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FRAUD IN A LAND OF PLENTY

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ABSTRACT—This Essay discusses the regulation of fraud in a developed economy and offers some explanations for why fraud appears to be on the increase. Ironically, regulation designed to combat fraud can actually increase fraud by attracting economic activity to fraud-ridden industries. In other words, regulation can create problems of its own by fostering the false perception that fraud is being addressed even when it is not. This analysis is relevant in the context of the current surge in sentiment to regulate cryptocurrencies in the wake of the FTX and Sam Bankman-Fried debacle. Such regulation threatens to attract more resources to cryptocurrency trading, which is a dubious proposition in light of the fact that cryptocurrencies produce little social value and merely transfer wealth rather than create it.

The Essay discusses some of the reasons why fraud may be on the increase. First, strong market forces aimed at reducing managerial agency costs have had the unintended consequence of increasing the incentives of top corporate managers to commit fraud. The market forces both richly reward managers for generating strong returns for shareholders and severely punish managers for failing to reach investors' expectations regarding corporate performance. While these rich rewards and strong punishments serve the interests of shareholders and society, they also enhance executives' incentives to commit fraud.

Another factor in the increase in fraud in financial markets has been the expansion of the concept of fraud. Historically, the term fraud was used to describe conduct that was truly egregious and involved purposeful deceit designed to provide the perpetrator with unlawful gains. As shown here, however, in the financial context the concept of fraud has been expanded to include behavior that is entirely inadvertent and benign. The expansion of the concept of fraud threatens to increase the incidence of traditional fraud by depriving the term "fraud" of its historic capacity for shaming because the prospect of being shamed is a significant deterrent to committing fraud.

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INTRODUCTION

Fraud is on the rise. A recent survey of 1,296 executives in fifty-three countries revealed a rising threat of fraud. An astonishing 46% of surveyed organizations reported experiencing fraud or related economic crimes over the past twenty-four months.[1] Reports of consumer fraud increased by 70% in 2021 alone relative to 2020, according to the Federal Trade Commission.[2] Virtually everyone who uses the internet regularly faces actual or attempted fraud, and 83% of organizations report phishing attacks.[3] In fact, one in ninety-nine emails is a phishing attack, with a majority of companies losing data and 52% experiencing credential compromise.[4] Nevertheless, the incredible rate of online fraud does not appear to be stifling the growth of e-commerce. In 2021, e-commerce sales in the United States reached $870 billion, representing a 14.2% increase over 2020 sales and a 50.5% increase over 2019 sales.[5]

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[1] PWC, PWC'S GLOBAL ECONOMIC CRIME AND FRAUD SURVEY 2022: PROTECTING THE PERIMETER: THE RISE OF EXTERNAL FRAUD 3 (2022), https://www.pwc.com/gx/en/services/forensics/economic-crime-survey.html [https://perma.cc/K4QJ-PCDU].

[2] Press Release, FTC, New Data Shows FTC Received 2.8 Million Fraud Reports from Consumers in 2021 (Feb. 22, 2022), https://www.ftc.gov/news-events/news/press-releases/2022/02/new-data-shows-ftc-received-28-million-fraud-reports-consumers-2021-0 [https://perma.cc/MBS6-4FMD] ("Reported fraud losses increase more than 70 percent over 2020 to more than $5.8 billion.").

[3] *Top 15 Phishing Attack Statistics (and They Might Scare You)*, CYBERTALK (Mar. 30, 2022), https://www.cybertalk.org/2022/03/30/top-15-phishing-attack-statistics-and-they-might-scare-you/#:~:text=In%202021%2C%2083%25%20of%20organizations,s%20doubled%20since%20early%202020 [https://perma.cc/KWH2-GKDT].

[4] *Id.*

[5] Jason Goldberg, *E-Commerce Sales Grew 50% to $870 Billion During the Pandemic*, FORBES (Feb. 18, 2022, 4:57 PM), https://www.forbes.com/sites/jasongoldberg/2022/02/18/e-commerce-sales-grew-50-to-870-billion-during-the-pandemic/?sh=682680c24e83 [https://perma.cc/G9RQ-GPZ3].

One would think that societies that experience very high levels of fraud would also suffer from low rates of growth. Fraud is socially destructive and welfare reducing. Avoiding fraud requires the costly allocation of real assets that could be put to more economically productive uses. Moreover, fraud not only harms its immediate victim; it also generates negative externalities by reducing people's incentives to engage in welfare-enhancing interactions with one another. As such, the specter of fraud can fundamentally harm society by eroding social trust and diminishing people's willingness to interact with one another in mutually beneficial social and economic activities. Interestingly, it does not appear to be the case that societies which experience high levels of fraud suffer from low levels of interpersonal interactions. In fact, the opposite seems to be true: wealthy societies thrive despite what appears to be widespread, even ubiquitous fraud.

In this Essay, I posit that trust, the same critical ingredient that fuels economic growth, also fuels fraud. Because trust is a critical component of both economic growth and fraud, we should view fraud as an unwelcome, but inevitable, feature of a successful economy. Consistent with this observation, fraud seems to be on the rise even as the economy is flourishing and markets are growing. Similarly, I observe that economies with very little trust will have very little fraud while economies that have significant amounts of trust will likewise have significant amounts of fraud. The reason for this is simple: people are unwilling to engage in economic activity with people they do not trust.

In societies with low levels of trust, people will be reluctant to engage with strangers. Economic interaction will be stunted and relegated to small social circles, such as kinship groups where people can trust each other. Confining trade in this way will limit the amount of fraud one observes, but at great cost. As trust increases, and people are more willing to interact with strangers, opportunities for fraud also increase. Moreover, as economies become more robust, as measured by increases in gains from trade and the rise of more effective systems of market discipline, fraud will increase.[6]

Widespread trust among market participants creates opportunities for fraud. This observation has important implications for how we view regulation. Market participants will be more willing to enter into business transactions with strangers when they believe that regulation is effective at preventing fraud. Unfortunately, regulators are motivated by self-interest to exaggerate the extent to which regulation is successful in reducing the incidence of fraud. To the extent that regulators and politicians lead market

[6] *See* Paul Povel, Rajdeep Singh & Andrew Winton, *Booms, Busts, and Fraud*, 20 REV. FIN. STUD. 1219, 1219–20 (2007).

participants to erroneously believe that regulation is successful in eliminating fraud, these market participants will decline to take steps on their own to limit their exposure to fraud. This, in turn, will lead to an increase in fraud. Thus, one insight of this Essay is that, ironically, any increase in regulation to prevent fraud will actually lead to an increase in the incidence of fraud to the extent that the new regulation creates the misconception that it has reduced the probability of fraud more than it actually has. This suggests that regulators should be required to accurately disclose to market participants the dangers of ongoing fraud and the shortcomings of regulation.

This Essay also explores the relationship between market discipline and regulation. For decades, powerful market forces successfully have worked to align the interests of corporate managers with the interests of shareholders. This Essay investigates how these market forces, which have created significant wealth, have also created high-powered incentives to create fraud. In short, the very market forces that align the interests of corporate managers and shareholders incentivize managers to commit fraud. The market forces that successfully discipline managers impose incentives on managers that feature both carrots and sticks. The carrots come in the form of high-powered executive compensation packages that reward executives for success at extraordinary levels. Executive compensation is highly correlated with firm performance, and executives at the helm of companies whose share prices perform receive incredibly rich payouts. The sticks come in the form of tenuous job security. I have no doubt that the benefits to shareholders from these incentives outweigh the costs. My point is simply that one of the costs of the current system of high-powered, incentive-based compensation is that it increases the incentives of executives to commit fraud. This is because executive compensation is closely tied to share price performance and share prices are subject to fraudulent manipulation by insiders.

Market forces not only reward high-performing managers but also punish (or "discipline" to use the vernacular popular in the corporate governance literature) poorly performing managers. Unfortunately, it appears that, as the probability of being disciplined for poor performance increases, so too do the incentives to commit fraud in order to avoid such market discipline. To the extent that U.S. capital markets have become more effective at disciplining managers for poor performance, we should expect the incidence of fraud to increase.

Fraud will occur where the benefits of committing fraud outweigh the costs. The costs of committing fraud are a function of factors including the

probability of detection and the severity of the punishment.[7] But the risks and results of criminal and civil sanctions are not the only deterrents to fraud. Reputational damage and social stigma are additional costs borne by fraudsters that serve to deter fraud.[8] From this perspective, while expanding the definition of fraud may have benefits, it can also have significant costs.

This Essay posits that increased fraud is occurring due to (1) increased opportunity to commit fraud, (2) increased benefits of committing fraud, (3) increased costs of refraining from fraud, and (4) decreased costs of committing fraud. Part I of this Essay contains some general observations about fraud in a market economy and the relationship between fraud and trust. It explains why fraud may increase as the economy is expanding, and why regulation may increase, rather than decrease, fraud, particularly where estimates about capacity of regulation to actually deter and reduce fraud are overly optimistic. In particular, this Part focuses on the relationship between regulation as it affects levels of trust and fraud in capital markets. In Part II, I discuss the relationship between market forces and fraud—by rewarding the appearance of success, markets also encourage achieving that appearance by any means, including fraud. Finally, in Part III, I discuss problems associated with expanding the definition of fraud beyond its common law definition. I will argue that the definition of fraud in securities law has been expanded almost beyond recognition in recent years. This expansion threatens to lead to an increase in more serious forms of fraud to the extent that the term "fraud" no longer carries the same deterrent stigma that it historically has carried.

I. FRAUD AND PERCEPTIONS

In this Part, I will discuss how market participants' perceptions of the efficacy of fraud regulation, and in turn market participants' trust, can lead to increased incidence of fraud. Widespread trust among market participants creates opportunities for fraud. This observation has important implications for how we view regulation. Market participants will be more willing to enter into business transactions with strangers when they believe that regulation is effective in preventing fraud. Unfortunately, regulators are motivated for reasons of self-interest to exaggerate the extent to which regulation is successful in reducing the incidence of fraud. To the extent that regulators and politicians lead market participants erroneously to believe that regulation

7 Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 176–77 (1968).

8 Jonathan M. Karpoff & John R. Lott Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J.L. & ECON. 757, 796–97 (1993); Eric Rasmusen, *Stigma and Self-Fulfilling Expectations of Criminality*, 39 J.L. & ECON. 519, 520–21 (1996).

is successful in eliminating fraud, these market participants will decline to take steps on their own to limit their exposure to fraud. This, in turn, will lead to an increase in fraud. Thus, ironically, any increase in regulation to prevent fraud will actually lead to an increase in the incidence of fraud to the extent that the new regulation creates the misperception that it has reduced the probability of fraud more than it actually has. This suggests that regulators should be required to accurately disclose to market participants the dangers of ongoing fraud, and the shortcomings of regulation.

