REDESIGNING FINANCIAL REGULATION

The Politics of Enforcement

Justin O'Brien

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John Wiley & Sons, Ltd

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Justin O'Brien
Canberra, August 2006

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Redesigning financial regulation: the politics of enforcement

The decision by a regulatory agency to prosecute corporations is (optimally) the considered result of a series of operational and strategic evaluations. Does the evidence exist for successful prosecution? Is the public interest advanced or stymied as a result of the actual application of legal sanction? What are the collateral implications, particularly if criminal law is used? Can the application of less coercive remedies secure more effective outcomes for the corporate entity under investigation and the wider industry sector in which it is nested? In the aftermath of a financial reporting scandal, the pressure on regulators to act, or to be seen to act, intensifies. The development of such intrusive strategies may lead to an increase in visibility and reduction in political pressure. They may also even secure corporate behavioural change. Ill-thought-out strategies risk intensifying destabilization, however, without dealing with underlying substantive issues that gave rise to the occurrence of scandal.

This is particularly problematic for those involved in securities and financial services regulation. In the absence of catastrophic failure, the sheer complexity of the legal framework mitigates the necessary confluence of political traction for systematic reform from developing. The presence (or absence) of wider constitutional or statutory safeguards can, in turn, advance, calibrate or block enforcement innovation. Actual capacity is further informed and constrained by organizational culture, operational discretion and enforcement proclivity. To assess regulatory efficacy it is necessary, therefore, to evaluate more precisely the vectors influencing policy calibration. Can changes to the enforcement firmament be traced to coherent reappraisal? Conversely, do they merely represent crisis management devoid of overarching strategic purpose, with reflexive muscularity driven by largely inchoate public demands for legalistic accountability? Is the retreat to formal legal sanction conditioned by the need to instil confidence in the regulator, the narrow legal framework or wider societal norms? How does one avoid or, at the least, mitigate the risk that application of increased authority will lead, if misapplied, to decreased legitimacy through regulatory overreach?

The management of these conflicting imperatives conditions evaluative judgement within the regulatory agency. This occurs at each stage of the decision-making process. Simultaneously, institutional actors further delineate the range of available options. The degree to which these external players influence the media discourse (on which political calculations inevitably centre) can be crucial in shaping the actual outcome of regulatory and prosecutorial decision-making.[1] The separate, discrete and ongoing access corporate actors have had to the executive and legislative

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[1] On the triangulated nature of regulatory pressures, focusing on insufficient resources, broad and diffuse responsibilities and a polarized political environment, see M. Sparrow, *The Regulatory Craft*, Brookings Institution, Washington DC, 2000; on the need to exercise a balancing act, see R. Nakamura and T. Church, *Taming Regulation*, Brookings Institution, Washington DC, 2003; on the role played by ideation in influencing that agenda within the financial services sector, see J. Kirshner, 'The Inescapable Politics of Money', in J. Kirshner (Ed.), *Monetary Orders: Ambiguous Economics, Ubiquitous Politics*, Cornell University Press, Ithaca, 2003; see also M. Blyth, 'The Political Power of Financial Ideas', ibid; for wider discussion on political coalition creation and recalibration in response to corporate governance reform, see P. Gourevitch and J. Shinn, *Political Power and Corporate Control, The New Global Politics of Corporate Governance*, Princeton University Press, Princeton, 2005.

branches of government, particularly in the United States, reinforces the ideational emphasis on the efficacy of market-led governance. Emasculation begins with requirements for extensive consultation and extends to partial or full devolution of responsibility for standard setting, enforcement and adjudication of suspected breaches. Franchising authority to associations, whose primary interest is to define, organize, secure and advance the agendas of their most vocal and influential members, creates an intractable conflict of interest. Far from offering normative improvements in policymaking, it risks magnifying the risk of agency capture. The question of how to exercise control over the corporation remains of profound public policy importance. Corporations and the intermediaries that mediate their access to the wider market have enormous capacity to subvert societal norms. These range from the distortion caused to the deliberative process by disproportionate financing of political systems to the corrosive impact on juridical formalism of creative compliance.[2] On occasion, this resistance to control can mutate into open rebellion, as when the net benefits of recidivism are gauged by 'amoral calculators'.[3]

The atomistic nature of the political system in the United States enhances significantly corporate leverage over legislative deliberation

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[2] See D. McBarnet and C. Whelan, 'The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control' (1991) 54 *Modern Law Review* 848 at 870. For an application of the analysis to the Enron case, see D. McBarnet, 'After Enron: Creative Compliance and the Uses of Corporate Social Responsibility' in J. O'Brien (Ed.), *Governing the Corporation*, John Wiley & Sons, Ltd, Chichester, 2005.

[3] This was central to the calculations of KPMG in the design and marketing of abusive tax shelters. For full details of the shelters and their operation, see US Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, 'U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals', 108–134 (November 18, 2003), at 5. Contrast also the evidence provided to the congressional committee by KPMG with the statement of facts eventually accepted by the partnership as part of a deferred prosecution deal signed on 28 August 2005, (http://www.usdoj.gov/usao/nys/Press%20Releases/August%2005/KPMG%20Statement%20of%20Facts.pdf).

and subsequent agency manoeuvrability.[4] The extent of the malaise uncovered since the collapse of stock prices in the aftermath of the dot.com bubble suggests a paradigmatic failure of the 'associational democracy' model.[5] The failure of enrolment to restrain self-interest was a major contributing factor to the corporate and financial reporting scandals.[6] Professional associations – accountants, lawyers, corporate directors – acting as political groupings emphasized the wider benefits accruing to society from liberalizing still further the market system. Due cognizance of the need to buttress the regulatory architecture was either downplayed or ignored.

Technical compliance with regulatory instruments – agreed after consultation – but wholesale derogation from the underpinning spirit overwhelmed the system. The resulting strain was unsupportable. It paved the way for the structural implosion that necessitated the partial regulatory redesign progressively introduced since the collapse of Enron in December 2001. As public unease dissipates, however, so too does the quiescence of organized business interests. The legislative programme has come under increased attack from a regrouped opposition, which has directed its ire at the regulatory agencies charged with implementation. Central to the reformulated ideational argument

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[4] See T. McCraw, *Prophets of Regulation*, Harvard University Press, Cambridge MA, 1984, pp. 301–302. Equally important is the extent to which regulators themselves internalize the arguments of those they are charged with overseeing, see, for example, J. Kruger, D. Levy and D. Egan, 'A Neo-Gramscian Approach to Corporate Political Strategy: Conflict and Accommodation in the Climate Change Negotiations' (2003) 40 *Journal of Management Studies* 803.

[5] See W. Streeck and P. Schmitter, *Private Interest Government*, Sage, One Thousand Oaks, 1985.

[6] Enrolment in this context refers to the recruitment of the regulated in the design stage of regulatory programmes. It suggests that by adopting a responsive mode regulators can secure much higher degrees of compliance, see J. Black, 'Mapping the Contours of Financial Regulation' (2003) *Working Paper, Centre for the Analysis of Risk and Regulation*, London School of Economics. For a critique from a United Kingdom perspective, which suggests that regulatory intrusion into specific governance practices could prove counter-productive, see J. Grey and J. Hamilton, *Implementing Financial Regulation, Theory and Practice*, John Wiley and Sons, Chichester, 2006.

is that the scandal of business misfeasance has been replaced by one informed by regulatory overreach. The challenge is directed primarily at the Securities and Exchange Commission (through legislative allies) and the Public Company Accounting Oversight Board (through court action). Public policy entrepreneurs, such as the combative State Attorney General of New York, Eliot Spitzer, who were pivotal in advancing muscular enforcement as the only effective means of securing corporate compliance, have moderated their approach. This can be traced, at least in part, to the electoral calendar, rather than an indication that corporate crime has been eradicated. The Department of Justice, alone, retains a stated intention to persevere with the aggressive pursuit of individual prosecutions. It combines this with the increased use of innovative strategies such as pre-trial diversion to influence wider corporate behaviour. These combine the punitive deterrence model with rehabilitative, restorative and redemptive dimensions. They take the form of enforced changes to specific governance practices within a single corporation accused of breaching securities or company law. In return, the prosecuting agency agrees to stay formal criminal or civil proceedings. These restrictions extend beyond minimum formal legal requirements. In a sense, the process equates to an experimental form of controlled 'corporate probation'. While undoubtedly effective, these strategies raise fundamental normative as well as operational problems. It is certainly questionable whether it is appropriate to apply (or threaten) criminal sanction to force internal corporate governance reform not mandated by legislation, listing requirements or SEC regulations. This reformulation of regulatory purpose has profound consequences for the internal governance of corporations. It partially reconfigures the enabling framework of corporate governance. It also constitutes rulemaking outside the normal consultative framework. Rules are now being made through litigation or, more precisely, the threat of it.

The lack of transparency and accountability involved gives arguable cause for an approach to the political class for relief. The demand for a return to the supremacy of the SEC in the governance of the financial markets typifies this. It reflects a determination to limit the capacity of criminal prosecutors and policy entrepreneurs from again disturbing the settled rules governing financial regulation.[7]

This book situates the quest for effective corporate governance and prudential financial regulation, therefore, within a framework conditioned by past failure, present manoeuvring for advantage and future implications.[8] This allows us to map not only what went wrong in corporate governance in the United States but to ascertain how and why the policy response adopted was fashioned. It provides the mechanism to adjudicate whether the reforms adopted in the wake of corporate crisis provide a panacea or merely a psychological placebo. I argue that to understand the politics of enforcement one must extend the analysis far beyond specific regulatory responses to the infractions of an individual corporate executive or corporate entity. To achieve this, one is forced to drill down into the foundations of the wider institutional architecture. This enables an evaluation of how changes to enforcement patterns impact on both the form and function of regulatory measures.[9] Furthermore, analysing enforcement stratagems requires the integration of instrumental and expressive terms of reference.[10] A complete assessment also necessitates the application of legitimacy and accountability criteria to

[7] For a comparative approach, suggesting that change was merely 'convulsive [and] episodic' in the United States, see J. Cioffi, 'Corporate Governance Reform, Regulatory Politics, and the Foundations of Finance Capitalism in the United States and Germany' (2006) 7 *German Law Journal* 533 at 558.

[8] See Peter John, *Analysing Public Policy*, Continuum Books, London, 2003, p. 14.

[9] This conception opens a rich literature. For how this plays out within the construction of law, see L. Edelman, C. Uggen and H. Erlanger, 'The Endogeneity of Legal Regulation: Grievance Procedures as Rational Myth' (1999) 105 *American Journal of Sociology* 404; on how it impacts on organizations, see L. Edelman and M. Suchman, 'The Legal Environments of Organizations' (1997) 23 *American Review of Sociology* 479.

[10] On the need to differentiate between instrumental and expressive application of the law, see K. Hawkins, *Law as a Last Resort*, Oxford University Press, Oxford, 2003, p. 5.

the processes of change as well as the normative objectives and actual outcomes.

The recently concluded trial of the most senior executives of Enron encapsulates neatly the difficulties explored in detail throughout the book. For epicures of the disjunction between technical compliance and criminal intent, the prosecution of Ken Lay and Jeffrey Skilling was pivotal in the catalogue of excess that typified corporate life on the cusp of the millennium. They were accused of orchestrating a vast criminal conspiracy that defrauded not only Enron's employees but constituted a fraud on the market and an assault on the integrity of the entire financial system. According to the Director of the Enron Task Force, Sean Berkovitz, the failed energy corporation, which spectacularly imploded in December 2001, 'defined the era of corporate fraud'.[11] This somewhat trite explanation informed the entire government case. It centred on a simplistic emotional narrative, which, while successful, underplayed the intricacies of how the criminal conspiracy actually worked. The wider questions of how this could have continued unchecked for years and whether the search for culpable conspirators was artificially restrained were left answered.[12]

Given the notoriety of the Enron collapse and its talismanic role in justifying an intrusive reform programme that has transformed the corporate governance regime in the United States, the approach

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[11] M. Flood, 'Enron Prosecution Team Gets New Leader', *Houston Chronicle*, 18 July 2005 (online edition).

