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March 17, 2003

Michael Courlander
Public Affairs Officer
United States Sentencing Commission
One Columbus Circle, N.E.
Suite 2-500
Washington, D.C. 20002-8002

Re: Sentencing Guidelines for United States Courts

Dear Mr. Courlander:

Please find enclosed comments on the United States Sentencing Commission's Guidelines for United States Courts

The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of regulations and their impact on society. As part of its mission, RSP produces careful and independent analyses of agency rulemaking proposals from the perspective of the public interest. The enclosed comments on the United States Sentencing Commission's Guidelines for United States Courts, do not represent the views of any particular affected party or special interest group, but are designed to evaluate the effect of the proposed guidelines on the public interest generally.

The Regulatory Studies Program appreciates the opportunity to comment. We hope that consideration of these comments will enhance the quality and development of regulations and policy regarding sentencing guidelines.

Wendy L. Gramm, Director
Regulatory Studies Program

Susan E. Dudley
Senior Research Fellow

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REGULATORY STUDIES PROGRAM

Public Interest Comment on Sentencing Guidelines for United States Courts¹

The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of the impact of regulation on society. As part of its mission, RSP conducts careful and independent analyses employing contemporary economic scholarship to assess rulemaking proposals from the perspective of the public interest. Thus, this comment on the United States Sentencing Commission's Guidelines for United States Courts does not represent the views of any particular affected party or special interest group, but is designed to evaluate the effect of the Agency's proposed guidelines on overall consumer welfare.

I. Introduction

The Sarbanes-Oxley Act of 2002 contains directives to the United States Sentencing Commission regarding fraud and obstruction of justice offenses committed by corporate executives that endanger the financial condition of a firm and adversely affect a large number of individuals. The Act contained language expressing particular concern for especially large corporate frauds. To address this concern, the Commission has proposed an amended table relating the dollar size of a fraud to the offense level to be consulted in the sentencing guidelines.²

The proposed options for the amended loss table, unfortunately, are likely to do little to discourage relatively large frauds and might encourage larger frauds, on the margin. This comment illustrates this perverse effect of the proposal and suggests that the Commission consider developing a structure that takes these incentive effects into account.

¹ Prepared by Jonathan Klick, Ph.D., Dorothy Donnelley Moller Research Fellow, The Mercatus Center. This comment is one in a series of Public Interest Comments from Mercatus Center's Regulatory Studies Program and does not represent an official position of George Mason University.

² The sentencing guidelines contain baseline "offense levels" for different crime categories, as well as adjustments for various aggravating factors. Judges then use the adjusted offense level to consult the sentencing table which indicates appropriate sentencing ranges, in months, by offense level.

II. Statutory Basis for Regulation

The corporate fraud amendment to the sentencing guidelines implements directives to the Commission contained in sections 805, 905, and 1104 of the Sarbanes-Oxley Act of 2002 (the "Act"), Pub. L. 107-204. The directives pertain to fraud and obstruction of justice offenses and require the Commission to promulgate amendments addressing, among other things, officers and directors of publicly traded companies who commit fraud and related offenses, offenses that endanger the solvency or financial security of a substantial number of victims, fraud offenses that involve significantly greater than 50 victims, and obstruction of justice offenses that involve the destruction of evidence. Under emergency amendment authority, the Commission promulgated guideline amendments, effective January 25, 2003, to implement these directives. The current proposal is meant to provide a permanent amendment concerning these issues.