Regulators and others favoring increased regulation point to prominent examples of fraud in order to justify increased regulation. For example, immediately "[a]fter the crypto exchange FTX filed for bankruptcy . . . Securities and Exchange Commission Chair Gary Gensler announced that he [would] crack down on the 'wild west' of crypto markets."[9] Similarly, elected officials such as Debbie Stabenow, Senate Agriculture Committee Chair, called for "greater federal oversight" of the crypto industry, proclaiming that "it is time for Congress to act" to prevent customer harm to users of cryptocurrency.[10] Massachusetts Senator and one-time presidential hopeful Elizabeth Warren pronounced that the fallout from the collapse of cryptocurrency exchange FTX shows an acute need for rigorous regulation to protect consumers.[11] Of course, increased regulation to ward off fraud is only defensible if such regulation actually succeeds in reducing the incidence of fraud.

Because fraud is difficult to detect, it is impossible to know how much fraud is being committed at any point in time. For the same reason, it also is difficult to measure how successful regulators are in detecting and preventing fraud. A particular problem is that regulators have incentives to overstate the extent to which they are successful in ferreting out and eliminating fraud. Another related problem is that the regulators are not

[9] Hal Scott & John Gulliver, *An SEC Rule May Cost FTX Crypto Customers Billions*, WALL ST. J. (Nov. 14, 2022, 5:46 PM), https://www.wsj.com/articles/an-sec-rule-may-cost-ftx-customers-billions-trading-exchange-crypto-assets-broker-dealers-investors-markets-11668455906 [https://perma.cc/4QT4-LNQE]; *see also* James Field, *SEC Chair Gary Gensler Reiterates Call for Digital Asset Registration in the Wake of FTX Collapse*, COINGEEK (Nov. 10, 2022), https://coingeek.com/sec-chair-gary-gensler-reiterates-call-for-digital-asset-registration-in-the-wake-of-ftx-collapse/ [https://perma.cc/V2U6-HW8E] ("Gensler has re-emphasised the need for digital asset platforms to bring themselves within the protective umbrella of SEC regulation as the FTX collapse continues.").

[10] Mehab Qureshi, *Sam Bankman-Fried Backed Bill to Regulate Digital Assets Finds Support from Several Senators in Wake of FTX Collapse*, BENZINGA CRYPTO (Nov. 11, 2022, 3:28 AM), https://www.benzinga.com/markets/cryptocurrency/22/11/29676699/sam-bankman-fried-backed-bill-to-regulate-digital-assets-finds-support-from-several-senato [https://perma.cc/ZDP2-XUBH].

[11] Mehab Qureshi, *Elizabeth Warren Calls for 'Aggressive Enforcement' Against 'Smoke and Mirrors' Crypto Industry After FTX Fiasco*, BENZINGA CRYPTO (Nov. 9, 2022, 11:18 PM), https://www.benzinga.com/markets/cryptocurrency/22/11/29650797/elizabeth-warren-calls-for-aggressive-enforcement-against-smoke-and-mirrors-crypto-industr [https://perma.cc/NNZ9-3ENJ].

subject to market forces, and the methods used for evaluating regulators' performance appear to be highly ineffective. Both mechanisms can lead to increased fraud due to undeserved market-participant trust in regulation. I will discuss each of these phenomena in turn.

A. The Role of Regulation in Setting the Expectations of Market Participants

Regulation and market-participant perception of regulation may be relevant to the prevalence of fraud in at least three ways. First, regulators have an incentive to exaggerate the efficacy of regulation due to self-interest. Second, regulation sometimes shifts risks from fraud rather than addressing fraud which can lead to a perception that fraud is effectively regulated. Third, regulation can legitimize industries that suffer from widespread fraud. Each of these can increase market-participant trust and in turn increase opportunity for fraud.

The Enforcement Division of the Securities and Exchange Commission (SEC) is the branch of the agency tasked with fighting fraud. The SEC touts the "Enforcement staff's skill in uncovering violations, its resourcefulness in deploying the right investigative tools and case strategy, and, above all, its doggedness in pursuing wrongdoers and obtaining remedies that promote market integrity while helping to protect investors."[12] The SEC's laudatory self-evaluation of its own performance suggests that its enforcement efforts "ensure accountability from senior executives at public companies and incentivize them to prevent misconduct at their firms."[13]

Significantly, the SEC appears to ignore its failures while touting its successes in deterring fraud. For example, days after the collapse of the FTX cryptocurrency exchange,[14] the SEC touted its focus on crypto, emphasizing that it had initiated "significant enforcement actions" against companies operating in this space.[15] The SEC's enforcement effort particularly focused on ensuring that major firms complied with their "core obligations including record-keeping and safeguarding customer information."[16] In May 2022, the SEC announced "the allocation of 20 additional positions to the unit

[12] Press Release, SEC, SEC Announces Enforcement Results for FY22 (Nov. 15, 2022), https://www.sec.gov/news/press-release/2022-206?utm_medium=email&utm_source=govdelivery [https://perma.cc/KV4B-V9GG].

[13] *Id.*

[14] *See* Alex Hern & Dan Milmo, *What Do We Know So Far About Collapse of Crypto Exchange FTX?*, GUARDIAN (Nov. 18, 2022, 1:33 PM), https://www.theguardian.com/technology/2022/nov/18/how-did-crypto-firm-ftx-collapse [https://perma.cc/P2Y4-BV73].

[15] Press Release, SEC, *supra* note 12.

[16] *Id.*

responsible for protecting investors in crypto markets."[17] The announcement of this expansion noted that "[t]he U.S. has the greatest capital markets because investors have faith in them, and as more investors access the crypto markets, it is increasingly important to dedicate more resources to protecting them."[18] Ironically, the SEC's announcement emphasized its allegedly successful efforts to monitor rules violations related to crypto asset exchanges, such as FTX.[19]

The point here is not to criticize either securities regulation in general or the SEC's performance in particular. Rather, the point is that there is a risk associated with the SEC's self-congratulatory rhetoric. The risk is that people will come to believe that the SEC is actually highly successful in combatting fraud. To the extent that market participants believe that SEC regulatory efforts are successful in eradicating fraud, they will eschew employing alternative mechanisms for protecting themselves. This means that increased regulation, when accompanied by self-congratulatory rhetoric from regulators, can lead to an increase in fraud if it causes an excess of trust among market participants.

The relationship between regulation and reputation also is relevant in this context. Regulation and reputation are substitutes: to the extent that market participants think that regulation is successful, then the reputation of their counterparties becomes less important to them than it otherwise would be. This, in turn, reduces the returns to firms from investing in developing a reputation for honesty and integrity.

Regulation benefits market participants by promoting public confidence in markets and encouraging broader participation in markets that they otherwise avoid due to concerns about fraud. Thus, anti-fraud regulation can actually *increase* fraud to the extent that it is ineffective but increases market-participant trust in the regulatory system. Regulation increases fraud by encouraging participation in fraud-prone markets by investors who are unable to fend for themselves and who would avoid entering such markets without the trust generated by the visible and, to them, seemingly effective regulation.

Regulation can increase the risk of fraud by shifting risks from sophisticated and capable market participants onto less sophisticated and less capable market participants. This appears to have occurred in the FTX collapse. A significant factor in the FTX collapse appears to have been the use of customer funds to prop up another company, Alameda Research, that

[17] Press Release, SEC, SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit (May 3, 2022), https://www.sec.gov/news/press-release/2022-78 [https://perma.cc/U8JL-NDVB].

[18] *Id.*

[19] *Id.*

also was controlled by Sam Bankman-Fried. Apparently, FTX loaned customer funds to Alameda, and Alameda was unable to repay the loans when it incurred significant losses in its trading operations.[20] As Professors Hal Scott and John Gulliver pointed out in an excellent analysis, these losses could have been avoided if these customer funds had been held in custodial accounts by regulated banks and broker-dealer firms, rather than by an unregulated crypto exchange such as FTX.[21]

Although typically banks and broker-dealers do act as custodians for investors in securities, a new SEC rule disincentivized them from doing so in the crypto market. As Professors Scott and Gulliver point out, in March 2022, the SEC issued a Staff Accounting Bulletin[22] that "required banks and their affiliated broker-dealers that custody crypto assets to include custodied assets on their balance sheets," which they were not previously required to do.[23] Including crypto assets on their balance sheets was costly because it subjected these financial institutions to higher capital and liquidity requirements.[24] As Scott and Gulliver observed, the SEC rule created "a big problem because the largest and most sophisticated custodians in the world are all banks or broker-dealers affiliated with banks. The new SEC accounting rule prevents firms such as State Street and BNY Mellon, which custody trillions in financial assets, from custodying crypto assets."[25]

Interestingly, the SEC implemented this rule because it viewed crypto assets as presenting "unique risks and uncertainties not present in arrangements to safeguard assets that are not crypto-assets, including technological, legal, and regulatory risks and uncertainties."[26] The key point is that the SEC regulation in no way reduced the risks associated with holding crypto. Rather, the SEC rule appears simply to have shifted the risk from sophisticated custodians like State Street and BNY Mellon onto FTX's customers, whose crypto assets were held by FTX rather than by a

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[20] Alexander Osipovich, Caitlin Ostroff, Patricia Kowsmann, Angel Au-Yeung & Matt Grossman, *They Lived Together, Worked Together and Lost Billions Together: Inside Sam Bankman-Fried's Doomed FTX Empire*, WALL ST. J. (Nov. 19, 2022, 11:00 AM), https://www.wsj.com/articles/sam-bankman-fried-ftx-alameda-bankruptcy-collapse-11668824201 [https://perma.cc/V748-XSJT]; Paige Tortorelli & Kate Rooney, *Sam Bankman-Fried's Alameda Quietly Used FTX Customer Funds for Trading, Say Sources*, CNBC (Nov. 13, 2022, 6:11 PM), https://www.cnbc.com/2022/11/13/sam-bankman-frieds-alameda-quietly-used-ftx-customer-funds-without-raising-alarm-bells-say-sources.html [https://perma.cc/EYD5-D3KB].

[21] Scott & Gulliver, *supra* note 9.

[22] *See* SEC Staff Accounting Bulletin No. 121, 17 C.F.R. pt. 211 (Mar. 31, 2022), https://www.sec.gov/oca/staff-accounting-bulletin-121 [https://perma.cc/W7L6-45HW].

[23] Scott & Gulliver, *supra* note 9.

[24] *Id.*

[25] *Id.*

[26] SEC Staff Accounting Bulletin No. 121, *supra* note 22.

sophisticated financial institution. In other words, the SEC's regulations failed to eliminate, and possibly even exacerbated, the risks associated with holding crypto.

