting at the expense of issuers and investors.

71. *See* Grundfest & Perino, *supra* note 57, at 337 (discussing studies showing that state court actions were filed primarily to evade the 1995 Act's stay of discovery and its higher pleading standards).

72. *See* Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (amending 15 U.S.C. §§ 77p, 78bb).

73. *See* Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 102 (1998) [hereinafter Painter, *Responding to a False Alarm*] (citing statistics prepared by Price Waterhouse).

74. *See id.* at 36 n.183 (citing Commission staff report that reviewed fifty-five complaints filed in securities class actions under state law since passage of the 1995 Act and found that forty-three of these cases (78%) had been filed in California).

75. *See id.* at 5 (discussing political contributions and lobbying power of Silicon Valley issuers and venture capitalists).

76. *See* H.R. 1689, 105th Cong. (1998); S. 1260, 105th Cong. (1998). The Senate passed S. 1260 by a vote of 79 to 21 on May 13, 1998, and the House passed H.R. 1689, as amended to conform to S. 1260, by a vote of 340 to 83 on July 22, 1998. *See* 144 CONG. REC. H6119-20 (daily ed. July 22, 1998).

77. *See* Painter, *Responding to a False Alarm*, *supra* note 73, at 53-54 (describing initial Commission opposition to the Uniform Standards Act followed by endorsement of the Act in return for minor adjustments to the Act and Senate floor discussion intended to create retroactive legislative history clarifying the 1995 Act's treatment of the scienter standard for suits under § 10(b) of the Exchange Act).

Ironically, the 1995 and 1998 Acts have not harmed the plaintiffs' lawyers who led the fight against them. The market share of the most prominent plaintiffs' firm increased substantially after 1995, probably because the new legal rules raised barriers to entry into securities plaintiffs' litigation.[78] Securities fraud suits have also been filed in record numbers after the 1995 Act.[79] Lawyers thus still thrive in the securities class action litigation system. It is more debatable, however, whether civil litigation remains as powerful a deterrent to fraud as it once was.

TAKING ON CONGRESS

The most consequential "pay to play" game in the 1990s was that of the special interests frustrating Levitt's regulatory agenda. Campaign contributions by all sides — accountants, high-technology firms, the financial services industry and the plaintiffs' bar — meant that the Commission, if it sought to infringe on special interests, always had to fear that it would be overruled by Congress.

The most powerful theme in Levitt's book is his struggle with a political system that gave regulated industries extraordinary influence in Congress. The Commission's independence was undermined by its constant need to go to Congress for funding, the threat of Congress preempting the Commission's rulemaking function, and Levitt's own quest for a second term, which required Senate confirmation. The Commission was hardly an "independent" agency, immune from pressure from either political branch of government.

The White House could have been a useful counterweight to the Congressional pressure described by Levitt, but it usually was not. The President did at least once tell Levitt's congressional critics to back off,[80] but with little effect. Before Enron, Worldcom, and similar scandals broke in 2002, the relatively few battles that "pro-investor" politicians waged were over class action litigation, which concerned the interests of plaintiffs' lawyers as much as investors themselves. This hypocrisy was not lost on defendant groups who alleged that anyone who stood in their way was in the pocket of plaintiffs' lawyers.

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78. DONNA NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS 434 (2003) (citing statistical evidence showing that a single law firm, Milberg Weiss, increased its share of securities class actions filed from 31% before the 1995 Act to 59% after the Act).

79. *Id.* at 428-29 (citing statistics from Stanford/Cornerstone Research showing 188 securities class actions filed in federal court in 1995, 109 in 1996, 174 in 1997, 233 in 1998, and then 259 in 2002).

80. *See* p. 306 (reprinting a September 29, 2000 letter from Senator Tom Daschle to the President objecting to legislative initiatives to curb SEC oversight of the accounting industry). "The White House later issued a statement saying that it strongly opposed Congressional interference with the SEC's rulemaking." P. 306.

Direct public appeal to investor protection as a goal in itself was not a political priority.

For Levitt to point out the degree that the political process had been corrupted might have cost him his reappointment in 1998, and he did not do so (even Levitt's book lacks an Appendix B listing the campaign contributions that accounting firms made to the authors of the letters included in Appendix A). On the other hand, a vigorous challenge to the role of campaign contributions in shaping securities laws might have forced Levitt's critics in Congress to back down. They might have retreated if Levitt had publicly explained why he believed they were behaving the way they were.