[12] See J. Roper, 'Ruemmler Working to Fillet Lay', *Houston Chronicle*, 15 May 2006 (online edition). A secondary theme focused on the distortions of language, see G. McWilliams and J. Emshwiller, 'Prosecutor Argues Skilling, Lay Used Trickery to Prop Up Enron', *Wall Street Journal*, 15 May 2006 (online edition). For a complete transcript of evidence, see http://kenlayinfo.com. As the government outlined its closing, Lay demonstrated adroit public relations by releasing a statement outlining his own summation. According to Lay, 'the Enron Task Force spent days upon days raising arguable issues not in any way related to the charges in the indictment against me in an effort to personally attack me and make the jury question my character. We firmly believe that the jury will see through this manoeuvre'. In the event it did not.

was a rational, if problematic, use of the adversarial legal method.[13] The reliance on public outrage rather than rational argument was evident by the concentration on the personal arrogance of the defendants. The evisceration of this morally objectionable, but legally neutral, character trait permeated the entire trial, and in particular the closing arguments. The government's rendition contrasted the contrite admission of (tainted) witnesses (who had a vested interest in minimizing their own complicity by emphasizing cultural imperatives), with the combative approach adopted by Skilling and Lay.[14] A prosecutor ascribed this to organizational norms first inculcated at Enron and now (apparently) transmitted reflexively to highly-paid legal advisors. It was, she claimed, a strategy steeped in 'extraordinary arrogance' and designed to 'ridicule, [to] condescend and [undermine through] profane [abuse].'[15] Such a character appraisal may approximate corporate reality and courtroom theatrics, but in itself is neither illegal nor necessarily immoral. Indeed, in the latter case, such an approach is given explicit constitutional protection by the Sixth Amendment.

The theatrical nature of the criminal trial in the common law system is one of its greatest strengths. It can generate a compelling narrative, guarantee media coverage and give the impression that none is above

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[13] The passage of Sarbanes–Oxley reconfigures in profound manner the enabling framework of corporate law heretofore administered at state level. For a classic account of how this worked in Delaware, the dominant jurisdiction in the United States, see J. Gordon, 'Corporations, Markets and the Courts' (1991) 91 *Columbia Law Review* 1931. For a critical assessment of Sarbanes–Oxley written from a state perspective, see L. Strine, 'The Delaware Way: How We Do Corporate Law', Speech to European Policy Forum, 5 July 2005, http://www.epfltd.org.

[14] Ken Lay died of a heart attack on 5 July 2006. The previous week prosecutors had demanded he forfeit $43.8m, the totality of his wealth. His passing not only invalidates this claim but also the conviction itself. See A. Jones and J. Emshwiller, 'Quirk of US Law Exonerates Lay, Possibly Hindering Asset Seizure', *Wall Street Journal*, 7 July 2006, p. C3.

[15] The author was in court for the closing arguments. The quotations that follow come from contemporaneous notes.

the law.[16] Its very theatricality, however, is also its greatest weakness. This is especially apparent in cases involving allegations of complex financial fraud. All too often misfeasance (an ethically dubious action) is conflated with malfeasance (a crime). Within an adversarial process, complexity can be reduced to soap operatic simplicity. When this happens, the approximation to truth is as carefully orchestrated as that displayed in its broadcast analogue. The Enron trial closely followed this script.

Fear and loathing were the common denominators. The demand that someone must be held to account for one of the largest bankruptcies in US history drove a prosecutorial case devoid of conclusive proof of wrongdoing. Having failed to produce untainted evidence capable of independent corroboration, prosecutor Kathryn Ruemmler was forced to admonish the jury to focus not on accounting fraud but on 'lies and choices. Do not let them get away with it.' Loathing of the technical nature of the defence permeated the prosecutorial rebuttal. Much of its case was built on plea agreements, which the defence argued were irrevocably tainted by the power of compulsion. Fear of perceived federal government excess and contempt for the morally suspect nature of its methods drove a joint-defence case that frequently invoked fundamental Christian beliefs. The prosecution 'mocked my client for having the audacity to get on the witness stand and proclaim his innocence', claimed Daniel Petrocelli, lead lawyer for Jeffrey Skilling. He then added a mantra of his own: 'Documents don't lie, people do.' This was designed to contrast the inherent superiority of an evidential trail which demonstrated the superiority of legally permissible mistakes and, arguably, poor business judgement, to the problems associated with accepting the testimony of those who had 'lost free will'.

There is, of course, nothing improper in all of this. Indeed, the dynamics of the trial process demand it. Both prosecution and defence

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16 See J. Coffee, 'No Soul to Damn, No Body to Kick: An Unscandalized Inquiry into the Problem of Corporate Punishment' (1981) 79 *Michigan Law Review* 386 at 424.

appealed shamelessly to individual juror vanity. The jury was courted by explicit deference to its capacity to disentangle one of the most complex financial trials heard in the United States. Simultaneously, as noted above in relation to the emphasis on arrogance (and in equally histrionic outbursts from the defence to the prosecution 'not to come to Houston, Texas and lie'), the jury was exposed to unsubtle emotional manipulation. These emotional drivers were not chosen by accident. How to read the jury has become an increasingly important calculation in the management of criminal trials. Witnesses are not merely coached; recruited focus groups, which mirror the demographics of the actual jury, are used to road-test trial strategies. The problem goes much deeper, rendering suspect the historical veracity of the verdict as coda for systemic failure.[17]

The trial poses a series of disturbing questions that permeate this book. These radiate outwards from the lack of effective compliance within the firm to indict the past regulatory regime, undermine the nature of the juridical response to the crisis and (inadvertently), despite the convictions, create the circumstances for policy reversal in the future.

The capacity of the compliance model to engineer productive change has been demonstrated to be ineffective. Although the reform agenda centres on a much more robust model of enforced self-regulation, it is still underpinned by self-certified compliance. Ironically, the accountancy profession itself, which was defenestrated as a consequence of its failure, retains a pivotal gatekeeper role in gauging the adequacy of internal corporate controls to identify and minimize risk. This enhanced policing role has ensnared the wider legal profession because of attempts to force corporations under

[17] For contrasting approaches taken by newspaper reporters who have both co-authored books on the Enron debacle, see R. Smith, 'Trial Fails to Answer Many Questions About Spectacular Collapse', *Wall Street Journal*, 26 May 2006 , p. A9; K. Eichenwald, 'In Enron Case, A Verdict on An Era', *New York Times*, 26 May 2006, p. B1.

investigation to waive client–attorney privilege. This has opened a new front in the battle for corporate control.

Here again, the methods deployed in the Enron case are extremely instructive. The creation of a dedicated task force formalized the transition from a piecemeal reactive approach to corporate crime to one that contains a significant prophylactic component. The multidisciplinary unit sifted through the voluminous regulatory filings, company records and congressional hearings to ascertain whether sufficient evidence existed to secure criminal indictments against individuals, the corporation or the financial institutions instrumental to the earnings phenomena. The strategy was designed to secure guilty pleas at each rung of corporate authority. In exchange for potential leniency, these executives pledged to cooperate with the federal authorities in the prosecution of the next level up.[18] The campaign was ruthlessly efficient. It secured no less than sixteen convictions within Enron alone, progressively isolating the most senior executives.[19]

The robust style could be traced, in part, to the professional background of those shaping policy within the Task Force. Many had been seconded from the division of organized crime rather than securities enforcement. Indicative was Andrew Weissmann, who joined the Task Force at its inception as Deputy Director. He had previously worked in the Eastern District of New York prosecuting the Mafia in Brooklyn. His tactics prompted serious questioning of allegedly strong-arm tactics. These included allegations of eliciting false testimony and threatening witnesses with indictments should they testify on behalf of defendants in a second trial involving Enron

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[18] See J. O'Brien, *Wall Street on Trial*, John Wiley & Sons, Ltd, Chichester, 2003, pp. 72–74.

[19] The strategizing continued until just before the trial of Ken Lay and Jeffrey Skilling was scheduled to start in Houston on 30 January 2006. The Task Force secured a plea agreement from Richard Causey, the former Chief Accounting Officer, on 28 December 2005. See *USA v. Richard Causey* CR-H-04-25 (S-2). The agreement, which includes a fine of $1.25m, also includes a prohibition on Causey profiting from selling his story to the media.

executives.[20] The strategic priorities came into sharper focus in 2004 when it was announced that Andrew Fastow, Enron's former Chief Financial Officer, had secured a plea agreement. Fastow had designed, executed and managed the transactions that shifted billions of dollars in liabilities off Enron's balance sheet.[21] The belated full disclosure of their purpose from October 2001 onwards was instrumental in hastening the corporation's demise. Fastow's decision to cooperate could be traced, in part, to the fact that the Task Force threatened a simultaneous prosecution of his wife, also a former Enron employee and beneficiary of the partnerships. In the absence of a deal, there was a serious risk that both would serve concurrent jail terms, leaving their children temporary orphans.[22] The ethical questions were deemed immaterial to the Enron Task Force, which concentrated instead on the ends such questionable means delivered: 'The cooperation gives us a window into Enron's executive suites. Whatever knowledge he

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[20] Weissmann enjoyed early success, not least with the successful prosecution in 2002 of Arthur Andersen on charges that the organization was institutionally culpable for allowing the shredding of documents related to its Enron business. The success, however, was short-lived. The Andersen conviction was overturned on appeal in 2005, see L. Greenhouse, 'Justices Reject Auditor Verdict in Enron Scandal', *New York Times*, 1 June 2005, p. A1. The only clear success at jury trial, prior to the conviction of Lay and Skilling involved the prosecution of senior executives involved in an earnings management transaction with Merrill Lynch, see J. Emshwiller and K. Scannell, 'Merrill Ex-Officials' Sentences Fall Short of Recommendations', *Wall Street Journal*, 22 April 2005 (online edition). The Justice Department had canvassed for sentences of between 15 and 33 years. The judge sentenced the former Head of Investment Banking to a 30-month prison term and the former Head of Structured Finance to 46 months. He described the crime as 'benign' in comparison to the scale of the bankruptcy.

[21] For clinical assessments of the partnerships and their impact on the firm's finances, see W. Powers, *Report of Investigation by the Special Investigative Committee of the Board of the Directors of Enron Corp*, 1 February 2002 (http://news.findlaw.com/hdocs/docs/enron/sicreport).

[22] Fastow was reduced to tears when he admitted in court that he misled his wife, leaving her open to charges of filing inaccurate tax returns, see J. Emshwiller and G. McWilliams, 'Enron's Fastow Testifies Skilling Approved Fraud', *Wall Street Journal*, 8 March 2006, p. A1.

has of who did what and who knew at Enron will be our knowledge', declared Leslie Caldwell, the then head of the Task Force.[23]

The centrality of Enron to the corporate scandals of the past few years meant that it was inconceivable that not prosecuting Ken Lay and Jeffrey Skilling could have been countenanced. The critical question raised pivots on whether it has the capacity to engineer credible change or serves merely to distract attention from a structural problem that remains unresolved.[24] Even more seriously, the methods used in creating the prosecutorial case served only to provide an alternative narrative that has the potential to undermine critical advances.