The general point that emerges from this discussion is that the very regulation intended to reduce the incidence of fraud sometimes can have the unintended effect of increasing fraud. This happens in at least two contexts. First, regulation can increase fraud when unsophisticated market participants overestimate the efficacy of regulation. Such a miscalculation can lead to a sort of regulation-induced complacency. When this occurs, such unsophisticated market participants will engage in market transactions that they would otherwise avoid. Because they have overestimated the efficacy of regulation, they are exposed to fraudsters.

Second, as we saw in the case of the regulation of the provision of custodial services for crypto assets by financial institutions, regulation sometimes does not actually reduce risk. Rather, regulation sometimes simply shifts risk from one set of market participants to another. Sometimes, as in the case of FDIC insurance, such regulation can be justified on the grounds that the regulation shifts risk from unsophisticated market participants (depositors) to another participant (the FDIC) that is better able to bear the risks. Other times, such as in the case of the SEC's regulation of the custody of crypto assets, regulation shifts risk from sophisticated market participants like financial institutions onto the shoulders of less sophisticated market participants (FTX's customers). The point here is not that regulation is bad, or even ill-advised. Rather the point is that regulation can induce a false sense of security because it is oversold to the public or otherwise misperceived by market participants. If market participants erroneously believe that financial regulation will be more effective than it actually is, then such regulation likely will lure unwitting new entrants into a marketplace where fraud occurs with greater frequency than is generally perceived. This, in turn, will increase the incidence of fraud.

Overconfidence in the efficacy of regulation on the part of market participants also inevitably will have the effect of reducing the incentives of market participants to engage in self-help by taking steps on their own to protect themselves from fraud. Thus, it is far from surprising that sketchy market participants will be strong proponents of regulation. This appears to have occurred in the case of FTX, as the now-defunct exchange claimed to be the "most regulated" crypto exchange.[27] FTX also was well known for

[27] Chris Prentice, Angus Berwick & Hannah Lang, *How FTX Bought Its Way to Become the 'Most Regulated' Crypto Exchange*, REUTERS (Nov. 18, 2022, 11:21 AM), https://www.reuters.com/technology/exclusive-how-ftx-bought-its-way-become-most-regulated-crypto-exchange-2022-11-18/ [https://perma.cc/J6RU-J3CL].

inviting closer scrutiny from authorities.[28] FTX actually appeared to have invited regulatory scrutiny by pursuing a strategy of acquiring stakes in companies that already had licenses from authorities.[29] FTX referred to this practice as "acquisitions for regulatory purposes."[30]

In this context, it is noteworthy that FTX and its disgraced CEO Sam Bankman-Fried were among the more pro-regulatory voices in the world of cryptocurrency.[31] FTX saw its "regulatory status as a way of luring new capital from major investors."[32] In fact, after the collapse of FTX, Bankman-Fried acknowledged that his prior statements supporting regulation were "just PR" and that regulators "make everything worse . . . they don't protect customers at all."[33] The support of market players for regulation makes perfect sense.

The takeaway here is not that capital markets should be unregulated. Rather, preliminary takeaways are that regulation should not be oversold and that regulators and others who influence policy should temper the public's expectations about the efficacy of regulation. If regulation is oversold such that the public's expectations about regulation's ability to reduce fraud exceed its actual capacity to do so, then regulation is likely to result in increasing, rather than decreasing, the amount of fraud in the system. Consider the extreme case where the public perceives a new regulatory regime to be entirely successful in combatting fraud when in fact the regime is entirely unsuccessful. The new regulation will entice previously skeptical potential market participants to engage in transactions that they would not have engaged in absent the confidence generated by the new regulations. In situations like this, where the public misperceives the efficacy of a particular regulatory regime, regulation will increase rather than decrease the amount of fraud in the system.

Another way that regulation can increase fraud is by legitimizing—and thereby expanding—business practices that are rife with fraud, regardless of whether such business practices increase societal wealth or serve any other legitimate social function (such as reducing poverty or income disparities or wealth disparities). A prime example of this phenomenon at work is the massive cry for regulation of cryptocurrencies in the wake of the collapse of

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[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *See* Qureshi, *supra* note 10; Chayanika Deka, *FTX CEO Sam Bankman-Fried Shares His Position on Crypto Regulations*, CRYPTO POTATO (Oct. 20, 2022, 1:21 PM), https://cryptopotato.com/ftx-ceo-sam-bankman-fried-shares-his-position-on-crypto-regulations/ [https://perma.cc/A6FG-535V].

[32] Prentice et al., *supra* note 27.

[33] *Id.*

FTX, irrespective of whether such cryptocurrencies provide any societal benefits.

After the FTX collapse, Treasury Secretary Janet Yellen redoubled her efforts to regulate cryptocurrencies, stating that "this is an industry that really needs to have adequate regulation and it doesn't."[34] What is particularly strange about Secretary Yellen's appeal for increased regulation is that she is actually skeptical of digital assets, and the Treasury Department has released a series of reports "highlighting the risks digital assets pose to investors and the broader financial system."[35] A potential problem with Secretary Yellen's call to regulate cryptocurrencies is that she fails to comprehend the extent to which comprehensive regulation of cryptocurrency will increase the overall size of the market by providing potential market participants with a false sense of security. At least some market participants are likely to view new regulation of cryptocurrency as being more effective than it actually is. As such, new regulation will attract additional participants to the marketplace, who will then find themselves the targets of crypto fraud.

Given the already massive size of the digital assets market, the case for expanding the size of this market is dubious at best. A report by the White House in September 2022 found that 16% of adult Americans had purchased digital assets.[36] While this is considerably less than the 58% of Americans reporting that they own stock,[37] it is still a significant percentage. A study by the *Wall Street Journal* (*WSJ*) found that hundreds of companies raising money in "the fevered market for cryptocurrencies" were using deceptive and fraudulent tactics to lure investors.[38] Fraud in this market appears to be rampant. In its review of 1,450 offering documents distributed to potential investors in crypto, the *WSJ* found 271 digital coin offerings that reflect transparent frauds in the form of "plagiarized investor documents, promises

[34] Alexander Saeedy & Andrew Duehren, *Yellen Says Crypto Needs Tighter Regulation After FTX Meltdown*, WALL ST. J. (Nov. 30, 2022, 11:30 AM), https://www.wsj.com/livecoverage/stock-market-news-today-11-30-2022/card/yellen-says-crypto-needs-tighter-regulation-after-ftx-meltdown-UEUjHmnH4itOrxp4XYjg [https://perma.cc/4YQP-BMR3].

[35] *Id.*

[36] Press Release, The White House, White House Releases First-Ever Comprehensive Framework for Responsible Development of Digital Assets (Sept. 16, 2022), https://www.whitehouse.gov/briefing-room/statements-releases/2022/09/16/fact-sheet-white-house-releases-first-ever-comprehensive-framework-for-responsible-development-of-digital-assets/ [https://perma.cc/U25L-BXXS].

[37] Lydia Saad & Jeffrey M. Jones, *What Percentage of Americans Own Stock?*, GALLUP (May 12, 2022), https://news.gallup.com/poll/266807/percentage-americans-owns-stock.aspx [https://perma.cc/C7KT-8F7W].

[38] Shane Shifflett & Coulter Jones, *Buyer Beware: Hundreds of Bitcoin Wannabes Show Hallmarks of Fraud*, WALL ST. J. (May 17, 2018, 12:05 PM), https://www.wsj.com/articles/buyer-beware-hundreds-of-bitcoin-wannabes-show-hallmarks-of-fraud-1526573115 [https://perma.cc/4URU-YNNC].

of guaranteed returns and missing or fake executive teams."[39] These 271 digital coin offerings garnered $1 billion in investor funds, with some investor funds disappearing almost immediately.[40] Over two dozen of the companies studied by the *WSJ* promised investors that they would receive financial rewards without any risk.[41] Others promised to make weekly payouts to investors or to double investors' returns.[42] One company, PlexCorps, raised $15 million by promising a 1,354% profit in less than a month.[43]

New regulation is not necessary to outlaw fraud because fraud already is illegal.[44] And existing anti-fraud laws should be vigorously enforced. The question is whether new regulation, which will simultaneously legitimize cryptocurrency and encourage the growth of the cryptocurrency market, is advisable. In my view, this depends in large part on the social value of cryptocurrency. Put simply, regulation is strongly advisable only in sectors of the economy whose growth we want to encourage. The stock market and the housing market are possible examples of markets whose growth should

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39 *Id.*

40 *Id.* (reporting $273 million in claimed losses by investors in these 271 offerings).

41 *Id.*

42 *Id.*

43 *Id.*

44 Fraud is a common law crime, and it is illegal under the federal wire fraud statute, 18 U.S.C. § 1343, and the federal mail fraud statute, 18 U.S.C. § 1341. As the Department of Justice has observed:

> The elements of wire fraud under Section 1343 directly parallel those of the mail fraud statute, but require the use of an interstate telephone call or electronic communication made in furtherance of the scheme. United States v. Briscoe, 65 F.3d 576, 583 (7th Cir. 1995) (citing United States v. Ames Sintering Co., 927 F.2d 232, 234 (6th Cir. 1990) (per curiam)); United States v. Frey, 42 F.3d 795, 797 (3d Cir. 1994) ([noting that] wire fraud is identical to mail fraud statute except that it speaks of communications transmitted by wire); *see also*, *e.g*., United States v. Prof[f]it, 49 F.3d 404, 406 n.1 (8th Cir. [1995]) (["T]he four essential elements of the crime of wire fraud are: (1) that the defendant voluntarily and intentionally devised or participated in a scheme to defraud another out of money; (2) that the defendant did so with the intent to defraud; (3) that it was reasonably foreseeable that interstate wire communications would be used; and (4) that interstate wire communications were in fact used[."]).

DOJ, CRIMINAL RESOURCE MANUAL § 941 (2020), https://www.justice.gov/archives/jm/criminal-resource-manual-941-18-usc-1343-elements-wire-fraud [https://perma.cc/C35H-UKCW].

be encouraged.[45] But, unlike other financial assets, standard cryptocurrencies such as Bitcoin have no intrinsic value.[46]

As two economists from the European Central Bank recently have observed, Bitcoin (and by logical extension other cryptocurrencies) "does not generate cash flow (like real estate) or dividends (like equities), cannot be used productively (like commodities) or provide social benefits (like gold)."[47] Generally speaking, the value of a financial asset is the present value of the stream of future income that an investor expects to receive as an owner of that asset. There is no future income associated with owning cryptocurrencies. Rather, the value of a cryptocurrency is based solely on the hope or expectation that in the future another investor will come along to offer a higher price for the asset than was paid previously.

