NEW DEAL ERA FINANCIAL REGULATION IN THE TWENTY FIRST CENTURY:
AN ETHICAL EXAMINATION OF THE SECURITIES ACTS OF 1933 AND 1934

A Thesis
submitted to the Faculty of
The School of Continuing Studies
and of
The Graduate School of Arts and Sciences
in partial fulfillment of the requirements for the
degree of
Master of Arts
in Liberal Studies

By

Robert R. Fay, B.S.

Georgetown University
Washington, DC
March 19, 2013
NEW DEAL ERA FINANCIAL REGULATION IN THE TWENTY FIRST CENTURY: AN ETHICAL EXAMINATION OF THE SECURITIES ACTS OF 1933 AND 1934

Robert R. Fay, B.S.

MALS Mentor: Douglas McCabe, Ph.D.

ABSTRACT

One of the still relevant laws created during Franklin Delano Roosevelt’s first one hundred days was the Securities Act of 1933 (15 USC §77a). The Securities Act of 1933 instituted a new era for financial regulation at the federal level. The purpose of the Act was to foment transparency and ethics into financial regulation with the hope of preventing another stock market crash or severe depression.

The Securities Act of 1933 is a currently valid law as is its sibling law, the Securities and Exchange Act of 1934 (15 USC §78a). Yet, recent corporate history has suggested dishonest or fraudulent practices creeping back into American financial culture when seemingly healthy companies suddenly declare bankruptcy. In their wake are the ruins of main street investors who may have lost their life investments.

Because the Securities and Exchange Act of 1934 puts a great responsibility for integrity upon independent accountants, this paper heavily analyzes the auditor’s ethical and legal role for honesty and integrity. This paper specifically analyzes the events and practices perpetrated by the Enron Corporation and by Bernard Madoff as two examples of large scale accounting and financial fraud in recent history. The scale of these frauds calls into question the current state of financial regulation.

Despite the reforms made by the Sarbanes Oxley Act of 2002 (15 USC §7241), this paper opines that the largest continued obstacle between auditors and honesty is for
their lack of independence related to the audit fee. Accordingly, this paper recommends that the Public Company Accounting Oversight Board institute regulations to 1) require periodic auditor rotations on publicly traded clients and 2) to escrow the audit fees between auditors and their clients so that auditors answer to a regulator for their fee.

This paper comments upon financial regulation as observed through selected artistic and literary dimensions. It analyzes works of F. Scott Fitzgerald, John Steinbeck, Ayn Rand and Oliver Stone by applying key concepts from the Securities and Exchange Acts of 1933 (and 1934) into the analysis of fictional characters.
DEDICATION

To my mother, Estelle
CONTENTS

<table>
<thead>
<tr>
<th>CONTENTS</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABSTRACT</td>
<td>ii</td>
</tr>
<tr>
<td>DEDICATION</td>
<td>iv</td>
</tr>
<tr>
<td>CHAPTER 1 INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>CHAPTER 2 FINANCIAL ETHICS THROUGH LITERARY AND ARTISTIC DIMENSIONS</td>
<td>5</td>
</tr>
<tr>
<td>CHAPTER 3 TRANSPARENCY AND ETHICS</td>
<td>23</td>
</tr>
<tr>
<td>CHAPTER 4 PECORA COMMISSION</td>
<td>34</td>
</tr>
<tr>
<td>CHAPTER 5 THE SECURITIES ACTS OF 1933 and 1934</td>
<td>40</td>
</tr>
<tr>
<td>CHAPTER 6 ENRON AND THE SECURITIES LAWS</td>
<td>52</td>
</tr>
<tr>
<td>CHAPTER 7 BERNARD MADOFF</td>
<td>65</td>
</tr>
<tr>
<td>CHAPTER 8 REFORM AND CONCLUSIONS</td>
<td>75</td>
</tr>
<tr>
<td>NOTES</td>
<td>84</td>
</tr>
<tr>
<td>BIBLIOGRAPHY</td>
<td>95</td>
</tr>
</tbody>
</table>
CHAPTER 1

INTRODUCTION

The study of ethics will frequently lead into case specific scenarios that are not black and white but are blurred with shades of grey. For any situational set of facts and circumstances, the ethical path is not always clear; however hopefully, the ethically challenged person will choose the path that is at least logical and morally justifiable. The study of corporate financial ethics, especially for the layman, can be daunting because the normative guidance in understanding the nomenclature surrounding the financial system as a whole can be confusing for either lack of experience, lack of education, or both. And yet, even in the smallest of households, the financial system looms over us —omnipresent— affecting everything from the cost of a mortgage and up to the economy of an entire nation.

Most people who interact with the financial system, even at the basic levels with just a checking or retirement account, will assume that their financial vehicles are being managed and regulated by professionals who have the investor’s best interests in mind. So the investor imparts a fair amount of trust onto financial institutions, and financial professionals such as attorneys, brokers, auditors and regulators. And yet, the reality is that the financial system itself is so vastly complex that even honest errors can happen. The risk for financial professionals to either miss a procedure, a rule, or a calculation for lack of knowledge or negligence is not insignificant. However, when a financial institution or professional intentionally misses a rule, a procedure or calculation not for negligence but for an intentional obfuscation or deceit of the truth and for the purpose of
financial misappropriation or other ill-gotten gain, then such an act is no longer ethically grey. It is a fraud.

During the last two decades, the frequency of financial frauds and particularly of corporate accounting scandals have caused even the casual observer to pause and question the efficacy not just of the purveyors of corporate fraud but of the financial regulatory system that (in theory) should have prevented such frauds. Although financial scandals have always existed in one form or another, the last two decades have witnessed scenarios that suggest there is perhaps something pervasively wrong in the scale, scope and frequency of their recent occurrence. Since the new millennium, the financial headlines have highlighted well known and otherwise respected corporations suddenly filing for bankruptcy or being accused of fraud—and not for small amounts but sometimes for billions of dollars. The list included but certainly was not limited to companies such as Enron (2001), Arthur Anderson (2001), Halliburton (2002), ImClone (2002), Merrill Lynch (2002), AIG (2008), Madoff (2008), and Lehman Brothers (2010), among others.

Whereas much could be written on the financial or monetary system as a whole or even upon all the interrelated issues within such a system including power and politics, this paper will instead focus on the financial actions (or inaction) of regulators and others who could have or should have exercised courage in the face of ethical danger. In this system, there are many such people ranging from corporate officers, accountants, attorneys, analysts, auditors, bankers, brokers, regulators and lawmakers. This paper will look at how “insiders” skewed financial statements, misrepresented themselves or otherwise bargained for their own benefit to the detriment of those otherwise trusting them not to.
In the twentieth century perhaps the greatest financial chasm was the stock collapse of 1929 and the resulting depression. Financially, physically and spiritually, the hardships endured by too many Americans during the 1930’s were catastrophic. And yet, out of that misery, certain courageous personalities created laws and regulations which sought to mitigate the damage that had already occurred and thereby also created hope to prevent any future such catastrophe from again occurring. Such was the spirit when Franklin Delano Roosevelt and Congress passed the Securities Act of 1933 (15 USC §77a) and the Securities and Exchange Act of 1934 (15 USC §78a).

As a defense against corporate fraud and for the public’s dissemination and protection, the Securities Act of 1933 and the Securities Act of 1934 required publicly traded companies 1) to submit to an annual financial audit and 2) to publicly disclose those audit results to the Securities and Exchange Commission (SEC). Within the securities industry, these acts therefore were among the first codifications over the accounting profession. Moreover, these acts also created regulatory provisions for stockbrokers and other industry “insiders” like corporate officers, attorneys, and accountants that they could not trade securities upon information not also made available to the public.

Similarly, the Banking Act of 1933 (12 USC 78) provided certain investment provisions that prevented commercial banks from acting as investment banks. This firewall was to prevent banks from being overly speculative with other people’s money in the hope that another market crash or credit catastrophe might be averted.

However today, when large and seemingly healthy companies suddenly announce insolvency shortly after their auditors or regulators have just asserted their financial soundness, such assertions of financial soundness are suspect. Therefore, using the two
Securities Acts of 1933 and 1934 as guidance, this paper will 1) examine the appropriate ethical roles for auditors, accountants, and regulators to report true financial results and 2) to examine whether or not the spirit as originally born in those acts have somehow been degraded in the early twenty-first century.

Using these depression era regulations, this paper will use case studies to analyze what happened in some well publicized events during the first decade of the millennium to include Enron, Arthur Anderson and Bernard Madoff. This paper will draw some conclusions about how these events unfolded and offer some prescriptions that could possibly prevent future accounting malfeasance.

This paper also includes a chapter of reflection upon American financial culture as depicted through literary and artistic dimensions. The literary and artistic dimension chapter offers a reflection that business is not necessarily limited to just financial headlines or financial media, but is also reflected for ethical analysis within popular culture. That analysis will still be through the prism of depression era financial regulations.
CHAPTER 2

FINANCIAL ETHICS THROUGH LITERARY AND ARTISTIC DIMENSIONS

Sometimes it is easier to understand complex scenarios not in the real world as they unfold, but in the fictional world of literature where the reader is allowed to enter into a character’s mind and to understand a character’s thoughts and reasoning. In American culture, there are so many artistic works surrounding the moral dimensions regarding the acquisition, creation or loss of wealth that it is fairly ubiquitous as a genre. Still, a reflection of financial ethics as revealed through artistic forms is relevant to understanding financial behavior as a whole.

The value of reviewing literary examples of financial culture is that it provides analysis of certain character traits of fictional people that might help us analyze real-world people or real-world headlines. Therefore, this chapter will provide a perspective on financial culture by reviewing selected works of American literature and film with the hope of providing some illumination onto financial ethics today. The works are presented in a loose chronological order. The selected works are F. Scott Fitzgerald’s The Great Gatsby, John Steinbeck’s The Grapes of Wrath, Ayn Rand’s Atlas Shrugged and Oliver Stone’s Wall Street.

1920’s – The Great Gatsby

F. Scott Fitzgerald’s The Great Gatsby depicts a fictitious town of East Egg, NY in the 1920’s as a place of wealth and luxury. To the degree that Fitzgerald supposes that East Egg might be coastal Long Island, that depiction would be generally accurate even for today. The historical context of the novel is inside the prohibition era when the production and consumption of alcohol in the United States was illegal. However,
despite the legal prohibitions, Fitzgerald shows Jay Gatsby as a man who otherwise throws lavishly large parties at his shoreline mansion with full orchestras, dancers and champagne flowing until early hours of the morning. Fitzgerald shows Gatsby as a man, with the wealth and freedom to lead an alcohol indulgent lifestyle but without any apparent fear of reprisal from the criminal justice system. In fact, Gatsby appears to have acquaintances in sufficiently high enough positions who otherwise afford him this degree of freedom. So factually speaking, despite the authority of law, Gatsby openly ignores the law.

Fitzgerald leaves the source of Gatsby’s wealth nebulous (at best) and without absolutely saying it, he strongly hints that Gatsby’s wealth is either ill-gotten or illegal.1 His party guests do not know the exact source of his wealth; but, they don’t seem to care either. His guests speculate that “he killed a man,”2 or that “he was a German spy during the war”3 or that “he’s a bootlegger.”4 So, whereas Gatsby is most probably a fraud and a cheat, East Egg accepts or at least tolerates him—if only to attend his parties and enjoy his alcohol.

Gatsby’s ethics are situational and relative. He ignores the law because it pleases him; and, if he is a bootlegger, or financial fraudster, it profits him. By understanding Gatsby’s mindset and how he maneuvers through society, we might better understand how a similarly situated “real-life-character” may maneuver through their own financial landscapes. Such real-life characters that ignore the law and create their own set of ethics could include any number of financial fraudsters such as Michael Milken (“junk bond king”), or Jeff Skilling (Enron) or Bernard Madoff (Ponzi scheme).

What is probably most notable about Gatsby is that he would otherwise delude people that he came from old family money and that he had attended fine schools.
Whereas the reader sees his delusions limited mostly in a social context, it is otherwise notable, as a practiced conman, just how easily and how affably Gatsby rattles off his fabricated pedigree. Fitzgerald gives us only hints of Gatsby’s business dealings, however, besides bootlegging, we can fairly assume that Gatsby is equally affable at defrauding investors to purchase worthless stocks or bonds based on excerpts of his phone calls. One such call revolves about transactions that must occur in small towns with the implication that those investors would not be sophisticated enough to see through his guises.

Fitzgerald’s Gatsby is important because, Gatsby’s excesses are widely acknowledged as a symbol of the 1920’s overall. Just as Gatsby’s party guests did not question Gatsby’s wealth too deeply —even if ill-gotten— most investors during the 1920s’ did not question the seeming unending financial gains of the stock market. During the 1920s’, as long as investors were “invited to the party” (the stock market) and having a good time (making gains), they did not worry too much about how the system worked, or whether it was based on fraud, or that it could collapse beneath them at any time. In fact, the 1920s’ fiction of unending gains would otherwise melt with history, when the stock market actually began to collapse in October of 1929.

For historical context, during the 1920s’ American financial markets were technically “self regulated.” That is, trading members of exchanges, like of the New York Stock Exchange, subscribed to a code of ethics, but neither brokers, traders, or companies were regulated by the federal government in the sense that they are today. Back then, Gatsby had something of a free reign. Certain elements of the financial industry today would enjoy turning the regulatory clock back to that time.
Although fictionalized, John Steinbeck’s The Grapes of Wrath is one of the better illustrations of human suffering in the 1930’s due (in part) to the financial collapse of the stock market and ensuing bank crisis. The Grapes of Wrath gave literary voice to an entire generation of displaced American farmers forced off of their land. The financial crash of 1929 had the unintended consequence of exacerbating the already difficult plight of too many farmers bearing the ravages of crop failure, prolonged drought and depressed commodity prices. In fact, while the Great Depression had several interrelated causes, and although the banking crisis affected everyone, the banking crisis hit farmers especially hard as farmers relied on banks to offer credit between the annual cycles of harvesting crops. Yet, in the 1930’s too many farmers had either 1) no harvest for drought induced crop failure and thus no income, or 2) a harvest of crops that produced too little income due to suppressed commodity market prices in general. In either case, traditional farmers, especially those on the central high plains were stressed somewhere on the scale of epic proportion. Steinbeck reflects this reality by creating a typical Oklahoma family of sharecroppers forced off of their land due largely to the financial industry and general banking practices.

In Chapter 5, Steinbeck draws a clear, if stark, relationship between the banks or bankers and the mortgaged farmer with the point of view coming clearly from the farmer. Steinbeck combined both narrative voice and dialogue. In narrative voice, Steinbeck speaks of a banking system operating within legal boundaries but otherwise designed and implemented against the tenant farmer. Even if sometimes reluctant, local bankers and the larger landholders conspired with a ruthless banking system. In fact, Steinbeck makes multiple references to the mortgage banking system as “a monster” or “the
monster.” So, even despite climatic circumstances beyond anyone’s control, the banking system forced lenders to foreclose on mortgages when payments were overdue; and, landowners evicted tenants when “one tractor can take the place of twelve or fourteen families.”

Consider the following passages where Steinbeck refers to banks as something to be feared because of their inhuman power. Steinbeck wrote:

... And the owner men explained the workings and the thinkings of the monster that was stronger than they were. A man can hold land if he can just eat and pay taxes; he can do that.

Yes, he can do that until his crops fail one day and he has to borrow money from the bank.

But - you see, a bank or a company can’t do that, because those creatures don’t breathe air, don’t eat side-meat. They breathe profits; they eat the interest on money. If they don’t get it, they die the way you die without air, without side-meat. It is a sad thing, but it is so. It is just so.

Steinbeck portrays a far away system (in the East) made up of Wall Street institutions that care very little for a small farming families. He portrays the banks reducing the Joads (and people like them) down to an impersonal financial transaction, a Wall Street side bet, a commodity, and not people. To the banks, the Joads are American serfs and expendable.