The explicit articulation of enforcement dynamics against individuals in morally strong but legally weak cases provided the opening for a defence that played into increasing unease about prosecutorial priorities.[25] In a series of interviews, newspaper articles and speeches, Ken Lay accused the Department of Justice of waging a political campaign that amounted to an abuse of process. 'It's ugly when there is the appearance of political influence on criminal prosecutions – and, of course, even uglier when the reality exists. The legal case against me, standing alone, is a flimsy, hollow shell and reeks of politics', he wrote in the *Washington Post* in 2004.[26] He launched a website and appeared on influential television current

[23] J. Emshwiller, 'Enron Trial Puts Focus on Fastow', *Wall Street Journal*, 30 January 2006, p. C1.

[24] As the case was proceeding, a $6.7 billion settlement involving a class action against major investment banks taken by the University of California Regents was reached in another court in the Houston complex. The settlement included payments by CIBC ($2.4 billion), JP Morgan ($2.2 billion) and Citigroup ($2 billion), see K. Hays, 'Judge Gives Approval on Enron Settlements', *Washington Post*, 22 February 2006 (online edition). It was approved while the jury in the Lay and Skilling trial was deliberating.

[25] A similar disquiet is witnessed in the increasing vocal opposition to Eliot Spitzer, the New York State Attorney General, see J. Kamansky, 'Sturm, Drang und Spitzer', *Wall Street Journal*, 3 March 2005 (online edition).

[26] K. Lay, 'The Politics of My Trial', *Washington Post*, 1 September 2004, p. A19.

affairs documentaries. Each intervention was carefully timed for maximum impact; each sought to provide distance from the other titans of corporate America on trial in courthouses from Birmingham to New York. Typical was an interview with CBS's *60 Minutes* in March 2005.[27] Lay claimed that he was unaware of the detail. He argued responsibility for criminal acts rested with underlings, such as Fastow, who defrauded the corporation and betrayed its trust. 'I cannot take responsibility for criminal activity of someone inside the company . . . Andy [Fastow] and his team were lying to me and the board and the senior executives', he complained.[28] Lay later traced his legal difficulties to over-zealous prosecutors, who submerged 'the rock of truth in a wave of terror'.[29] He argued that the delay in bringing the case could be traced not to its inherent complexity but to the fact that 'it is complicated to find crimes that do not exist.'[30]

Lay and Skilling claimed that an essentially viable firm was the victim of a panicked market that temporarily lost faith in an inherently sound, if complex, business model, prompting an irrevocable 'death spiral'.[31] The prosecutorial emphasis on Enron as a proxy for corporate malfeasance provided, for the executives, confirming evidence that they were subject to nothing less than a politically inspired show trial.[32] The opening statements witnessed the delivery of mutually exclusive and largely already publicly rehearsed allegations. The defence focused on the need for the jury to adjudicate narrow,

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[27] CBS *60 Minutes*, 'Ken Lay: I Was Fooled', 13 March 2005 (http://www.cbsnews.com/stories/2005/03/11/60minutes/main679706.shtml).
[28] Ibid.
[29] M. Flood, 'Ken Lay Rails at Prosecutorial Wave of Terror', *Houston Chronicle*, 13 December 2005 (online edition).
[30] Ibid.
[31] Lay's lawyer put the point succinctly: 'He was the man at the controls. But failure is not a crime', see A. Barrionuevo, 'Opening Arguments in the Trial of Ex-Enron Chiefs', *New York Times*, 1 February 2006 (online edition).
[32] For an account suggesting the defence of 'psychological denial' offered by Lay and Skilling was inherently flawed, see J.B. Stewart, 'Enron Defence Wins Award for Year's Worst', *Wall Street Journal*, 31 May 2006, p. D3.

exceptionally complex and contestable interpretations of disclosure obligations. Lawyers for both men depicted a hysterical marketplace that was panicked by erroneous rumour. 'The odour of the wolf got into the flock, and the flock stampeded', suggested Lay's chief lawyer in a moment of metaphorical clarity.[33] For the prosecution, this was mere dissembling to cover unethical behaviour that no right-thinking person could ignore. To buttress its case, the government's narrative drive raised more questions than it was prepared to answer.

Enron was exceptionally adept at playing Wall Street by beating earnings expectations. As it faced imminent collapse, the game took on a critical and criminal dimension. Using snippets of conversations with analysts, which the defence later argued were taken out of context, a prosecutor framed the issue with the help of a theatrical prop: a penny taken from a glass jar. By depositing the penny on the jury rail with a dramatic flourish, the prosecutor explained the imperative to marginally beat expectations on Wall Street of earnings per share.[34] The prop also served as an unsubtle metaphor for an entire business culture. It had led to the spectacular growth and sudden demise of a corporation once deemed the most innovative in the country but now indelibly associated with corporate excess, hubris and corporate corruption. A string of government witnesses, including Fastow, maintained the organizational culture of the corporation was ultimately responsible for increasing their own moral hazard. 'Within the culture of corruption Enron had, a culture that rewarded financial

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[33] G. McWilliams and J. Emshwiller, 'Trial Begins with a Tale of Two Enrons', *Wall Street Journal*, 1 February 2006.

[34] See A. Berenson, *The Number: How the Drive for Quarterly Earnings Corrupted Wall Street and Corporate America*, Random House, New York, 2003. Berenson argues that the growth of 'consensual analyst forecasts', technological change in the mid-1980s and the need for analysts to generate 'accurate [research], a difficult feat without the help of the companies they covered' combined to distort its predictive capacity at the very moment it became the dominant means of valuation (pp. 92–93). For its application to the Enron trial, see G. McWilliams and K. Scannell, 'Profit Tweaking May Lose Favour after Enron Trial', *Wall Street Journal*, 16 February 2006, p. C1.

reporting rather than rewarding economic value, I believed I was being a hero. I was not. It was not a good thing. That's why I'm here today.'[35]

Even though he personally made upwards of $46m and had a 'booty list', which suggested an expected personal profit of $116m, Fastow was forced to concede that Skilling and Lay did not profit directly from the transactions.[36] He suggested that the indirect benefit justified their prosecution. 'When you misrepresent the nature of the company, artificially inflate earnings, hide losses, when you do things like this to cause your stock price to rise, that is stealing. We stole.'[37]

Ascertaining who exactly stole and what precisely constitutes culpability (in both legal and moral terms) is much more problematic.[38] The transactions were constructed with the approval and knowledge of Wall Street. Enron raised more than $15m in the first series of LJM transactions and $400m in the second. Most of this

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[35] G. McWilliams and J. Emshwiller, 'Fastow Testifies That Lay Knew About Enron Woes', *Wall Street Journal*, 8 March 2006 (online edition). Fastow also accepted that he was 'extremely greedy' and he had lost his 'moral compass', see A. Barrionuevo, 'Fastow Testifies Lay Knew of Enron's Serious Problems', *New York Times*, 8 March 2006 (online edition).

[36] Curiously this admission was dismissed as an aside in the *New York Times* coverage and not covered at all in the *Wall Street Journal*, see A. Barrionuevo, 'Fastow Testifies Lay Knew of Enron's Problems', *New York Times*, 9 March 2006 (online edition). The exchanges that prompted the admission are given extensive coverage in B. Sapino Jeffreys, 'Fastow: Skilling Got "Zero" From Unlawful Deals', *Texas Lawyer*, 9 March 2006 (online edition).

[37] C. Johnson, 'Fastow Says "We Stole" as Enron Defense Assails His "Greed"', *Washington Post*, 9 March 2006, p. D1.

[38] For a wider discussion of responsibility in large and complex organizations, see E. Wolgast, *Ethics of an Artifical Person: Lost Responsibility in Professions and Organisations*, Stanford University Press, Stanford, 1992, pp. 19–39. Culture can provide a restraining force if embedded as part of wider norms, see M. Granovetter, 'Economic Action and Social Structure: The Problem of Embeddedness' (1985) 91 *American Journal of Sociology* 481. The critical question is whether these norms can be institutionalized without external impetus. The effect of social networks in this case was corrosive of virtue rather than confirming of it.

came from investment banks and other Wall Street insiders. This, in turn, suggests systemic problems of corporate intentionality that extend far beyond the confines of the Enron towers. Rather than defining the era of corporate fraud, Enron was symptomatic of it.[39]

The public policy implications involved in even beginning to address this reality are truly enormous. It was notable that in directions to the jury, the trial judge provided the capacity to convict if it felt that the executives engaged in 'wilful ignorance'. This refers to a deliberate decision not to inquire into unpalatable facts. There is considerable precedent to suggest liability if the failure to investigate is designed to claim plausible deniability in the event of apprehension.[40] Arguably, similar charges could be laid against the wider board of directors, which has largely escaped formal governmental sanction, if not private class-action securities litigation.[41] Other institutional actors who owed a fiduciary duty of care to the corporation have been leniently treated.[42]

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[39] According to Paul Sarbanes, 'Enron was the canary in the mineshaft', quoted in 'Enron's Hard Lessons for Corporate Bosses', *Financial Times*, 26 May 2006 (online edition).

[40] As early as 1963 federal courts argued liability could be levelled if the executive officer 'recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either wilfully or through inattention obvious danger signs of employee wrongdoing', see *Graham v. Allis-Chalmers Manufacturing Co* 188 A.2d 125 (Del 1963) at 130. For the functional equivalence of not determining the truth of a probable fact with true knowledge, see Model Penal Code, subsection 7. US Sentencing Guidelines, which were updated in 2004, equate wilful ignorance to a breach of trust or abuse of position, see USSG Manual 8C2.5(b). More generally, see T. Rivers, 'How to Be Good: The Emphasis on Corporate Directors' Good Faith in the Post Enron Era' (2005) 58 *Vanderbilt Law Review* 631 at 664. For a general discussion, see A. Taslitz, 'Wilfully Blinded: On Date Rape and Self-Deception' (2005) 28 *Harvard Journal of Law and Gender* 381 at 413.

[41] See B. Masters, 'Enron's Quiet Outrage', *Washington Post*, 2 June 2006, p. D1.

[42] No criminal charges were laid against Enron's legal representatives, but it has agreed a settlement with the remnants of the corporation without admitting liability. A spokesman suggested that the legal partnership could have defended its position but wanted to avoid 'protracted litigation', see Associated Press, 'Vinson and Elkins Agree $30m Settlement', www.law.com, 2 June 2006.

Although individual executives at Merrill Lynch were prosecuted, and both it and the Canadian Imperial Bank of Commerce agreed non-prosecution agreements in exchange for substantial changes to their internal governance, since the Andersen reversal no attempt has actually been made to indict a corporation on criminal charges.[43] The situation is further complicated because investment banks do not owe explicit fiduciary duties in law beyond managing conflicts of interest.[44]

The trial exposed, therefore, glaring inadequacies in the capacity of the criminal justice system to neutralize the complicity of investment banks, which were complicit in facilitating the earnings conspiracy the executives were convicted of leading. This suggests that an emphasis on symbolic individual prosecutions alone may not have the demonstration effect hoped for to inculcate more widespread deterrence. As the trial graphically demonstrated, Enron's governance structures conformed to – or exceeded – what were then industry best-practice standards.[45]

Despite the win in Houston, there can be little doubt that the government has been bruised by its experience of prosecuting white-collar crime. The overturning on appeal of what had been

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[43] The Department of Justice has, however, indicted the securities law class action specialists, Milberg Weiss. The indictment accuses the firm of providing inappropriate referral payments to plaintiffs in order to bring suits. The law firm has denied wrongdoing and established a website to counter the allegations, see www.milbergweissjustice.com. The reputational costs to Milberg Weiss have already begun to mount, see A. Lin, 'NY Comptroller Seeks to Jettison Milberg as Pension Fund Counsel', *New York Law Journal*, 2 June 2006 (online edition).

[44] See A. Tuch, 'Investment Banks as Fiduciaries: Implications for Conflicts of Interest' (2005) 29 *Melbourne University Law Review* 478.