In this way, many cryptocurrencies generally resemble, but are distinguishable from, traditional Ponzi schemes. A Ponzi scheme "is an age-old fraud in which inflows of new money pay off earlier investors."[48] The

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[45] It appears clear that housing markets should be encouraged because housing markets facilitate home ownership, and home ownership is desirable. *See* CHRISTOPHER E. HERBERT & ERIC S. BELSKY, U.S. DEP'T OF HOUS. & URB. DEV., THE HOMEOWNERSHIP EXPERIENCE OF LOW-INCOME AND MINORITY FAMILIES 3–6 (2006), https://www.huduser.gov/publications/pdf/hisp_homeown9.pdf [https://perma.cc/NH5R-H4K7]. Stock markets should be encouraged because such markets provide funding for business which provides employment and creates economic growth.

[46] *See* Ulrich Bindseil & Jürgen Schaaf, *Bitcoin's Last Stand*, EUR. CENT. BANK BLOG (Nov. 30, 2022), https://www.ecb.europa.eu/press/blog/date/2022/html/ecb.blog221130~5301eecd19.en.html [https://perma.cc/3AGW-PJFN]. Of course, stablecoins are an exception. A stablecoin is a type of cryptocurrency that is designed to maintain a fixed value over time. The value of a stablecoin is often, though not always, pegged to the value of a specific tangible asset such as real currency, often the U.S. dollar. James Royal, *What Are Stablecoins and How Do They Affect the Cryptocurrency Market?*, BANKRATE (May 12, 2022), https://www.bankrate.com/investing/stablecoin-cryptocurrency/ [https://perma.cc/XC5F-LNER]. Stablecoins' value is supposed to remain stable because such value is supported by actual assets like cash and money market instruments. For example, Tether is a stablecoin that claims to have as many dollars to back up the outstanding currency as there are coins in circulation. Stablecoins resemble money market funds in that they are backed by fixed assets and are supposed to lack volatility. *How Stablecoins Differ from Bitcoins? Stablecoin Development*, BITDEAL, https://www.bitdeal.net/difference-between-stablecoin-and-bitcoin [https://perma.cc/ASE5-Y88W]. Of course, if the funds received by an issuer from the sale of stablecoins are invested in volatile or risky assets, and those assets decline in value, the value of the underlying stablecoin will not be stable. Moreover, stablecoins potentially are subject to "bank runs" if large numbers of purchasers of stablecoins simultaneously attempt to cash in their coins and the issuer is unable to meet those requests for funds. There is no guarantee that the value of a stablecoin actually will remain stable, and many stablecoins have dropped below their pegged value. Michelle Singletary, *This Crypto Investing Was Supposed to Be 'Stable.' It's a Wild Ride.*, WASH. POST (June 3, 2022, 7:00 AM), https://www.washingtonpost.com/business/2022/06/03/terra-stablecoin-investing-lessons/ [https://perma.cc/XE4F-8XM4].

[47] Bindseil & Schaaf, *supra* note 46.

[48] David Segal, *The Crypto Ponzi Scheme Avenger*, N.Y. TIMES (Nov. 11, 2022), https://www.nytimes.com/2022/11/11/business/crypto-ponzi-scheme-hyperfund.html [https://perma.cc/2PEP-KM54].

defining feature of a Ponzi scheme is that the value of the assets being sold is not related to the intrinsic value of the asset itself, but rather to the willingness of other subsequent investors to buy the asset. Cryptocurrencies, such as Bitcoin, resemble, but are not identical to, true Ponzi schemes since they do not involve actual fraud. Those selling Bitcoin generally do not make misrepresentations to sellers that the value of the coins will increase in the future. The buyer hopes that the value will increase in the future, but in the absence of a promise from the seller, there is no fraud.

On the other hand, many cryptocurrency schemes are actual Ponzi schemes. For example, issuers of OneCoin, a Bulgarian-based cryptocurrency, garnered $4 billion from investors around the world before its "charismatic co-founder" Ruja Ignatova closed the fund and simply disappeared.[49] In another scam, HyperFund promoted the sale of memberships, with a starting price of $300, that allowed buyers to earn so-called "rewards" that would accrue daily to their accounts. Those rewards were paid in a cryptocurrency called "HU" that was supposed to trade in parity with the U.S. dollar.[50] Investors were promised that the cash they spent would be allocated to promising and profitable crypto projects.[51] In fact, HyperFund's only product was its memberships. Members recruited new members in return for a percentage of the new members' investments, making HyperFund a classic Ponzi scheme.[52]

Another important feature of cryptocurrency is its extreme volatility.[53] This is not surprising given that the value of cryptocurrency is based on speculation. Because cryptocurrency values are not based on any economic fundamentals, they tend to fluctuate on the basis of things like tweets by influential gadflies such as Elon Musk.[54] For example, in January 2021, Musk tweeted about a meme coin called Dogecoin. In the four hours after the tweet, the price of Dogecoin increased by over 300% before dropping by almost 50%.[55]

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[49] *Id.*

[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] Jackson Wood, *Putting Crypto Volatility in Context: What We Can Learn from the History of Bitcoin Crashes*, COINDESK (July 18, 2022, 10:28 AM), https://www.coindesk.com/learn/putting-crypto-volatility-in-context-what-we-can-learn-from-the-history-of-bitcoin-crashes/ [https://perma.cc/B8H8-HN7M] ("Volatility is nothing new for cryptocurrencies and . . . should be expected.").

[54] *10 Elon Musk Tweets That Created Waves in Crypto World*, OUTLOOK (Oct. 28, 2022, 6:28 PM) https://www.outlookindia.com/business/10-elon-musk-tweets-that-created-waves-in-crypto-world-news-233190 [https://perma.cc/9NEY-QC2J].

[55] *Id.*

Yet another feature of cryptocurrency, including Bitcoin and Monero, is that they "created new opportunities for . . . drug trafficking, money laundering, and crypto-jacking."[56] The criminal activities associated with the use of cryptocurrencies include tax evasion, money laundering, and Ponzi schemes, and "traditional crimes such as kidnapping, murder, and extortion are slowly becoming part of the cryptocurrency world."[57] In a stunning rebuke of Bitcoin on the European Central Bank blog, Ulrich Bindseil and Jürgen Schaaf observed that Bitcoin, the dominant cryptocurrency, "is rarely used for legal transactions."[58] Bindseil and Schaaf go on to point out that "Bitcoin has been marketed as a global decentralised digital currency. However, Bitcoin's conceptual design and technological shortcomings make it questionable as a means of payment: real Bitcoin transactions are cumbersome, slow and expensive. Bitcoin has never been used to any significant extent for legal real-world transactions."[59] Bitcoin, and other cryptocurrencies, are "neither suitable as a payment system nor as a form of investment . . . and thus should not be legitimised."[60]

There are thousands of cryptocurrencies in existence. Some are clearly securities, others are not. But cryptocurrencies like Bitcoin are "cumbersome, slow and expensive to use."[61] As a result, cryptocurrencies are not a particularly useful form of payment. For example, it takes roughly ten minutes to validate most transactions using Bitcoin, and the transaction fee for using the currency was about $20 in 2021.[62] Thus, cryptocurrency has largely failed in its stated objective of serving as a substitute for government-backed fiat currency.[63] It remains a speculative investment.

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[56] Sesha Kethineni & Ying Cao, *The Rise in Popularity of Cryptocurrency and Associated Criminal Activity*, 30 INT'L CRIM. JUST. REV. 325, 329 (2020).

[57] *Id.* at 337–38.

[58] Bindseil & Schaaf, *supra* note 46.

[59] *Id.*

[60] *Id.*

[61] Eswar Prasad, *The Brutal Truth About Bitcoin*, N.Y. TIMES (June 14, 2021), https://www.nytimes.com/2021/06/14/opinion/bitcoin-cryptocurrency-flaws.html [https://perma.cc/PWE5-79U4].

[62] *Id.*

[63] Katanga Johnson, *Crypto Is Unlikely to Replace Traditional Money, Fed's Barr Says*, BLOOMBERG (Oct. 12, 2022, 12:51 PM), https://www.bloomberg.com/news/articles/2022-10-12/fed-s-barr-says-crypto-unlikely-to-replace-traditional-money [https://perma.cc/M4YR-JH2V]; Tory Newmyer, *Cryptocurrency Is Suddenly Everywhere—Except in the Cash Register*, WASH. POST (Jan. 12, 2022, 7:14 AM), https://www.washingtonpost.com/business/2022/01/12/crypto-versus-cash/ [https://perma.cc/6W9P-HAL4] ("But for all the hype, there's scant evidence that digital currencies stand on the threshold of some kind of mainstream breakthrough. While a recent Pew Research Center survey found that 16 percent of Americans have used cryptocurrency in some way, most buy it as a speculative investment, not for its originally intended purpose—as a way to pay for goods and services.").

The point here is emphatically not that cryptocurrencies should be outlawed. Rather the point is simply that that cryptocurrency has little social utility, and trading in this asset class is rife with fraud. There seems to be no recognition of these basic facts in the myriad calls for new regulation of crypto that are coming in the wake of the fall of FTX.[64] Specifically, what is missing from the current debate is any consideration of the extent to which new regulation will lead to more fraud. More generally, the issue is the extent to which new regulation will serve to legitimize and thereby expand the size of the crypto market. Legitimizing the crypto industry through regulation will create more opportunities for fraud because market participants' perceptions of regulation lead to greater trust.

Put simply, new regulation is only justified if the benefits outweigh the costs. One of the costs of any new regulation is that it legitimizes the activity being regulated. It is far from clear that it makes sense to further legitimize trading in cryptocurrencies. In this context, it is important to distinguish cryptocurrencies from blockchain technology. Cryptocurrency is, in theory, a (very unstable) store of value.[65] Blockchain is a shared, immutable ledger for recording transactions and keeping track of assets.[66] While blockchain technology is used to record transactions in cryptocurrency, it is certainly not limited to that function. Rather, anything of value, including tangible assets such as houses, cars, cash, and land, and intangible assets such as intellectual property, can be tracked and traded on a blockchain.[67]

Blockchain technology holds considerable promise for improving the quality of payments systems because it provides near-simultaneous settlement and low transaction costs for transferring assets, among other features.[68] As experts recently have observed, however, blockchain technology can only improve the quality of a payments system if a suitable basis for such payments is available on the blockchain.[69] In particular, any digital asset used to make payments using blockchain technology "must

[64] In fact, some calls for regulation of crypto indicate, wrongly in my view, that cryptocurrencies have an important role to play as speculative investments, hedges against weak currencies, or potential payment instruments. *See* Aditya Narain & Marina Moretti, *Regulating Crypto: The Right Rules Could Provide a Safe Space for Innovation*, FIN. & DEV., Sept. 2022, at 18, 18.

[65] Frank Corva, *Bitcoin Is a Store of Values*, NASDAQ (Sept. 30, 2022, 11:42 AM), https://www.nasdaq.com/articles/bitcoin-is-a-store-of-values [https://perma.cc/Y7P7-T8NS]; *see* Wood, *supra* note 53.