While the Joad family faces a forced eviction and imminent bulldozing of their home, Pa Joad bears a shotgun in protest and argues about banks with the driver as if a shotgun would stop the process. The narrative is as follows:

“It’s not me. There’s nothing I can do. I’ll lose my job if I don’t do it. And look - suppose you kill me? They’ll just hang you, but long before you’re hung, there’ll be another guy on the tractor, and he’ll bump the house down. You’re not killing the right guy.”

“That’s so,” the tenant said. “Who gave you orders? I’ll go after him. He’s the one to kill.”
“You’re wrong. He got his orders from the bank. The bank told him, ‘Clear those people out or it’s your job.’”

“Well, there’s a president of the bank. There’s a board of directors. I’ll fill up the magazine of the rifle and go into the bank.”

The driver said, “Fellow was telling me the bank gets orders from the East. The orders were, Make the land show profit or we’ll close you up.”

“But where does it stop? Who can we shoot? I don’t aim to starve to death before I kill the man that’s starving me.”

“I don’t know. Maybe there’s nobody to shoot. Maybe the thing isn’t men at all. Maybe like you said, the property’s doing it. Anyway, I told you my orders.”

“I got to figure,” the tenant said. “We all got to figure. There’s some way to stop this. It’s not like lightning or earthquakes. We’ve got a bad thing made by men, and by God that’s something we can change.”

The key argument of this dialog is the implication that if the system itself is “made by men” then it can be “changed by men.” Steinbeck implies that somehow the banking system itself must be broken if it has the potential to cause so much human misery. Yet, legally the bank is certainly within bounds to take possession of a property in mortgage default. Still, both Joad and the driver are powerless. The driver can choose not to bulldoze the house, but only at the cost of losing his job. Joad is reduced to a minor player in a system beyond his control and which is arguably rigged against him. His shotgun can have no effect upon the banking system or upon his plight.

Yet, Joad’s logic is otherwise sound. If the financial system or elements of the financial system are “created by men,” and are somehow “broken by men,” then they should be “fixable by men.” Joad thereby exhibits the courage of a small man to make a stand against a system greater than himself. How many accountants, auditors, Wall Street analysts, or regulators either saw or suspected real fraud at Enron and yet did not
“fix” the problem before it was too late? How many “Joad-like” families were created in the ensuing bankruptcy of Enron? Who is willing to be the whistleblower when the usual corporate reaction is to destroy the messenger? Joad shows the sort of courage that is needed among a certain class of persons in Washington or on Wall Street even today.

For the context of this paper, Steinbeck clearly shows that some financial reform was necessary to further prevent further damage not just to the financial system but to all families like the Joads. The Banking Act of 1933 and Securities Acts of 1933 were part both of that reform. Still, Steinbeck had the benefit of hindsight. Steinbeck wrote the novel in 1939 when it was just in 1932 and 1933 that the financial system was on the teetering verge of a collapse. As evidenced by the financial lobby industry, lawmakers don’t usually “fix” laws to be more favorable to people like the Joads. They usually “fix” them more favorable to institutions like the banks. Herbert Hoover is a good example. Hoover was reluctant and did not institute banking reforms while FDR made reform a priority after his inauguration. So again, to echo Joad’s words, “We’ve got a bad thing made by men, and by God that’s something we can change.”

Given the shape of the country’s various financial woes today, we could still use courageous people to recognize the “fix” and to affect the change.

1950’s – Atlas Shrugged

The opposite of financial regulation would simply be “laissez faire” or “hands off” economics. Ayn Rand’s Atlas Shrugged motivated a certain generation of cold-war era thinkers that self-interests and unfettered economic freedom are intrinsically preferable to the ostensibly profit-dampening effects of the many regulations otherwise designed to promote social or environmental welfare. The inclusion of Rand in this section is not necessarily to agree or disagree with her philosophy, but to show how her philosophy
may have influenced persons who were otherwise charged with business innovation and profit against those who were conversely charged to regulate (and tax) such innovation or profit.

Most U.S. regulatory agencies have a dual role to both promote and regulate their respective industries. The Federal Aviation Administration is charged to both regulate air-safety and to promote air-commerce. Police are sometimes called to defend freedom of speech (or protest) while protecting the citizenry from property damage or riot. The Securities and Exchange Commission has the dual mission to both protect investors and to facilitate capital formation. Despite the dual roles promulgated upon regulatory agencies, Rand’s writing appears to eschew most regulatory authority.

In *Atlas Shrugged*, the fictional protagonist—John Galt—is a successful industrialist who drops out of known society to a self-induced secret exile somewhere into the mythical “wild west” of Utah—as if modern society did not exist. He induces other industrialists to join him and he forms a fraternity of like-minded men who choose not to mingle with the masses of humanity that would otherwise pillage their profits through forced union wages or other government regulation. Somehow, Galt believes that his self-imposed exile will benefit humanity by making humanity realize that the creators of production (the industrialists) are the source of all “good,”¹³ and that other factors of production (like labor) are “parasites.”¹⁴

In Part III, Chapter VII, the fictional Galt seizes the national radio microphone and broadcasts his philosophies of “existence,” of “morality,” and of “virtue” by making an unscheduled speech to the nation. Although Rand sprinkles such philosophy throughout the book, this chapter is particularly so infused. Rand makes Galt a savior of sorts. For this critic however, Galt’s speech is a thinly veiled disguise for Rand’s own
elitist rant against some perceived social inequities perpetrated upon upper crust industrialists by a lower cast proletariat. Galt’s speech is perhaps best analyzed by looking first at the conclusion. His concluding statements are as follows:

But to win it requires your total dedication and a total break with the world of your past, with the doctrine that man is a sacrificial animal who exists for the pleasure of others. Fight for the value of your person. Fight for the virtue of your pride. Fight for the essence of that certainty and the absolute rectitude of knowing that yours is the Morality of Life and that yours is the battle for any achievement, any value, any grandeur, any goodness, any joy that has ever existed on this earth.

You will win when you are ready to pronounce the oath I have taken at the start of my battle - and for those who wish to know the day of my return, I shall now repeat it to the hearing of the world: ‘I swear-by my life and my love of it - that I will never live for the sake of another man, nor ask another man to live for mine.’

In Galt’s statement that “I will never live for the sake of another man,” Rand apparently eschews any responsibility to support government services or regulation that might benefit society as a whole if perhaps it would take away from any individual wealth. And whereas there is a time and a place for individualism, Rand’s philosophy overwhelmingly supports individualism to the detriment of society which (again) she sometimes views as “parasites.” Consider other statements in Galt’s radio broadcast as the following:

The symbol of all relationships among such men, the moral symbol of respect for human beings, is the trader. . . . A trader is a man who earns what he gets and does not give or take the undeserved.

Do you ask what moral obligation I owe to my fellow men? None - except the obligation I owe to myself, to material objects and to all of existence: rationality. I deal with men as my nature and theirs demands: by means of reason. I seek or desire nothing from them except such relations as they care to enter of their own voluntary choice.

The only proper purpose of government is to protect man’s rights, which means: to protect him from physical violence. A proper government is only a policeman, acting as an agent of man’s self-defense, and, as such, may resort to force only against those who start the use of force. The only proper functions of a government are: the police, to protect from
criminals; the army, to protect you from foreign invaders; and the courts, to protect your property and contracts from breach or fraud by others, to settle disputes by rational rules, according to objective law.  

It is a fallacy to think that the only purpose of government is to protect a man from physical violence. Schools provide education, sanitation districts provide clean water and transportation departments provide roads and bridges. And ostensibly, the financial regulatory system protects investors from the likes of John Galt. Are these not proper forms and use of government?

Rand wrote that the courts are only to protect property and contracts from breach and fraud according to objective law. In this particular passage, Rand does not explicitly state, but strongly suggests that “objective law” should probably favor the industrialist. She fails to acknowledge that even an industrialist could possibly step outside of legal, if not just moral, boundaries. Moreover, she fails to acknowledge that the outcome of a legal dispute may not favor the industrialist. Indeed, the courts have sometimes been the mechanism of last resort to create a more fair society by protecting the labor force from industrialists who have otherwise exploited children, exploited women and minorities, exploited investors, and exploited the environment.

Lastly, consider the John Galt quote where Rand wrote:

> We will open the gates of our city to those who deserve to enter, a city of smokestacks, pipe lines, orchards, markets and inviolate homes...With the sign of the dollar as our symbol - the sign of free trade and free minds - we will move to reclaim this country once more from the impotent savages who never discovered its nature, its meaning, its splendor.

One might ask themselves, “Did Rand include the dollar sign as a symbol of virtuosity as a joke?” However, Rand is neither satirical nor comedic. She is serious and philosophical. Regarding this dollar sign, who are “the impotent savages who never discovered its nature, its meaning, its splendor?” Does she refer to Native Americans
slaughtered by the onset of European industrial and military might? Or, does she merely refer to the masses of unorganized workers, like Steinbeck’s Joads, who might wish to have a minimum wage for labor produced. To be fair, Rand’s philosophy is not without some merit. Who does not want to be rewarded for the fruits of their vision, of their industry, or of their labor? Everyone does.

The problem is that Rand’s fictional character, John Galt, promotes a world that somehow magically runs smoothly by itself and does not recognize that fraud, corruption or deceit can occur even at the industrial ownership level. Perhaps it was because Atlas Shrugged was written in the wake of McCarthyism and entrenched in cold war era thinking that her philosophy was particularly intoxicating to a generation of thinkers. The likes of Alan Greenspan, Ronald Reagan, and even Bill Clinton have all at one time or another, espoused free trade.

Following Ayn Rand’s lead, the financial industry itself usually rejects any form of regulation promulgated upon it from the outside. In 1933, the financial industry handily protested the passage of the securities and banking acts as over-reaching and onerous. In 1999, the financial industry rejoiced, after congress repealed key provisions of the 1933 Banking Act; but then was reluctant to admit that financial markets catastrophically melted in 2008 (in part) for lack of that regulation. It is perhaps not overstating, even poetic, to observe that the power of an author (of fiction) so influenced the mindset of a generation of political elites that they could nearly ruin a financial system but for the mere idea of deregulation.

When Rand published Atlas Shrugged in 1957, the United States was not even the same country as when she immigrated in 1925. By the late 1920’s, America had probably already outgrown a “wild west” notion of itself; and yet, this is exactly the
image that Rand appears to have latched onto. America was just no longer a continent available for the plunder, whereas before in the unspoiled wilderness, the only usual law was that which a man might carve out between himself and nature. Such is the mythology and reality of the American experience, of homesteading, and of manifest destiny. But by the 1950s', with the population explosion in the cities, and increased competition for land, space and resources, to pretend that its citizens could regulate themselves peacefully without some sort of government influence would be naive. And yet, from a law and order or even from a financial regulatory perspective, this is the notion that Rand and many Americans still romanticized.

_1980’s – Wall Street (The Movie)_

The 1980’s was a decade of changing values, of an increased emphasis on financial awareness and prosperity. There was a sense that the American workforce was becoming less homogenous, more computerized and more economically polarized with greater competitive values being placed on “success” or “prosperity”. In pursuit of that prosperity, Oliver Stone’s _Wall Street_ perhaps best encapsulated the changing ethical landscape and especially for those young people that chose to work in finance.

In the 1980’s, the financial regulatory system, if imperfect, was nevertheless developed and mature. That is, the system for securities to reach public markets had sufficient regulatory and technological controls to help prevent and detect fraud. Moreover, perhaps because of that systemic maturity, the mindset among a certain class of traders and financial professionals to “work around” those controls had also reached a certain level of sophistication. It is this level of sophistication to evade control mechanisms in pursuit of gain that is depicted in _Wall Street._
What Stone depicts in *Wall Street* is not that an ethical or legal lapse “could possibly” occur, but instead, he shows “how” it could occur. Stone shows how a character can situation-ally rationalize a risk to reward calculation to be at least momentarily profitable enough to knowingly make an unethical or illegal act. In *Wall Street*, the illegal acts are due to the crime of “insider trading” when brokers (or others) might trade public stocks based on information not likewise made available through public channels.²¹

Charlie Sheen plays the film’s protagonist character, Bud Fox, as an uncommonly motivated young trader working at an investment house. Bud, however, is restricted to a mundane entry level job of cold calling potential clients for unsolicited trades. Bud realizes that making such unsolicited calls will never yield him the sort of high flying career in which he dreams of earning millions of dollars. Bud’s career accelerates only when he meets Gordon Gecko - the fictional Wall Street tycoon who was played by the Oscar winning Michael Douglas.

At first, Bud’s lapse of judgment is almost innocuous. In an effort to curry favor and maintain audience with the otherwise unimpressionable Gecko, Bud half-wittedly divulged “inside information” to Gecko about an upstart airline where Bud’s father worked. Bud knew that information only because his father was a mechanic and union steward at that particular airline. At this point, however, Bud’s divulging of inside information did not involve forethought; he gave it almost by accident and in an effort to merely stay in conversation with Gecko. However, because that information proved profitable for Gecko, and by default also profitable for Bud, it created a slippery slope. The tycoon (Gecko) would expect more.
However, Bud only develops a full ethical lapse when he is seduced by Gecko to knowingly act as a spy on one of Gecko’s targeted takeovers.

While driving through New York City in the back of a Gecko’s limousine, Gecko tells Bud: “I want to know where he goes and what he sees, I want you, pal, to fill out the missing picture.”22 Bud has forethought, he responds: “Mr. Gecko, that’s not exactly what I do. I could lose my license. If the SEC found out, I could go to jail. That’s inside information. Isn’t it?”23 But Gecko already has leverage on Bud. Gecko responds:

You mean like when a father tells his son about a court ruling on an airline?

I am afraid, pal, unless your father is on the board of directors of another company, you and I are going to have a very tough time doing business together...24

... Wake up, will you, pal? If you’re not inside, you’re outside! - ok?25

Gecko’s revelation that business is conducted on the “inside” is revealing in and of itself. Despite the financial laws, it makes complete sense. Still, it must be difficult for an ambitious yet idealistic trader to realize that his hero works around or outside of the law. And so, because Gecko senses that Bud isn’t ready to play by the “real” rules, Gecko is literally ready to throw Bud off to the curb. In the scene, Gecko tells the driver to pull over and then tells Bud: “I hope you don’t mind if I drop you off here, I’m late. Buddy, it’s been nice meeting you – ok?”26

Bud is compliant albeit confused. He gets out of the car. Yet, perhaps because Bud is literally already “outside” on the street and senses that his opportunity to make vast sums of money is also literally slipping away, he takes a risk. In the scene, Bud taps the car window. Gecko opens it. Bud acquiesces—he states: “Alright, Mr. Gecko. You got me.”27 And, with that single statement, Bud is corrupted. He has now given
complete forethought and intent to commit the financial crime of insider trading on behalf of Gecko.

An analysis of Gecko must mention greed. Gecko’s greed speech is arguably one of the most famous financial quotes in cinematic history. In the scene, Gecko is speaking at a meeting of stockholders at the fictitious Teldar Paper Company in which Gecko makes a tender offer for the purpose of a takeover. He induces the shareholders to accept his offer, and the following is an excerpt from that speech:

... The point is ladies and gentlemen that greed for lack of a better word is good. Greed is right. Greed works, and clarifies, cuts through and captures the essence of the evolutionary spirit. Greed in all of its forms, greed for life, greed for love, greed for money, greed for knowledge has marked the upward surge of mankind and greed, you mark my words, will not only save Teldar Paper, but that other malfunctioning corporation called the U.S.A.  

In his book, Separating Fools From Their Money, Scott MacDonald believes that Gecko’s greed speech was actually patterned after (junk bond king) Iwan Boesky’s speech delivered to U.C. Berkeley graduates in 1986. In that speech Boesky said, “Greed is all right, by the way ... I want you to know that I think greed is healthy. You can be greedy and still feel good about yourself.”