[45] Its code of ethics was regarded as a paragon of best practice. The problem was that compliance was not regarded as essential, a determination that allowed the Board of Directors to derogate from its application when it permitted the Chief Financial Officer to set up an off-balance-sheet trading concern, funded by international investment banks. See W. Powers, *Report of Investigation by the Special Investigative Committee of the Board of the Directors of Enron Corp*, 1 February 2002 (http://news.findlaw.com/hdocs/docs/enron/sicreport/).

presented as seminal prosecutions has proved deeply embarrassing. Most problematic has been the reversal of the Arthur Andersen obstruction of justice case, also taken by the Enron Task Force. In a partial rewriting of history, much was made in the Lay and Skilling trial of the suppression of material information from the auditors. The government had justifiable cause to mock the defence claim that the accounting mechanisms deployed on incomplete information were perfectly legal. Equally, however, the federal government's revised depiction of a global accountancy brand, which it had hounded to what the Supreme Court determined to be unjustified destruction, as a victim of deception is equally suspect.

Outside of Enron, the government has had a mixed result in prosecuting white-collar crime. While the Chief Executive of WorldCom faces a lifetime in jail, his counterpart at the disgraced HealthSouth corporation managed to convince a jury of his innocence, despite a succession of guilty pleas from executives. Even more controversially, as this book was going to press, the National Association of Securities Dealers controversially dropped charges against a prominent Credit Suisse First Boston banker accused of manipulating the initial public offering market. The banker, Frank Quattrone, had been accused of allocating preferential shares to individual executives whose corporations later engaged the investment bank in lucrative underwriting assignments. The charges had formed the basis of a failed criminal indictment brought by the Department of Justice in 2002. Quattrone was tried twice on obstruction of justice charges. On the first occasion the jury failed to agree a verdict. When he was convicted following a retrial the following year, the verdict was overturned on appeal. The Department of Justice now has to decide whether to retry the case for a third time on the basis of a complaint that has now been withdrawn by the regulatory authorities responsible.[46] Class actions using evidence amassed in joint regulatory investigations led

[46] See A. Ross Sorkin, 'NASD Ends Case Against Quattrone', *New York Times*, 2 June 2006 (online edition). For discussion of the initial trial, see J. O'Brien, above note 18, pp. 211–218.

by Eliot Spitzer, the State Attorney General of New York, have failed to convince federal judges. The SEC itself has found its renewed emphasis on the demonstration effect of prosecutions questioned.[47] All of this leads one to the inescapable conclusion that authority requires legitimacy and that requires accountability considerations to govern the conduct of the regulator as well as the regulated.

Galbraith has noted that we must come to terms with 'the basic fact of the twenty-first century – a corporate system based on the unrestrained power of self-enrichment.'[48] The central corporate and public policy imperative is to ascertain whether an emergent global financial architecture capable of intersecting with national regulatory regimes will result in normatively-improved governance structures or merely facilitate the global export of the strategic gaming that contributed to such a serious crisis within the US capital markets. The governance changes introduced in the aftermath of crisis have a profound impact on those emergent practices. A senior representative of the Australian Securities and Investments Commission noted wistfully in a recent interview with the author: 'Let's face it; Sarbanes–Oxley is a global law.'[49] Supporters claim that investor protection requires an integrated response and reject any suggestion of regulatory imperialism.[50] The recently departed Director

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[47] The *New York Times*, which has taken a robust line on the need to prosecute, has changed tack significantly, giving extensive coverage to the morality of charging executives. For the case of an executive who used expressive moral criteria to justify not settling in the face of government pressure, see J. Anderson, 'A CEO Who Wouldn't Say "I Settle"', *New York Times*, 19 March 2006 (online edition).

[48] J.K. Galbraith, *The Economics of Innocent Fraud*, Houghton, New York, 2004, p. 44.

[49] Interview, Brisbane, 19 August 2005.

[50] See W. McDonough, 'Accountability in an Age of Global Markets', in J. O'Brien, above note 2. See also the companion chapter by A. Schaub, 'European Responses to Corporate Governance Challenges', in the same volume.

of Enforcement at the SEC, Steven Cutler, maintains that regulatory cooperation has become essential to garner evidence of wrongdoing and ensure global market integrity.

> 'There is no company that we end up proceeding against that doesn't have an office overseas, and invariably we are going to be seeking documents relating to that operation overseas. Over the last decade, [we have done] a nice job of establishing and maintaining very good relations with our counterparts overseas. [However] that level of cooperation and that kind of close working relationship can only exist if our laws bear some relation to one another. If we end up prosecuting something that my counterpart in London thinks is crazy for us to be prosecuting because [they think] it is perfectly OK, then they are not going to provide a lot of help I wouldn't think, and vice versa. And ultimately as our markets go more and more global, the more pressure there is on the free market communities to arrive at something that approaches convergence'.[51]

Evidence of that cooperative approach can be seen in litigation now before the courts in New York and Sydney as well as London.[52] An insider-trading investigation launched by the SEC explicitly thanks the Financial Services Authority in the United Kingdom along

[51] Interview, Washington DC, 23 May 2005. The need for an integrated response is intensified because of the global expansion of financial services conglomerates, albeit ones which tend to be anchored primarily in securities, insurance or investment banking. A joint report released by the Basel committee on Banking Supervision, International Organization of Securities Commissions and the International Association of Insurance Supervisors, suggests these are a fundamental and 'permanent fixture on the financial landscape', see The Joint Forum, *Regulatory and Market Differences, Issues and Observations*, May 2006, p. 4. Full text at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD215.pdf.

[52] The case of three British investment bankers extradited to the United States to face charges of criminal fraud typifies this concerted approach. Despite vociferous opposition, based largely on political considerations of the remit of extradition procedures, the British courts ruled that the US had jurisdictional authority, see J. Willman, 'How Britain's Unlikeliest Martyrs Put America on Trial', *Financial Times*, 15 July 2006, p. 11.

with counterparts in Denmark, Croatia and Austria.[53] The recent insider-trading prosecution taken by the Australian Securities and Investments Commission against Citigroup Global Capital Markets also suggests a degree of coordination in prosecutorial strategies.[54] The case, which Citigroup vigorously defends, centres on what ASIC claims was the investment bank's alleged 'unconscionable' conduct in failing to manage conflicts of interest. ASIC has confirmed that it consulted with international partners prior to taking the case. How effective that consultation is and whether it extends between disclosure- and prudential-based regulatory subsystems is another matter entirely.

Remarkably, the case was taken just days after Citigroup was released from restrictions placed on its acquisition strategy by the Federal Reserve because of questions relating to its ethical foundations. This suggests considerable ongoing difficulties in integrating the conflicting imperatives of prudential- and disclosure-based regulation.[55] Despite these difficulties, a discernible drive

[53] 'SEC Complaint Charges International Insider Trading Ring', Press Release 2006-53, 11 April 2006. Full text available at: http://www.sec.gov/news/press/2006/2006-53.htm. The case, which began with an investigation on movements of Reebok shares prior to its acquisition by Adidas, has mushroomed. The alleged ringleaders orchestrated an elaborate information-gathering system, which included a mole in the *Business Week* printing plant in Wisconsin, the recruitment of exotic dancers and even informants prepared to leak information about a grand jury investigation into accounting irregularities in Bristol-Myers Squibb, see Southern District of New York Press Release, 'New Jersey Grand Juror Accused of Leaking Information', 11 May 2006. Full text at http://www.usdoj.gov/usao/nys/Press%20Releases/May%2006/Smith,%20Jason%20Complaint%20PR.pdf.

[54] J. O'Brien, 'Insider Trading Case to Test Chinese Walls', *Irish Times*, 1 May 2006, p. 14.

[55] On the need for increased cooperation within IOSCO through the development of multilateral memorandums of understanding, see 'IOSCO Strengthens International Cooperation to Fight Illegal Securities and Derivatives Activities', Press Release, Seoul, 16 October 2003. Full text at: http://www.iosco.org/news/pdf/IOSCONEWS60.pdf. The memorandum is available on the IOSCO website: http://www.iosco.org. The problems are intensified, however, because of the nature of financial conglomerates, whose activities crosscut traditional supervisory

towards a more muscular enforcement paradigm can be detected, albeit one that stresses responsive regulation and takes due cognizance of the influence of cultural factors on both regulatory style and scope.[56] This is most apparent in a reconceptualization of the form and function of compliance as a restraining force.[57] The International Organization of Securities Commissions explicitly states the need for market intermediaries to transcend black letter law calculation of compliance to incorporate a 'high ethical' dimension.[58]

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demarcations. These present problems associated with strategic purpose and regulatory culture. These difficulties exist even when jurisdictions adopt an integrated approach to supervision and require 'close attention and effort' to minimize gaps in oversight and ensure cohesiveness of purpose, see The Joint Forum, above note 51 at 10. For difficulties associated with prudential regime dynamics and a scathing criticism of prudential regulatory failure in the Australian context, see Royal Commission of Inquiry, *The Fall of HIH Insurance*, Commonwealth of Australia, Canberra.

[56] The Joint Forum, above note 51 at 29. For an analysis that centres on regulation as a means for modifying behaviour, see C. Scott, 'Analysing Regulatory Space: Fragmented Resources and Institutional Design' (2001) Summer *Public Law* 331; for behaviour modification as a key evaluative indicator, see C. Hood, H. Rothstein and R. Baldwin, *The Government of Risk*, Oxford University Press, Oxford, 2004, pp. 20–22.

[57] See IOSCO, 'Compliance Function at Market Intermediaries', March 2006. Full text at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD214.pdf.

[58] Ibid, p. 4. This mirrors the strategic calculations of the Securities and Exchange Commission in its advice to the legal profession, see H. Goldschmidt, 'A Lawyer's Role in Corporate Governance: The Myth of Absolute Confidentiality and the Complexity of the Counseling Task', Association of the Bar of the City of New York, New York, 17 November 2003. For Goldschmidt, 'absolute emphasis on confidentiality is incomprehensibly out of balance' with the profession's code of practice. This formulation carries an implicit threat. It suggests that unless the legal profession accepted the need to report out as a principle of best practice, the SEC would codify such a requirement. Goldschmidt concludes robustly: 'The day of narrowly couched technical legal advice should be over.' Full text online at http://www.sec.gov/news/speech/spch111703hjg.htm. For the accountancy profession, see D. McBarnet, 'After Enron: Corporate Governance, Creative Compliance and the Uses of Corporate Social Responsibility' in J. O'Brien, above note 2, pp. 205–222. See also C. Whelan and D. McBarnet, *Creative Accounting and the Cross-Eyed Javelin Thrower,* John Wiley & Sons, Ltd. Chichester, 1999.

The IOSCO report specifically argues that proactive enforcement is necessary to ensure that the compliance function has sufficient intra-institutional power to identify and rectify risk. To achieve this, IOSCO recommends 'direct examination, by the regulator, of the compliance function at the time of license application' and subsequent ongoing inspection.[59] The report is notable for the level of intrusion into the actual form of governance arrangements and regulatory practice. It suggests, for example, that an effective inspection regime needs to take into consideration the following factors:

> The adequacy of the firm's policies and procedures, the structure of the compliance function (such as the degree of independence and lines of reporting), human and material resources dedicated to the compliance function, qualifications and fitness of the person(s) responsible for compliance, and possible or mandated measures taken to address deficiencies previously identified.[60]

The critical question is how such benchmarking is actually measured and whether the limitations associated with archipelagic regulatory regime dynamics can be transcended. Highly placed industry sources suggest that the entire process amounts to 'rule-making by litigation', which bypasses the consultative dimension.[61] This raises serious and unresolved questions of authority. As with the negotiated prosecution innovation adopted by the Department of Justice in Washington, it risks, if misapplied, the displacement of 'creative compliance' in favour of even more problematic questions of regulatory legitimacy. Despite these dangers, there is considerable evidence of global diffusion of this form of regulatory innovation.