[66] *What Is Blockchain Technology?*, IBM, https://www.ibm.com/topics/what-is-blockchain [https://perma.cc/FK8V-XLU3].

[67] *Id.*

[68] Blockchain Technology and the Future of Digital Payments, Memorandum from Kevin S. Schwartz, Rosemary Spaziani, David M. Adlerstein, David E. Kirk & Samantha M. Altschuler, Att'ys, Wachtell, Lipton, Rosen & Katz 1 (Dec. 2, 2022) (on file with author).

[69] *Id.*

maintain a stable value," which is something that, within the universe of cryptocurrencies, only stablecoins have the prospect of doing.[70]

Recognition of these basic institutional facts about cryptocurrency and blockchain suggest that regulation of stablecoins likely makes more sense than regulation of cryptocurrencies in general for the simple reason that, unlike cryptocurrency in general, stablecoin is an asset class worth growing in size. Safe, reliable stablecoins are a useful component of blockchain technology to further the goal of providing a safe, reliable, inexpensive payments mechanism, particularly for people without access to a traditional banking system. For example, many people in developing countries rely on family members living abroad to send money back home to help defray expenses.[71] Money remittances can account for well over one-third of the gross domestic product (GDP) in some countries, such as El Salvador, Haiti, and Tonga.[72] Safe, reliable stablecoins may be the safest and least expensive way of effectuating remittances.[73] As one commentator has observed:

> SWIFT transfers can be costly, with some banks charging 3% to 5%, while others charge a fixed fee of $25 to $45. Transfers via Western Union cost $25 on average for online transfers, $2.99 to $29.99 via credit/debit card and $7.99 when done in-store. On the other hand, stablecoins like USDC can cost $3 to $5 to send on Ethereum and less than $0.01 on the BNB Smart Chain, Tron and Cardano blockchains.[74]

Thus, one critical question that must be addressed in determining whether to expand regulation is whether one wants the underlying market that is subject to such regulation to expand or to contract. And, even where there is a strong case that market growth should be encouraged by regulation, it will not always be the case that regulation will reduce fraud. Where regulation is more ineffective at preventing fraud than people generally anticipate, regulation can increase the incidence of fraud. In the case of stablecoin, the role of regulation generally should track that of money market mutual funds[75]: regulations should verify that the assets used to back up stablecoin are of sufficiently high quality and high liquidity, so that runs on the bank are avoided.

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[70] *Id.*

[71] Anthony Clarke, *How Cryptocurrency Could Help Tackle Global Income Inequality*, COINTELEGRAPH (Aug. 31, 2022), https://cointelegraph.com/news/how-cryptocurrency-could-help-tackle-global-income-inequality [https://perma.cc/SJ2V-28CZ].

[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] *See* Lawrence Schmidt, Allan Timmermann & Russ Wermers, *Runs on Money Market Mutual Funds*, 106 AM. ECON. REV. 2625, 2630 (2016).

This Section addresses what might best be described as regulatory hubris in the context of fraud. I start with the proposition that regulators have an incentive—and a tendency—to exaggerate their ability to reduce fraud. This, in turn, can lead ordinary consumers and investors, who are the intended beneficiaries of this regulation, to overestimate the ability of anti-fraud regulation to reduce fraud. Ironically, this can lead to a situation in which new regulation actually increases the incidence of fraud by lulling market participants into a false sense of security. In simple terms, regulators' claims of success in reducing fraud can allow more fraud to occur by lowering market participants' guards and incentivizing risk-taking.

An important implication of this analysis is that one of the issues that policymakers should consider when deciding whether to regulate (or to expand the scope of regulation in a particular area) is whether the inevitable expansion of the markets being regulated is actually desirable or not. The analysis here suggests that while expansion (and improvement) of the market for stablecoins may well be desirable because of its role in the payments system, the argument for expanding the regulation of cryptocurrency generally is exceedingly weak.

B. Problems in Measuring Regulators' Performance

Just as market-participant perception that fraud is effectively regulated increases opportunity for fraud, so too does market-participant perception that regulators are effective at enforcing fraud regulation. So, another problem with reliance on regulation to reduce fraud is that it is very difficult to evaluate how regulators are performing.[76] A November 15, 2022 article in the investor-focused Daily Memo from *WealthManagement.com* is a good illustration of how the investing world gauges the performance of the SEC. The headline was "SEC Recovered Record $6.4B in Civil Penalties, Disgorgement in Fiscal Year 2022."[77] The premise of the article, of course, is that the SEC's success in collecting large fines from the companies it regulates provides a good gauge (or at least the best available gauge) of the SEC's performance. A bit further on, the piece applauds the SEC for

[76] For an earlier version of this argument that I made, see Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL'Y 639, 639–43 (2010), which argues that SEC Commissioners and staff are motivated by various perverse incentives that, among other things, lead them to promote the appearance that markets are in crisis.

[77] Patrick Donachie, *SEC Recovered Record $6.4B in Civil Penalties, Disgorgement in Fiscal Year 2022*, WEALTHMANAGEMENT.COM (Nov. 15, 2022), https://www.wealthmanagement.com/regulation-compliance/sec-recovered-record-64b-civil-penalties-disgorgement-fiscal-year-2022 [https://perma.cc/JG5S-7LDX].

increasing "the amount of total enforcement actions to 760 in fiscal year 2022, a 9% jump from the previous year."[78]

These two metrics, the dollar amount of SEC recoveries and the number of enforcement actions brought, are the measuring rods of SEC success. For example, when the SEC announced its enforcement results for fiscal year 2021, the lead was devoted to a report of the number of enforcement actions brought:

> The Securities and Exchange Commission today announced that it filed 434 new enforcement actions in fiscal year 2021, representing a 7 percent increase over the prior year. Seventy percent of these new or "stand-alone" actions involved at least one individual defendant or respondent. The new actions spanned the entire securities waterfront, including against emerging threats in the crypto and SPAC spaces. For example, the SEC charged a company for operating an unregistered online digital asset exchange,[79] charged a crypto lending platform and top executives alleging a $2 billion fraud,[80] and brought an action against a special purpose acquisition company, its merger target, top executives, and others for alleged misconduct in a SPAC transaction.[81] The SEC's whistleblower program was critical to these efforts and had a record-breaking year.
>
> The agency filed 697 total enforcement actions in fiscal year 2021, including the 434 new actions, 120 actions against issuers who were delinquent in making required filings with the SEC, and 143 "follow-on" administrative proceedings seeking bars against individuals based on criminal convictions, civil injunctions, or other orders.[82]

Statistics about the size of the fines recovered by the SEC followed closely on the heels of the reports about numbers for enforcement actions brought. The SEC reported that in fiscal year 2021, "the SEC also obtained judgments and orders for nearly $2.4 billion in disgorgement and more than $1.4 billion in penalties, which represented a respective 33 percent decrease

[78] *Id.*

[79] Press Release, SEC, SEC Charges Poloniex for Operating Unregistered Digital Asset Exchange (Aug. 9, 2021), https://www.sec.gov/news/press-release/2021-147 [https://perma.cc/6JHD-X27W].

[80] Press Release, SEC, SEC Charges Global Crypto Lending Platform and Top Executives in $2 Billion Fraud (Sept. 1, 2021), https://www.sec.gov/news/press-release/2021-172 [https://perma.cc/4FBL-Y3PT].

[81] Press Release, SEC, SEC Charges CPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination (July 13, 2021), https://www.sec.gov/news/press-release/2021-124 [https://perma.cc/QJ89-9KU9].

[82] Press Release, SEC, SEC Announces Enforcement Results for FY2021 (Nov. 18, 2021), https://www.sec.gov/news/press-release/2021-238 [https://perma.cc/5DG6-2CQ7].

and 33 percent increase over amounts ordered in the prior fiscal year in these categories."[83]

The SEC's evaluation of its performance in 2022 differed little from its 2021 evaluation. The evaluation, contained in the SEC's self-reporting of its enforcement results, begins by highlighting the number of enforcement actions filed in the previous year:

> The Securities and Exchange Commission today announced that it filed 760 total enforcement actions in fiscal year 2022, a 9 percent increase over the prior year. These included 462 new, or "stand alone," enforcement actions, a 6.5 percent increase over fiscal year 2021; 129 actions against issuers who were allegedly delinquent in making required filings with the SEC; and 169 "follow-on" administrative proceedings seeking to bar or suspend individuals from certain functions in the securities markets based on criminal convictions, civil injunctions, or other orders. The SEC's stand-alone enforcement actions in fiscal year 2022 ran the gamut of conduct, from "first-of-their-kind" actions to cases charging traditional securities law violations.[84]

Consistent with past practice, the SEC also focused on the amount of money it collected in fines, observing that "[m]oney ordered in SEC actions, comprising civil penalties, disgorgement, and pre-judgment interest, totaled $6.439 billion, the most on record in SEC history and up from $3.852 billion in fiscal year 2021."[85]

There are several problems with using these particular metrics to evaluate the SEC's performance. First, the metrics ignore important indicia of regulatory performance, like the severity of the defendants' wrongdoing. Under these criteria, minor recordkeeping violations receive the same credit as major frauds. Moreover, these metrics also fail to give credit for uncovering wrongdoing that is difficult to detect. Wrongdoing that is self-reported by regulated firms, or that is reported by whistleblowers, receives the same credit as wrongdoing that required significant resources to uncover.

In a nutshell, the metrics we use to evaluate the SEC, which also are the metrics that the SEC uses to evaluate itself, skew enforcement resources away from addressing issues that are difficult to detect, such as fraud, and towards issues that are easy to detect and that can be settled for large amounts of money. Since fraud is notoriously difficult to detect,[86] this means that the SEC will focus less on fraud and more on other regulatory infractions than it otherwise would. The consequences of using such skewed metrics to

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[83] *Id.*

[84] Press Release, SEC, *supra* note 12.

[85] *Id.*

[86] Kyle Tuberson, *Why Is Fraud So Hard to Detect?*, ICF (Sept. 21, 2017), https://www.icf.com/insights/cybersecurity/federal-fraud-detection-analytics [https://perma.cc/R2FV-JF48].

evaluate the SEC's performance are manifest. In particular, the focus on the number of enforcement actions brought and the size of the recoveries made creates a strong disincentive for the SEC to spend resources to ferret out fraud carefully hidden by relatively impecunious fraudsters. Allocating resources to discovering fraud that is hard to detect, or that results in a smaller dollar amount of SEC recovery, will make the SEC look ineffective by reducing the number of cases it can bring and lowering the amount it can collect in fees.