What is notable is that Bud’s previous affable character changed after his corruption. He became comfortable not only with obtaining illegal information for Gecko, but with profiting from it. He appears to believe himself invincible. Bud feels so invincible that he attempts to corrupt or recruit his college chum, Roger, an attorney working for a corporate law firm. That firm just happens to service a company that Gecko has targeted for takeover. Bud wants Roger to divulge confidential client information. We are uncertain whether Roger actually acquiesces. In fact, Roger tells Bud that divulging such information would be illegal.
Consider the dialog as follows:

ROGER: Come on Buddy, you wouldn’t want to get me disbarred now, would you?
BUD: Oh, Who’s listening? It’s just one college buddy talking to another.
ROGER: Yeah, right. . . .
BUD: Oh, Relax, Roger, everybody’s doing it, but if you don’t know, then, you don’t know.
ROGER: . . . and if I did, what’s in it for moi?
BUD: More money than you ever dreamed of - nobody gets hurt.30

What is especially notable about this scene is just how innocuous their conversation occurred. It really was just a conversation between two old friends. There were no official minutes, no transcripts and no witnesses. The viewer saw no evidence to suggest that Roger actually lost his integrity. However, if Roger were somehow corruptible, it would have been very easy, in this very informal setting, to collude with Bud. This nearly identical scenario surely must happen in real life whether it occurs at bars, in restaurants or on golf courses.

_Bud Fox - Game Over_

The viewer must remember that Bud is still an employee at the investment house and the investment house is likewise profiting from Bud’s activities. But, the house does not seem to be asking too many questions. In fact, Bud’s manager gives him a private office and a secretary. The manager tells Bud, “the minute that I laid eyes on you, I knew you had what it takes.”31 But, he doesn’t specify what “it” was. Still, Stone hints that at least elements of Bud’s colleagues and management might have suspected that Bud was involved with illegal insider trading. His senior colleague, Louis, just rhetorically asks him, “What’s going on Bud, you know something?”32—but doesn’t really expect an answer.
The only time that the house really appeared concerned about Bud’s otherwise lucrative activity is at the end of the movie, when the Securities and Exchange Commission is in Bud’s office and waiting to arrest him. Only when Bud is escorted away in handcuffs, does the same manager who had given Bud the private office and the secretary also state, “The minute I laid eyes on you, I knew you were no good.” The manager’s statements are certainly contradictory. At first, the manager believed that Bud “had what it takes,” but when Bud is arrested, he declared Bud to be “no good.” The manager cannot have it both ways. To the viewer, the appearance is that the manager did not rule out the possibility that Bud was involved with insider trading, but that the manager also wanted to maintain an air of plausible deniability since the house was likewise profiting. If the house was implicated in Bud’s illegal actions, they too could be held criminally liable. So, in that scene, it was convenient, if not disingenuous, for the manager to distance himself (and the firm) from Bud.

**Literary Conclusions**

It might be fairly easy for us to guess how these various characters might view certain forms of financial regulation. We could easily see John Galt or Gordon Gecko disagreeing with the Securities or Banking regulations as too burdensome on business or profits. Conversely, we could envision that the Joads might hope for minimum wage laws, or mortgage derivative reform laws, so that neither the John Galts or the Gordon Geckos of the world might so easily exploit them.

Again, fictional scenarios allow us to enter into the mindset of the characters as situations evolve around them. It would be very easy to read a financial headline which declares a fraud, a Ponzi scheme or an insider trading scheme and smugly think, “I would never do that” when we don’t really know the entire story. The power of fictionalized
scenarios presented through art and literature helps us "fill in" what may be operating behind real closed doors or inside real minds when those doors or minds are otherwise closed to public viewings. And whereas our "filling in" the scenario might be purely speculative, such speculation based on all other available facts and circumstances might lead to at least a reasonably plausible hypothesis of actual events.
CHAPTER 3

TRANSPARENCY AND ETHICS

*Baseball and Business, An Analogy*

One could compare the business world to a professional baseball game. The various public companies in the marketplace are like baseball teams competing against each other for outcomes. While baseball teams compete to win games, businesses compete to win profits. Just as the outcome of a baseball game is depicted on the scoreboard with wins and losses, the outcome in business is depicted on financial statements as profits and losses.

The investor is similar to a baseball fan. The fan probably paid for admission to the game and sits in the stands watching the game, just like the investor who paid for a share of stock and watches it’s price in the newspaper. The fan and the investor each respectively has an interest in the outcome of the game or of the stock; the fan wants his team to a win and the investor wants his stock to make a profit. Lastly, in business, independent auditors are like umpires while regulatory agencies (such as the Securities and Exchange Commission) are like Major League Baseball itself.

People enjoy watching baseball because of the transparency. One fact in every baseball game is that there is a winner and a loser. And, the wins and losses are based on rules. A particular fan on a particular day may not enjoy the outcome of a particular game, but with current instant replay technology, umpires can review and analyze any particular play from multiple different camera angles. So when the rules are followed and enforced, there is little room for argument. When there is room for argument, professional umpires will render their better judgments based on a review of the plays. In
fact, when the baseball rules are followed, the same team that suffered a loss today might win tomorrow, not by caprice, but based on their performance as measured by the official rules. While umpires review baseball “plays,” auditors review financial “transactions.”

One advantage that most baseball fans have over investors is that, on the whole, fans understand the rules of baseball better than investors understand financial rules. Baseball is ubiquitous—it is very frequently on television. The fan probably even played it at some point and therefore is already familiar with the rules and knows what to expect. And if not, fortunately for the fan, Major League Baseball employs professional umpires that understand and enforce all the rules. Baseball works because the players, the officials and all involved agree to and follow the same set of rules. Moreover, the game is played on an open field with full transparency for fans, journalists and competitors to observe and judge.

For the investor, financial transparency is a little more complicated. Financial rules like GAAP (Generally Accepted Accounting Procedures) are not well known to most investors. Most investors did not play with accounting rules as children and they did not watch accounting on television. Moreover, individual accounting transactions and audit procedures are not videotaped for instant replay from different angles for the public to watch. They tend to be done in private and behind closed doors.

_Umpires, Auditors, Independence and Salary_

In baseball, the auditor is best equivalent to that of an umpire. It is the auditor’s place to judge whether or not the company played by the rules correctly and to opine accordingly. Just as baseball players and umpires both know the official rules of baseball, the auditor and the company should likewise both know and follow accounting rules collectively known as GAAP (Generally Accepted Accounting Principles). And,
since public companies should be playing by the same accounting rules as any other public company, their success or failure should be dictated relative to each other only by other non-accounting factors such as their product line, competitiveness and key strategic or management decisions. Still, the primary method of keeping track of a company’s success or failure is by measuring their numeric outcomes of profit and loss.

The baseball umpire has a slight structural edge over the auditor as the umpire is not hired or paid directly by any baseball team. Instead, the umpire is an employee of Major League Baseball (MLB) which is the umbrella organization under which all franchised teams exists. MLB and its umpires are otherwise independent of any team. Based on sourcing the umpire’s salary alone, the umpire’s judgments are not compromised to favor any one team. The umpire is in a position to make independent judgments according to the rules of baseball only.

However, unlike the umpire, a financial auditor of a publicly traded company is not a salaried employee of some disinterested umbrella organization. Instead, the financial auditor is a contractor who is retained by the company under audit to perform a service for that company while that service is the audit itself. The contract auditor charges a fee for that service. Moreover, those fees are sometimes quite lucrative. Thus, because of the auditor’s interest in those fees, the financial arrangement between the auditor and the audited has the potential to introduce an ethical slope into the audit arrangement which could potentially question the auditor’s actual independence.

**Auditor Opinions and Responsibilities**

Financial audits are conducted by certified public accountants. According to professional accounting and auditing ethics, the auditor works not on behalf of the company being audited, and not on behalf of himself, but on behalf of all investors in the
marketplace who might potentially make an investment with the company being audited. So whereas the company under audit pays the auditor for the audit, the auditor's actual duty is to the public and not to himself. That is the theory.

Because modern accounting and auditing practices require specialized knowledge, the profession is regulated. An auditor must be an accountant who is licensed by a state to practice as a certified public accountant (CPA) in that state. A certified public accountant must have 1) obtained a bachelor's degree (or higher) in accounting; 2) passed a written examination on accounting principles; 3) obtained qualified and verified audit experience from a qualified CPA firm; and, 4) stayed current with annual continuing education requirements. These are the minimum requirements to practice in the profession. Certain industry specific sectors and clients like *multi-employer employee benefit plans*, or entities with *federal awards*, or companies subject to SEC (Securities and Exchange Commission) regulations require that the auditor have specialized experience and knowledge in those areas.

Historically, the general public has held the accounting profession in high esteem. The esteem may stem from so many people who rely on certified public accountants to prepare and file their annual income tax returns. But, taxation is just one practice area for accountants. The area that produces the highest risk for malpractice is in financial auditing.

The product of an audit is the *audit opinion*. The auditor issues a written report with an audit opinion to the board of directors of the company under audit. For a public company, the same report is also available to investors and to the SEC. The auditor can issue one of three different opinions. If the auditor found that the company’s financial statements were prepared in accordance with Generally Accepted Accounting Principles
(GAAP), then the auditor would issue an “unqualified” opinion. If the auditor found that the company materially prepared financial statements in accordance with GAAP but also found certain qualified departures from GAAP, then the auditor would issue a “qualified” opinion and list the qualifications in his report. If the auditor found many errors and concluded that company’s financial statements were not prepared in accordance with GAAP then, the auditor should issue an “adverse” opinion. Lastly, if the auditor found that the company just did not provide adequate records to form an opinion, then the auditor’s report should “disclaim” an opinion altogether. It should be noted that whatever opinion an auditor renders is a matter based on his professional judgment.

*Auditors and Liability*

The auditor’s major risk for liability is for issuing an improper opinion in the audit report. For example, if an auditor issued a *favorable* or “unqualified” opinion when he should have issued a *disfavorable* or “adverse” opinion, then the auditor could potentially be sued by a third party (like an investor) for virtue of the investor having relied on the auditor’s improper audit opinion and losing the investment.

Moreover, the auditor could be held to civil, criminal and/or professional liability. If an investor loses his investment because he based his investment, in part, on an improper audit opinion, then, the auditor might be civilly liable to the investor for the investment loss only. If the auditor *knowingly* issued a wrong opinion, the auditor could be also be held criminally liable for fraud and serve jail time. Depending on the facts and circumstances, the state could impose professional restrictions on the accountant like requiring more education, barring him from engaging in any more audits or simply just taking away his CPA license altogether.
The state which issued the CPA license is the primary regulator of the auditor. However, there are other agencies watching the independent auditor’s work. Those entities could include but are not limited to the Internal Revenue Service, the Securities and Exchange Commission, the American Institute of Certified Public Accountants, the Department of Labor, and any other agency which receives or reviews the auditor’s work.

Lastly, CPA’s in public practice are required to carry *errors and omissions* insurance. Not surprisingly, the cost to purchase *errors and omissions* insurance is highest for those accountants that practice auditing. Because of those costs, certain CPA’s may choose to *not* practice auditing and just avoid the additional risk and liability altogether. So, if an accountant can not meet the additional insurance requirements to audit, or deems the premiums otherwise too high, then that accountant will probably just excuse himself from auditing altogether. In this manner, the insurance company likewise functions as a “quasi-regulator.”

*Negligence or Malfeasance*

With all of the regulations and liability facing the auditor, why might an auditor issue an improper audit opinion? In some scenarios, and there are many, the auditor may have simply, for lack of knowledge or skill, gotten over his head and *negligently* issued a favorable audit report when he should have issued something else.¹ In other cases where knowledge and skill are not an issue, and yet the auditor otherwise issued a *knowingly* improper audit opinion, which is a fraud, we can only speculate what caused it. For such improper audit opinions, this thesis will heavily speculate upon the auditor’s personal “greed” as the causative factor.
Truths and Consequences

The auditor has a motivation to keep his audit client pleased. If the client is pleased with the auditor’s work, which means that the auditor issued an “unqualified” (i.e. a “clean”) audit opinion, the client will pay the audit fee gladly. Moreover, the client might likely re-engage the auditor for next year’s audit work. And, of course, the auditor would be happy and motivated to do next year’s audit and receive next year’s audit fee too! However, if the auditor had issued an “adverse” or even a “qualified” audit opinion, such opinions might cause problems for the client, and the client may delay paying the audit fee while the client and auditor argue about the audit report.

There are many possible outcomes to an auditor issuing an “adverse” or “qualified” opinion. Upon announcement of such an opinion, new investors would be hesitant to invest with the company. Also, depending on the facts, the company’s public stock price could fall as existing investors seek to divest from a company that could potentially have even worse problems later on. Accordingly, the company’s ability to attract and maintain capital would be diminished. Moreover, an “adverse” or “qualified” audit opinion could alert outside regulators (like the Securities and Exchange Commission) of a problem and trigger them to send in their own auditors and attorneys. In an extreme case, an “adverse” audit opinion could begin a process where the SEC could actually bar or delist the company from trading its shares on public exchanges. In any scenario, investors and regulators would begin asking problematic questions that the company would rather just avoid.

An auditing firm can decide which clients it will accept, maintain or reject. However, rejecting a company for an ethical concern can be difficult when the audit fees are otherwise quite large or materially important to the auditor.
For example, in the 2000 year alone, Arthur Anderson received $25 million from Enron for their audit fee and another $27 million for other Enron related non-audit fees. So, Anderson received a total of $52 million in fees that year alone from Enron! When fees like these are involved, and when the auditor’s bonuses or awards are given for “keeping the client happy” and “keeping business in the door,” then an auditor might make the calculated decision that “keeping everyone happy” is worth the risk of issuing a knowingly improper and/or fraudulent audit opinion. In fact, such an audit strategy might prove profitable in the short term, but over time, such strategy tends to be unsustainable and fall apart. In Anderson’s case, because they were forced to dissolve as an auditing firm, it would have been more ethical and profitable—in the long run—to have just issued the correct “adverse” opinion when they were aware of problems. Still, we can speculate that Anderson made the short sighted decision that the “truth” would have been too costly in terms of a lost client and especially in terms of the lost fees.

Auditors and Opinions – Independence Revisited

So the Enron example begs a question, when exactly did Arthur Anderson “get comfortable” with an improper audit opinion? They had received $52 million in total fees in the year 2000 alone. If they had received say, only $30 million, would that reduction have been enough to change their minds? At what point would the auditors just assertively say, “We’re not getting paid enough for the potential problems with this client. We will just issue an adverse opinion and reject them as a client for next year?” The threshold will be different for each firm.

A more likely scenario is that the auditor contracted to do the audit for some amount. Then, in the course of the audit, the auditor found problems or discrepancies that he brought forward to the company’s management and/or board of directors. With
the company aware that the auditor has some “adverse information” about the company, which could, as previously discussed, lead to problems for everyone, the company may try to come to an “accommodation” with the auditor to prevent that adverse information from becoming public. That “accommodation” might frequently be in the form of “additional fees,” which for lack of a better word, in some circles, might sometimes be called a “bribe.” That is, it is within the realm of possibility, if not fiction, that an unethical auditor would accept additional fees to mitigate the risk of issuing a knowingly improper audit opinion.

The problem for the auditor is that after issuing an improper opinion, he or she is married to both the opinion and to the client. Once issued, he can’t very easily separate from either one. The client’s problems have suddenly become the auditor’s problems. The two have entered into something of a conspiracy.