Precisely because changes to the governance structure of the capital markets in the United States represent the most significant driving force behind this global change, it is imperative to evaluate more precisely what specific factors influence regulatory recalibration in

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[59] IOSCO above note 54 at 17.

[60] Ibid, at 18.

[61] Interview, Sydney, 9 May 2006.

that market before extending the analysis to how the change impacts on international practice. First, the regulatory terrain is mapped and the impact of Sarbanes–Oxley is examined. I then trace how change in the relative power of institutional actors influenced the design and direction of regulatory policy. I then explore weaknesses associated with the compliance model before examining in more detail the operation of pre-trial diversion, the most controversial mechanism deployed in the pursuit of behavioural change within both corporations and the markets in which they operate.

2

Taming the corporation? Sarbanes–Oxley and the politics of symbolism

The Public Company Accounting Reform and Investor Protection Act 2002 (Sarbanes–Oxley) represents the single most significant change to the governance of business organizations since the New Deal architecture erected in the 1930s.[1] The coalescence of exogenous (a deteriorating crisis of confidence in the integrity of the market system) and endogenous (the desire of politicians to erect a firewall against accusations of causal responsibility) factors transformed the balance of power within Congress. This convergence allowed policy entrepreneurs to advance an agenda at variance to the interests of

[1] For Sarbanes–Oxley as a path-dependent reaction to scandal, see L. Ribstein, 'Bubble Laws' (2004) 40 *Houston Law Review* 77. For an account suggesting Sarbanes–Oxley is an 'unprecedented . . . federalization of corporate law [designed to restore] systemic legitimacy', see J. Cioffi, 'Corporate Governance Reform, Regulatory Politics, and the Foundations of Finance Capitalism in the United States and Germany' (2005) 7 *German Law Journal* 533 at 548. For strategic imperatives of the Securities and Exchange Commission, see R. Karmel, 'Realizing the Dream of William O. Douglas, The Securities and Exchange Commission Takes Charge of Corporate Governance' (2005) 30 *Delaware Journal of Corporate Law* 79. For the role of entrepreneurs, see P. Gourevitch and J. Shinn, *Political Power and Corporate Control*, Princeton University Press, Princeton, 2005, pp. 241–259; for a scathing assessment, criticizing the 'lack of rationale', see R. Romano, 'The Sarbanes–Oxley Act and the Making of Quack Corporate Governance' (2005) 114 *Yale Law Journal* 1521.

associational groupings, which had heretofore exercised an ideational and material grip on the legislature. The resulting reform, based on and extending the disclosure regimen of the Securities Act 1933 and Securities Exchange Act 1934, has the potential to transform the dynamics of regulatory enforcement by reconfiguring the wider corporate governance paradigm. Translating the potential for change into successful policy outcomes, however, requires not just recalibration of the internal governance of corporations or credible enforcement but also the markets in which they operate. Despite its ostensibly stringent provisions, Sarbanes–Oxley fails to address this component of the associational matrix.[2]

The legislation can only deliver on its stated objectives if accompanied by a Pauline conversion for which there remains, at best, inconclusive evidence.[3] As a consequence, it is arguably better understood as an exercise in political symbolism.[4] This is not to denigrate its importance. As the centrepiece of the reform agenda, the legislation significantly increases criminal sanctions against both corporate executives and the accountancy profession. The extension is presented as a normative necessity to assure the continued legitimacy of the wider market system.[5] As with the initial architecture, it is predicated on the transformative power of increased disclosure. Transparency, underwritten by greater personal and corporate accountability, is designed to result in more ethical

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[2] Here, the role of gatekeepers is essential. By providing advisory services, they can underwrite wider integrity, or acquiesce to, or proactively engage in, collusive activity, see J. Coffee, *Gatekeepers: The Professions and Corporate Governance*, Oxford University Press, Oxford, 2006.

[3] See J. O'Brien, 'Governing the Corporation: Regulation and Corporate Governance in an Age of Scandal and Global Markets' in J. O'Brien (Ed.) *Governing the Corporation*, John Wiley & Sons, Ltd, Chichester, 2003.

[4] See, in particular, M. Edelman, 'Symbols and Political Quiescence' (1960) 54 *American Political Science Review* 695.

[5] For a critique suggesting this is itself a deceit, see J.K. Galbraith, *The Economics of Innocent Fraud,* Allen Lane, London, 2004. See also C. Lindblum, *The Market System*, Yale University Press, New Haven, 2001.

markets. As with all legal instruments, however, effectiveness depends on the degree to which business internalizes its internal logic or, alternatively, transacts its way around the substantive provisions by engaging in technical compliance. This, in turn, depends on the dynamics of regulatory enactment and subsequent enforcement.

Power to influence regulatory outcomes is contingent on a complex bargaining process. In the battle for advantage, the capacity to translate preferences into policy outcomes depends on the relative power of disparate interest groups to generate coalitions of sufficient strength to influence the strategic calculation of the targeted constituency.[6] Given the coordination problems involved, delivering wholesale reform is exceedingly rare. This is particularly so in the United States, where the political system is exceptionally fragmented.

This chapter examines the critical factors that led to the emergence of disclosure as a restraining force and why the system failed so spectacularly. It argues that this can be traced directly to structural changes in the governance of financial markets throughout the 1990s, which weakened the foundational basis of the disclosure-based regime. This enables us to delineate more precisely the mechanisms discrete interest groups deploy to influence the direction and scope of regulatory policy. Second, the rationale and main provisions of Sarbanes–Oxley itself are traced. Third, we assess the impact on the managerial cohort and those providing intermediating services to the corporation. Precisely because the accountancy profession has lost its capacity to self-regulate, particular attention is placed on the creation, governance structures and strategy adopted by the Public Company Accounting Oversight Board. In the fourth section, drawing from the work of Murray Edelman,[7] the defining features of 'symbolic'

[6] See P. Gourevitch and J. Shinn, above note 1; for electoral coalition building in the United States, see G. Tsebelis, *Veto Players: How Political Institutions Work*, Russell Sage Foundation, New York, 2002.

[7] See M. Edelman, *The Symbolic Uses of Politics*, University of Illinois Press, Urbana, 1964; M. Edelman, *Constructing the Political Spectacle*, University of Chicago Press, Chicago, 1988.

legislation are delineated to argue that Sarbanes–Oxley is talismanic of the form.

The Strategic Calculation of Congress

The establishment of the Securities and Exchange Commission was an integral component of the regulatory architecture commissioned in response to the Great Crash of October 1929 and the Depression that followed. The perceived chicanery of Wall Street eroded the dominance of institutional actors. Congressional hearings catalogued a litany of banking abuse, including insider-trading and price-fixing. More seriously they also publicized the existence of corrupted networks, which dispensed advantages to preferred clients.[8] Banking complicity in the crisis was the subject of the initial focus of the congressional investigation in the 1930s. The critical question of how the wider securities industry should be governed could not be avoided, however.

In particular, the ideational certainty that facilitated the network of stock exchanges to operate outside of governmental regulation was fatally undermined.[9] The patina of legitimacy provided by listing requirements had long been suspected as an essentially worthless

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[8] In many ways these prefigure the contemporary crisis. As with the 1930s, initial quiescence has been replaced by increasingly shrill protestation about exorbitant costs associated with compliance and intense lobbying to block implementation, hollow out or revisit substantive provisions. For the definitive account, see J.K. Galbraith, *The Great Crash*, Penguin, London, 1992. See also C. Geisst, *Wall Street, A History*, Oxford University Press, New York, 1997, pp. 222–227. On the cyclical nature of speculative bubbles, see C. Kindleberger, *Manias, Panics and Crashes*, John Wiley & Sons, Inc., Hoboken, 2000. For a regulatory history of the period, see T. McCraw, *Prophets of Regulation*, Harvard University Press, Cambridge MA, 1984; see also J. Seligman, *The Transformation of Wall Street, A History of the Securities and Exchange Commission and Modern Corporate Finance*, Aspen, New York, 2003.

[9] The exchanges served as 'institutional hybrids: part gambling dens, part legitimate public marketplaces, part symbols of the rise and fall of national prosperity, ' see T. McCraw, above note 8, p. 164.

assurance of integrity. A leading academic lawyer, who had been involved in earlier hearings that led to the creation of the Federal Reserve in 1913, Samuel Untermeyer, complained bitterly at the time about what he saw as an abdication of a responsibility in bringing the market to account. He fulminated that 'some day when there is a real investigation of the history of the Stock Exchange we shall get a picture of the means by which billions of dollars have been literally filched from the public through the machinery of that institution that is still permitted to remain beyond official government regulation, supervision and control, and above and beyond the law.'[10] As the markets increased in economic and political importance throughout the 1920s, the essentially private concerns of speculators became matters of profound public policy.

The combination of continued economic stagnation and a presidential mandate that promised a 'New Deal' transformed this wider governance. Three key changes were introduced by James Landis, described by his political biographer as 'the outstanding theoretician of American regulation'.[11] First, in the Securities Act 1933 an independent accountant had to certify the authenticity of accounts offers by new entrants to the securities market. This was extended to cover all those trading by the Securities and Exchange Act 1934, which also transferred, in theory, the oversight function to the newly-established SEC.[12] Thirdly, Congress divined that a major contributing factor to the speculative scandal and resulting

[10] C. Geisst, above note 8, p. 228.

[11] T. McCraw, above note 8, p. 154.

[12] In practice this function was performed by the accountancy profession. The emergent regime was predicated on the enhanced gatekeeper function of the auditor. After initial hostility, expressed through the pages of the *Journal of Accountancy*, the profession actively collaborated with the SEC to ensure its centrality in regulatory design. This was achieved primarily through its enfranchisement in standards setting in conjunction with the office of the SEC Chief Accountant, see T. McCraw, above note 8, pp. 190–191. For an assessment which questions whether the changes had any tangible impact on the authenticity of financial reporting, see B. Merino, 'Financial Reporting in the 1930s' (2003) 27 *Accounting Forum* 270.

scandal was the role played by the banking sector. Rather than accept assurances that conflicts of interest could be contained, or managed, the Glass–Steagall Act of 1933 ordered the separation of commercial and investment banking. Primacy over the regulation of the internal governance of corporations was left at state level; the federal government was charged with enhancing the transparency of how these firms intermediated with the wider investing public. This set the stage for an acrimonious dispute, which has continued unabated ever since, with policy entrepreneurs fencing within multiple battlegrounds over the strategic purpose and practical limits of financial regulation.

There are remarkable parallels between the passage of the regulatory architecture in the 1930s and the contemporary crisis. As in 1933 with the passage of Glass–Steagall and the Securities Act, when Congress moved to act in 2002, the legislation was hurriedly put together, framed in an atmosphere of crisis and passed almost unanimously with little contestation. Precisely because of the importance of exogenous factors, media salience and the intuitive normative value of transparency, interest groups failed to gain sufficient traction to defeat the measures. After the initial move to action, however, the salience dissipated. The failure to secure political traction served notice on the putative reformers that the limits of quiescence had been reached. Attempts by business today to limit the remit of the Securities and Exchange Commission over the granularity of regulation covering internal control mechanisms mirror the charged atmosphere pertaining as Landis was drawing up the legislation that established the agency. Writing in 1934 just before the bill was debated in Congress, Landis complained: 'The Stock Exchange Bill is receiving a terrific beating. All the corporate wealth of this country has gone into the attack and carried it all the way to the White House.'[13] Although the bill was passed and the SEC established, its remit and authority waned incrementally at first and dramatically in the 1990s. The reduction in power failed to ignite

[13] T. McCraw, above note 8, p. 178.

public controversy. Paradoxically, periodic successes, such as the insider-trading investigations and high-profile individual prosecutions, enhanced the visibility of the SEC but not necessarily its authority.

