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With Andrew Ross Sorkin
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Good morning. High profile cases like those against the FTX founder, Sam Bankman-Fried; the Theranos founder, Elizabeth Holmes; and the Nikola founder, Trevor Milton, have made corporate fraud a hot topic, but new research suggests that what we see only barely reflects the extent of the problem. In today's newsletter, we look at why one group of researchers thinks that, on average, 10 percent of public companies commit securities fraud each year.



The fraud that goes unnoticed



By [Ephrat Livni](#)
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On a recent visit to Salt Lake City, Alexander Dyck ordered Chinese takeout and received a branded fortune cookie wishing him wealth and promoting FTX, presumably packaged before the crypto empire's epic collapse. "I should have saved it," he said regretfully.

Dyck is a professor of [finance](#) at the University of Toronto, who just published a provocative [new study](#) on the pervasiveness of corporate fraud. The study has been passed around in the world of academia in recent weeks, and has become a fascination among general counsels, corporate leaders and investors.

It suggests that only about a third of frauds in public companies actually come to light, and that fraud is disturbingly common. Dyck and his co-authors estimate that about 40 percent of companies are committing accounting violations and that 10 percent are committing what is considered securities fraud, destroying 1.6 percent of equity value each year — about \$830 billion in 2021.

“What people don’t get is how widespread the problem of corporate fraud is,” Dyck said about his study, which was published in the Review of Accounting Studies this month.

Tip of the iceberg

Last year, Trevor Milton, the founder of Nikola, the electric vehicle maker, and Elizabeth Holmes, founder of the blood testing company Theranos, were both found guilty of fraud in high profile trials. Holmes’s sentencing coincided with the swift fall of FTX, founded by Sam Bankman-Fried, all of which left 2022 with a distinctly fraudulent flavor.

But the amount of fraud perpetrated at any given time stays pretty steady, Dyck said.

Dyck and his colleagues wanted to scratch the surface of misconduct in public companies to figure out how much of it goes undiscovered normally. To do this, they first examined a period of unique scrutiny in accounting history, the 2001 demise of the auditing firm Arthur Andersen following the collapse of Enron.

At that time, the firm’s former clients were in the spotlight and new auditors were far more motivated to uncover wrongdoing, given the suspicions looming over companies that had worked with Arthur Andersen. That should make the rate of fraud they found more accurate than other measures. But the probes didn’t uncover more wrongdoing among Arthur Andersen’s clients than at other businesses reliant on other auditors. The same ratio of fraud appeared in a set of

comparisons with other research, which led them to conclude it is consistent. They used this rate of fraud to conclude that about a third of corporate fraud goes unnoticed.

Given how common fraud is at audited public companies, Dyck said, misconduct is likely even more pervasive in privately held businesses, particularly in crypto, which is only loosely regulated.

In the trenches

Even people who have spent their careers digging into corporate wrongdoing have trouble estimating just how much fraud goes on in big business, and how little is detected.

Allison Herren Lee, a former commissioner and interim chair at the Securities and Exchange Commission, has worked as an enforcement lawyer and inside a mismanaged business. She said she's very familiar with how people in business try to push the limits, but was surprised by the study's estimate that a third of misconduct goes unnoticed.

In the early 2000s, Lee was a partner at a law firm in Denver where she did a stint at the telecommunications provider Qwest Communications International, on loan as an adviser to the company then helmed by Joseph Nacchio. She often found herself advising clients against the risky measures the company proposed to undertake hastily and with minimal legal review, she said. In 2007, Nacchio was convicted of securities fraud and [sentenced to prison](#).

Still, it's very difficult to prove misconduct and target everyone involved in wrongdoing, Lee said. People involved often feel they are just testing boundaries rather than violating the law and such schemes can be sprawling in major corporations. "To prosecute fraud you have to show intent," she said. "In big public companies that's tough, because it takes a village to commit fraud."

One way to address this would be to eliminate [the need to show criminal intent](#) and make it easier to punish executives for permitting wrongdoing on their

watch, a move proposed by Democratic Senator Elizabeth Warren of Massachusetts in 2019. The bill got little traction.

Psychology of a fraudster

Corporate crime fighters agree that fraud is a major problem. But some are critical of the new study's expansive take on the term. The research relied on studies with varying definitions, that applied to a range of kinds of misconduct, including settled cases arising from accusations of accounting violations that were never ultimately proven by the prosecution.

“The use of the term ‘fraud’ in this article’s title is highly problematic. The authors themselves concede that they use the word ‘fraud’ ‘loosely’ and for ‘simplicity,’” said Joseph Grundfest, a Stanford Law School Professor, former S.E.C. Commissioner and creator of a database that tracks federal securities fraud cases. “But events they call fraudulent include alleged frauds that weren’t frauds, honest mistakes and differences of opinion about accounting treatment. Calling all these events ‘frauds’ is like ‘loosely’ calling a mouse an elephant for the sake of ‘simplicity’ and then rationalizing the overbroad categorization on grounds that both are mammals. Just as mice are not elephants, alleged frauds are not frauds, and differences of opinion are also not frauds.”

The mind-set of a typical fraudster is at the heart of the definitional issues, said [Donald Langevoort of Georgetown University Law Center](#), a former special counsel to the S.E.C. who has written extensively about corporate crime and is familiar with the studies underlying the research by Dyck and his colleagues.

Legally speaking, prosecutors have to prove intent to defraud, but that’s not easy because perpetrators are often expert at lying to themselves, and defiant about the rules, he said. “People inside Enron were convinced accounting was bad and they are good,” he said. “Executives who think like that will cross the line.”

The S.E.C. recently [adopted a rule](#) aimed at changing that mentality. When it goes into effect later this month, it will require registered companies to develop clawback policies. Such rules allow companies to recover incentive-based pay

from current or former executives if it was based on wrongly reported financials and the business is forced to do an accounting restatement.

Knowing that their own bonuses are on the line will encourage even defiant executives to be more vigilant, Langevoort said. But the new rule, and [other efforts to crack down on corporate fraud](#), leave some businesses untouched.

Take Bankman-Fried of FTX, now under house arrest at his parents' home in California, awaiting trial on an array of criminal fraud charges. He's accused of siphoning billions of dollars from his businesses, facilitated by the fact that there were few financial records. On social media, in interviews and in his new Substack newsletter, the fallen executive has insisted he didn't steal funds and could have saved FTX if lawyers hadn't forced him to cede his spot as C.E.O. and file for bankruptcy in November.

“Self-deception has been rampant in crypto but it's not like in traditional finance where people say ‘the bureaucrats are holding us back,’” Langevoort said. “It's more like ‘there's a brave new world to invent and you gotta break some eggs to make an omelet.’”