Moreover, if the auditor gains a reputation for being “difficult”—read too ethical—or for having a history of issuing too many “adverse” or “qualified” opinions, then that auditor may find that obtaining additional clients could be challenging. Clients look at the audit not as something that they want but something that they need. Clients frequently need a financial audit so that they can be publicly traded on a stock exchange. Clients frequently need a financial audit as the required terms of a bank loan. So, the client tends to look at the audit as a commodity that can be bought in the open marketplace like any other commodity. The client just needs to find the right seller who offers the right commodity—namely an “unqualified audit opinion.” The question becomes that given all the competition among CPA firms, “which CPA firm will the client choose?” They will choose the one that will give them the most value for the
dollar spent. They will choose the one that will give them the "unqualified opinion" that they need.

In theory, issuing an improper opinion should not arise because the auditor is supposed to be independent enough to issue whatever appropriate opinion would fall within professional standards. The audit fee should have been agreed to "in writing" before the engagement ever started. It is possible, but not absolute, that the opinion may have likewise been agreed upon before the audit ever started, not in writing of course, but with a nod, a wink, a reputation or just chit chat over a good golf game.

*Transparency Revisited*

To make the baseball analogy again, the umpire receives the same salary from a third party regardless of any one judgment call and so he has no conflict of interest for salary. It would be ludicrous, if say some big league ball player were to pull a $1,000 bill at first base and ask the umpire to call him "safe" instead of "out." The fans would see it, the cameras would see it, and the media would see it. Moreover, if some big league team didn't like umpire "A" and instead hired umpire "B" for "better" results, the game would be ludicrous. So, the transparency standard in professional baseball is really set fairly high. This is the standard to which independent auditors should likewise aspire.

The reality seems to be that when auditors like Arthur Anderson found that their audit fees were high enough, they would be willing to sell their integrity. When professional standards dictate that an auditor should issue an "adverse" opinion or should make required disclosures, and instead issues an "unqualified opinion" with no disclosures—for extra pay—it would be the same as if an umpire who should have called an "out" instead called a "safe" because someone paid him extra to do it.
The industry should make auditing more like baseball. There should be new reforms as to how “independent” auditors are selected and, more importantly, as to how they are paid. Auditors should be provided to public companies the way umpires are provided to baseball games. That is, instead of CPA’s providing a contract service “for profit”, perhaps “salaried” auditors should be assigned to companies from some outside and relatively disinterested third party or agency.
CHAPTER 4

PECORA COMMISSION

The United States Senate commissioned Ferdinand Pecora, a New York state district attorney, to lead an investigation into the banking or financial practices that preceded the stock crash of 1929 and the ensuing depression. The original resolution to conduct an investigation was authorized by a Republican senate in early 1932 and the inquiry was reauthorized with an expanded scope by a Democratic Senate in early 1933. Pecora’s final report was issued in June of 1934. A study of Pecora’s investigation is noteworthy, from a financial historical perspective, to understand the state and mood of the country before federal securities legislation was enacted.

Ferdinand Pecora was not an official member of Roosevelt’s “Brain Trust,” however, his inquiry into banking activity dovetailed well with the activities of other reform minded “Brain Trusters.” There was a widespread belief among the “Brain Trust” crowd that corporate America was responsible for certain unregulated and predatory practices which caused or exacerbated the 1929 crash.

One of those men, Adolf Berle, had co-authored a 1932 book entitled The Modern Corporation and Private Property. According to financial author Jerry W. Markham, “Berle contended that corporate powers were ‘powers in trust’ and that large corporations were actually public institutions that should be regulated by the government to ensure that they were managed for the benefit of society.” Yet during the early 1930’s, and especially in the wake of the “communist scares”, the idea among the corporate leadership that corporations should exist for the “benefit of society” sounded perhaps too
much like "socialism." Accordingly, the financial sector’s opposition to reform was strong.

So, while Pecora made inquiries and documented the history leading to the 1929 crash, others like Berle were simultaneously advocating new legislation to regulate the stock markets. Their fruits would be the Securities Act of 1933 (15 USC §77a) and the Securities and Exchange Act of 1934 (15 USC §78a). Accordingly, Pecora’s final report did not make any specific legislative recommendations.

The highlights of Pecora’s inquiry were public Senate trials of certain high profile bankers. These trials unveiled particular instances of corporate malfeasance that, if not the smoking guns for the stock crash of 1929, at least highlighted possible contributing factors. They pointed as to why financial reform was actually necessary. During these inquiries, the most notable were the inquiries of Charles E. Mitchell, the chairman of National City Bank, and of Jack Morgan of J.P. Morgan & Company.

*National City Bank*

Early millennial images of baseball players and financial executives having the appearance of falsifying or obstructing their testimony before Congress and then otherwise being acquitted of perjury might suggest a new or different normal. So, it is hard to imagine that an executive from an international bank could be so candid during a Senate inquiry as to openly incriminate himself. Perhaps congressional inquiries during the 1930’s carried more clout.

In April 1933, Charles E. Mitchell was candid enough during his Senate inquiry to incriminate himself for tax evasion; however, it is his chairmanship of National City Bank and its business practices during his Pecora testimony that are germane to this paper.
The Senate’s own synopsis of National City Bank stated the following:

The committee selected National City not only because it was the second largest bank in the country, but also, as former committee chairmen Peter Norbeck explained, because of “its recognized leadership in the orgy of speculation which led to the business collapse.”\(^{10}\)

Moreover, Michael Hiltzik captured the same essence as he wrote in his book, *The New Deal A Modern History*, the following:

Pecora succeeded in casting the nation’s largest bank as an impeccably groomed racketeering enterprise. He showed how they dressed up crooked and incompetent enterprises to appear gilt-edged. For example, they marketed a $16,500,00 bond issue for Brazil’s *Minas Gerais* state by vouching for its prudent and careful administration despite possessing in their files a letter from the bank’s own agent remarking on the “complete ignorance, carelessness and negligence of the state’s leadership. Pecora documented how the bank pressured small investors into risky ventures, loaded them down with stock loans in the overheated markets of the Roaring Twenties, and left them penniless when the tide ran out.\(^{11}\)

In the above passage, Hiltzik calls National City’s operation an “impeccably groomed racketeering enterprise”, which is very strong language. Yet, if National City Bank knowingly misrepresented the Brazil bonds and sold them as “sound” when they otherwise knew that they were not sound, as Hiltzik implies, then the bank was merely self-dealing for their own interests and perpetrating a fraud. Yet, one could assume a wider scope suggested in Hiltzik’s observation, because if fraudulent or overly speculative practices were being perpetrated by the largest bank in the country, then an argument could be made that without stronger regulation there is nothing to stop any of the smaller ones from doing the same.

Also, regarding Pecora, Hiltzik wrote:

... he cornered Mitchell into admitting that he had avoided paying income tax in 1929 by contriving a $2,800,000 loss on National City stock by selling it to “a friend...a person of some means,” from whom he bought it back in 1932 at the same price. The buyer, it transpired was Mitchell’s
wife. Mitchell relinquished his post at National City a few days after this disclosure, and was indicted later in the year for tax evasion.\textsuperscript{12}

The significance of the above tax transaction is that it shows the degree of deceit for which Mitchell, chairman of the largest bank in the country, was personally capable.\textsuperscript{13} If Mitchell was comfortable defrauding the government for revenues on such large magnitudes of income, he was probably likewise comfortable with defrauding investors and clients of the bank. The fact that Mitchell resigned from National City Bank "a few days\textsuperscript{14}" after his testimony shows the power that transparency and public disclosure could have not just on National City Bank but on the financial industry as a whole.

\textit{J.P. Morgan \\& Company}

Hiltzik also reflects on Pecora's May 1933 inquiry of Jack Morgan and upon the practices of the J.P. Morgan \\& Company. Morgan's testimony would show that large banks can potentially hold significant influence and political power over elected officials by merely giving them gifts. Morgan's gifts were usually financial instruments, like stocks, given at below market prices for which the recipient could then exercise at market price for a virtual "guaranteed profit."\textsuperscript{15} If the reader substitutes the word "bribe" for "gift," then the reader will understand Hiltzik's implication.

It is notable that Morgan only offered such gifts to persons or families on his "preferred lists" or people that were influential and could prove helpful to J.P. Morgan \\& Company.\textsuperscript{16} Such gifts were not made available to the general public. It is also notable that members on the preferred list included members of Roosevelt's own administration including Treasury Secretary William H. Woodin.\textsuperscript{17}

Hiltzik wrote that, "The Morgan partners scrambled to deny that they had expected any quid pro quo, financial, political, or otherwise, from anyone on the lists in
return for the near guarantee of profits. Moreover, Hiltzik observed that, “The web of influence spun by the partners and their “friends” was large: the firm’s twenty partners held among them 167 directorships in eighty-nine corporations with assets totaling $20 billion. So, Hiltzik therefore portrays J.P. Morgan & Company as a colossal private equity firm with gifts, favors and money to spread around. Although in the above caption Morgan denied a *quid pro quo* relationship for members on his preferred list, it would be naive to believe that Morgan did not at least watch how his “friends” subsequently behaved. Morgan, in effect, was influencing powerful people to think, or to act, or to vote, in a way that might be useful to the J.P. Morgan Company.

Such gifts seem to have the aura of “insider trading” even though back then such gifts, if ethically questionable, were probably legal. Today, individual lobbyists are tightly regulated and such gifts would probably be illegal. According to Hiltzik, Jack Morgan’s feeling about the Pecora inquiry were as follows:

In private, he groused repeatedly about the very idea that, as the scion of Wall Street’s most distinguished clan, he should be hauled before a tribunal and grilled by someone with “the manner and the manners of a prosecuting attorney who is trying to convict a horse thief.”

The picture that we get from Hiltzik implies that Morgan held himself, and his wealth, to a different (rarified) level of exclusivity for which congressional scrutiny was either distasteful or should just not apply. Still, similar to the inquiry on Mitchell, the inquiry on Morgan had uncovered a tax evasion scheme because Morgan had not filed his personal income tax returns.

At a time when legislative attention was already focused on making financial reform a reality, the value of Pecora’s inquiry was to cast a previously hidden public light into the dark corners of high finance. Pecora’s hearings showed the public that if
financial transparency is ethically desirable in the stock market, then a certain lack of transparency, and even abuse, existed in some sectors of the financial marketplace. Regarding the hearings, a Colliers Magazine editor, John B. Kennedy, was quoted in the Chicago Tribune as follows:

This country can survive the shock of the truth. . . . This is true even though we have to hear so many tales of mismanagement among the mighty that it may seem that the only difference between a bank burglar and a bank president is that one works at night. . . .

The logic would follow that the lack of transparency was a contributory cause of the 1929 crash and subsequent depression. For purposes of financial reform, the net effect of the Pecora inquiries was to significantly ease passage of the Securities and Exchange Acts of 1933 and 1934 which together would become the linchpins for modern financial transparency.
CHAPTER 5

THE SECURITIES ACTS OF 1933 and 1934

To understand how depression era laws still affect financial processes in the twenty-first century, a review of their origin, history and nature is appropriate. The many reform minded laws created by President Franklin D. Roosevelt’s (FDR) administration were collectively known as the “New Deal.” Specifically, the Securities Acts of 1933 and 1934 encapsulated liberal democratic philosophies that sought to better regulate the securities’ markets with the intent to help prevent another stock crash, banking crisis and depression by forcing Wall Street and financial firms to provide investors with more transparent and truthful investment information. Among other “full-disclosure” requirements, these new laws required that stock issuers must register their securities with the government and include audited financial statements with their registration.1

An Idea in Coming

It would seem that the promulgations made by the Securities Acts of 1933 and 1934 were already reflections of ideas that had been floating around before FDR’s election. The Securities Acts were drafted in the spirit and sentiment of Supreme Court Justice Louis Brandeis. In his 1914 book, Other People’s Money and How Bankers Use It, Justice Brandeis famously wrote that “sunlight is said to be the best of disinfectants, electric light the most efficient policeman.”2 Brandeis’ concern was for the accumulation and control of excessive and unregulated wealth and how it threatened democracy.
Brandeis’s sentiment was likewise expressed during FDR’s 1932 presidential campaign when the candidate said:

There can be only one great principle to guide our course in the coming years. We have learned the lesson that extravagant advantage for the few ultimately depresses the many. . . . We must put behind us the idea that an uncontrolled, unbalanced economy, creating paper profits for a relatively small group, means or ever can mean prosperity.  

When elected, there could be little mistake that FDR’s legislative philosophy would include financial reform. In the excerpt above, the “relatively small group” to which FDR refers can be inferred to mean the bankers, financiers, attorneys and accountants on Wall Street and beyond.

In his book Benjamin V. Cohen: Architect of the New Deal, author William Lasser expressed that “the evils and excesses of bankers and brokers came to represent the abdication by American business of its fundamental responsibility to serve, rather than exploit, the American people.”  

This line of thought was popular among certain reform era men and was also expressed in Adolf Berle’s book, The Modern Corporation, in which Berle expressed sentiments that large corporations have evolved to such a point that they now regard their workers much like feudal lords had once regarded their serfs or as plantation owners had once regarded their slaves. Berle generally opined that that the entire American workforce has changed from individual and localized control of small business to large industrial corporate behemoths with management separated from its workforce sometimes by very long distances. The corporation, with its separated ownership from management and its separation of ownership from labor, was the ultimate reflection of that change.

Because of this newfound and widespread separation between ownership and the workforce, investors might buy and sell shares of ownership on open exchanges.
problem occurs, however, when an entire class of speculators can gamble with the separated shares of ownership. In many ways stock represents not just bits of ownership of the company, but also a bit of a worker’s job and a bit of his livelihood. The open, unregulated and highly speculative gambling of other people’s stock by large financial institutions could lead to the exploitation of an unsophisticated investor. It was this exploitation within the financial industry that Roosevelt sought to rectify.

At his inaugural address, Roosevelt already had in mind the creation of a securities reform law. Roosevelt announced, “The money changers have fled from their height seats in the temple of our civilization.” His reference to “money changers” is a direct reference to the New Testament account of Jesus also driving the money changers out of the temple. Most Americans would have understood his symbolism; the speech would have delivered its intended effect. Roosevelt intended to change Wall Street’s core practices of unregulated, self-serving, gambling towards one of transparency and accountability for the protection of the small American investor. The Securities Acts of 1933 and the Securities Act of 1934 were the mechanisms for that change.

_The Securities Act of 1933_

At Roosevelt’s request, Senator Huston Thompson originally drafted the first version of The Securities Act of 1933 and that bill attempted to regulate securities issuers. Thompson included several key new reforms including the government registration of new stock issues. Expecting an easy passage, on March 29, 1932, Roosevelt sent the bill to congress with the pronouncement of a new principle of “caveat vendor,”—seller beware. Roosevelt said, “This proposal adds to the ancient rule of caveat emptor (let the buyer beware) the further doctrine ‘let the seller beware.’”
Thompson’s proposal, however, proved too draconian and at times too vague for the Senate to accept. The proposal mandated that companies must register their new issues of stock with the government, but the proposal threatened to revoke the stock issue if the registration statement was found to be subsequently incomplete after its filing—even after its trading had begun. Such an imposition would create too much risk on the issuer. House Speaker Sam Rayburn deemed this and other provisions of the proposed bill as unworkable. Rayburn informed the president that the bill had to be rewritten or that it was doomed. Rayburn’s admonishment was not as an obstructionist since he supported the idea of securities regulation.

The administration enlisted the help of Felix Frankfurter, a Harvard law professor, and his “happy hot dog” assistants Ben Cohen, James Landis and Thomas Corcoran to rewrite the bill. While Corcoran and Cohen were former students of Frankfurter’s, Landis was also a Harvard law professor. Together, over the course of a weekend, these four lawyers rewrote Thompson’s bill and saved it from a near certain death. Although Frankfurter led the team, Cohen was the chief draftsman.