In the absence of the kind of catastrophic crisis witnessed in the Great Crash of 1929 or the extent of corporate scandal revisited at the cusp of the millennium, battles over financial regulation take piecemeal form through refinements to individual legislative clauses. Just as prevalent, however, are disputes between executive agencies and associational groups with differing degrees of enfranchisement over the design and implementation of specific regulatory instruments. The fragmented and technical nature of this glacial process masks the cumulative effect of technical change. It can leave an outer shell of protection lacking the structural substance to withstand systemic shocks.

Throughout the 1990s many of the key provisions of the New Deal were eroded by such a shift in the regulatory climate.[14] The tripartite relationship between the market, the corporations who access it and the regulatory authorities was conflated into a Manichean battle over whether the state or the market was best placed to deliver effective control. The individuated nature of congressional politics and the growing importance of financial services as the underwriter of the wider political system were instrumental driving factors inside the Washington Beltway.[15] The acceptance by the Clinton administration of neo-liberalist economic arguments in relation to the governance of the markets narrowed significantly not only the strategic range of policy options but also the capacity of regulatory agencies to resist calls for further deregulation. This further embedded the ideational

[14] J. Nofsinger and K. Kim, *Infectious Greed*, Prentice Hall, New Jersey, 2003, p. 250.

[15] See P. Heywood, 'Political Corruption: Problems and Perspectives', in P. Heywood (Ed.) *Political Corruption*, Blackwell Publishing, Oxford, 1997, p. 15; see also E. Drew, *The Corruption of American Politics*, Overlook Press, New York, 2000; F. McChesney, *Money For Nothing, Politicians, Rent Extraction and Political Extortion*, Harvard University Press, Cambridge MA, 1997.

power of neo-liberalism, which had been steadily growing across the public policy discourse since the early 1970s.[16]

The repeal of the Glass–Steagall Act of 1934 separating commercial and investment banking was indicative of how the neo-liberal economic consensus has become embedded into the political mainstream. A central dimension of the New Deal regulatory architecture, it was revoked without public dissension.[17] The recombination, mandated by the Financial Modernization Act of 1999, was a major contributing force to the subsequent scandal.[18] The FMA demonstrated the growing importance of securitization to economic growth. It also revealed Wall Street's ability to reinvent itself as a model of probity.[19] Legislative confidence was placed on the promise that the inherent conflicts

[16] D. Harvey, *A Brief History of Neo-Liberalism*, Oxford University Press, Oxford, 2005, pp. 43–55.

[17] Of equal importance was the passage of the Private Securities Litigation Reform Act of 1995 (Public Law 104-67), which made it more difficult to take securities litigation, and the Securities Litigation Uniform Standards Act of 1998 (Public Law 105-33), which removed court adjudication of securities cases from state level. These developments reduced civil litigation at precisely the same time as public enforcement also waned and managerial incentives increased, thus minimizing the efficiency of deterrence at precisely the same time as exuberance clouded investor judgement about gatekeeper necessity, see J. Coffee, *Gatekeepers, The Professions and Corporate Governance*, Oxford University Press, Oxford, 2006, pp. 60–69.

[18] See R. Lowenstein, *The Origins of the Crash*, The Penguin Press, New York, 2004, p. 97; see also J. O'Brien, *Wall Street on Trial*, John Wiley & Sons, Ltd, Chichester, 2003, p. 102.

[19] For a magisterial sociological review, see S. Fraser, *Wall Street, A Cultural History*, Faber and Faber, New York, 2005; see also K. Phillips, *Wealth and Democracy, A Political History of the American Rich*, Broadway Books, New York, 2002, pp. 347–371. The quest for ownership of technological knowledge (or at least credit for facilitating its expansion) spurred political belief in the dynamics of the new economy. As Susan Strange has commented, however, this, coupled with the growth in proprietary trading, fundamentally changed the underlying risk calculus. For a prescient analysis, see S. Strange, *Mad Money*, Manchester University Press, Manchester, 1998; see also S. Strange, 'Finance in Politics: An Epilogue to Mad Money' in R. Tooze and C. May (Eds) *Authority and Markets, Susan Strange's Writings in Political Economy*, Palgrave, Basingstoke, 2002, pp. 116–118.

of interest posed by recombination could be effectively managed.[20] Glaring inadequacies in the putative market for corporate control were largely ignored. These included the insider-trading excesses of the 1980s that led to the disintegration of Drexel Burnham Lambert; the asset-stripping that defenestrated large swathes of industrial America; and the savings and loan debacle, which provided initial evidence of the dangers associated with unregulated proprietary trading. Within the professions, evidence of compromised audits was dismissed. Individual financial reporting failures at Sunbeam and Waste Management were presented as irrelevant outliers. When the Securities and Exchange Commission questioned the policy implications of an apparent disintegration in the integrity of financial statements, it faced concerted hostility from both the accountancy profession and the legislature.[21]

Given the risk involved and Wall Street's past record, the critical question is how the SEC could be so effectively ignored. Three factors were crucial. First, the revolving door between the political and business elite provided powerful institutional support for the perceived benefits of securitization. The importation into the executive of former investment banker Robert Rubin is apposite.[22] As Treasury Secretary,

[20] The insider-trading case taken by the Australian Securities and Investments Commission against Citigroup suggests regulatory scepticism. One senior ASIC representative told the author: 'If insider trading is an integral component of the investment banking model as we know it, then this is an assault on the investment banking model as we know it', Melbourne, 4 April 2006. For a discussion of the issues raised by the case, see J. O'Brien, 'Insider Trading Case to Test Chinese Walls', *Irish Times*, 1 May 2006, p. 14.

[21] A. Levitt, *Take on the Street*, Pantheon Books, New York, 2002; see also A. Levitt, 'Corporate Governance and the Culture of Seduction' in R. Gandossy and J. Sonnenfield (Eds) *Leadership and Governance From the Inside Out*, John Wiley & Sons, Inc., Hoboken, 2004.

[22] The revolving door between Wall Street and the corridors of power in Washington is longstanding and prevalent. In June 2006, Hank Paulson, the former Chief Executive of Goldman Sachs, was appointed Treasury Secretary. The reverse is also true. Earlier in 2006, William McDonough left the Public Company Accounting Oversight Board to become Vice Chairman of Merrill Lynch.

Rubin was instrumental in navigating the passage of the FMA. Following the outbreak of scandal he argued, somewhat implausibly, that 'the great bull market masked many sins, or created powerful incentives not to dwell on problems when all seemed to be going well – a natural human inclination'.[23] This explanation fails to take adequate cognizance of uncomfortable but known facts. The SEC and leading figures within the legacy accounting regulator had explicitly warned that financial reporting integrity had collapsed.[24] The account also underplays the private disputes within the Clinton administration about the efficacy of internal controls advanced by the investment houses.[25]

Second, the inordinate caution and bureaucratic overreach of a cumbersome regulatory framework was deemed the most significant brake on the development of the new economy. Senior executives in the banking and accountancy profession regarded the SEC as an irritant and enlisted key congressional allies to advance their cause. They suggested *sotto voce* that the SEC's concern about financial reporting displayed histrionic paranoia.[26] Third, the wider legislative changes were indicative of congressional and executive calculation that sufficient cross-party support existed to minimize 'the determinants of future political disaffection and political sanctions'.[27] The pricking of the overblown equity markets in April 2000 did not initially challenge belief in the efficacy of the self-policing model. Things did not even demonstrably change after the collapse of Enron. The tipping point was the catastrophic fall of WorldCom. Its failure provided a spectacular backdrop for congressional hearings already convened into Enron.[28] It also highlighted the complicity of a much

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[23] R. Rubin, *In an Uncertain World*, Thomson Texere, New York, 2003, p. 337.

[24] See S. Zeff, 'How the US Accounting Profession Got Where It Is Today' (2003) 17 *Accounting Horizons* 267.

[25] See J. Stiglitz, *The Roaring Nineties*, Norton, New York, 2003, pp. 159–162.

[26] See A. Levitt, above note 21, p. 221.

[27] See M. Edelman, above note 4 at 701.

[28] In addition, a range of other corporations were forced to restate earnings and admit accounting manipulation. These included Xerox, Adelphia, Qwest, Global Crossing

wider range of actors. As with the Pecora Hearings into the Great Crash, it was untenable to limit congressional investigation to single firms. This posed significant risks to the wider political system, which was dependent on contributions from the financial services sector and which had also been instrumental in eroding regulatory oversight against the wishes of the SEC chairman.

The systemic nature of the scandal thus forced a temporary realignment. Maintaining faith in the efficacy of self-policing was no longer feasible in political terms. Congress retreated to a tried political discourse that trumpeted the need to protect the metaphorical 'small investor'. While the events leading to the passage of Sarbanes–Oxley indicate a remarkable degree of consensus, it is also the case that the political establishment had much to gain. Adopting a discourse that posited the blame on corrupted individuals deflected from the underlying structural conditions. It also dissipated salience when it had the most potential to impinge on the political environment. With mid-term elections scheduled for the following November, there was a common determination that if corporate failure could not be eradicated, an effective political firewall could and should be erected.[29]

This, in turn, necessitated the re-enrolment of the regulatory elite so disparaged four years previously. The changed circumstances provided the opportunity for policy entrepreneurs to force through the

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and Tyco. A landmark study of the General Accountability Office found restatements increased dramatically throughout the late 1990s. In 1997, 92 companies restated; in 1998, that number increased to 102. In 1999, a total of 174 restated; in 2000 it reached 201 and in 2002, 225 released revised financial statements. Of these, 39% related to financial revenue, see GAO, *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges*, 03–138, October 2002.

[29] For political calculations, see R. Romano, above note 1; see also J. Macey, 'A Pox on Both Your Houses: Enron, Sarbanes–Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules' (2003) 81 *Washington University Law Quarterly* 329.

best-practice guidelines they had advocated throughout the 1990s.[30] The legislation and the accompanying changes to the governance of the primary exchanges do not mark an endpoint in securities and corporate regulation in the United States. From the beginning, one of the main sponsors of the legislation, Michael Oxley, made clear that its central provisions were negotiable. In a web-cast organized by PricewaterhouseCoopers, he argued: 'any time that Congress deals with white-hot issues like we dealt with in corporate accountability and accounting misdeeds, there are bound to be some issues that ought to be revisited'.[31] Before examining in more detail how the elevation of the legislation to symbolic status is a pivotal component of the battle for regulatory control, it is instructive to highlight first the key provisions.

The Provisions of Sarbanes–Oxley

The legislation serves four interlinked purposes. It creates new structures to regulate both the audit process and the profession; increases the responsibilities and liabilities of corporate boards to insure against future malefaction; provides protection for internal whistleblowers; and enhances the authority of the Securities and Exchange Commission to police the market. As noted above, the most important structural innovation is the creation of the Public Company Accounting Oversight Board.[32]

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[30] See W. Chandler and L. Strine, 'The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State' (2003) 152 *University of Pennsylvania Law Review* 954. See also P. MacAvoy and I. Millstein, *The Recurrent Crisis in Corporate Governance*, Palgrave Macmillan, New York, 2003. For an account which suggests an inherent tension between 'transparency regulation and structural regulation', see J. Cioffi, above note 1 at 545.

[31] A. Hill, 'Has Corporate America Learned Its Lesson?', *Financial Times*, 30 December 2002 (online edition).

[32] Public Law 107-204, s. 101, s. 102, s. 104 and s. 107.