Reform of the campaign-finance system, to the extent constitutionally permitted,[81] is one remedy for the regulatory capture strategies that frustrated Levitt. Other less controversial measures, however, could also guard the Commission from capture through Congressional interference. First, the Commission's budget should be fixed over a long period of time (with periodic increases tied to inflation and the level of enforcement activity). Commission staff members' pay thus would not depend upon the whim of legislators who may be displeased at enforcement or rulemaking decisions.[82] Second, the Chairman should perhaps be limited to a single, but longer, term to prevent reconfirmation from being implicitly conditioned on appeasement of special interests in Congress. Finally, the Commission should make public (perhaps on its web-site) all communications it receives from Members of Congress or their staff concerning rule making and enforcement activities. If the letters published in Appendix A to Levitt's book had been available to newspapers at the time they were written, such disclosure might have facilitated Levitt's case against congressional interference.

CONCLUSION

Levitt's book omits some important issues. It virtually ignores the debate over Congress's weakening of civil litigation as a deterrent for securities fraud in the 1990s. It also does not refute the possibility that the Commission spent political capital on some issues, such as Regulation FD, that were tangential to the core problems in the 1990s: misinformation, investor overoptimism, and overvaluation in the stock market.[83] Levitt also owes his readers a better explanation of why important gatekeepers, such as analysts and lawyers, were not pursued

81. *See* McConnell v. Fed. Election Comm'n, 123 S. Ct. 2071 (2003).

82. Federal judges for example, are constitutionally protected with lifetime tenure and no reduction in salary. Commissioners and their staff, by contrast, have relatively little protection and commensurately less independence from Congress.

83. *See generally* ROBERT SHILLER, IRRATIONAL EXUBERANCE (2000).

by the Commission with the same vigor that was devoted, with mixed results, to accountants.

Levitt's practical advice for investors is helpful. He does not, however, adequately explain why small investors should invest in individual stocks at all, rather than in diversified funds whose managers can overcome at least some disadvantages the market imposes on unsophisticated investors.[84] Even if all of Levitt's recommendations for reform were implemented and all investors followed his advice, leveling the playing field between individual investors and sophisticated market participants may still be a losing proposition. To the extent this book encourages individual investors to engage in stock picking, in effect to try to outguess the market, Levitt's advice may not be sound.[85]

Nonetheless, this book is an exceptionally interesting account of Levitt's fight against special interests that sought to derail his agenda as Chairman of the Commission. Levitt tells investors how severe their collective-action problems are in a political system in which everybody else can coordinate. He powerfully indicts a political system in which he stood virtually alone as a voice for the investing public. Voters, as well as investors, would profit from listening to what he has to say.

84. Levitt does, however, discuss the perils of investing in poorly managed mutual funds, or funds with excessive or undisclosed fees. *See* pp. 41-64 (Chapter Two, "The Seven Deadly Sins of Mutual Funds"). Nonetheless, he did not foresee the seriousness of the conduct — illegal late trading and market timing transactions that while legal should be disclosed — that would scandalize the mutual fund industry in 2003. *See* Stephen Labaton, *S.E.C.'s Oversight of Mutual Funds Is Said to Be Lax*, N.Y. TIMES, Nov. 16, 2003, at A1. ("I believe this is the worst scandal we've seen in 50 years, and I can't say I saw it coming" (quoting Arthur Levitt (internal quotation marks omitted))).

85. One study examined 110,000 individual accounts at a national discount brokerage firm and found that between 1990 and 1996, 20% of investors who bought at least 25 stocks demonstrated stock picking ability by choosing stocks that on average performed significantly better than market averages (adjusted for the risk level in the investment). These investors picked stocks that on average gained 44% per year compared with 14.5% for the Wilshire 5000 index. Seventy percent of the investors, however, did worse than the market averages when transaction costs were included. *See* JOSHUA D. COVAL ET AL., CAN INDIVIDUAL INVESTORS BEAT THE MARKET? (Harvard Business School, Negotiation, Organizations, and Markets Unit, Working Paper 02-45, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=364000.