Frankfurter advised his assistants to model the bill after the English Companies Act of 1929. In British law, the issuer needed only to sign and date a stock prospectus and then file it with their government. If any required disclosures might be missing from the prospectus, British law lacked any actual penalties on the issuer. Accordingly, Cohen and the others redrafted the Thompson proposal to require that the registration of securities only apply to issues of new securities. The government would then disclaim the soundness of any particular security already on the market. If the required disclosures were missing or if there was a material misstatement of fact within the registration package, then the government’s only enforcement action would be to suspend
the security from registration and bar its trading. Moreover, the government could only make an enforcement action within 30 days of the securities filing and could prevent the issuer from selling any new issues during that time. Ultimately, the Senate accepted these provisions and the Securities and Exchange Act was passed on May 27, 1933.

**Securities Act of 1933 - Key Provisions**

Among other provisions, the Securities Acts of 1933 made the key requirement that public companies must file audited financial statements with the government. That is, the 1933 Securities Act required that publicly traded companies must file a “one time” registration statement and a “one-time” set of audited financial statements before making a public offering of stock. Because the Securities Act of 1933 required companies to provide audited financial statements from independent accountants, it significantly expanded the scope of accountants and auditors role within the process of capital formation. Because the auditor would have the power to challenge the company’s management about financial results, accountants themselves became a quasi-regulator.

Under the 1933 Securities Act, the issuer and the auditor could incur civil liability if the registration statement contained any false statements if a third party relied on the false statement. For auditors, the liability for false statements is relative, because even if the auditor’s report contained a false statement, perhaps not intentionally, but because the auditor relied on whatever information the client provided, the auditor could defend himself by claiming that he otherwise exercised “due diligence” and “good faith” and “did not know” of the inaccuracy himself.

The U.S. Constitution explicitly gives Congress the authority to regulate interstate commerce. Since the Securities Act of 1933 made it specifically unlawful to sell an unregistered security through “the mails” and through “interstate commerce,” Congress

44
affirmed securities regulation as within its purview. Securities regulation had been previously governed mostly through a patchwork of state laws. The Postmaster General would therefore also become an unintended if ubiquitous regulator of securities transactions.

The effect on independent accountants from the Securities Act of 1933 is that their audited financial statements would be attached to the registration statement. If a material misstatement of fact was for virtue of a fraudulent or misleading financial statement —like on a balance sheet or income statement— then the government could suspend registration and thus suspend any trading of the issuer. Such suspension could cripple the capital formation and business expansion of the issuer. Lasser wrote:

Cohen, Corcoran, and Landis were “Particularly anxious through the imposition of adequate civil liabilities to assure the performance by corporate directors and officers of their fiduciary obligations and to impress upon accountants the necessity for independence.”

While in a similar line of thought, Hiltzik observed:

Landis, Cohen and Corcoran . . . imposed responsibility not only on a corporation’s directors and top executives, but also on accountants, lawyers, appraisers, and other professionals whose contributions were material to the disclosure statement. They made no secret of the fact that their goal was to raise the “ethical and professional standards of the accounting profession” and foster the creation of a body of generally accepted financial reporting standards in corporate accounting and law through this new regulatory regime and become one of the most important legacies of the New Deal.

Thus the professionalism and function of the independent auditor, and of the certified public accountant, was amplified from the Securities Act of 1933 with the intent of protecting the unsophisticated investor.

In debating the exact role that auditors should have, Markham wrote:

Congress proposed that government auditors should be hired to audit the books of companies selling stock to the public. That proposal was short
lived. As Colonel Arthur Carter, senior partner of (the) accounting firm Haskins & Sells, testifying before the assembled senators, said, "you had better plan on some more buildings in Washington to house [the auditors]" Heeding that warning, Congress decided to rely on the accounting industry for audits.\textsuperscript{22}

It is interesting that Congress missed an opportunity for government auditors to verify the financial statements of public companies. To compare, the IRS uses its own governmental employees to audit income tax returns; the IRS has never outsourced that role to contractors. Moreover, the likelihood of an IRS auditor falsifying an audit is unlikely because the IRS auditor is a salaried employee of the government and, all else being equal, he has no financial motive in the outcome of the audit itself. Since the government wants to maximize its tax revenue, it pays the auditor’s salary with the idea that the government will probably gain more in tax revenue than expend on the auditor’s salary.

However, for purposes of registering securities, the government has no direct revenue interest in the financial audit of a publicly traded company. Because the financial audit would be just another document to attach to a stock’s registration statement to foster openness and transparency for investors at large, the audit by itself is simply revenue neutral to the government. So, the requirement to file audited financial statements with the registration statement might be like filing a “birth certificate” with a passport application, or “college transcripts” with a job application. In those cases, the federal government may not care where the certification for birth, or the college transcripts originated as long as they were otherwise legitimately from a recognized U.S. state or a recognized university. The securities registration process would be similar. The government wouldn’t care from where the financial statements came as long as they came from an independent (certified public) accountant.
In the securities registration process, Congress was not apparently willing to pay for the assurances that a governmental audit could provide and instead passed down that expense onto the company itself. By missing this opportunity, Congress perhaps saved precious government resources but also introduced into the registration process an ethical slope. That slope would be the risk that the auditor would not be independent (in fact) from the company that he or she is auditing. This risk was previously discussed in Chapter 3 of this thesis.

Regarding the new legislation, Hiltzik summarized:

The lawyers and accountants who had formerly done their bidding would themselves operate under legal constraints and strict professional standards. The responsibilities the law imposed on these advisors would also give them the power to say no - no to stock schemes, no to watered books, no to the multitude of underhanded tricks they had once condoned as a matter of course. The law would implicitly invest accountants and lawyers with new powers in the boardroom, a revolution not relished by the officers and directors who were accustomed to ruling their firms as undisputed dictators.23

It would be a fair assumption that the creators of the 1933 Securities Act, if they were still alive, would still have concerns today for the current advisors, accountants and attorneys that are running our modern markets.

*Securities and Exchange Act of 1934*

The purpose of the Securities and Exchange Act of 1934 was to expand the scope and reach of the 1933 Securities Act. Whereas the 1933 Act reached only new issues of stock, the 1934 Act sought to regulate the exchange “as a whole” and reach most all issues of stock. Accordingly, the 1934 Securities Act then increased the “one time registration requirement to become an annual requirement replete with annual audited financial statements.”24 If companies wanted to maintain their public listing, they would have to comply. Similar to the 1933 Act, the 1934 Securities Act made stock issuers and
their auditors liable for published misstatements if a third party investor relied on those misstatements.25

To help the government receive all of these new registration and financial statements, the Securities Act of 1934 created the Securities and Exchange Commission (SEC).26 The SEC would become the cognizant agency for enforcing regulations.27 Not surprisingly, industry insiders wanted a weak regulatory agency. In fact, Richard Whitney of the New York Stock Exchange attempted to make the SEC into the “self-regulated” image of the New York Stock Exchange itself by proposing that its new officers would be selected from Wall Street investment firms.

Hiltzik reprinted testimony from congressional hearings on the proposed 1934 legislation. One of the bill’s drafters, Tommy Corcoran, observed that if Congress allowed the SEC to be composed of representatives from investment houses, that it “would be like advising that one put a baby into a cage with a tiger to regulate the tiger.”28 In light of regulatory scandals surrounding Enron and Bernie Madoff, Corcoran’s metaphor may have in fact become a reality.29

Hiltzik wrote of the following exchange between Senator Thomas Gore of Oklahoma and Tommy Corcoran. Gore asked:

Is it your theory, at least, that most of the evils that proceed from dealing in stocks, and so forth, result from machinations and sinister activities on the part of the stock exchange as such, or from brokers and outsiders and officers and directors who are manipulating their own stock? Who is the chief sinner in this scheme?

“It is hard to tell who is the chief sinner, sir,” Corcoran replied. “There are so many sinners.”30
Insider Trading Provisions

One other key provision of the Securities and Exchange Act of 1934 is the prohibition against insider trading. Section 21 of the 1934 Act reads as follows:

Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security ....while in possession of material, nonpublic information, or has violated any such provision by communicating such information in connection with, a transaction on or through the facilities of a national securities exchange or from or through a broker or dealer, and which is not part of a public offering by an issuer of securities other than standardized options or security futures products, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by the person who committed such violation;#31

And, moreover it stipulates the following:

The actions authorized by this section may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring. #32

The Commission may transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of this title or the rules or regulations there- under to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this title. #33

In reading the first excerpt, we find that the penalty for “insider trading” is “civil” and not “criminal.” Such civil penalties usually are the mere imposition of a fine. However, in the second and third excerpts, they make reference to “any other actions that the Commission or the Attorney General are entitled to bring” which implies that the stock issuer, the dealer, the broker, or the auditor, could all be held for criminal action. The insider trading provisions are the same provisions under which Martha Stewart was criminally prosecuted (but not convicted) for her role in selling Imclone Stock, or the provisions under which Enron executives were prosecuted for selling stocks with
knowledge of accounting malfeasances, or in the *Wall Street* scenes as discussed in Chapter 2 (of the thesis).

**Opposition - Richard Whitney**

The Democratic agenda during the 1932 election had already included stock market reform in its platform.\(^{34}\) With the advent of the Pecora hearings, and after the March 1933 inauguration, it was no surprise to anyone that actual reform was nearby. In 1933 and 1934, one of the highest profile opponents to Securities and Exchange reform was Richard Whitney, president of the New York Stock Exchange.

According to Hiltzik, while the 1934 Securities Act was being drafted, Richard Whitney met with Roosevelt to try to lobby for a series of “self-regulatory” measures instead of actual legislative measures on the stock market.\(^{35}\) In Whitney’s mind, he believed that the legislation was overreaching as “the exchange is a perfect institution.”\(^{36}\)

Regarding FDR, Hiltzik wrote:

> The President had spent his life rubbing shoulders with people like Richard Whitney, and he knew that their primary goal - perhaps their only goal - was to preserve their personal prerogatives, if need be at the expense of the community and the nation.\(^{37}\)

Hiltzik also observed that Roosevelt had confided with fellow “Brain Truster” Adolf Berle.

> The fundamental trouble with this whole Stock Exchange crowd is their complete lack of elementary education. I do not mean lack of college diplomas, etc., but just inability to understand the country or the public or their obligation to their fellow men. Perhaps you can help them to acquire a kindergarten knowledge of these subjects.\(^{38}\)

In the succeeding decades, the financial industry’s opposition to the Securities Acts would not be for their existence, as was Richard Whitney’s, but for their spirit. In the wake of Enron, or Bernard Madoff, the country would see examples of companies *mechanically*
complying with the requirements to perform an audit and to register it with the government, but in that process sometimes stretching that compliance so thin as to include vagaries and half truths—and then causing some people to question the viability of the process itself.
CHAPTER 6

ENRON AND THE SECURITIES LAWS

In the new millennium, if there was a single company that entered the popular lexicon as being the metaphor, the virtual synonym, for financial fraud, it would probably be Enron. Enron ended as a scandal because they did not follow the promulgations or even the spirit of the Securities Acts of 1933 and 1934. Even if Enron failed financially, it could have winded down in a normal bankruptcy, without scandal, if they had simply been more transparent and truthful.

Since Enron, there have been other larger companies that have had larger scandals like World Com or AIG. In fact, it is sometimes difficult to read financial news and not become numb over the revelation of yet another large scale scandal. However, it was Enron in late 2001 that first caught and maintained the public’s attention due to the size and scope of its errors. At the time, Enron became the largest U.S. corporate bankruptcy. However, what was especially notable for Enron was that it had the power to destroy one of the oldest and most venerated accounting firms in the United States, its auditor, Arthur Anderson. The focus of this chapter, then, will be to examine how Enron, and its auditor, evaded or ignored the securities laws, and especially the 1934 Act, that were supposedly already in place to prevent such errors or fraud from occurring.

From the outset, it should be noted that Enron’s failings were human failings. It was how Enron’s leaders chose to interact with the existing legal and financial framework which created the scandal. If its officers had simply not been blinded with greed and hubris, history may have credited Enron for truly innovative thinking in the energy derivative markets.
Journalism and the First Amendment

In their book, *Separating Fools From Their Money*, MacDonald & Hughes make the following observation regarding Enron, "None of the players who should have been keeping an eye on management - the auditors, outside directors, or outside shareholders - could, in fact, exert any power over senior managers."

That quote is fair enough, but, it does not cover the entirety. There were other actors like investment bankers, financial analysts, attorneys and even public officials that should have had a better check on the irregular pulse of Enron. Except for the public officials, all of these actors would have some sort of a financial interest in Enron whether it be for their fee of commission. Ultimately, it was the financial press, the journalists, those that had no direct financial tie to Enron, that opened the company up to public scrutiny.

Enron imploded in a series of events between August and December of 2001. Earlier that year, a financial journalist Bethany McLean of *Forbes* magazine had written a March 5, 2001 article titled "Is Enron Overpriced?" In that article, she had asked some basic questions about Enron’s earnings and operations, but she was not able to find basic answers. Before she published the article, she spoke with Enron’s management to clarify lingering questions and yet she still came away with only vagaries and obfuscations. From the outside, her article was probably the beginning of the end for Enron. In this sense, the free press, acted as the best guardian of the public investor when, in theory, the auditors and accountants should have been the first line of defense. It should be noted also that McLean’s salary was paid by *Forbes* magazine and not by Enron. So, in this sense, she truly was in an independent position to report what she saw, which in theory, was the same independence that the auditors should have enjoyed.
Accounting Issues

The financial press has already written extensively about Enron’s management decisions and of its history from inception to demise. However, the real accounting issues that brought it down were twofold. The first issue was Enron’s creation and use of certain “Special Purpose Entities” (SPEs). Enron, and its auditors, failed to fully disclose their use of SPEs on the financial statements. The second issue was their use of “mark to market” accounting, which allowed Enron to record certain amounts of income estimates as if they were real when in fact those estimates were not well grounded in reality. The combination of using SPE’s and “mark to market” accounting allowed Enron to both hide liabilities and to create paper and sometimes fictional income. Again, although these issues were of an accounting nature, they were in fact management decisions made by human beings.

Special Purpose Entities

Normally, SPE’s can be a legitimate mechanism to hedge risk or receive favorable financing for certain operations within a company. For instance, companies might create an SPE, usually a separate corporation or partnership, to isolate or remove certain assets and then lease them back to the company. An airplane, a building, or even a factory could technically be shifted into a SPE and then leased back to the company itself. This arrangement could have benefits where a company may technically control an asset, but where it can also mitigate its exposure to liability.

For Enron, they created SPE’s to create a “hedge” on their own stock price. In layman’s terms, Enron created SPE’s to effect an off balance sheet “bet” that if their stock price went down, then, the SPE would pay Enron the value of the decline. The SPE’s acted as the clearing entity between Enron and some other party like a bank or
other institutional investor. For the layman, Enron was gambling that its stock would never go down. In a competitive market, to believe that a single stock could never decline is to be stuck in the human condition of hubris.

Under certain circumstances, the accounting rules required that the SPE must be consolidated with its parent entity for financial reporting purposes. That means that when the parent company reports financial results to the SEC, that they would likewise have to report the financial results of the SPE, as if the two entities were one. Moreover, the existence and details of the SPE would have to be reported in the notes of the financial statements. Under other circumstances, the SPE might not have to be consolidated and it could be kept “off balance sheet.” The advantage of not showing a SPE on a consolidated basis would be to hide any liabilities that management does not want to show outside of the core business. Such liabilities, if consolidated, would make the core company look less profitable overall. Enron tried to make some of its SPE transactions fit into the “off balance sheet” category when really, according to Generally Accepted Accounting Principles (GAAP), they should have consolidated it into the main Enron financial statements. Because they should have been consolidated, the 1934 Securities Act would have likewise required their full disclosure.

