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WALL STREET FRAUD AND FIDUCIARY DUTIES: CAN JAIL TIME SERVE AS AN ADEQUATE DETERRENT FOR WILLFUL VIOLATIONS?

HEARING

BEFORE THE

SUBCOMMITTEE ON CRIME AND DRUGS

OF THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

MAY 4, 2010

Serial No. J–111–88

Printed for the use of the Committee on the Judiciary

U.S. GOVERNMENT PRINTING OFFICE
63–555 PDF WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

VerDate Nov 24 2008 11:29 Feb 07, 2011 Jkt 063555 PO 00000 Frm 00001 Fmt 5011 Sfmt 5011 S:\GPO\HEARINGS\63555.TXT SJUD1 PsN: CMORC

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WALL STREET FRAUD AND FIDUCIARY DUTIES: CAN JAIL TIME SERVE AS AN ADEQUATE DETERRENT FOR WILLFUL VIOLATIONS?

TUESDAY, MAY 4, 2010

U.S. SENATE,
SUBCOMMITTEE ON CRIME AND DRUGS,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:30 a.m., in room SD–226, Dirksen Senate Office Building, Hon. Arlen Specter, Chairman of the Subcommittee, presiding.

Present: Senators Specter, Whitehouse, Klobuchar, and Kaufman.

OPENING STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Chairman SPECTER. Good morning, ladies and gentlemen. The Judiciary Subcommittee on Criminal Law will now proceed with this hearing on the issues of alleged Wall Street fraud and what is the appropriate governmental response.

The issues have come into sharp focus recently with the filing of charges by the Securities and Exchange Commission against Goldman Sachs. We have seen an economic crisis gripping the country for many months, enormous loss of jobs, enormous loss of gross national product, problems that are worldwide, and serious issues have been raised as to the connection between the so-called mortgage bubble and what has happened.

In the allegations by the Securities and Exchange Commission, they have focused on packaging of mortgages, subprime mortgages, then bundled and then securitized with the stock being sold backed up by those subprime mortgages. The allegation has been made that the player who put together the mortgages then engaged in short selling. But a question arises as to what the duty, if any, is owed by the participants in this kind of an arrangement where investments are sold, what reliances on the part of the purchasers that there is a sense of a solid investment, while at the same time they are being sold short, which is a bet that they are going to go down in price. Some defenses have been raised, but we are dealing here with sophisticated buyers, and we are going to inquire into that.

There are complicated arrangements with a variety of definitions and classifications, different duties owed as to someone who is de-

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fined as a broker, someone who is defined as a dealer, someone who is defined as an investment adviser. And the final resolution of duties really depend upon how Congress sees it. We have the authority to define those relationships once we understand them. An extraordinarily complex field.

I have long believed that it is insufficient to have fines for fraud. For corporate fraud, if you have a fine, it is calculated as part of doing business. And even where you have $1 billion fines, it is a relative matter where you have corporations which have $85 billion in net proceeds and very, very substantial profits.

I had experience as a public prosecutor years ago and found that criminal convictions worked as an appropriate measure of punishment and worked as a deterrent to others. This Subcommittee has the responsibility for making recommendations to the full Committee and in turn to the full Senate as part of a legislative package as to what kind of penalties ought to be imposed.

The Assistant Attorney General of the Criminal Division had a conflict this morning, but we will have an afternoon session to hear his testimony. We have very distinguished witnesses and a great deal of testimony, so I am going to keep this opening statement brief.

I turn now to my distinguished colleague Senator Kaufman.

STATEMENT OF HON. EDWARD E. KAUFMAN, A U.S. SENATOR FROM THE STATE OF DELAWARE

Senator KAUFMAN. Yes, Mr. Chairman, I want to tell you I have rarely seen a hearing that had better timing than this one. I mean, talk about being at the right place at the right time, and it is not unusual for the Chairman to do that. I think he has been one of those people that has constantly looked out for how we can change things, how we can make things better, and how we can better make sure that the law is enforced.

So thank you for holding the hearing today, and I am looking forward to the testimony.

Chairman SPECTER. Thank you very much, Senator Kaufman.

Our first witness is Ms. Barbara Roper, the Director of Investment Protection for the Consumer Federation of America, an alliance of approximately 300 pro-consumer organizations representing approximately 500 individual consumers. Ms. Roper has extensive experience conducting studies of abuses in the financial planning industry and is an adviser on financial reform. Ms. Roper earned her bachelor's degree from Princeton University, a frequent witness before Congressional committees.

We welcome you here, Ms. Roper, and look forward to your testimony.

STATEMENT OF BARBARA ROPER, DIRECTOR OF INVESTOR PROTECTION, CONSUMER FEDERATION OF AMERICA, PUEBLO, COLORADO

Ms. ROPER. Thank you very much. Mr. Chairman, members of the Committee, I greatly appreciate the opportunity to testify before you today on an issue that I have been working on since I first joined CFA in 1986, which is the need to hold brokers to a fiduciary duty to act in the best interest of their customers.

At CFA, our primary focus has been on protecting average, retail investors. But as last week's hearing in the Permanent Subcommittee on Investigations made clear, institutional investors are also in need of protection from Wall Street's increasingly predatory ways. And it is that aspect of the issue I will be talking about today.

In examining the root causes of the financial crisis, many have observed that Wall Street firms no longer exist to primarily serve the needs of their customers. Indeed, the Goldman Sachs executives who testified last week seemed bewildered at times at the notion that anyone would expect them to do so. In their world, it appears that everyone takes it for granted that customers who cannot look out for their own interests are simply sheep waiting to be shorn and that the only imperative they recognize is the imperative to maximize the firm's profits. While no single approach can offer a panacea, extending the fiduciary duty to brokers and to their dealings with institutional investors has the potential to significantly improve the culture on Wall Street.

So what would it look like if these Wall Street firms were required to act in the best interests of their customers?

For starters, it would be considerably more difficult to sell a product that you had specifically designed in order to move risks off your own balance sheet and in order to make a bet against it. At the very least, you would have to at least disclose the reasons for believing the securities were in the best interest of the customer, the nature of your role in that transaction and the conflicts of interest, and the risks that the client might be exposed to in the deal. Providing boilerplate disclosures that you might be either long or short the transaction would not suffice. And a firm's proprietary trading practices generally would have to be accompanied by more robust disclosures and enhanced protections to ensure that the transactions truly benefited the customer. In other words, fiduciary duty could help to significantly rein in the kinds of abuses that were highlighted in last week's hearings.

Fiduciary duty could play a similarly beneficial role in targeting the kind of abusive practices that have been used to sell local governments all around the country on derivatives and other swaps arrangements. For example, it is hard to see how an investment bank could sell a swap designed to help a county hedge its interest rate risks that expose that county to greater risks—risks that were far greater than the risk that they were actually hedging, as has been experienced in communities all over the country. And what about those multi-million-dollar surrender fees that clearly benefit the investment bank, but what about the customer? At the very least, all of these features would have to be disclosed, including such factors as the firm's financial interest in the trade and the maximum exposure of the customer would have to disclosed under a fiduciary duty. And if the customer would be better off in a traditional fixed-rate bond or variable-rate bond, then that is what the investment bank would have to recommend.

In considering whether to expand fiduciary duty, Congress would need to decide when and to what that duty should apply. The legislative proposals currently under consideration offer several different approaches. The financial regulatory reform bill that passed

the House requires the SEC to adopt a fiduciary duty for brokers when they provide personalized investment advice to retail investors, and it permits the agency to extend that fiduciary duty to institutional investors. Unfortunately, the Senate bill, which started out stronger than the House bill, now does nothing to strengthen the fiduciary duty for investment advice. Senator Akaka and Senator Menendez have indicated that they plan to offer an amendment to fix that problem by substituting the House language, which is something that CFA strongly supports.

On the other hand, the derivatives package in the Senate bill does include a fiduciary duty for swaps dealers in their dealings with Government entities, pension plans, endowments, or retirement plans. Because it covers derivatives, this provision fills an important gap necessary to reach the full range of Wall Street abuses that contributed to the crisis. Furthermore, because derivatives are among the most opaque and complex investments, they represent an area where all but the most sophisticated institutional investors are at an extreme disadvantage in their dealings with Wall Street and most in need of the fiduciary protection.

As with any regulation, imposing a fiduciary duty on brokers will be only as effective as the regulatory enforcement that backs it up. Regulators, therefore, need to be prepared to impose fines that are commensurate with the damage to the customers, to hold supervisors accountable for the actions of those they supervise, and to pull the licenses of individuals who commit serious violations. But given the potential profits at stake in this area, as you have noted, fines are rarely going to be heavy enough to serve as a true deterrent. Holding out the possibility of jail time for violations has the potential to provide that deterrent. Moreover, tying criminal sanctions to willful violations would set an appropriately high bar to ensure that only the most egregious abuses result in jail sentences. As such, we believe that expanding the fiduciary duty and imposing criminal sanctions for willful violations could serve as a truly effective deterrent to the kinds of abuses that brought the global economy to the brink of collapse.

Thank you.

[The prepared statement of Ms. Roper appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Ms. Roper.

Our next witness is Mr. Andrew Weissmann, from the firm of Jenner & Block, co-chair of the White-Collar Defense Unit there. Mr. Weissmann served as director of the Enron Task Force, was the chief of the Criminal Division of the United States Attorney's Office for the Eastern District of New York, later special counsel to the Director of the FBI; a graduate of Columbia Law School.

We welcome you here, Mr. Weissmann, and the floor is yours.

STATEMENT OF ANDREW WEISSMANN, PARTNER, JENNER & BLOCK, NEW YORK, NEW YORK

Mr. WEISSMANN. Thank you, Senator Specter, Senator Kaufman, and staff. As the former director of the Enron Task Force, I see certain parallels between the response to Enron and the issues being addressed today regarding the financial crisis. Now, as then, for instance, we have learned that the stability of the institutions we re-

garded as most robust may be illusory. But while comparisons are tempting, we have yet to see in the current crisis the kind of systemic fraud that occurred at Enron.

I am not convinced at all that all or even the core of the conduct that we find most troubling on Wall Street now is properly considered criminal.

Of course, Wall Street is not immune from criminal activity, but to the extent there is misconduct, there are abundant tools at the Government's disposal to address the problem now. Thus, even if jail time for certain Wall Street misconduct is the best prescription for the current crisis, that goal does not require additional Federal crimes. I will make three points.

First, before we add more criminal statutes to the Federal code, we should examine those that are already available to prosecute financial crime. Here, an anecdote of my own may be illustrative. I was a Federal prosecutor for 15 years, and when I switched from prosecuting organized crime bosses in New York City to going after financial fraud on Wall Street, I sought advice from a senior prosecutor regarding what I thought were intricate securities fraud statutes. His advice to me was get to know the mail and wire fraud statutes really well and not to worry about the rest. That is all embroidery.

That advice was a recognition that in our technological age it is hard to see what criminal conduct at a financial institution would not satisfy the jurisdictional hook of the mail or wire fraud statutes. Any e-mail or SEC filing in service of a scheme to defraud could suffice. Even if we were to define new fiduciary duties, it is difficult to imagine what kind of material breach would not involve a misstatement or omission and, thus, be covered by at least one and probably several of the existing Federal criminal statutes. And if the misstatement is not material or the intent not willful, it is not evident that the conduct can or should be considered criminal.

Another point that I would like to make is that a statute that criminalizes the breach of fiduciary duties could be struck down by the Court as impermissibly vague. Inquiries into the existence and scope of fiduciary duties can be a highly fact-specific project. If fiduciary duties are imported into the criminal context, their vagueness may take on constitutional significance.

The Supreme Court is currently considering this issue in three cases involving the so-called honest services statute, which criminalizes the use of the mail or wires to deprive someone of "the intangible right of honest services," a statute that some have criticized as criminalizing everything from defrauding a client to an employee calling in sick for a day.

Imposition of criminal liability for breaching fiduciary duties would raise similar concerns about notice and fairness. For instance, would it be a Federal crime for a broker to fail to read diligently a prospectus or call a client daily about the market? Would every breach of a duty of care now become a crime?

Given the pending Supreme Court decisions on the honest services statute, it would be wise to wait at least for the Court to speak before initiating legislation criminalizing conduct in this area.

But there are other reasons not to leap to criminalizing conduct that is not now the subject of even civil liability. The line sepa-

rating criminal conduct from all other is society's starkest boundary between right and wrong, and it should continue to be reserved for the most egregious misconduct.

Second, it would be better to regulate problematic conduct directly or to first define the scope of specific fiduciary duty obligations in the civil context than to impose a vague criminal stricture that would leave the Government with unwarranted discretion and the public without the certainty of clear rules.

Finally, the case for regulatory weapons, new ones, has not been made. Current law provides civil regulatory agencies with numerous tools. Executives and brokers can be barred from the industry by the SEC; corporations can lose their license to sell securities or to contract with the Government; and corporations' profits can be wiped out by both the SEC and the Department of Justice.

To the extent that one believes that the SEC, in spite of some contrary examples, has been a toothless tiger, the remedy is to encourage the SEC and the Civil Division of the Department of Justice to make greater use of their enforcement authority, not to rush to criminalize new conduct.

Thank you.

[The prepared statement of Mr. Weissmann appears as a submission for the record.]

Chairman SPECTER. Thank you, Mr. Weissmann.

Our next witness is Mr. Damon Silvers, associate general counsel for the AFL–CIO, where his responsibilities include corporate governance, pension, general business law issues. He was part of the AFL–CIO legal team that won severance payments for laid-off workers from Enron and WorldCom. He graduated from the Harvard Law School and has an MBA from the Harvard Business School.

Welcome, Mr. Silvers, and we look forward to your testimony.

STATEMENT OF DAMON A. SILVERS, POLICY DIRECTOR AND SPECIAL COUNSEL, AFL–CIO, WASHINGTON, DC

Mr. SILVERS. Thank you and good morning, Chairman Specter, Senator Kaufman, and staff. I am Damon Silvers. I am now the policy director of the AFL–CIO, a recent promotion, and I serve as the Deputy Chair of the Congressional Oversight Panel for TARP. My testimony before this Committee is on behalf of the AFL–CIO and not on behalf of the Congressional Oversight Panel, its staff, or its Chair.

The financial crisis that began in 2007 has had a devastating effect on working Americans. The U.S. economy lost 8 million jobs. Pension funds saw their asset values decline by close to $3 trillion, a drop of 30 percent, driven by broad equity market declines in the 40-percent range, from which the markets have yet to fully recover.

Mass home foreclosures, which not so long ago were a distant memory of the Great Depression, now seem to be a permanent feature of American life, running this year at the rate of 2.8 million foreclosures a year.

Finally, the American public had to foot the cost, yet unclear, of rescuing the financial system.

As a general matter, the AFL–CIO believes that proper structuring and implementation of financial regulation is key to pro-

tecting the public from the consequences of financial boom and bust cycles, and we support strengthening and passing the Wall Street Accountability Act of 2010.

We have always been skeptical of the line that we heard from then President Bush after Enron that everything was fine, just a few bad apples in the barrel that needed to be weeded out and prosecuted. In that sense, jail time, or the threat of jail time, for willful acts is not an adequate deterrent for financial misconduct, nor is the criminal law in and of itself adequate to police our financial system.

However, we also believe that the fundamental fairness of our society is at issue when we look at the application of the criminal law to securities fraud and other types of business cases.

There is a public perception in the wake of the events of 2008 that unfortunately has some justification that a small number of wealthy and powerful Americans did vast damage to our country and to the lives of millions of families with relatively no personal consequences. A double standard with respect to willful illegal activity should not be acceptable in a democracy.

Now, recently we have seen action by the Securities and Exchange Commission on a major case related to the financial crisis involving Goldman Sachs, which Barbara Roper referred to, and the press is reporting that the Justice Department has opened a criminal investigation. The legal arguments associated with this case have revealed a paradox with implications for the criminal law. Many Americans seek financial advice from their stockbrokers. Yet the reality is that the legal obligations of a broker are simply limited to recommending securities that are suitable and reasonable for their clients, not putting their clients' interests first. There is also no obligation for brokers to avoid or disclose conflicts of interest.

The AFL–CIO supports a clear fiduciary standard for both broker-dealers and investment advisers, as was provided in the original draft of Chairman Dodd's Wall Street Accountability Act. I have attached to this testimony a letter from SEC Chairman Mary Schapiro to Chairman Dodd which discusses this issue in further detail. We particularly support requiring dealers in derivatives, when dealing with institutional clients such as pension funds and municipalities, to meet a fiduciary duty standard.

In the context of adopting such a clear uniform standard, Congress should adopt companion language in the criminal code addressing willful breaches of fiduciary duty by brokers, much as the criminal code addresses willful acts of securities fraud or intentional breaches of fiduciary duty in the ERISA context. I would submit there is nothing particularly exotic about criminalizing intentional breaches of fiduciary duty. It is a well-known feature of our pension law today.

There is another gap in our system of accountability for Wall Street, a gap you, Mr. Chairman, have taken the lead in addressing, for which we commend you, and that is the area of aiding and abetting securities fraud. While the aiding and abetting problem is a civil issue and not a criminal issue, it has consequences for the enforcement of the criminal securities laws. Effective deterrence of both civil and criminal securities fraud has always been in part re-

liant on the ability of investors themselves to pursue those who defraud them, and thus to draw the attention of the SEC and the Justice Department. This chain of events simply does not occur when private parties have no ability to pursue investment banks and other third-party actors in securities fraud cases.

The AFL–CIO has long taken the view that the financial system needs to be regulated not with an assumption that the system is populated either by saints or villains, but by ordinary people subject as all of us are to economic and organizational pressures. Strong, comprehensive regulation is the right approach to such a system today as it was in the days when our securities laws were first enacted. But the criminal law is a necessary part of such a system, as my fellow witnesses have pointed out, for the most egregious acts.

Thank you very much for the opportunity to testify before this Subcommittee.

[The prepared statement of Mr. Silvers appears as a submission for the record.]

Chairman SPECTER. Thank you, Mr. Silvers.

We will proceed now with 10-minute rounds of questioning. We may have to modify depending upon how many Senators arrive in terms of the length of the hearing, but we will start at 10 minutes.

Ms. Roper, how would you classify Goldman Sachs on the scale of definitions in the transaction being pursued by the SEC?

Ms. ROPER. Well, in the transaction, the Abacus transaction that is at the base of the SEC case, the issue in dispute is a very narrow technical one. Did Goldman Sachs, when they supplied all of that information about ACA's involvement in selecting the mortgages, misrepresent the facts by leaving out John Paulson's role? And, you know, I do not have the expertise to judge that decision. What I do know is that in the series of transactions that were described in that hearing, the Goldman Sachs executives continually said, "We are just market makers. We are just market makers. We are providing liquidity. We are bringing buyers and sellers together."

But the evidence in their e-mails and the evidence in their own statements suggests that that is clearly not the role—they were not limited to playing that role. They were actively moving securities off their books onto the books of their customers. They were looking to get out from under risk. They were packaging these products for a particular intent. And in several cases, they specifically stepped back from their role of market maker. For example, when they had a customer who wanted to short a stock, arguably what a market maker would do would be to bring those customers together. They retained the right to short it instead. They stepped ahead of their customers. When they had customers who wanted them to support a transaction, they refused because they knew it was a bad deal.

So, you know, their conduct may well—I mean, their conduct in many of these instances may well have been perfectly legal, which is the first problem we have to solve. We need to create an obligation for brokers to act in the best interests of their customers to recognize that the notion, in light of the complexity and opacity of products today, the notion that institutional investors, that the majority of institutional investors can look out for their own interest is simply a fiction.

Chairman SPECTER. Ms. Roper, what standard applied to Goldman Sachs in this transaction? What duty of care?

Ms. ROPER. Well, if they were acting as a broker and if the sale was not a private placement where—well, even if it were a private placement, they would have had a suitability obligation, they would have had an obligation that particularly in this context is really barely removed from a fraud standard. In other words, they would have needed to make sure that the customer was permitted to engage in this transaction. They would have needed to make sure that the customer wanted a security that roughly resembled what they were offering, but then they would not have had to take the next step of saying among all of the things I have available to sell that fill the bill, you know, that fit those qualifications, is this the one that is best for the customer?

Chairman SPECTER. Ms. Roper, would you say they had a duty, as you characterize it, to act in the best interests of the customer?

Ms. ROPER. Well, I think they had a moral duty to do that, but I do not think they necessarily had a legal duty because of a basic gap in our current laws.

Chairman SPECTER. I understand that Senator Kaufman needs to go to the floor at 10. Let me yield to you at this point, Senator Kaufman.

Senator KAUFMAN. Thank you. I would just like to deal with one point. There are a lot of things I would like to deal with, but unfortunately in this job you do not get to say where you are going to be.

Anyway, Mr. Weissmann raised a good point that a lot of people raised. He says that the regulators had the ability to do this, everybody has got a right, we really don't need to change the law and just let things go on the way they are. And I would like to ask each one of you: Isn't our responsibility to make sure this does not happen again? We went through 8 years where we had regulators that basically did not enforce the law, and not because they were bad, they just did not think that we should have laws on regulation. I mean, they were quite clear about that from top to bottom.

So one of my concerns as we move forward on this—and I think that Senator Specter's idea of criminalizing this thing just—since I am not going to be here for a long time, I agree with what Mr. Silvers says—that there really is a crisis in this country, and I do not think it is a populist statement. I just think there is a crisis in terms of people thinking there are two different rules. So basically I am for, you know, doing something about it.

But starting with Mr. Weissmann, then others, don't you think it is important that the Congress give the regulators clear law on this since the regulators had the ability, as you said so well, to do so many of these things and they did not do it? Just in regard to this one question of criminalizing things, and I would like Ms. Roper and Mr. Silvers to make a comment.

Mr. WEISSMANN. I agree with the sentiment and I agree that there is an issue with respect to the public viewing there as being two worlds and two different systems that are going on. But I think that creating a new criminal statute, which was similar to some of what was done post-Enron, will not cure the problem. You can look at Goldman—and I do not think we know the facts yet—but if

there was a misrepresentation in terms of the disclosure, that can be prosecuted civilly, and if it is intentional, that can be prosecuted criminally.

The answer is to have oversight of the Department of Justice and the SEC to be taking those actions. Putting yet another law on the books might sound good to the public, and that Congress is interested in making sure something happens, but it will not assure that somebody actually implements it.

So Goldman, assuming that there was wrongdoing there, could happen again without the SEC and the Department of Justice being vigilant about oversight with the current tools that they have.

Senator KAUFMAN. Ms. Roper.

Ms. ROPER. You know, it is no mystery you all have a huge task before you in dealing with the current crisis. The number of things that went wrong to create this crisis is really sort of mind-boggling. And in addressing it—I mean, yes, you have to regulate where we have in the past chosen not to regulate, so, for example, in the over-the-counter derivatives markets.

Where there are things that were not illegal that should have been illegal, we need to make it clear that they are illegal. And I think the conduct in this area is one of those areas.

The system did not work because there were sort of structural flaws in the system because we had institutions that were too complex to be effectively regulated or to be handled when they started to fail. We need to fix those aspects of the problem. And, yes, we need to make it clear to regulators what it is that we expect them to do in enforcing the laws, and then we need to hold them accountable for doing it.

One of the biggest concerns about this legislation, which CFA strongly supports, is that it relies for its success on regulators to do effectively what they did very poorly in the run-up to this crisis. And so there is a job to be done after the legislation is passed and holding them accountable, and providing them with clear guidance in terms of the laws you expect them to enforce makes that easier.

Senator KAUFMAN. Mr. Silvers.

Mr. SILVERS. I will make two points, one about the specific legal issues involved in the broker-dealer area and what the problem is. The problem lies in what my fellow witness Mr. Weissmann said about a misrepresentation. My understanding of the Goldman case in a nutshell, it is like if you went to buy a car, and you said to the dealer, "Is this car safe?" And the car dealers says, "Yes, the car is safe." And the dealer may or may not have made a misrepresentation to you, but what the dealer did not tell you is that the car has been selected for you by someone who has taken out a life insurance policy on your life.

Now, not telling you that is not a misrepresentation. I do not know—and I think no one in this country at the moment knows—whether not telling you that in the context of a derivatives transaction by a broker-dealer constitutes fraud. That is going to be the subject of extensive litigation. It is unquestionable, though, that if we had a fiduciary standard, any fiduciary standard, that not telling you that in that context would breach that fiduciary standard.

The criminal issue is if you did not tell somebody that intentionally, if you had e-mails saying, oh, you know, we better not tell the customer what we are doing because if they found out they would behave differently, and we really want them to buy this and that sort of thing, if you had that type of intentional, willful conduct, should that be a crime? I suspect that if you think about it in the context of the auto analogy I drew, most of us would say that feels like a criminal act.

The point of my testimony is that it is—in order to have sort of consistent fabric of the law, willful, intentional, egregious breaches of fiduciary duty in general in our legal framework are crimes.

Now, Senator, you raised the much broader and more difficult problem of what do we do about regulators and enforcement agencies that do not do their jobs. I think there is an easy answer and there is a hard answer. The easy answer is we ought to at least fix the structural problems that make it very unlikely they will do their jobs. The AFL–CIO's view is that it is dysfunctional to ask prudential regulators to protect consumers, that those two missions are in profound conflict, and we support an independent consumer financial protection agency for that reason. So that is a structural fix.

We do not view the SEC, the Securities and Exchange Commission, as having a structural problem. We are pleased with the general direction of its leadership. But I think we have to recognize that as long as large financial institutions wield the kind of political power that they do in our society currently, the efficacy of our regulatory agencies is always in jeopardy. And I think that is one of the reasons why the AFL–CIO very strongly supports your efforts, along with Senator Brown's, to do something about the size of those institutions.

Senator KAUFMAN. I just want to say that we had the meltdown in 1929. In 1933, we came and we passed good laws, hard laws, Glass-Steagall and others, that lasted us for generations. I think the Chairman here—I want to cosponsor your bill. I think the Chairman is on to something in terms of the fact—and I do not feel like a populist when I say that. The fact that the vast majority of Americans could not understand what Goldman Sachs was doing in the testimony, but everybody that knew and follows what goes on knew what they were saying, and it all had to do with this broker-dealer relationship. But I think every single person I have run into since that hearing says, "That was wrong," and we know that is wrong. It is the Potter standard. We know it when we see it. And guess what? If I am an auto dealer and I do that or I am someone that is in another business and I do that, where I am basically, you know, misrepresenting what it is that I am doing, that the other side, I do not let them know what my real personal position is in what I am doing, every American knows that is wrong, and every American knows in just about every other industry and business we are in, if you do that you go to jail.

So I support what—I do not think that is—I do not believe—now anything that says something like that is populism. I do not think that is populism, because the people I talk to that are upset about it are not populists or anything else. The people I talk to that watched what went on said, "This is just wrong. I know it is wrong.

Everybody knows it is wrong. You should go to jail when you do something like what Goldman Sachs did." They cannot go to jail now because it is not against the law.

So, Mr. Chairman, I support totally what you are doing. I think we need strong laws. Great fences make great neighbors. And I think that we need some kind of a criminal statute to deal with this.

Chairman SPECTER. Thank you very much, Senator Kaufman.

Ms. Roper, we are on a point before I yielded to Senator Kaufman where I was asking you whether you thought that Goldman Sachs acted in the best interests of the customer.

Ms. ROPER. No. I mean, I do not think you can remotely conclude from the evidence that has been put forward that they were looking to act in the best interests of the customers or recognized any obligation to do so.

Chairman SPECTER. Mr. Weissmann, what duty, if any, do you think Goldman Sachs owed to the customers?

Mr. WEISSMANN. Well, I do not think we know yet enough about the intricacies of that case. But one thing that we do know is the laws that they are currently subject to. If they, in fact, misrepresented the role of one of the people who was going to be influential in picking securities in the Abacus deal, then that is currently a civil and criminal offense, criminal obviously if it is done with the requisite intent.

Chairman SPECTER. Well, what if it is a failure to disclose that participation?

Mr. WEISSMANN. If there was no misrepresentation and they simply did not disclose it, but they were serving as a market maker, then that is something that is legal.

Chairman SPECTER. Do you think Congress ought to change that if that conduct is legal?

Mr. WEISSMANN. No, I do not. I think that there is a place for caveat emptor. If I as a buyer want a heightened duty at a financial institution, there is currently a clear mechanism for doing so. You can have a discretionary account. You can pay that financial institution to be an investment adviser and have them—you can choose to have a different type of relationship where you are not going to just give the institution instructions, and then they have a fiduciary duty currently to carry it out and to offer you suitable securities. But if you decide to have a relationship where they are going to be exercising any form of discretion, then there currently is a fiduciary duty requirement, certainly in New York where I am from.

Chairman SPECTER. Well, let us explore that for just a minute. Is there no implicit representation when Goldman Sachs sells these securities that Goldman Sachs does not have an intent to bet against them to, in effect—wait until the question is finished.

Mr. WEISSMANN. Sorry.

Chairman SPECTER. Wait until Goldman Sachs is, in effect, of a mind that these securities are going to go down in value, when you talk about a misrepresentation, how would you distinguish that kind of a mens rea that the value is going to go down according to Goldman Sachs, isn't that really a misrepresentation?

Mr. WEISSMANN. I think that is a great question, and I think it is very fact specific. If the issue is what is being implicitly represented when somebody is a market maker, I think that people who deal with market makers implicitly understand—and I think this was, in fact, in Goldman disclosures—that the market maker could be taking all sorts of different positions, that there could be people including Goldman Sachs that are thinking that it is a foolish thing to be on one side of the deal versus the other. I think that is, by definition, what a market maker is.

Chairman SPECTER. Well, how about the participation of Mr. Paulson as alleged? And I agree with you, we do not know all the facts yet. But as alleged, Mr. Paulson was the person who put these subprime mortgages together, and he is a major hedge fund operator. And as it worked out, he, according to the allegation, selling them short, made $1 billion. How can even a sophisticated investor exercise diligence to go into a bundle of subprime mortgages and figure out what they are when the person who is putting them together knows what they are and thinks they are going to go down in value? How about that?

Mr. WEISSMANN. I agree with you, if those are the facts, if it turns out that that is what Mr. Paulson was doing, and Goldman knew it and was representing otherwise, then that clearly is not only a civil problem, but it could be a criminal problem. I think that my point earlier is that——

Chairman SPECTER. It could be? When you say Goldman knew what Mr. Paulson was doing?

Mr. WEISSMANN. The only reason I say it could be a criminal problem is, as a former prosecutor, one looks for criminal intent and whether one can prove that beyond a reasonable doubt. But assuming those set of facts, you would look at civil liability and to make a criminal case in connection with misrepresentations about the fact that a person was choosing undisclosed—in fact, a misleading statement was made about that person's role in the security that was being marketed. That would be very different and raises—I think that is the reason there is such a strong reaction to the Goldman Sachs allegations by the SEC. It is not simply the market maker factor. It is the issue of whether the disclosure was misleading about what Mr. Paulson's role was going to be. And if those bear out, then I think everyone has good reason to be upset about what happened.

Chairman SPECTER. Well, how about the nondisclosure? Isn't nondisclosure sufficient to establish culpability? Nondisclosure of a very material fact?

Mr. WEISSMANN. That could be. Under the current securities laws, a material omission can be prosecuted civilly, and it can be prosecuted criminally under the current civil laws and criminal laws.

Chairman SPECTER. Mr. Silvers, Mr. Weissmann is moving along here. He is, I think, conceding that there is criminal liability here on the facts as represented. Maybe we do not need to change the law at all. What do you think?

Mr. SILVERS. Well, I think you need to follow very carefully these distinctions between misrepresentations, misleading statements, and omissions. My understanding is that the question of an omis-

sion under current law for a broker-dealer or a market maker is at best unsettled, and that that really is the nub of this discussion; the question of whether the general securities law standard that Mr. Weissmann referred to at the end of his comments, which is the standard that would apply to an issuer of securities—or an investment adviser who has fiduciary duties. An issuer has a set of statutory duties that are non-fiduciary. The adviser has fiduciary duties.

Chairman SPECTER. How would you classify Goldman Sachs in this transaction?

Mr. SILVERS. Well, Goldman Sachs appears to have been a broker-dealer acting as a market maker. It is unclear to me whether or not in the context of doing that they were rendering investment advice. If they were rendering investment advice, their defense is going to be they are not covered by the Advisers Act because it was incidental to their market-making function.

Chairman SPECTER. Well, when you say rendering investment advice and that is the fiduciary standard, Congress has the authority to define what investment advice is. But if you have Goldman Sachs selling these securities knowing that they were in a bundle of subprime mortgages put together by an individual who thinks they are going to go down in value, isn't that sufficient to the customer, when you talk about a fiduciary duty, to tell them what is happening? Fiduciary duty is a big fancy word, but, in effect, to tell them what is going on?

Mr. SILVERS. Mr. Chairman, I think what you are pointing out here is that the reality of behavior today by broker-dealers is that it involves both sort of old-fashioned sort of market-making caveat emptor type behavior where a customer shows up and says, "I want a particular security. Sell it to me, please. Quote me a price," which is, I think, what the framers of the securities laws in the 1930s had in mind. It also involves investment advice. The customer who calls up and says, you know, "Tell me, Mr. Broker, what would you suggest I buy today," or "What do you think my portfolio mix ought to look like?" They do not have discretion over the account, but they are rendering advice.

And a third thing which I think is really the key to understanding the Goldman situation, which is something that looks sort of like being an issuer, which is you are packaging a security. Goldman knew something about the internal workings of these securities, according to the allegations at least, that a customer could not possibly have known in a way that a traditional market maker would not.

Chairman SPECTER. Even a sophisticated investor?

Mr. SILVERS. What Goldman knew, apparently, according to the allegations was that John Paulson, who had a short position, was putting the package together.

Chairman SPECTER. Mr. Silvers, is it adequate to deal with this kind of conduct with a fine? I note a media report that Goldman's value declined some $21 billion. Is it sufficient to impose a fine? Or what kind of a fine would be big enough to be punishment? What kind of a fine would be big enough to be a deterrent to others? Is there any fine sufficient to equate a jail sentence in terms of deterring other people?

Mr. SILVERS. Well, Mr. Chairman, I am reluctant to comment about the details of this case for the same reason as my fellow witnesses are. But I will comment in detail about what your question is in general.

It has been a mystery to me throughout my involvement in these issues why it is that fines in the area of securities fraud and other investment issues are as small as they are in relation to the firms and the conduct involved. But it is a feature of our system that they are very small in relation to a firm like Goldman Sachs.

Chairman SPECTER. Well, is any fine sufficient compared to a jail sentence?

Mr. SILVERS. I think there is a qualitative difference.

Chairman SPECTER. Ms. Roper, is a fine sufficient? Do we need jail sentences here as a deterrent?

Ms. ROPER. I agree that white-collar criminals should face the same risk of going to jail, arguably, that they do much greater damage. And if you look at the history of the fines that are imposed, even the most, you know, extensive fines that have been imposed in recent years, they are a drop in the bucket compared to the profits that the firms are making on this activity. And as a practical matter, we will not get fines at the level that would inflict that kind of damage.

If you look, for example, in the issue of JPMorgan's sales of swaps to communities around the country which have left towns, school boards firing people in debt, it was the criminal investigation into price fixing in that market that ultimately convinced JPMorgan to shut that unit down. It was the threat of jail time, which one JPMorgan employee actually did a little, that really sort of got their attention. And I do not think, given the kind of profits that they were making in that business that you could have done it with the traditional tools.

Chairman SPECTER. Mr. Weissmann, would fines have been sufficient in the Enron case, or don't you really need jail time to have a deterrent?

Mr. WEISSMANN. I agree with you that there are cases where you need jail time to have a sufficient deterrent. I think it is a complicated question. First, for corporations, there is no jail time, so the kinds of—to answer your question about what can be an adequate deterrent, sometimes a fine is not going to be sufficient, and other measures, such as a monitor barring the company from engaging in certain types of transactions, either permanently or for a temporary period, can serve a deterrent value.

Individual prosecutions criminally can serve a deterrent value, but not necessarily for corporations because they can simply cut loose that employee and not really take to heart what that means in terms of systemic change at the institution. So when you deal with corporations, the issue of jail time is really illusory, and you have to sort of figure out what else one can do other than a fine to get the company's attention when you really have egregious conduct.

Chairman SPECTER. Mr. Weissmann, I want to shift to a little different subject. The Supreme Court has said that aiding and abetting does not give rise to civil liability under the securities acts. I have introduced legislation, cosponsored by others, to change

that. Congress, of course, has the authority to change the laws, or the Supreme Court interpretation on something other than a constitutional issue. Aiding and abetting is a crime. How can you have conduct defined as a crime, which is a much tougher standard to prove a crime, than civil liability? Wouldn't it logically follow that there ought to be civil liability for aiding and abetting?

Mr. WEISSMANN. I think that the current state of the law is certainly unusual in that you have a criminal aiding and abetting statute, but it is not true that there is no civil liability. It is a question—the Court, I think, interpreting what Congress had done, determined that the SEC has enforcement power. And I think, candidly, what was going on——

Chairman SPECTER. Unusual? Do you know of any other case where conduct is defined as criminal conduct but does not give rise to a civil claim?

Mr. WEISSMANN. Not off the top of my head. I am sure there are, but not sitting here right now.

Chairman SPECTER. Let me move to one other subject because I want to bring in the second panel. You omitted the paragraph in a revised statement which you submitted that—it is a long one, but I think it is a very important issue, and I want to read it. This was in your first statement and omitted from your second statement.

"Likewise, to the extent that civil lawsuits brought by private individuals have also failed to create a sufficient deterrent effect, the problem may well be that the likelihood of civil liability is too low rather than civil sanctions are too weak. In particular, prior to imposition of new criminal liability, it may be worth examining whether some of the road blocks erected to prevent civil strike suits have been unintended consequences of blocking legitimate civil claims, particularly when they concern complex financial instruments. For example, it has been made intentionally difficult to comply with pleading requirements that dictate that the initial complaint must spell out the specifics of the civil fraud even prior to taking discovery. This may be unwarranted when the securities involved do not trade on a transparent open market—many structured financial products do not—and the practices of the financial institutions are not seen by the investor. Similarly, even in cases of blatant fraud, victims may find it difficult to overcome case law that almost automatically deems buyers so-called sophisticated investors even if they understand little about the complex securities marketed to them and even if they were told the securities were not complex at all."

Now, that is pretty complicated for C–SPAN viewers, but the people in the field will understand it. Aren't you really saying there that the law has gone too far and that the decisions, Congressional decisions, the 1995 Private Securities Litigation Reform Act requiring particularity when the plaintiff really cannot know the facts and has gotten them traditionally by discovery but cannot now, and that the limitations on the pleading rules on the recent Supreme Court decision have gone too far, and that there ought to be greater latitude in the civil lawsuits? You are suggesting that if there were that latitude, that might deal with the issue as opposed to criminal liability. Should we reduce the particularity necessary for a plaintiff——

Mr. WEISSMANN. Yes——

Chairman SPECTER [continuing]. And revise the pleading standards as interpreted by the Supreme Court?

Mr. WEISSMANN. Well, I think that the Supreme Court was correct in the *Stoneridge* decision in recognizing a difference in terms of who would be bringing the lawsuit and trusting that the SEC would be looking after the public interest with the concern that many lawsuits are brought as strike suits where they are not meritorious. And the issue is how to screen out the so-called strike suits that, frankly, are a tax on all of us because they are not meritorious, and you have corporations spending a fortune defending them.

The reason for the change in what I submitted was because the issue of how to best regulate, how to best deter conduct. I do not think comes from bringing more private civil lawsuits. I do not think that is a mechanism for effecting change. I think that there are other ways to do it, but I do not think corporations respond to that. I think that what you get, because there are so many frivolous lawsuits like that, is corporations spending a lot of money and correctly viewing the vast majority of those cases as not meritorious.

Chairman SPECTER. Mr. Weissmann, can you answer yes or no? If you can, I would like you to do that. If you cannot, I understand. But can you answer yes or no that there ought to be greater latitude on pleading?

Mr. WEISSMANN. I think the answer is——

Chairman SPECTER. To avoid a motion to dismiss.

Mr. WEISSMANN. I am sorry. I did not hear you.

Chairman SPECTER. To avoid a motion to dismiss.

Mr. WEISSMANN. I do not actually know, but I do not think that the current standard is inappropriate as set forth by *Stoneridge* and recent Supreme Court cases.

Chairman SPECTER. Why did you take the paragraph out of your resubmitted statement?

Mr. WEISSMANN. Precisely for the reason I told you, which is that the issue of how to best regulate conduct, how to best—what I understood this hearing was about was what is the best way, when there is wrongdoing at corporations, to get them to change.

Chairman SPECTER. What did you think was the best way to regulate conduct when you submitted your first statement?

Mr. WEISSMANN. Exactly what I wrote. When I looked at that paragraph, I realized that that did not address——

Chairman SPECTER. Did you change your mind on the best way to regulate conduct?

Mr. WEISSMANN. Yes, I did.

Chairman SPECTER. OK. Thank you very much, Ms. Roper, Mr. Weissmann, and Mr. Silvers. I appreciate your testimony.

Chairman SPECTER. We will move now to panel two: Professor John Coffee, Professor Henry Pontell, Professor Verret, and Professor Ribstein.

Without objection, we will insert into the record the written statements of the witnesses unavailable for this hearing.

[The statements appear as a submissions for the record.]

Chairman SPECTER. Our first witness is Professor John C. Coffee, Jr., the Adolf A. Berle Professor of Law at Columbia, also the director at Columbia of the Center on Corporate Governance. Professor Coffee has a very distinguished record as a member of the Legal Advisory Board of the New York Stock Exchange and NASD and a member of the Economic Advisory Board of Nasdaq. He has been a professor at an amazing array of law schools—Harvard, Stanford, Virginia, Michigan. Is that correct, Professor Coffee?

Mr. COFFEE. I have been a busy professor at all the ones you just named.

Chairman SPECTER. Wow, a lot of law schools. And he has the most widely used casebooks on securities regulation and corporate law. The Adolf A. Berle Professor of Law Chair at Columbia is named after an extraordinarily distinguished professor who wrote the casebooks and the treatises for many years. Professor Coffee is a graduate of Amherst and the Yale Law School.

The floor is yours, Professor Coffee. Five minutes.

STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA LAW SCHOOL, NEW YORK, NEW YORK

Mr. COFFEE. Thank you, Chairman Specter and members of the staff. My message is simple and direct: A fundamental hole exists in the center of the pending financial reform legislation that is now wending its way through Congress, and it will continue to exist unless and until Congress tells broker-dealers and investment banks basically that the client comes first, or in the language of lawyers, that broker-dealers and investment banks owe a fiduciary duty to the investor.

Conflicts of interest played a key role in causing and intensifying the 2008 financial crisis. I study financial history. That is not unusual. Conflicts of interest have played a key role in most of our major financial meltdowns.

We saw, we have seen already this morning—I will not rehash the history of what happened with investment banks and credit rating agencies giving inflated ratings and selling products that they were personally betting against. But I want to take you back just 10 years ago when we had Enron and WorldCom. At that time, we found that securities analysts were making inflated recommendations which they in contemporaneous e-mails discounted and showed they disbelieved. At that time, an iconic securities analyst, a man called Jack Grubman at Citicorp, told the world that what others called a conflict, he called a synergy. I think that was symptomatic. He was underplaying the role of conflicts.

That same attitude was prevalent last week when there was another symptomatic moment. At a critical point in last week's Goldman hearings, Senator Susan Collins asked a panel of Goldman executives did they have a fiduciary duty to act in the best interests of their clients. They were sort of stumped by that question and gave somewhat halting answers, but one of them eventually said that he did believe that "we have a duty to serve our clients."