III. Declining Cost of Fraud

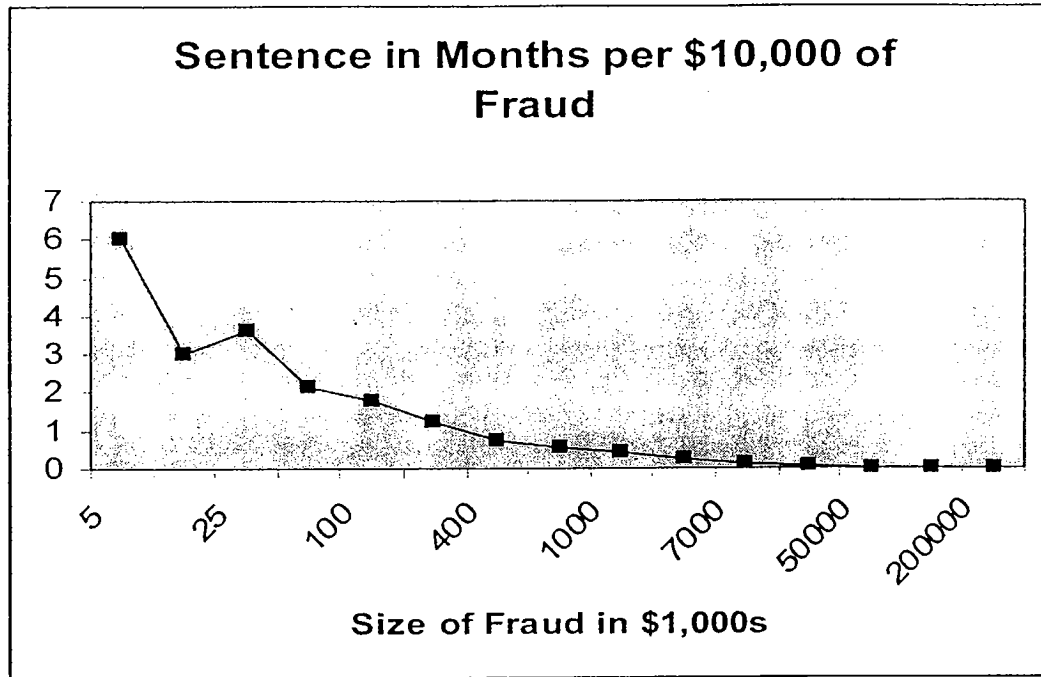
The Commission offers three options to amend the loss table in §2B1.1(b)(1), which provides guidance for determining the offense level to be used on the sentencing table in the case of a corporate fraud conviction. The options each offer varying degrees of gradation relating the dollar valuation of the loss resulting from the fraud to a corresponding offense level.

In its request for comments, the Commission notes that it added loss categories at \$200,000,000 and \$400,000,000 to address concerns articulated in the Sarbanes-Oxley Act of 2002 about "particularly extensive and serious fraud offenses." This implies that the Commission sees value in and, in fact, imputes a mandate to discourage larger frauds even more than relatively smaller frauds. While this certainly makes sense, none of the proposed alternative loss tables is likely to achieve this goal.

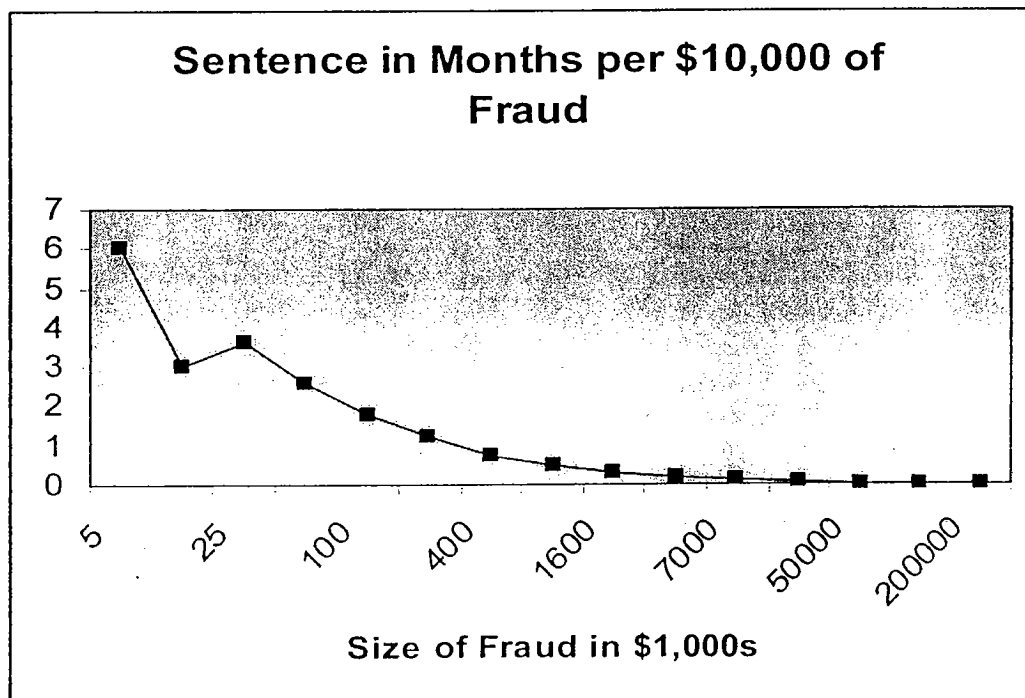
If the criminal sentences are to serve a deterrent value for corporate executives and there is a desire to deter especially egregious frauds at an even greater rate, one would expect that the incremental increase in the sentence increases as the size of the fraud grows. However, in the options offered by the Commission, we see the exact opposite. The average sentence per dollar of fraud loss is actually decreasing as the fraud grows. This is illustrated in the following graphs:³

³ The data in these graphs come from the sentencing guidelines and the proposed amendment. The y axis measures the sentence in months given by the guidelines (taking the midpoint of the suggested sentence and assuming 0 or 1 criminal history points) divided by the upper limit of the loss category given in the proposed tables. This figure is multiplied by 10,000 to scale the numbers. The x axis is the upper limit of the loss category in the proposed tables (in thousands of dollars).