Enron’s Chief Financial Officer, Andy Fastow, created many of these special purpose entities and mostly in the form of limited partnerships, where he acted as either the general partner, or as a limited partner with a controlling interest. The rules stated that to keep a SPE “off balance sheet”, that at least 3% of the SPE has to be funded with assets from some other independent party. The problem for Enron was that Fastow sometimes had trouble finding a counter party, and to avoid consolidating the SPE financial statements with Enron, he would set up either himself or another straw man, like
a friend, as the “independent” general partner. Thus, the 3% outside SPE control was not independent. Moreover, instead of using 3% of outside capital, he infused some SPEs with Enron’s own stock. Yet, because Fastow ultimately controlled the SPEs and because he was also an officer of Enron, he had a conflict of interest between his duty as an officer of Enron and as a partner of the SPE. According to the insider trading rules, with limited exceptions, transactions that Fastow made on behalf of an SPE and on behalf of Enron would need to be disclosed in both the financial statements and to the SEC.

The Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp, i.e. the Powers Report, was commissioned by Enron’s board of directors, in the immediate wake of their December 2001 bankruptcy, to help them understand the facts and circumstances surrounding the Fastow partnerships. The Powers Report conceded that Enron indeed made certain financial statement disclosures regarding the partnerships. However, they also concluded as follows:

... these disclosures were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships. The disclosures also did not communicate the nature or extent of Fastow’s financial interest in the LJM partnerships. This was the result of an effort to avoid disclosing Fastow’s financial interest and to downplay the significance of the related party transactions and, in some respects, to disguise their substance and import.

If the disclosures had been more accurate, more detailed and if they had at least disclosed the magnitudes of dollars involved, perhaps the more traditional outside parties like the stock analysts and the bankers would have cast a more critical eye. Such disclosure would have invoked the spirit of the 1933 and 1934 Securities Acts instead of barely meeting their mechanical compliance.
Because Enron's board specifically approved of Fastow managing the LJM partnerships before they were even created and because the LJM partnerships carried hundreds of millions of dollars of potential liability for Enron, the Powers Report shows that the board itself was negligent for their lack of oversight. Still, Enron's board consulted Andersen about the viability of using Fastow's partnerships and Andersen did not specifically advise them against it. The lead audit partner at Andersen, David Duncan, even told the board, "Obviously, we are on board with all of these." Because Andersen was less critical when they should have been more critical, they had the appearance of rubber stamping whatever Enron wanted. More importantly, Anderson drafted and signed Enron's financial statements knowing that they were missing details about the partnership SPEs. In light of the fact that Fastow and Andersen had kept the actual SPE financial results "off balance sheet," such non-disclosure was intentional. When the magnitudes were in the hundreds of millions of dollars, such omissions created a material misstatement and again violated not just the meaning but the spirit and intent of the 1933 and 1934 Securities Acts for full transparency.

Mark to Market Accounting

According to journalist Bethany McLean, before one of Enron's key management consultants, Jeff Skilling, accepted a position with Enron, and who later became Enron's chief operating officer, he insisted that Enron switch their accounting basis on natural gas contracts from "historical cost" to "mark-to-market." The impact of Enron's decision regarding this change can not be understated because although mark-to-market accounting is appropriate for an investment portfolio of stocks or bonds, the method was a departure from how natural gas dealers normally booked the assets and revenues on contracts. Adapting "mark-to-market" accounting would enable Enron to suggest that it
was more profitable (on paper) at the inception of a contract than what its actual cash-flow could support.

Because Skilling wanted to report results outside of established GAAP, Enron would in turn have to request approval from the SEC. According to McLean, the SEC was initially skeptical of allowing it because they were concerned about the proper estimation of future gas prices which can, like other commodities, be volatile. Skilling convinced the SEC that Enron’s profit would be based on “known spreads and balanced positions.” It is unclear to this writer what Skilling exactly meant by “balanced positions,” but it suggests that the balance is between natural gas supply and natural gas demand. Nevertheless, in 1992, the SEC allowed Enron to make the change. Mark-to-market accounting allowed Enron management to report their entire estimated income of a long term, say 10 year, contract in the same year that they signed the contract regardless of any actual cash flowing through the door. For Enron, mark to market would prove a very subjective accounting method and prone to manipulation that would encourage short term thinking.

According to McLean, a respected Wall Street analyst, Jim Chanos, stumbled on a Wall Street Journal article that argued that “outsiders had no way of knowing the assumptions that companies like Enron, Dynegy, and El Paso used to book their earnings.” Regarding Chanos, McLean wrote:

... he flipped open Enron’s 1999 10K. He read: “The market prices used to value these transactions reflect management’s best estimates.” He thought: “A license to print money.”

So the effect of mark-to-market, is that it would allow Enron to inflate earnings with overly optimistic estimates of what natural gas prices would be in the future. Moreover, if natural gas prices did not match their expectations, that is, if they declined over time,
according to the rules, Enron would have to adjust their income estimates downward to match the decreased price because of the changed assumptions. It turned out, however, that when gas prices did decline, or if collectability with a contract became uncertain, then Enron’s management, i.e. Andrew Fastow, would conveniently not revise their original estimates downward so as to artificially support Enron’s stock price and credit rating. By not revising the original estimates downward, Fastow was creating the appearance of profitability that did not exist and no one, not even the auditors, forced him to behave otherwise. In the 2000 year, when Enron attempted to enter its new broadband market, and despite the objections of at least one lower level auditor, Carl Bass, who Andersen had subsequently fired, Enron fictitiously recorded $53 million dollars of revenue on a deal that had already fallen apart in negotiations. Enron and Andersen justified the revenue by claiming the “future potential” of the technology. Between Enron and Andersen, this is the definition of complicity with fraud. The 1934 Securities Act specifically forbade management or its auditors to report such material misstatements of fact, and yet Enron and Arthur Anderson did it anyway.

**Sherron Watkins**

The danger for any hierarchal organization is that the members may succumb to a type of “groupthink” as fostered by their leaders. Whereas groupthink can provide a unifying force among members, if the underlying assumptions are flawed, it can cause the entire group to be blinded to the truth. When such blinders are cast, and especially when cast for greed, the group and its leaders need an outsider to help them see an alternative vision. Sherron Watkins (sic) was a finance executive at Enron but outside of the core Ken Lay, Jeff Skilling and Andrew Fastow leadership. After Skilling’s
resignation, she began to ask Ken Lay, Enron’s founder, Chairman, and then CEO, some tough questions, but, for investors she asked too late.

Watkins took over for Cliff Baxter in June 2001 after Baxter resigned from Enron, and she began reporting directly to Andy Fastow, the CFO. But, then in August 2001, another of Enron’s key leaders, Jeffery Skilling, also suddenly resigned. Watkins began asking some critical questions. Part of Watkins new job was to identify and review any Enron assets that might be available for sale. As a result, she found certain Fastow partnerships, i.e. the Raptors, which indicated massive accounting errors and probably even fraud. Watkins saw Enron’s future which would be the collapse of the Raptors SPE, and because of its scale, therefore possibly the collapse of Enron.

In a rare example of corporate whistle blowing, Watkins did two important things. She met informally with external auditors (Andersen) to share her concern about the “smoke and mirrors” of Enron’s assets related to the Special Purpose Entities. It should be noted that Watkins was a former Andersen employee; she could maneuver through their culture. More importantly, she issued a memo to the Chairman, Ken Lay bringing his specific attention to the accounting problems within the SPEs. In light of the press coverage that Enron had already received from Forbes, and in light of the sudden departure of two key Executives, Baxter and Skilling, Watkins was looking to protect herself. She wrote:

Has Enron become a risky place to work? For those of us who didn’t get rich over the last few years, can we afford to stay? . . .

. . . I am incredibly nervous that we will implode in a wave of accounting scandals. My eight years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax. Skilling is resigning now for “personal reasons,” but I would think he wasn’t having fun, looked down the road
and knew this stuff was unfixable and would rather abandon ship now than resign in shame in two years.\textsuperscript{20}

Her memo also gave several methods to fix the problem which included recognizing “a loss” for the accumulated past misstatements since 1997. Lay’s response was to have Enron’s law firm, Vinson and Elkins review her concerns.

In the wake of the Skilling resignation, the \textit{Wall Street Journal} also began asking questions. In an August 2001 article, Skilling had told reporter John Emshwiller that he left Enron partly because of undue pressure to meet earnings projections even though he had previously cited personal reasons.\textsuperscript{21} The discrepancy between Skilling’s two versions for departure are not particularly problematic, except that, the second version about the stock price is simply more truthful. But, the \textit{Wall Street Journal} was following a scent. Consider the following excerpts from that same article.

\ldots Mr Lay promises to address the longtime analyst and investor complaint that Enron doesn’t provide enough information about its extremely complex operations, which include not only construction of natural-gas pipelines and power plants but the trading of an ever-expanding array of commodities.\ldots

\ldots Mr. Lay says Enron will start putting out more detailed information on individual business segments and “give a better idea of the profitability of various businesses.\ldots

“I truly do not understand all their financial arrangements, and I’ve sent information on their deals to accountant friends and they don’t understand them either,” says Rebecca Follwili, an analyst at Howard Weil, who refers to Enron’s accounting methods as a “black box.”\textsuperscript{22}

By reporting Enron as a “black box,” Emshwiller suggested that Enron’s accounting methods were nebulous and not comprehensible. On the article’s publication date, August 28th, 2001, Lay had already received Watkin’s memo and realized that Enron would probably have to consolidate some of the partnership losses which would in turn affect its stock price. Lay had begun to sell off his Enron stock while the prices were still
relatively high compared to the certainty that they would head downward after a restatement. Selling stock before the public has similar knowledge of adverse circumstances is the definition of “insider trading” which is specifically prohibited by the Securities Act of 1934.

Those write downs would occur at the quarter ended September 30, 2001. According to the publishers at Professional Education Services, “Financial statements for 1997 to 2000 were restated resulting in a $586 million reduction in net income, and a $2.6 billion debt increase, and a $1.2 billion reduction in stockholders equity.” The Wall Street Journal did not let these filings go unnoticed. On Wednesday, October 17, 2001, the day after Enron filed its third quarter earnings with the SEC, the Wall Street Journal began a three day series of articles on Enron. In the October 17, 2001 article, Emschwiler wrote:

... Mr. Fastow’s yield from options for the 12 months through August 31 was $4.6 million, according to disclosure reports compiled by Thomson Financial. Mr. Lay netted about $70 million from exercising options during this period, while Mr. Skilling, the former president, realized nearly $100 million.

... Kenneth Lay, said the write-offs were designed as part of an effort to “find anything and everything that was a distraction and was causing a cloud over the company. . . .”

Lay’s statement technically is accurate. By writing down the assets at the third quarter 2001, Enron was correcting a wrong, but Lay’s quotation in the Wall Street Journal article made Enron’s adjustment sound like a minor bookkeeping error. In reality, Enron was mitigating major damage from past negligence and fraudulent reporting. Moreover, with the executives exercising their options within a year before the write-down, they knowingly used “inside knowledge” to avoid their own losses which under the 1934 Securities Act is a crime. The executive cash outs stand in stark contrast with the
average investor who suffered severe losses. Eventually, Fastow and Skilling served prison time while Lay died in prison. If these men had simply followed the law, the company may still have been bankrupt, but they would have been free to pursue any other activity.

Arthur Andersen, LLP

Because Andersen was supposed to be the guardian of the public investor, it is noteworthy how they responded to Enron’s third quarter 2001 loss disclosure and subsequent public scrutiny. David Duncan, the lead auditor on the Enron engagement team told his staff to “exercise the firm’s document retention policy” which his staff interpreted to mean “destruction.” They began to shred documents. To the casual observer, shredding audit documents looked like Andersen was destroying incriminating evidence that could potentially be used against themselves in court. Such documents may have shown that they knew or should have known that they had issued improper audit opinions.

The government’s perception was that Andersen’s shredding was an obstruction of justice, a reasonable assessment. In fact, on June 16, 2002, Arthur Andersen was convicted of “obstruction of justice” but not for the stated act of shredding. The jury otherwise convicted Andersen for an internal email which recommended “deleting some language that might suggest we have concluded the release is misleading.”

Despite the obstruction charge, it is notable what came out in testimony during the trial. The Wall Street Journal reported:

Andersen’s own senior partners, including the accounting specialist John Stewart of the firm’s Professional Standards Group, rued on the stand how the firm had compromised its independence and allowed Enron to dictate its auditors’ decisions. Enron even controlled which Andersen people worked on the company’s audits.
Independence is the very foundation of the auditing profession and it was independence which Andersen’s David Duncan sold to Enron. It is true that Andersen profited in the short term by appeasing Enron; but in the long term, it would have been more profitable for Andersen to have remained a viable company. Andersen was in a difficult position trying to balance the client’s needs with professional diligence. But professionally and ethically, Andersen should have been prepared to lose Enron as a client and associated consulting fees. In fact, in the early part of 2001, Andersen had already had those internal discussions.³⁰

Andersen had its criminal conviction later overturned by the U.S. Supreme Court on a procedural technicality that the judge had not issued clear instructions to the jury.³¹ Despite the reversal, Andersen had already dissolved its audit business and because of the mark on its reputation it would not return. Despite Andersen’s ultimate U.S. Supreme Court acquittal, and despite the fact that Andersen was a worldwide company and that Enron was serviced only by Andersen’s Houston office, the general public still looked at Andersen as the modern metaphor of crooked accounting. The ultimate problem for the public would be the lingering doubt, much like the doubts raised in the Pecorra hearings, that the Enron and Arthur Andersen relationship was not unique.
CHAPTER 7

BERNARD MADOFF

In 2008, the Bernard Madoff investment scandal was the largest identified Ponzi scheme in the United States. Investors lost a total of $65 billion dollars. The size and scope of Madoff’s scheme dwarfed even that of Enron. It is difficult to believe that Madoff perpetrated his fraud for so long, an estimated 20 years, because there were multiple red flags along the way. The single event that brought Madoff’s scheme down was not for the structural safeguards, like an SEC examination, or for an audit report, which should have caught him. Instead, in the wake of the financial panic of 2008, Madoff was simply unable to pay cash on demand to investors who had requested it. This chapter will analyze the structural safeguards related to the Securities Acts of 1934 that should have caught Madoff’s crimes, but did not.

According to Erin Arvedlund, Bernard Madoff should not have had to operate a Ponzi scheme. He actually ran a legitimate brokerage business through the 1960s and 1970s. In fact, when other brokers still made stock trades using paper, telephone and mail, Madoff was at the forefront of technology and early implemented electronic trading systems when it was not yet fashionable. In 1971, the NASDAQ, National Association of Securities Dealers Automated Quotations, established the first electronic communications system and Madoff was one of the first to use it. Arvedlund states:

Madoff ultimately joined the NASD National Market System Design Committee in 1979, and headed the Design Committee again from 1981 to 1983. Madoff took an active role in the discussions that led to the creation of the Intermarket Trading System. Subsequently, the Intermarket Trading System (ITS) exploded onto Wall Street.
Arvedlund also quoted a financial journalist at the time, Peter Chapman, who said that “Madoff made it sound like he was Al Gore inventing the Internet, like he invented NASDAQ.”⁵ Madoff did not invent NASDAQ, but, he was in at the ground floor and became instrumental to its early improvements. Moreover, because the SEC wanted to reduce the monopoly of the New York Stock Exchange and because Madoff helped develop a system that accomplished that, Arvedlund again quotes Chapman who stated, “The SEC loved him for that.”⁶

In the 1970’s and 1980’s, Madoff was well ahead of his competitors technologically, and he became well known in both NASDAQ and SEC circles for innovation and profitability.⁷ Between 1990 and 1993, Madoff was the chair of the NASD (National Association of Securities Dealers) which was the “self-regulatory” organization overseeing the NASDAQ market.⁸ So, it is with great irony that Madoff himself was, in a sense, once a “regulator” of the NASDAQ securities market.