Now, whatever he meant by that, the correct answer is simple and unambiguous: Except in a very few States, like California, broker-dealers owe no fiduciary duty, no general fiduciary duty to

their clients. That defines the problem, and that makes possible the continuation of serious conflicts of interest.

What brokers today owe is a much lesser dilute standard set forth in something called the suitability rule. The suitability rule is passed not by Congress, not by the SEC, but by self-regulatory bodies that began with the Stock Exchange and the NASD, and it is now a rule of FINRA, but it requires only that the broker not believe on facts that the client has disclosed to him that this particular security is unsuitable, is contrary to their needs given the information they have disclosed to the broker. That is a much lesser standard. A fiduciary duty requires that you act in the best interests of the investors. So the difference is between today a standard that says do not recommend a security if it is clearly unsuitable on facts the client has told you versus act always in the best interests of the customer.

Acting in the best interests of the customer, is that a bad idea? Several panelists in their prepared statements will tell you and have set forth in their statements that a fiduciary duty is inefficient, vague, ambiguous, and liability-laden. I think basically these are a laundry list of Chicken Little reasons telling us that the sky will fall in if we mandate that you act in the best interests of the customer. Let me make some basic points about whether or not the sky will fall in.

First of all, the securities laws contain a number of specified fiduciary duties and have done so since 1940. If you look at the Investment Company Act of 1940, it has a Section 36 which last month a unanimous Supreme Court interpreted to continue to set forth the fiduciary duty that governed. The Supreme Court reversed the decision of the Seventh Circuit that had sought to eliminate that fiduciary duty. So that is what all mutual funds are subject to today, a fiduciary duty about setting their own investment contracts.

There was a major hearing in front of a body called the Investment Company Institute 3 weeks ago. I was the keynote speaker at their lunch, and at that lunch they all agreed that they could live with the *Jones* v. *Harris* standard that the fiduciary duty recognized by the Supreme Court was not going to be a significant business problem for them. My point is the sky is not falling in in that field.

Now let us talk about the Investment Advisers Act of 1940, a different statute. All investment advisers are subject to a fiduciary duty, and most of the major investment banks already live with that standard in at least part of their activities. So much of what they do, they do live with the fiduciary duty. Chairman Schapiro at the SEC has proposed a uniform standard. The House Committee did and with no strong objection from FINRA at the time of that proposal.

My point is that the world is living with fiduciary duties today. The sky is not falling in. And I think the key issue for Congress is: Is it going to accept the current world, which is, as some described it, caveat emptor in terms of what can be done in the private world of placement agents? Or is it going to insist on a fiduciary duty? That is for Congress to answer. I do not have time to go into all the issues about the criminal law, but I would point out

that because the Supreme Court is certain, almost absolutely certain to be invalidating the existing honest services fraud statute—which is an overbroad, overripe statute that I previously criticized. But because they are unlikely to invalidate that statute, there is a need for a more focused, specialized statute dealing with just the fiduciary duties of a broker-dealer and not the fiduciary duties of all people at all times, which is what the honest services fraud statute was.

You are going to have an empty slate, not the slate that everybody has been describing as having many laws. The principle on a services statute would be invalidated, and you do need something to replace it.

So at this point, let me stop and just say that I think the key issue is the fiduciary duty, and I congratulate you for being on that right track.

Thank you.

[The prepared statement of Mr. Coffee appears as a submission for the record.]

Chairman SPECTER. Thank you, Professor Coffee.

Our next witness is Professor Henry Pontell, teaches criminology and law and society at the University of California at Irvine, has a bachelor's degree and master of arts and Ph.D., all conferred by the State University of New York at Stony Brook. He has devoted three decades of academic scholarship to the problem of financial fraud and white-collar crimes, served as vice president of the American Society of Criminologists and president of the Western Society of Criminology.

Thank you for coming a long way, Professor Pontell, and we look forward to your testimony.

STATEMENT OF HENRY N. PONTELL, PROFESSOR OF CRIMINOLOGY, LAW & SOCIETY, UNIVERSITY OF CALIFORNIA–IRVINE, IRVINE, CALIFORNIA

Mr. PONTELL. Thank you, Chairman Specter, staff, and thank you for the invitation to discuss policy issues related to the use of criminal punishment to deter financial fraud.

White-collar and corporate crimes impose an enormous financial burden on citizens, and it must be appreciated that they constitute a more serious threat to the well-being and integrity of our society than traditional kinds of street crime. As a Presidential Commission put the matter, "White-collar crime affects the whole moral climate of our society. Derelictions by corporations and their managers, who usually occupy leadership positions in their communities, establish an example which tends to erode the moral base of the law."

There are several major themes that I want to address in this brief presentation which summarizes my longer written testimony, and I will stick closely to the issue of deterrence through criminal punishment, which I was asked to concentrate on, versus the larger issues of the crisis.

First, I want to support the infliction of criminal penalties on white-collar and corporate criminals who violate criminal laws. The current spate of financial sanctions is no more than an additional and mildly bothersome cost of doing business.

Second, I want to emphasize that persuasive anecdotal evidence indicates that particularly for potential white-collar offenders the prospect of criminal penalties can be effective deterrents. There is no definitive empirical evidence to prove this. To mount a satisfactory experiment on the subject would violate ethical standards. But we know that upper-class businesspersons fear shame and fear incarceration. They are rational calculators par excellence.

Third, I would endorse the notion that regulatory agencies, most notably the Securities and Exchange Commission, be empowered to mount criminal prosecutions with internal personnel. Too often interagency agendas that must be negotiated between an agency and the Department of Justice inhibit effective deterrent responses to white-collar and corporate crime.

Fourth, I believe the public is growing increasingly restive about the failure of the criminal law to be tied to the crimes of those who engaged in them. The war on drugs snared a horde of financially marginal people. There has been no similar war on financial thugs. To make a decisive move toward deterring fraud in the higher echelons of business, a significant influx of enforcement resources is necessary to allow investigators and prosecutors to bring major cases.

Fifth, besides considering harsher penalties, Congress needs to seriously consider having chief criminologists and fraud experts as central officers of regulatory agencies, just as there currently are chief legal counsels and economists. A fraud analysis should be conducted before any new regulatory legislation is enacted so that we can avoid repeating mistakes of the past.

Given the low probability of apprehension and the likelihood of no or light punishment, white-collar crime is seen as a rational action in many cases. The comparative leniency shown white-collar offenders has been attributed to several factors related to their status and resources, as well as to the peculiar characteristics of their offenses.

Empirical evidence supports the leniency hypothesis. A study of persons suspected by Federal regulators in Texas and California to be involved in serious financial crimes during the savings and loan crisis of the 1980's revealed that between only 14 percent and 25 percent were ever indicted. The study also examined the sentences imposed in S&L cases involving mean losses of a half million dollars and found that the average sentence was 3 years—significantly less than the average prison terms handed to convicted burglars and first-time drug offenders tried in Federal court.

Some financial writers have labeled past reactions of politicians to corporate scandals as "hysterical," arguing that "penalties for failure are not merely lower earnings, but lawsuits, prosecution, huge fines, and long prison terms." They may be correct about failure causing lawsuits and even fines; but they are mistaken about prosecution. Long prison terms are not caused by mere failure; they are caused by serious criminal behavior.

A central problem that underlies deterrent strategies is that despite some high-profile cases, the Government has trivialized criminal fraud to the point that it is routinely dealt with at the lowest offense levels, and when larger cases are discovered they are more likely to be pursued civilly and not criminally. We can look at a key

example in the current crisis. The FBI publicly announced in 2004 that there was the potential for "an epidemic of mortgage fraud," yet Attorney General Michael Mukasey declined to create a task force to investigate the root causes of the subprime debacle, likening the problem to "white-collar street crime" that could best be handled by individual United States Attorneys' Offices. The lack of Government response after the alarm had been sounded stands in direct contrast to the Government's response to the savings and loan crisis—a financial disaster that was approximately 1/30 the size of the one we are currently experiencing. The central issue here is strong, proactive policing.

In conclusion, in August 2009, Maurice (Hank) Greenberg, former AIG chief executive officer, and Howard Smith, the company's former chief financial officer, paid $15 million to the SEC to settle the charge that they had misstated the financial condition of the company. Regarding the dynamics of white-collar crime, it was noteworthy that Greenberg did not admit guilt and insisted that had he been charged criminally with securities fraud, he would have fought the case rather than settle. This might be regarded as a piece of evidence favoring the view that the most effective tactic against white-collar offenders is the criminal charge. They find notably onerous and oppressive the stigma associated with a criminal label, while a financial penalty can be written off as not much more than the relatively small price of doing business—especially monkey business.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Pontell appears as a submission for the record.]

Chairman SPECTER. Thank you, Professor Pontell.

Our next witness is Professor J.W. Verret, assistant professor of law at George Mason University, where he teaches corporate and security law. Prior to joining the faculty at George Mason, Professor Verret was an associate in the SEC enforcement defense practice at Skadden Arps in Washington. He has his bachelor's degree from Louisiana State University, a master's from Harvard's Kennedy School of Government, and his law degree from the Harvard Law School.

Thank you for coming in, Mr. Verret, and the next 5 minutes are yours.

STATEMENT OF J.W. VERRET, ASSISTANT PROFESSOR, GEORGE MASON UNIVERSITY, ARLINGTON, VIRGINIA

Mr. VERRET. Thank you, Chairman Specter and Ranking Member Graham, and distinguished members of the Subcommittee. I appreciate the invitation to testify today. As you said, my name is J.W. Verret. I teach securities law at George Mason, and I also work with the Mercatus Center at George Mason. I also direct the Corporate federalism Initiative, a network of scholars who are dedicated to studying the intersection of State and Federal authority in corporate governance.

Considering new legislation requires that we compare the costs of the new law against its benefits. This is typically a very complicated process. For today's proposal, however, the exercise is fairly simple. A criminal fiduciary duty standard for securities brokers

would impose inordinate costs on the securities markets that would be passed through to investors while doing little to stop future financial crises.

I will also note that comparing today's topic to the Goldman Sachs controversy is inappropriate. That case is complex and that case awaits a final verdict. I certainly do not need to remind the Committee on the Judiciary that it would be foolhardy to make new legislation under the assumption that wrongdoing occurred without a full trial on the issue.

If it is ultimately determined that Goldman Sachs did engage in wrongdoing, the Department of Justice already has the necessary tools to prosecute securities fraud under Section 10(b) of the Securities Exchange Act of 1934. The legislation under consideration today, then, would not assist in prosecuting fraud of the sort alleged in the Goldman Sachs case, if indeed fraud occurred in that case in the first instance.

My work focuses in part on fiduciary duties in State corporation law. I was privileged to clerk for the Delaware Court of Chancery, one of the sources of American corporate law. The concept of fiduciary duties we are discussing today emerged from that court in many ways.

The challenge for judges reviewing business investments, under a fiduciary duty standard and after the fact, is that it is too tempting to decide whether a decision was fair at the time it was made in light of how the investment ultimately performs. Business decisions, like purchases of investment products, are highly risky. That is why they can be so profitable. But in administering fiduciary duty laws, it is nearly impossible to avoid being influenced by the perfect vision of hindsight.

Such Monday morning quarterbacking would, however, chill the securities markets in a significant way at a time when they are already under severe strain.

Getting fiduciary duties right in the civil liability sphere is difficult enough. Making fiduciary duty violations into criminal violations would pose an even greater challenge.

There are a wide variety of different relationships between securities brokers and their clients. Some securities brokers act as counselors; some merely facilitate transactions at the client's direction. Some brokers cater to large institutional investor clients; others cater to individual retail clients. The contracts governing these relationships are equally diverse. A global fiduciary standard for all of these relationships would limit investors' flexibility to design contracts appropriate for their particular needs.

By way of analogy, consider for a moment the market for foreclosed housing. Foreclosed homes are more likely to need significant refurbishment and have high maintenance costs. Banks foreclosing homes do not have the resources to inspect all of those foreclosed homes. So foreclosed homes sell "as is" at a deep discount. Buyers with the skills to gauge the risk are willing to buy those foreclosed homes, without requiring absolute guarantees from the banks that are selling them because they offer the possibility for generous profit, but also, of course, in tandem, they offer the possibility of significant risk.

Now, if we were to mandate that banks selling foreclosed homes issue an absolute guarantee on the homes they sell, there would no longer be a market for those homes, and a recovery in the housing market would be all but impossible.

The same thing would happen in the securities markets if we made brokers, through an unprecedented criminal fiduciary duty standard, absorb all of the risk of the financial products that they sell, particularly given the protections of 10(b)(5) in this area. The securities markets would freeze up. Brokers would operate under the possibility of prosecutions that, through hindsight bias, targeted them for selling products that lost money despite being fair risks at the time that they were sold.

A criminal fiduciary duty standard for securities brokers is a misguided idea. A civil fiduciary duty standard also poses the risk of significant cost. Now, should this Committee decide to institute a civil standard for securities brokers, I would urge an exemption permitting brokers and their clients to opt out of fiduciary liability to permit transactions for which all of the parties to the transaction feel fiduciary duties are not entirely appropriate.

I thank you again for the opportunity to testify, and I look forward to answering your questions.

[The prepared statement of Mr. Verret appears as a submission for the record.]

Chairman SPECTER. Thank you, Professor Verret.

Our next and final witness on this panel is Professor Larry E. Ribstein, who occupies the Mildred Van Voorhis Jones Chair in Law at the University of Illinois College of Law. Professor Ribstein is the author of leading treatises on limited liability as well as two business association casebooks. From 1998 to 2001, he was co-editor of the Supreme Court Economic Review and has written or co-authored approximately 140 articles on corporate securities and partnership law. He has a bachelor's degree from Johns Hopkins and a law degree from the University of Chicago.

We appreciate your being with us, Professor Ribstein, and we look forward to your testimony.

STATEMENT OF LARRY E. RIBSTEIN, MILDRED VAN VOORHIS JONES CHAIR, ASSOCIATE DEAN FOR RESEARCH, UNIVERSITY OF ILLINOIS COLLEGE OF LAW, CHAMPAIGN, ILLINOIS

Mr. RIBSTEIN. Thank you, Senator Specter, for the invitation to testify today. My testimony focuses on whether securities professionals, including investment bankers, should have fiduciary duties and whether there is a criminal liability for willful breach of these duties.

In summary, I believe this is the wrong tool or these are the wrong tools for dealing with any problems that might exist in the investment banking industry or the securities industry generally.

A fiduciary duty is one of the most amorphous concepts in the law, and that is not a Chicken Little statement. That is simply a statement of fact. Courts and commentators have used fiduciary language to describe many duties arising in a bewildering variety of circumstances, from doctor-patient to shareholder-director. It is not clear, for example, precisely how fiduciaries differ or whether they include a duty of care, implied contractual covenant of good

faith and fair dealing, duties arising out of contractual relationships, duties imposed only because of unequal sophistication, information, or bargaining power.

Fiduciary duties in their strict sense of a duty of unselfish conduct are appropriate only in a limited case where one party delegates open-ended management power over his property to another. This is the classic situation for imposing fiduciary duties. This is the situation that Justice Cardozo referred to when he called for duties stricter than the morals of the marketplace, and it is far removed from the usual situations involving investment bankers, broker-dealers, and investment advisers.

Fiduciary duties, I would also remind the Committee, are predominantly a matter of State law. There is no general Federal common law on which courts can draw to determine the dimensions of a new Federal statutes or a fiduciary duty.

A general fiduciary duty applicable to a broad range of investment banker dealings could leave significant uncertainty as to the nature of the duties in each specific context. For example, it may not be clear under a general fiduciary duty what types of conflicts of interest are permissible, what types of compensation investment bankers are entitled to earn, when contracts waiving fiduciary duties are enforceable, whether disclosure of conflicts is sufficient to avoid a fiduciary duty, what types of information must be disclosed, how material omitted information must be to trigger liability, to whom a duty is owed, and what the remedy for a breach of duty should be.

Professor Coffee raised the existing fiduciary duties under the Investment Company Act and the Investment Advisers Act as an indication that these are unfounded fears, but I would point out that in the case of the Investment Company Act, in the case that was recently decided by the Supreme Court in *Jones* v. *Harris*, that duty, which is actually fairly specifically defined in Section 36(b) of the Investment Company Act, is still unclear after 40 years of litigation and not a single plaintiff victory at trial. There is also an ambiguous, ill-defined duty for investment advisers defined by case law and, again, not very clear. So I think those are examples rather than counter examples of the problems that we might be facing by imposing a fiduciary duty.

Disclosure duties are, in fact, generally sufficient without resorting to inventing a new investment banker fiduciary duty, and that would include the situation involved in the Goldman Sachs case. If those omissions, those misrepresentations were material, there is, in fact, a remedy under existing law. If they were not material and there was no material nondisclosure, then there should be no remedy.

Any new investment banker duty should not be imposed as part of a general fiduciary duty, and it should emerge from careful study, which the current financial reform bill pending before Congress requires for new standards of care for broker-dealers and investment advisers.

I would add that the application of criminal penalties would significantly exacerbate the problems of applying inherently vague and ambiguous fiduciary duties, possibly violating constitutional rights. Vague criminal duties may actually result in less deterrence

of misconduct than would be accomplished by more precise remedies by failing to inform parties of the conduct that they must avoid.

We also must keep in mind—and this is the closest I am really going to get this morning to a Chicken Little statement—that criminal fiduciary duties may overdeter by threatening punishment even of socially valuable behavior. Legitimate firms seeking profits over the long haul will give a very wide berth to behavior that poses even the slightest risk of criminal sanctions that could put them out of business or send individual employees to jail. This could impose significant social costs by inhibiting innovation, among other things.

Broad criminal liability for breach of fiduciary duty could encourage abusive prosecutorial power. We have seen examples of this in recent back-dating cases. Without defining the duties that give rise to criminal penalties, we give powerful weapons to prosecutors, and I think we should keep this in mind.

In conclusion, whatever problems exist in the securities markets—and I am not one to say that there are no such problems and that no remedies are called for—criminal fiduciary duties are the wrong tool to deal with them.

Thank you again for the invitation, and I welcome any questions.

[The prepared statement of Mr. Ribstein appears as a submission for the record.]

Chairman SPECTER. Well, thank you, Professor Ribstein.

Professor Coffee, is it practical to define fiduciary duty in a criminal context with sufficient specificity to avoid the problems of due process of law being vague and indefinite?

Mr. COFFEE. Well, two responses to that. First of all, this statute is much narrower than some of the criticisms suggest it is. It does not just say you are a fiduciary, go out and observe a punctilio of an honor the most sensitive. It is focused on a special context: the broker-dealer giving investment advice or the broker-dealer soliciting purchases or sales. That is really going to be the context, which is also the Goldman context, of the broker-dealer functioning as a placement agent, selling securities that it has packaged to its investors. Now, that is a context that the statute does address because your statute—and I have made some suggestions to narrow it further—only addresses the broker-dealer giving investment advice or soliciting purchases or sales. And in that context, we know what is going on. I think that is not a general duty. It does not mean you will be liable for negligence, and it will only be a willful violation. Willful violation in the Federal criminal law means a conscious intent to defraud the investor and receive a gain at the investor's expense.

Now, taking that all together, I think that the standard of fiduciary duty is very much like the standard of 10(b)(5). You are going to be trying to cheat someone. The difference between the two is that while we have been told by everyone, including Mr. Weissmann in the prior panel, that 10(b)(5) is sufficient, 10(b)(5) does not reach all contexts. 10(b)(5) does not reach, for example, the context where there is not a purchase or sale, and the Supreme Court said that in the *Merrill Lynch* v. *Dabit* case. That is the context that the fiduciary duty standard would reach. So there are

areas that the fiduciary duty standard would reach that nothing else reaches.

Finally, I would say the most important thing for Congress to do is to specify the fiduciary duty standard, not so much the criminal penalty, because we cannot tell regulators to enforce the law without first telling the subject people in the private sector what their duties are, what you must do is put the interests of the client first; what you must do is act in the best interests of the client in giving investment advice or in soliciting purchases or sales. I do not think that approaches being vague at all.

This is not the problem of the honest services fraud statute, which did not tell you whether it was addressing Federal law, State law, and it was subject to every possible interpretation so that the Boy Scout oath could be brought into the honest statute.

This is very narrow. Selling or giving investment advice, you must act in the best interests of the customer. It does not affect the mere market maker who is quoting a two-sided market. It requires you to do something much more specific, and I think there is no serious void for vagueness problem.

And, finally, the SEC is given express authority to draft exemptions, interpretations. They can add a great deal of density, extending the law, explaining where it applies and where there are exemptions. And I have suggested some revisions to your statute that would give the SEC greater authority to give exemptions and safe harbors, all of which will curb the problems of overdeterrence.

So that is my long answer to your short question.

Chairman SPECTER. Professor Ribstein, doesn't that delineation in the parameters of the proposed legislation pretty much answer the issues which you have raised?

Mr. RIBSTEIN. I do not think so, Senator. The standard best interests of the client is actually pretty close to a broad fiduciary standard. It could be interpreted to extend all the way to refraining from all kinds of unselfish—all kinds of selfish conduct, which is really what the fiduciary duty does, but it extends that to a situation that is not really the situation that is governed by that strong fiduciary duty generally, the mere rendering of advice, rather than the turning over of complete delegation of control, which is normally the situation where the fiduciary duty of unselfishness applies.

So what we would have under that standard is, again, decades of litigation, just like we had with the fiduciary duty in Section 36(b) of the Investment Company Act, where courts eventually might define a standard, but until they do, parties would not know exactly what standard, what kinds of conduct are forbidden them. And, again, we get the problems of overdeterring innocent, socially productive conduct, and possibly underdeterring conduct that we really want parties to refrain from.

Chairman SPECTER. Professor Ribstein, would the existing laws impose criminal liability on Goldman Sachs for what is alleged by the SEC?

Mr. RIBSTEIN. If they are guilt of what they have done—and I would go back to Andrew Weissmann's testimony earlier today—they did it willfully, they did it with scienter, they engaged in fraud, then yes.

Chairman SPECTER. Professor Verret, you said on an analogy to housing that brokers would have to conduct widespread investigations. Is that really so? We are talking illustratively in the context of the SEC complaint against Goldman Sachs. These are things Goldman Sachs knew. Now, this is not a matter of telling the party in that line to go and investigate matters. These are things they knew and failed to disclose, acts of omission. Isn't that significantly different from the consideration you raised?

Mr. VERRET. Well, I would offer first that this statute would not be limited solely to the Goldman fact situation, so it would be used much, much more broadly. And I think, frankly, contrary to Professor Coffee's analysis, I would offer that, you know, we have seen a number of pieces of language and legislation become very, very widely defined by the SEC, and I would offer as an example the definition of "offer" under the registration statement rules and how offer has come to mean not just offer, but any communication of any kind.

And so I am still concerned about the uncertainty in the fiduciary duty standard, and, you know, the fact patterns that would be subject to the statute would be much wider than the Goldman scenario. And even in the Goldman scenario, I would point out one difficulty, which would be that if you are a fiduciary to a wide variety of different, potentially conflicting interests, you could be in a very difficult spot. Let us remember, you know, you change the fact pattern a little bit or even in the Goldman scenario, if Goldman had had fiduciary duty to the investors who lost money, let us remember they might have had a fiduciary duty to Mr. Paulson as well. So what if Paulson comes to Goldman and says, "Here is some information I have got through my own investigations and here is why I think housing is going to go down?" If Goldman had an obligation to share that information with other investors, they might be violating their duty of confidentiality to Mr. Paulson.

So putting someone in a fiduciary duty situation that is already subject to a variety of different conflicting interests might just set them up to fail without any malicious intent.

Chairman SPECTER. Professor Verret, how about the issue of adequacy of fines? Don't you think that to have some deterrent effect there have to be jail sentences at the end of the rainbow?

Mr. VERRET. Well, under the securities laws already, we have a number of different jail sentences for securities fraud. And so I think—I do not think we need to add new legislation for fines. I think we already have a lot of fines on the books and a lot of jail sentences on the books for this type of activity.

Chairman SPECTER. So you would agree that jail is necessary, but it ought to be imposed under existing law?

Mr. VERRET. It depends on the situation. It depends on the situation. And I do not want to say that I think that the Goldman situation deserves jail time or not because it is just way too early to tell.

Chairman SPECTER. I was not putting Goldman in the question.

Mr. VERRET. OK.

Chairman SPECTER. Professor Ribstein, how about it? Are fines sufficient as a deterrent?

Mr. RIBSTEIN. They may or may not be, Senator. I think we have to take into account both the costs and benefits of imposing criminal liability. If we want——

Chairman SPECTER. You have Professor Pontell's example of a $50 million fine willingly paid with the statement that had there been a criminal prosecution, it would have been vigorously defended.

Mr. RIBSTEIN. If we define the criminal liability appropriately, then a criminal penalty is justified. My problem is——

Chairman SPECTER. A criminal penalty could be fine or jail. I am asking you whether you think that it would be indispensable to move to jail as an effective deterrent.

Mr. RIBSTEIN. What I meant to say earlier is if we define the criminal conduct appropriately, then a criminal penalty is also appropriate. but my concern in what we are hearing today——

Chairman SPECTER. Well, criminal penalty again, but I am asking about jail differentiated from fine, which is a criminal penalty.

Mr. RIBSTEIN. If we define the criminal conduct appropriately, then I think a criminal penalty could be also appropriate. My concern today is defining a breach of fiduciary duty criminally without adequately specifying what that breach entails.

Chairman SPECTER. Well, I have asked you several times whether criminal penalty means jail, and I will not ask you again.

Professor Pontell, if $50 million is not enough as a deterrent, willingly paid as opposed to contrasting a defense had there been a criminal charge as opposed to a civil charge, is there any fine sufficient to act as a deterrent?

Mr. PONTELL. That is difficult to determine, Mr. Chairman. The amount of fines varies, and, you know, depending on the offender, on the resources of the offender and/or the offending corporation, some fines may amount to what citizens may consider parking tickets. I mean, $15 million to Maurice Greenberg is, you know, a considerable fine; $600 million to Michael Milken was a very considerable fine, but not a major part of their overall wealth or assets. So, I mean, paying those fines is, again, a cost of doing business.

Chairman SPECTER. Thank you, Professor Pontell.

Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman. Thank you for hosting and holding this hearing. I think it is an important one, and I appreciate your directing the Committee's attention to this.

Just to follow up on the discussion that we have been having, I recall the pharmaceutical industry being hit with literally billions of dollars in fines for marketing pharmaceutical products for off-label uses and unapproved uses, and they went right back at it again because the fines were simply a cost of doing business. I am not remembering the numbers off the top of my head, but it was several billion dollars in fines, but they were making several tens of billions of dollars in profits from the marketing, and so the conduct continued, and they kept being brought back in to pay more fines, and it was just a cost of doing business.

So I think when you look at the way many of our monetary penalties are structured and you compare that to the vast wealth, the huge numbers of dollars that are often involved in these major transactions, you can easily get to a situation in which monetary

penalties alone simply by definition are inadequate. And unless people are looking at an actual sentence of incarceration, you are never going to have serious enforcement behind it. So I appreciate what you are doing.

I wanted to ask the Committee's view. We have talked a little bit about the Goldman allegations, which suggest that in a transaction Goldman was designing the product with the assistance of an investor who was going to bet against the product, and the question is: Should the person who was being sold the product also be given kind of fair dealing knowledge that this was not just a Goldman-designed product, this was a product that was designed with the assistance of somebody who would then be betting against it? And I have heard anecdotal stories of similar sorts of transactions where products were being resold, securitized in tranches, and the bottom tranche, often an equity tranche, became the sort of signal to the rest of the market for whether the higher-rated tranches were marketable and were valid and people should invest in them, and they would look first to the bottom tranche and see how that went. And I have heard anecdotally stories of Wall Street houses selling off the equity tranche or the worst-rated tranche in order to open the market for the other ones, but having cut a side deal with the buyer of the equity tranche, that takes away any risk of the equity falling.

And so, in effect, you had a sham equity buyer whose job—if the allegations are true, a sham equity buyer whose job was to come in and look like a legitimate equity buyer who had made an independent assessment of the risk of the product and thought it was investment worthy, when, in fact, they were propped up with this side deal that said to them if it goes wrong, we will stack you with a lot of shorts on this other stuff so that you come out fine.

Again, that raises the same question. Should the investors in the other tranches have been made aware that there was more to that deal than met the eye?

And so a lot of this, I think, comes down to a question of what disclosure is fair, and that raises questions of whether a fiduciary duty is appropriate to prompt that disclosure. It also raises just more general questions about whether somebody, anybody structuring a deal should be transparent about who is in on the deal and what all the terms of it are, not just the apparent terms that the public sees. And I would love to hear your comments on that question. Professor Coffee had his finger up first.

Mr. COFFEE. I think what you have just described is something known as the liquidity put. You actually sold the equity tranche, but the big bank gave an option to resell it, gave a put agreement. They would buy it back if you lost liquidity, and you, the hedge fund that bought the equity tranche, could not sell it. What that shows is that these conflicts of interest can happen, often come back and even haunt the original bank that is subject to the conflicts. These liquidity puts put billions of dollars of liabilities onto the balance sheets of our major commercial banks and partially necessitated the TARP bailout. So conflicts of interest——

Senator WHITEHOUSE. Hoist with their own petard, would you say? Wasn't that Shakespeare's phrase?

Mr. COFFEE. That may be true, but the injury flows through to the American investor who had to bail them out. When conflicts get too prevalent, we find that everybody starts losing in a very opaque, nontransparent world. I think if you had a fiduciary duty standard, you would not design transactions in that way. You would not let one side write or pick the portfolio and sell it to the other side.

This can be dealt with partly through a disclosure standard, but I think the fiduciary duty standard, first of all, tells the operative managers what they are supposed to do, and that is the first obligation of the law, to——

Senator WHITEHOUSE. Let me ask you to follow up on a point you just made that I find very interesting. You just made the point that when there is a sort of risk, at least, of a systemic loss of confidence, the fact that these products are not transparent causes, the immediate financial result back to the bank of having to buy it back and get hit with it, but it also is something that people looking at the financial system, thinking that they understood it, thinking that they were comfortable with the way it was, suddenly think, "Oh, my gosh, this is a lot weirder than I thought. Until this settles out, I had better get my money out," so it could actually contribute to system instability to have all of this off the books, sort of nontransparent back-door dealing going on when it becomes apparent to the public that they have been sort of left out of the real equation.

Mr. COFFEE. I think there were elements of a financial panic in 2008, and I think the lack of transparency always increases the possibility of that sudden revelation that produces a panic.

Certainly, Lehman fell because of a panic, and everyone backed away because they did not know what the full liabilities were.

Senator WHITEHOUSE. Yes. Transparency has stability value then.

Professor Ribstein, you wanted to say something?

Mr. RIBSTEIN. Well, Senator, the Goldman transaction, I think, really points out some of the problems that we run into with imposing a broad fiduciary duty here, because there is a question about what needs to be disclosed by whom to whom that arises out of this transaction.

Now, it turns out that, in fact, the buyer of the securities, as alleged in the complaint, IKB, was a bank that was, in fact, remarketing these securities, as I understand it, through a subsidiary, so it was engaged a little bit in what Goldman is being accused of doing. It was in effect insuring this block of securities. Warren Buffett was quoted as saying yesterday that——

Senator WHITEHOUSE. That does not excuse the original person. Under the criminal law, if you are a fence——

Mr. RIBSTEIN. Well——

Senator WHITEHOUSE [continuing]. And you sell something to somebody who then fences it, that does not excuse the first fence.

Mr. RIBSTEIN. No, Senator, I was not trying to indicate that. What I was saying is that we had a very sophisticated party on the other side, and there has to be a difference between the duty to disclose to this sort of party and what the duty to disclose is to other sorts of parties. And I think that these are the kinds of questions

that need to be addressed and are not necessarily addressed by a broad standard about best interests of the client or fiduciary duties or whatever broad statement you want to use.

Senator WHITEHOUSE. Well, I appreciate the witnesses being here. I appreciate Senator Specter holding this. What I see is that in my State the damage that began on Wall Street and then washed like a financial tsunami across the country, we are still digging out from, and we are in no mood to allow this to happen again, and I think it is very important for hearings like this to look into ways in which the criminal law can be used to discourage the kind of Wall Street misconduct that has taken ordinary families in Washington and Rhode Island and subjected them to really grievous personal suffering from unemployment, from loss of their health insurance, from loss of their jobs, from loss of their financial security. So thank you very much.

Chairman SPECTER. Thank you, Senator Whitehouse.

I want to insert into the record the article published by the McClatchy Newspapers way back on November 1, 2009, where they pointed out that in 2006 and 2007, the Goldman Sachs Group—this is their article—"peddled more than $40 billion in securities backed by at least 200,000 risky home mortgages, but never told the buyers it was secretly betting that a sharp drop in U.S. housing prices would send the value of those securities plummeting. Goldman's sales and its clandestine wagers completed at the brink of the housing market meltdown enabled the Nation's premier investment bank to pass on most of its potential losses to others before a flood of mortgage defaults staggered the U.S. and global economies. Only later did investors discover that what Goldman had promoted as AAA-rated investments were closer to junk."

Without objection, the full article will be made a part of the record.

[The article appears as a submission for the record.]

Chairman SPECTER. Just a few more questions on related subjects. Professor Coffee, as you know, the Supreme Court of the United States has held that aiders and abettors are not liable under the securities laws, and I and others have introduced legislation to change that decision. Congress has the authority to do that where it is not based on the Constitution. The criminal law imposes sanctions for aiding and abetting. Do you know of any case where the standard of the criminal law is met but does not give rise to a claim for relief or a cause of action under civil law?

Mr. COFFEE. You asked that same question of Mr. Weissmann earlier, and I was thinking then——

Chairman SPECTER. Well, I did not get an answer. That is why I am asking——

Mr. COFFEE. I do not know of another instance like that. As you know, I have testified in favor of your aiding and abetting legislation, and I am not generally a fan of what I will call stock-drop litigation. But I think aiders and abettors are a particularly good target for private enforcement to focus on, because they are the gatekeepers.

Chairman SPECTER. You heard the questions that I asked about the missing paragraph in the second submission by Mr. Weissmann. With respect to the issue of whether there could be

some reasonable enforcement by private lawsuits if the standards of pleading were relaxed so that there did not have to be the specificity which has traditionally been obtained, the facts and materials in discovery, do you think that those limitations go too far?

Mr. COFFEE. Well, of course, I was asked by the White House in 1995 what I thought of that statute, and I and Professor Langford both wrote a letter to the President at his request which said that we thought the statute did go too far, and my view from 1995 has not changed that dramatically.

I would suggest that if you made one change in this area, it would be not to repeal the pleading rule, but to give the Federal district court, which is right on top of the case, discretion to permit limited discovery in cases where it thought there has been some showing made of irregularity or fraud. That would give discretion to the court rather than letting either side. Now, we have an all-or-nothing rule. Either you show fraud with particularity, or you get no discovery. And it is hard to show fraud without discovery.

If you gave the district court a little bit more discretion, allowing it to order some limited discovery before it ruled on the motion, I think that might deal with the intermediate case and let there be justice on the specific facts and circumstances.

Chairman SPECTER. So you wrote to the President?

Mr. COFFEE. In 1995, I was requested to by the White House Counsel's Office.

Chairman SPECTER. I wrote to the President, too, in 1995 suggesting that he veto it. Now, do you think he vetoed it for your letter or mine, or neither or both?

Mr. COFFEE. I do not suggest I had any impact, but my view was the same then and now.

Chairman SPECTER. Just an irrelevant short story. I was in my condo at about 10:30 one night when I got a call from the White House, and the President was on the line, and he said, "Do you have time if I read to you part of my veto message?" And I said I did, and your letter was probably close to mine. He had a number of the elements in the veto message.

One final question for you, Professor Coffee, and that is, I and others have introduced legislation to change the Supreme Court ruling on pleading, going so far from what had been the traditional interpretation of the Federal Rules of Civil Procedure. What do you think of those Supreme Court decisions of limited——

Mr. COFFEE. You are talking now about *Iqbal* and *Twombly*, the two Supreme Court cases.

Chairman SPECTER. Yes.

Mr. COFFEE. I think it is judicial legislation. It is not usually what the Court does. I am not a fan of the old 1938 civil rules which gave the plaintiff maybe too much ability, and I think *Iqbal* and *Twombly*, outside of the securities law context, will screen out some meritorious cases as well as some non-meritorious cases.

Inside of the field of securities law, *Iqbal* and *Twombly* do not mean that much because the PSLRA has a much more protective provision in it than *Iqbal*—*Iqbal* and *Twombly* only require plausibility. The PSLRA requires that there be strong evidence of fraud shown before discovery.

Chairman SPECTER. I note your Yale Law School background. Was Judge Clark teaching Civil Procedure when you were there?

Mr. COFFEE. He taught me Constitutional Law, not Civil Procedure.

Chairman SPECTER. I did not know that Judge Clark taught——

Mr. COFFEE. I am sorry. I thought you said Judge Bork. Did I mishear you?

Chairman SPECTER. I said Clark. I did not say——

Mr. COFFEE. Oh, Charlie Clark had retired by the time I went to law school. You went there before me.

Chairman SPECTER. Oh, I do not think so at all.

[Laughter.]

Mr. COFFEE. All right. I take that back. But he was retired.

Chairman SPECTER. Judge Charles Clark did teach my class Civil Procedure, and he led off with the case of *Dioguardi* v. *Durning*, which I will remember forever because he was so effective, about an immigrant who wrote some things down on a slip of paper, sent him to the Federal court, and it was held that that was a notice pleading. Quite a change from what Judge Clark said writing the Rules of Civil Procedure as to what the Supreme Court has recently said.

Well, thank you very much, Professor Verret, Professor Pontell, Professor Coffee, and Professor Ribstein. I very much appreciate your coming in. This is an ongoing issue, and we thank you.

That concludes the hearing.

[Whereupon, at 11:25 a.m., the Committee recessed, to reconvene at 2 p.m., this same day.]

AFTERNOON SESSION (2:02 p.m.]

Chairman SPECTER. Good afternoon, ladies and gentlemen. The Criminal Law Subcommittee of the Committee on the Judiciary will now continue the hearing. We heard from seven witnesses this morning, and the Assistant Attorney General in charge of the Criminal Division, Hon. Lanny A. Breuer, was in New York, and we appreciate his coming back because he has really key testimony to provide as the chief law enforcement officer in the Criminal Division. So welcome, Mr. Assistant Attorney General, and we look forward to your testimony.

STATEMENT OF HON. LANNY A. BREUER, ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION, U.S. DEPARTMENT OF JUSTICE, WASHINGTON, DC

Mr. BREUER. Thank you, Mr. Chairman, and it is always good to be with you, and thank you for inviting me to be part of the hearing and giving me the opportunity to discuss the issue of fraud on Wall Street and how most effectively to deter it.

Let me begin, Mr. Chairman, by assuring you that the Department of Justice, together with its law enforcement partners, shares your determination to root out, prosecute, and punish financial fraudsters. These crimes erode the public's confidence in our markets and institutions, siphon billions of dollars from hard-working Americans, and have convinced many that Wall Street is somehow above the law.

In many respects, we are better positioned now than ever before to uncover and prosecute financial fraud. As you know, Mr. Chair-

man, the Financial Fraud Enforcement Task Force is spearheading our efforts. The task force provides a unique forum to discuss trends, develop data and intelligence-driven enforcement strategies, offer training and coordinate sweeps, and other cooperative and creative enforcement initiatives.

The task force's leadership is joined by action on the ground. As you know, the Department has been deploying increased resources to combat financial fraud, and it has been more forward leaning in terms of its investigative techniques and its efforts to coordinate and cooperate with our law enforcement counterparts, both here and abroad.

At the same time, we have been unwavering in our commitment to ensure tough but fair penalties for corporations and individuals alike. These penalties have included and they must include jail time in appropriate cases.

Since I appeared before the full Committee in December, there have been several new prosecutions by task force members that are worth noting. In March, the President of Park Avenue Bank in New York was charged with attempting to fraudulently obtain more than $11 million in taxpayer rescue funds from the Troubled Asset Relief Program, TARP. Just 2 weeks, the U.S. Attorney in Newark charged the chief executive of Capitol Investments USA with a $880 million Ponzi scheme stemming from the solicitation of investors in a purported grocery distribution business. Last Thursday, the former treasurer and senior executive vice president of Doral Financial Corporation was convicted after a 5-week trial for his role in a scheme to defraud investors that caused a $4 billion decline in share value.

And just yesterday, Mr. Chairman, after a month-long trial, our prosecutors in the Fraud Section, along with our partners in the Oklahoma U.S. Attorney's Office, secured a conviction of a lawyer and his colleague in a massive fraud, a securities fraud, a pump and dump. Right after the verdict, the defendants yesterday were detained until their sentencing in late August.

The Department's commitment to vigorously identify and pursue any wrongdoing in our corporate boardrooms and on Wall Street will not and does not end with the indictment. As I mentioned a moment ago, our prosecutors and agents are determined to ensure that wrongdoers are punished and that potential wrongdoers are deterred. This means seeking jail time whenever appropriate. Thus, the Department has sought significant prison sentences against white-collar criminals.

For example, since I appeared before the full Committee, since then the Department secured a 50-year sentence for Tom Petters for a $3.7 billion Ponzi scheme, and just last week, a 117-month sentence for Charles "Chuck" E. Hays for a Ponzi scheme involving stock, index, and other futures.

We obtained a 7-year sentence for the principal outside attorney for Refco for his role in executing Refco's more than $2.5 billion fraud, and we secured a 5-year sentence for former Credit Suisse broker Eric Butler.

In addition to seeking prison sentences for individual offenders in appropriate cases, an essential part of our criminal enforcement strategy is to hold corporations accountable as well. The Depart-

ment believes that corporate guilty pleas and deferred prosecution agreements, fines, and the imposition of independent compliance monitors in appropriate cases serve the important criminal enforcement goals of specific deterrence, general deterrence, and rehabilitation. It is not our experience that companies treat such resolutions as a cost of doing business. It is our experience that corporate resolutions have a very real deterrent.

In sum, the financial crisis has demanded an aggressive, comprehensive, and well-coordinated law enforcement response. The Department and its partners on the Financial Fraud Enforcement Task Force are committed to this effort. We will look at all allegations of financial crime closely, follow the facts where they lead, bring our resources to bear to prosecute those who have committed crimes, and seek appropriately tough sentences for individuals and corporations alike.

Mr. Chairman, I want to thank you for your interest and commitment to all of this, and I would be happy to answer any of your questions.

[The prepared statement of Mr. Breuer appears as a submission for the record.]

Chairman SPECTER. Well, thank you very much, Mr. Breuer.

The case which you cite with a 50-year sentence, that is a long sentence. What were the facts of the case?

Mr. BREUER. So in the Petters case, that was a businessman in Minnesota who was involved, Mr. Chairman, in a massive commodities fraud, Ponzi scheme, where he induced investors to invest money with him under the understanding that they were making reasonable, conservative investments in commodities that were then going to be resold. In reality, what this fellow was doing was anything but that, Mr. Chairman. He was simply doing a classic Ponzi scheme where he would take the investments of the latter investors, provide some money to the early investors, and would keep this Ponzi racket going forward.

Chairman SPECTER. Do you know whether there was any publicity given to that sentence?

Mr. BREUER. There was some, Senator. There was. I mean, I would have to go back to see how much and whether it was sufficient. But there was some publicity given to it. I can go back and let you know how much.

Chairman SPECTER. There has been some comment that the prosecutions which have come out of the Wall Street fraud have been on minor participants contrasted with the savings and loan matters a few years back. The case you mentioned does not appear to be a matter of Wall Street fraud. Or was it?