For example, the SEC's success in 2022 in achieving new records for collecting civil fines was "driven in part by the mammoth $1.2 billion penalties against JP Morgan Securities, as well as 16 other firms for failing to preserve text message communications on personal devices."[87] While it is never good to fail to comply with laws and regulations, the fact is that these infractions were recordkeeping violations.[88] They do not reflect fraudulent conduct. Significantly, there was no indication that the recordkeeping violations of the firms involved, which included "many of the largest players in financial services" such as Bank of America, Citigroup, Morgan Stanley, and UBS,[89] caused even minimal harm to the clients of these financial institutions.[90]

This Section focused on the relationship between identifying fraud and SEC enforcement of regulations. Calling for new regulation is a knee-jerk reaction to significant fraud, particularly fraud that becomes highly salient. Unfortunately, however, while regulating is easy, enforcing regulation effectively is far from it. And missing from virtually all cries for regulation is any consideration of how existing regulation was insufficient, or about the precise manner in which new regulation will prevent the latest fraud from making the headlines.[91]

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[87] *See* Donachie, *supra* note 77.

[88] Patrick Donachie, *SEC Fines Firms $1.1B for WhatsApp, Texting Record-Keeping Failures*, WEALTHMANAGEMENT.COM (Sept. 27, 2022), https://www.wealthmanagement.com/regulation-compliance/sec-fines-firms-11b-whatsapp-texting-record-keeping-failures [https://perma.cc/DJ38-F2UW].

[89] *Id.*

[90] The SEC's announcement of the penalties only referred vaguely to the firms' failures to maintain trust and the importance of recordkeeping in preserving market integrity. Press Release, SEC, SEC Charges 16 Wall Street Firms with Widespread Recordkeeping Failures (Sept. 27, 2022), https://www.sec.gov/news/press-release/2022-174 [https://perma.cc/P33B-TGWB].

[91] Interestingly, faced with calls for new regulation, SEC Chair Gary Gensler has indicated that the rules necessary to regulate the crypto industry are already in place. *See* Robert Schroeder, *As FTX Collapse Spurs Calls for Tighter Rules, 'We're Already Suited Up' on Crypto, SEC Chief Gensler Says*, BARRON'S (Dec. 7, 2022, 12:37 PM), https://www.barrons.com/articles/crypto-ftx-sec-gary-gensler-51670434606 [https://perma.cc/G277-28PG].

On the whole, this Part discussed that one important role played by regulation is the promotion of confidence and trust in the markets by their participants. Oddly, however, it appears that regulation inspires trust and confidence in markets even where there is little evidence that the regulation is particularly successful in reducing fraud. In some ways, this is not surprising in light of the fact that regulators have strong incentives to convince Congress and the public that their efforts to combat fraud are successful even when they are not. And the crude metrics generally used to evaluate regulators' performance (the number of cases brought and the amount of fines collected) merely muddy the waters.

The following Part of this Essay examines the role of two particular market forces, executive compensation and activist shareholder engagement, in incentivizing fraud in securities markets. In a nutshell, the problem of ineffective fraud regulation and enforcement is compounded by the fact that market forces (in particular executive compensation and activist shareholder engagement) incentivize fraud in securities markets. These market forces and their impact on incentivizing securities fraud will be explored next.

II. Market Forces and Fraud: Of Carrots and Sticks

When fraud becomes more profitable, we will observe more of it. Similarly, when not committing fraud becomes more costly, we will observe more of it. For the reasons observed in this Part, in recent decades the gains from engaging in fraud have increased and the costs of refraining from engaging in fraud also have increased. As such we should expect to see an increase in fraud.

A. Carrots: Performance-Based Compensation and Fraud

Fraud is, of course, not new. But dramatic changes in executive compensation have led to significant changes in the incentives for executive managers to commit fraud.[92] Between 1990 and 2001, CEO compensation rose by 463%, dramatically outpacing increases in worker pay, which increased by 42%, and corporate profits, which increased by 88%.[93] This rise in executive compensation is due to performance-based cash plus stock and

[92] *What Led to Enron, WorldCom and the Like?*, STANFORD GRADUATE SCH. OF BUS. (Oct. 15, 2003), https://www.gsb.stanford.edu/insights/what-led-enron-worldcom [https://perma.cc/6PXG-KWSZ] ("The corporate governance failures seen in the 1990s reflect significant changes in the incentives of managers. For starters, there were dramatic changes in CEO compensation.").

[93] *Id.*

stock option awards.[94] These forms of executive compensation have averaged 77% of total compensation for S&P 500 CEOs in recent years.[95]

As CEO compensation rose, so too did accounting problems and other issues associated with fraud. At the same time that CEO compensation was mushrooming, so too was the number of earnings restatements made by public companies: "In 1997, 116 firms restated their earnings; by 2001, that number had more than doubled, to 270. What these metrics reflect is 'management's growing incentive, willingness, and ability to manipulate earnings.'"[96] The point here is that the increased use of performance-based compensation over time created incentives for corporate managers to engage in fraud. It is at least possible that the perceived increase in corporate fraud at certain times, particularly the late 1990s and early 2000s, was "a predictable outcome" of the "changed incentives" caused by the increase in performance-based compensation.[97] This general point was made by Alan Greenspan when he was Chair of the Federal Reserve Board:

> Why did corporate governance checks and balances that served us reasonably well in the past break down? At root was the rapid enlargement of stock market capitalizations in the latter part of the 1990s that arguably engendered an outsized increase in opportunities for avarice. An infectious greed seemed to grip much of our business community . . . . Too many corporate executives sought ways to "harvest" some of those stock market gains. As a result, the highly desirable spread of shareholding and options among business managers perversely created incentives to artificially inflate reported earnings in order to keep stock prices high and rising. This outcome suggests that the options were poorly structured, and, consequently, they failed to properly align the long-term interests of shareholders and managers, the paradigm so essential for effective corporate governance. The incentives they created overcame the good judgment of too many corporate managers. It is not that humans have become any more greedy than in generations in the past. It is that the avenues to express greed have grown so enormously.[98]

Prosecutors have sought to link fraud with the incentives generated by incentive-based compensation:

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[94] *Id.*

[95] RICHARD TORTORIELLO, S&P GLOB. MKT. INTEL., IN THE MONEY: WHAT REALLY MOTIVATES EXECUTIVE PERFORMANCE? 3 (2018), https://www.spglobal.com/marketintelligence/en/documents/sp-global-market-intelligence-executive-compensation-march-2018.pdf [https://perma.cc/5K57-XCM6].

[96] STANFORD GRADUATE SCH. OF BUS., *supra* note 92.

[97] Merle Erickson, Michelle Hanlon & Edward L. Maydew, *Is There a Link Between Executive Equity Incentives and Accounting Fraud?*, 44 J. ACCT. RSCH. 113, 115 (2006).

[98] *Federal Reserve Board's Semiannual Monetary Policy Report to the Congress Before S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (testimony of Alan Greenspan, Chairman of the Federal Reserve).

> For example, in the Bernie Ebbers case (the former CEO of WorldCom), the prosecution argued that Ebbers was motivated to commit fraud when the end of a wave of mergers and the beginning of a meltdown in the telecom industry put pressure on the company's share price. They argued that "Ebbers's personal fortune was largely based on WorldCom shares, and he had borrowed nearly $400 million with those shares as collateral." Ebbers maintained that he committed the fraud to keep up with Wall Street expectations and not for personal gain—he held his shares until WorldCom filed for bankruptcy in July 2002, three months after he was forced to resign and one month after the fraud was uncovered. Similar allegations about the link between fraud and executive stock options were made in other cases . . . .[99]

This is not to criticize performance-based executive compensation schemes of any kind, particularly performance-based compensation that uses share-price performance as its basic measure of performance. The benefits of performance-based executive compensation schemes are significant. They reduce agency costs, which are the costs associated with having actions taken by agents on behalf of principals,[100] by serving to align the incentives of managers with the interests of shareholders.[101] The extent to which particular forms of executive compensation, such as equity incentives, lead to fraud is far from clear.[102] On the other hand, corporate boards of directors and policymakers should understand that compensation arrangements affect incentives in both good ways, by providing incentives to improve corporate performance, and in bad ways, by providing incentives to commit fraud.

As the potential gains from fraud increase, it stands to reason that enforcement efforts to combat fraud should increase as well. In addition to devoting more resources to monitoring potentially fraudulent conduct and increasing penalties for fraud, clawbacks of money paid to executives increasingly are being adopted as policies.[103] Such clawback policies may be seen as a way to address fraud concerns, even where actual fraud cannot be

[99] Erickson et al., *supra* note 97, at 115.

[100] In the corporate context, shareholders are the principals on whose behalf various agents, including boards of directors and managers, act. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–10 (1976).

[101] Performance-based compensation reduces agency costs by incentivizing corporate managers (the agents) to act in the interests of their principals (the shareholders). *See, e.g.*, Yacine Belghitar & Ephraim Clark, *Managerial Risk Incentives and Investment Related Agency Costs*, 38 INT. REV. FIN. ANALYSIS 191, 191–92 (2015) (finding that compensation-based incentives significantly reduced agency costs in study of U.K. firms).

[102] *See, e.g.*, Erickson et al., *supra* note 97, at 140 (finding a lack of consistent evidence of a link between equity incentives and accounting fraud).

[103] *See* Joshua A. Agen, *Compensation Clawbacks: Trends and Lessons Learned*, FOLEY & LARDNER LLP (Oct. 21, 2020), https://www.foley.com/en/insights/publications/2020/10/compensation-clawbacks-trends-and-lessons-learned [https://perma.cc/GH87-GQ2Z] ("Executive compensation clawback policies continue to grow in popularity.").

proven. On October 26, 2022, the SEC adopted new rules that will require public companies to claw back incentive-based executive compensation that was awarded based on materially false financial statements that subsequently required restatement.[104] The new rules differ from previous clawback rules in that prior rules only allowed for executive compensation to be recouped in case of misconduct. Instead, the new rules provide for compensation to be clawed back regardless of whether the restatement of financial performance was caused by fraud or some other factor. These new rules can be justified on the grounds that fraud is difficult to prove and that executives are to be compensated for performance, so bonuses and other performance-based compensation are not deserved if the data on which such compensation was granted turns out to have been faulty.

B. Sticks: Activist Investors and Fraud

Just as the prospect of garnering significant compensation can incentivize managers to commit fraud, so too can managers be motivated to commit fraud by the fear of losing their jobs or by the fear of being publicly shamed for poor performance. Shareholder activists monitor company performance and may identify managers as targets for activist campaigns. Being identified as a target for shareholder activism is not only embarrassing, it is career-threatening because activist investors often successfully agitate for underperforming managers, both officers and directors, to be replaced. Generally speaking, shareholder activism simply involves efforts by shareholders to effectuate change within the corporation whose shares they own.[105] But shareholder activists come in a variety of forms.[106]

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[104] Press Release, SEC, SEC Adopts Compensation Recovery Listing Standards and Disclosure Rules (Oct. 26, 2022), https://www.sec.gov/news/press-release/2022-192 [https://perma.cc/ZCM2-Y8RT]; Listing Standards for Recovery of Erroneously Awarded Compensation, 87 Fed. Reg. 73,076, 73,085 (Oct. 26, 2022).