Madoff was a licensed broker, which is a license to mechanically buy and sell trades on behalf of an institutional investor. He was not a “registered investment advisor” which is a license to give advice about securities to individuals. Yet, Madoff had managed savings for small investors, friends and relatives, as early as the 1960s. According to Erin Arvedlund, “his investment advisory business was always illegal.”⁹ So, even while he was receiving accolades for modernizing the exchanges, and even while he was chairman of the NASDAQ, he was also always on the wrong side of the law.

As early as 1992, there were indications that Madoff was not operating legally. One of Madoff’s feeder funds, a Florida firm called Avellino & Bienes, forwarded investor money to Madoff. The feeder fund became under SEC investigation for
suspected Ponzi activity. That fund guaranteed investors that their investments were 100% safe and that they would earn a guaranteed return.\textsuperscript{10} Such statements are, in part indicative of a Ponzi scheme because most investment advisors would warn about market volatility and that past performance does not guarantee future results. In 1993, the SEC closed down Avenillo & Bienes and permanently barred them from acting as an investment company. It is curious and inexplicable, however, that the SEC's enforcement action stopped only at Avenillo & Bienes. According to Michael Bienes, their only investment strategy was to forward all money to Madoff.\textsuperscript{11} Avenillo & Bienes did not make any investment decisions. It was Madoff who had advised them how to set up their business and who specifically told them not to register as investment advisors.\textsuperscript{12} According to Bienes, they were naïve and unsophisticated accomplices.\textsuperscript{13}

In conjunction with the investigation of Avenillo & Bienes, the SEC had made certain inquiries of Madoff. However, it is believed that because the investors with Avenillo & Bienes were made "whole," the SEC had considered the outcome "good" and therefore did not proceed any further against Madoff. The SEC did not seem to consider that Avenillo & Bienes may have returned investor money which was misappropriated from other Madoff feeder funds.\textsuperscript{14}

The Securities and Exchange Act of 1933 would have required Avenillo & Bienes to offer investors a prospectus of registered securities. They were certified public accountants, so it is questionable whether they were as unsophisticated as they had claimed. There is a lingering question if Madoff's past reputation in the financial community prevented the SEC from looking too much beyond Avenillo & Bienes and towards Madoff himself. Even if Avenillo & Bienes were unwitting accomplices to the
Ponzi scheme, the law worked as intended against them, but it failed for whatever reason to reach Madoff.

In an effort to duplicate Madoff’s investment returns, which were uncharacteristically high, a Boston investment advisor, Harry Markopolos, analyzed Madoff’s published returns and determined that they were impossible and that they had to be based upon fraud. In 2000, Markopolos made an official compliant to the Securities and Exchange Commission’s Boston District Office (BDO) by providing a detailed written analysis of Madoff’s funds. It is unclear exactly why the SEC dropped the Markopolos complaint. It is clear, however, that the Assistant Regional Director of the SEC’s North East Regional Office (NERO) wrote an email to the NERO director in which she said:

As we discussed, after reviewing the complaint received [via the BDO] from Harry Markopolos of Rampart Investments about purported performance claims for funds managed by Bernard Madoff, and some information about Madoff and others identified in the complaint, I don’t think we should pursue this matter further.\textsuperscript{15}

It is possible that Madoff’s reputation as a past chairman of the NASDAQ, and manager of one of the world’s largest hedge funds replete with his industry connections, colored her vision to write, “I don’t think we should pursue this matter further.” Otherwise, if she had not made those considerations, it wouldn’t have made sense to drop the complaint.

In 2001, two financial journalists wrote about Madoff and questioned his returns. Michael Ocrant wrote an article in \textit{MAR/Hedge} titled “Madoff Tops Charts; Skeptics Ask How.” Ocrant wrote:

\ldots most of those who are aware of Madoff’s status in the hedge fund world are baffled by the way the firm has obtained such consistent, nonvolatile returns month after month and year after year. \ldots
In addition, experts ask why no one has been able to duplicate similar returns using the strategy and why other firms on Wall Street haven’t become aware of the fund and its strategy and traded against it, as has happened so often in other cases. 

Ocrant’s implication was that Madoff’s returns were simply too good to be true. He doesn’t specifically write that Madoff’s funds were fraudulent, but he draws the reader to a place where certain questions demand an answer. Financial journalist Erin Arvedlund likewise wrote an article in Barrons that same year titled “Don’t Ask, Don’t Tell” in which she makes similar points as Ocrant, but she took special issue with Madoff’s excessive secrecy. Regarding a Madoff investor who she had interviewed for the article, she wrote:

This investor declined to be quoted by name. Why? Because Madoff politely requests that his investors not reveal that he runs their money. “What Madoff told us was, ‘If you invest with me, you must never tell anyone that you’re invested with me. It’s no one’s business what goes on here,’” says an investment manager who took over a pool of assets that included an investment in a Madoff fund. “When he couldn’t explain [to my satisfaction] how they were up or down in a particular month, “he added, “I pulled the money out.”

Although the purpose of each article was to encourage some oversight authority to investigate Madoff, neither article accomplished that goal by itself.

The SEC was created by the Securities and Exchange Act of 1934 with the mission to protect investors. Before the Madoff Ponzi scheme actually fell apart in December of 2008, within the preceding 8 years, the SEC had 3 times opened investigations into complaints about Bernard Madoff Investment Services. They were a comedy of errors. In all cases, the SEC examiners seemed to lack the experience or expertise to properly investigate the Madoff Ponzi scheme after they were otherwise given very credible and detailed evidence from distinguished fund managers or finance professionals.
The causes of the three investigations were as follows. First in 2003, the SEC’s Office of Compliance, Investigation and Examinations (OCIE) in Washington DC opened an investigation into Madoff based on a complaint from an otherwise unnamed hedge fund manager. That fund manager performed some pre-investment diligence on a Madoff feeder fund. The manager declined to invest, because after performing diligence, he could not understand Madoff’s operation. Second, in 2004, the SEC’s North East Regional Office (NERO) opened up a nearly parallel investigation based on an unintended revelation from a routine audit of yet a different hedge fund (Renaissance Meritage). Renaissance’s managers also could not understand how Madoff made profits. Among other items, they were uncomfortable with Madoff’s auditor who they felt was a related party. One of the emails from the managers read:

> It’s high season on money managers, and Madoff’s head would look pretty good above Elliot Spitzer’s mantle. I propose that unless we can figure out a way to get comfortable with the regulatory tail risk in a hurry, we get out. The risk-reward on this bet is not in our favor.

And third, the SEC opened up an investigation in 2006 based upon another complaint filed by the tireless Harry Markopolos.

For the two investigations beginning in 2003 (OCIE) and 2004 (NERO), the SEC focused either on the wrong issue like “front running” or whether Madoff was an “investment advisor” versus a “broker/dealer” instead of the larger issue of whether or not Madoff was engaged in fraud or if there was a Ponzi scheme. It is notable that in the first two investigations, the examination staff was relatively inexperienced and lacked the skill in financial or forensic auditing appropriate to a Ponzi scheme.

There were elements, moreover, within the SEC that seemed to delay, obstruct or hinder their investigations. On the 2003 OCIE team, when the March 24th field evidence
suggested that Madoff’s transactions did not make sense, the OCIE management shelved the audit on April 6th. On the 2004 NERO team, when the field evidence suggested that Madoff was acting as an unregistered investment advisor, the 2004 NERO examiners asked to expand the scope of the audit away from “front running” but, they were denied.

In testimony, Nee explained that he did not want examiners to spend time pursuing the investment adviser registration issue because the examiners had already spent almost three months on the examination and “we don’t have unlimited time.”

The implication suggests that the investigations team was allowed to go only so far before their supervisors would call it off. The two examinations beginning in 2003 and 2004 respectively morphed together and were finished in September of 2005. Because the investigation staff was inexperienced, and because they made procedural errors, like not verifying transactions with third parties, their findings were inconclusive on any fraud or Ponzi issues. Neither team investigated the allegations against Madoff’s auditor being a related party.

The third SEC investigation began in 2006, and it was based on the October 2005 Harry Markopolos complaint. The Markopolos complaint was assigned again to the North East Regional Office (NERO), but NERO management gave the case to a relatively inexperienced attorney. Because the 2004 NERO team had just finished examining Madoff, those teams advised the 2006 team to look at the “investor advisor” issue. By doing so, the 2006 team failed to adequately address the Ponzi issue. Regarding when to finish the audit, the lead examiner testified as follows:

I knew what we did and what we didn’t do, so I knew that we ultimately did not get the confirmations with the counterparties. I relied on the judgment of my supervisors that we were done.
Despite the fact that the 2006 examiners had caught Madoff in lies under oath, a serious offense, their only official finding was that Madoff should register with the SEC as an “investment advisor” instead of just a “broker dealer.” They found no official evidence of a Ponzi scheme.

According to Harry Markopolos, he felt that the SEC team that had investigated his complaint was “... incapable of winning a game of Clue if they were given all the answers . . .”23 On a more serious note, he also observed that, “The SEC’s employees are not trained as fraud examiners, nor are they trained to call witnesses.”24 On an ironic note, Markopolos wrote that Madoff likewise felt the same way, that is that the SEC was basically “incompetent.”25 Regarding Madoff, Author James B. Stewart wrote, “Madoff said he was ‘astonished’ that the SEC’s enforcement investigation hadn’t exposed his fraud, and added there were times when he ‘thought the jig was up.’”26 From the outside, it is discomfiting to read that the regulatory agency charged with safeguarding public investments simply just failed.

Regarding the auditor issue, according to Markopolos, Madoff had allegedly told potential investors that his auditor, David Friehling, was his brother-in-law when in fact, Friehling “... definitely was not his brother-in-law.”27 Moreover, Markopolos wrote:

It seems likely that Madoff claimed he was a relative because it was the only plausible reason he could think of to explain why a sophisticated multibillion-dollar hedge fund would use a two-person storefront operation in a small town as its auditor.28

Madoff confessed to the Ponzi scheme in December of 2008 and was sentenced soon after in June 2009. Friehling pled guilty in November of 2009. However, so far, he has not been sentenced.29 The delay in sentencing is probably due to Friehling’s ongoing cooperation with the government to prosecute or investigate other suspicious parties.
Bernard Madoff Investment Securities accepted money from several “feeder funds,” like its largest feeder, Fairfield Greenwich Group and Fairfield Sentry. Those feeder funds would have had their own auditors. Fairfield Sentry’s auditor was Price Waterhouse Coopers, a large international accounting firm.

Normally, an auditor of funds would obtain the investment custodian’s independently prepared “report on internal controls” which is known in the industry as the “SAS 70” report. Madoff had no such report. Moreover, for a large fund like Madoff’s, the investment advisory role would normally be segregated from the custodian of assets role, but in Madoff’s case, the two roles were commingled. The commingling was another “red flag.” Because Madoff was the custodian for billions of dollars, and, because he did not have, and could not provide, a report on internal controls (SAS 70), the absence of such a report should have created a “red flag” for Price Waterhouse. They should have at least had considered the possibility of fraud, or of an increased risk for it. Such considerations are required by professional standards. And yet, Price Waterhouse gave Fairfield and other feeder funds a clean audit opinion.

An analysis by Albert D. Spaulding suggests, but not conclusively so, that because the feeder funds were given clean audit opinions that the auditors should somehow be held either legally or ethically accountable; his conclusion was, however, that they were not. Markopolos is more stringent and suggests that any banking professional should have “a policy of mandatory fraud reporting to the authorities as soon as they spotted something amiss.” Such a policy would make investors more comfortable, but unless that policy was backed up with regulatory authority, the hedge funds would be unlikely to do business with such a policy for fear of an error being misunderstood as a fraud.
When independence is the hallmark of the auditing profession, Madoff’s auditor of 17 years was invested in the Madoff funds and thus was not independent. As an investor, David Friehling had a profitable interest in the outcome of Madoff’s financial statements and thus had motive to rubber-stamp them. For performing almost no actual audit procedures, Friehling received a $14,000 per month fee. If Madoff’s auditor had been rotated or “chosen and paid” through a regulatory mechanism, the Ponzi scheme might have been discovered earlier.

There is still the lingering question as to “why” Madoff felt it necessary to engage in such a large fraud. Speculation is worthy. Some people have postulated that Madoff was involved with organized crime or that Madoff was involved with a larger money laundering operation from illicit profits. It is all speculation. The most likely scenario is that after having made some early mistakes, he probably just didn’t want to lose his stature and pride in the financial community. Whatever the motivation of his crime, the Securities Act of 1934 was designed to prevent and catch the fraud, but in Madoff’s case, it failed.
CHAPTER 8

REFORM AND CONCLUSIONS

The Enron scandal brought public scrutiny to the accounting profession and within reach of the legislative process. After Enron, the most notable regulatory action over accounting was the passage of the Sarbanes Oxley Act of 2002. The intent of the Sarbanes Oxley Act (15 USC 7241 and 18 USC 1350) was to give significant strength to the securities and regulatory laws. The best ethical guidance, for accountants and public company executives are financial laws that promote a healthy respect and fear of the legal and enforcement systems. Sarbanes Oxley (SOX) injected teeth into a system that could now issue harsh prison sentences and financial penalties onto auditors or CEOs. This paper contends that fear of punishment, while a significant deterrent, is not enough and that reforms to foster auditor independence are still needed.

Sarbanes Oxley Act

In the immediate wake of Enron’s collapse, The Sarbanes Oxley Act was passed on July 30, 2002. Sarbanes Oxley brought in sweeping reforms that made it the largest overhaul to the accounting regulatory structure since the Securities and Exchange Act of 1934. It added some important structural safeguards. It created the Public Company Accounting Oversight Board (PCAOB) and the requirement that auditors of public companies register with the Public Company Accounting Oversight Board. It required a mandatory PCAOB inspection of those accountants (and their firms). It also required that company executives—CEO’s and CFO’s—must personally certify the financial statements along with their auditors. CEO’s can no longer hide under the mantra that “they are not accountants.” Also importantly, it codified punishment for violation of the
Securities Act of 1934 including up to 25 years in prison and up to a $25 million fine. These changes are not light. They are significant.

However, the Sarbanes Oxley Act of 2002 existed before 2008, the year that Madoff was caught. It did not stop him, his auditor, or the feeder fund auditors from continuing the perpetration of that massive fraud. It did not stop the financial collapse of Lehman Brothers or AIG. Sarbanes Oxley fell short in two places. It did not make the auditor truly independent by segregating the auditing fees from the company audited; and, it did not provide for mandatory auditor rotations.

*Auditor Independence - Auditor Fees*

Sarbanes Oxley did well to make auditors fearful of prison terms. Fear is a powerful motivator. But, it did not give auditors the freedom and independence that they need from being bound to their audit fee. Auditors need the freedom from audit fees much like the journalistic “free speech” freedoms that financial journalists Bethany McLean or Erin Arevedlund enjoyed against Enron or Madoff respectively. For true independence, it is the audit fee that stands between the auditor and independence. As long as the auditing role remains vested in private accounting firms, and there is no reason that it should not remain there, the accounting firm, like any other business, will endeavor to maximize its profits. So, the only issue would be “how” to separate the audit fee from the engagement and still incentivize the auditors to stay in business and to get paid. One solution is fairly simple and the framework largely already exists. That framework just needs to be slightly modified for maximum benefit.

Because the Public Company Accounting Oversight Board already exists, and has a mechanism to monitor registered accounting firms, it would be easy to create an additional internal mechanism, *an exchange*, where the audit fees are still paid by the
company, but where the fees are put on deposit at the PCAOB in advance of the audit. In turn, the PCAOB would pay the auditor. Although the client still pays the fee, the auditor would answer to the PCAOB for the fee and not to the client. As a regulator, the PCAOB would still hold the CPA firms responsible for professional conduct and professional standards; but, for payment of fees, it could act as an intermediary, a conduit between the company and the auditor.