Mr. BREUER. Well, Senator, it was not a matter of Wall Street fraud in the sense of it was not literally on Wall Street and it was not, for instance, a financial institution. But to the degree we are talking about a fellow who purported to be an investor—an investment person who was seeking investment to the degree that he was seeking and getting investments for many both retail and perhaps some institutional investors, I think if we take a more expansive view of what we mean by Wall Street, which is those who we bring into our confidence, those who we provide money to, and

those who have in one way or another acted criminally, then in the broader sense I think it was.

Chairman SPECTER. Well, tell me what the facts were on the case where you got 117 months.

Mr. BREUER. So the 117 months, Senator, was also a fellow by the name of Hays. From what I remember, he also was involved in a Ponzi scheme.

Chairman SPECTER. Was it a Wall Street matter?

Mr. BREUER. Again, he was not based in New York. He was out in the Midwest, Senator, I think as well in Minnesota. And, again, it was a fellow who was seeking investments, structuring transactions to avoid reporting requirements. And so, again, Senator, I would say it would not be, as I think you are thinking of, a classic Wall Street case; rather, I would say it is more of a national case dealing with those who, once again, have preyed upon the——

Chairman SPECTER. And the 7-year sentence in the Refco case?

Mr. BREUER. Right. So the Refco case—and it will take me a moment. I think the Refco case, Senator, was one of the lawyers involved in that case, and I guess that was a case of securities fraud and had to do with false reporting. So I do think that—again, it is a little hard to define, but it deals more broadly with financial fraud and this administration's commitment to prosecuting all types of financial fraud and holding those accountable.

Chairman SPECTER. Was it any of the cases involving prominent Wall Street operators?

Mr. BREUER. Well, Senator, I know what you are saying, and let me be clear here. I am not disputing the premise of what you are suggesting. But, of course, there is——

Chairman SPECTER. Well, I do not have any premises——

Mr. BREUER. But let me begin by——

Chairman SPECTER. I am just asking questions.

Mr. BREUER. There is the Credit Suisse case. In the Credit Suisse case, you had a Credit Suisse official who misrepresented—he and another misrepresented the securities that they were selling. They claimed that the securities that they were selling were secure securities that were backed by investment-grade securities. I think the suggestion was that they were investment grade and perhaps dealt with student loans. In reality, they were not investment grade. They were mortgage-backed securities that underlay the investment and were, in fact, extraordinarily risky. In that case, one was a plea, one was a conviction in the Eastern District of New York, and the defendant was convicted and is now in jail.

Chairman SPECTER. And what was the sentence?

Mr. BREUER. I think it was 5 years. Yes, it was 5 years.

Senator, I would say—I am sorry.

Chairman SPECTER. The Subcommittee would be interested in knowing about what prosecutions have been brought in the course of the past couple of years as we have seen evidence on Wall Street fraud. We are trying to deal here with what deterrent effect there is, and that is why we are on this looking at the kind of situations that are before the public today. And in order to have the deterrent effect, the case obviously—you are an experienced prosecutor; I have had some experience at it—has to be in the realm where others are similarly situated, has to have sufficient notoriety, and that

really turns on the positioning of the person, whether they are an underling, whether they are in a prominent position, whether they are one of the lead names in the profession.

Do you have any examples of that kind of a case——

Mr. BREUER. Well, let me give you a few examples, Senator——

Chairman SPECTER. Let me finish the question.

Mr. BREUER. I am sorry.

Chairman SPECTER. Any examples of that with a tough sentence.

Mr. BREUER. Well, let me do my best and give you a few examples, and then you can let me know if you think that they fit the bill at all.

Last week, the former treasurer and senior executive vice president of Doral was convicted of securities and wire fraud, Mr. Chairman, after a 5-week trial, and that trial dealt with a scheme to defraud investors and potential investors with respect to the stock of his Puerto Rican-based company.

Chairman SPECTER. Wall Street?

Mr. BREUER. Well, it was publicly traded, sure, a publicly traded company.

Chairman SPECTER. Was the defendant a Wall Street operative?

Mr. BREUER. Well, I think the defendant was the senior vice president and treasurer, and I think he was based in Puerto Rico, Mr. Chairman. But his actions led to a $4 billion decline in share value, so we think of that as an important case and a case that occurred just last week. And, of course, there has been no sentence yet.

And then——

Chairman SPECTER. What will you be looking for there?

Mr. BREUER. Well, I am not the—I do not yet know what the Department will be seeking. It will be seeking, I am sure, a very, very significant sentence, I am sure.

Chairman SPECTER. Mr. Breuer, how are the sentence recommendations determined? For example, to what extent do you play a role in them? Are there any cases which reach the Attorney General on sentencing?

Mr. BREUER. Well, the Attorney General is keenly interested in this issue, very interested.

Chairman SPECTER. Well, does he make decisions on sentencing?

Mr. BREUER. In significant cases, I will brief him typically on what the case is, the status of the case. He will often ask about the strength of a case or where we are on a case where he is aware of the investigation stage. And though I do not think he will ever be the person who will weigh in on a specific sentence, I think his orientation is always known.

And then, Mr. Chairman, when I will weigh in is in various circumstances. There are many cases where the Criminal Division partners up with the U.S. Attorneys around the country. We do that very often. And in those cases, I will be briefed by the lawyers and will weigh in as to what we are seeking in a sentence. That is not atypical at all.

And often the prosecutors in the case, of course, who have been living and breathing the case will have a very reasoned and a very strong view, and it will virtually always be within the realm of the advisory sentencing guidelines.

For the kinds of cases we are talking about, Mr. Chairman, of this value, typically the sentences are very, very stark and very, very high. But we do seek very stiff sentences in these kinds of cases when appropriate, and it often is appropriate.

Chairman SPECTER. Are you familiar with the Siemens prosecution, Mr. Breuer?

Mr. BREUER. I am, Senator. To a degree I am familiar with the Siemens prosecution.

Chairman SPECTER. Well, that is a case where Siemens, according to the information provided to me, agreed to pay a total criminal fine of $450 million and a disgorgement of $350 million in profits, and nobody went to jail. Siemens' income, according to the information I have, was $104 billion, and income in excess—or approximately $2.5 billion in fiscal year 2008. Did that conviction arise during the course of the current administration?

Mr. BREUER. It did, Senator. It did, Mr. Chairman. It was an ongoing investigation, and you are right. Let me just add a little to what you say.

First, Siemens, its total monetary penalties were actually $1.6 billion. That would include both from the U.S. and in Germany. The company was incredibly cooperative and very, very helpful in the information it provided over an extensive period.

In making Siemens' plea, we made it as an absolute explicit provision that there was absolutely no protection for any of the individuals of Siemens. And, therefore, the individuals, executives, and others who were involved remain exposed, and the matter is not closed. Simply all that we have done is have a plea against a corporation. We have not closed out nor have we claimed to have closed out investigations with respect to individuals. They are ongoing.

And, Mr. Chairman, I agree with you. I think the hallmark of an effective criminal justice plan must be that we will prosecute individuals when appropriate and ongoing. And I should say in that vein, Mr. Chairman, just 2 weeks ago we received the longest sentence in an FCPA case in the history of the FCPA when we obtained an 87-month sentence against a fellow who had violated and was convicted of the FCPA. So we will continue to pursue that.

Chairman SPECTER. Well, you are saying that even though the case was concluded against the corporation, the matter is ongoing as to the individuals? Ordinarily, a case is wrapped up once and for all. Before a corporation will pay a fine, they want to know that that is the limit of their liability.

Mr. BREUER. Right.

Chairman SPECTER. And there is obviously a motivation to not have the jail sentence and for the corporation to pay a fine. And this morning, we heard very extensive testimony—not that it was surprising—that fines are added into the cost of doing business. One testimony related to one defendant who paid $50 million and said if it had been a criminal prosecution, he would have fought it tooth and nail. But you are saying that you are really going to go after some people in this Siemens matter?

Mr. BREUER. Well, Mr. Chairman, what I am saying is that—I do not want to say whether we are or not for the reasons that I know you understand well. But what I will say is the following: We

are not willing—and you are absolutely right, corporations do want to settle these cases, they do want to pay money, and they do want the assurance that the matters will be closed against the individuals of their company. We did not allow that to happen in that case, and we will not let it happen for the reasons you said.

Now, in the Siemens case, I do want companies to feel an enormous incentive to come in and to disclose, and in Siemens, they did come in, they did disclose, and they provided us with an enormous amount of information. And so there was a real judgment that there was a real merit to having closure with respect to that and for the company to be rewarded for providing us with almost unparalleled cooperation.

Chairman SPECTER. Did you start the prosecution before they made the disclosures?

Mr. BREUER. I do not think so in that case. I think, Senator, I will have to go back—that is a good question.

So my colleague is right. In this case, of course, one of the challenges that I was going to go into is in this particular case the prosecution began in Germany, and then we, of course, as we try now more and more to deal with the challenges we have, are working closely with our international colleagues and partners. That was a case where it began with the German prosecutors, and, of course, many of the individuals involved are in Europe. But there, nonetheless, it began in Germany. The company—we reached out, I believe. The company provided us with an enormous amount of information, and——

Chairman SPECTER. Mr. Breuer, what I am getting at is, Did they provide you with information after you already had the case?

Mr. BREUER. No. I mean, Mr. Chairman, in a case like this, these are very complicated cases, and this, of course, was a massive example of violations of the FCPA in different countries. And so there, there is no question that the law firm providing us and Siemens providing us with information were able to provide us with information that we would not have had but for them giving us the information. It was all over the world. Frankly, we would not have had the resources to have investigated to the degree that the company provided us the information. And so they did get a benefit for that. The benefit they got was certainty in the resolution of the corporate deal. What they did not get was closure for the individuals.

Chairman SPECTER. Well, keep us posted as to what you are doing there.

According to a story published last night by David Heath on the Huffington Post called "Too Big to Jail," bank regulators like the Office of Thrift Supervision in the context of the current financial crisis have made no criminal referrals to the Department of Justice concerning fraud by the financial institutions. Do you know whether that is correct?

Mr. BREUER. Mr. Chairman, I, as you know, just came back from New York, and someone just told me about that Huffington Post article. I do not know if that is correct. What I can say, if this is of help—and I will get back to you right away about that—is that what I can tell you is that we have required and ensured that our relationships with the regulators are robust and active. I meet regularly with the head of the SEC enforcement, as do my colleagues.

I meet regularly now with the head of the CFTC enforcement. And, indeed, Mr. Chairman, since we last appeared before you, we now have two CFTC lawyers who are actually detailed to our Fraud Section so that we can ensure and move as quickly as we can when those kinds of cases ought to be prosecuted criminally.

With respect to that particular regulator, I do need to get back. I just do not know if we have received any referrals or not.

Chairman SPECTER. Are you familiar with the OxyContin settlement, Mr. Breuer?

Mr. BREUER. I am generally aware of it, Mr. Chairman. I am.

Chairman SPECTER. Well, that is a case where OxyContin agreed to pay $19 million to 26 States on giving inaccurate information on dosages, which resulted in deaths. Three executives entered guilty pleas. The company's president paid $19 million in fines, top lawyer $8 million. Paul Goldenheim, medical director, paid $7.5 million. Nobody went to jail. Was that handled by the prior administration?

Mr. BREUER. It was, Mr. Chairman. Nonetheless, I am happy to give you a little bit of background. As I understand that case, it was a misbranding case where Purdue claimed that its product, OxyContin, that the slow-release version of that product had less negative consequences than other types of the similar drug. So the issue was what their claims were with respect to the slow-release formulation.

The company pled, of course, to the felony. The individuals pled to the misdemeanor, as I recall, for misbranding, which in essence is a strict liability—it is a strict liability provision, Mr. Chairman. I do not think there was proof—and, of course, it was not under my watch, but I do not think there was proof that the senior executives, including the general counsel and others, were aware of these particular representations that were being made by Purdue.

The company itself forfeited in total monies to State, Federal, civil suits hundreds and hundreds of millions of dollars, and right now the executives have been barred from the industry for an extended period of time. So I think that is a little bit of what happened in that particular case.

Chairman SPECTER. Well, when you say they entered a plea to a misdemeanor, as we know from our joint experiences, that is often a compromise, does not indicate that there was not evidence of a felony. And the critical point is that there were deaths, that they were controlling officials, and nobody went to jail.

Mr. BREUER. Right.

Chairman SPECTER. Do you think that was an appropriate disposition on the sentencing issue?

Mr. BREUER. Well, Mr. Chairman, it was not under my watch. I would want to know the facts better before I gave you a specific answer with respect to that. More generally, I am concerned. I do believe—and I very much agree with your thesis, Mr. Chairman—that responsible individuals who break the criminal laws and who are executives ought to go to jail.

In a case with a strict liability statute—and, again, I do not know what gave rise, but just I know that they did a plea to the strict liability statute in essence. There, obviously, I think that would give us all more pause before we——

Chairman SPECTER. You have said that twice about strict liability, and that raises the suggestion that there was no intent. But on these facts, that does not look like an exoneration. I do not know the details either, and I would like you to report back on that, whether there was evidence of mens rea, whether they could have been prosecuted for something else, and that was an accommodation. But the critical thing is you can go to jail for a case without specific intent.

I am way past my time. I have been filibustering, Senator Klobuchar, just a little bit. I had some experience at that.

What I would like to do, Mr. Breuer, is I would like to set up an ongoing review process so that we can keep track of the cases which you are handling and see what is going on with them. I have a long portfolio of cases which were egregious, giant corporations, fines, no jail sentences, minuscule compared to net profits, and a real question. This is a problem that I have seen my entire tenure here, that in the litigation process there is just too much of a tendency to resolve the case, a fine which looks good in a sense but I think is meaningless. I think that was the conclusion of the two panels which we had this morning. There were people on the other side. We had balanced panels, and some were defending Wall Street. But very overwhelming testimony from a professor from UCLA at Irvine, a criminologist, about deterrence. Of course, you do not really need to know that jail deters people and fines do not. You do not need to know that at all. But I would like you to keep this Subcommittee posted on what happens, especially out of the Wall Street line.

Mr. BREUER. Mr. Chairman, I will. And if I may just comment for a moment, in my 1 year as AAG, I would like to think that we have been going full bore. We have indicted 46—we have had 46 indictments just in the FCPA area in that 1 year, Mr. Chairman. That is more than in the entire history of FCPA. That is of individuals. As I mentioned to you before the other Senators came, we just 2 weeks ago got the largest and longest sentence in the FCPA area in the history of that statute, 87 months. We have strike forces now in health care. We are in more than half a dozen cities. We will be in 13, we hope, by the end of the year, and in 20 by the next year. We are bringing real cases. We have probably had over a dozen trials. So if you do not plea to what we demand, we have been asking and going to trial, and we have gotten convictions in every one of those cases. Those people are going to jail, and with respect to Wall Street, we are looking hard at those.

We are also doing this with respect to mortgage fraud where we are creating strike forces and partnerships with not just the U.S. Attorneys but with State and local governments as well.

So I am delighted to let you know what we are doing. We are recruiting great people to our Fraud Section in the Division, but it is a very dynamic time, and I do not want the misimpression to be that the Criminal Division is not working in all areas. It is. I know you are not suggesting otherwise, but whether the cases are very big, Mr. Chairman, or smaller, you have my word that we are working tirelessly at them, and we are seeking jail time in the great preponderance of these cases.

Chairman SPECTER. Well, those are impressive statistics, and I accept what you say. And we would like to pursue them, and we would like to see the level of defendant, whether they are minor figures in the overall scheme or whether they are prominent, whether the sentences relate to something which is an effective deterrent. And that is the function of the Judiciary Committee on oversight.

Senator Klobuchar, would you be willing to accept the gavel?

Senator KLOBUCHAR. I can just stay for a good 5 to 10 minutes, but I can do it for that amount, and then maybe Senator Kaufman can do it.

Chairman SPECTER. Well, you can pass the gavel on.

Senator KLOBUCHAR. I will do that.

Chairman SPECTER. We had a lengthy hearing this morning. Senator Kaufman was present.

Senator KLOBUCHAR [presiding]. I realize that. Very good. Thank you. Thank you, Senator Specter.

Thank you, Mr. Breuer, for being here today, and I am most interested, after we did the Fraud Enforcement Recovery Act—as you know, Senator Kaufman was very involved in that as well—how things are going with that. I wanted to thank you and the Justice Department for the good work you did on the Tom Petters case, which is know was mentioned before I got here. That was a huge case, just hundreds of millions of dollars lost. I think next to the Bernie Madoff case, it was the second biggest case, and it was located in our State of Minnesota, and a lot of people lost a lot of money. So I appreciate the good work and the strong sentence that the Minnesota U.S. Attorney's Office was able to get in that case.

I wondered, first of all, just an update on FERA, the Fraud Enforcement Recovery Act. How are you using that money? I think it nearly doubles the FBI's mortgage and financial fraud budget, but how is law enforcement in general targeting fraud with that money?

Mr. BREUER. Well, it has been incredibly helpful both in the way that the statute and the amendments were made to encompass conduct that before was not so easy to address.

With respect to resources, Senator, they are being used wisely. I meet every week with the head of the Criminal Investigation Division of the FBI, Kevin Perkins, and often with his superior, T.J. Harrington. And among the issues that are at the very top is the issue of going after financial fraud, mortgage-related fraud.

We have right now probably over 1,000 people charged around the country for mortgage-related frauds, from the most basic to the most advanced and complicated, and that we could not do without the additional resources that we have received.

In our Fraud Section, we have additional attorneys. The U.S. Attorneys have additional attorneys, and the FBI, of course, is doing it. So it is very robust. There are strike forces throughout the country. The Financial Fraud Enforcement Task Force, President Obama's task force to address all financial crime, benefits enormously from these additional resources, and the various working groups, whether those are working groups dealing with mortgage fraud, rescue fraud, recovery fraud, or securities and commodities fraud, the added resources are being deployed in all those areas.

Senator KLOBUCHAR. Thank you. A witness who testified this morning—Andrew Weissmann—was skeptical about imposing a fiduciary obligation on brokers or an increased focus on jail time on bad actors. I disagreed with some of his testimony. But there was one point that I thought was worth exploring with you, and that was whether and how we can increase enforcement of existing statutes and remove road blocks to civil liability.

One of his points was that regulatory agencies could punish bad actors through civil sanctions more frequently than they do. For example, the SEC could bar executives and brokers from the industry in some circumstances. The SEC and DOJ can assign Federal monitors to corporations. Obviously, banning individuals from an industry is a very serious sanction that would send a strong message.

Do you have any idea how frequently these kinds of punishments are used? And is there a role for Congress to encourage agencies to use these kinds of serious civil sanctions more? And do you think that that would, just like jail time, create a different culture?

Mr. BREUER. Well, Senator, I do not know the numbers of how often the regulators do it, but I absolutely think that robust tough regulators are essential. And I think right now the folks who are in charge at the SEC and the CFTC are just that. They are robust and they are tough, and they take their assignments, I know, very seriously. And I do think that those kinds of sanctions have real clout.

I do not think those sanctions are a replacement for the Department of Justice pursuing appropriate cases criminally. I think we have to do that, and we must do that. But I do think that there is a role for a tough regulator. I think there is a very big role for the Department, and I think our ongoing dialog—I meet regularly with the head of enforcement at the SEC, regularly with the head of enforcement at the CFTC. My fraud chief, Dennis McInerney, behind me does the same. And I think that that dialog is essential. There are cases where we should both do them together. There are cases where, frankly, we should only do them, where there is just sheer criminality and perhaps not a regulatory component. And, of course, there will be the others, which maybe Mr. Weissmann was referring to this morning, that ought to get a regulatory response.

Senator KLOBUCHAR. So do you think that is something in addition to potential jail time that would be helpful if we looked at that more?

Mr. BREUER. Absolutely.

Senator KLOBUCHAR. OK. In your testimony, back to the Financial Fraud Task Force, the task force has established a financial fraud coordinator in every U.S. Attorney's Office across the U.S. to facilitate uniform and aggressive enforcement. How does this work, and how do they work with their local law enforcement people?

Mr. BREUER. So it is essential that the Nation and our citizens have a right to know that as an administration we are acting in a coordinated manner and in an appropriately aggressive manner. What we are trying to do is get our arms around what we are prosecuting and what the dilemmas and problems are and what are good strategies and lessons. So the task force does everything, Senator. It keeps track of prosecutions. It comes up with theories for prosecutions. It comes up with theories of training. And, frankly,

in many cases like in the health care area that I referred to, the strike forces, we sometimes find the very same bad actors. First, maybe they were in Minnesota, and when we are on them in Minnesota, they move on.

What these financial coordinators do in the U.S. Attorney's Office is ensure that each U.S. Attorney has one point of contact so that every U.S. Attorney's Office knows what we want to hear back from them and also has one person who can collect the information. This way we can track do they have sufficient resources, are they using their prosecutors in the best way, and what can Main Justice do. And so that is really what they are doing.

And then, of course, the task force itself is probably an unprecedented example of State and local and Federal coordination, and in part, that is also what these coordinators will do. They will be the people on the spot to ensure whether they do it or their colleagues in the U.S. Attorney's Offices, that they are having real partnerships with the Attorneys General or others. And that is the role.

Senator KLOBUCHAR. OK. What steps have you taken to implement the changes and like what are people saying out in the field about how it is going?

Mr. BREUER. Well, it is a little self-serving. I think people think we are doing a lot. I really do. I mean, some of these cases are going to take longer, but when you are bringing as many health care fraud cases as we are and Medicare fraud cases as we are, when you have over 1,000 people charged with mortgage-related fraud, when you have an unprecedented number of cases against the FCPA, when we have this robust training program—we have brought TARP-related cases already. We are dealing very closely with Earl Devaney, the Chairman of the Recovery Board. I think people feel that we are playing a very active and real role.

Having said that, I am keenly aware that there are those who are wondering why certain types of cases have not yet been brought, but overall, I think any objective view would say that this is an unprecedented time of prosecutorial and regulatory action and oversight.

Senator KLOBUCHAR. Well, it was much needed, so thank you very much, Mr. Breuer.

Mr. BREUER. Thank you, Senator.

Senator KAUFMAN [presiding]. Mr. Attorney General, Assistant Attorney General, I just want to associate myself with Senator Specter's question. I am sorry it is on such short notice, but I just found out about it. But this is pretty devastating. Mr. Black alleges that during the savings and loan crisis—which you and I have talked about and everyone has talked about. One of the keys to kind of find out what is going on are whistleblowers and referrals. And he alleges in the article in the Huffington Post whereas during the S&L crisis there were thousands of referrals, there have not been any on this. That would be very, very, very disturbing. So I do not know. It may turn out that way.

But I will tell you what. It does not strike me, after sitting reading and following all this stuff, but especially in the Permanent Subcommittee on Investigations when you have regulators like the Office of Thrift Supervision, the head of the Office of Thrift Supervision did not realize that 90 percent of the home equity loans at

Washington Mutual were stated income loans and 63 percent of the ARMs were stated income loans and 50 percent of the subprime were stated income loans. This is after the same head of the Office of Thrift Supervision—I think his name is Mr. Reed—said that stated income loans are anathema to the banking industry, and where the Inspector General Thorson from Treasury said that these percentages of stated income loans are a target-rich environment for fraud. It is not hard to think that maybe the regulators did not—I mean, are there any regulators on the Financial Fraud Enforcement Task Force?

Mr. BREUER. Many. For instance, if we just use one example, in the Securities and Commodities Working Group—and, really, the task force, it is the working groups that are really the enforcement component. The co-chairs are myself, the U.S. Attorney from the Southern District, Mr. Bharara, and Rob Khuzami, the head of enforcement at the SEC. And the CFTC is very involved as well, so many regulators—I think there are two dozen agencies represented by the task force.

Senator KAUFMAN. That is why it makes it so hard. Again, I can well believe—and I do not even want to know about referrals that are still secret. I am not saying that. But it just seems hard to believe that this far down the road we have not had significant enough referrals from the regulatory agencies. After all, that is what they are supposed to do.

Now, again, I realize that the regulatory agencies that were in place while most of this went on have turned out to be folks that believed in no regulation. I mean, essentially it is clear that the feeling was let the market kind of work it out and let us not regulate. And I think—I know—I am not—I do not want to go over this too much, but it is such a key point to this thing.

Mr. BREUER. Right. Senator, the one thing I will say—and, look, I cannot address that, of course.

Senator KAUFMAN. Right.

Mr. BREUER. And I have not read the article, but what I can tell you—and I may have mentioned it before. I do not know if you were in the room. We are meeting, I am personally meeting regularly and my most senior people are meeting regularly with the top people at the SEC, the top people at the CFTC. We are meeting with regulators throughout in all different areas, and, frankly, we will continue to. The head of the TARP, the IG, Mr. Barofsky, we are meeting with him.

Senator KAUFMAN. Good.

Mr. BREUER. And others. So we are on top of it, and we will call it—I will call this agency as well, and I just do not know if they have or have not referred, but we will find out.

Senator KAUFMAN. I am talking about that basically his allegation was nobody is referring.

Mr. BREUER. Right.

Senator KAUFMAN. And that, in fact, one of the key ways we were successful during the S&L crisis was the matter of referrals. And, remember, the other problem is we had at the time of the S&L, we had a lot more people involved in the Justice Department. Now that is the reason we passed FERA. FERA is—the main objective of FERA, as you and I have talked about—and we have talked

about it in these hearings. I really appreciate what you are doing on mortgage fraud. I think that is important. But the FERA funds primarily were to go after the folks, the kingpins, kind of like when we passed the drug legislation to go after the drug kingpins, not the drug dealers. So we are really interested—and I am not saying "we" like the imperial "we," like me.

Mr. BREUER. Right.

Senator KAUFMAN. I am just saying it is clear when you look at the debate and the discussion of this bill, this is primarily targeted at—and not any kind of retribution. This is not about retribution. This is just—I mean, I am absolutely convinced, after the hearings we had on the Permanent Investigations Subcommittee and the studies I have been doing for this bill, that there is rampant fraud in these cases. I do not see how you can explain behavior other than there was a concerted effort to be engaged in fraud. I am not talking about any specific case.

Let me ask you something. The stated income loan, things like that, you know, when you get big numbers, aren't they—do they merit—and I am not talking about Washington Mutual, just in general. Where you have a system where people are accepting less than—I mean, much, much less than what is generally recognized as good marketing practice in order to package together these mortgage fraud things and then ship them off and to sell them to somebody else, doesn't that seem like that would be an area that at least we can look at—that Thorson was right, that this is like a target-rich environment?

Mr. BREUER. Senator, I want to be careful about saying what we are going to look at or not look at.

Senator KAUFMAN. Sure.

Mr. BREUER. But what I will say is that no matter how important or high up you are, we will look at the conduct, your conduct, and if we conclude that there was criminal intent in what you did, we will pursue it. Sometimes that may mean in these structures that it is going to take us longer because of all the reasons we all understand.

Senator KAUFMAN. Right. We talked about that. I totally agree with that.

Mr. BREUER. Right. But let me be clear here. We are incredibly invested, my team is incredibly invested, the Attorney General is, and that is not just the Criminal Division, but it is the U.S. Attorneys throughout the country. And in any scenario, if we can develop the facts and we can establish criminal intent, we will absolutely prosecute cases.

Senator KAUFMAN. And, by the way, and to be absolutely clear, I look on the Justice Department as kind of a black box on this, that I do not want to know what is going on inside the black box, I should not know what is going on in the black box. That is why it is so scary when you hear someone allege that we are not getting referrals from the agencies, which you know that and whistleblowers are our two best sources. That is why it is so scary, because I do not want to get into the black box. I do not want to get into how you are making decisions. I do not want to get into any of those kinds of things. We do know that it is incredibly difficult. These are complex cases.

Mr. BREUER. Senator, one thing I want to make sure we are clear, I do not want to talk about a particular regulator, the one you——

Senator KAUFMAN. Sure.

Mr. BREUER. But we are absolutely getting referrals from regulators.

Senator KAUFMAN. OK.

Mr. BREUER. We have strong relationships with regulators. We are meeting with the regulators. And we have been getting referrals from the regulators, and we are going to continue to get referrals. And when we do not get referrals, I and my colleagues are at the regulators complaining and whining and yelling and cajoling. We want these cases, and we are aggressively going after them.

Senator KAUFMAN. I think this is a good point to adjourn the hearing. Thank you very much.

I have a couple housekeeping things. Chairman Leahy has submitted a statement for the record which, without objection, I would offer. I do not see any objection.

[The prepared statement of Senator Leahy appears as a submission for the record.]

Senator KAUFMAN. The record in this matter will remain open for 1 week.

Thank you very much for your testimony, and the hearing is adjourned.

Mr. BREUER. Thank you, Senator.

[Whereupon, at 2:51 p.m, the Subcommittee was adjourned.]

[Submissions for the record follow.]

SUBMISSIONS FOR THE RECORD

United States Senate

Committee on the Judiciary
Subcommittee on Crime and Drugs

"Wall St. Fraud and Fiduciary Responsibilities:
Can Jail Time Serve as an Adequate Deterrent for Willful Violations?"

May 4, 2010

Testimony of

William K. Black

Associate Professor of Economics and Law

University of Missouri – Kansas City

Chairman Specter, Ranking Member Graham, distinguished Members of the Subcommittee, thank you for this invitation to testify before you. I regret that my travel to Iceland to assist with the problems of fraud in their financial crisis makes it impossible to appear before you in person today. My primary appointment is in economics. I have a joint appointment in law. I am a white-collar criminologist. My research focuses on elite frauds at financial institutions and financial regulation. I was a senior financial regulator that, at the staff level, led the reregulation of the S&L industry under Chairman Gray. The S&L debacle led to the felony conviction of over 1000 priority defendants (senior insiders and those that aided their frauds). I trained FBI agents and AUSAs to conduct investigations and try cases and our staff to identify and report accurately major frauds. I served as an expert witness for the government in three successful prosecutions, including a "Top 100" case. Scholars that research public administration have written two books and one journal article that use my role as an exemplar of effective regulation. I have placed my bio at the end of the text of this written statement.

The answer to your question is: only prison sentences can deter the violations that caused the debacle. We should, however, never rely solely on prosecutions to constrain crimes. The criminal justice system needs to work with regulation not only to make regulation more effective, but also to prevent "private market discipline" from becoming a "criminogenic" oxymoron. To understand the vital role that the criminal justice system must play if we are to avoid the recurrent, intensifying financial crises that have beset this and many other nations for nearly three decades we must begin by understanding the epidemics of "control fraud" that are driving these crises.

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An Introduction to "Control Fraud"

"Control frauds" are seemingly legitimate entities controlled by persons that use them as a fraud "weapon." (The person that controls the firm is typically the CEO, so that term is used in this testimony.) A single control fraud can cause greater losses than all other forms of property crime combined. Neo-classical economic theory, methodology, and praxis combine to optimize criminogenic environments that hyper-inflate financial bubbles and produce recurrent, intensifying financial crises. A criminogenic environment is one that creates such perverse incentives that it leads to widespread crime. Financial control frauds' "weapon of choice" is accounting. Neoclassical theory, which dominates law & economics, is criminogenic because it assumes that control fraud cannot exist while recommending legal policies that optimize an industry for control fraud. Its hostility to regulation, endorsement of opaque assets that lack readily verifiable market values, and support for executive compensation that creates perverse incentives to engage in accounting control fraud and optimizes fraudulent CEOs' ability to convert firm assets to the CEO's personal benefit have created a nearly perfect crime. Studies have shown that control fraud was invariably present at the typical large S&L failure. There is a consensus about the decisive role of control fraud in the Enron era frauds. The FBI began testifying publicly in September 2004 that there was an epidemic of mortgage fraud and predicting that it would cause an economic crisis if it were not contained. Similar widescale control frauds have driven financial crises in other nations. It is astounding, therefore, that neo-classical economists overwhelmingly ignore even the possibility of control fraud in the current crisis.

Judge Easterbrook and Professor Fischel are the leading proponent of the naive neoclassical theory that markets automatically and promptly exclude frauds. They view managers as so pure that "a rule against fraud is not an essential or even necessarily an important ingredient of securities markets" (1991: 283). Their book was written after Professor Fischel, as a consulant to three of the most notorious control frauds of the 1980s, tried out their theories in the real world – and found that they failed catastrophically. Fischel praised the worst frauds. Fischel & Easterbrook did not disclose to their readers that their theories were falsified in the real world.

George Akerlof's famous article about lemons markets (1970) illustrated one of the worst problems that asymmetical information could cause and began the research that led to the award of the Nobel Prize in Economics to him and two other scholars of asymmetrical information in 2001. The examples of lemons markets that Akerlof explored in that article were all anti-consumer control frauds in which the deceit hides quality defects in the goods. Akerlof explained that this could cause a Gresham's dynamic in which cheaters prospered and market forces drove honest competitors out of the industry. A Gresham's dynamic is intensely criminogenic. Akerlof was one of the first to realize that white-collar criminals didn't simply commit crimes – they created the perverse incentives that twisted private market discipline into a immoral force that harmed markets. Indeed, Akerlof demonstrated that if fraud becomes serious it can cause markets to fail rather than to clear (a point I will return to shortly).

Epidemics of control fraud are superb devices for hyper-inflating financial bubbles. Akerlof & Romer and I both warned in 1993 that the S&L control frauds had caused the Southwest

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commercial real estate bubble to hyper-inflate (Akerlof & Romer 1993; Black 1993). The epidemic of mortgage fraud was essential to the creation of the largest bubble in history, the U.S. housing bubble (Black 2010).

Fraud is instrinsically dangerous to markets in another fashion that can cause crises. At law, the defining element of fraud that distinguishes it from other forms of larceny is deceit. A fraudster gets the victim to trust him – and then betrays that trust. Fraud, therefore, is the most effective acid for destroying trust. Epidemics of accounting control fraud lead to massively overstated asset values. This can cause bankers to distrust other bankers – which can cause markets to collapse instead of clear.

Neo-Classical Economic Policies are Criminogenic: They Cause Control Fraud Epidemics

Neo-classical economics failed to build on Akerlof's work to develop a coherent theory of fraud, bubbles, or financial crises (Black 2005). It continued to rely on a single methodological approach (econometrics) that inherently produces the worst possible policy advice during the expansion phase of a bubble.

Control frauds can cause enormous losses, while minimizing the risk that controlling officers will be sanctioned because only the CEO can (Black 2005):

- Optimize the firm's operations and structures for fraud
- Set a corrupt tone at the top, and suborn controls, employees and officers into becoming allies
- Convert firm assets to the CEO's personal benefit throught seemingly normal corporate compensation mechanisms
- Optimize the external environment for control fraud, e.g., by creating regulatory black holes.

These perverse factors were first identified in connection with the S&L debacle of the 1980s. The National Commission on Financial Institution Reform Recovery and Enforcement (NCFIRRE) (1993), report on the causes of the S&L debacle documented the patterns.

> The typical large failure was a stockholder-owned, state-chartered institution in Texas or California where regulation and supervision were most lax.... [It] had grown at an extremely rapid rate, achieving high concentrations of assets in risky ventures.... [E]very accounting trick available was used to make the institution look profitable, safe, and solvent. Evidence of fraud was invariably present as was the ability of the operators to "milk" the organization through high dividends and salaries, bonuses, perks and other means (NCFIRRE 1993: 3-4).
>
> [A]busive operators of S&L[s] sought out compliant and cooperative accountants. The result was a sort of "Gresham's Law" in which the bad professionals forced out the good (NCFIRRE 1993: 76).

James Pierce, NCFIRRE's Executive Director, explained:

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> Accounting abuses also provided the ultimate perverse incentive: it paid to seek out bad loans because only those who had no intention of repaying would be willing to offer the high loan fees and interest required for the best looting. It was rational for operators to drive their institutions ever deeper into insolvency as they looted them (1994: 10-11).

A lender optimizes accounting control fraud through a four-part recipe. Top economists, criminologists, and the savings and loan (S&L) regulators agreed that this recipe is a "sure thing" – producing guaranteed, record (fictional) near-term profits and catastrophic losses in the longer-term. Akerlof & Romer (1993) termed the strategy: *Looting: Bankruptcy for Profit*. The firm fails, but the officers become wealthy (Bebchuk, Cohen& Spamann 2010).

- Extremely rapid growth
- Lending at high (nominal) yield to borrowers that will frequently be unable to repay
- Extreme leverage
- Providing grossly inadequate reserves against the losses inherent in making bad loans

Nonprime mortgage lenders followed the same recipe. Growth was extreme.

> In summary, the bank in our analysis pursued an aggressive expansion strategy relying heavily on broker originations and low-documentation loans in particular. The strategy allowed the bank to grow at an annualized rate of over 50% from 2004 to 2006. Such a business model is typical among the major players that enjoyed the fastest growth during the housing market boom and incurred the heaviest losses during the downturn (Jiang, Aiko & Vylacil 2009: 9).

Loan standards collapsed. Cutter (2009), a managing partner of Warburg Pincus, explains:

> In fact, by 2006 and early 2007 everyone thought we were headed to a cliff, but no one knew when or what the triggering mechanism would be. The capital market experts I was listening to all thought the banks were going crazy, and that the terms of major loans being offered by the banks were nuttiness of epic proportions.

Leverage was exceptional. Unregulated nonprime lenders had no meaningful capital rules.

Honest lenders would establish record high loss reserves pursuant to generally accepted accounting principles (GAAP). "The industry's reserves-to-loan ratio has been setting new record lows for the past four years" (A.M. Best 2006: 3). The ratio fell to 1.21 percent as of September 30, 2005 (*Id.*: 4-5). Later, "loan loss reserves are down to levels not seen since 1985" (roughly one percent) (A.M. Best 2007: 1). It noted that these inadequate loss reserves in 1985 led to banking and S&L crises. In 2009, IMF estimated losses on U.S. originated assets of $2.7 trillion (IMF 2009: 35 Table 1.3) (roughly 30 times larger than bank loss reserves).

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Fraud Warnings

The claim that no one could have foreseen the crisis is false. Unlike the S&L debacle, the FBI was far ahead of the regulators in recognizing that there was an "epidemic" of mortgage fraud and that it could cause a financial crisis. The FBI warned in September 2004 (CNN) that the "epidemic" of mortgage fraud would cause a "crisis" if it were not contained. The FBI has emphasized that 80 percent of mortgage fraud losses occur when lending industry insiders are part of the fraud scheme. The FBI deserves enormous credit for sounding such a strong, accurate, and public warning. Special praise should also go to Inman News, which put out a series of reports about mortgage fraud that culminated in a compendium in 2003 entitled: "Real Estate Fraud: The Housing Industry's White-Collar Epidemic." The warnings about appraisal fraud were equally stark – "Home Insecurity: How Widespread Appraisal Fraud Puts Homeowners at Risk" (Demos 2005). The remarkable fact is that the private sector, the regulators, and the prosecutors failed to take effective action despite these warnings. The failure to act is all the more troubling because the nonprime lenders followed the distinctive four-part recipe for lenders optimizing accounting control fraud that regulators, economists, and criminologists had documented and explained in the S&L debacle, during financial privatization (e.g., tunneling), and in the Enron-era control frauds.

Fraud Markers

S&L regulators (in the 1980s) and criminologists and economists (in the 1990s) had identified fraud "markers" (a term borrowed from pathology) that only fraudulent lenders would employ. Gutting underwriting is essential for lenders engaged in accounting control fraud because they have to make massive amounts of bad loans in order to grow extremely rapidly and charge premium interest rates in order to optimize near-term accounting "profits." Banks (and economists) have known for centuries that gutting mortgage underwriting leads to "adverse selection" (lending to borrowers that will often not be able or willing repay their loans). The "expected value" of adverse selection is sharply negative, i.e., the lender will invariably lose money (once the losses become manifest).

S&L regulators looked for fraud "markers", such as deliberately lending to uncreditworthy borrowers by inflating appraisals or by ignoring a track record of defaults that no honest lender would commit (Black, Calavita & Pontell 1985; Black 2005).
S&L regulators used these markers to identify and close the accounting control frauds while they were reporting record profits and minimal losses in the 1980s before they could cause a nationwide financial bubble, a general economic crisis, or recession. The most obvious marker is when lenders do not even take prudent steps to prevent fraud, but rather cover it up.

There is no honest reason for deliberately failing to establish adequate loss reserves, yet the typical nonprime lender slashed general loss reserves while risk was surging and GAAP required reserves to increase. That constitutes accounting and securities fraud, but it is also a marker of accounting control fraud. The officers controlling nonprime lenders, by keeping loan loss reserves at trivial levels, maxmized the lenders' fictional income – and their compensation.

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Similarly, appraisal fraud is not only a fraud but a "marker" of a broader fraud scheme. An honest secured lender would never inflate, or permit others to inflate, appraisal values. The 2009 FINCEN report explains why appraisal fraud adds enormously to losses from mortgage fraud.

> Lenders rely on accurate appraisals to ensure that loans are fully secured. The Appraisal Institute and the American Society of Appraisers testified that "...it is common for mortgage brokers, lenders, realty agents and others with a vested interest to seek out inflated appraisals to facilitate transactions because it pays them to do so. Higher sales prices typically generate higher fees for brokers, lenders, real estate agents, and loan settlement offices, and higher earnings for real estate investors. Appraisal fraud has a snowball effect on inflating real estate values, with fraudulent values being ... used by legitimate appraisers....

The Gresham's dynamic that the accounting control frauds deliberately induced in appraisals has been established repeatedly in surveys of appraisers.

> A new survey of the national appraisal industry found that 90 percent of appraisers reported that mortgage brokers, real estate agents, lenders and even consumers have put pressure on them to raise property valuations to enable deals to go through. That percentage is up sharply from a parallel survey conducted in 2003, when 55 percent of appraisers reported attempts to influence their findings and 45 percent reported "never." Now the latter category is down to just 10 percent.
>
> The survey found that 75 percent of appraisers reported "negative ramifications" if they refused to cooperate and come in with a higher valuation. Sixty-eight percent said they lost the client -- typically a mortgage broker or lender -- following their refusal to fudge the numbers, and 45 percent reported not receiving payment for their appraisal.

Control frauds, either directly or indirectly through the perverse incentives their compensations systems create for loan officers, loan brokers, and mortgage brokers, cause, encourage, and accede to endemic appraisal fraud.

The New York Attorney General's investigation of Washington Mutual (WaMu) (one of the largest nonprime mortgage lenders) and its appraisal practices supports this dynamic.

> New York Attorney General Andrew Cuomo said [that] a major real estate appraisal company colluded with the nation's largest savings and loan companies to inflate the values of homes nationwide, contributing to the subprime mortgage crisis.
>
> "This is a case we believe is indicative of an industrywide problem," Cuomo said in a news conference.

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> Cuomo announced the civil lawsuit against eAppraiseIT that accuses the First American Corp. subsidiary of caving in to pressure from Washington Mutual Inc. to use a list of "proven appraisers" who he claims inflated home appraisals.
>
> He also released e-mails that he said show executives were aware they were violating federal regulations. The lawsuit filed in state Supreme Court in Manhattan seeks to stop the practice, recover profits and assess penalties.
>
> "These blatant actions of First American and eAppraiseIT have contributed to the growing foreclosure crisis and turmoil in the housing market," Cuomo said in a statement. "By allowing Washington Mutual to hand-pick appraisers who inflated values, First American helped set the current mortgage crisis in motion."
>
> "First American and eAppraiseIT violated that independence when Washington Mutual strong-armed them into a system designed to rip off homeowners and investors alike," he said (*The Seattle Times,* November 1, 2007).