The PCAOB is charged with establishing enhanced quality control mechanisms over the audit process and the accountancy profession more generally. It is mandated to conduct inspections, launch disciplinary proceedings and apply sanctions when warranted. Significant additional controls have been enacted to reposition the authority of the audit. Auditors are prohibited from the provision of non-audit services without the explicit approval of the audit committee.[33] The audit firm is mandated to provide a report which explicitly examines the accounting treatment used and the impact alternative interpretations would have on financial projections.[34] While there is not to be a mandatory rotation of audit firms, the lead partner must change every five years.[35] The revolving door between the corporation and the profession is temporarily jammed with the ban on an accounting partnership carrying out an audit if a senior executive at the corporation to be examined had participated in the exercise for the accounting firm in the preceding twelve months.[36] The PCAOB represents a qualitative improvement in the quality of auditor oversight by generating prudential equidistance from both the regulated (in terms of standard creation) and the political establishment (through budgetary independence).

The range of civil and criminal penalties against individual directors or executive officers is increased to ensure compliance. Chief Executive and Chief Financial Officers are forced to attest the truthfulness of corporate accounts.[37] This is designed to minimize any future defence based on ignorance. Financial penalties for certification failure are set at $5 million and up to twenty years' imprisonment. Engaging in a scheme that fraudulently misrepresents material facts to the marketplace is now punishable with a prison term of up to

[33] Public Law 107-204, s. 202.
[34] Public Law 107-204, s. 204 and s. 301.
[35] Public Law 107-204, s. 203.
[36] Public Law 107-204, s. 206.
[37] Public Law 107-204, s. 302 and s. 906.

twenty-five years.[38] The penalty for obstruction, including, but not limited to, document shredding, is increased to twenty years.[39] There is recognition that management may pressurize the auditor. It becomes a federal offence for a director or other officer of the corporation to attempt fraudulently to influence, coerce, manipulate or mislead any accountant involved in the audit.[40]

Congress determined that all corporations must improve their internal governance structures. This is achieved primarily by buttressing the role and independence of the audit committee.[41] At least one of the members of the committee must be a financial expert.[42] The audit committee is given the right to hire auditors and has the ultimate responsibility to adjudicate on whether it is appropriate for the accounting firm to provide non-audit services, which, if allowed, must be disclosed.[43] Each member of the audit committee is mandated to be independent and is barred from accepting any consultancy fees from the corporation or any of its key suppliers. Most controversially, the audit committee is charged with ensuring that internal controls are commensurate with levels of operating risk.[44]

These include the maintenance of records that reflect particular transactions and the attestation by management that the controls are robust enough to ensure early reporting of any material fact whose disclosure could impact on the veracity of the financial statements. Not only has the framework to be tested but also the evidence on which evaluation is based must be capable of retrieval. The SEC was provided significant discretion to design new standards for controlling

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[38] Public Law 107-204, s. 807.

[39] Public Law 107-204, s. 802 and s. 1102.

[40] Public Law 107-204, s. 303.

[41] Public Law 107-204, s. 301. Senior management is further mandated to disclose any deficiency in internal controls (s. 302) and the corporation must immediately report to the SEC any material changes in financial condition discovered in that process (s. 409).

[42] Public Law 107-204, s. 407.

[43] Public Law 107-204, s. 201 and s. 202.

[44] Public Law 107-204, s. 404.

risk. Taken together these measures mandate significant intrusion into the internal governance of the corporation. The Act also calls for the disclosure of all off-balance-sheet transactions within the context of increased internal financial control mechanisms.[45]

As noted above, corporations must disclose to the SEC any material changes in financial condition or operation.[46] The need to place a copy of a corporate ethics programme with the SEC and report any derogation represents a new departure.[47] It transforms ethics from an often unrealized and potentially unrealizable aspiration into strategic calculation and obligation. Some of the most egregious examples of unethical behaviour revealed in the governance crisis are explicitly proscribed. No executive may sell stock at a time when pension fundholders are precluded.[48] Furthermore, extending loans to senior executives or directors is severely curtailed.[49]

Stock options and bonuses paid as a consequence of earnings that have subsequently to be restated are liable to disgorgement. While this provision applies when the perpetrator is brought to justice, it fails to tackle the issue of how stock options create the dynamic for aggressive financial engineering in the first instance. Protection of whistleblowers is mandated.[50] There is a further obligation on the audit committee to create proactively procedures to receive and retain complaints.[51]

Guarding the Gatekeepers?

Given the alleged involvement of Arthur Andersen (and later KPMG through its use and abuse of tax shelters) in the unfolding

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[45] Public Law 107-204, s. 404.
[46] Public Law 107-204, s. 409.
[47] Public Law 107-204, s. 406.
[48] Public Law 107-204, s. 306.
[49] Public Law 107-204, s. 402.
[50] Public Law 107-204, s. 806.
[51] Public Law 107-204, s. 301.

corporate financial reporting scandals, it was not unexpected that the media and political discourses would simplify the crisis to a corrupt alliance between the accountancy profession and morally bereft executives. On the surface it offers a plausible narrative. Despite the internal and external calls for restraint throughout the 1990s, outlined above, the securitization of the economy dramatically altered the balance of power within the accountancy profession itself.[52] The audit transmogrified from the defining feature of professional expertise into a loss-leading vehicle designed primarily to gain access to lucrative managerial consultancy contracts. The rising stock market reinforced the ideational certainty of asset-lite trading strategies, which were, in turn, fuelled by bombastic media coverage.[53] Accounting failure and the re-emergence of Levitt made the profession a convenient scapegoat for wider systemic failures. In a remarkable volte-face, the most avuncular proponents of muscular enforcement were transformed into comic book cops, pitted against the villains of Wall Street and the executive suite. This was reinforced by skilful media manipulation, particularly from new entrants to the regulatory enforcement arena. They claimed that self-regulation reflected a wider policy failure. Lacking the restraining protocols governing the SEC and, to a limited extent, the Department of Justice, these actors leaked information about ongoing investigations. Not surprisingly, it generated an agenda

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[52] See, for example, the pivotal speech given by Arthur Levitt to New York University in 1998 on accounting tricks. The full text is available from the Securities and Exchange Commission, Press Release 95, 1998.

[53] The reality of constant deadlines; susceptibility to subliminal or actual bias because of exclusive but partial access; journalistic laziness in failing to triangulate contested accounts; maladroit but unobserved handling of source material as well as commercial and ideological considerations combine to influence the strategic manner in which any news organization devotes resources to the shaping of a particular story or narrative. For discussion of the media's role in facilitating the boom, see A. Dyck and L. Zingales, 'The Bubble and the Media', in P. Cornelius and B. Kogut, *Corporate Governance and Capital Flows in a Global Economy*, Oxford University Press, New York, 2003. See also H. Kurtz, 'On CNBC, boosters for the boom', *Washington Post*, 12 November 2002 (online edition). Media coverage of enforcement activity appears to be a mirror image.

that emphasized the importance of their involvement.[54] In such an atmosphere, self-regulation without an enforced externally validated component was politically unacceptable.

Sarbanes–Oxley explicitly rejects the self-validated peer review system for the accountancy profession itself.[55] It is replaced with a much more muscular approach to oversight.[56] As such, the creation of the Public Company Accounting Oversight Board marks a significant, if partial, retraction from the self-regulatory basis of associational governance. Critics argue that the PCAOB merely replicates existing capacity adding to regulatory complexity for little demonstrable return.[57] The criticism underplays the leverage accrued by providing the agency with structural independence. By increasing the financial and organizational distance from the regulated, the PCAOB overcomes inherent deficiencies associated with the self-policing paradigm. First, it is funded through a compulsory industry levy proportionate to individual firm market share. This minimizes the risk of potential industry capture. It also reduces potential political interference associated with threats to congressional subvention.

[54] For discussion, see J. O'Brien 'The Politics of Enforcement: Eliot Spitzer, State–Federal Relations and the Redesign of Financial Regulation' (2005) 35 *Publius* 449. A seasoned investment banker suggested to the author that 'Spitzer's brilliance was in taking legally weak but politically and morally strong cases and using the threat of prosecution to bluff outrageously', Interview, New York City, 15 May 2006.

[55] This was justified on the abuse of trust. For its centrality in regulatory legitimacy, see C. Scott 'Accountability in the Regulatory State' (2000) 27 *Journal of Law and Society* 38 at 39.

[56] W. McDonough, 'Accountability in an Age of Global Markets', in J. O'Brien, above note 3, p. 65.

[57] J. Nofsinger and K. Kim, above note 14, pp. 212–213; for a critique questioning the lack of tangible evidence to support the contention that splitting audit and consultancy necessarily increases effectiveness, see R. Romano, above note 1; for greater risk associated with managerial propensity to game audit to conserve or enhance the value of stock options, see C. Cullinan, H. Du and G. Wright, 'A Note on the Relationship Between Director Independence and Misstatements' Paper presented to Accountable Governance Conference, Queen's University, Belfast, 20–22 October 2005.

Second, while the PCAOB board of directors must contain two financial experts, both nomination and acceptance rest with the SEC not the profession. Third, although the PCAOB is obliged to subject accounting standards to industry consultation, the profession does not have veto power over what are now legislative instruments. Furthermore, the standards receive validation and, therefore, authority and legitimacy from the SEC. This resolves some coordination problems and allows for the development of a systematic approach to emergent problems. This potential for increased capacity pivots extends beyond organizational structure. Just as important has been the strategic concentration on the nature of the inspection regimen itself.

The PCAOB suggests that enhanced audit quality requires inculcating values into conceptions of corporate value. To achieve this objective, the PCAOB has measured how individual firm culture impacts on ethical norms.[58] The approach is designed to ensure corporate tone reflects strategic priorities rather than merely public relations.[59] By bridging the gap between aspiration and modern practice, the PCAOB explicitly links the 'soft' governance of business ethics to 'hard' corporate law. Auditors are not only asked if they lost any business because of inordinate pressure but, more importantly, what happened to the audit partner involved, and to what extent did the loss impact on bonus payments? The 'information-gathering' component extends down to the least experienced members of the audit teams.

The confidence that the accountancy profession can act as effective gatekeepers in this regard is questionable, given both past complicity and the defence offered by Arthur Andersen in the Enron debacle. David Duncan, the Andersen partner running the Enron account, admitted overseeing the destruction of documents but claimed in

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[58] W. McDonough, above note 56, p. 57.

[59] For the centrality of behaviour modification to effective regulation, see C. Hood, H. Rothstein and R. Baldwin, *The Government of Risk*, Oxford University Press, Oxford, 2004, p. 180.

court that this should not be confused with the underlying issue: the auditors had disagreed with and disapproved of Enron's off-balance-sheet transactions. Duncan testified that Andersen reasoned that the use of such aggressive mechanisms 'was an area of corporate governance, and as long as it had been thoroughly vented through the corporation, that was a business determination [for] Enron [and not its advisors].'[60]

Following its conviction in June 2002, Andersen continued to maintain that it should not be punished for guilt by association. According to the partnership, 'the reality here is that this verdict represents only a technical conviction.'[61] The argument received partial backing from the Supreme Court.[62] The critical point is that Andersen viewed its responsibility in the design and execution of the aggressive accounting in strict legal terms. Each transaction was individually audited and accepted. At no stage did the partnership take into consideration how the aggregate fundamentally distorted the overall picture. Andersen complained, moreover, that it was an unwitting victim of Enron's deceptions. Other key associational actors mounted similar defences over Enron and again in advance of multi-billion dollar settlements of class action securities litigation on WorldCom.