This paper does not contend that “federalizing” the audit function outright with government auditors is the answer. It would make little economic sense to kill or cripple the entire private sector accounting industry. The public accounting firms that service the largest corporations in the United States, “The Big Four,” have accumulated a pool of talent that would be difficult to duplicate on a government payroll. Instead, this paper suggests that the government should act as an intermediary—like an escrow agent—between the auditor’s fee and the client’s payment.

In a real estate transaction, the escrow agent confirms that all the required mortgage and disclosure documents are in proper form and signed by the applicable parties before any money is actually transacted or disbursed. Neither the bank, nor the real-estate agent, nor the buyer, nor the seller, none of them work for the escrow company. But, if the escrow agent finds something missing, the transaction stops until the problem is remedied. In a sense, the escrow agent is a quasi-regulator. The escrow agent keeps all parties on the same page, and in so doing, affects transparency and ethical behavior. The escrow agent does not create a market, she merely accommodates the market that already exists.

For auditors, if the PCAOB acted as an escrow agent while also acting as a regulator, then the auditor’s first obligation would be to satisfy the PCAOB and not
necessarily the client company. If the auditor found irregularities, the PCAOB would still pay the auditor. Such a system could only foster true independence.

Auditor Rotations

The Sarbanes Oxley Act (SOX) requires that the accounting firm must make mandatory internal “partner” rotations every five years on the audit client. This falls a little short. Instead, SOX should have required that the public company should rotate its auditing firm every five years. The drafters probably had originally wanted a mandatory accounting firm rotation, it would only make sense. Given the way the financial lobby can influence Congress, however, the drafters probably didn’t have the clout to make such a drastic change. The partner rotation was probably the best accommodation that they could muster in exchange for the stiff sentencing penalties. As late as March 2012, the Wall Street Journal reported that Congress discussed a bill that “would block regulators from requiring that companies change their outside auditors regularly.”¹

Under this thesis proposal, at the end of the auditor’s expired term, the client company would put the audit out for bid on a PCAOB exchange. Then, any of the registered accounting firms that wish to bid for that audit contract may do so. The client company could still choose the lowest bidder, or the highest bidder, it doesn’t matter, as long as they select a different auditor and that agreed upon audit price is known to all parties including the PCAOB. The PCAOB would then accept the company’s payment in escrow on behalf of the accounting firm. The PCAOB would then pay the new accounting firm out of the escrow when the audit is complete and delivered to the SEC. By keeping the audit fee segregated from the client, and because the auditor knows he will be rotated out in a few years anyway, the fees become a non-issue. Those fees theoretically would already have been collected by the PCAOB--they aren’t going to

78
grow or shrink. In this way, the auditor is at liberty to disclose whatever facts may come to light without worrying about the fee.

Currently, the audit, as a commodity, is treated as a personal service contract. That is, the manner in which the audit is conducted, the chemistry between the auditor and the client is controlled by the client purchasing the audit. Personal service contracts are like the choice that a person exercises to choose a barber over a hairstylist. If the choice is a barber, the consumer can choose Joe over Bob. Even if both barbers provide that same service, there could be other intangibles that make the consumer prefer one over the other. It is personal. In the haircut scenario, the consumer is being touched during the service and certainly should have that right to choose who will perform the haircut. The audit service is viewed similarly. Because the auditor is looking at confidential client data, the audit client has the right to choose who will access to it. Auditing has not yet been reduced to a fungible services like mowing a lawn, or digging a ditch, where the personal dynamics between the provider and the consumer matter less.

For a public company, however, this paper contends that those client preferences should be mitigated in favor of the public’s interest. For a public company, the audit as a commodity, should be able to be performed by whomever the PCAOB may approve to conduct it. The PCAOB might approve an auditing firm of the company’s choice, but it might also reserve the right to send in a different team of auditors.

If Enron had been subject to mandatory auditor rotations, and if Andersen was rotated out, the magnitude of the “off balance sheet” partnerships would have been discovered and disclosed earlier. If Madoff had been subject to mandatory auditor rotations, the Ponzi scheme would at least have been discovered and disclosed. In both
cases, if the new auditors had found irregularities, they would not fear for their continued fees because those fees had already been paid to the PCAOB.

**Counterarguments**

This paper proposes that two reforms to strengthen the spirit of the Securities and Exchange Act of 1934 would include 1) mandatory auditor rotations and 2) the governmental control of escrowed audit fees. The discussion of mandatory auditor rotations is already occurring in the United States, so that opposing point of view is known. Because the idea of escrowing accounting fees is original, there has been no discussion in industry regarding the idea and the opposing viewpoint is not specifically known but could be reasonably surmised.

During the 2012 year, the Public Company Accounting Oversight Board discussed the idea of mandatory auditor rotations in multiple venues including with Congress. On October 18, 2012, the PCAOB held a seminar in Houston, Texas bringing together 20 panelists from academia and industry. Most of the participants had strong views against mandatory auditor rotation that included both cost and lost expertise. According Daniel Cancelmi of Tenant Healthcare said “Requiring companies to rotate their auditors will not provide any additional audit quality that isn’t already being provided by having lead audit partners rotate.” Others, such as Robert T. Blakely, who sat on numerous corporate boards including Fannie Mae and MCI gave compelling testimony emphasizing the need for a trained and competent audit committee to oversee management and the auditors. Mr. Blakely suggested requirements that the audit committee’s education and experience should be regulated in lieu of mandatory rotations.
Although no data exists on opinions regarding an escrowed audit fee, an implication can be made based on previous reform measures that opposition would be equally strong. The industry would likely argue, much as Richard Whitney argued against the Securities and Exchange Acts in 1933, that the cost and burden of escrow ing the audit fee would introduce inefficiency into the system.

Epilogue

Both Presidents Jefferson and Washington were slave owners. They benefitted from human trafficking. And yet, the Declaration of Independence declared that “all men are created equal.” As Virginians, they could declare such ideas since they knew in their hearts that all men were not created equal. The un-propertied white males in most of the Northern states knew that they weren’t equal; they couldn’t vote. Still, the founders created a constitution that provided a framework which could, if politically tenable at some point, eliminate slavery. The Constitution specifically prohibited the importation of slaves after the year 1808, after which, that discussion might reopen. So, the founders provided a mechanism that at some point, the country might decide that “all men” meant “all men” and eliminate slavery.

With the creation of the PCAOB, a framework has been created that could make independent auditors truly independent --and not just in name. If the collective political will ever decides that “independent auditors” means “independent auditors,” then by virtue of the proposals in this thesis, that framework to implement a solution, i.e. through the PCAOB, exists.

Chapter 4 (this thesis) cited the Senate committee hearings between Thomas Corcoran and Senator Gore. During those hearings, to pass the Securities and Exchange Act of 1934, when Gore asked Corcoran to identify the chief sinners between Wall Street
bankers, attorneys or traders, Corcharan responded, “It’s hard to tell who the chief sinner is sir. . . . There are so many sinners.”\textsuperscript{6} That exact sentiment was displayed publicly by the “Occupy” movement between 2011 and 2012. That movement started on “Wall Street” and spread nationally as “sit-ins” developed in public squares all around the country. The protesters’ messages were about income inequality and corporate and financial malfeasance over society at large. Still, their message delivery was disorganized and chaotic. If they had had a single unified message, it was lost somewhere through the unwashed public squatting that surrounded them.

Their original message about Wall Street corruption (or reform) somehow got diffused through their public spectacle. At best, they conveyed a generalized sense of anxiety about financial practices over which they felt powerless to control. They were like Joad and his shotgun, (Chapter 2 --this thesis), who tried to prevent the bulldozing of his home, except the protesters were not so brazen to bring a shotgun to the town square. Many Americans did not know exactly what the demonstrators were specifically highlighting because financial abuse is not something that you can see the way that you can see a house being bulldozed. To the degree that corporate and accounting scandals had received prior publicity before the Occupy movement, the hope for auditor reforms could have been generally included within their scope for financial reform.

At this point in U.S. history, the consideration of even moderate reform like putting audit fees in escrow at a regulatory agency, or rotating auditors, would amount to something of a political fantasy. It would be on the order of magnitude similar to when H.G. Wells wrote about space travel in 1898 or when Jules Verne wrote about deep sea voyages in 1870. At the time, the premise for either of these science fictions was within scope of intellectual curiosity but not within the scope of technological practicality. The
machines, to fly a man to the moon, or, to take a man to the ocean floor, had not yet been created. Still, the idea that space machines could exist, or could be developed, was within intellectual range. This is the political case with auditor reform.

The financial lobby has already opposed the idea of auditor rotation. So, the idea for escrowing the auditor’s fee and making the auditor answerable to the PCAOB would also meet resistance. In the meantime, the public can only hope that, the provisions within the Sarbanes Oxley Act that threaten prison time for violations of the Securities and Exchange Act of 1934 are strong enough to forgo the structural independence that auditor rotation and escrowed fees could provide and which in turn would compel corporations and their auditors to tell the truth.
NOTES

CHAPTER 1


CHAPTER 2


2 Fitzgerald, The Great Gatsby, 44

3 Ibid., 44.

4 Ibid., 61.


6 Ibid., 33

7 Ibid., 34.

8 Ibid., 33.

9 Ibid., 40.

10 Steinbeck may have used this term to paraphrase FDR's 1933 inaugural speech where "everything was fixable." Moreover, in the context of this paper, the term "by men" is only used to maintain the literary style employed by Steinbeck. For purposes of argument, women are included within its meaning.

11 Steinbeck, The Grapes of Wrath, 34.


13 In the context of Galt's radio address, it is this writer's opinion that Rand's literary and philosophical use of the terms "good", "moral", "wealth", "profit" and "trade" are interrelated ideas and practically interchangeable.

14 "I heard three parasites assert that my brain and my life were their property, that my right to exist was conditional and depended on the satisfaction of their desires." Rand, Atlas Shrugged, 1048. Also, "Just as the mystic is a parasite in matter, who appropriates the wealth created by others—just as he is a parasite in spirit, who plunders the ideas
created by others—so he falls below the level of a lunatic who creates his own distortion of reality, to the level of a parasite of lunacy who seeks a distortion created by others.”
Ibid., 1045.

15 Ibid., 1069.

16 Ibid., 1048

17 Ibid., 1022.

18 Ibid.

19 Ibid.

20 Ibid., 1067.

21 This crime is illegal specifically because of the Securities and Exchange Act of 1933.


23 Ibid., Scene 7, 34:41.

24 Ibid., Scene 7, 34:49.

25 Ibid., Scene 7, 35:12.

26 Ibid., Scene 7, 35:30.

27 Ibid., Scene 7, 36:50.

28 Ibid., Scene 12, 1:14:44 to 1:18:00.


30 Weiser and Stone, Wall Street, Scene 9, 55:38 to 56:16.

31 Ibid., Scene 10, 1:06:59.

32 Ibid., Scene 8, 42:05.

33 Ibid., Scene 17, 1:55:11.
CHAPTER 3

1 Although Bernard Madoff’s auditor also committed fraud, it is questionable whether or not he had the requisite skill to audit a hedge fund.

2 Professional Education Services, LP, Enron: Fraud, Deception, and the Aftermath (Granit Bay, CA: Professional Education Services, LP, 2011), 100.

CHAPTER 4

1 United States Senate Historical Office, “Subcommittee on Senate Resolutions 84 and 234 (The Pecora Committee),” United States Senate, http://www.senate.gov/artandhistory/history/common/investigations/Pecora.htm (accessed January 20, 2013). Note: The Senate webmaster incorrectly input Resolution 234 onto the title of this page as the downloadable text version showed resolution 239. (accessed January 20, 2013).


6 Ibid., 151.


8 Ibid., 174. Richard Whitney, president of the New York Stock Exchange, unsuccessfully met with Roosevelt to lobby against corporate reform laws. See this thesis (Chapter 5).
9 Examples include: Roger Clemmons (2008), Mark McGwire (2005), Lloyd Blankenfein-Goldman Sachs (2010).


12 Ibid., 81.

13 Senate website suggests that National City Bank was then the second largest bank, but, this paragraph analyzes Hiltzik’s claim where he stated that it was the largest bank.

14 Hiltzik, The New Deal, 81.

15 Ibid., 81-82.

16 Ibid.

17 Ibid., 83.

18 Ibid., 82.

19 Ibid.

20 Note: The intent of this paper is to focus on financial and securities market regulation and ethics. To keep this paper focused, it will not examine the history of regulating lobbyists per se. However, the “insider trading” element is directly addressed and made illegal by the Securities and Exchange Acts of 1933 and 1934. See Chapter 5 (this paper).

21 Hiltzik, The New Deal, 80.


23 Historically, it is worth comment that the Banking Act of 1933 was also created concurrent with the Pecora inquiries as a related reform measure.
CHAPTER 5

1 Before the federal Securities Acts of 1933 and 1934 existed, the laws that governed the issuance of securities were an inconsistent collection of state regulations. The federal acts would look to create some consistency.


4 Ibid., 71.


6 Lasser, Benjamin V. Cohen, 71.

7 Ibid.


9 Lasser, Benjamin V. Cohen, 72.

10 Ibid.

11 Ibid.

12 Hiltzik, The New Deal, 89.

13 Lasser, Benjamin V. Cohen, 72.

14 Ibid., 76.

15 Ibid., 76.


20 Lasser, *Benjamin V. Cohen*, 76.


27 The creation of the Securities and Exchange Commission would usurp some authority already (then) given to the Federal Trade Commission.


29 See discussions in chapters 6, 7 and 8 (this thesis) on lax SEC enforcements.


34 Hiltzik, The New Deal, 85.


36 Ibid., 177.

37 Ibid., 174.

38 Ibid., 174-175.

CHAPTER 6


3 Professional Education Services, Enron: Fraud, Deception, and the Aftermath (Granite Bay, CA: Professional Education Services, 2011), 36.

4 Ibid.

5 Fox, Enron: The Rise and Fall, 158-159.

6 The Securities and Exchange Act of 1933, and specifically Schedule A, requires certain disclosures including item (24) . . . “the general effect concisely stated of every material contract made, not in the ordinary course of business. . . .”, and item (32) . . . . “a copy of the underlying agreements or indentures affecting any stocks, bonds, or debentures offered or to be offered.


8 Ibid., 165-166.

9 Fox, Enron: The Rise and Fall, 158.


11 Ibid., 41.

12 Ibid.


25 Enron’s stock had been trading as high as $90 per share before the restatement. After the restatement and ensuing bankruptcy, its stock fell below a dollar and ultimately became worthless.


29 Ibid.
30 Fox, *Enron: The Rise and Fall*, 228.


CHAPTER 7


3 Ibid., 33.

4 Ibid., 34.

5 Ibid.

6 Ibid., 35.

7 Ibid., 34.

8 Ibid., 44.

9 Ibid., 54.


12 Arvedlund, *Too Good to Be True*, 224.


15 Ibid., 2-7.


19 Professional Education Services, The Madoff Ponzi Scheme and the SEC, 4-2.

20 Ibid., 3-31.

21 Ibid., 4-43.

22 Ibid., 5-78.

23 Harry Markopolos, No One Would Listen (Hoboken: John Wiley & Sons, 2010), 155.

24 Ibid., 163.

25 Ibid., 159.


27 Markopolos, No One Would Listen, 47.

28 Ibid., 48.


31 Ibid.

32 Markopolos, No One Would Listen, 182.

CHAPTER 8


BIBLIOGRAPHY

Books


Pamphlets


Film and Documentary Video


Journals and Periodicals


Websites


United States Senate Historical Office, “Subcommittee on Senate Resolutions 84 and 234 (The Pecora Committee),” United States Senate. 
http://www.senate.gov/artandhistory/history/common/investigations/Pecora.htm (accessed January 20, 2013). Note: The Senate webmaster incorrectly input Resolution 234 onto the title of this page as the downloadable text version showed resolution 239. (accessed January 20, 2013).