Note particularly Attorney General Cuomo's claim that WaMu "rip[ped] off ... investors." That is an express claim that it operated as an accounting control fraud and inflated appraisals in order to maximize accounting "profits." A Senate investigation has found compelling evidence that WaMu acted in a manner that fits the accounting control fraud pattern. http://levin.senate.gov/newsroom/release.cfm?id=323765

Pressure to inflate appraisals was endemic among nonprime lending specialists.

> Appraisers complained on blogs and industry message boards of being pressured by mortgage brokers, lenders and even builders to "hit a number," in industry parlance, meaning the other party wanted them to appraise the home at a certain amount regardless of what it was actually worth. Appraisers risked being blacklisted if they stuck to their guns. "We know that it went on and we know just about everybody was involved to some extent," said Marc Savitt, the National Association of Mortgage Banker's immediate past president and chief point person during the first half of 2009 (*Washington Independent,* August 5, 2009).

These markers are pervasive in the current crisis and would have allowed effective regulatory intervention. They can be used to prosecute the senior officials that caused the current crisis and they can be used to limit future crises. Current regulators and prosecutors did not recognize the markers and act effectively on the FBI warning. Current regulators and prosecutors have been so blinded by anti-regulatory ideology that they joined the private sector in failing to act effectively even against lenders that specialized in what the trade openly called "liar's loans."

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Echo Epidemics of Accounting Control Fraud

The primary epidemic of accounting control fraud by nonprime lenders produced "echo" epidemics of upstream and downstream control fraud. The primary mortgage fraud epidemic created a criminogenic environment that caused the upstream mortgage fraud epidemic. The downstream epidemic consists of those that purchased the nonprime product. The downstream epidemic could not have existed without the endemic mortgage fraud the other two fraud epidemics produced, but the downstream epidemic allowed both of the mortgage fraud epidemics to grow far larger.

In order to maximize their (fictional) accounting income, the nonprime lenders needed to induce others to send them massive quantities of relatively high yield mortgage loans with supporting appraisals, without regard to credit quality. The nonprime lenders created perverse incentives that produced a series of "Gresham's" dynamics. This did not require any formal agreement (conspiracy), which made it far easier to create an upstream echo epidemic and far harder to prosecute. Traditional mortgage underwriting has shown the ability to detect fraud prior to lending. The senior managers that controlled nonprime mortgage lenders that were control frauds, therefore, had to eliminate competent underwriting and suborn "controls" to pervert them into fraud allies.

When the nonprime lenders gutted their underwriting standards and controls and paid brokers greater fees for referring nonprime loans they inherently created an intensely criminogenic environment for loan brokers and appraisers. The brokers' optimization strategy was simple – refer as many relatively high yield mortgage loans as possible, as quickly as possible, with applications and made the borrower appear to qualify for the loan. The nonprime lenders, in essence, signaled their intention not to kick the tires and weed out even fraudulent loan applications and appraisals. I call this the financial version of "don't ask; don't tell" (a justly maligned U.S. military policy about gays serving in our armed services).

The downstream epidemic of accounting control fraud could not be created by the nonprime lenders because they could not create a downstream Gresham's dynamic. Indeed, the argument runs the other direction. The nonprime loan purchasers, by adopting "don't ask; don't tell", produced a criminogenic environment that helped drive the primary mortgage fraud epidemic. While press accounts have asserted that nonprime lenders had no concern about mortgage quality because they intended to sell the nonprime loans, that claim assumes away the central problem that the lender has no power to force someone to purchase the loans. The nonprime lenders were selling mortgages that were frequently fraudulent and worth dramatically less than lender's book value. They were selling in circumstances that the economic theory of "lemon" markets predicts can only be sold at a significant discount from the original book value (Akerlof 1970). Neoclassical economic theory predicts that "private market discipline" will prevent any downstream fraud (Black 2003). Fraudulent downstream investors rationally overpay for assets in order to obtain greater short-term yield (increasing accounting income) and rationally adopt a financial "don't ask; don't tell" policy with regard to asset quality and losses. Investors overpaid massively for nonprime CDOs – by 65 to 85 cents on the dollar. This created an overwhelming incentive to avoid massive loss recognition through a downstream epidemic of accounting fraud.

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The bankruptcy examiner's recent report on Lehman reveals that Lehman employed two common forms of accounting fraud – it did not recognize huge losses on assets and it used REPO transactions for the purpose of hiding those losses from creditors, investors, and regulators. Note that the downstream purchasers – including Fannie and Freddie – were never required to purchase fraudulent loans. Large numbers of liar's loans, for example, would not have counted towards Fannie and Freddie's regulatory requirement to purchase set percentages of below median income mortgages precisely because income was commonly grossly inflated. The CEOs that controlled the large financial players purchased over a trillion dollars in liar's loans not because they were required to or because President Clinton and Bush gave speeches favoring broader home ownership but because purchasing such loans created increased accounting income (in the near term), which maximized their bonuses.

Mortgage Fraud became Endemic

It is commonly reported that roughly 40% of U.S. mortgage lending during 2006 were nonprime, evenly split between subprime (known credit defects) and "alt-a" (purportedly high credit quality, but lacking verification of key underwriting data). "Alt-a" loans, by definition, did not conduct traditional underwriting (Bloomberg 2007; Gimein 2008). Liar's loans were sold under the bright shining lie that the borrowers had excellent credit characteristics essentially equivalent to prime borrowers. Investment banks typically called their liar's loans "prime" loans on their financial statements.

When discussing a category known in the trade as "liar's loans", however, it is well to be keep in mind the likelihood of deliberate misreporting of data. Over time, "alt-a" and "subprime" loans came to increasingly common features. Lehman, for example, had a subsidiary that specialized in liar's loans (Aurora) and one (BNC) that specialized in subprime. Aurora increasingly made liar's loans to borrowers that reported substantial credit problems and BNC increasingly made liar's loans to its subprime customers. When Lehman finally shut down BNC, Aurora continued to make liar's loans to borrowers disclosing defective credit. That is an extraordinary fact, for these were the borrowers whose incomes were typically grossly inflated. If even after the loan broker falsified much of the information on the application (Aurora purchased 95% of its liar's loans) the application showed obvious credit defects and Aurora still purchased the loans, then these actions are only rational for an accounting control fraud.

The implications of this are critical. It became the norm for liar's loans to be made on the basis of loan applications that, while fraudulent, also showed serious credit defects.

The typical presentation states that almost half of subprime loans, by 2006, did not conduct traditional underwriting. That percentage may be seriously underestimated. Lenders appear to have lied increasingly by describing liar's loan as "prime" loans. Credit Suisse reported in March 2007 that "we believe the most pressing areas of concern should be stated income (49% of originations), high CLTV/piggyback (39%), and interest only/negative amortizing loans (23%)." This is a good example of "layered risk." The sum of the three percentages exceeds 100% because it was common to make loans that had at least two, sometimes each, of these characteristics.

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A small sample review of nonprime loan files by Fitch (2007), found that underwriting had to be eviscerated to permit the endemic fraud that came to characterize nonprime mortgage lending.

> Fitch's analysts conducted an independent analysis of these files with the benefit of the full origination and servicing files. The result of the analysis was disconcerting at best, as there was the appearance of fraud or misrepresentation in almost every file.
>
> [F]raud was not only present, but, in most cases, could have been identified with adequate underwriting, quality control and fraud prevention tools prior to the loan funding. Fitch believes that this targeted sampling of files was sufficient to determine that inadequate underwriting controls and, therefore, fraud is a factor in the defaults and losses on recent vintage pools.

MARI, the Mortgage Bankers Association (MBA's) experts on fraud, warned that "low doc" lending caused endemic fraud.

> Stated income and reduced documentation loans ... are open invitations to fraudsters. It appears that many members of the industry have little historical appreciation for the havoc created by low-doc/no-doc products that were the rage in the early 1990s. Those loans produced hundreds of millions of dollars in losses for their users.
>
> One of MARI's customers recently reviewed a sample of 100 stated income loans upon which they had IRS Forms 4506. When the stated incomes were compared to the IRS figures, the resulting differences were dramatic. Ninety percent of the stated incomes were exaggerated by 5% or more. More disturbingly, almost 60% of the stated amounts were exaggerated by more than 50%. These results suggest that the stated income loan deserves the nickname used by many in the industry, the "liar's loan."

The same obvious question (which neither Fitch nor MARI asked) arises: why did lenders fail to use well understood underwriting systems that are highly successful in preventing fraud -- even when they knew that fraud was endemic and would cause massive losses? The same obvious answer exists – it was in the interests of the controlling officers to optimize short-term accounting income. Turning a blind eye to endemic fraud helped optimize reported income and their executive compensation.

MARI's reference to the "early 1990s" refers to a number of S&Ls that originated or purchased "low doc" loans in the early 1990s. These loans caused "hundreds of millions of dollars in losses." Those losses were contained because the regulators promptly used their supervisory powers to halt the practice when they realized that it was growing and becoming material. We acted because we recognized that not underwriting maximized adverse selection and guaranteed high real losses (after near-term, fictional, profits). We ordered a halt to the practice even while many of the lenders were reporting that the lending was profitable. "Hundreds of millions of dollars in losses" is serious, but if the losses are contained at that

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level the number of lender failures will be minimal and there will be no risk of a crisis. Unfortunately, our regulatory successors had no "historical appreciation" for successful supervisory policies or the identification of accounting control fraud. They issued ineffective "cautions" to the industry that "low doc" loans could be risky, but refused to order an end to the practice and never considered the possibility that the lenders were control frauds.

Thomas J. Miller, Attorney General of Iowa, testimony at a 2007 Federal Reserve Board hearing shows why fraud losses are enormous:

> Over the last several years, the subprime market has created a race to the bottom in which unethical actors have been handsomely rewarded for their misdeeds and ethical actors have lost market share.... The market incentives rewarded irresponsible lending and made it more difficult for responsible lenders to compete. Strong regulations will create an even playing field in which ethical actors are no longer punished.
>
> Despite the well documented performance struggles of 2006 vintage loans, originators continued to use products with the same characteristics in 2007.
>
> [M]any originators ... invent ... non-existent occupations or income sources, or simply inflat[e] income totals to support loan applications.
>
> Importantly, our investigations have found that most stated income fraud occurs at the suggestion and direction of the loan originator, not the consumer.

Because these risks were "layered" – interacting to produce far greater risk (IMF 2008: 4-5 & n.6) – honest nonprime lenders would have responded by establishing record high general loss reserves in accordance with generally accepted accounting principles (GAAP). Instead, A.M. Best reported in February 2006 that: "the industry's reserves-to-loan ratio has been setting new record lows for the past four years" (A.M. Best 2006: 3). The ratio fell to 1.21 percent as of September 30, 2005 (*Id.*: 4-5). One year later, A.M. Best reported: "loan loss reserves are down to levels not seen since 1985" (roughly one percent) (A.M. Best 2007: 1). A.M. Best went on to point out that these grossly inadequate loss reserves in 1985 led to a decade-long crisis in banking and S&Ls. In 2009, IMF estimated losses on U.S. originated assets of $2.7 trillion (IMF 2009: 35 Table 1.3). Total U.S. bank and S&L general loss reserves in 2006 were under $100 billion, so general loss reserves would have had to be roughly 30 times larger to be adequate. If the lenders had established adequate loss reserves they would have reported that they were deeply unprofitable, which was the economic reality. The banking regulatory agencies, the SEC, and "private market discipline" all failed to require even remotely adequate reserves and minimal honesty in financial reports. The current control frauds used the same optimization techniques as did the S&Ls – but they did it on steroids. The primary epidemic directly created the upstream epidemic and was a necessary, but not sufficient, cause of the upstream epidemic.

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If You Don't Investigate, You Won't Find

Criminologists and financial regulators have long warned that the failure to regulate the financial sphere *de facto* decriminalizes control fraud in the industry. The FBI cannot investigate effectively more than a small number of the massive accounting control frauds. Only the regulators can have the expertise, staff, and knowledge to identify on a timely basis the markers of accounting control fraud, to prepare the detailed criminal referrals essential to serve as a roadmap for the FBI, and to "detail" (second) staff to work for the FBI and serve as their "Sherpas" during the investigation.

The agency regulating S&Ls made criminal prosecution a top priority. The result was over 1000 priority felony convictions of senior insiders and their co-conspirators. That is the most successful effort against elite white-collar criminals. The agency also brought over 1000 administrative enforcement actions and hundreds of civil lawsuits against the elite frauds. One result of this was an extensive, public record of fact that fraud was "invariably present" at the "typical large failure" (NCFIRRE 1993). The Enron-era frauds were accounting control frauds and while the effort against them was too late and weaker than the effort against the S&L frauds it involved scores of prosecutions and provided substantial public documentation.

The FBI, however, after a brilliant start in identifying the epidemic of mortgage fraud, went tragically astray and its efforts to contain the epidemic failed. The FBI suffered from a horrific systems capacity problem. It did not have the agents or expertise to deal with the concurrent control fraud epidemics it faced this decade. Its systems capacity problems became crippling when 500 white-collar specialists were transferred to national security investigations in response to the 9/11 attacks and the administration refused to allow the FBI to hire new agents to replace the lost white-collar specialists.

The most crippling limitation on the regulators', FBI's, and DOJ's efforts to contain the epidemic of mortgage fraud and the financial crisis was not understanding of the cause of the epidemic and why it would cause a catastrophic financial crisis. The mortgage banking industry controlled the framing of the issue of mortgage fraud. That industry represents the lenders that caused the epidemic of mortgage fraud. The industry's trade association is the Mortgage Bankers Association (MBA). The MBA followed the obvious strategy of portraying its members as the victims of mortgage fraud. What it never discussed was that the officers that controlled its members were the primary beneficiaries of mortgage fraud. It is the trade association of the "perps." The MBA claimed that all mortgage fraud was divided into two categories – neither of which included accounting control fraud. The FBI, driven by acute systems incapacity, formed a "partnership" with the MBA and adopted the MBA's (facially absurd) two-part classification of mortgage fraud (FBI 2007). The result is that there has not been a single arrest, indictment, or conviction of a senior official of a nonprime lender for accounting fraud.

One of the most dramatic, and unfortunate differences between the S&L debacle and the current crisis is that the financial regulatory agencies gave the FBI no help in this crisis – even after it warned of the epidemic of mortgage fraud. The FBI does not mention the agencies in its list of

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sources of criminal referrals for mortgage fraud. The data on criminal referrals for mortgage fraud show that regulated financial institutions, which are required to file criminal referrals when they find "suspicious activity" indicating mortgage fraud, typically fail to do so. There is no evidence that the agencies responsible for enforcing the requirement file criminal referrals have taken any action to crack down on the widespread violations.

The crippling mischaracterization of the nature of the mortgage fraud epidemic came from the top, as the *New York Times* reported in late 2008.

> But Attorney General Michael B. Mukasey has rejected calls for the Justice Department to create the type of national task force that it did in 2002 to respond to the collapse of Enron.
>
> Mr. Mukasey said in June that the mortgage crisis was a different "type of phenomena" that was a more localized problem akin to "white-collar street crime."

The nation's top law enforcement official swallowed the MBA's mischaracterization of the mortgage fraud epidemic and economic crisis hook, line, sinker, bobber, rod, reel, and boat they rowed out into the swamp. Because Mukasey refused to investigate the elite frauds he created a self-fulfilling prophecy in which the FBI and DOJ pursued only the "white-collar street crim[inals]" (the small fry) and therefore confirmed that the problem was the small fry. The pursuit of the small fry was certain to fail.

The MBA's success in causing the FBI to ignore the control frauds reminds me of this passage in the original *Star Wars* movie where Obi-Wan uses Jedi powers to pass through an Imperial check point with two wanted droids in plain sight:

Stormtrooper: Let me see your identification.
Obi-Wan: [*with a small wave of his hand*] You don't need to see his identification.
Stormtrooper: We don't need to see his identification.
Obi-Wan: These aren't the droids you're looking for.
Stormtrooper: These aren't the droids we're looking for.
Obi-Wan: He can go about his business.
Stormtrooper: You can go about your business.
Obi-Wan: Move along.
Stormtrooper: Move along... move along.

Luke: I don't understand how we got by those troops. I thought we were dead.
Obi-Wan: The Force can have a strong influence on the weak-minded.

The FBI isn't supposed to be "weak-minded" about elite white-collar criminals. It is not supposed to be misled by "Jedi mind tricks" by the lobbyists for the "perps." It is not supposed to fail to understand the importance of endemic markers of accounting control fraud at every nonprime specialty lender where even a preliminary investigation has been made public.

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The FBI, DOJ, banking regulators, SEC, and all the purported sources of "private market discipline" failed to act against (and even praised) the *perverse incentive structures* that the accounting control frauds created to cause the small fry to act fraudulently. Those incentive structures ensured that there were always far more new small fry hatched to replace the relatively few small fry that the DOJ could imprison. Accounting control frauds deliberately produce intensely criminogenic environments to recruit (typically without any need for a formal conspiracy) the fraud allies that optimize accounting fraud. They create the perverse Gresham's dynamic that means that the cheats prosper at the expense of their honest competitors. The result can be that the unethical drive the ethical from the marketplace. Had Mukasey been aware of modern white-collar criminological research he would have been forced to ask why tens of thousands of small fry were able to cause an epidemic of mortgage fraud in an industry that had historically successfully held fraud losses to well under one percent of assets. Ignoring good theory produces bad criminal justice policies.

The Size of the Mortgage Fraud Epidemic Swamps the FBI

The size of the current financial crisis and the incidence of fraud in the current crisis vastly exceed the S&L debacle. The FBI testified that it "increased the number of agents around the country who investigate mortgage fraud cases from 120 Special Agents in FY 2007 to 180 Special Agents in FY 2008...." Its testimony noted that it employed "1000 FBI agents and forensic experts" against the S&L frauds (Pistole 2009). It received over 63,000 criminal referrals for mortgage fraud in the last year for which it has full data (a figure that has risen substantially every year). The FBI, therefore, can investigate only a tiny percentage of criminal referrals for mortgage fraud. The FBI reports that 80% of mortgage fraud losses occur when "industry insiders" are involved in the fraud (FBI 2007).

Only federally insured banks and S&Ls are required to file criminal referrals. Non-insured lenders made 80% of nonprime mortgage loans (subprime and "alt-a"), and the made the worst nonprime loans that most invited fraud. These lenders can make criminal referrals and it would be in the interests of honest lenders to do so, but they rarely do. That means that the first approximation of the true annual incidence of mortgage fraud would be to multiply 63,000 by five (315,000). That extrapolation, however, would only be sound if (A) insured lenders spotted all mortgage fraud and (B) filed criminal referrals when they spotted likely frauds. The FBI believes that insured entities identify mortgage frauds prior to lending in about 20% on "no doc" loans (known in the trade as "liar's loans") (*New York Times,* April 6, 2008). Multiplying 315,000 by five produces a product of over 1.5 million.

The data on referrals show that the typical insured lender rarely files when it finds mortgage fraud. The October 2009 FinCEN report on criminal referrals for mortgage fraud (in jargon, Suspicious Activity Reports (SARs) found:

> In the first half of 2009, approximately 735 financial institutions submitted SARs, or about 50 more filers compared to the same period in 2008. The top 50 filers submitted 93

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> percent of all [mortgage fraud] SARs, consistent with the same 2008 filing period. However, SARs submitted by the top 10 filers increased from 64 percent to 72 percent.

Only a small percentage of mortgage lenders, 75 in total (roughly 10% of federally-insured mortgage lenders), filed even a single criminal referral for mortgage fraud during a mortgage fraud epidemic. Of the 735 that make at least one filing, fewer than 200 file more than four referrals. A mere ten filers provide the FBI with almost three-quarters of all SARs mortgage fraud filings. We cannot form an appropriate estimate of the degree of under-filing of criminal referrals when insured banks find fraud, but we can infer that the failure to file is pervasive. The logical explanation for the widespread failure of lenders to file criminal referrals when they discover mortgage frauds is that they fear that if they file FBI would come to the lender and discover its complicity in the fraud.

To sum it up, in FY 2007 the FBI has had less than one-eighth of the resources it had to investigate the S&L frauds despite the fact that the current crisis is perhaps 30 times worse than the S&L debacle. It was facing well over a million mortgage frauds annually. It could investigate under 1000 cases per year. If every investigation was successful the FBI would be completely ineffective in preventing or even slowing materially the epidemic of mortgage fraud. Mukasey's strategy of going after the small fry gave the control frauds a free pass and had to fail to deter the small fry.

Could this crisis have been prevented?

Yes. Indeed, in many ways this was an easier crisis to contain successfully than many prior financial crises. The United States had extensive experience with nonprime mortgage lending – and it always ended badly. This is the third nonprime failure in twenty years. Nonprime lending, on its face, is inherently imprudent. I quoted MARI about the nonprime losses of the early 1990s and explained how we used supervisory powers to end those losses. No expensive failures resulted and there was, of course, no crisis. Those were primarily "low doc" and (marginally) subprime loans.

Nonprime lenders suffered considerably worse losses (and many failures) in the late 1990s. These nonprime lenders were also known for their predatory lending practices, which led to serious (but not criminal) sanctions by the Federal Trade Commission. The most disturbing aspect of this series of nonprime failures was that elite commercial banks rushed to acquire the predatory lenders even as they were failing and sued by the FTC. President Bush even appointed the most infamous predatory subprime lender (and his largest political contributor), as our ambassador to the Netherlands.

The nonprime loans of the current crisis were an order of magnitude worse than in the early 1990s. They were subprime loans with severe credit defects and "no doc" ("liar's loans"). I've explained why that produces severe adverse selection. Adverse selection is criminogenic. It can produce fraud epidemics.

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I noted the how the "layered" nature of the risk of nonprime loans surged during the crisis. These risks interact, the whole is far riskier than the sum of the parts – and the sum of the parts would have been terrifying to any honest lender. By 2006 and 2007, it was common for nonprime loans to include each of these characteristics:

- A trivial, or even no, downpayment
- The minimal downpayment was funded by another loan
- The purported loan-to-value (LTV) ratio was substantial
- The actual LTV was far higher, often >100%, because the appraisal was inflated
- The loan was occurring during the worst financial bubble in history, so the LTV once the bubble burst would greatly exceed 100%
- The loans were increasingly secured by junior liens
- The loan was "no doc" and the representations were not verified
- The information on the loan application was false
- The lender "qualified" the borrower for the loan on the basis of whether he could pay the initial, far lower ("teaser") interest rate rather than the fully indexed rate
- The borrower could not afford to pay the fully indexed interest rate (even if the borrowers "stated income" was accurate – it was typically inflated)
- The loan payments were less than the interest due (negative amortization)
- The home was not being purchased by someone who would occupy the home (despite a contrary representation on the application)
- While it was never typical, it became common for the mortgage term to be 40 years

Any experienced lender, investment banker, accountant, regulator, or rating agency official would recognize that this was a formula for disaster. They would also understand that packaging a thousand of these toxic mortgages together in a collateralized debt obligation (CDO) in which 80 percent of the derivative was structured as top "tranche" and was supposedly worthy of a "AAA" rating was too good to be true. CDOs are no better than the underlying mortgages (the various "credit enhancements" proved ephemeral). I learned by reading here in Reykjavik a recently released governmental report on Iceland's banking crisis, that large amounts of worthless debt instruments of Iceland's "Big 3" banks were put into CDOs because their debt carried relatively high credit ratings. It should not be necessary to add that the ratings for the (deeply insolvent and massively fraudulent Icelandic banks) bore no relationship to reality and that this debt did not adequately "enhance" CDO credit quality.

I've discussed the warnings of an "epidemic" of mortgage fraud, which began in 2003, were embraced by the FBI in 2004, and were supplemented by warnings of endemic appraisal fraud in 2005. "Stated income" loans became known throughout the industry as "liar's loans" and grew to roughly 30% of total new mortgages by early 2007. Many lenders made liar's loans their primary product. How difficult was it for a regulator (or purchaser of nonprime mortgages or CDOs) to figure out that a business strategy of making "liar's loans" was imprudent?

The nonprime market also made no sense on other dimensions. As I've just explained, the risk of loss rose spectacularly during the decade as loan quality collapsed, fraud became endemic in

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nonprime loans, and the bubble hyper-inflated. Logically, this should have caused a dramatic increase in loss reserves and should have caused nonprime "spreads" to widen substantially. Instead, the officers controlling the lenders reduced loan loss reserves to ridiculous levels – and spreads narrowed. The first dimension demonstrates endemic accounting and securities fraud. The second dimension demonstrates that markets were not only "inefficient", but also became increasingly inefficient throughout the growing crisis.

While Greenspan and other failed regulators have claimed that no one warned of the coming crisis; that was truer of the S&L debacle than the current crisis. I've shown that there were strong, early warnings of endemic fraud and predictions that it would cause a crisis. Nonprime loans, as I've explained, had a consistently bad track record and their problems were sufficiently recent that they should have been well known to both private and public sector leaders. The Enron-era control frauds and New York Attorney General Spitzer's investigations were fresh in Americans' minds. Those frauds made clear that:

- The most elite corporations engaged in fraud
- Those frauds were led from the top
- Accounting fraud produced exceptional deception – firms such as Enron that were grossly insolvent and unprofitable purported to be immensely profitable
- The large frauds were able to get "clear opinions from top tier audit firms
- Executive compensation was a major driver of the frauds
- Banks funded the accounting control frauds rather than exerting effective "private market discipline" against them
- Effective regulation was essential to limit such frauds

During the S&L debacle, by contrast, only one economist (Ed Kane) warned publicly of a coming crisis arising from bad assets – and he did not warn about the wave of control fraud. Economists virtually unanimously opposed our reregulation of the industry (Paul Volcker was the leading exception). Economists, including Alan Greenspan, were leading allies of the worst S&L accounting control frauds.

The most difficult aspect of the current crisis to contain was that roughly 80% of nonprime loans were made by entities not subject to direct federal regulation (primarily mortgage bankers). (Note that this also meant they were not subject to the Community Reinvestment Act (CRA) and to requirements to file criminal referrals.) The Federal Reserve (Fed), however, had unique statutory authority to regulate all mortgage lenders under the Home Ownership and Equity Protection Act of 1994 (HOEPA), but Greenspan and Bernanke refused to use it. Finally, over a year after the secondary market in nonprime loans (CDOs) collapsed, and after Congressional pressure to act, the Fed used its HOEPA authority to order an end to some of the most abusive nonprime lending practices. Prior to that time, the federal regulatory agencies acted aggressively

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throughout the decade to assert federal "pre-emption" of state regulation as a means of attempting to prevent the states from protecting their citizens from predatory nonprime lenders.

All the regulators needed to do to prevent the crisis was ban lending practices that were rational only for control frauds engaged in looting. The regulators consistently refused to do so because of their anti-regulatory ideology. Traditional mortgage underwriting practices are highly effective against fraud. The regulators knew what reforms would work, but refused to mandate the reforms.

By the time this crisis began economists (Akerlof & Romer 1993), regulators (Black 1993); and criminologists (Calavita, Pontell & Tillman 1997; Black 2003; Black 2005) had developed effective theories explaining why combining financial nonregulation and modern executive and professional compensation produced criminogenic environments that led to epidemics of accounting control fraud. We also explained why these were near perfect frauds and explained how control frauds used their compensation and hiring and firing powers to create a "Gresham's" dynamic that allowed them to suborn the "independent" professionals that were supposed to serve as "controls" and transform them into allies. (This is similar to HIV's ability to infect the immune system.)

One of the important practical aspects of control fraud research findings is the existence of fraud "markers." These can be used to identify the frauds even while they are reporting record profits and minimal losses. The fraud markers also make it possible to prosecute successfully complex frauds because jurors can understand that it makes no sense for honest firms to engage in such practices but makes perfect sense for frauds.

Equally importantly, our research showed how to contain a spreading epidemic of accounting control fraud. These policies were exceptionally effective in containing the S&L debacle. The existence of these research findings and our regulatory record of successful efforts against the accounting control fraud should have made it far easier for our regulatory successors (and any honest bankers) to identify the frauds at an early date and take effective action against them.

What if We Had Looked?

Within the last month, facts have been revealed about three massive nonprime players that show the strong evidence of elite criminality that would have been revealed – in some cases, five years ago – had there been real investigations.

WaMu

Readers interested in reading the Senate Permanent Subcommittee on Investigations' report and the underlying documents can find them through this link:
http://levin.senate.gov/newsroom/release.cfm?id=323765

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WaMu was an obvious disaster. Its advertising campaign mocked prudent bankers and made it clear that WaMu's answer to potential borrowers would be "yes." Here are the high points picked up by the *New York Times* and the *Huffington Post* in two recent columns:

http://www.nytimes.com/2010/04/13/business/13wamu.html?hpw

April 12, 2010

Memos Show Risky Lending at WaMu

By SEWELL CHAN

WASHINGTON — New documents released by a Senate panel show how entrenched Washington Mutual was in fraudulent and risky lending, and highlighted how its top executives received rewards as their institution was hurtling toward disaster.

The problems at WaMu, whose collapse was the largest in American banking history, were well known to company executives, excerpts of e-mail messages and other internal documents show.

The documents were released on Monday by the Senate Permanent Subcommittee on Investigations, which began an inquiry into the financial crisis in November 2008. The panel has summoned seven former WaMu executives to testify at a hearing on Tuesday, including the former chief executive Kerry K. Killinger.

The panel called WaMu illustrative of problems in the origination, sale and securitization of high-risk mortgages by any number of financial institutions from 2004 to 2008.

"Using a toxic mix of high-risk lending, lax controls and compensation policies which rewarded quantity over quality, Washington Mutual flooded the market with shoddy loans that went bad," the panel's chairman, Senator Carl Levin, Democrat of Michigan, said.

Mr. Killinger was paid $103.2 million from 2003 to 2008. In WaMu's final year of existence, he received $25.1 million, including a $15.3 million severance payment.

In fairness to the reporter, I note that reporters rarely write their headlines. The headline, however, exemplifies the weak analysis and lack of candor that dominates coverage of this crisis. WaMu's failure was caused by fraudulent lending practices, not "risky lending." "Risk", as we conventionally use that word in economics and finance, had nothing to do with any of the three

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epidemics of accounting control fraud. WaMu's senior managers deliberately put in place incentive structures that produce massive fraud – then gutted the protections (underwriting and controls) that honest lenders use (successfully) to limit fraud. In combination with providing trivial loss reserves and an executive compensation system based largely on short-term accounting "income", this produced a "sure thing." It was certain that the strategy would produce record (albeit fictional) short-term profits. If other lenders followed similar practices (as was extremely likely), it was also certain hyper-inflate the bubble. That meant WaMu's bad loans could be masked for years through refinancings (WaMu also delayed the recognition of losses by making primarily option ARM loans that allowed extremely low mortgage payments for up to a decade – payments so low that they produced serious negative amortization.) By masking the inevitable defaults for many years the senior executives were able to be become exceptionally wealthy. It was also certain that this would lead to disaster for the firm. But the failure of the firm does not represent a failure of the fraud scheme.

Criminologists view WaMu as a "vector" spreading the fraud epidemic through the financial system. But one should have limited sympathy for the purchasers of WaMu's fraudulent loans for the reasons the Fitch study demonstrated. The fraudulent mortgages were typically obvious on the face of the document. Had the purchasers of WaMu's mortgages, typically (allegedly) sophisticated parties, engaged in due diligence they would have found widespread fraud. Indeed, that is one of the weaknesses of endemic mortgage fraud – it is relatively easy to spot. The purchasers, however, engaged in "don't ask; don't tell" because their senior officers knew that purchasing relatively high yield nonprime loans would produce record short-term accounting income (and extraordinary compensation).

Killinger was made rich by the lending policies that destroyed WaMu. The fact that he is complaining in his Congressional testimony that it was "unfair" that the taxpayers didn't bail out WaMu after he trashed it epitomizes the demise of elite accountability and its replacement with a sickening sense of absolute entitlement of the group that Simon Johnson and Peter Kwak aptly refer to as the financial "oligarchs" (2010).

http://www.huffingtonpost.com/2010/04/13/kerry-killinger-exwamu-ce_n_535749.html

Kerry Killinger, Ex-WaMu CEO, It's 'Unfair' Bank Didn't Get Bailed-Out

MARCY GORDON | 04/13/10 11:35 AM |

> WaMu was one of the biggest makers of so-called "option ARM" mortgages. They allowed borrowers to make payments so low that loan debt actually increased every month.

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The Senate subcommittee investigated the Washington Mutual failure for a year and a half. It focused on the thrift as a case study on the financial crisis.

Senior executives of the bank were aware of the prevalence of fraud, the Senate investigators found.

The investors who bought the mortgage securities from Washington Mutual weren't informed of the fraudulent practices, the Senate investigators found. WaMu "dumped the polluted water" of toxic mortgage securities into the stream of the U.S. financial system, Levin said.

In some cases, sales associates in WaMu offices in California fabricated loan documents, cutting and pasting false names on borrowers' bank statements. The company's own probe in 2005, three years before the bank collapsed, found that two top producing offices – in Downey and Montebello, Calif. – had levels of fraud exceeding 58 percent and 83 percent of the loans. Employees violated the bank's policies on verifying borrowers' qualifications and reviewing loans.

Citicorp

The full prepared statement of Mr. Richard Bowen, Former Senior Vice President and Business Chief Underwriter of CitiMortgage Inc. before the Financial Crisis Inquiry Commission on April 7, 2020 can be found here:

http://www.fcic.gov/hearings/04-07-2010.php

Mr. Bowen's testimony received far less attention because he testified on the same day as Alan Greenspan and Citi's former top officials. This is unfortunate because he was far more candid about Citi's operations than were its former senior officials. Mr. Bowen disclosed that Citi was also a massive vector, selling roughly $50 billion annually in mostly bad mortgages (primarily to Fannie and Freddie).

The delegated flow channel purchased approximately $50 billion of prime mortgages annually. These mortgages were not underwriten by us before they were purchased. My Quality Assurance area was responsible for underwriting a small sample of the files post-purchase to ensure credit quality was maintained.

These mortgages were sold to Fannie Mae, Freddie Mac and other investors. Although we did not underwrite these mortgages, Citi did rep and warrant to the investors that the mortgages were underwritten to Citi credit guidelines.

In mid-2006 I discovered that over 60% of these mortgages purchased and sold were defective. Because Citi had given reps and warrants to the investors that the mortgages

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were not defective, the investors could force Citi to repurchase many billions of dollars of these defective assets. This situation represented a large potential risk to the shareholders of Citigroup.

I started issuing warnings in June of 2006 and attempted to get management to address these critical risk issues. These warnings continued through 2007 and went to all levels of the Consumer Lending Group.

We continued to purchase and sell to investors even larger volumes of mortgages through 2007. And defective mortgages increased during 2007 to over 80% of production.

Lehman Brothers

The bankruptcy examiner conducted an investigation of Lehman Brothers. The report reveals that Lehman Brothers was engaged in large scale accounting and securities fraud by failing to recognize losses so large that it had failed as an enterprise. Lehman's senior executives sought to cover up its failure with a series of very large ($50 billion) quarter end REPO transactions. Curiously, the report puts no emphasis on the underlying fraud that drove the fraud concentrates on the second-stage REPO cover up.

Here is a link to the full series of the bankruptcy examiner's reports:

http://lehmanreport.jenner.com/

My oral and written testimony before House Financial Services on April 20, 2010 provides a detailed description of the evidence indicating accounting control fraud at Lehman. Lehman was one of the principal vectors of liar's loans in the world. The links are:

http://c-spanvideo.org/program/id/222787

http://www.house.gov/apps/list/hearing/financialsvcs_dem/black_4.20.10.pdf

Goldman Sachs

Now, we learn that the SEC charges that Goldman Sachs should be added to the list of elite financial frauds. It is a tale of two (unrelated) Paulsons. Hank Paulson, while Goldman's CEO, had Goldman buy large amounts of collateralized debt obligations (CDOs) backed by largely fraudulent "liar's loans." He then became U.S. Treasury Secretary and launched a successful war against securities and banking regulation. His successors at Goldman realized the disaster and began to "short" CDOs. Mr. Blankfein, Goldman's CEO, recently said Goldman was doing "God's work." If true, then we know that God wanted Goldman to blow up its customers.

Goldman designed a rigged trifecta: (1) it secured additional shorting pressure from John Paulson (CEO of a hedge fund that Goldman would love to have as an ally) that aided

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Goldman's overall strategy of using "the big short" to turned a massive loss caused by Hank Paulson's investment decisions into a material profit, (2) helped make John Paulson a massive profit – in a "profession" where reciprocal favors are key, and (3) blew up its customers that purchased the CDOs. Paulson and Goldman were shorting because they believed that the liar's loans were greatly overrated by the rating agencies. Goldman let John Paulson design a CDO in which he was able to help pick the nonprime packages that were most badly overrated (and, therefore, overpriced). Paulson created a CDO "most likely to fail." Goldman constructed, at John Paulson's request, a "synthetic" CDO that had a credit default component (CDS). The CDS allowed John Paulson to bet that the CDO he had constructed (with Goldman) to be "most likely to fail" would in fact fail – in which case John Paulson would be become even wealthier because of the profit he would make on the CDS.

Now, any purchaser of the "most likely to fail" CDO would obviously consider it "material information" that the investment was structured for the sole purpose of increasing the risk of failure (and helping Goldman "big short" strategy designed to offset losses on Hank Paulson's worst investments). The SEC complaint says that Goldman therefore defrauded its own customers by representing to them that the CDO was "selected by ACA Management." ACA was supposed to be an independent group of experts that would "select" nonprime loans "most likely to succeed" rather than "most likely to fail." The SEC complaint alleges that the representations about ACA were false.

The obvious question is: did John Paulson and ACA know that Goldman was making these false disclosures to the CDO purchasers? Did they "aid and abet" what the SEC alleges was Goldman's fraud? Why have there been no criminal charges? Why did the SEC only name a relatively low-level Goldman officer in its complaint? Where are the prosecutors?

The Rating Agencies

The Senate has released documents from the rating agencies that demonstrate that they were willingly manipulated by perverse compensation arrangements to give grotesquely inflated ratings to liar's loans. At the barest minimum, the rating agencies were leading enablers of the downstream epidemic of accounting control frauds.

Fannie and Freddie

The SEC found accounting control fraud at Fannie and Freddie and forced large restatements of their financial statements. If they won their bet on interest rates they gained. When Fannie lost on its interest rate risk gambles it used fraudulent "hedge" accounting to avoid recognizing its losses. When Freddie won on its interest rate gambles it used fraudulent "hedge" accounting to defer recognizing the gain until it had a bad quarter that would lead the executives to fail to obtain their maximum bonus. Freddie's managers could then make the gain magically appear so that they would receive their maximum bonus. (This is a variant on "cookie jar reserves.")

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When the SEC found that Fannie and Freddie had engaged in accounting fraud their financial regulator, which was then OFHEO, forced CEO changes. OFHEO also (finally) limited what had been the rapid growth of their portfolio (which they used primarily to take interest rate risk prior to the SEC action.)

Because Fannie and Freddie were privatized, their officers designed their compensation system in the same perverse manner as most firms (Bebchuk & Fried 2004), they stood to gain enormous compensation if they inflated short-term accounting income. As Mr. Raines explained in response to a media question as to what was causing the repeated scandals at elite financial institutions:

> **We've had a terrible scandal on Wall Street. What is your view?**
> Investment banking is a business that's so denominated in dollars that the temptations are great, so you have to have very strong rules. My experience is where there is a one-to-one relation between if I do X, money will hit my pocket, you tend to see people doing X a lot. You've got to be very careful about that. Don't just say: "If you hit this revenue number, your bonus is going to be this." It sets up an incentive that's overwhelming. You wave enough money in front of people, and good people will do bad things.

http://msnbci.businessweek.com/magazine/content/03_20/b3833125_mz020.htm[1]

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[1] Raines' observation about the perverse impact of such compensation systems has been confirmed by statistical tests. As Bebchuk & Fried, the leading experts on compensation systems, observed in their study of Fannie Mae's compensation system:

> As we noted at the outset, we do not know whether Raines and Howard were in any way influenced by the incentives to inflate earnings created by their compensation packages. There is a growing body of evidence, however, that in the aggregate, the structure of executive pay affects the incentive to inflate earnings.[10] For example, pay arrangements that enable executives to time the unwinding of equity incentives have been correlated with attempts to increase short-term stock prices by inflating earnings. Thus, the problem of rewards for short-term results is of general concern.
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> n. 10 *See, e.g.*, Scott L. Summers & John T. Sweeney, **Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis**, 73 *Acct. Rev.* 131 (1998). For further discussion of this problem, see [Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004):] at 183-85.

Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage. Lucian A. Bebchuk and Jesse M. Fried. *Journal of Corporation Law*, 2005, Vol. 30, pp. 807-822 (at p. 811).

Even scholars opposed to many aspects of financial regulation have noted the endemic nature of these perverse incentives and their close ties to accounting and securities fraud. Markham, Jerry W. **Regulating Excessive Executive Compensation – Why Bother?** (available on SSRN: See, e.g., pp. 20- 21). The depth of consensus on this issue is shown by the strong concurrence of the intellectual father of executive bonus systems, Michael Jensen, who has concluded that (as implemented) they have caused pervasive perverse incentives and led to endemic accounting and securities fraud. Jensen concludes:

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Raines learned that the unit that should have been most resistant to this "overwhelming" financial incentive, Internal Audit; had succumbed to the perverse incentive. Mr. Rajappa, Senior Vice President for Operations Risk and Internal Audit instructed his internal auditors in a formal address in 2000 (and provided the text of the speech to Raines). ($6.46 refers to the earnings per share (EPS) number that will trigger maximum bonuses.)

> By now every one of you must have 6.46 branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breath and dream 6.46, you must be obsessed on 6.46.... After all, thanks to Frank [Raines], we all have a lot of money riding on it.... We must do this with a fiery determination, not on some days, not on most days but day in and day out, give it your best, not 50%, not 75%, not 100%, but 150%. Remember, Frank has given us an opportunity to earn not just our salaries, benefits, raises, ESPP, but substantially over and above if we make 6.46. So it is our moral obligation to give well above our 100% and if we do this, we would have made tangible contributions to Frank's goals (emphasis in original).

In addition to allowing the CEO to convert firm assets to his personal benefit through seemingly normal corporate means, executive compensation has two additional advantages to accounting control frauds. The CEO of a large corporation cannot send a memorandum to 5000 employees instructing them to commit accounting fraud – but he can send the same message with near impunity through the compensation system. The CEO ensures that the compensation system creates a criminogenic environment that produces powerful incentives for subordinated to engage in accounting fraud in order to maximize their bonuses (which will maximize the CEO's

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- When managers make any decisions other than those that maximize value in order to affect reporting to the capital markets they are lying
- And for too long we in finance have implicitly condoned or even collaborated in this lying. Specifically I am referring to "managing earnings", "income smoothing", etc.
- When we use terms other than lying to describe earnings management behavior we inadvertently encourage the sacrifice of integrity in corporations and in board rooms and elsewhere

Recent Evidence from Survey of 401 CFO's Reveals Fundamental Lack of Integrity

- Graham, Harvey & Rajgopal survey ("Economic Implications of Corp. Fin. Reporting" http://ssrn.com/abstract=491627) of 401 CFOs find:
- 78% of surveyed executives willing to knowingly sacrifice value to smooth earnings
- Recent scandals have made CFOs less willing to use accounting manipulations to manage earnings, but
- Perfectly willing to change the real operating decisions of the firm to destroy long run value to support short run earnings targets

Jensen, Michael. **Putting Integrity Into Finance Theory and Practice: A Positive Approach (June 9, 2007)** (available on SSRN).

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bonus and the value of his stock) – all with complete deniability from the CEO. Generous bonuses for even lower level managers also provide a powerful social pressure against whistle blowers coming forward and leading all their peers to lose their bonuses.