[105] Mary Ann Cloyd, *Shareholder Activism: Who, What, When, and How?*, HARVARD L. SCH. F. ON CORP. GOVERNANCE (Apr. 7, 2015), https://corpgov.law.harvard.edu/2015/04/07/shareholder-activism-who-what-when-and-how/ [https://perma.cc/H43P-7ZPR].

[106] Efforts of activist investors fall along a spectrum based on the significance of the desired change and the assertiveness of the investors' activities. On the more aggressive end of the spectrum is hedge fund activism that seeks a significant change to the company's strategy, financial structure, management, or board. On the other end of the spectrum are one-on-one engagements between shareholders and companies triggered by Dodd–Frank's "say on pay" advisory vote. *Id.* Traditionally, activist investors such as Carl Icahn and Nelson Peltz have used their funds, and the resources of investors in hedge funds they control, to buy up a significant minority block of shares in a company and seek a small number of board seats which may be used to agitate for complete board control. In recent years there has been a dramatic increase in the number of activist hedge funds, with hundreds of new activist hedge funds being launched. *See id.*

Activist investors also will launch so-called "vote no" campaigns.[107] In such campaigns, the activist investor urges shareholders to decline to vote for particular directors who have been nominated for office by the incumbent board.[108] Other activist campaigns urge for changes to board governance practices. A particularly popular activist campaign that will be discussed in the following Section of this Essay asks companies to declassify their boards of directors. Some activist campaigns seek to limit the company's ability to shift legal fees to unsuccessful shareholder litigants, remove exclusive forum bylaw provisions, provide transparency around succession planning, provide proxy access, or a change board composition through increasing board diversity or naming an independent director as chair.[109] Other activist efforts are directed at changing executive compensation plans, such as modifying vesting terms; changing oversight of certain functions, such as audit and risk management; or changing the company's behavior as a corporate citizen, such as lobbying, environmental policies, climate change preparedness, and labor practices.[110]

Like performance-based executive compensation, shareholder activism is beneficial from a wealth-maximization perspective because it lowers agency costs. Shareholder activism induces managers to act in ways that further the interests of shareholders by maximizing shareholder wealth. It disciplines corporate managers and mitigates the problem of managerial shirking.[111] Activist investing recently has been described as "omnipresent."[112] Observers point out that "[i]t doesn't matter how big your company is . . . there's a limitless number of potential activists out there . . . . Any company at any time can get tagged" by activists.[113] The chief focus of activist investors is underperformance: "Underperformance is something

[107] *Id.*

[108] *Id.*

[109] *Id.*

[110] *Id.*

[111] *See* Matthew R. Denes, Jonathan M. Karpoff & Victoria B. McWilliams, *Thirty Years of Shareholder Activism: A Survey of Empirical Research*, 44 J. CORP. FIN. 405, 406, 415 (2017). Of course, this is not to say that activist investors never make mistakes. There are many famous cases of activist investors mistargeting companies and making improvident investments in them. *See, e.g.*, Jack Hough, *Activist Investors Aren't Good at Fixing Companies. Or Investing*, BARRON'S (Feb. 5, 2023), https://www.barrons.com/articles/activist-investing-disney-netflix-51675447951 [https://perma.cc/8PCP-M4FE] (describing notable examples of mistargeting by activist investors Carl Icahn, Bill Ackman, and Dan Loeb). This is not a particular public policy concern since the activist investors lose money when they mistarget companies and therefore have strong incentives to avoid doing so.

[112] Nick Rockel, *How to Handle Activist Investors*, FORTUNE (Oct. 7, 2022, 1:00 PM), https://fortune.com/2022/10/07/modern-board-activist-investors/ [https://perma.cc/V4DP-4EKY].

[113] *Id.*

that's going to get questioned."[114] But other factors besides performance, such as "lack of attention to ESG [environmental, social and governance] matters," also attract activist investors.[115]

While monitoring by activist investors is clearly efficient and beneficial, it also can incentivize fraud. Because the main focus of activist investors is underperformance, the best way to avoid an activist investor is to show consistent strong performance against the indicators that activist investors care about. Unfortunately, the fear of being ousted or simply embarrassed by an activist investor campaign likely provides incentives for managers to overstate their performance results in order to avoid such ouster or embarrassment.

As with performance-based executive compensation, however, the solution to any perceived problems with activist investing is not to regulate or discourage such investing. Rather, the best strategy might well be to increase the penalties for fraud to account for these increased incentives to commit fraud. Of course, it always is possible, at least theoretically, simply to enforce existing regulations more effectively, although it is not obvious what the precise mechanism for doing this would be.

One increasingly common form of corporate fraud, perhaps motivated in part by an incentive to avoid the "stick" of being labelled a poor performer, is greenwashing.[116] The term greenwashing refers to the practice of misleading consumers, investors, regulators, and others about the impact that a company, product, or service has on the environment. Basically, greenwashing is "the practice of falsely promoting an organization's environmental efforts or spending more resources to promote the organization as green than are spent to actually engage in environmentally sound practices."[117] As society in general and investors and consumers in particular have become more concerned about the environment, managers'

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114 *Id.*; *see also* PWC, THE DIRECTOR'S GUIDE TO SHAREHOLDER ACTIVISM 13 (2022), https://www.pwc.com/us/en/services/governance-insights-center/pwc-the-directors-guide-to-shareholder-activism.pdf [https://perma.cc/XUM8-8PS2] ("Poor performance in the stock market, weak earnings compared to peers, governance missteps, and lack of attention to ESG matters can all trigger shareholder activism.").

115 *See* PWC, *supra* note 114.

116 Magali A. Delmas & Vanessa Cuerel Burbano, *The Drivers of Greenwashing*, 54 CAL. MGMT. REV. 64, 64 (2011) ("More and more firms are engaging in greenwashing, misleading consumers about their environmental performance or the environmental benefits of a product or service. The skyrocketing incidence of greenwashing can have profound negative effects on consumer and investor confidence in green products."). Of course, greenwashing can also be a "carrot" as well as a "stick" to the extent that managers are rewarded for being perceived as performing well in addressing environmental concerns.

117 Karen Becker-Olsen & Sean Potucek, *Greenwashing*, ENCYCLOPEDIA OF CORP. SOC. RESP., https://link.springer.com/referenceworkentry/10.1007/978-3-642-28036-8_104 [https://perma.cc/FV3Y-2VXS]. The term greenwashing was introduced by the environmentalist Jay Westerveld in 1986. *Id.*

incentives to engage in greenwashing have increased along with the corresponding increase in the fraud of greenwashing.[118] Specifically, strong demand for environmental, social, and governance (ESG) investing provides a powerful incentive for greenwashing. Globally, ESG mutual funds have experienced rapid growth in recent years, with ESG fund assets reaching a value of $2.5 trillion at the end of 2022, an increase of almost 12% over the prior quarter, which was almost twice the growth rate of the mutual fund market as a whole. [119] As SEC Commissioner Hester Peirce observed, greenwashing is a "real" concern because "advisers can mint money by calling their products and services 'green' without doing anything special to justify that label."[120]

Examples of greenwashing abound. Perhaps the most notorious example of greenwashing was Volkswagen's emissions scandal:

> Volkswagen admitted to cheating emissions tests by fitting various vehicles with a "defect" device, with software that could detect when it was undergoing an emissions test and altering the performance to reduce the emissions level.
>
> This was going on while to the public the company was touting the low-emissions and eco-friendly features of its vehicles in marketing campaigns. In actuality, these engines were emitting up to 40 times the allowed limit for nitrogen oxide pollutants.[121]

Other famous examples or greenwashing include Nestlé, which in 2018, released a statement claiming to have "ambitions" for its packaging to be 100% recyclable or reusable by 2025, while not actually doing anything to achieve this ambitious goal. In stark contrast, Nestlé was named (along with

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[118] Delmas & Cuerel Burbano, *supra* note 116, at 84.

[119] Brian Baker, *ESG Investing Statistics 2023*, BANKRATE (Jan. 31, 2023), https://www.bankrate.com/investing/esg-investing-statistics/ [https://perma.cc/YRC8-ATC6]; SEC, RECOMMENDATIONS FOR ESG 3 (2021), https://www.sec.gov/files/spotlight/amac/recommendations-esg.pdf [https://perma.cc/6ZLB-GJZR] ("ESG investing has grown significantly in recent years; according to the [Investment Company Institute], 'socially conscious' registered investment products grew from 376 products/$254 billion in assets under management ('AUM') at the end of 2017 to 1,102 products/$1.682 trillion in AUM by the end of June, 2020."); Letter from Lisa Woll, Chief Exec. Officer, US SIF, to Vanessa Countryman, Sec'y, SEC (June 14, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8916213-245007.pdf [https://perma.cc/6K5S-7ZF4] ("Since 1995, when the US SIF Foundation first measured the size of the US sustainable investment universe—the pool of assets whose managers consider ESG criteria as part of investment analysis and engagement—at $639 billion, these assets have increased more than 25-fold to $17.1 trillion in 2020, a compound annual growth rate of 14 percent.").

[120] Hester Peirce, *Statement on Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies*, SEC (May 25, 2022), https://www.sec.gov/news/statement/peirce-statement-esg-052522 [https://perma.cc/D66X-7B37].

[121] Deena Robinson, *10 Companies Called Out for Greenwashing*, EARTH.ORG (July 17, 2022), https://earth.org/greenwashing-companies-corporations/ [https://perma.cc/H2GV-V42P].

Coca-Cola and PepsiCo), the world's worst plastic polluter in 2020.[122] The problem of greenwashing seems particularly acute in the financial services industry. Large financial institutions, including JPMorgan Chase, Citibank, Bank of America, Wells Fargo, Barclays, Bank of China, HSBC, Goldman Sachs, and Deutsche Bank all have been accused of greenwashing, specifically, of "talking a big game about combating climate change" while "lending enormous sums to the industries that contribute the most to global warming, like fossil fuels and deforestations."[123]

To deal with the problem, the SEC has begun to focus on greenwashing and other misleading ESG claims. In March 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement, declaring that:

> Consistent with increasing investor focus and reliance on climate and ESG-related disclosure and investment, the Climate and ESG Task Force will develop initiatives to proactively identify ESG-related misconduct. The task force will also coordinate the effective use of (Enforcement) Division resources, including through the use of sophisticated data analysis to mine and assess information across registrants, to identify potential violations.
>
> The initial focus will be to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules. The task force will also analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies.[124]

In April 2022, the SEC proposed a major environmental disclosure rule: "The Enhancement and Standardization of Climate-Related Disclosures for Investors."[125] The rule requires issuers to include certain climate-related information in their public disclosures. These focused efforts by the SEC and new regulation requiring greater transparency potentially serve as an example of more stringent regulation that could actually help to curb greenwashing fraud. The rule attempts to directly address the problem of greenwashing by providing more "reliable, comparable and consistent climate-related disclosures" which are viewed as "essential for investors to

[122] *Id.*

[123] *Id.*

[124] Press Release, SEC, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42 [https://perma.cc/ZJC9-864L].