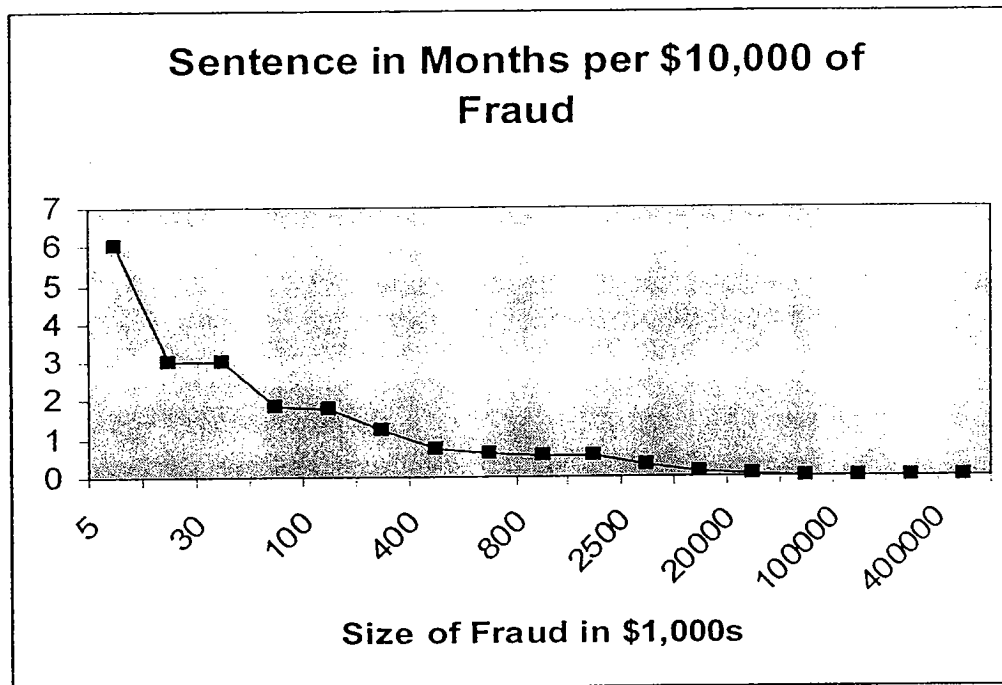
Option A



Option B



Option C



Assuming that the gain to corporate executives engaged in a fraud is proportional to the resulting loss from the fraud and that the probability of law enforcement officials detecting the fraud is constant, the proposed loss tables provide decreasing marginal deterrence. That is, once a fraud is committed, it is actually rational for the executives to engage in more fraud because the punishment effectively becomes cheaper on average as the fraud grows.

Perhaps the stated assumptions are unrealistic. Specifically, it might be the case that larger frauds are more likely to be detected. This would dampen or even reverse the declining average cost of fraud implied in the graphs above. This is an unanswered question. If the Commission holds the assumption that larger frauds are more likely to be detected, it should present some empirical evidence in its support. However, proving such a proposition would be difficult as the data are effectively censored. That is, we do not know the size of undetected frauds.

The foregoing analysis also implicitly assumes that the marginal cost of additional months on a sentence is linear to the executives. If, in fact, the marginal cost is increasing, then the declining average cost of fraud effect would again be dampened or reversed. However, if the marginal cost is decreasing, the effect is heightened. This too is an empirical question that is difficult to answer.

Noting those two caveats, it seems clear that none of the Commission's proposals does an adequate job of providing relatively high deterrence for "particularly serious or extensive fraud offenses."

IV. Conclusion and Recommendation

The Sentencing Commission attempted to answer congressional concerns regarding corporate frauds of an especially large magnitude. In its proposed changes to the loss table in §2B1.1(b)(1) the Commission sets up an incentive structure that achieves the exact opposite. The proposed sentencing structure actually induces a situation of declining marginal deterrence which has the potential to produce larger frauds on the margin.

A superior loss table would provide increasing marginal deterrence whereby the average cost imposed on the perpetrators of a fraud increases with the scale of the fraud. Such a system would go a long way to discouraging especially egregious offenses.