Fannie and Freddie CEOs caused them to purchase huge amounts of nonprime assets because, with their growth restricted the way to create fictional accounting income and maximize their bonuses was to purchase for their portfolio the highest yield assets. This is the same strategy that most of the investment banker CEOs followed. OFHEO had ample regulatory power to order that an end to this strategy. It failed to do so because it did not believe that regulating assets purchases was an appropriate regulatory policy prior to those assets causing serious losses. The bubble masked those losses by allowing refinancing. The CEOs of Fannie, Freddie, Bear Stearns, Citi, Wachovia, Merrill Lynch, and Lehman followed similar strategies for the same perverse reasons (and that list is not exhaustive).

Other Nations Suffering from Control Fraud during this Crisis

Very recent reports by governmental authorities in Ireland and Iceland provide strong support for concerns that control fraud played a role in their bank failures.

Specific Proposals to Reduce and Deter Accounting Control Fraud

1. Eliot Spitzer, Frank Partnoy and I proposed in our December 19, 2009 op ed in the *New York Times* – that AIG's emails and key deal documents be made public so that we can investigate the elite control frauds. (I have called for the same disclosures of Fannie and Freddie's key documents.) Goldman used AIG to provide the CDS on these synthetic CDO deals and Hank Paulson used our money to bail out Goldman when AIG's CDS deals drove it to failure. Treasury also used AIG to secretly bail out UBS – a massive Swiss bank engaged in a conspiracy with wealthy Americans to commit tax evasion/fraud. In essence, Americans paid UBS' fine – and gave it over $4 billion is walking away money. AIG was not insured, the U.S. had no responsibility to bear its losses. AIG's managers, directors, and trustees have failed to make any response to our requests that they assist these vital investigations by releasing the documents. (I have received no response to my similar open requests to Fannie and Freddie.)

2. Clarify that investors and creditors may pursue a private right of action against those that "aid and abet" relevant frauds under the securities laws.

3. Enact Representative Kaptur's bill to authorize, fund and direct the FBI to hire 1000 additional white-collar crime specialists as FBI agents to replace those transferred to national security and add resources necessary to take on the backlog of control frauds.

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4. The regulators, FBI, and DOJ should follow a successful strategy used during the S&L debacle and create a "Top 100" priority list of the most significant criminal cases arising from the Great Recession.

5. All home lenders should be required to file criminal referrals (SARs) when they discover a reasonable suspicion of a federal crime.

6. The regulatory agencies should revitalize their criminal referral processes (which effectively ceased to exist with regard to control frauds).

7. The regulatory agencies should "detail" experienced examiners and supervisors to the FBI and DOJ so that they can serve as "Sherpas" to aid the investigations and prosecutions and have access to "6e" grand jury materials.

8. DOJ/FBI should create a national task force to investigate the systemically dangerous institutions (SDIs) and other major originators, sellers, and purchasers of nonprime paper and financial derivatives.

9. Where appropriate, the FBI should use undercover investigators and electronic surveillance in investigating control frauds.

10. The FBI should terminate immediately its "partnership" with the MBA.

11. The regulatory agencies should reinstate requirements for full underwriting of income, assets, liabilities, credit ratings, and appraised values for all mortgage lenders. They should, by rule, require that this underwriting be evidenced contemporaneously in writing and be maintained on site for at least five years (and off site for ten years from the date of the loan being made). While violating such rules is not a crime, this requirement is one of the most effective means of establishing the necessary intent of those that seek to evade the requirement.

12. The agencies should immediately review every significant nonprime lender under their jurisdiction to determine whether they have made roughly the number of criminal referrals that would be expected given the epidemic of mortgage fraud. Where lenders have filed far too few referrals they should be priorities for special purpose examinations to determine whether their failure to file referrals is an indicator that they are a control fraud.

13. The regulatory agencies, including the CFTC, SEC, FBI, and DOJ, should create a position of the "Chief Criminologist" staffed by someone tasked with remaining current with white-collar criminological findings and ensuring that such findings, where relevant, be provided as input to senior decision-makers.

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14. Create minimum federal requirements for fiduciary duties, which have been badly eroded by state "competition in laxity." Delaware corporations, for example, have generally eliminated the duty of care.

15. Take conflicts of interest exceptionally seriously. Forbid financial institutions to make any loans to their employees, officers, boards, and professionals (e.g., senior personnel of their outside auditors and rating agencies).

16. Remove the perverse incentive caused by compensation not tied to demonstrated, long-term performance. This is one of the leading criminogenic environments globally.

17. Reform professional compensation to remove the perverse incentives and "Gresham's dynamic" now common.

Biography of William K. Black

Bill Black is an Associate Professor of Economics and Law at the University of Missouri – Kansas City (UMKC). He is a white-collar criminologist. He was the Executive Director of the Institute for Fraud Prevention from 2005-2007. He has taught previously at the LBJ School of Public Affairs at the University of Texas at Austin and at Santa Clara University, where he was also the distinguished scholar in residence for insurance law and a visiting scholar at the Markkula Center for Applied Ethics.

He was litigation director of the Federal Home Loan Bank Board, deputy director of the FSLIC, SVP and General Counsel of the Federal Home Loan Bank of San Francisco, and Senior Deputy Chief Counsel, Office of Thrift Supervision. He was deputy director of the National Commission on Financial Institution Reform, Recovery and Enforcement. His regulatory career is profiled in Chapter 2 of Professor Riccucci's book *Unsung Heroes* (Georgetown U. Press: 1995), Chapter 4 ("The Consummate Professional: Creating Leadership") of Professor Bowman, et al's book *The Professional Edge* (M.E. Sharpe 2004), and Joseph M. Tonon's article: "The Costs of Speaking Truth to Power: How Professionalism Facilitates Credible Communication" *Journal of Public Administration Research and Theory* 2008 18(2):275-295.

George Akerlof called his book, *The Best Way to Rob a Bank is to Own One* (University of Texas Press 2005), "a classic." Paul Volcker praised its analysis of the critical role of Bank Board Chairman Gray's leadership in reregulating and resupervising the industry:

> Bill Black has detailed an alarming story about financial - and political - corruption. The specifics go back twenty years, but the lessons are as fresh as the morning newspaper. One of those lessons really sticks out: one brave man with a conscience could stand up for us all.

Robert Kuttner, in his *Business Week* column, proclaimed:

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> Black's book is partly the definitive history of the savings-and-loan industry scandals of the early 1980s. More important, it is a general theory of how dishonest CEOs, crony directors, and corrupt middlemen can systematically defeat market discipline and conceal deliberate fraud for a long time -- enough to create massive damage.

Black developed the concept of "control fraud" – frauds in which the CEO or head of state uses the entity as a "weapon." Control frauds cause greater financial losses than all other forms of property crime combined and kill and maim thousands. He helped the World Bank develop anti-corruption initiatives and served as an expert for OFHEO in its enforcement action against Fannie Mae's former senior management.

He teaches White-Collar Crime, Public Finance, Antitrust, Law & Economics (all joint, multidisciplinary classes for economics and law students), and Latin American Development (co-taught with Professor Grieco, UMKC – History).

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TESTIMONY OF
CONNECTICUT ATTORNEY GENERAL RICHARD BLUMENTHAL
BEFORE THE SUBCOMMITTEE ON CRIME AND DRUGS
OF THE SENATE COMMITTEE ON THE JUDICIARY
MAY 4, 2010

One lesson of the current economic crises is clear: deterring Wall Street malfeasance requires more than regulatory window dressing and modest financial penalties. Clear, effective reform is vital to deter Wall Street wrongdoers. The financial reform legislation currently before the Senate will help stop reckless and abusive financial practices, but it can and should be strengthened.

To protect consumers, investors, and the economic well-being of all Americans -- many of them dependent on investments for their retirement financial security, Congress should, among other measures:

First, extend the existing investment advisor fiduciary duty standard to broker-dealers who also provide investment advice; and

Second, ensure that regulators and prosecutors seek civil *and* criminal penalties sufficient to deter future violations.

Brokers must be held to a fiduciary duty standard when providing investment advice. Our rapidly changing and increasingly complex financial services marketplace demands strong standards of conduct especially for anyone who recommends specific investments to individuals. The existing regulatory framework and standards of responsibility are inexplicably different depending on whether the advice is from an investment advisor or a securities broker-dealer, even when the advice is the same.

In reality, the legal and practical distinctions between a broker-dealer and investment advisor are often completely lost on many individual investors. Our regulatory rules must reflect how the world actually works, not arcane and false distinctions that have little relevance to the workings of Wall Street.

As Attorney General, I have seen similar consumer confusion regarding insurance brokers and agents. In both situations, consumers expect that the broker or agent would act in their best interests.

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I have successfully sued insurance brokers for failing to disclose to consumers that they had received hidden, undisclosed commissions from insurers that incentivize brokers and agents to sell a particular insurer's policies. Since 2005, cases challenging the payment of undisclosed contingent commissions brought by my office and other attorneys general around the country have resulted in settlements returning billions of dollars in improper fees and kickbacks to consumers.

Notwithstanding any federal or state legal requirements or industry custom, any individual acting in a fiduciary relationship must disclose conflicts of interest. I recently won a first-in-the-nation trial verdict against Wells Fargo Bank's insurance broker subsidiary (Acordia) in which the court ruled that Wells Fargo broke Connecticut law when it failed to tell insurance consumers about hidden kickbacks the company was paid in exchange for favoring a group of "preferred" insurers. The judge found that Acordia Inc. had a fiduciary duty to its clients because it told consumers it was acting in their best interest. As part of that duty, the court ruled Acordia should have disclosed when it accepted so called "contingent" commissions from insurers because such commissions are a conflict of interest.

A consumer's belief that insurance brokers and agents are acting in their best interest -- therefore requiring a fiduciary duty to disclose conflicts of interest -- may very well be equally applicable to an investment broker-dealer. However, clear federal regulatory requirements would be preferable.

Currently, investment advisors are subject to an overarching fiduciary standard under the Investment Advisors Act of 1940 and must act in the best interests of their clients. Investment advisors must make full and fair disclosure to clients regarding any conflicts of interest. In contrast, brokers are salespeople who are merely required to sell only those investments that are generally "suitable" based the investor's individual objectives and circumstances.

According to a 2008 RAND Corporation study sponsored by the Securities and Exchange Commission (SEC), investors often have difficulty understanding these important differences. As a result they may fail to realize that a broker typically receives more compensation for recommending certain specified investments, even if another product would actually be more appropriate for the investor. This confusion is understandable given that many brokers now market themselves as financial advisors -- not simply salespeople -- and offer extensive personalized investment planning services.

The financial reform bill currently being considered by the Senate (S.3217) fails to extend the investment advisor standards of responsibility to broker-dealers. Rather, the current bill calls for another study of the benefits of "imposing a uniform fiduciary duty on financial intermediaries who provide similar investment advisory services."

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Those benefits are already clear. No further study is necessary. The Senate should act now to protect investors by applying the same regulatory framework and standard of responsibility to investment advisors and broker-dealers.

I urge adoption of provisions contained in an amendment proposed by United States Senators Robert Menendez and Daniel Akaka, which is nearly identical to the provision that was included in the financial reform bill already passed by the House of Representatives (H.4173). These provisions:

- Extend the fiduciary duty standard currently applicable to investment advisors to brokers and dealers when they provide "personalized investment advice about securities to a retail customer."
- Require that both investment advisors and broker-dealers act in the "best interest of the customer" without regard to their own financial interests.
- Mandate disclosure by broker-dealers and investment advisors of any material conflicts of interest.
- Mandate disclosure to each retail customer when a broker or dealer sells only proprietary or other limited range of products so that such investors have notice of conflicts of interest.
- Extend the SEC enforcement authority under the Investment Advisors Act and the Securities Exchange Act of 1934 to investigate and punish violations of standards of conduct to broker-dealers and investment advisors.

The provisions will help protect ordinary investors from unscrupulous brokers who fail to disclose inherent conflicts of interest when they recommend a particular investment product and receive a commission on its sale. Moreover, these provisions ensure that investors who obtain personalized investment advice from *either* an investment advisor or a broker-dealer will receive advice that is in their best interests and that such broker-dealer owes a fiduciary responsibility to the investor.

Second, meaningful deterrence for financial fraud and other abuses must include a vigorous application of a range of enforcement tools – significant civil penalties, criminal prosecution and even imprisonment, where appropriate. Large civil and criminal fines and prison time for culpable executives will deter such fraud by ensuring companies do not treat enforcement actions merely as "the cost of doing business". Individuals directly responsible for the illegal conduct should not escape punishment.

Too often, financial fraud violations result in regulatory wrist-slaps. Regulators propose civil settlements that are woefully inadequate for serious malfeasance and the

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harm to consumers, investors, and our economy. Prosecutors too often refrain from bringing charges against those lawbreakers even when willful violations are clear-cut.

One recent example occurred in a case before Judge Rakoff of the Southern District of New York in which the SEC alleged that Bank of America failed to adequately disclose to its shareholders the hefty bonus payouts and huge losses of its merger partner, Merrill Lynch. The SEC initially sought the court's approval of a $33 million settlement. After Judge Rakoff rejected that settlement as inadequate, the SEC upped the ante to $150 million. The Judge reluctantly approved that amount – but only after criticizing the agreement as "half-baked justice." Judge Rakoff said that he would have preferred that the penalties be paid by the executives responsible for the misdeeds, rather than the shareholders. I agree with Judge Rakoff.

Assessing civil penalties that fail to directly target those responsible for the wrongdoing does little to deter future violations of our securities laws. Effective deterrence requires hitting outlaw executives and other white-collar criminals where it hurts – their own pocketbooks – and subjecting them to the risk of severe criminal penalties.

Such criminal enforcement by the Department of Justice and United States Attorneys is already available for willful violations of existing federal securities laws, including the Securities and Exchange Act of 1934, the Securities Act of 1933, the Investment Advisors Act of 1940, and certain provisions of the Sarbanes-Oxley Act of 2002. Convictions can result in significant criminal penalties, including hefty fines and lengthy prison sentences. For example, an individual who willfully violates the Securities Exchange Act of 1934 can be fined up to $5 million and imprisoned for up to 20 years. In addition, prosecutors may apply general criminal statutes to various forms of securities fraud. For example, the mail and wire fraud statutes provide for criminal fines and imprisonment.

We must ensure that regulators and prosecutors have the resources necessary to investigate and charge violations of our securities laws and other forms of fraud and that they actually use these powerful tools. Although establishing that such violations are "willful" is obviously more difficult than the lower standard required for civil penalties, the increased deterrence achieved by criminal prosecutions is a dividend that makes the extra effort worthwhile.

I appreciate the subcommittee's interest in this critically important consumer protection for individual investors and look forward to working with you on this measure.

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Statement of Lanny A. Breuer
Assistant Attorney General
Criminal Division
United States Department of Justice

Before the United States Senate
Committee on the Judiciary
Subcommittee on Crime and Drugs

Hearing Entitled
"Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?"

May 4, 2010

Good afternoon, Mr. Chairman, Senator Graham, and distinguished Members of the Subcommittee. Thank you for inviting me to be part of this hearing and giving me the opportunity to discuss the issue of fraud on Wall Street and the critical role of jail time in deterring white collar crime.

Introduction

I am privileged to represent the Department of Justice at this hearing and to lead the Criminal Division's more than 400 exceptional lawyers. With our partners in the U.S. Attorneys' offices around the country, the Federal Bureau of Investigation, the Securities and Exchange Commission, and a host of other agencies, we are fully committed to rooting out and prosecuting financial fraud, whether perpetrated on Main Street or Wall Street. In its many forms – including mortgage, corporate, and securities fraud – financial fraud has a serious and damaging impact on our financial, credit, and housing markets. These crimes erode the public's confidence in our markets and

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institutions, siphon billions of dollars from hardworking Americans, and have led to a growing cry by many that Wall Street does not play by the same rules as Main Street.

The Department has aggressively prosecuted financial fraud, and we will continue to do so. Indeed, in the wake of the financial crisis and the unprecedented sums of taxpayer money that have been invested in economic recovery, the Attorney General has led the Department in redoubling our efforts to combat financial fraud and help restore the public's faith in the integrity of our markets and institutions. With the creation of the Financial Fraud Enforcement Task Force, we have entered an era of heightened enforcement in the area of financial fraud and other white-collar crimes. As I will describe, the hallmarks of this era of heightened enforcement are increased attention and resources focused on financial fraud, increased information sharing within the law enforcement community, enhanced cooperation and coordination with our law enforcement partners, and tough penalties for both corporations and individuals – including jail time in appropriate cases.

Financial Fraud Enforcement Task Force

In November 2009, the President signed an Executive Order establishing a new interagency Financial Fraud Enforcement Task Force (FFETF or Task Force) to combat financial crime. The Task Force is actively engaged in an ongoing effort to strengthen our collective efforts – in conjunction with our federal, state, and local partners – to investigate and prosecute significant financial crimes relating to the current financial crisis; to recover ill-gotten gains; and to ensure just and effective punishment for those

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who perpetrate financial crimes. The Task Force's mission is not just to hold accountable those who helped bring about the last financial meltdown, but to prevent another meltdown from happening. By punishing criminals for their actions, we send a strong message to anyone looking to profit from the misfortune of others.

The FFETF's membership is comprised of individuals from the highest levels of the federal government. It is chaired by the Attorney General, and its Steering Committee, led by the Deputy Attorney General, includes the FBI, the Department of the Treasury, HUD, and the SEC. Drawing on the substantial resources of the federal government, the FFETF counts among its members the Department of Justice, the FBI, the Department of the Treasury, HUD, the SEC, the CFTC, the Department of Homeland Security, the Department of Labor, the Federal Trade Commission, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of Thrift Supervision, the Office of the Comptroller of the Currency, the Recovery Accountability and Transparency Board, the Internal Revenue Service-Criminal Investigative Division, the Special Inspector General for the Troubled Asset Relief Program, the U.S. Postal Inspection Service, the U.S. Secret Service, and many other federal departments, agencies, and offices.

The FFETF is leading an aggressive, coordinated, and proactive effort to investigate and prosecute financial crimes. We have marshaled both criminal and civil enforcement resources to investigate and prosecute financial fraud cases, recover stolen funds for victims, address discrimination in lending and financial markets, and enhance

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coordination, cooperation, and information sharing among authorities responsible for investigating and prosecuting significant financial crimes and violations.

Essential to the Task Force's mission is enforcement. The FFETF is focusing our investigative and prosecutorial efforts on the types of financial fraud that affect us most significantly in this time of economic recovery, including:

- Mortgage fraud – from foreclosure rescue and loan modification frauds to systematic lending fraud in the nationwide housing market;
- Securities fraud – including Ponzi schemes, misrepresentations to investors, and corporate frauds, such as traditional insider trading;
- Recovery Act and rescue fraud – to ensure that taxpayers' investment in America's economic recovery is not siphoned away by a dishonest few; and
- Discrimination – to ensure that the financial markets work for all, and that no one is unfairly targeted based on impermissible characteristics.

The Task Force is also enhancing coordination with state, local, tribal, and territorial authorities responsible for investigating and prosecuting significant financial crimes, including coordinating with the National Association of Attorneys General (NAAG) and the National District Attorneys Association. One of the most effective tools for combating financial fraud is our long-standing partnership with federal, state, and local law enforcement and regulatory agencies. Collaboration, communication, and

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information-sharing have long been a proven solution to the nation's most complex crimes.

Since I last appeared before the Senate Judiciary Committee in December of 2009, the Task Force has been actively increasing coordination and enforcement. The Task Force has established a Financial Fraud Coordinator in every United States Attorney's Office across the nation to facilitate uniform and aggressive enforcement against criminals in the financial arena. The Task Force has launched a website, providing the public with a single location to access resources from the numerous Task Force members to protect themselves from financial fraud and to report it – wherever and however it occurs.

Task Force members have been active in their enforcement efforts. For example, in March, the president of Park Avenue Bank in New York was charged with attempting to fraudulently obtain more than $11 million in taxpayer rescue funds from the Troubled Asset Relief Program. Also in New York, an investment banker with UBS has been charged, along with an accomplice, by the U.S. Attorney's Office in an insider trading scheme related to information about certain mergers and acquisitions contemplated by UBS clients. In another Task Force case, seven Wall Street professionals and attorneys from New York, New Jersey, and Connecticut were indicted on multiple counts of securities fraud and conspiracy for their participation in a scheme involving inside information regarding mergers and acquisitions of public companies. Two weeks ago, the U.S. Attorney in Newark charged the chief executive of Capitol Investments USA

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with a $880 million Ponzi scheme stemming from the solicitation of investors in a purported grocery distribution business.

As even this past month demonstrates, Task Force efforts around the country are starting to bear fruit. In Las Vegas, the president of a real estate development investment company was sentenced to 12 years' imprisonment and ordered to pay $86.9 million in restitution to over 1,000 victims for a massive loan fraud scam. In Minnesota, a man who ran a Ponzi scheme involving commodity pools was sentenced to almost 10 years' imprisonment and ordered to pay more than $20 million in restitution to his victims. In Dallas, a federal jury convicted the managing director of AmeriFirst Funding Corp. for fraudulent securities offerings that raised more than $50 million from more than 500 victim investors. He will be sentenced in July.

We also saw several guilty pleas in April, due in no small part to the strength and quality of the Task Force's cases. For example, in San Francisco, the CFO of a private equity firm pleaded guilty to insider trading on information regarding Tempur-Pedic International. A Minneapolis man pleaded guilty in a Ponzi scheme case involving a foreign currency trading fraud that took $190 million from 1,000 investors.

Although the Task Force has made substantial steps in leading the charge of heightened cooperation, enforcement, and deterrence, there's more work to do. We expect, over the next several months, to announce new cases and sentences, all of which

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we believe will send a clear message that financial fraud, in all of its forms, will not be tolerated.

Fraud Enforcement and Recovery Act

Last year, Congress passed the Fraud Enforcement and Recovery Act (FERA) with broad bipartisan support, and the President signed it into law on May 20, 2009. I would like to thank Chairman Leahy, Senator Kaufman, Senator Grassley, and the other sponsors for their leadership on this important effort. The Department of Justice worked closely with the Senate Judiciary Committee and other Members of Congress in strong support of FERA.

The Act allows the Department of Justice to prosecute anyone who fraudulently obtains or uses money expended by the Government during the economic crisis, such as money from the Troubled Asset Relief Program (TARP), under the American Recovery and Reinvestment Act, or other economic relief. Further, FERA enhanced the reach of the False Claims Act (FCA), one of the Department's most effective civil tools for deterring and redressing fraud against Government programs, ensuring that the FCA continues to protect taxpayer funds against those who would misuse them. FERA also amended the federal securities fraud statute, Section 1348 of Title 18, to cover fraud schemes involving commodities futures and options.

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We are continually reexamining our statutory authorities and resources to make sure that we have the tools we need to safeguard the integrity of our markets and to protect our citizens from fraud. On behalf of the Department, I would like to express the continued desire to work with the Subcommittee on legislative proposals in order to support our criminal prosecutions against financial crimes and to enhance our authorities to bring offenders to justice.

Resources

Robust resources dedicated to fighting financial fraud are the starting point for effective law enforcement in this area. As a Department, resources are being added to address mortgage fraud and related financial crimes. In Fiscal Year 2009, U.S. Attorneys received total enhancements of 59 line prosecutor and 17 support positions for this effort. The Department's budget for Fiscal Year 2010 contains additional fraud enforcement resources, including five additional Criminal Division prosecutors and 35 U.S. Attorney's Office positions. And, in the Fiscal Year 2011 budget, the Department has asked for five fraud positions in the Criminal Division and 109 fraud positions in the various U.S. Attorneys' Offices.

The numbers, of course, don't tell the whole story. The quality of our people will play a big role in our success. In the Criminal Division, we are attracting extraordinary new talent at the line attorney and leadership levels. The new chief of our Fraud Section, Denis McInerney, is a good example. Denis joined the Division recently from Davis

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Polk & Wardwell. He's a former AUSA and deputy chief of the Criminal Division in the Southern District of New York.

By increasing resources to address financial fraud and bringing in dynamic and talented people, we believe our prosecution achievements in combating financial fraud will only grow.

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Criminal Enforcement Efforts

Since even before the launch of the FFETF, the Administration was aggressively investigating and prosecuting wrongdoing that contributed to the financial crisis and wrongdoing that resulted from it. In doing so, we built upon the lessons and successes of the Department's efforts over the last several years to combat corporate fraud. Since 2002, the Department has obtained approximately 1,300 corporate fraud convictions, including convictions of more than 200 corporate chief executives or presidents, more than 120 vice presidents, and more than 50 chief financial officers.

The Department's commitment to vigorously identify and pursue wrongdoing in our corporate boardrooms and on Wall Street has only grown stronger in the wake of the economic crisis. Our prosecutors and agents are determined to ensure that wrongdoers are punished. This means seeking jail time whenever appropriate. We believe that these efforts are critical to restoring investor confidence in the markets and ensuring that our corporate citizens play fair.

Recognizing the deterrent value of jail time, the Department has sought significant prison sentences against white collar criminals. For example, the Department secured a 150-year sentence for Bernard Madoff, a 50-year sentence for Tom Petters, a 324-month sentence for Colin Nathanson, a 293-month sentence for Michael Riolo, a 20-year sentence for Richard Piccoli, and a 117-month sentence for Charles "Chuck" E. Hays for perpetrating separate Ponzi schemes. We obtained a 100-year sentence for Edward Okun for perpetrating a scheme to defraud clients of his 1031 Tax Group LLP.

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The Department secured sentences of more than 25 years each for two executives of National Century Financial Enterprises (NCFE) following their convictions on conspiracy, fraud, and money laundering charges. Just a couple of weeks ago, we secured an 87-month sentence of an individual for violations of the Foreign Corrupt Practices Act (FCPA), the longest ever under the statute. We obtained a seven-year sentence for the principal outside attorney for Refco for his role in executing Refco's more than $2.5 billion fraud. The Department also secured a five-year sentence for former Credit Suisse broker Eric Butler for misrepresenting to investors that auction rate securities were backed by guaranteed student loans when they were actually backed by much riskier mortgage-backed securities, and a four-year sentence for a former vice president of American International Group (AIG) for his role in a scheme to manipulate the company's financial statements through the use of $250 million sham re-insurance transactions.

As these and the countless other substantial prison sentences that we have obtained demonstrate, the punishment for perpetrators of financial fraud can be substantial. Fraud offenses carry significant statutory penalties—for example, up to 20 years for each count of wire fraud and up to 25 years for each count of securities fraud. In addition, depending on the amount of loss and other factors, the application of the federal sentencing guidelines related to fraud offenses, results in significant guidelines sentencing ranges. Using the criminal statutes in our arsenal and faithfully applying the sentencing guidelines, the Department has sought, and will continue to seek, appropriately stiff sentences for financial fraud defendants.

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After the Supreme Court's decision in the Booker case, the sentencing guidelines are advisory. Thus, even when the Department recommends a significant sentence within the guidelines range, the sentencing judge is not required to impose a guideline sentence. Indeed, United States Sentencing Commission data show that the percentage of defendants sentenced within the guidelines has decreased since Booker. In the first quarter of Fiscal Year 2010, for example, 40 percent of fraud defendants were sentenced below the guidelines. We are carefully monitoring what appears to be an increased disparity in white-collar sentencing, particularly in high-loss securities fraud cases. In the meantime, we will continue to seek appropriately tough sentences for individuals.

In addition to seeking prison sentences for individual offenders in appropriate cases, an essential part of our criminal enforcement strategy is to hold corporations accountable as well. Thus, in numerous cases, we have sought and obtained corporate guilty pleas and the payment of substantial criminal fines. For example, the Department recently obtained a guilty plea and criminal fine of $400 million from BAE Systems on charges of conspiring to defraud the United States. In other cases, the Department has entered into a deferred prosecution agreement (DPA) with the corporate wrongdoer. For example, in December 2009, the Department and the Manhattan District Attorney's Office contemporaneously entered into DPAs with Credit Suisse and secured an overall total $536 million forfeiture for Credit Suisse's violations of the International Emergency Economic Powers Act (IEEPA). In addition to the payment of substantial fines and/ forfeitures and the implementation of significant remedial measures, the Department's

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resolutions with corporations may require the retention of an independent compliance monitor in appropriate cases. Such independent compliance monitors help to ensure that the corporation's compliance programs are appropriately designed and implemented to prevent and detect future corporate wrongdoing.

The Department believes that corporate guilty pleas and DPAs, corporate fines, and the imposition of independent compliance monitors serve the important criminal enforcement goals of specific deterrence, general deterrence, and rehabilitation. The beneficial impact of such resolutions on a corporation's culture, its compliance programs, and its future behavior generally goes beyond the particular area of wrongdoing. For example, a corporation's enhancement of its internal controls as part of a resolution relating to FCPA violations should help the corporation to prevent and detect not only future foreign bribery by its employees but a range of other potential criminal conduct. It is not our experience that companies treat guilty pleas and DPAs (and their related collateral consequences), fines, and independent corporate monitors (not to mention the significant costs and disruptions of criminal investigations) as a cost of doing business. In our experience, corporate resolutions have a real deterrent effect.

The Department believes that corporate resolutions are a complement to, not a substitute for, prosecutions of individuals. Thus, when the Department enters into a corporate resolution, the plea agreement, DPA, or other agreement typically provides that the corporate resolution does not protect the corporation's officers, directors, or employees, or any other individuals, from prosecution. Indeed, in many situations, the

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corporation's officers and employees are also prosecuted. For instance, not only did Kellogg, Brown & Root plead guilty to violating the FCPA, agree to pay a $402 million fine, and retain an independent compliance monitor for three years, but its former Chairman and CEO, Jack Stanley, and two other individual defendants also were criminally prosecuted. To be sure, despite the Department's emphasis on the prosecution of individuals, individuals may not be prosecuted in some cases, for reasons ranging from a lack of jurisdiction or sufficient admissible evidence to the running of the statute of limitations. But, to be clear, our criminal enforcement strategy in financial fraud cases is to seek tough penalties from corporations and individuals alike.

Aggressive Law Enforcement Techniques

By its nature, financial fraud is a sophisticated crime. We believe that our approach to fighting these kinds of crimes can be no less sophisticated. In several criminal enforcement actions, we have used aggressive law enforcement techniques to stay on offense in bringing criminals to justice.

In a case that has garnered much attention, a Southern District of New York grand jury in October 2009 indicted Raj Rajaratnam, the manager of the multi-billion dollar hedge fund, Galleon Management, LLC, and five others, with participating in an insider trading scheme that netted more than $20 million. Subsequently, charges were brought against 15 other defendants, including an attorney at a major law firm. To date, 11 of the 22 defendants have pleaded guilty, including four of the six defendants arrested with Rajaratnam in October and a former high-ranking IBM executive.

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This case has been described as the largest hedge fund insider-trading schemes ever charged by the Department. According to the charging documents, the defendants are alleged to have traded repeatedly on material, nonpublic information given as tips by insiders and others at hedge funds, public companies, and investor relations firms. The tipsters and tippees allegedly even used disposable, prepaid cell phones to try to conceal their conduct. As a result of their insider trading, these defendants and others allegedly gained millions of dollars of illegal profits for themselves and the hedge funds with which they were affiliated.

This case is believed to represent the first time that court-authorized wiretaps have been used to target significant insider-trading on Wall Street. It demonstrates our commitment to being aggressive and innovative in investigating and prosecuting white-collar crimes. We have numerous tools at our disposal to help us accomplish our mission, and we will continue to use all of them.

We made that clear once again in a recent FCPA investigation in which the Criminal Division's Fraud Section used undercover law enforcement techniques to uncover what we allege to be widespread fraud and corruption. As a result, 22 executives and employees of companies in the military and law enforcement products industry were indicted for their involvement in schemes to bribe foreign government officials. The investigation involved the most expansive use ever of undercover techniques to uncover

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FCPA violations. Taken together, these two cases reflect a new chapter in proactive and innovative white-collar criminal enforcement.

Securities Fraud Enforcement Efforts

The Department has successfully prosecuted many high-profile securities and commodities fraud cases and has sent a clear message to those who have preyed on investors. Working closely with the SEC and the CFTC, the Department has brought a number of important prosecutions related to other criminal conduct exposed by the financial crisis. And, since the financial meltdown began in the fall of 2007, we have intensified our efforts to combat significant financial frauds. For example, the FBI currently reports more than 2,200 pending corporate and securities fraud investigations across the country, many with losses exceeding $100 million, and several with losses over $1 billion. Efforts to hold accountable the most egregious corporate and securities fraud offenders resulted in 473 convictions in FY 2009 alone. The establishment of the FFETF has even further increased focus on financial frauds and our close cooperation and collaboration with the SEC and the CFTC.

Securities-related crimes come in all types and stripes, and new methods are constantly emerging and being tested by fraudsters. But traditional frauds and schemes continue to exist. Indeed, the financial crisis itself has exposed established fraud schemes that had been thriving undetected in the booming American and global financial system.

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The Madoff case, brought by the U.S. Attorney's Office for the Southern District of New York, the FBI, and the SEC, is probably the most prominent example. In this case, Bernard Madoff was charged on eleven counts of securities fraud, investment adviser fraud, mail fraud, wire fraud, money laundering, false statements, perjury, false filings with the SEC, and theft from an employee benefit plan. He was ultimately sentenced on June 29, 2009, to 150 years in prison for perpetrating a Ponzi scheme that resulted in billions of dollars in losses to thousands of investor-victims. Moreover, the district judge in the case entered an order of forfeiture totaling $170 billion.

From the discoveries made in this case, the Department has uncovered and pursued a number of related matters – including, for example, a case against Madoff's accountant who pleaded guilty on November 3, 2009, to a nine-count indictment charging securities fraud and related offenses; a case against another Madoff employee who pleaded guilty on August 11, 2009, to ten felony counts; and a case against two computer programmers for Madoff who were charged on November 13, 2009, with conspiracy and with falsifying the books and records of a broker-dealer and of an investment adviser.

Another example is the Stanford case brought by the Criminal Division's Fraud Section together with the U.S. Attorney's Office for the Southern District of Texas. The case was investigated by the FBI and United States Postal Inspection Service. In June 2009, Robert Allen Stanford and four other individuals were indicted in connection with a scheme to defraud thousands of U.S.-based investors of approximately $8 billion in Certificates of Deposits. The indictment charges that the defendants misrepresented the

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financial condition of Stanford International Bank, Ltd., its investment strategy, and the extent of its regulatory oversight by Antiguan regulators, all the while siphoning off investor funds for personal use.

According to court documents, defendant Stanford is alleged to have fraudulently lured investors to trust him with their money and instead funneled funds to various "pet projects" that were not profitable. As the gap between reality and the reported value of the Bank's assets grew, the Chief Financial Officer, allegedly at defendant Stanford's direction, directed the accounting department to manipulate the Bank's revenue/asset values. In addition, defendant Stanford is alleged to have bribed the head of the Antiguan Financial Services Regulatory Commission to ensure that it did not conduct a thorough examination of the Bank's books and records. On August 27, 2009, the former Chief Financial Officer of the Bank pleaded guilty and agreed to a preliminary order of forfeiture of $1 billion.

In another recent prosecution, this one relating to a $3.65 billion Ponzi scheme, the United States Attorney's Office for the District of Minnesota obtained the conviction of Thomas Petters late last year on wire fraud, mail fraud, and related charges. Petters obtained billions in money and property by inducing investors to provide his company with funds ostensibly to purchase merchandise that was to be re-sold to retailers at a profit. In fact, no such purchases were ever made. Instead, Petters and his co-conspirators diverted the funds to make lulling payments to investors, paying off those who assisted in the scheme, funding businesses owned by Petters, and financing his

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extravagant lifestyle. Six co-conspirators also pleaded guilty for their roles in the scheme. Petters recently was sentenced to 50 years in prison for his crimes.

In yet another instance, in a case brought by the U.S. Attorney's Office for the Eastern District of New York, two former Credit Suisse brokers were charged with securities fraud for misrepresenting to investors that auction-rate securities were backed by guaranteed student loans, when they were actually backed by much riskier mortgage-backed derivatives, enabling the brokers to earn much higher commissions. Investor losses allegedly exceeded $1 billion. One defendant pleaded guilty, and one defendant was convicted by a jury. The defendant who was convicted after trial, Eric Butler, was sentenced to five years' imprisonment, a $5 million fine, and forfeiture of $250,000.

Commodities Fraud Enforcement Efforts

Commodities fraud is another area in which the Department's prosecutors work closely with partner agencies, including the CFTC and its Division of Enforcement, to coordinate enforcement efforts against those who engage in such fraud. Commodities schemes vary widely – from relatively basic frauds premised ostensibly on commodity and foreign exchange investments to sophisticated market manipulation frauds. The more basic schemes simply incorporate commodity futures trading terms in otherwise recycled Ponzi scams. More complex schemes entail efforts to manipulate the futures market in a particular commodity like propane, intentionally distorting supply and

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demand dynamics by "cornering" the market through massive purchases that dry up the supply.

The recent Hays case in Minnesota is an example of the results we have achieved by working collaboratively in this area. Defendant Hays defrauded investors of more than $20 million through a Ponzi scheme involving purported investments in stock index futures and other futures contracts. In a case worked jointly by the Criminal Division's Fraud Section, the U.S. Attorney's Office in Minnesota, and the U.S. Postal Inspection Service – together with the CFTC – defendant Hays was charged in a criminal complaint and arrested. We seized, among other assets, a $3 million yacht that defendant Hays had purchased with investor funds and bank accounts containing approximately $1 million in fraudulently obtained funds. On the very same day, the CFTC filed a civil enforcement action against defendant Hays and his company. Shortly thereafter, in April 2009, defendant Hays pleaded guilty to mail and wire fraud and financial transaction structuring charges and agreed to forfeit all proceeds of his scheme. Just last week, Hays was sentenced to 117 months' imprisonment and ordered to pay over $21 million in restitution. Our combined efforts on the Hays case demonstrate that, by working together, we can move quickly to charge, convict, and forfeit the assets of those who engage in commodities fraud.

In another example, the U.S. Attorney's Office for the Southern District of Florida, in coordination with the FBI, prosecuted Michael Riolo, who, on October 16, 2009, received a sentence of 293 months imprisonment in connection with his role in

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organizing a multi-million dollar Ponzi scheme. According to court documents, defendant Riolo owned and operated two companies that he used to defraud investors (including several current and former police officers) out of millions of dollars. Defendant Riolo induced individuals to invest money with him in the foreign exchange market by leading them to believe that they would receive substantial profits from their investments. Instead, he diverted investor funds for other purposes, including for his own personal use and benefit. In total, defendant Riolo caused more than 80 investors to invest approximately $44 million, based on materially false statements and omissions of material facts.

As evidenced by these examples, commodities fraud does not occur solely in jurisdictions where trading exchanges operate. To the contrary, this fraud – like so many other forms of fraud – sees no boundaries. We will continue our coordinated enforcement efforts with the CFTC in jurisdictions throughout the country to uncover and prosecute commodities fraud. To augment our expertise and resources in the commodities fraud area, two detailees from the CFTC's Division of Enforcement have joined the Criminal Division's Fraud Section. This detailee program already has increased the number of commodities fraud matters we are able to handle and further improved our strong working relationship with the CFTC.

Conclusion

In sum, the financial crisis has demanded an aggressive, comprehensive, and well-coordinated law enforcement response, including vigorous fraud investigations and

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prosecutions of individuals who have defrauded their customers and the American taxpayer and otherwise placed billions of dollars of private and public money at risk. The Department and its partners on the FFETF are committed to this effort. We will ensure that we look at all allegations of fraud closely, follow the facts where they may lead, bring our resources to bear to prosecute those who have committed crimes, and seek appropriately tough sentences for individuals and corporations alike.

Thank you for the opportunity to provide the Committee with this brief overview of the Department's efforts to address financial fraud and our views on the deterrent effect of jail sentences and corporate penalties, and I look forward to working with the Subcommittee further. I would be happy to answer any question from the Subcommittee.

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Testimony of Professor John C. Coffee, Jr.

Adolf A. Berle Professor of Law
Columbia University Law School

Before the Subcommittee on Crime and Drugs of the
United States Senate Committee on the Judiciary

May 4, 2010

Hearing on S.3217
"Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?"

226 Dirksen Senate Office Building

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Chairman Specter, and Fellow Senators:

I am honored to be before this Committee to discuss the proposed legislation, which would impose a fiduciary duty on brokers and dealers (and investment banks) to act in their clients' best interests and specify criminal penalties for its willful violation. This is an idea that has been discussed for years, but whose time has come because of recent developments. My basic message is that a fundamental hole exists in the financial reform proposals now before Congress that this bill fills. Conflicts of interest played a key role in causing the 2008 financial meltdown. Although no statute can eliminate all conflicts of interest, the proposed statute (with some modest proposed revisions) would compel investment banks to address them more carefully and cautiously. Symbolically, it would also state a simple idea that may have been forgotten by some: the client comes first!

Introduction

At last Tuesday's hearing, several Goldman executives were asked a simple question by Senator Susan Collins from Maine: Did they have a fiduciary duty to act in the best interests of their clients? They all appeared stumped by it, and one (Daniel J. Sparks, the former head of Goldman's mortgage department) responded ambiguously: "I believe we have a duty to serve our clients." Whatever that equivocal answer was intended to mean, the correct answer to Senator Collins's question is simple and (to most) surprising: broker-dealers do not owe a fiduciary duty to their clients,[1] except under special circumstances (such as a discretionary account) or under the law of a very few states (California is different from most other states in

[1] The leading precedents in the Second Circuit are International Order of Foresters v. Donaldson, Lufkin & Jenerette, 157 F.3d 933, 940 (2d Cir. 1998); de Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293 (2d Cir. 2002). The logic of these cases is that a fiduciary relationship requires two critical elements: (1) reliance by the customer on the broker, and (2) domination and control by the broker. See also U.S. v. Chestman, 947 F.2d 551, 568-69 (2d Cir. 1991) (en banc).

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this respect).[2] Because the state law of New York applies to our principal capital markets, the truth is that Goldman (or any other New York-based investment banks) owes no general fiduciary duty to its clients.

Instead, investment banks (and broker-dealers generally) owe a much lesser obligation, which arises under the rules of the self-regulatory body with jurisdiction over them. That body – the Financial Industry Regulatory Authority (FINRA) – and its precursors, the NASD and the NYSE, have long promulgated what are known as "suitability rules." These rules, which derive originally from the NYSE's "Know Your Customer Rule," require that the broker-dealer in recommending to the customer the purchase or sale of a security must have "reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."[3] Although this means that a broker should not recommend a risky penny stock to an 80 year old widow on a pension, it has little application to institutional investors, and there is no private cause of action for its violation.[4] Moreover, the "suitability" rule requires only that the security is not unreasonable for the particular investor, given that investor's financial position – not that the sale or purchase be in the investor's best interests.

That is the key difference: a fiduciary duty requires the fiduciary to act in the "best interests" of its client, whereas the suitability norm requires only that the recommended security be "within the ballpark" in terms of what the broker knows (if anything) about the investor's needs and financial position. Also, under a suitability standard the broker is under no obligation to disclose (1) its own investment strategies (even when they are adverse to the client's), or (2)

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[2] Massachusetts also takes an intermediate position. See Patsos v. First Albany Corp., 741 N.E. 2d 841 (2001).
[3] See NASD Manual, Conduct Rules, Rule 2310(a)(1996).
[4] One small qualification: to a limited extent, egregious violations of the suitability rule (such as in churning cases) may also violated Rule 10b-5. But see O'Connor v. R.F. Lafferty & Co. Inc., 965 F.2d 893 (10th Cir. 1992) (dismissing case on grounds that suitability violations were insufficient to violate Rule 10b-5).