[125] The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21,334 (Apr. 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249) https://www.federalregister.gov/documents/2022/04/11/2022-06342/the-enhancement-and-standardization-of-climate-related-disclosures-for-investors [https://perma.cc/QRK8-LFAX].

accurately integrate climate risks and opportunities into their investment decision-making processes."[126]

Managers are more likely to commit fraud when they have incentives to do so. The incentives to commit fraud come in the form of "carrots" when the rewards for committing fraud grow, and "sticks" when the costs for declining to commit fraud increase. Increased performance-based executive compensation, fears of activist investors, and consumer and investor demand for ESG investing have all increased managers' incentives to engage in fraud. Thus, it should not be surprising that fraud is on the rise.

An appropriate response to the phenomenon of increased fraud should be increased enforcement efforts and increased sanctions. Of course, other responses to increased fraud are theoretically possible. For example, in principle, one might increase the social stigma associated with fraud, but it is not clear how one might go about doing this. There are really only two possible practicable approaches to decreasing fraud. One approach is to increase penalties by increasing sanctions. The other is to increase the probability of detection by increasing enforcement efforts.

III. EXPANDING CONCEPTIONS OF FRAUD

A major theme of this Essay has been the exploration of ways that expanding the benefits of committing fraud, raising the costs of not committing fraud, and increasing the opportunities to commit fraud all increase the incidence of fraud. In this Part, I take a slightly different approach by pointing out that fraud can increase when the costs of committing fraud go down. Perhaps the most obvious way that the costs of committing fraud can go down is by decreasing the penalties for committing fraud. But formal government punishment is not the only penalty associated with fraud: another important component of the punishment associated with committing fraud is the stigma of becoming a fraudster.[127]

People who commit fraud find others reluctant to interact with them economically or socially.[128] Stigmatization thus plays an important role in the criminal justice system, beyond mere moral disapproval, by engendering private reluctance to interact with one who has committed fraud.[129] This observation about stigmatization, of course, is a straightforward implication

[126] Letter from Paul Bodnar, Kathryn Fulton & Elizabeth Kent, Managing Dirs., Blackrock, to Vanessa A. Countryman, Sec'y, SEC (June 17, 2022), https://www.blackrock.com/corporate/literature/publication/sec-enhancement-and-standardization-of-climate-related-disclosures-for-investors-061722.pdf [https://perma.cc/LW22-4V8V].

[127] Rasmusen, *supra* note 8, at 520–21.

[128] *Id.* at 520.

[129] *Id.* at 540.

of Gary Becker's seminal insight that the incidence of fraud and other crime will depend on the probability of detection and the severity of the punishment.[130] Being stigmatized is one form of punishment. And more severe stigmatization associated with fraud translates directly into more severe punishment.

Scholars have hypothesized that stigmatizing known criminal behavior "may be as powerful a disincentive to crime as public punishment."[131] With stigma serving as a powerful deterrent to crime, it stands to reason that reducing the stigma associated with being dubbed a fraudster will increase the incidence of fraud. Here I argue that the stigma associated with being characterized as a fraudster has decreased because the concept of what it means to engage in fraud has expanded so much that even entirely unproblematic behavior can be characterized by legal experts as involving fraud.

Traditionally the term fraud has been used to describe intentional deception intended to result in personal gain.[132] Over time, however, the term has been used to describe conduct that is not intentional and does not result in personal gain. For example, the term fraud in securities law describes not only intentional misstatements of material facts, but also unintentional failures to state facts necessary to make other disclosures not misleading. In other words, it is an open question whether the law of securities fraud is necessarily tethered to traditional conceptions of fraud.[133]

To illustrate this point, this Essay will discuss in detail the accusation of securities fraud leveled against Harvard University by two prominent securities lawyers, one a sitting Commissioner of the SEC, and the other a law professor at Stanford.[134] In a paper, Daniel Gallagher and Joseph Grundfest accused Harvard, and, by extension, one of its professors, Lucian Bebchuk, of securities fraud.[135] Professor Bebchuk had organized something called the Shareholder Rights Project that waged proxy contests at over a hundred companies to eliminate so-called "staggered" or classified boards of

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[130] Becker, *supra* note 7, at 176.

[131] Rasmusen, *supra* note 8, at 540.

[132] *See, e.g.*, *Fraud*, AMERICAN HERITAGE DICTIONARY (2d coll. ed. 1991) (defining fraud as "[a] deception deliberately practiced in order to secure unfair or unlawful gain").

[133] *See* Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 515 (2011).

[134] Daniel M. Gallagher & Joseph A. Grundfest, *Did Harvard Violate Federal Securities Law? The Campaign Against Classified Boards of Directors* (Rock Ctr. for Corp. Governance, Working Paper No. 199, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2536586 [https://perma.cc/2WMV-L7HH].

[135] Andrew Ross Sorkin, *An Unusual Boardroom Battle, in Academia*, N.Y. TIMES DEALBOOK (Jan. 5, 2015, 9:42 AM), https://archive.nytimes.com/dealbook.nytimes.com/2015/01/05/an-unusual-boardroom-battle-in-academia/ [https://perma.cc/BJV8-4J3V].

directors, in which only a fraction of a company's board of directors is elected in any year.[136] When boards of directors are not staggered, the entire board is up for election every year, making it easier for activist investors and corporate "raiders" to take over a company in a proxy contest.[137] When a staggered board is in place it can take multiple years for an outsider to gain control over a target company's board of directors. When the board is not staggered, the entire board can be replaced immediately.

The alleged fraud in the proxy solicitations engineered by Harvard's Shareholder Rights Project was that it relied on "the categorical assertion that staggered boards are associated with inferior financial performance," citing "only one study suggesting a contrary result, and perfunctorily dismiss[ing] that study's conclusions with contestable language."[138] Arguing that the academic research contradicting the Harvard Proposal is much more extensive than the proxy solicitations disclosed and that other studies linking staggered boards to improved financial performance were not mentioned, Gallagher and Grundfest claimed that Harvard committed securities fraud.[139]

However, the Harvard Shareholder Rights Project utilized SEC Rule 14a-8 to put its precatory proposal to destagger corporate boards to a shareholder vote.[140] Under Rule 14a-8, subject to certain prescribed exclusions, public companies are required to include shareholder proposals in their annual proxy statements to investors. Shareholder proposals under 14a-8 are limited to five hundred words.[141] As such, space to discuss the full field of academic research on staggered boards in the proxy solicitations was limited. These shareholder proposals also are subject to the SEC's anti-fraud rule, Rule 14a-9, which is almost comically broad.[142] For example, the then-Chair of the SEC announced in 2013 that "it is important to pursue even the smallest infractions" including "violations such as control failures, negligence-based offenses, and even violations of prophylactic rules with no intent requirement."[143]

Fundamental to the Gallagher and Grundfest analysis was the modern, well-accepted notion that securities fraud encompasses not only affirmative misstatements, but also material omissions.[144] In other words, while no

[136] Gallagher & Grundfest, *supra* note 134, at 20–21.

[137] *Id.* at 1.

[138] *Id.* at 33.

[139] *Id.*

[140] *Id.* at 4–5.

[141] *Id.*

[142] *Id.*

[143] Mary Jo White, Chair, SEC, Remarks at the Securities Enforcement Forum (Oct. 9, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370539872100# [https://perma.cc/K4FT-FW5U].

[144] Gallagher & Grundfest, *supra* note 134, at 44–54.

falsehoods whatsoever were identified in these proxy solicitations, fraud nevertheless had been committed because of a failure to make what Gallagher and Grundfest deemed to be an adequately balanced presentation.

This fantastically broad, postmodern conception of securities fraud trumpeted by well-known securities law experts comes with a significant cost: to the extent that this conception is broadly embraced, it threatens to reduce the moral outrage traditionally associated with the term fraud. Such a broadening of the meaning of the term fraud would decrease the deterrent effect of being labelled a "fraudster." The current, overly broad conception of securities fraud runs the risk of promoting even more real (traditional) fraud because it describes as fraudulent entirely benign conduct, thereby destigmatizing the term "fraud" and reducing the stigma of being accused of fraud. The basic idea is that the term fraud should convey and connote the concept of "wrongdoing" if it is to continue to have moral authority in U.S. securities regulation. Unfortunately, this may no longer be the case.

CONCLUSION

Markets can tolerate significant levels of fraud as a percentage of all economic activity as long as the welfare gains from the remaining, legitimate, nonfraudulent activity are sufficiently high. As established in this Essay, fraud cannot exist without trust. As levels of trust increase, people become willing to enter into transactions with a broader circle of counterparties. This expanded universe of counterparties creates greater opportunities for fraud. Thus fraud, though deplorable, can be a sign of market strength, not market weakness, for the simple reason that strong, robust markets provide more opportunities for fraud.

This Essay has offered a series of explanations for why fraud appears to be on the increase. First, I note that a feature of advanced markets that, somewhat ironically, often leads to an increase in financial fraud is regulation. Regulation is routinely and automatically touted as a response to fraud, notwithstanding the lack of specific evidence that regulation is successful in reducing fraud. A particularly significant problem is that regulation is often "oversold," leading to the public perception that regulation is more successful in reducing fraud than it actually is. This, in turn, results in economic activity being attracted to regulated industries, regardless of whether there is any economic or social value to the economic activity being encouraged.

This analysis is particularly significant and relevant in the context of the current surge in sentiment to regulate cryptocurrencies in the wake of the FTX and Sam Bankman-Fried debacle. Attracting more resources to cryptocurrency trading is a dubious idea in light of the fact that

cryptocurrencies produce nothing and merely transfer wealth rather than create it.

Next, I observed that increasingly strong market forces aimed at reducing managerial agency costs have increased the incentives of top corporate management to commit fraud. Specifically, market forces both richly reward managers for generating strong returns for shareholders and severely punish managers for failing to reach investors' expectations regarding corporate performance. While these rich rewards and strong punishments serve the interests of shareholders and society, they also create increased incentives for fraud.

A final factor in the increase in fraud in financial markets has been the expansion of the concept of fraud. Historically, the term fraud was used to describe conduct that was truly egregious and involved purposeful deceit designed to provide the perpetrator with unlawful gains. As shown here, however, in the financial context the concept of fraud has been expanded to include behavior that is entirely inadvertent and benign. The expansion of the concept of fraud threatens to increase the incidence of traditional fraud by depriving the term "fraud" of its historic capacity for shaming because the prospect of being shamed is a significant deterrent to committing fraud.