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that it believes, or has reasons to know, that a particular security is likely to underperform the general market for such securities.

The idea that an investment professional providing investment advice to its clients should act in the best interests of the client is hardly radical. Investment advisers have been subject to such a duty since 1940 (when Congress enacted the Investment Advisers Act of 1940). Clearly, the sky has not fallen in as a result of this legislative mandate in 1940. Indeed, last year when both the Obama Administration and the House Financial Services Committee proposed a financial reform bill that would have imposed a fiduciary duty (albeit in somewhat milder form) on brokers, the proposal drew little opposition at the time from the securities industry. Instead, the proposal was withdrawn because of fierce opposition from the insurance industry (and some financial advisors) – none of whom would be affected by this legislation. SEC Chairman Mary Schapiro has also supported legislation "that would mandate a uniform fiduciary standard for finance service professionals providing investment advice about securities to investors."[5]

A year ago, the issue of subjecting broker dealers to a fiduciary standard would have been viewed primarily as an issue of consumer protection for retail investors. Today, the issues at stake transcend simply the protection of retail investors (important as that goal is). The Goldman hearings last week and the SEC's complaint against Goldman raise serious issues about the level of integrity in our capital markets. Although I will leave it for the courts to resolve the issues in the SEC's complaint, the idea that an investment banking firm could allow one side in a transaction to design the transaction's terms to favor it over other, less preferred clients of the investment bank (and without disclosure of this influence) disturbs many Americans (including longtime Wall Street analysts). Such conduct is not only unfair, it has an adverse impact on

[5] Most recently, she made the above-quoted comment in a March 9, 2010 letter to Senator Christopher J. Dodd, Chairman of the Senate Committee on Banking, Housing and Urban Affairs.

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investor trust and confidence and thus on the health and efficiency of our capital markets. Today, housing finance in the United States is stalled, and it may remain so long as global capital markets distrust the securitization process. To be sure, other participants in the capital markets share responsibility for this distrust (for example, the credit rating agencies), but the prospect that an investment bank can both assemble and sell a portfolio of financial assets to its clients, while betting against that portfolio, does not instill confidence. Reduced confidence means in turn that both investor resistance and a higher cost of capital become likely.

Finally, the case for mandating greater integrity on the part of investment bankers seems particularly justified when the very survival of that industry was attributable to a bailout financed by the American taxpayer. Congress has a responsibility to restrict dubious and risky practices that, while profitable in the short-run, could again injure both the health and integrity of our capital markets over the long run.

II. The Predictable Objections to a Fiduciary Standard

However unremarkable the idea is that a broker-dealer should behave as a fiduciary to its clients, the claim will be made in response by opponents that subjecting investment bankers to such a standard is infeasible, will place broker-dealers in a hopelessly conflicted position, and will expose them to excessive liability. This is a Chicken Little "the-sky-will-fall-in" claim, but its dubious logic needs to be examined. The core of this argument is the correct observation that a securities dealer inherently deals with both sides of the market – buyers and sellers, the "short" and the "long" side. Because the dealer is making a two-sided market, it will be argued that the dealer cannot act exclusively in the "best interests" of either side, because the interests of both sides are inherently adverse.

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This is a straw man argument. In the Abacus offering (which supplies the fact pattern for the SEC's complaint against Goldman), Goldman was not a neutral dealer, but a soliciting placement agent. Acting as a placement agent for a securities offering that one has itself designed is very different from a dealer simply quoting a two-sided spread. The fact that Goldman lost money on the deal was because it could not sell out its offering (and so like an unsuccessful underwriter had to absorb the weak securities that it could not sell). As a placement agent selling its own offering, Goldman should have recognized an obligation to act in the best interests of those investors to whom it offered the Abacus offering. To be sure, in the case of a "synthetic" CDO (such as the Abacus offering), there inherently had to be a "short" side that bets against the offering, but Goldman should not have permitted one client to bias the deal in its own favor; nor should it have represented that a neutral and objective portfolio manager was selecting the portfolio if it knew that the "short" side was heavily influencing the selection of the securities in the portfolio.

Put differently, Goldman's obligations should have been the same whether it was selling a "real" CDO (which would have actually owned RMBS securities) or a "synthetic" one (in which credit default swaps are written with respect to "reference" RMBS securities). Investors who relied on Goldman in the case of a "real" CDO would have naturally expected that Goldman would have sought attractive securities that it did not expect to default). Put simply, this is why they came to Goldman: for its expertise and skill. That the CDO was instead a "synthetic" one and thus inherently involved a "short" side (and a credit default swap) changes nothing; the investor in the synthetic CDO should continue to be able to expect that Goldman is seeking attractive securities (not "dogs") to place in its portfolio.

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The investor who comes to Goldman seeking to take a short position can suggest a specific portfolio to Goldman, and Goldman can if it wishes take the long side – at its own risk. But Goldman should not be able to pass on the "long" side risk of such a portfolio to its investors, because then it would not be acting in their best interests where the portfolio had been designed to favor the short side. The language in the amendment to S.3217 is consistent with this interpretation.

A second predictable objection will be that a fiduciary duty standard will expose the broker to liability for failure to warn the client (even a sophisticated client) about sudden changes in market conditions or business risks. Markets fluctuate rapidly, and macro-economic events can impact markets suddenly and in surprising ways. Suppose then that commodity prices, interest rates, or currency exchange rates begin to change, and this exposes a particular client to serious risk because of a trading position that he has knowingly taken. Is the broker liable to the client under a fiduciary standard if he does not promptly warn the client and advise him to modify or hedge his position? Carried to an extreme, such an obligation might require a prompt warning within a day or even hours. This would be, I agree, an onerous burden to place on the broker (and courts have declined to do so).[6] But the language in this proposed legislation does not impose any obligation on the broker in such a case. Rather, its fiduciary standard is carefully limited. Currently, it says:

> "A registered broker or dealer that provides investment advice . . . shall have a fiduciary duty to act in the best interests of the investor and to disclose the specific facts relating to any actual or reasonably anticipated conflict of interest . . ."

[6] This is essentially the fact pattern in de Kwiatkowski v. Bear Stearns & Co., 306 F.3d 1293 (2d Cir. 2002). In my judgment, this statute would not change the result in that case.

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This limiting language ("that provides investment advice") has several important implications:[7] First, it would exempt the dealer who simply quotes a spread ($8 bid, $8.05 asked), because the broker is not providing investment advice. Nor is the broker under any continuing duty to warn the investor of any change in market conditions, because this language contemplates that the duty arises at the time of the giving of the investment advice. On the other hand, if the broker designs a product and expects to short it a day later, that is a "reasonably anticipated conflict of interest" and must be disclosed.

Another predictable objection will be that this proposed statute is unnecessary because the field is already fully regulated by Rule 10b-5 and by criminal statutes (such as the mail and wire fraud statutes) that reach all forms of securities fraud. This is again a half truth. Although the reach of Rule 10b-5 is broad, it has some well-known limitations. For example, (1) there must be a purchase or sale, and (2) there must be "scienter" – or an intent to defraud. Under proposed Section 15(a)(3)(A), the SEC could take enforcement action even if there was no purchase or sale, because the fiduciary obligation applies to the provision of investment advice to a client (even if a transaction does not occur). Similarly, the SEC could enforce Section 15(a)(3)(A) without showing scienter because fiduciaries are under a duty to do more than not defraud their client, but must act in their "best interests." (I, of course, recognize that there could not be criminal enforcement in the absence of scienter, but the SEC is already authorized by Section 21(d) of the Securities Exchange Act to seek an injunction for any violation of the Securities Exchange Act or the rules thereunder – and so can enforce this provision).

Until recently, it might have been argued that any violation of the proposed criminal provision in Section 15(a)(3)(B) would also violated the "Honest Services Fraud" statute (18 U.S.C. § 1346) and thus was superfluous and unnecessary. But, it is today clear that the Supreme

[7] I suggest below that this "investment advice" limitation could be made even clearer in proposed revised language.

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Court is intent on invalidating Section 1346 as unconstitutionally vague. The Court took three cases this year involving Section 1346 and appeared skeptical at their oral argument of the Section's constitutionality.[8] We will know Section 1346's fate by late June. In contrast, the language of proposed Section 15(a)(3)(B) is far less problematic. It clearly is governed by federal law and specifies that its duty is to act in the investors' best interests (whereas Section 1346 referred generally to "the duty of honest services" without defining that duty's content in any way).

A final and frivolous objection is that imposing a fiduciary duty on broker-dealers will give rise to increased and non-meritorious private litigation against them. No private cause of action is proposed by this legislation, and hence, under existing Supreme Court precedents, private parties will not be able to sue based upon the proposed statute.[9] At most, a possibility exists that arbitrators in securities arbitrations may consider this provision in disputes between a customer and a broker (and that to me seems desirable). But clearly this statute will not support a class action.

On this basis, we should expect Section 15(a)(3)(A) to be enforced primarily by SEC civil actions, with only rare use of criminal prosecutions (although the existence of criminal penalties does, of course, carry an in terrorem deterrent threat).

III. Suggested Revisions

One change in the drafting of Section 15(a)(3)(A) seems plainly necessary to carry out its intended effect. Section 15(a)(3)(A) now provides that "a registered broker or dealer that provides investment advice . . . shall have a fiduciary duty . . . ," and Section 15(a)(3)(B) provides that "any person subject to a fiduciary duty under subparagraph (A)" commits a crime

[8] The cases included United States v. Black, 530 F.3d 596 (7th Cir. 2008) and United States v. Skilling, 554 F.3d 529 (5th Cir. 2009).
[9] See, e.g., Touche Ross & Co. v. Redington, 442 U.S. 560 (1979).

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when they willfully breach that duty. Unfortunately, there is a gap here. The "registered broker or dealer" in Section 15(a)(3)(A) will almost always be a corporation, limited liability company or other legal entity – and not a natural person. As now drafted, only the legal entity would commit the crime. Possibly, corporate officers could be convicted of aiding and abetting the corporate entity's breach, but it would be simpler to directly impose this duty on the corporate executive or registered representative as well. Thus, I suggest that clause (A) read:

> "3(A) A registered broker or dealer, or any agent, employee or other person acting on behalf of such a broker or dealer, who (1) provides investment advice regarding the purchase or sale of a security or a security-based swap, or (2) solicits or offers to enter into a purchase or sale of a security or security-based swap with an investor, shall have a fiduciary duty to act in the best interests of the investor and to disclose the specific facts relating to any actual or reasonably anticipated conflict of interest relating to that security or transaction or contemplated transaction. The Commission may adopt such rules and regulations to define the full scope and application of this duty, to grant exemptions and to adopt safe harbors, if and to the extent it finds such additional rules, regulations, exemptions and safe harbors necessary or appropriate in the public interest or for the protection of investors."

The foregoing language applies to agents and employees and thus subjects them also to the fiduciary duty and to the criminal penalty in proposed Clause (B). This change is also needed because Section 15(b)(3) of the Securities Exchange Act, which generally covers employees and agents of a broker-dealer, expressly does not apply to Section 15(a). Because these proposed amendments are all to Section 15(a), Section 15(b)(3) would be inapplicable to them. Next, this amendment makes clearer that the broker-dealer must be providing investment advice or soliciting investors to enter a transaction before its fiduciary duty is triggered. Finally, this revision authorizes the SEC to adopt exemptions and safe harbors to the extent consistent with the public interest and the protection of investors. This will respond to any fears of overbreadth or unintended consequences.

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With respect to Clause (B), the proposed statute's criminal provision, I have two comments (besides my earlier comment that it will be inapplicable to individuals in the absence of the changes discussed above):

First, criminal liability hinges on the defendant attempting "to effect . . . any transaction" or "to induce . . . the purchase or sale of any security." But a defendant for corrupt or self-interested reasons could seek to convince an investor not to sell or not to purchase securities. For example, the broker might wish to convince the investor not to invest in a transaction offered by a competitor, and this conduct could also breach a fiduciary duty. Although this is a more remote prospect, a modest revisions to Clause (B) could include this conduct as well by prohibiting the communication of materially misleading investment advice.

Finally, there is the question of penalties. This proposed provision will reach a wide range of misconduct, some of it serious, some of it less so. Persons who commit crimes of lesser culpability do not need to face a 25 year sentence. One way to draw a rough but sensible distinction would be to provide that in cases involving gains to the broker-dealer, or losses to investors, of less than $1,000,000, the maximum penalty should be no more than five years. Of course, reasonable people can disagree on at what point a penalty becomes disproportionate to the gravity of the crime. Still, as a former Reporter to the American Bar Association for its standards on "Sentencing Alternatives and Procedures" in connection with its Minimum Standards for Criminal Justice Project, I would point out that the American Bar Association has taken the position that sentences in excess of ten years should be reserved for exceptionally serious offenses committed by exceptionally dangerous offenders. On that basis, I would recommend reducing the 25 year maximum penalty and in addition providing a lower ceiling (probably around 5 years) for offenses that did not result in a high gain or loss.

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I do agree, however, that criminal penalties are particularly effective in deterring white collar crime.

CONCLUSION

The time has come for Congress to state clearly that broker-dealers must recognize a fiduciary duty. Eight years ago after the burst of the dot.com bubble and when Enron and WorldCom had just collapsed in fraud, we faced a similar moment when Sarbanes-Oxley was enacted, and we saw then that some securities analysts had ignored their duties to their clients. The now infamous Jack Grubman of Salomon and Citicorp had even proclaimed that wearing multiple hats as both an investment banker to management and an analyst to investors was "not a conflict, but a synergy." That same sentiment seems to have arisen again, proving that some in the industry do not learn. Predictably, this same moment will arise again, years from now perhaps, unless the broker's obligations are more clearly specified. It is time to complete what Sarbanes-Oxley began and clearly state the broker's obligations.

Once, "placing the customer first" was the clearly understood norm for investment banks, as they knew they could only sell securities to clients who placed their trust and confidence in them. That model was also efficient because it told the client that it could trust their broker and did not need to perform due diligence on, or look between the lines of, the broker's advice. But, with the rise of derivatives and esoteric financial engineering, some firms may have strayed from their former business model. Both to protect investors and to maintain market transparency and economic efficiency, the traditional norm that brokers should serve their clients (and not seek to profit from their losses) should be legislatively mandated.

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Written Testimony of
andré douglas pond cummings
Visiting Professor of Law, University of Iowa College of Law
Professor of Law, West Virginia University College of Law
Before the Subcommittee on Crimes and Drugs of the United States Senate
Committee of the Judiciary

"The Financial Market Crisis and White Collar Crime"

May 4, 2010

Mr. Chairman and Members of the Subcommittee:

By way of introduction, I am andré douglas pond cummings, a law professor for the past seven years teaching corporate law and securities regulation, amongst other subjects, and a former corporate lawyer at Kirkland & Ellis in Chicago, IL. My corporate practice in Chicago focused on representing numerous clients in the offering of publicly registered securities and in the representation of clients engaged in all manner of high profile mergers, acquisitions and divestitures. I believe it is fair to say that since my graduation from law school in 1997, that my time and energy has been devoted to studying, understanding, and analyzing the U.S. capital markets and the way that our nation seeks to protect its investors.

Senator Specter aims today through these hearings to examine the misconduct on Wall Street in recent years, particularly those activities that precipitated the financial market crisis of 2008 and what many now refer to as the "Great Recession." Specifically, I understand the purpose of this hearing is to determine whether civil liability and fines are sufficient to deter the kind of reckless decision making and apparent criminal engagement by Wall Street firms and banks that precipitated the crisis or whether jail sentences are required to deal with such conduct as a proper deterrent. I appreciate the

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invitation to address this important question. I will posit in what follows, that our system of punishing white collar crime and those directors and executives that brazenly engage in such crime is largely inadequate and that a thorough and thoughtful repositioning is necessary in order to better align the goals of our nation's economic endeavors and our responsibility to protect U.S. investors. In responding, I have drawn on the thinking and writing of economists, academics and additional leading law professors on the subject.[1]

Deregulation

A disquieting Congressional trend toward deregulation has emerged in the past twenty years or so, which has enabled a corporate culture to develop and a Wall Street environment to ripen into one wherein a near global economic meltdown was possible, if not inevitable, were it not for an extraordinary governmental and taxpayer bailout. Studies indicate that the most efficient and productive capital markets are those that combine a strong private enforcement function through shareholder lawsuit together with effective governmental regulation. A leading study of the forty-nine largest stock markets in the world, conducted by a troika of economists — Dartmouth's Rafael La

[1] *See* JOSEPH E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS AND THE SINKING OF THE WORLD ECONOMY 12-18 (2010); *see also* PAUL KRUGMAN, THE RETURN OF DEPRESSION ECONOMICS AND THE CRISIS OF 2008 194 (2009); SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 3-13 (2010); ROBERT SKIDELSKY, KEYNES: THE RETURN OF THE MASTER 3-28 (2009); STEVEN RAMIREZ, TOWARD A MORE PERFECT CAPITALISM (NYU Press forthcoming 2010) (manuscript on file with author); THOMAS SOWELL, THE HOUSING BOOM AND BUST (2009); Mary Kreiner Ramirez, *Prioritizing Justice: Combating Corporate Crime from Task Force to Top Priority*, 93 MARQUETTE L. REV. (forthcoming 2010); Timothy A. Canova, *Financial Market Failure as a Crisis in the Rule of Law: From Market Fundamentalism to a New Keynesian Regulatory Model*, 3 HARV. L. & POL'Y REV. 369, 370 (2009); Mary Kreiner Ramirez, *The Science-Fiction of Corporate Criminal Liability: Containing the Machine Through the Corporate Death Penalty*, 47 ARIZONA L. REV. 933, 962 (2005); Jena Martin Amerson, *What's In A Name: Transnational Corporations as Bystanders Under International Law*, ___ ST. JOHN'S L. REV. ___ (forthcoming 2010); Lucian A. Bebchuk, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, YALE J. ON REG. (forthcoming 2010); Steven Ramirez, *Subprime Bailouts and the Predator State*, 35 DAYTON L.REV. 81, 109 (2009); William K. Black, *Those Who Forget the Regulatory Successes of the Past Are Condemned to Failure*, XLIV, ECON. & POLITICAL WEEKLY 13, 80-86 (2009); andré douglas pond cummings, *Racial Coding and the Financial Market Crisis* (unpublished manuscript, forthcoming 2010).

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Porta, Yale's Florencio Lopez De Silanes, and Harvard's Andrei Shleifer, found that private lawsuits, combined with common-sense regulation and governmental control, is the most effective method to successfully manage national capital markets.

The deregulatory strategy that descended on Capital Hill in the 1990s and early 2000s actually took the exact opposite tack than that identified in the healthy capital markets construction outlined directly above. Successful capital markets require the threat of strong private lawsuits combined with common-sense regulation and governmental control. Nearly every financial market legislative enactment by Congress in the 1990s either weakened the private lawsuit component or scaled back common-sense governmental regulation of the financial services sector – precisely the opposite of what is commonly understood to be the best approach to maintaining the integrity of strong and sustainable capital markets. The Private Securities Litigation Reform Act of 1995 (PSLRA) got this capital market truism backward: it restricted the private enforcement component of stable, healthy capital markets and acted to disincentivize careful corporate leadership by restricting private shareholders from bringing legitimate enforcement actions.

While the PSLRA represents a destructive deregulatory enactment adopted by Congress in the run up to the 2008 collapse, many other unfortunate enactments contributed, including the Commodities Futures Modernization Act of 2000, the Gramm-Leach-Bliley Act of 1999, the Telecommunications Act of 2006, the Securities Litigation Uniform Standards Act of 1998, the SEC and court's failure to regulate hedge funds, and numerous Securities and Exchange Commission rules promulgated under its rulemaking authority. The SEC's errors included exempting large Wall Street investment firms from

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minimum capital requirements, repealing a rule designed to prevent manipulative short selling and limiting shareholder's ability to recover for securities fraud. This trending toward deregulating large portions of the financial services sector provided the cover necessary for corporate directors and executives to engage in reckless decision-making and breathtaking risk-taking as very little government oversight existed in the subprime mortgage asset backed securitization industry and run-up to the market collapse.

With governmental oversight effectively neutered and the private lawsuit enforcement mechanism emasculated, corporations through their executives failed spectacularly in properly assessing risk in connection with the subprime mortgage market and many corporate leaders led their firms straight toward bankruptcy (were it not for taxpayer bailouts).

Corporate Purpose and Criminal Deterrence

In a deregulated environment, numerous factors contribute to undercut the deterrence mechanism of current corporate criminal sanction. There exists a strong expectation amongst corporations that detection and prosecution for engaging in criminally sanctioned activity is unlikely and punishment will not be severe. A corporate culture exists, due in part to the deregulatory trend outlined above that ignores wrongdoing or fails to take responsibility for it. Further, there is a kind of invincibility that accompanies those that engage in corporate criminal conduct that legal and political influence will shape the law and protect the criminal engagement. Indeed, there seems to exist a governmental reluctance to harm the economy by actually sanctioning criminal corporate conduct. For these reasons, current white collar crime is not functionally deterred in our current corporate environment.

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One underlying premise of deterrence is fear of punishment, but few large corporations are criminally prosecuted. The likelihood of a large firm being captured, criminally prosecuted and convicted is extremely low. Corporations and its leaders recognize that the risk of criminal capture is quite low and so it factors that risk into the decision as to whether to break the law by applying a straightforward cost-benefit analysis. The corporate decision to engage in cost-benefit analyses is not particularly malevolent, as its corporate purpose is to maximize shareholder profit, thus the decision is rational. If the purpose of the corporation is to maximize shareholder wealth, and the punishment for illegal conduct is to pay a fine, then the rational approach for any corporation is to calculate the likely gain it profits through increased revenue or cost-savings from committing the crime, and then compare that to the likely fine discounted by the likelihood of the wrongdoing being discovered, successfully prosecuted, and sanctioned. Simply stated, once the costs and benefits are compared, if the cost of wrongdoing discounted by likelihood of discovery is less, then the rational choice is to commit the crime and pay the sanction if the crime is discovered. If the crime is not discovered, all the better. Our corporate law development embraces and accepts this conceptualization.

In our current system of corporate criminalization, corporations and its executives, are incentivized to engage this cost-benefit analysis and it is no surprise then that we find Toyota choosing not to repair its "sticking accelerator" problem or Goldman Sachs allowing a client to select the most toxic subprime mortgage instruments to be packaged into an investment that the client will take a short position in while Goldman Sachs packages the product and peddles it to a different client/investor that seeks the

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mortgage backed security for purposes of taking a long position, without disclosing the fact that the security was manufactured by its first client to fail. In truth, studies indicate that corporations will engage in not just criminal behavior, but nefarious and blatantly criminal activity, often internationally, if the cost-benefit analysis renders the course of action most profitable. The financial market crisis is clear and convincing evidence of recklessness and criminal engagement for profit. Citigroup's CEO Charles O. Prince, III famously said during the subprime mortgage and housing boom "As long as the music is playing, you've got to get up and dance." Further, Morgan Stanley's CEO John J. Mack said in light of the market collapse "We cannot control ourselves. You have to step in and control the Street."

Congress has been called upon to "control the street" and to figure out how to reprioritize the current contextualization of "maximize profit" even to the point of criminal offense, so long as it makes bottom line sense. One way Congress can step in to control the street, is to attach prison sentences to corporate executives that recklessly defraud the public, destroy their firms and cause their corporations to pay billions of dollars in fines for breaking U.S. law. If the cost-benefit analysis renders breaking the law attractive in hopes that the crime will go undetected, then perhaps the specter of certain prison time for executives undertaking the cost-benefit analysis will disincentivize the criminal activity.

Possible Going Forward Solutions

Criminal Sanction for Bailed Out CEOs. In light of the taxpayer bailouts of nearly every important Wall Street and commercial bank in 2008 and 2009, one possible sanction includes adopting harsh criminal and administrative penalties for those

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corporations that act so recklessly that they require taxpayer bailouts to "save" or "shore up" the U.S. economy. Prison for executives that run their firms into the arms of taxpayer bailouts would seemingly deter recklessness, criminality, greed and avarice. U.S. corporate law has evolved to a point where the Chief Executive Officer reigns supreme as nearly untouchable in the modern marketplace. The model of shareholder democracy has been ameliorated to the point that the CEO and his pursuit of personal fortune is the primary driver behind most corporate positioning. The CEO dominates American corporations to the extent that he is held to very few standards of responsibility and is able to stave off all shareholder dissent through careful calculation. CEOs of publicly traded companies have the distinctive privilege of selecting their own nominal supervisors—the board of directors.

The CEO in the United States has the power to appoint the board of directors that "oversees" his performance; to maneuver board members off of the board if they challenge his decisions; to establish his compensation through the board committee that he appoints; to make reckless decisions that are protected by the business judgment rule; to exercise nearly unfettered power as the duty of care and duty of loyalty have been judicially emasculated to the point of near nonexistence; and to escape private shareholder lawsuits as class action securities fraud actions have been Congressionally neutered to a near terminal state. CEOs and corporate management have been empowered by U.S. corporate law to generate personal short term profit and gain at the expense of long term vitality and shareholder profit maximization in breathtaking ways.

One of the enduring themes of the financial market crisis is that Wall Street executives overleveraged or allowed such reckless overleveraging of their balance sheets

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that nearly every major firm faced imminent collapse and bankruptcy. The simple reason that these CEOs and other executives allowed their firm's to walk to the very edge of the bankruptcy precipice is because they all pursued the fantastic profits that were being kicked off in the securitized subprime mortgage industry. Short term profit, tied into his executive compensation, motivated the audacious decision making, criminal motivation and recklessness that forced a federal taxpayer bailout. The reckless pursuit of profit in the above described subprime mortgage-backed securities market is a powerful example of this short term personal profit driven vision.

Most of the corporate executives that steered their companies into the subprime mortgage morass walked away with bonuses and compensation, not jail time. In the ultimate irony, some of the compensation paid to these reckless executives came from the very TARP bailout funds that were needed to keep the overleveraged firms afloat. While corporate executives that recklessly capsized their firms avoid jail time and any significant consequence for their actions, many Americans remain jobless and with retirement accounts in shambles. Something seems very wrong with this current picture.

Corporate Crimes Division Within Department of Justice. Presently, corporate crime in our country is pursued through various Department of Justice (DOJ) task forces, including the Corporate Fraud Task Force, and through the Criminal Division Fraud Section and individual U.S. Attorney's Offices. In light of the scandals that have laid waste to shareholders and investors in the early part of the 21st century, including the 2002 scandals of Enron, WorldCom, Adelphia, Tyco, etc. and the most recent subprime mortgage crisis, it appears clear that a centralized, focused DOJ Corporate Crimes Division is necessary and critical. According to Professor Mary Kreiner Ramirez, rather

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than a collection of ad hoc task forces that seek to coordinate policy among a vast array of offices and agencies, the relentless waves of corporate criminality support the need to create this permanent base within DOJ. This Corporate Crimes Division could efficiently investigate and prosecute crimes of national and multi-national corporations spanning multiple districts, and pursue a coordinated national policy that affirms the commitment of the DOJ to fight large-scale corporate crime which costs taxpayers trillions, frustrates the capital markets, increases the cost of raising capital for the honest businesses, and undermines citizens' confidence in the rule of law. Given the cost of corporate crime, creating the Corporate Crimes Division promotes superior institutional design that should yield substantial benefit.

Congress should proceed judiciously but with great purpose as the current corporate criminal law model is weak, ineffective and militates toward perverse incentives. Strengthening criminal sanction for white collar crime, including prison sentences is an important step in that direction. Some estimates indicate that the costs of economic crime outweigh the costs of street crime by measures ranging from 10 to 1 to 50 to 1. We simply must protect American citizens better against those that perpetrate economic crimes.

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Statement by James K. Galbraith, Lloyd M. Bentsen, jr. Chair in Government/Business Relations, Lyndon B. Johnson School of Public Affairs, The University of Texas at Austin, before the Subcommittee on Crime, Senate Judiciary Committee, May 4, 2010.

Chairman Specter, Ranking Member Graham, Members of the Subcommittee, as a former member of the congressional staff it is a pleasure to submit this statement for your record.

I write to you from a disgraced profession. Economic theory, as widely taught since the 1980s, failed miserably to understand the forces behind the financial crisis. Concepts including "rational expectations," "market discipline," and the "efficient markets hypothesis" led economists to argue that speculation would stabilize prices, that sellers would act to protect their reputations, that *caveat emptor* could be relied on, and that widespread fraud therefore could not occur. Not all economists believed this – but most did.

Thus the study of financial fraud received little attention. Practically no research institutes exist; collaboration between economists and criminologists is rare; in the leading departments there are few specialists and very few students. Economists have soft-pedaled the role of fraud in every crisis they examined, including the Savings & Loan debacle, the Russian transition, the Asian meltdown and the dot.com bubble. They continue to do so now. At a conference sponsored by the Levy Economics Institute in New York on April 17, the closest a former Under Secretary of the Treasury, Peter Fisher, got to this question was to use the word "naughtiness." This was on the day that the SEC charged Goldman Sachs with fraud.

There are exceptions. A famous 1993 article entitled "Looting: Bankruptcy for Profit," by George Akerlof and Paul Romer, drew exceptionally on the experience of regulators who understood fraud. The criminologist-economist William K. Black of the University of Missouri-Kansas City is our leading systematic analyst of the relationship between financial crime and financial crisis. Black points out that accounting fraud is a sure thing when you can control the institution engaging in it: "the best way to rob a bank is to own one." The experience of the Savings and Loan crisis was of businesses taken over for the explicit purpose of stripping them, of bleeding them dry. This was established in court: there were over one thousand felony convictions in the wake of that debacle. Other useful chronicles of modern financial fraud include James Stewart's *Den of Thieves* on the Boesky-Milken era and Kurt Eichenwald's *Conspiracy of Fools*, on the Enron scandal. Yet a large gap between this history and formal analysis remains.

Formal analysis tells us that control frauds follow certain patterns. They grow rapidly, reporting high profitability, certified by top accounting firms. They pay exceedingly well. At the same time, they radically lower standards, building new businesses in markets previously considered too risky for honest business. In the financial sector, this takes the form of relaxed – no, *gutted* – underwriting, combined with the capacity to pass the bad penny to the greater fool. In California in the 1980s, Charles Keating realized that an S&L charter was a "license to steal." In the 2000s, sub-prime mortgage origination was much the same thing. Given a license to steal, thieves get busy. And because their performance seems so good, they quickly come to dominate their markets; the bad players driving out the good.

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The complexity of the mortgage finance sector before the crisis highlights another characteristic marker of fraud. In the system that developed, the original mortgage documents lay buried – where they remain – in the records of the loan originators, many of them since defunct or taken over. Those records, if examined, would reveal the extent of missing documentation, of abusive practices, and of fraud. So far, we have only very limited evidence on this, notably a 2007 Fitch Ratings study of a very small sample of highly-rated RMBS, which found "fraud, abuse or missing documentation in virtually every file." An efforts a year ago by Representative Doggett to persuade Secretary Geithner to examine and report thoroughly on the extent of fraud in the underlying mortgage records received an epic run-around.

When sub-prime mortgages were bundled and securitized, the ratings agencies failed to examine the underlying loan quality. Instead they substituted statistical models, in order to generate ratings that would make the resulting RMBS acceptable to investors. When one assumes that prices will always rise, it follows that a loan secured by the asset can always be refinanced; therefore the actual condition of the borrower does not matter. That projection is, of course, only as good as the underlying assumption, but in this perversely-designed marketplace those who paid for ratings had no reason to care about the quality of assumptions. Meanwhile, mortgage originators now had a formula for extending loans to the worst borrowers they could find, secure that in this reverse Lake Wobegon no child would be deemed below average even though they all were. Credit quality collapsed because the system was designed for it to collapse.

A third element in the toxic brew was a simulacrum of "insurance," provided by the market in credit default swaps. These are doomsday instruments in a precise sense: they generate cash-flow for the issuer until the credit event occurs. If the event is large enough, the issuer then fails, at which point the government faces blackmail: it must either step in or the system will collapse. CDS spread the consequences of a housing-price downturn through the entire financial sector, across the globe. They also provided the means to short the market in residential mortgage-backed securities, so that the largest players could turn tail and bet against the instruments they had previously been selling, just before the house of cards crashed.

Latter-day financial economics is blind to all of this. It necessarily treats stocks, bonds, options, derivatives and so forth as securities whose properties can be accepted largely at face value, and quantified in terms of return and risk. That quantification permits the calculation of price, using standard formulae. But everything in the formulae depends on the instruments being as they are represented to be. For if they are not, then what formula could possibly apply?

An older strand of institutional economics understood that a security is a contract in law. It can only be as good as the legal system that stands behind it. Some fraud is inevitable, but in a functioning system it must be rare. It must be considered – and rightly – a minor problem. If fraud – or even the perception of fraud – comes to dominate the system, then there is no foundation for a market in the securities. They become trash. And more deeply, so do the institutions responsible for creating, rating and selling them. Including, so long as it fails to respond with appropriate force, the legal system itself.

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Control frauds always fail in the end. But the failure of the firm does not mean the fraud fails: the perpetrators often walk away rich. At some point, this requires subverting, suborning or defeating the law. This is where crime and politics intersect. At its heart, therefore, the financial crisis was a breakdown in the rule of law in America.

Ask yourselves: is it possible for mortgage originators, ratings agencies, underwriters, insurers and supervising agencies NOT to have known that the system of housing finance had become infested with fraud? Every statistical indicator of fraudulent practice – growth and profitability – suggests otherwise. Every examination of the record so far suggests otherwise. The very language in use: "liars' loans," "ninja loans," "neutron loans," and "toxic waste," tells you that people knew. I have also heard the expression, "IBG,YBG;" the meaning of that bit of code was: "I'll be gone, you'll be gone."

If doubt remains, investigation into the internal communications of the firms and agencies in question can clear it up. Emails are revealing. The government already possesses critical documentary trails -- those of AIG, Fannie Mae and Freddie Mac, the Treasury Department and the Federal Reserve. Those documents should be investigated, in full, by competent authority and also released, as appropriate, to the public. For instance, did AIG knowingly issue CDS against instruments that Goldman had designed on behalf of Mr. John Paulson to fail? If so, why? Or again: Did Fannie Mae and Freddie Mac appreciate the poor quality of the RMBS they were acquiring? Did they do so under pressure from Mr. Henry Paulson? If so, did Secretary Paulson know? And if he did, why did he act as he did? In a recent paper, Thomas Ferguson and Robert Johnson argue that the "Paulson Put" was intended to delay an inevitable crisis past the election. Does the internal record support this view?

Let us suppose that the investigation that you are about to begin confirms the existence of pervasive fraud, involving millions of mortgages, thousands of appraisers, underwriters, analysts, and the executives of the companies in which they worked, as well as public officials who assisted by turning a Nelson's Eye. What is the appropriate response?

Some appear to believe that "confidence in the banks" can be rebuilt by a new round of good economic news, by rising stock prices, by the reassurances of high officials – and by not looking too closely at the underlying evidence of fraud, abuse, deception and deceit. As you pursue your investigations, you will undermine, and I believe you may destroy, that illusion.

But you have to act. The true alternative is a failure extending over time from the economic to the political system. Just as too few predicted the financial crisis, it may be that too few are today speaking frankly about where a failure to deal with the aftermath may lead.

In this situation, let me suggest, the country faces an existential threat. Either the legal system must do its work. Or the market system cannot be restored. There must be a thorough, transparent, effective, radical cleaning of the financial sector and also of those public officials who failed the public trust. The financiers must be made to feel, in their bones, the power of the law. And the public, which lives by the law, must see very clearly and unambiguously that this is the case. Thank you.

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Statement Of Senator Patrick Leahy (D-Vt.),
Chairman, Senate Judiciary Committee
Hearing Before The Judiciary Subcommittee On Crime And Drugs,
On "Wall Street Fraud And Fiduciary Duties: Can Jail Time Serve As An Adequate Deterrent For Willful Violations?"
May 4, 2010

As the Senate continues to debate the Wall Street reform bill, I thank Senator Specter for holding this important hearing. In these difficult economic times, we must make every effort to ensure accountability for the massive wave of fraud on Wall Street and beyond that has so undermined our economy, and we must protect taxpayers from ongoing fraud that could slow our economic recovery. Often the best way to deter the kind of reckless and outrageous conduct that can bring down financial institutions and harm so many Americans is to ensure that those who commit these crimes actually go to jail.

Criminals who jeopardize our financial institutions and break the law must be investigated, prosecuted and held accountable for their actions. Fraud can eviscerate the life savings of hardworking Americans, while those who commit these crimes walk away free of punishment, or with fines and penalties that they simply dismiss as the cost of doing business. Today's hearing will explore the important question of whether those who handle financial transactions for so many Americans have a fiduciary duty, and whether they should be criminally liable for violating that duty.

I am working toward a similar goal of criminal accountability and fraud prevention in an amendment I will propose today to the Wall Street reform bill. The amendment is supported by Senators Grassley, Kaufman and Specter, and will strengthen law enforcement's capacity to investigate and prosecute the kinds of financial fraud. The amendment will strengthen protections for whistleblowers, who often serve as an early warning system to stop fraud before it damages financial institutions and the economy.

Every month, we learn of more scandals in the financial industry, as leading financial institutions and money managers, like some of those in charge of Goldman Sachs, are charged with participating in multimillion dollar fraud schemes. It is time to hold people accountable. That means providing the tools and resources that law enforcement needs to investigate, restore order, and ensure justice. Our amendment protects criminal investigations from outside interference, empowers law enforcement and prosecutors with new tools for fighting fraud, and strengthens protections for whistleblowers who detect and expose financial fraud.

The amendment we will propose will increase sentences for those who commit financial institution fraud and securities fraud. Despite the enormous losses in many securities fraud cases, a preliminary analysis by the Unites States Sentencing Commission suggests that securities fraud offenders may often receive shorter sentences than other white collar offenders who cause similar harm. Our amendment will direct the Sentencing Commission to review and amend the sentencing guidelines for these types of fraud, taking into account the importance of sending people to jail as a deterrent and the potential and actual harm to the public from these offenses.

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This amendment also protects criminal investigations by ensuring that regulators, investigators, and prosecutors work together to stop financial fraud. It requires regulators to consult with prosecutors to ensure that important regulatory steps do not inadvertently undermine criminal investigations and prosecutions.

The amendment provides law enforcement with additional tools for the effective investigation, prosecution, and punishment of individuals who commit financial fraud. It allows those who move money overseas to evade taxes to be charged with money laundering, which can result in increased charges and sentences. Our amendment also extends the statute of limitations for securities fraud cases from five years to six years, which will allow law enforcement to bring more and stronger securities fraud cases, and thereby increase deterrence, victim restitution, and respect for the rule of law on Wall Street. Tax fraud and securities fraud schemes are often difficult to identify and extremely complex, meaning that the statute of limitations can expire before prevent important cases can be charged. Tax fraud already has a six-year statute of limitations. Securities fraud is equally complex and hard to detect, so it should as well.

I am pleased that the legislation reported by the Banking and Agriculture Committees establishes strong new whistleblower protections. Senator Grassley and I have worked hard with those Committees to strengthen these whistleblower protections. With the right protections, whistleblowers can help root out the kinds of massive Wall Street fraud that have harmed so many Americans. The amendment I will offer today goes further still to extend important protections for whistleblowers who step forward to report fraud and abuse, often at great risk to their careers and livelihoods.

For more than three decades, I have fought in Congress to combat fraud and protect taxpayers. Last year, I authored the Fraud Enforcement and Recovery Act with Senator Grassley and Senator Kaufman. That legislation is the most significant anti-fraud legislation in more than a decade. Since its enactment, it has provided law enforcement with new tools to detect and prosecute financial and mortgage fraud. I also worked with Senators Grassley, Kaufman, Specter, Sanders, and others to add important new measures to the health reform legislation enacted earlier this year, to tackle the fraud that has contributed greatly to the skyrocketing cost of health care.

The amendment that we will introduce today is an important next step. It builds on these anti-fraud efforts to make sure that those responsible for committing fraud in the financial industry are held fully accountable for their actions. Those on Wall Street must be held to the same standards for criminal accountability as those on Main Street. I commend Senator Grassley, Senator Kaufman, and Senator Specter for their hard work on these issues. I hope all Senators will support this bipartisan amendment. I thank Senator Specter for holding today's important hearing.

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United States Senate

Committee on the Judiciary
Subcommittee on Crime and Drugs

"Wall St. Fraud and Fiduciary Responsibilities:
Can Jail Time Serve as an Adequate Deterrent for Willful Violations?"

May 4, 2010

Testimony of

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Chairman Specter, Senator Graham, and members of the Subcommittee. Thank you for your invitation to discuss policy issues related to the use of criminal punishment to deter financial fraud.

White-collar and corporate crimes impose an enormous financial burden on citizens, and it must be appreciated that they constitute a more serious threat to the well-being and integrity of our society than traditional kinds of street crime. As a Presidential Commission put the matter, "White-collar crime affects the whole moral climate of our society. Derelictions by corporations and their managers, who usually occupy leadership positions in their communities, establish an example which tends to erode the moral base of the law…"

There are several major themes that I want to address in this brief presentation.

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First, I want to support the infliction of criminal penalties on white-collar and corporate criminals who violate criminal laws. To do so requires that the Congress enact further legislation that imposes criminal sanctions on financial actions that have been demonstrated to seriously harm the public and are known to produce such consequences by their perpetrators. The current spate of financial sanctions is no more than an additional and mildly bothersome cost of doing business.

Second, I want to emphasize that persuasive anecdotal evidence indicates that particularly for potential white-collar offenders the prospect of criminal penalties can be effective deterrents. There is no definitive empirical evidence to prove this—to mount a satisfactory experiment on the subject would violate ethical standards. But we know that upper-class businesspersons fear shame and fear incarceration and will attend to credible threats of such consequences if they knowingly break the law; they are par excellence rational calculators.

Third, I would endorse the notion that regulatory agencies, most notably the Securities and Exchange Commission, be empowered to mount criminal prosecutions with internal personnel. Too often inter-agency agendas that must be negotiated between an agency and the Department of Justice inhibit effective deterrent responses to white-collar and corporate crime.

Fourth, I believe the public is growing increasingly restive about the failure of the criminal law to be tied to the crimes of those who engaged in them. The war on drugs snared a vast horde of financially marginal people. There has been no similar war on financial thugs. Cynics suggest in fact that imprisoning some of the Wall Street malefactors might help to upgrade the way prisons are run. To make a decisive move toward deterring fraud in the higher echelons of business, a significant influx of enforcement resources is necessary to allow

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investigators and prosecutors to bring major cases. Representative Marcy Kaptur has proposed legislation to do just this with H.R. 3995, the "Financial Crisis Criminal Investigation and Prosecution Act."

As a university-based criminologist, I have researched and written about white-collar and corporate crime for almost thirty years. I conducted federally-funded research on health care fraud and on the savings and loan crisis. I have also written about the role of fraud in major financial debacles, including the savings and loan crisis, the corporate and accounting meltdowns of 2002, the Orange County, California bankruptcy of 1994, the largest municipal failure in American history, and the current global financial meltdown.

Much remains to be criminally investigated and dealt with in regard to the widespread financial frauds in the mortgage industry and on Wall Street, the failure of regulatory oversight, the continued general reluctance and slow response by government to identify white-collar and corporate crimes, particularly those acts constituting insider, or "control frauds." These issues have been taken up by others in ongoing testimony before Congress. I want to concentrate on the issue of punishment and the efficacy of criminal deterrence regarding these crimes.

Given the abundant opportunities that many persons have to engage in white-collar crime, it is interesting that more people do not. The most obvious reason is their fear of punishment. Deterrence rests on the fundamental utilitarian premise that people will seek pleasure and avoid pain. So, when the potential risks associated with a white-collar crime outweigh the potential gains, a rational individual will decide against the behavior. Much of our criminal law is based on this assumption about human nature.

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A central concern about white-collar and corporate crime is that the risk-reward ratio is out of balance - that is, potential rewards greatly outweigh the risks. Given the low probability of apprehension and the likelihood of no, or light punishment, white-collar crime is seen as a "rational" action in many cases. The comparative leniency shown white-collar offenders has been attributed to several factors related to their status and resources, as well as to the peculiar characteristics of their offenses, including their high educational level and occupational prestige which produces a "status shield" that protects them from the harsh penalties applied with greater frequency to common criminals. White-collar defendants' high incomes and the willingness often of corporations to pay their exorbitant legal expenses with shareholder funds enable them to secure expensive legal counsel, whose level of skill and access to defensive resources is generally unavailable to lower-class defendants. Finally, white-collar crimes frequently involve complicated financial transactions in which the victims are either aggregated classes of unrelated persons, such as stockholders, or large government agencies, such as the IRS. These victims do not engender the kind of commiseration that individual victims of street crimes can elicit from judges and juries.

Empirical evidence supports the leniency hypothesis. A study of persons suspected by federal regulators in Texas and California to be involved in serious financial crimes during the savings and loan crisis of the 1980s revealed that between only 14 percent and 25 percent were ever indicted. The study also examined the sentences imposed in S&L cases involving mean losses of a half-million dollars and found that the average sentence was 3 years - significantly less than the average prison terms handed to convicted burglars and first-time drug offenders tried in federal court.

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The U.S. Sentencing Guidelines can enhance penalties for financial crimes based on losses attributable to fraud, the number of victims, whether the fraud involved special skills or sophisticated means, and whether the defendant worked in the investment business or as an officer or director of a public company. Critics argue that such penalties can have a chilling effect on productivity. In fact, some financial writers have labeled past reactions of politicians to corporate scandals as "hysterical," arguing that "penalties for failure are not merely lower earnings, but lawsuits, prosecution, huge fines, and long prison terms." They may be correct about failure causing lawsuits and even fines; but they're mistaken about prosecution. Long prison terms are not caused by mere failure; they are caused by serious criminal behavior.

Certainly, the risk-reward ratio is central to capitalism. Economist John Maynard Keynes was a proponent of risk-taking, which he called "animal spirits." Historian Walter A. McDougall maintains that the U.S. economy was built by "scramblers, gamblers, scofflaws, and speculators." But there are many ways to define acceptable risk-taking, and that must be seriously addressed by Congress in terms of outlawing practices that involve blatant conflicts of interest and the willful gaming of regulations in order to gain unfair advantage.

A central problem that underlies deterrent strategies is that despite some high profile cases, the government has trivialized criminal fraud to the point that it is routinely dealt with at the lowest offense levels, and when larger cases are discovered they are more likely to be pursued civilly and not criminally. We can look at a key example in the current crisis. The FBI publicly announced in 2004 that there was likely to be "an epidemic of mortgage fraud," yet Attorney General Michael Mukasey declined to create a task force to investigate the roots of the subprime debacle, while likening the problem to "'white-collar street-crime' that could best be

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handled by individual United States attorneys' offices." The lack of government response after the alarm had been sounded by federal agents stands in direct contrast to the government's response to the savings and loan crisis; *a financial disaster that was approximately one-thirtieth the size of the one we are currently experiencing*.

New laws that impose tougher penalties on white-collar criminals might well deter some potential offenders. Adhering to the new guidelines would also serve to redress the sentencing imbalance between white-collar and traditional "common" criminals. A federal prosecutor has declared: "You [should] deal with white-collar crime the same way as street crime. You try to raise the likelihood they will be caught and punished."

Current laws likely fail to deter satisfactorily because white-collar offenders are aware of the absence of vigorous enforcement. The central issue here is *proactive policing*. With most traditional crimes, the fact that an offense has occurred is readily apparent; with most corporate crimes, the effect is not readily visible. Once the offense becomes known, however, apprehending suspects of corporate crime is almost always easier than apprehending those involved in traditional crime. When a house is burglarized or a car is stolen it is often difficult and costly for police to find the thief. If it is discovered that a company engaged in bribery to secure a defense contract, there is no need for police to set up roadblocks or print "Wanted" posters to find the corporate suspect. Unless, of course, the white-collar malefactor packages his ill-gotten gains and heads for a country with which the United States does not have a satisfactory extradition treaty.

Some scholars believe that we do not need "more" regulation; rather, we need "smarter" regulation. Simply applying harsher laws to corporations and individuals, they argue, will only produce a subculture of resistance within the corporate community "wherein methods of legal

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resistance and counterattack are incorporated into industry socialization." Regulation works best when it is a "benign big gun" - that is, when regulators can speak softly but carry big sticks in the form of substantial potential criminal penalties.

Joseph T. Wells, the founder and former chairman of the Association of Certified Fraud Examiners, has offered a newer strategy: *executive transparency*. Wells argues for a law requiring corporate executives to open up their own personal bank accounts to scrutiny by auditors and regulators. The rationale is that in many of the high-profile corporate fraud cases, the crime is not discovered until *after the money has been spent,* often for wildly luxurious and frivolous things. Wells cites the huge "loans" Bernie Ebbers gave to himself so that he could buy hundreds of thousands of acres of timberland and the biggest cattle ranch in Canada; the profligate spending by the Rigas family, including the construction of their own private golf course; the millions of dollars embezzled by Mickey Monus to finance his personal basketball league; and the grotesque self-indulgence of Dennis Kozlowski. As Wells notes, major corporate fraud cases almost always begin at the top.

> To head off the financial rape of public corporations, I would suggest a law that requires selected company insiders to furnish their individual financial statements and tax returns to independent auditors. They should also sign an agreement allowing access to their private banking information. The data should be available in cases where suspicions arise.

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Executives of public corporations have a fiduciary duty to act in the best interests of shareholders, and Wells' call for "transparency" seems entirely consistent with that duty.

A hierarchical structure of corporate sanctions also has been proposed, in which the first response to misconduct consists of advice, warnings, and persuasion; then escalates to harsher responses culminating in what is termed "corporate capital punishment" or the dissolution of the offending company. The goal of this model is compliance which is understood within a dynamic enforcement routine where enforcers try to get commitment from corporations to comply with the law and can back up their negotiations with credible threats about the dangers they face if they choose to go down the path of non-compliance. The strength of such a system is that it works at multiple levels and holds all the actors involved - executive directors, accountants, brokers, legal advisers, and sloppy regulators - accountable for criminal misconduct.

Besides considering harsher penalties, Congress needs to seriously consider having *chief criminologists and fraud experts as central officers of regulatory agencies*, just as there currently are chief legal counsels and economists. A fraud analysis should be conducted before any new regulatory legislation is enacted so that we can avoid repeating mistakes of the past which included ignoring both the potential for widespread fraud that acted as an accelerant for expanding economic bubbles, and the creation of "criminogenic environments" where conflicts of interest and regulatory loopholes allowed opportunities for fraud to flourish with impunity.

Strong laws carrying substantial penalties are necessary. I would also argue that regulatory agencies be given prosecutorial powers so that they can operate more directly and effectively when suspected criminal activity surfaces. This would avoid the all-too-common historic problems and inefficiencies associated with communication, coordination and inter-

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agency competition between regulatory and prosecutorial agencies. For deterrence to be effective against powerful individuals and large corporations there needs to be more than merely token criminal cases, and that will take a rather large government effort to accomplish in light of the resources and determination of potential defendants to avoid a criminal conviction.

In August 2009, for instance, Maurice (Hank) Greenberg, former AIG chief executive officer and Howard Smith, the company's former chief financial officer, paid $15 million to the SEC to settle the charge that they had misstated the financial condition of the company. Had the truth been revealed, AIG would have failed to meet key earnings and growth targets. Regarding the dynamics of white-collar crime, it was noteworthy that Greenberg did not admit guilt (but why else would he pay the financial penalty?) and insisted that had he been charged criminally with securities fraud he would have fought the case rather than settle. This might be regarded as a piece of evidence favoring the view that the most effective tactic against white-collar offenders is the criminal charge. They find notably onerous and oppressive the stigma associated with a criminal label, while a financial penalty can be written off as not more than the relatively small price of doing business—especially monkey business.

Thank you again for the opportunity to present these ideas before the Subcommittee, and I am happy to answer any questions.

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United States Senate

Committee on the Judiciary

Subcommittee on Crime and Drugs

HEARING ON

"WALL STREET AND FIDUCIARY DUTIES: CAN JAIL TIME SERVE AS AN ADEQUATE DETERRENT FOR WILLFUL VIOLATIONS"

MAY 4, 2010

STATEMENT OF LARRY E. RIBSTEIN, MILDRED VAN VOORHIS JONES CHAIR, UNIVERSITY OF ILLINOIS COLLEGE OF LAW.

Chairman Specter, Ranking Member Graham, and distinguished members of the Committee:

Thank you for the invitation to testify today. My name is Larry E. Ribstein. I am Associate Dean for Research and Mildred Van Voorhis Jones Chair, University of Illinois College of Law. I have taught and written extensively in the areas of corporate and securities law for 35 years. Among my main current areas of research are the law and theory of fiduciary duties and corporate criminal liability. A more complete biography is appended to this testimony.

My testimony focuses on two issues raised by this hearing. First, to what extent should investment bankers have fiduciary duties to investors? Second, should there be criminal liability for willful breach of these duties?

To summarize my conclusions, these duties are the wrong tool for dealing with any problems that might exist in the investment banking industry. Based on my analysis and research concerning the nature and function of fiduciary duties,[1] fiduciary duties are an amorphous concept which courts and commentators have applied in many different forms to many different types of conduct. Applying these duties to investment bankers would cast a potentially wide net over not only bad conduct but also conduct that should be viewed as clearly legitimate. Moreover, even under a narrow view of these duties, they are inappropriate for most aspects of investment banking. These problems with fiduciary duties would be significantly exacerbated by imposing criminal liability for their breach.

I. THE AMORPHOUS NATURE OF FIDUCIARY DUTIES

"Fiduciary duty" is one of the most amorphous concepts in the law. The concept has been developed through centuries of case law. Part of the problem is that courts and commentators have used fiduciary language to describe duties in a bewildering variety of circumstances ranging from seemingly straightforward contractual relationships between franchisees and franchisors[2] to professional relationships of dependence such as between patients

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[1] *See* Larry E. Ribstein, *Are Partners Fiduciaries?* 2005 U. ILL. L. REV. 209.

[2] Harold Brown, *Franchising: A Fiduciary Relationship*, 49 Tex. L. Rev. 650 (1971).

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and doctors[3] and pharmacists and customers.[4] J.C. Shepherd, a leading commentator, despairs of "confusion and uncertainty in applying the fiduciary principle to disparate fact situations."[5] As discussed in the following sections, numerous questions arise concerning the definition of fiduciary duties.

A. DUTY OF CARE

A fiduciary duty may or may not include a duty of care as distinguished from one to refrain from stealing or outright cheating. The two types of conduct are similar in that a careless fiduciary in effect cheats on her obligation of devoted service. However, a strict duty to devote time to the beneficiary's business would have no natural limit. Thus, Shepherd notes that "the duty of care has absolutely no necessary connection with fiduciary relationships."[6]

B. GOOD FAITH

A fiduciary duty differs from the implied covenant of good faith and fair dealing courts have generally applied to contractual relationships. In most types of commercial relationships, arguably including many of those in the investment banking business, the parties operate at arm's length and expect to be able to bargain on their own behalf and serve their own interests as long as they do so in good faith.[7]

The duty to bargain in good faith is illustrated by the leading case of *Katz v. Oak Industries, Inc.*,[8] involving a corporation's duties to holders of its debt securities. Delaware Chancellor Allen held that "[t]he terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders. . . [I]f courts are to provide protection against such enhanced risk, they will require either legislative direction to do so or the negotiation of indenture provisions designed to afford such protection." The court further determined the corporation's duty by asking whether it is

> clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith--had they thought to negotiate with respect to that matter. If the answer to this question is yes, then, in my opinion, a court is justified in concluding that such act constitutes a breach of the implied covenant of good faith.[9]

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[3] Marc A. Rodwin, *Strains in the Fiduciary Metaphor: Divided Physician Loyalties and Obligations in a Changing Health Care System,* 21 Am. J.L. & Med. 241, 247-48 (1995)

[4] *Anonymous v. CVS Corp.*, 728 N.Y.S.2d 333, 336-39 (N.Y. Sup. Ct. 2001).

[5] J.C. Shepherd, LAW OF FIDUCIARIES 7 (1981).

[6] *Id.* at 49.

[7] *See, e.g.*, John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role,* 89 Colum. L. Rev. 1618, 1658 (1989) (noting that "a contracting party may seek to advance his own interests in good faith").

[8] 508 A.2d 873, 879 (Del. Ch. 1986).

[9] Id. at 880.

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In other words, the implied covenant of good faith is to be determined by examining the terms of the parties' contract. This raises the question of when the contract provides the limits of the parties' duties and when the court should add a default fiduciary duty to the express contract.

C. CONFIDENTIAL RELATIONSHIPS

A fiduciary duty differs from a "confidential relationship" which involves the entrustment of information by one party to another. A federal case illustrates this difference. *United States v. Chestman*[10] held that a broker was not liable for insider trading based on his client's alleged misappropriation of information from the client's wife because the husband and wife did not have a fiduciary relationship breach of which was necessary to find misappropriation. The court made clear that it meant that there was no fiduciary duty in the specific sense of an expectation of confidentiality arising from "repeated disclosure of business secrets between family members."[11] Even viewing fiduciary duties from this same narrow perspective, a dissenting judge disagreed as to their application, basing an expectation of confidentiality on shared control within a family corporation. Importantly for present purposes, even if the parties had a duty to maintain confidentiality of information, they would not necessarily have had other fiduciary duties, including the core fiduciary duty of unselfish conduct discussed below.

D. UNEQUAL POSITION

A fiduciary duty cannot be based solely on disparities between the parties of sophistication, information or bargaining power. Where the problem is simply disparity of bargaining power, the appropriate remedy is to refuse to enforce the contract between the parties on the ground that it is unconscionable, rather than to enforce the contract and add a fiduciary duty to it. A broad fiduciary duty may not be appropriate even if one party is more sophisticated or informed than the other. For example, in *Burdett v. Miller*,[12] although Judge Richard Posner held that an accountant who held himself out as a financial advisor was a fiduciary under the facts of the specific case, he was careful to note that "we do not mean to suggest that every expert is automatically a fiduciary." Rather, he reasoned that a fiduciary duty was justified under the particular facts of the case because the accountant

> cultivated a relation of trust with [the client] over a period of years, holding himself out as an expert in a field (investments) in which she was inexperienced and unsophisticated. He knew that she took his advice uncritically and unquestioningly and that she sought no "second opinion" or even--until the end, when at last her suspicions were aroused--any documentary confirmation of the investments to which he steered her.[13]

In other words, even where there is a clear disparity between the parties as to expertise and sophistication, courts will impose a fiduciary duty only after analyzing the precise nature of the

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[10] 947 F.2d 551 (2d Cir. 1991).

[11] Id. at 569.

[12] 957 F.2d 1375, 1381 (7th Cir. 1992).

[13] *Id.*

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client's reliance on the alleged fiduciary. The relationship in *Burdett* obviously differs from the arm's length relationships between sophisticated parties that are common in investment banking.

II. APPROPRIATE APPLICATION OF FIDUCIARY DUTIES

Although the courts have used fiduciary language to describe many types of duties in a wide variety of situations, closer examination of the cases and consideration of underlying theory suggests that only one type of case is appropriate for the application of fiduciary duties in the strict sense of the term – that is, a situation in which the owner of property delegates open-ended management power over the property to a manager or fiduciary. This specific situation justifies requiring the entrusted party to refrain from self-interested conduct.

The most famous description of this duty is that of Justice Cardozo in *Meinhard v. Salmon*[14]:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions (citation omitted). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

As Justice Cardozo indicates, it is necessary to distinguish relationships in the "workaday world" in which "[m]any forms of conduct permissible . . . for those acting at arm's length" from relationships in which the parties are "bound by fiduciary ties" and forbidden from engaging in this ordinary commercial conduct. Delegating power to manage a business, as Meinhard did to Salmon, is such a situation. The beneficiary of the duty wants and expects the fiduciary to maximize the value of her property. However, the delegation of power means the beneficiary has little ability to force the fiduciary to perform or even to determine whether the fiduciary has performed adequately.[15]

The law's response in this situation is to empower the courts to supervise the fiduciary through the imposition of the fiduciary duty. However, courts are not in much better position than the beneficiary to determine whether the fiduciary has performed adequately. After all, courts are not business experts and a courtroom is not a good place to analyze business decisions.

Fiduciary duties address these problems by subjecting fiduciaries, at least in the absence of contrary agreement, to a duty under which "thought of self was to be renounced, however hard the abnegation," in Justice Cardozo's words. This means fiduciaries have a legal duty to forego

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[14] 164 N.E. 545, 546 (N.Y. 1928).

[15] See Robert Cooter & Bradley J. Friedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. Rev. 1045 (1991).

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any gain from the relationship except perhaps for some reasonable compensation. This clear-cut remedy saves courts from having to fully evaluate how well the fiduciary performed while significantly reducing the fiduciary's motive to cheat the beneficiary.

The problem with this remedy, as Justice Cardozo suggests, is that it is quite harsh and remote from conduct generally expected in the commercial world. It is accordingly necessary to carefully define the relationships in which the harsh fiduciary remedy is appropriate. Otherwise, imposing the default fiduciary duty may either unnecessarily require parties to incur the costs of contracting around the duty, or cause them to avoid potentially valuable relationships because the fiduciary duty makes the relationship too costly. Examples of relationships involving fiduciary-like delegation of control over property include the trustee-beneficiary relationship in a trust and the relationship between a manager and a publicly held corporation. On the other hand, a stringent fiduciary duty is unnecessary when an owner has significant ability to control or supervise the agent's conduct through other means.

As indicated above, fiduciary duties are appropriately viewed as "default" duties in the sense that they are subject to the parties' contrary agreement. This qualification is necessary because the wide variation in contractual relationships makes it impossible for courts or legislators to design a duty or set of duties that precisely fit all contexts. In particular, contracts differ across the critical dimension of the amount of control property owners delegate to managers, and therefore the extent to which fiduciary duties are necessary. Also, the parties may want to provide for exceptions to the strict duty of unselfishness to enable them, for example, to engage in particular types of business outside the duty. Even if a particular state law purports to impose a mandatory fiduciary duty, the parties may be able in effect to contract out of the duty by contracting for the application of another state's law. Moreover, the parties have flexibility to contractually define their relationships so that they are not "fiduciary" in nature.

III. STATE VS. FEDERAL LAW

Fiduciary duties are predominantly a matter of *state* law. State courts, or federal courts applying state law, have defined these duties and the situations in which they arise case by case over hundreds of years. There is no general federal common law on which courts can draw to determine when fiduciary duties should be applied, the precise nature of default fiduciary duties, or the interpretation or enforcement of contracts varying the default rules. Rather, to the extent fiduciary duties arise under federal law they do so under specific statutes. Courts applying these statutes must decide which elements of or approaches to fiduciary law to borrow from the states, and how to adapt this large body of law to suit the objectives of the federal statute at issue.

An example of the problems raised by federal fiduciary duties is Section 36(b),[16] added to the Investment Company Act in 1970 and recently interpreted by the Supreme Court in *Jones v. Harris*.[17] This section provides that the investment adviser of a registered investment company "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature" from the investment company or its investors. This provision forced the federal courts to develop for the first time a "fiduciary duty" for mutual

[16] 15 U.S.C. § 80a-35(b).

[17] 2010 WL 1189560 (S. Ct. March 30, 2010).

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fund investment advisers. Although the federal courts ultimately converged on the Second Circuit standard for applying the Section 36(b) duty articulated in *Gartenberg v. Merrill Lynch Asset Management, Inc.*,[18] the resulting litigation produced much smoke in terms of litigation costs without a single plaintiff victory at trial.[19] The Supreme Court in *Jones* ultimately vacated the Seventh Circuit's rejection of *Gartenberg,* but according to a concurring opinion did not "endorse the "*Gartenberg* standard" and "does not countenance the free-ranging judicial 'fairness' review of fees that *Gartenberg* could be read to authorize."[20] Thus, forty years after Congress added the "fiduciary duty" to the Investment Company Act, there is still no clear standard that meaningfully constrains mutual fund adviser fees.

The difficulties with a fiduciary duty under federal law reflect the broader problem of imposing inflexible, one-size-fits-all mandatory duties of any kind under the federal securities laws. These laws must keep pace with dynamic and constantly evolving financial markets. Congress recognized the limitations of the securities laws when it enacted the first federal securities statute, the Securities Act of 1933. In the words of William O. Douglas, chair of the SEC before serving on the Supreme Court, "[a]ll the Act pretends to do is to require the "truth about securities" at the time of issue, and to impose a penalty for failure to tell the truth. Once it is told, the matter is left to the investor."[21] A disclosure duty can adjust to myriad new structures and mechanisms by simply requiring firms to tell the truth about them. By contrast, enacting a new substantive obligation such as a fiduciary duty freezes this obligation into place, perhaps for decades as with Section 36(b). Although the SEC can promulgate new rules and exceptions, it is ultimately limited by the statute. There is therefore only so much the SEC can do to mitigate the problems created by statutory imposition of a mandatory fiduciary duty that is inappropriate for many situations to which it is being applied.

IV. APPLICATION TO INVESTMENT BANKING

The application of a mandatory fiduciary duty to investment bankers would be inappropriate for several reasons under the above analysis.

First, a general "fiduciary duty" applicable to a broad range of investment banker dealings would leave significant uncertainty as to the nature of the duties in each specific context. As discussed above, courts and commentators have applied the fiduciary concept to a wide variety of relationships and to embrace a number of different duties in those relationships, including due care, good faith, confidentiality and absence of self dealing. Thus, a prominent commentator has noted that "the fiduciary duty principle, both generally and in the context of

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[18] 694 F.2d 923, 928 (2d Cir. 1982).

[19] *See* M. Todd Henderson, *Justifying Jones* (November 10, 2009), forthcoming University of Chicago Law Review, U of Chicago Law & Economics, Olin Working Paper No. 491, available at http://ssrn.com/abstract=1499410.

[20] 2010 WL 1189560 at 12.

[21] William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 171 (1933).

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investment advice providers, is too amorphous to serve as a standard setter."[22] Among the many questions posed by the creation of a new fiduciary duty are:

(1) What types of conflicts of interest are permissible (particularly including whether investment bankers can participate in market-making, which inherently involves positions on both sides of the market)?

(2) What types of compensation investment bankers are entitled to earn?

(3) When are contracts waiving fiduciary duties, including those entered into by investment bankers' sophisticated clients, enforceable?

(4) Is disclosure of conflicts alone sufficient to avoid a fiduciary duty?

(5) What types of information must the fiduciary disclose?

(6) How material must omitted information be to trigger liability?

(7) To whom is the fiduciary duty owed (that is, to the issuers that are the investment bankers' clients, the issuers' shareholders, or the market as a whole)?

(8) What are the remedies for breach?

Second, the above analysis shows that a fiduciary duty in the properly narrow sense of refraining from self-dealing would be inappropriate in most investment banking situations. Although investment bankers may be delegated discretion by the customer, this rarely is the sort of complete delegation that justifies imposing what Justice Cardozo called "the punctilio of an honor the most sensitive." If the situation clearly does not call for such a duty, the courts would have to invent the appropriate duty out of a whole cloth without the benefit of contractual adjustment of statutory default rules as under state law.

In most, if not all, investment banking situations, disclosure duties are sufficient without resorting to inventing a new investment banker fiduciary duty. For example, in the situation alleged in the SEC's recent complaint against Goldman, Sachs & Co, Goldman was said to have "structured and marketed" a security to investors, particularly including a bank (IKB). To the extent there was any fiduciary-type delegation of discretion, it was to the collateral manager, ACA, which is not a defendant in the case and has not been accused of wrongdoing. Rather, the alleged wrongdoing in the case is Goldman's failure to disclose John Paulson's role in selecting the reference portfolio for the security. The SEC alleged violations of antifraud provisions in existing securities statutes arising from Goldman's incomplete disclosures regarding the portfolio selection process. If the facts are as alleged and the non-disclosures are material, Goldman may be held liable under existing law and no new fiduciary duty is necessary to create an obligation to disclose. On the other hand, if Goldman did not breach an existing duty to disclose material facts, there is no apparent justification for holding Goldman liable under *any* theory, including a

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[22] Barbara Black, *Fiduciary Duty, Professionalism and Investment Advice* at 3 (March 28, 2010), University of Cincinnati Public Law Research Paper, http://ssrn.com/abstract=1579719.

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fiduciary theory. This is true whether or not Goldman can be deemed to have an interest that conflicts with that of its customer.

In short, simply imposing an ill-defined "fiduciary duty" would result in massive uncertainty. Moreover, in the absence of a classic fiduciary relationship discussed above involving complete delegation of control, the parties should be able to act self-interestedly just as they do in general commercial dealings, subject to the contractual covenant of good faith and fair dealing. Where a contracting party is deemed to require protection, the federal securities laws generally should provide that protection through mandatory disclosure or antifraud rules.

Under some circumstances investment bankers might be subjected to new professional duties beyond pure disclosure. However, for the reasons discussed above, any such new duty should be articulated in detail and should not be imposed as part of a general fiduciary duty. The current version of the Restoring American Financial Stability Act calls for the SEC to study existing standards of care for broker-dealers and investment advisers who provide personalized investment advice and recommend securities to retail customers. This call for study reflects the fact that there is currently no well-developed set of federal fiduciary duties for either investment advisers or broker-dealers even in their dealings with retail customers. Clearly such additional study would be even more necessary before imposing new federal fiduciary duties in connection with investment bankers' advice at the wholesale level.

Finally, the arguments against fiduciary duties apply regardless of the nature of the security or instrument being sold. These instruments might involve new types of risks that customers do not well understand or create systemic risks that the dealer and customer do not internalize. More disclosure may be appropriate. However, a vague or inappropriate fiduciary duty would still not be the right way to deal with the situation. The broad application of strict fiduciary duties might discourage legitimate conduct. Conversely, the vagueness and ambiguity of the fiduciary duty might lead courts to permit conduct that should be forbidden, perhaps without appropriate disclosures.

Whatever problems Congress might find to exist in investment banking, fiduciary duties are the wrong tool for dealing with the problems.

V. CRIMINAL PENALTIES EXACERBATE THE PROBLEMS OF FIDUCIARY DUTIES

The above analysis of fiduciary duties applies irrespective of the nature of the remedy applied to breach of the duty. However, the application of criminal penalties significantly exacerbates the problems of applying inherently vague and ambiguous fiduciary duties. This is so even if criminal penalties are attached only to "willful" violations, since it is necessary to define what behavior is being engaged in "willfully." Some of these additional problems from criminal liability for fiduciary breach are discussed in the following sections.

A. VAGUENESS

As stated in Senator Specter's press release announcing this hearing, "a jail sentence is enormously different" from a mere civil liability or fine. The Fifth Amendment of our Constitution recognizes this difference by seeking to ensure that defendants are alerted to the

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precise nature of conduct that triggers criminal punishment. Although vague laws are always a concern, they are particularly problematic when they result in jail terms.

As discussed above, courts have applied fiduciary duties to many types of conduct. Unless the statute prescribing such duties is very clear, it will leave courts wide discretion in deciding what situations give rise to fiduciary duties and what those duties entail. Even if the statute precisely describes the situations to which the duty applies, this still may leave a lot of ambiguity, particularly if the duty applies outside the traditional range of fiduciary relationships. For example, Congress articulated the fiduciary duty under Section 36(b) of the Investment Company Act applied in *Jones v. Harris* to apply solely to investment advisers' role in setting their compensation. Yet despite this definition, the statute triggered decades of costly and fruitless litigation.

B. DETERRENCE

The press release and remarks on the Senate floor announcing this hearing emphasize that "criminal prosecutions are an effective deterrent." This may be true in general, but the effectiveness of criminal penalties depends on the conduct that is sought to be deterred being precisely defined in the statute. As discussed above, fiduciary duties have been used quite broadly to refer to a wide variety of conduct of obligations.

One effect of using criminal fiduciary duties to deter investment banker misconduct is that the vagueness of these duties may actually result in *less* deterrence of misconduct than would be accomplished by more precise remedies. This was noted in the 19th century by Jeremy Bentham, who argued that common law crimes failed to achieve effective deterrence. He called these crimes "dog law" because, similar to the way dogs perceived discipline by their owners, the judges made up crimes as they went along without adequately notifying potential miscreants of what conduct to avoid. A broad new fiduciary duty for investment bankers could fall into this category because, like common law crimes, courts would develop it a case at a time.

Under-deterrence also may result from the difficulty of proving criminal liability. Prosecutors may find it difficult to win cases under a willfulness standard and the criminal standard of proof beyond a reasonable doubt. This is particularly so if courts and prosecutors are wary of the social consequences of applying new fiduciary standards in a criminal context. For example, only a couple of criminal backdating prosecutions ultimately were successful despite reports of potentially very widespread misrepresentations, and although these cases involved conventional disclosure violations rather than a new and untried federal fiduciary duty. As a result, a new criminal fiduciary duty could divert prosecutorial resources from their more effective use in deterring conventional fraud to a lower-value pursuit of elusive criminal penalties.

In addition to the problem of under-deterring bad behavior, fiduciary duties may over-deter by threatening punishment even of socially valuable behavior. Given the seriousness of criminal prosecution, legitimate firms seeking profits over the long haul will give a very wide berth to behavior that poses even the slightest risk of putting them out of business or sending the individual employees to jail. This is clearly true for securities firms for which criminal prosecution might be a death sentence. Thus, the fact that civil remedies may be, as Senator

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Specter noted, merely a "cost of doing business" is actually a good thing to the extent that it avoids this over-deterrence effect of criminal penalties.

Over-deterrence may impose significant costs on society by inhibiting innovation. Firms may stick to the most established practices and financial instruments for which fiduciary standards have been well-developed in order to avoid liability risks through behavior whose risks are uncertain. Although new financial instruments and practices have inflicted harm on the market, they have also significantly added to the markets' liquidity and efficiency.

Some over-deterrence may be worth getting rid of socially costly behavior by irresponsible firms. However, these bad firms bent on destructive behavior may not be much deterred by the threat of new criminal penalties from breach of fiduciary duties. Irresponsible firms likely already are committing criminal fraud by lying about what they are doing.

At the same time, broad criminal liability for fiduciary breach might even turn good firms into criminals. A legitimate firm might unwittingly find that it may have committed a crime by possibly having breached a new fiduciary duty. The firm then might have an incentive to cover up its offense by committing criminal fraud. In other words, vague laws pose a risk of entangling firms in a web of guilt not unlike what enveloped the hapless protagonist of Kafka's *The Trial.*

C. ABUSE OF PROSECUTORIAL POWER

Broad criminal liability for breach of fiduciary duty could have the perverse effect of encouraging abuse of prosecutorial power. That is not to say that abuse of prosecutorial power is a widespread problem in society. Most prosecutors are honest and operate with great integrity. However, even the smallest increased risk of prosecutorial misconduct can be a serious social problem given the importance of an honest criminal justice system. Criminal penalties for corporate misconduct give rise to highly politicized trials in which the stakes for the prosecutors for their jobs and future careers are particularly high. At the same time, the high standard of proof required for a criminal conviction increases the prosecutors' incentive to cheat.

While a new corporate criminal liability increases prosecutors' incentive to cheat, criminal liability for breach of fiduciary duty gives them a powerful new weapon that is subject to potential abuse. Again in the backdating cases, judges dismissed trials and even threw out convictions in the face of evidence of prosecutorial misconduct, including threatening potential defense witnesses. Broad and vague criminal penalties for breach of fiduciary duty increase the range of threats prosecutors can make even against defendants and potential witnesses who reasonably believe their conduct was legitimate. For example, prosecutors might be able to increase their chances of success by using the threat of a fiduciary duty prosecution to get firms facing possible shut-down to put pressure on their employees to cooperate with prosecutors.

VI. CONCLUSION

Any proposal to impose new fiduciary duties on investment banking firms, and particularly one for criminal penalties for breach of any such duties, is very likely to be ill-advised, and should be adopted only after extensive study that takes into account the significant potential costs and risks discussed above. Such new duties and penalties almost certainly will have little or no effect in decreasing the level of fraud in the investment banking industry or

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reducing systemic risk in securities markets. On the contrary, these penalties may even increase risk and fraud by deterring efficient practices in the securities industry and reducing effective discipline of fraudulent behavior. Clearly in light of these potential dangers, new fiduciary duties and penalties require the most careful and extensive deliberation.

BIOGRAPHY

Professor Larry E. Ribstein is the Mildred Van Voorhis Jones Chair in Law, the Associate Dean for Research and Co-Director of the Program in Business Law and Policy at the University of Illinois College of Law. He is a graduate of the Johns Hopkins University and the University of Chicago Law School. In addition to full-time appointments in the law schools of University of Illinois, George Mason University and Mercer University he has visited at the law schools of the University of Texas, New York University, Washington University, Southern Methodist University and St. Louis University.

Professor Ribstein has taught business associations and securities law for 35 years. He is the author of leading treatises on limited liability companies (*Ribstein & Keatinge on Limited Liability Companies*) and partnership law (*Bromberg & Ribstein on Partnerships*), as well as two business associations casebooks (Ribstein & Lipshaw, *Unincorporated Business Entities,* 4th edition 2009 and Ribstein & Letsou, *Business Associations, 4th edition, 2003*). His books also include *The Sarbanes-Oxley Debacle* and *The Constitution and the Corporation* (both with Henry Butler), *The Law Market* (2009, with Erin O'Hara), *The Rise of the Uncorporation* (2010) and *The Economics of Federalism* (with Kobayashi). From 1998-2001 he was co-editor of the *Supreme Court Economic Review.*

Ribstein has written or co-authored approximately 150 articles on subjects including corporate, securities and partnership law, constitutional law, bankruptcy, film, the internet, family law, professional ethics and licensing, uniform laws, choice of law and jurisdictional competition.

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Consumer Federation of America

Testimony of
Barbara Roper, Director of Investor Protection
Consumer Federation of America

Wall Street and Fiduciary Duties:
Can Jail Time Serve as an Adequate Deterrent for Willful Violations?

Before the
Committee on the Judiciary Subcommittee on Crime and Drugs
U.S. Senate

May 4, 2010

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Chairman Specter, Ranking Member Graham and Members of the Committee:

My name is Barbara Roper. I am Director of Investor Protection of the Consumer Federation of America (CFA). CFA is a non-profit association of approximately 280 organizations founded in 1968 to advance the consumer interest through research, advocacy, and education. I appreciate the opportunity to appear before you today to discuss how imposing a fiduciary duty on Wall Street, and backing that duty with tough criminal sanctions, can enhance investor protection and market integrity.

Since I first joined the organization in 1986, CFA has been making the case that brokers who offer investment advice should be held to a fiduciary duty to act in the best interests of their clients. Our primary focus has been on strengthening protections for average, retail investors. But, as last week's hearing in the Permanent Subcommittee on Investigations graphically demonstrated, retail investors are not alone in needing enhanced protections. Institutional investors, once thought to be capable of looking out for themselves, also need protection from Wall Street's predatory ways.

We greatly appreciate your leadership in holding this hearing to explore what role an expanded and strengthened fiduciary duty can plan in providing that protection. In my testimony today, I want to start by discussing the fiduciary duty issue in the context of the current financial crisis. Then I will discuss how Wall Street abuses that contributed to the financial crisis relate to problems encountered by retail investors in their dealings with brokers. And, finally, I will discuss various options for strengthening protections for institutional and retail investors alike through adoption of an enhanced fiduciary duty.

Wall Street, the Financial Crisis, and Fiduciary Duty

While the factors that contributed to the financial crisis are myriad and mind-numbingly complex, the basic mechanics of the crisis are well established. Beginning in the late 1990s and early years of this decade, underwriting standards of mortgage lenders began to erode. By the middle of the decade, those standards had all but disappeared. Able to book an immediate and substantial profit selling their mortgages to be repackaged into securities, mortgage lenders no longer had to worry about whether borrowers were likely to repay. And the investment banks that purchased those mortgages were equally unconcerned as long as they could structure the mortgage-backed securities in ways that allowed them to win the AAA credit ratings that were essential to their sale. Indeed, when the supply of mortgages couldn't keep pace with Wall Street demand, they developed even more complex structures – collateralized debt obligations (CDOs) based on lower tranches of mortgage-backed securities, CDOs-squared based on lower tranches of CDOs, and synthetic CDOs based on derivatives designed to mimic the performance of particular mortgage pools. And everyone in the chain, from the loan originator to the rating agencies to the Wall Street bankers packaging and selling the securities, was raking in record profits, right up to the point when the bubble burst, housing prices dropped, and the once AAA-rated securities turned toxic.

Financial institutions that had loaded up on the mortgage-backed securities because of their combination of high ratings and high returns suddenly faced devastating losses. At many

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institutions those losses were magnified by excessive use of leverage and reliance on short-term financing. When Bear Stearns stumbled and Lehman Brothers fell, fear gripped the markets. Lack of transparency meant no one knew the nature and extent of risks various players were exposed to. And the fall of Lehman demonstrated how the use of OTC derivatives purportedly to hedge risk had instead both magnified those risks and spread them throughout the financial system.

In the wake of the crisis, some on Wall Street have expressed at least a mild sense of regret for their industry's role. In testimony before the Financial Crisis Inquiry Commission, for example, Goldman Sachs CEO Lloyd Blankfein expressed dismay over "the rationalizations that were made to justify that the downward pricing of risk was justified."[1] And he acknowledged that the firms had rationalized "because a firm's interest in preserving and growing its market share, as a competitor, is sometimes blinding – especially when exuberance is at its peak." Mr. Blankfein expanded on that explanation in his statement last week before the Permanent Subcommittee on Investigations, saying: "What we and other banks, rating agencies and regulators failed to do was sound the alarm that there was too much lending and too much leverage in the system -- that credit had become too cheap."[2] What comes through from these statements, however, is that Wall Street, while accepting some responsibility, views its role as at best secondary. They were simply market makers, according to this account, bringing together buyers and sellers, and providing liquidity to the markets – doing "God's work," if you will.

The evidence, however, suggests a much deeper culpability. Wall Street's blame is not simply that they failed to recognize risk building up in the system, or failed to adequately sound the alarm when they did recognize that risk, or failed to warn their customers against doing things that were harmful to those customers' interests. Wall Street's blame is that, in their pursuit of the profits that fed their multi-billion-dollar bonus pools, they abandoned any sense of responsibility to ensure that the products they developed and sold served some economic utility or served their clients' interests or benefited anything but their own bottom line.

This reality was on full display in last week's hearing before the Permanent Subcommittee on Investigations. As the Subcommittee noted in its release in advance of the hearing, "Goldman and other investment banks played a crucial role in building and running the conveyor belt that fed toxic mortgages and mortgage-backed securities into the financial system." Documents released by the Subcommittee call into question Goldman's efforts to portray itself simply as a market maker serving client needs:

- When discussing the fact that a customer was interested in taking a short position in Anderson Mezzanine Funding 2007-1, a synthetic CDO that Goldman had assembled,

[1] Testimony of Lloyd C. Blankfein, Chairman of the Board and Chief Executive Officer, Goldman Sachs Group, Inc., before the Financial Crisis Inquiry Commission, January 13, 2010.
[2] Testimony of Lloyd C. Blankfein, Chairman of the Board and Chief Executive Officer, Goldman Sachs Group, Inc., before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate, hearing on "Wall Street and the Financial Crisis: The Role of Investment Banks," April 27, 2010.

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one executive noted that Dan Sparks, the head of Goldman's mortgage department, "might [want] to preserve that ability for Goldman.[3]

- Another employee described in his performance review how he had "saved the firm hundreds of millions of dollars" by refusing client requests to "support the GSAMP program," which was a Goldman Sachs subprime mortgage-backed security program.[4]

In the first instance, Goldman appears to have been putting its own proprietary trading interests ahead of the interests of its clients. In the second, it appears to have walked away from the role of market maker as buyer or seller of last resort in order to protect its own bottom line.

Particularly relevant to a discussion of how fiduciary duty might affect Wall Street practices is the description of Goldman's actions as it sought to reduce its own exposure to and then bet against a mortgage market it viewed as headed for serious trouble. According to Subcommittee documents, Goldman began in late 2006 to instruct its sales force to sell mortgage-backed securities and CDOs "containing or referencing high risk assets that Goldman Sachs wanted to get off its books."[5] Various emails among Goldman employees refer to the investments "as a way to distribute junk that nobody was dumb enough to take first time around" and to certain clients as "too smart to buy this junk."[6] One employee describes the "real bad feeling across European sales about some of the trades we did with clients," trades that had cost clients more than $1 billion in losses on just five deals. Adding to the resentment in the latter case, the team did not feel it had been adequately rewarded "for getting this business done" considering all the money it "ended making/saving the firm."[7]

The cynical disregard for client well-being exposed in certain Goldman Sachs emails is hardly new to Wall Street. Similar conduct was on display as far back as the early 1990s, when Bankers Trust took supposedly "sophisticated" investors, such as Gibson Greeting, Inc. and Procter & Gamble, to the cleaners selling them risky interest rate swaps based on complex formulas that the companies clearly didn't understand. In his 2003 book *Infectious Greed*, Frank Partnoy offers the following illustration of the culture at Bankers Trust:

> As one former managing director put it, "Guys started making jokes on the trading floor about how they were hammering the customers. They were giving each other high fives. A junior person would turn to his senior guy and say, 'I can get [this customer] for all these points.' The senior guys would say, 'Yeah, ream him.'"[8]

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[3] Opening Statement of Sen. Carl Levin, U.S. Senate Permanent Subcommittee on Investigations Hearing, "Wall Street and the Financial Crisis: The Role of Investment Banks," April 27, 2010.
[4] Ibid.
[5] Chris V. Nicholson, "Deal Book: The Goldman Emails, or How to Sell Junk," *The New York Times*, April 28, 2010.
[6] Ibid.
[7] Ibid.
[8] Frank Partnoy, *Infectious Greed, How Deceit and Risk Corrupted the Financial Markets*, Henry Holt and Company (New York), 2003, p. 55, citing Brett D. Fromson, "Guess What? The Loss is Now ... $20 Million: How Banks Trust Sold Gibson Greetings a Disaster," *Washington Post*, June 11, 1995, p. A1.

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Nor was Goldman Sachs alone among investment banks in putting its own interests ahead of those of its customers. A *Washington Post* account of CDO sales practices at Merrill Lynch sounded many of the same themes:

> The CDO alchemy involved extensive computer modeling, and those who wanted to wade into the details quickly found that they needed a PhD in mathematics.
>
> But the team understood the goal, said one trader who spoke on condition of anonymity to protect her job: Sell as many as possible and get paid the most for every bond sold. She said her firm's salespeople littered their pitches to clients with technical terms. They didn't know whether their pitches made sense or whether the clients understood.[9]

Another example of Wall Street's corrupt culture can be found in the sale of derivatives to governments across the country and around the world. The Greek debt scandal is the most notorious, but a recent account in *The New York Times* describes how municipalities, school districts, sewer systems and other tax-exempt debt issuers from around the country "are ensnared in the derivatives mess" because of municipal swaps that blew up when the credit markets collapsed.[10] Even before that collapse, the U.S. Justice Department had reportedly launched a criminal investigation looking at whether J.P. Morgan and others conspired to overcharge governments on "swaptions," which are options that grant the owner the right but not the obligation to enter into a swap.[11] And a number of government bodies have filed lawsuits challenging excessive fees and other features of the transactions.[12]

A more detailed look at how Wall Street profited at taxpayer's expense can be found in the SEC's probe into J.P. Morgan Chase & Co.'s sale of derivatives to Jefferson County, Alabama to finance a new sewer system. In November, the bank agreed to a $722 million settlement that required it to pay a fine of $25 million, to pay $50 million to the county to assist displaced county employees, residents, and sewer ratepayers, and to cancel $647 million in fees it had charged the county to unwind the derivatives transactions in question.[13] The charges that were settled involved pay-to-play allegations and millions in bribes that landed one county official in jail. Bad as the bribery and corruption were, the real scandal is the underlying conduct, in which J.P. Morgan sold the county billions of dollars of derivatives that profited J.P. Morgan handsomely but brought the county to the brink of bankruptcy.

Over the course of the sewer financing project, Jefferson County did 23 swap deals, as described in an account in *Rolling Stone*.[14] At one point, it reportedly had more outstanding

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[9] Jill Drew, "Frenzy," *Washington Post*, December 16, 2008, p. A1.
[10] Gretchen Morgenson, "The Swaps That Swallowed Your Town," *The New York Times*, March ??, 2010.
[11] Naked Capitalism, "JP Morgan Under Criminal Investigation for Jefferson County, Other Swaps," Oct. 29, 2008, quoting a *Bloomberg* article.
[12] Ibid.
[13] Securities and Exchange Commission, "J.P. Morgan Settles SEC Charges in Jefferson County, Ala. Illegal Payments Scheme," November 4, 2009.
[14] The description in this paragraph comes from an article by Matt Taibbi, "Looting Main Street: How the nation's biggest banks are ripping of American cities with the same predatory deals that brought down Greece," *Rolling Stone*, March 31, 2010.

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swaps than New York City. In 2008, however, a series of penalties built into the swaps deals began to kick in, including one related to failed insurance on the deal that forced the county to pay off $800 million of its debt in four years instead of 40. As a result, the annual payment on Jefferson County's debt jumped from $53 million in 2008 to $636 million in 2009. There were other problems with the swaps, including a mismatch between the interest rates paid to the county and those it was required to pay out that left it getting lower payments from J.P. Morgan than it was forced to pay out to bondholders. When the county was unable to make its swap payment to J.P. Morgan, the bank cancelled the deal, charging the $647 million termination fee that it was required by the SEC settlement to relinquish.

As a result of all this, Jefferson County has seen its credit rating slashed. It has laid off workers, increased sewer bills by more than 400 percent, and it is still weighted down with billions in debt county taxpayers will be paying off for decades to come. As Taibbi concludes in his account of the fiasco:

> The destruction of Jefferson County reveals the basic battle plan of these modern barbarians, the way that banks like JP Morgan and Goldman Sachs have systematically set out to pillage towns and cities from Pittsburgh to Athens. These guys aren't number-crunching whizzes making smart investments; what they do is find suckers in some municipal-finance department, corner them in complex lose-lose deals and flay them alive. In a complete subversion of free-market principles, they take no risk, score deals based on political influence rather than competition, keep consumers in the dark – and walk away with big money.

A respected financial blogger writing about another deal involving J.P. Morgan and an Alabama government body, makes a similar point. Working from an account in a *Bloomberg* article, the writer notes that, if correctly described, "this looks like a deal almost certain to have turned out badly for the county," adding:

> This is not at all uncommon for OTC derivatives, where even if the transaction in theory has merit, the fees charged are so high as to make the deal uneconomical to the client. But clients almost universally lack the skills to properly model the deal to figure this out. Most deals don't blow up as spectacularly as this one did, so most clients never figure out they were had.[15]

This point about institutional clients' lacking the skills to evaluate the complex investments recommended to them arises in the CDO context as well and is directly relevant to the question of what duty the broker should owe those clients. Quoted in an article in *Knowledge@Wharton*, Greenwich Financial Services President William Frey had this to say about the near impossibility of evaluating complex CDOs for the typical institutional client:

> Evaluating the CDO would require studying each mortgage security in it, altogether comprising many thousands of mortgages – perhaps hundreds of thousands of them … A thorough evaluation would require studying the loan-to-value ratios of the mortgages, the geographical locations of the homes,

[15] Ibid.

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> unemployment rates, local default and foreclosure rates, and other factors determining how many homeowners were likely to default.
>
> "For all practical purposes, unless you have the most sophisticated software on the market, which few investors have, you rely on the ratings agencies," Frey says.

These accounts comport with something CFA has suggested for some time: that the complexity and opacity of modern financial products has rendered obsolete the notion that typical institutional investors are capable of looking out for their own interests. That view was also voiced by SEC Commissioner Luis Aguilar in a speech last Thursday before the Investment Adviser Association. A longtime champion of holding brokers to a fiduciary duty when they give advice, Commissioner Aguilar said: "It is readily apparent from recent Commission enforcement cases — such as the cases involving auction rate securities — that all investors, including institutional investors, need the protection of the fiduciary standard."[16]

Fiduciary Duty and Retail Investors

Although the focus of this hearing is on fiduciary duty as it relates to the financial crisis, it is worth taking a moment to examine the issue as it relates to retail investors as well. After all, the abuses described in the Permanent Subcommittee on Investigations hearing mirror, albeit on a far larger scale, the kind of problems average retail investors encounter in their everyday dealings with broker-dealers. The most common problem faced by retail investors is sale of products to benefit the broker's bottom line rather than the client's financial well-being. In a fairly typical example, a broker might recommend a particular mutual fund or 529 plan or variable annuity, not because it has the lowest fees, the best management, or the best allocation of assets to match the client's investment goals, but rather because it pays the highest commission or makes revenue sharing payments to the firm. As in the Goldman case, investors can also be harmed when brokers sell them investments they are trying to unload from their own inventory, or when they sell products in which the firm has a direct financial stake. While the issues at stake may not seem dramatic when compared with Wall Street conduct that rocked the global economy, the impact on individuals can be substantial, since even small differences in cost or performance can make large differences in accumulated savings over the life of a long-term investment.

There is one notable difference between the abuses targeting institutional and retail investors. Institutional clients of Goldman Sachs and J.P. Morgan and others may not have realized how massive the conflicts were between their interests and those of the investment banks, or how badly they were being taken, but they likely did realize or should have realized that the firm was not acting as their trusted adviser. Retail investors are routinely lured into making precisely that mistake, however, by brokers who call themselves financial advisers, offer services such as "retirement planning" or "investment planning" that appear to be advisory in nature, and market those services based on the advice offered. Not surprisingly under these circumstances, the average investor cannot distinguish between brokers and advisers and

[16] Speech by SEC Commissioner Luis Aguilar, "Protecting Investors by Requiring that Advice-Givers Stay True to the Fiduciary Framework," before the annual conference of the Investment Adviser Association, April 29, 2010.

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certainly doesn't recognize that their "financial adviser" operates under a lower legal standard than an "investment adviser."[17] Lured into believing they are in a relationship of trust, investors are unlikely to be on their guard against practices that may pit their interests against the broker's.

Suitability vs. Fiduciary Duty

When talking about imposing a fiduciary duty on brokers, it is useful to start with an understanding of the current lay of the land. Under the Securities Exchange Act and rules of the Financial Industry Regulatory Association (FINRA), the legal obligation of brokers when selling securities is to make suitable recommendations and to know enough about their customers to determine what would be suitable. As fiduciaries, investment advisers must have a reasonable basis for believing their recommendations are in the best interests of the customer.[18] In addition, an investment adviser must disclose all material information, including information about conflicts of interest that could bias their recommendations. While a broker is not permitted to mislead the investor, brokers do not have the same obligation as advisers to provide all information that an investor might view as material to the transaction.[19] Finally, because of the way the SEC has interpreted the broker-dealer exclusion from the Investment Advisers Act over the years, most investment advice offered by brokers is not subject to regulation under the Advisers Act. As long as the advice is offered in connection with and reasonably related to a securities transaction, it is viewed as "solely incidental" to that transaction and is excluded from regulation under the Advisers Act.

The Goldman CDO deals described in the investigation of the Permanent Subcommittee on Investigations offer a perfect model for discussing the difference between suitability and fiduciary duty. Leaving aside legal questions about what Goldman should have disclosed in the Abacus case, the firm has at least a plausible claim that it when it was selling various CDOs to its customers, it was not acting as an investment adviser and thus subject at most to a broker's suitability obligations.[20] Under a suitability standard, and particularly as applied in the institutional investor context, the broker arguably has little obligation beyond determining that the investor meets the standards for participating in a particular type of deal and that the deal in question has characteristics consistent with what the investor is seeking – for example, a security that offers exposure to the mortgage market and a particular credit rating. No one has suggested, that I am aware of, that Goldman violated that standard.

So what might the various transactions described in that hearing looked like if subject to a fiduciary duty?

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[17] See, for example, Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, and Farrukh Suvankulov, RAND Institute for Civil Justice, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,* commissioned by the Securities and Exchange Commission, 2008.

[18] While the fiduciary duty is not explicit in the Investment Advisers Act, the Act has been interpreted by the Supreme Court to impose a fiduciary duty.

[19] This is particularly true in the world of private placements, where sophisticated investors are deemed to be capable of fending for themselves and not in need of the full protections of the regulated marketplace.

[20] That was the view expressed by Goldman's Fabrice Tourre when asked by Sen. Susan Collins whether he felt he had a fiduciary duty to act in the best interests of his clients.

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- Goldman is accused of structuring certain securities specifically so that it could move risks off its own balance sheet and bet against the securities. It is hard to imagine how Goldman could recommend securities to customers that it had structured specifically for this purpose, though it is just barely conceivable that there might be very narrow circumstances under which it would be in a customer's best interests to purchase such securities. Without question, however, the wholesale sale of such securities engaged in by Goldman, according to the Subcommittee investigation, would not be possible under a fiduciary duty.

- Even if a firm believed it was permissible under a fiduciary duty to sell securities it had designed in order to short, it could not sell such deals to clients without disclosing its role in the transaction, its reasons for believing the securities were nonetheless a good investment for the client, and the risks they could be exposed to through the deal. Providing boilerplate disclosures that the firm might be either long or short in the deal would not be adequate.

- Under a fiduciary duty, there would have been no ambiguity about Goldman's responsibility to tell investors in the Abacus deal about the role hedge fund manager John Paulson had played in selecting the mortgage bonds underlying the CDO. That would clearly be material information that a fiduciary would be required to disclose.

- Recognizing the conflict of interest it entails, a fiduciary duty places strict limits around principal or proprietary trading. It requires enhanced disclosures and client permission to ensure that the client fully understands and consents to the conflicts in the arrangement.

- As for the swaps deals at the heart of the Jefferson County case, it is hard to imagine how J.P. Morgan could have sold most of the deals at all, since they put the county at severe risk of bankruptcy. At the very least, it would have had to eliminate features – such as the mismatch in interest rates – that greatly increased the county's risk.

- In selling swaps to municipalities, a fiduciary obligation to disclose all material information could force disclosure of such information as the maximum payment the municipality could be exposed to and the financial interest of the firm in the transaction. Given widespread allegations of over-charging in this market, bringing these charges out of the dark would be a significant benefit in and of itself.

Enhancing the Fiduciary Duty to Address Abuses that Contributed to the Crisis

As the above discussion should make clear, imposing a fiduciary duty on Wall Street firms could help to rein in many of the most egregious practices that have been exposed as we learn more about the causes of the financial crisis. To accomplish that goal, Congress would need to impose a fiduciary duty on brokers and swaps dealers comparable to the duty investment advisers have to their clients. Beyond that, Congress would need to decide when and to what that duty should apply.

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Typically, a fiduciary duty flows from a relationship of trust or reliance. A logical approach, therefore, is to apply the duty to advice, whether about securities, commodities, or derivatives. In defining what constitutes advice, it would be important to include recommendation of products, particularly where the broker or swaps dealer has a decided information advantage. A further question is whether the fiduciary duty should apply to all such recommendations, or only to transactions with a certain subset of institutional investors. There is a strong case to be made for applying the fiduciary duty to any recommendation, on the grounds that recommendations as a general matter should be made in the best interests of the customer. If Congress chose to apply the fiduciary duty in more limited circumstances, the most logical group to identify as needing the fiduciary protection would be government entities, pension funds, and non-profit organizations. Another option would be to leave it to the regulators to determine what groups need the fiduciary protection and under what circumstances.

A third question to address is what obligations would be triggered by a fiduciary duty in various circumstances. It is not necessary or even necessarily desirable to define those duties explicitly. The fiduciary duty is a facts-and-circumstances-based standard. The obligations it imposes depend on the nature of the relationship and, in particular, the degree of reliance. This makes it well suited to circumstances in which customers would display widely varying degrees of sophistication and independence. A model could be the approach taken under the Investment Advisers Act, where some specific obligations are spelled out by rule, but those rules serve to clarify rather than limit the extent of the duty.

Current Legislative Proposals

When the Obama Administration released its White Paper on financial regulatory reform nearly a year ago, it included a recommendation to hold brokers to a fiduciary duty when they give investment advice. The focus of that proposal was on the need to enhance protections for retail investors, but legislative proposals put forward to enact that recommendation have the potential to extend its protections to institutional investors. The following is a brief overview of proposals put forward to date.

House Legislation: The financial regulatory reform bill that passed the U.S. House of Representatives in December (H.R. 4173, the Wall Street Reform and Consumer Protection Act) includes a provision on fiduciary duty. Section 7103 of the bill directs the SEC to adopt rules imposing a standard of care for brokers when they give personalized investment advice to retail customers that is the same as the standard imposed on investment advisers under the Investment Advisers Act. The heading of that section specifically identifies that standard of care as a fiduciary duty, which is consistent with court interpretations of the duty investment advisers owe their clients. While the provision requires the SEC to adopt rules with respect to advice to retail investors, it permits the agency to extend the fiduciary duty to "such other customers as the Commission may be rule provide." As such, this provision authorizes but does not require the Commission to adopt rules imposing a fiduciary duty on brokers when they give investment advice to institutional investors or some subset of institutional investors. The section includes two provisions designed to clarify that certain practices common among brokers are permitted under the fiduciary duty: 1) charging commissions or other transaction-based compensation and 2) selling from a limited menu of products or selling proprietary products. Although the

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legislation directs that the standard must be "no less stringent than the standard applicable to investment advisers under section 206(1) and (2)" of the Advisers Act, the SEC would have considerable leeway in defining the fiduciary duty and determining how it should apply in various different contexts.

Dodd Discussion Draft: When Senate Banking Committee Chairman Chris Dodd released his discussion draft of regulatory reform legislation last November, he adopted a different approach to the issue. Section 913 of the draft bill would have removed the broker-dealer exclusion from the Investment Advisers Act. Under that approach, brokers would have been subject to regulation under the Investment Advisers Act (and held to a fiduciary duty under that act) when they gave advice about securities for compensation. Their coverage under the act would have no longer hinged on whether the advice in question was "solely incidental" to their activities as brokers. Because the Investment Advisers Act does not distinguish between retail and institutional investors in its application of the fiduciary duty, this approach would have automatically imposed a fiduciary duty on brokers in their dealings with institutional clients when those dealings included advice about securities. Like the House bill, the Senate discussion draft included provisions to clarify that transaction-based compensation and sale from a limited menu of products would be permitted. It also included a provision designed to permit principle trading by brokers, subject to a requirement that they have adequate protections in place to ensure that the trades were in the best interests of their customers.

Senate Bill: Before the regulatory reform bill (S. 3217, the Restoring America's Financial Stability Act) was reported out of the Senate Banking Committee, the fiduciary duty provision had been significantly eroded, to the point where it no longer offered any new protections. The original language had been stripped and replaced with a requirement that the SEC study "gaps and overlaps" in regulation between brokers and investment advisers. Much of the focus of the study is on regulatory resources rather than on the duty owed to investors. Moreover, while the legislation requires the SEC to initiate a rulemaking to eliminate any gaps and overlaps in regulation, it does not provide the agency with the authority necessary to impose a fiduciary duty on brokers when they give investment advice. In short, as currently written, the bill requires the SEC to waste time and resources to study an issue it has already studied extensively and denies it the authority it needs to eliminate a known gap in investor protection. Strengthening this provision of the bill has been identified as a priority by consumer and investor advocates and state regulators.

Akaka-Menendez Amendment: Senators Daniel Akaka and Robert Menendez have announced their intention to offer an amendment on the floor regarding fiduciary duty. Their amendment would substitute the House language for the current study language in the Senate bill. As such, it would require a rule to impose a fiduciary duty on brokers when they give personalized advice to retail investors and permit the agency to extend that protection to other classes of investors as it sees appropriate. That amendment has been endorsed by CFA, AARP, Americans for Financial Reform, the North American Securities Administrators Association, the National Association of Secretaries of State, and the National Governors' Association, as well as various investment adviser and financial planner professional organizations.

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Dodd-Lincoln Derivatives Bill: The derivatives reform provisions worked out between the Senate Agriculture and Banking Committees also include a provision on fiduciary duty. Specifically, Section 731 of the bill imposes a fiduciary duty on swaps dealers who give advice about a swap to or enter into a swap with a government entity or a pension plan, endowment, or retirement plan. Because it covers advice about derivatives, this provision fills an important gap necessary to reach the full range of Wall Street abuses that contributed to the crisis. (All of the other provisions only apply the fiduciary duty to investment advice, which by definition means advice about securities.) Furthermore, because derivatives are among the most complex and opaque investments, they represent an area where all but the most sophisticated institutional investors are at an extreme disadvantage in their dealings with Wall Street and most in need of fiduciary protection.

As with any regulation, imposing a fiduciary duty on brokers will be only as effective as the regulatory enforcement that backs it up. Without real enforcement teeth behind it, any increase in regulatory standards is likely to have limited benefits. After all, an investment bank that is willing to engage in flagrant violations of pay-to-play rules is unlikely to be terribly conscientious about ensuring that its recommendations are in the best interests of customers. Regulators need to be prepared to impose fines that are commensurate with the damage to customers. But, given the potential profits at stake in this area, fines are rarely going to be heavy enough to serve as a true deterrent. Holding out the possibility of jail time for willful violations, as the title of this hearing suggests, has the potential to provide that deterrent. By tying criminal sanctions to willful violations, such an approach would set an appropriately high bar to ensure that only the most egregious abuses result in jail sentences. Combined with an approach that imposes fines that cannot be dismissed as a cost of doing business, holds supervisors accountable for the actions of those they supervise, and de-licenses individuals who commit serious violations, imposing criminal sanctions for fiduciary violations could serve as a truly effective deterrent to the kind of abuses that helped to bring about our current financial crisis.

Conclusion

In examining the root causes of the financial crisis, many have commented on the change in culture on Wall Street. Although they may ascribe it to different causes – the decision of investment banks to go public or an emphasis on proprietary rather than customer services as a major revenue source – most long-time observers of the industry appear to agree that Wall Street firms no longer exist primarily to serve the needs of their customers. Indeed, the Goldman Sachs executives who testified before the Permanent Subcommittee on Investigations seemed at times to be bewildered by suggestions that anyone would expect them to do so. They appear to live in a world in which everyone simply takes it for granted that products are designed to serve no economic purpose except to make the firm money, customers who can't look out for their own interests are viewed as sheep waiting to be shorn, and the only obligation they recognize is the obligation to maximize firm profits. While no single approach should be viewed as a panacea, expanding the fiduciary duty to brokers and their dealings with institutional investors could force a significant and beneficial change in the culture on Wall Street. Average retail investors, who in the crisis have suffered the collateral damage of the investing mistakes of institutional investors, would benefit indirectly. But, in looking to strengthen protections for institutional investors, we must not leave protections for retail investors on the cutting room floor. That is why passage of

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the Akaka-Menendez amendment must be part of any effort to strengthen fiduciary duty and must be included in any comprehensive financial regulatory reform bill.

Thank you again for inviting me to testify here today. I look forward to answering any questions you may have.

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Testimony of Damon A. Silvers

Policy Director and Special Counsel

American Federation of Labor and Congress of Industrial Organizations

Senate Committee on the Judiciary

Subcommittee on Crime and Drugs

Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?

May 4, 2010

Good morning Chairman Specter and Ranking member Graham and members of the Committee. My name is Damon Silvers, I am the Policy Director of the AFL-CIO and Special Counsel to President Trumka. I also serve as the Deputy Chair of the Congressional Oversight Panel for the Troubled Asset Relief Program (TARP). My testimony before this Committee is on behalf of the AFL-CIO and not on behalf of the Congressional Oversight Panel, its staff or its chair.

The financial crisis that began in 2007 and reached its peak, hopefully, in the fall of 2008, together with the global economic crisis that followed in its wake, had a devastating effect on working Americans. The U.S. economy lost eight million jobs, during a period when just keeping up with population growth required that our economy create 3 million jobs. Pension funds saw their asset values decline close to $3 trillion, a drop of 30%, driven by broad equity market declines in the 40% range. A wide variety of investment products turned out not to perform as advertised—from debt instruments that turned out to be tied to subprime mortgages, to hedge funds that turned out to offer beta performance

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at alpha prices, to lifestyle funds that turned out not to be protected from market risk any more than an all-equity fund. Recent market gains have yet to restore funds to their pre 2007 levels.

Mass home foreclosures, which not so long ago were a distant memory of the Great Depression, now seem to be a permanent feature of American life. According to the Congressional Oversight Panel's April report, more than 6 million homes are at risk of foreclosure as of February, 2010, with foreclosure filings running at a rate of close to 3 million a year and showing no signs of slowing down.

Finally, the American public had to foot the cost of rescuing the financial system. That rescue took the form of the TARP, almost free credit from the Federal Reserve System, and Federal Reserve System purchases of a variety of long term notes, most prominently mortgage backed securities issues by FNMA and FHLMC ("Fannie and Freddie"). It is difficult to price the full cost of government support for the financial system. While estimates of the cost of TARP from the CBO have shrunk from an initial estimate of more than $356 billion to currently less than $110 billion, there is no question in my mind that in part this is a consequence of setting short term interest rates at effectively 0%, combined with allowing banks and other financial actors to be less than aggressive in writing down impaired assets such as mortgage backed securities and second mortgage loans. It seems likely to me that while this approach makes TARP more profitable, it harms our economy at significant cost to the public.

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Effectively, in the space of about a year and a half, we went from a period when financial institutions were contributing 40% of the total profits of the S&P 500, to a moment when the nation's large financial institutions were (with a few exceptions) effectively insolvent. The nature of financial institutions is that they are not short term entities. The asset side of their balance sheets contain a wide variety of long term obligations, together with reserves to account for the losses associated with those assets. Thus a sudden change in the state of the banks from hyper-profitability to bankruptcy strongly suggests that there were problems with the banks' financial reporting during the period of hyperprofitability.

As a general matter, the AFL-CIO believes that proper structuring and implementation of financial regulation is key to protecting the public from the consequences of financial boom and bust cycles. We have always been skeptical of the line that we heard from then President Bush after Enron that everything was fine, just a few bad apples in the barrel that needed to be weeded out and prosecuted. We said then, and we repeated during this most recent and most severe financial crisis that the real problems were structural—the rise of unregulated shadow markets in first energy and then credit derivatives, the dismantling of the protective structures of Glass Steagall, the weakening of our system of investor protections through the Central Bank of Denver case that gave effective immunity to investment banks from civil securities litigation, and the rise of unregulated market actors like hedge funds and private equity funds. In that sense jail time, or the threat of jail time, for willful acts is not an adequate deterrent for financial misconduct, nor is the criminal law in and of itself adequate to police our financial system.

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However, we also believe that the fundamental fairness of our society is at issue when we look at the application of the criminal law to securities fraud and other types of business cases. Most Americans live in a world where the criminal law is a real form of accountability looming in the background. We incarcerate more Americans as a percentage of our population than any other advanced economy. We imprison significantly more Americans than we did in 1970 as a percentage of our population. Yet there is a public perception in the wake of the events of 2008 that a small number of wealthy and powerful Americans did vast damage to our country and to the lives of millions of families with relatively no personal consequences.

Recently we have seen action by the Securities and Exchange Commission on a major case related to the financial crisis involving Goldman Sachs, and the press is reporting that the Justice Department has opened a criminal investigation. The legal arguments associated with this case have revealed a paradox with implications for the criminal law. Many Americans seek financial advice from their stock brokers in much the same way we seek legal advice from our personal attorney or medical advice from our doctor—in the expectation that the advice given will be in our interest as client or patient. Yet the reality is that the legal obligations of a broker are simply limited to recommending securities that are suitable and reasonable to their clients—not putting their clients' interests first. There is also no obligation for brokers to avoid or disclose conflicts of interest.

The AFL-CIO supports a clear fiduciary standard for both broker dealers and investment advisors. I have attached to this testimony a letter from the Chairman of the Securities

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and Exchange Commission to Chairman Dodd of the Senate Banking Committee which discusses this issue in further detail.

In the context of adopting such a clear uniform standard, Congress should adopt companion language in the criminal code addressing willful breaches of fiduciary duty by brokers, much as the criminal code addresses willful acts of securities fraud or intentional breaches of fiduciary duty in the ERISA context.

There is another gap in our system of accountability for Wall Street, a gap you Mr. Chairman have taken the lead in addressing—and that is the area of aiding and abetting securities fraud. Up until the Supreme Court's decision in the Central Bank of Denver case in the mid-1990's, investors had the right to seek damages from investment banks and others who helped public companies commit securities fraud.[1] Following that decision, the lower courts found that in cases of heightened culpability, called "scheme liability" cases, third party actors could still be held accountable by their victims. This position was overturned by the Supreme Court in its Stoneridge decision, leaving a legal landscape where a person may be sued for aiding and abetting a hold up of a gas station but not for aiding and abetting a multi-billion fraud like Enron that cost thousands of people their jobs and retirement savings.[2]

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[1] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A. 511 US 164, 114 S. Ct. 1439, 128 L.Ed. 2d 119 (1994).
[2] Stoneridge Investment Partners v. Scientific Atlanta, 552 U.S. 148, 128 S.Ct. 761, 169 L.Ed.2d 627 (2008).

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While the aiding and abetting problem is a civil issue and not a criminal issue, it has consequences for the enforcement of the criminal securities laws. Throughout the history of the securities laws, the Securities and Exchange Commission has recognized that its resources and those of the Justice Department are inadequate by themselves to police the vast U.S. securities markets. Consequently, effective deterrence of both civil and criminal acts has always been in part reliant on the ability of investors themselves to pursue those who defraud them, and thus to draw the attention of the Securities and Exchange Commission and the Justice Department. This chain of events simply does not occur when private parties have no ability to pursue investment banks and other third party actors in securities fraud cases.

These two holes in our system of investor protections—the lack of fiduciary standard for brokers and the lack of aiding and abetting liability for securities fraud—are part of a larger pattern of Swiss cheese regulation of our financial markets that developed over a generation. The Wall Street Accountability Act of 2010 seeks to close a large number of the loopholes in this system, but it does not include either of these matters. These are areas where the Act should be strengthened.

The AFL-CIO has long taken the view that the financial system needs to be regulated not with an assumption that the system is populated neither by saints or villains, but by ordinary people subject as all of us are to economic and organizational pressures. Strong, comprehensive regulation is the right approach to such a system today as it was in the days when our securities laws were enacted. Criminal law is a necessary part of such a

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system, and it is important that it cover willfully dishonest conduct comprehensively, and be backed up by a fair civil regime that allows the victims of such acts to obtain compensation from those who victimized them.

The AFL-CIO hopes this Subcommittee will be able to act to remedies these holes in the fabric of our securities laws in the light of the painful experiences of the last few years. Please let us know if we can be of further assistance to the Committee. Thank you for the opportunity to testify before you today.

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TESTIMONY

J.W. Verret, Assistant Professor
George Mason University School of Law
Senior Scholar, Mercatus Center at George Mason University

Before the Senate Committee on the Judiciary, Subcommittee on Crime and Drugs, hearing entitled "Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?"

9:30 a.m. on Tuesday, May 4, 2010
226 Dirksen Senate Office Building

Chairman Specter, Ranking Member Graham, and distinguished members of the Subcommittee, thank you for the invitation to testify today. My name is J.W. Verret. I am an Assistant Professor of Law at George Mason Law School and a Senior Scholar with the Mercatus Center at George Mason University, where I am a member of the Financial Markets Working Group.

I also direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of state and federal authority in corporate governance.

Considering new legislation requires that we compare the costs of the new law against its benefits. This is typically a complicated process. For today's proposal, however, the exercise is fairly simple. A criminal fiduciary duty standard for securities brokers would impose inordinate costs on the securities markets that would be passed through to investors while doing little to stop future financial crises.

I will also note that comparing today's topic to the Goldman Sachs controversy is entirely inappropriate. That case is complex and awaits a final verdict. I certainly don't need to remind the Senate Committee on the Judiciary that it would be foolhardy to make new legislation under the assumption that wrongdoing occurred without a full trial on the issue.

If it is ultimately determined that Goldman Sachs did engage in wrongdoing the Department of Justice already has the necessary tools to prosecute securities fraud under Section 10b of the Securities Exchange Act of 1934. The legislation under consideration today, then, would not assist in prosecuting fraud of the sort alleged in the Goldman Sachs case, if indeed fraud occurred in that case at all.

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My work focuses on fiduciary duties in state corporation law. I was privileged to clerk for the Delaware Court of Chancery, one of the sources of American corporate law. The concept of fiduciary duties we are discussing today emerged from that Court in many ways.

The challenge for judges reviewing business investments, under a fiduciary duty standard and after the fact, is that it is tempting to decide whether a decision was fair at the time it was made in light of how the investment ultimately performs. Business decisions, like purchases of investment products, are highly risky. That is why they can be so profitable. But in administering fiduciary duty laws it is nearly impossible to avoid being influenced by the benefit of hindsight.

Such Monday morning quarterbacking would however chill transactions in the securities markets at a time when they are already under severe strain.
Getting fiduciary duties right in the civil liability sphere is difficult enough. Making fiduciary duty violations into criminal violations would pose an even greater challenge.

There are a wide variety of different relationships between securities brokers and their clients. Some securities brokers act as counselors, some merely facilitate transactions at the client's direction. Some brokers cater to large institutional investor clients, others cater to individual retail clients. The contracts governing these relationships are equally diverse. A global fiduciary standard for all of these relationships would limit investors' flexibility to design contracts appropriate for their particular needs.

By way of analogy, consider the market for foreclosed housing. Foreclosed homes are more likely to need significant refurbishment and have high maintenance costs. Banks foreclosing homes do not have the resources to inspect them all. So, foreclosed homes sell "as is" at a deep discount. Buyers with the skills to gauge the risk are willing to buy the foreclosed homes, without requiring absolute guarantees from the seller.

If we were to mandate that banks selling foreclosed homes issue an absolute guarantee on the homes they sell, there would no longer be a market for those homes and a recovery in the housing market would be all but impossible.

The same thing would happen in the securities markets if we made brokers, through an unprecedented criminal fiduciary duty standard, absorb all of the risk of the financial products they sell. The securities markets would freeze up. Brokers would operate under the specter of prosecutions that, through hindsight bias, targeted them for selling products that lost money despite being fair risks at the time they were sold.

A criminal fiduciary duty standard for securities brokers is a misguided idea. A civil fiduciary duty standard also poses risks. Should this Committee decide to institute a civil fiduciary duty standard for securities brokers, I would urge an exemption permitting brokers and their clients to opt-out of fiduciary liability to permit transactions for which the parties feel fiduciary duties are not appropriate.

I thank you for the opportunity to testify, and I look forward to answering your questions.

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Written Testimony
United States Senate Subcommittee on Crime and Drugs of the Committee on the Judiciary
"Wall Street and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?"
May 4, 2010

Mr. Andrew Weissmann
Partner, Jenner & Block LLP

Good morning Chairman Specter, Ranking Member Graham, and members of the Committee and staff. I am Andrew Weissmann, a partner at the law firm of Jenner & Block in New York. I served for 15 years as an Assistant United States Attorney in the Eastern District of New York and had the privilege to represent the United States as the Director of the Department of Justice's Enron Task Force and Special Counsel to the Director of the FBI. I also am an adjunct Professor of Law at Fordham Law School, where I teach Criminal Procedure. I am here testifying today on my own behalf.

As the former Director of the Enron Task Force, I see certain parallels between the period following the Enron scandal and the present period following the financial crisis. Now, as then, we have learned that:

- the stability of the institutions we regard as most robust may be illusory;
- sometimes the very complexity of sophisticated financial practices can serve as a cover for blatant fraud;
- the interconnectedness of the global economy may magnify the effects of misconduct, causing collateral damage throughout the system; and
- some of the institutions charged with monitoring and investigating misconduct have failed to see what, in hindsight, can look very clear.

And now, as then, we face the question of what measures we might undertake to better prevent the kinds of conduct that caused such damage to the economy and the public.

To the extent that the current financial crisis can be blamed on willful conduct unburdened by concern for law and ethics, I am in agreement with Senator Specter that it should be recognized as criminal and prosecuted no differently than criminal behavior that occurs apart from Wall Street. I also agree that the threat of civil liability for individuals can sometimes be no substitute for the prospect of jail time or, more broadly, for the retributive moral effect of the imposition of criminal responsibility.

I am not convinced, however, that all -- or even the core -- of the conduct that we find most troubling on Wall Street at this juncture is properly considered criminal. While it is tempting to think that we have not learned the lessons from Enron, we have yet to see the kind of systemic fraud that occurred in that institution. Moreover, to the extent that there is misconduct at play here -- and inevitably there will be some, since Wall Street is not immune from crime -- there are strong and abundant tools already at the government's disposal, if it were to choose to use them. Thus, even if the prescription for the current crisis is in part to impose jail time for

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certain Wall Street misconduct, that goal does not necessitate creating additional federal crimes. In short, in my view neither Enron nor the current Wall Street conduct that causes us concern and even outrage were preventable but for the dearth of federal criminal laws.

I will make three main points.

I. The Current Federal Criminal Statutes Provide Adequate Tools to Prosecute and Punish Financial Crime.

The advisability of criminalizing the breach of fiduciary duties owed by financial institutions to clients must be examined in the context of the federal criminal statutes that are already available. Much has been written about the sheer number of federal criminal statutes on the books, and without repeating those compendiums, it suffices to note the enormous growth of federal crimes, including so-called white collar crimes.[1] Most relevant here is the breadth of some existing federal criminal statutes that apply to financial fraud, specifically the mail and wire fraud statutes.[2]

For example, Chapter 63 of the Title 18 of the United States Code contains eleven different provisions criminalizing different forms of mail and wire fraud. To win a conviction under the broadest of these sections, a prosecutor needs only to show (beyond a reasonable doubt, of course) that the defendant used the mails or the wires as part of a scheme to defraud. In our technological and bureaucratic age, almost every action taken by someone at a financial institution satisfies this jurisdictional hook -- any email or SEC filing can suffice. The simplicity and breadth of these statutes is widely recognized; prosecutors of financial fraud almost always bring charges under one of these provisions along with whatever other statutes are more narrowly tailored to the particular crime at issue. One anecdote is illustrative: when I switched from prosecuting organized crime bosses in New York City to going after financial fraud on Wall Street and sought advice on the workings of the intricate securities fraud criminal statutes, a senior white-collar prosecutor told me that the mail and wire fraud statutes were the only ones I would ever really need to know; everything else I might charge was gravy.

The basic mail and wire fraud statutes can be supplemented by myriad others. Indeed, given the breadth of the federal criminal statutes currently available to prosecutors of white-collar crime, it is unclear what conduct that we would think should be a crime does not already come within the current statutory regime. Where a material misstatement or omission regarding an investment is intentionally made, criminal liability is already provided under the mail and wire fraud statutes, as well as the federal laws criminalizing securities fraud. *See* 18 U.S.C. sections 1341, 1343 and 1348 and 15 U.S.C. section 78. Even if one were to expand the scope of the fiduciary duties of financial institutions and their employees, it is hard to see how a breach of fiduciary duty would not involve a misstatement or omission of some kind. Where the

[1] *See, e.g.,* William J. Stuntz, *The Pathological Politics of Criminal Law*, 100 MICH. L. REV. 505, 514-15 (2001); Susan A. Ehrlich, *The Increasing Federalization of Crime*, 32 ARIZ. ST. L.J. 825, 825-26 (2000); Am. Bar Ass'n, Criminal Justice Section, Task Force on the Federalization of Criminal Law, *The Federalization of Criminal Law* 7, 51 (1998).
[2] *See* Stuntz, *supra* note 1, at 516-17.

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misstatement is not material or the intent not willful, it is not evident that the conduct could be, much less should be, considered criminal. That leads me to my next point.

II. A Statute Criminalizing Breaches of Newly Defined Fiduciary Duties Could Prove Impermissibly Vague.

Even in the civil context, the definition of the scope of fiduciary duties can prove a challenge. Even after centuries of cases analyzing the duties of fiduciaries in different contexts, the inquiry into the exact nature of a fiduciary's obligation in a particular case is often highly fact-specific.[3] Moreover, courts have been hesitant to apply fiduciary duties so broadly so as to change the default rule of caveat emptor.[4]

The poorly defined nature of whether and when there is a fiduciary duty would have particular resonance in the criminal context, where issues of vagueness and notice take on constitutional dimension.[5] The Supreme Court is presently considering the scope of this constitutional dimension in three cases involving challenges to the so-called honest services statute, 18 U.S.C. section 1346, which criminalizes using the mail or the wires to execute a scheme to deprive someone of "the intangible right of honest services."[6] Justice Scalia has long been an ardent critic of this statute, which he recently criticized by saying, "It is simply not fair to prosecute someone for a crime that has not been defined until the judicial decision that sends him to jail."[7] In addition to the concern regarding the lack of notice, the federal courts have recognized other serious issues with that statute ranging from the lack of consistency with which it is applied[8] to its effect of transforming internal company policies into a legal obligation

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[3] *See, e.g.*, *DeKwiatkowski v. Bear, Stearns, & Co.*, 306 F.3d 1293, 1306 (2d Cir. 2002) (collecting instances in which existence of fiduciary duty between broker and investor depended on facts distinguishing situation from the "ordinary case"); *In re Daisy Systems Corp.*, 97 F.3d 1171, 1178 (9th Cir. 1996) (rejecting conclusion that relation between investment banker and client is not a fiduciary one, as "existence of a fiduciary relation is a question of fact which properly should be resolved by looking to the particular facts and circumstances of the relationship at issue").

[4] *See, e.g.*, *DeKwiatkowski*, 306 F.3d at 1307-08 (collecting cases refusing to find an ongoing fiduciary duty between broker and investor absent special circumstances or contract to do so); *cf. United States v. Dial*, 757 F.2d 163, 168 (7th Cir. 1985) (Posner, *J.*) (stating that principal "trusts the fiduciary to deal with him as frankly as he would deal with himself" because he or she has "bought candor").

[5] *See Bouie v. City of Columbia*, 378 U.S. 347, 350, 84 S.Ct. 1697, 12 L.Ed.2d 894 (1964) (stating that it is a "basic principle that a criminal statute must give fair warning of the conduct that it makes a crime").

[6] *See Black v. United States*, No. 08-876 (argued Dec. 8, 2009) (concerning whether a conviction under 18 U.S.C. s. 1346 for private conduct requires finding that the defendant reasonably anticipated economic harm); *Weyhrauch v. United States*, No. 08-1196 (argued Dec. 8, 2009) (concerning whether 18 U.S.C. s. 1346 "mandates the creation of . . . a federal common law defining the disclosure obligations of state government officials"); *Skilling v. United States*, No. 08-1394 (argued Mar. 1, 2010) (concerning whether 18 U.S.C. s. 1346 is unconstitutionally vague if it does not require proof that defendant's conduct was intended to advance private gain instead of the employers' interests).

[7] *Sorich v. United States*, 129 S. Ct. 1308, 1310 (2009) (Scalia, *J.*, dissenting from the denial of certiorari).

[8] *See, e.g.*, *United States v. Rybicki*, 354 F.3d 124, 163 (2d Cir. 2003) (Jacobs, *J.*, dissenting) (surveying the lack of uniformity among the circuits in application of s. 1346).

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enforced by criminal liability.[9] That statute has been said to criminalize both defrauding a client and an employee wrongly calling in sick for a day. Imposition of criminal liability for a breach of one's fiduciary duties would pose similar risks: whether a defendant had a "fiduciary duty" and what constitutes a breach would be exceedingly ill-defined. For instance, would every breach of duty of care become a federal crime, such that a broker's failure to read diligently all prospectuses or to call a client with updated financial prognoses every day could subject her to criminal sanction? Better to regulate the conduct at issue directly if there is a perceived problem than to use the criminal law to impose a vague stricture that would leave the government with unwarranted discretion and the public without the certainty of clear rules.

Whatever conclusions the Supreme Court reaches in the three cases before it about the constitutionality of the honest services statute will undoubtedly bear directly on the permissible scope of a federal statute criminalizing breaches of fiduciary duties by brokers or others on Wall Street. It would be wise to wait for the Supreme Court to set constitutional standards in this area before initiating the creation of a new federal criminal statute that could well run afoul of the law.

But there are other reasons not to leap to criminalizing conduct that is not now the subject even of civil liability. First, the line separating criminal conduct from all other is society's starkest boundary between right and wrong. It has been reserved, and should continue to be reserved, for the most egregious misconduct. Second, prior to imposition of criminal liability for new fiduciary duties, it would be preferable to first define the scope of specific fiduciary duty obligations in the civil context. It may be that new civil regulation will be sufficient to discourage the problematic practices. Even if it does not succeed, the experience of applying any new fiduciary duty in the civil context will give shape and content to the duty, thus lessening the fairness and notice concerns if the breach of the duty is ultimately criminalized.

III. Additional Protection Against Misconduct Could Be Remedied by Increasing Enforcement of Existing Statutes and Removing Roadblocks to Civil Liability.

While it is true that a corporation may incorporate the costs of lawsuits and civil judgments into the cost of doing business, civil liability nevertheless has a role to play in discouraging misconduct on Wall Street. Regulatory agencies have at their disposal numerous serious civil sanctions. For example,

- individuals, executives, and brokers can be barred from the industry by the SEC;
- corporations can lose their license to sell securities or the privilege of contracting with the government; and
- corporations' profits can be wiped out by both the SEC and DOJ; and they can face not just hefty fines, but also the assignment of federal monitors.

For a corporation, these civil sanctions can be far more painful than a criminal indictment. Moreover, the lower standard of proof for these forms of non-criminal sanction should enable the SEC and civil prosecutors to readily bring and make cases if the conduct is in fact wrongful, as

[9] *See Sorich*, 129 S. Ct. at 1310 (Scalia, *J.*, dissenting from the denial of certiorari).

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they need only establish their cases by a preponderance of the evidence. As the SEC's actions in the auction rate securities context demonstrate, the SEC is capable of taking action that protects tens of thousands of investors and punishes wrongdoers. To the extent that one believes that the SEC, in spite of some contrary examples, has been a toothless tiger, the remedy is to encourage the SEC and the civil division of the DOJ to make greater use of their civil enforcement authority, not to rush to criminalize new conduct.

In sum, it is admirable that Congress would take up the issue of what can be done to learn from history. Prior to the imposition of new criminal liability, however, the prudent and fair thing to do -- as well as perhaps the most efficacious -- is to examine the current tools at hand and less Draconian measures that can be taken to assist the public in reducing the risk that they will again be the victims of corporate misconduct.

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