It remains very much open to question whether financial intermediaries accept the need for the strategic application of ethical considerations. The debate over the internal controls provision of Sarbanes–Oxley and the argument that it represents excessive and invasive surveillance suggest business reticence about the implications of the emergent control nexus. Given this widespread denial of responsibility, it is therefore necessary to investigate why Congress did

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[60] B. McClean and P. Elkind, *The Smartest Guys in the Room*, Penguin Viking, New York, 2004, p. 407.

[61] Ibid, p. 406.

[62] It ruled that it was impossible to mount a successful prosecution on evidence tampering because Andersen had not been informed that it was under formal federal investigation at the time.

not extend the remit to other financial intermediaries. Ignorance is not a credible rationale. As Congress was debating the provisions of the act, the complicity of investment banks in the design and execution of structured finance products was aired at hearings on Capital Hill. The answer, I argue, rests on the fact that the legislation was designed primarily as an exercise in political symbolism.

The Politics of Symbolism

The costs associated with compliance have been instrumental in driving opposition to the substantive provisions.[63] Lost in the contemporary noise of contestation is the fact that the symbolic nature of the legislation itself may be its most problematic aspect. The explanatory power of the 'symbolic' lens relates to its capacity to frame the rationale for enactment and the management of subsequent implementation. This approach offers, in turn, two distinct advantages. First, why do policies tend only to be pursued if they are in the ultimate interests of those regulated? Second, what factors govern the dissipation of initial fervour, even when the legislation or the enforcement mechanisms it mandates fail? In a seminal article, Murray Edelman traces the causal mechanism to public quiescence. He correlates this with the degree to which stated policy objectives satisfy the preferred choices of constituent groups. He argues that regulatory dynamics are conditioned by the fact that 'the interests of organized groups in tangible resources or in substantive power are less easily satiable than are interests in symbolic reassurance'.[64]

This is not to denigrate the importance of symbolic legislation. On the contrary, symbolic legislation performs an essential function. It offers the reassurance of an overarching policy framework, which guards against or, at a minimum, (supposedly) limits the opportunities

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[63] W. Donaldson, speech to Business Roundtable, Washington DC, 14 October 2004. Full text at http://www.sec.gov/new/speech/spch101404whd.htm.
[64] M. Edelman, above note 4, p. 695.

for malefaction. As Edelman observed: 'the laws may be repealed in effect by administrative policy, budgetary starvation, or other little-publicized means; but the laws as symbols must stand because they satisfy interests that politicians fear will be expressed actively if a large number of voters are led to believe that their shield against a threat has been removed.'[65]

On a broader conceptual level, while Edelman clarified the need for 'the most exhaustive scrutiny to ascertain whether their chief function is symbolic or substantive', the analytic defect lies in the fact that no explicit schema is provided to ascertain defining characteristics.[66] When stripped to its fundamentals, Edelman's essential point is twofold. First, only legislation that serves an overarching systemic purpose, such as the Securities Act of 1933 and Securities Exchange Act of 1934, can be truly described as symbolic. Second, the capacity for distortion occurs precisely because despite incremental change, the underpinning rhetoric remains intact – in this case greater transparency and accountability in financial statements. While the rationale retains currency, therefore, piecemeal erosion through regulatory implementation disputes hollows out fundamental protections. This process creates a situation where 'those who are deprived become defenders of the very system of law which permits the exploiters of resources to act effectively'.[67]

Given the fact that the legislature, presidency and executive agencies all trace Sarbanes–Oxley's lineage directly to the securities legislation of the 1930s, there is little difficulty in ascertaining its symbolic progeny. As Edelman suggests, each political goal is at once

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[65] Ibid, at 702.

[66] M. Edelman, *The Symbolic Uses of Politics*, University of Chicago Press, Urbana, 1964, p. 43.

[67] M. Edelman, above note 4 at 702. Later work suggests quiescence is not simply a function of passivity or apathy but rather is moulded by the construction of politics as spectacle, see M. Edelman, *Constructing a Political Spectacle*, University of Chicago Press, Chicago, 1988.

a name and a metaphor to create reassurance.[68] The official title of the act explicitly rendered its central symbolic purpose. Furthermore, it performed six crucial symbolic functions.[69] It enhanced the popularity of the officeholder (or, more accurately, arrested a precipitous decline); provided reassurance that significant action was being taken; simplified a complex problem; asserted a normative improvement in governance with applicability across the states; provided an identifiable class of perpetrator, in this case the accountancy profession; and posited an educative function by suggesting a tangible way in which to insert an ethical basis to corporate governance design.

An exercise in symbolism also requires an effective diffusion mechanism. Crucially, the underlying message must not be diluted by the capacity of elite groups to distort or taint the underlying message.[70] Those factors held firm during the passage of Sarbanes–Oxley and its immediate aftermath. The adroit use of television captured images of once deified executives arriving in federal and state courthouses in handcuffs. It reinforced the perception of zero-tolerance towards corporate crime. The recalibration of federal sentencing guidelines served a supporting role.

After four years of relative quiescence, a concerted counterattack has begun, emboldened by spectacular court failures, including the acquittal of Richard Scrushy of HealthSouth, the first chief executive charged under the legislation with orchestrating financial reporting fraud. This change in the relative force of regulatory actors reinforces, rather than undermines, the value of the symbolic nomenclature. For Edelman: 'it is only as symbols that these statutes have utility to most of the voters. If they function as reassurances that threats in the economic environment are under control, their indirect effect is to permit greater exploitation of tangible resources by the organized

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[68] M. Edelman, above note 67, pp. 157–158.

[69] See B. Stolz, 'The Foreign Intelligence Surveillance Act of 1978: The Role of Symbolic Politics' (2002) 24 *Law and Policy* 269 at 271–272.

[70] See J. Hart, 'President Clinton and the Politics of Symbolism: Cutting the White House Staff' (1995) 10 *Political Science Quarterly* 385 at 397.

groups concerned than would be possible if the legal symbols were absent'.[71] The noise of contestation can provide the illusion of robust oversight that may be lacking in substance. In fact, given the failure to force regulatory oversight on other key intermediaries, it may never have been there in the first place. Within the context of Sarbanes–Oxley, for example, it was initially proposed that lawyers should 'noisily withdraw' by reporting to the SEC if they become aware of financial misrepresentation. In the final act this was watered down to the reporting of any concerns about potential breaches to the Chief Legal Counsel or Chief Executive Officer. In part, this can be traced to successful lobbying by the legal community to retain independence of action. Conversely, it could also be argued that while the accountancy profession has faced the most stringent oversight, it is also the single biggest beneficiary of the increased cost of compliance. In addition, despite the fact that the SEC has been empowered and its capacity enhanced by the creation of the PCAOB, much of the policing function remains in the hands of the accountancy profession itself. As noted above in relation to the corporate defences adopted by Andersen (and, initially, by KPMG before its eventual capitulation in September 2005), reliance on emasculated conceptions of compliance remains widespread. There are profound echoes of Edelman in the warnings by the SEC of sharp practice at variance to the spirit of the legislation across the range of financial intermediaries.[72]

The federalization of corporate law is also problematic. The legislation's 'sentinel' importance rests, in part, on the explicit rejection of the facilitative underpinning of state-administered company law.[73] The mandatory control on the composition of executive committees of the board of directors usurps the flexibility

[71] M. Edelman, above note 4 at 702.

[72] See W. Donaldson, above note 63. See also W. Donaldson, speech to London School of Economics, 25 January 2005. Full text at: http://www.sec.gov/news/speech/spch012505whd.htm.

[73] See G. Imperato, 'Corporate Crime and Compliance: What Does the Government Expect?' (2005) 52 *Federal Lawyer* 25.

offered by individual state corporation codes.[74] Sarbanes–Oxley does not address in a meaningful sense the wider problem associated with the fragmented nature of the United States regulatory regime. The regulatory objectives of a disclosure-based regulatory authority, for example, are very different from a prudential authority, which, in turn, differ from the strategic objectives of a criminal enforcement agency. For one prominent state judge, Sarbanes–Oxley represents a form of 'creeping intrusion' that, if unchecked, could 'undercut the valuable space for innovation and flexibility that Delaware's approach to corporation law creates'.[75] The emphasis on detailed disclosure of prescribed governance practices challenges the narrow contractual basis of Delaware corporate law, which traditionally gave exceptional discretion to management and boards to design and implement governance structures relevant to specific organizational structures and culture. Strine accepts the symbolic value of many of the provisions of Sarbanes–Oxley but suggests the problem rests primarily with the demand side of the market: investors did not give due cognizance to already disclosed information. 'I am not sure that the system is as broken as some would have it and I am also not sure that it is a wise investment of public resources to protect investors in areas where they can protect themselves', he explained in an interview with the author.[76] He added that it is essential to 'differentiate between what is an outrage and what was a crime.'

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[74] Criticism of state-based regulation stems from the concern that it facilitates weak controls by facilitating a 'race to the bottom', see W. Cary, 'Federalism and Corporate Law, Reflections on Delaware' (1974) 83 *Yale Law Journal* 663. For a robust defence of Delaware's approach, see L. Strine, 'Derivative Impact: Some Early Reflections on the Corporation Law Implications of the Enron Debacle' (2002) 57 *The Business Lawyer* 1371. The more muscular approach adopted at federal level significantly constrains innovation at state level, see M. Roe, 'Delaware's Competition' (2003) *Harvard Law Review* 588.

[75] L. Strine, 'The Delaware Way: How we do Corporate Law', Speech to European Policy Forum, 5 July 2005. Full text on request from http://www.epfltd.org.

[76] Interview, Wilmington, 24 May 2004.

Strine suggests that the involvement of the SEC in dictating internal procedures risks reducing the promise of corporate governance capacity to banal box ticking. Getting directors to take their responsibilities more seriously represents a much more effective control mechanism. That is easier said than done, a point readily admitted by the Vice Chancellor. Cultural change in corporate America has led to exaggerated price differentials between executives, middle management and workers. The social fabric has torn, prompting what Strine terms particularly brutal forms of anti-social engineering. 'You wonder with all the focus on competitiveness, of being rough and ready, downsizing, whether this has contributed to a false Darwinism among the people at the top: "we are the winners and we created all this value" yet "we are expendable too, so we'd better take it when we can get it."'[77]

What emerges most clearly from this critique of the legislation is the risk of creating a narrow template in which form replaces substance. As a consequence, Sarbanes–Oxley's prescriptive nature is its weakest aspect, rendering it incapable, on its own, of dealing with another bout of misfeasance. This, Strine postulates, leads to the threat of further federal intervention.[78]

If the promise of better governance is to be delivered, enforcement strategies must, however, be capable of delivery. The critical question is whether this is best served on a federal basis or devolved to the vagaries of state or personal actor agendas. There is considerable merit in the argument advanced by Strine for non-jury courts staffed by a politically balanced judiciary. In essence, however, his argument buttresses rather than rejects the existing federal model. By his own admission, Delaware represents a de facto ideal, albeit one geographically and metaphorically located outside the Beltway. If

[77] Ibid.

[78] For an assessment which posits the threat of a 'strong SEC' acting in support of the soft governance regime associated with the Delaware model, rather than its actual deployment as the optimum strategy, see R. Prentice 'The Inevitability of a Strong SEC' (2005) *Cornell Law Review*. Text available at http: /ssrn.com/abstract = 753624.

Delaware represents an ideal, how should one characterize the public policy implications of the insertion into the regulatory space of politically ambitious State Attorneys General?[79]

To complicate matters further, the direction of SEC policy is heavily dependent on the ideological composition of its five appointed commissioners. This is not to suggest it is conceivable that its new leadership will countenance substantive provisions revision, at least in the short term. What is possible, however, is a change in enforcement priorities. Change is likely, however, to be piecemeal, with the shield offered by Sarbanes–Oxley progressively weakened by sustained ideological and material assault. The most effective rhetorical weapons endorse the normative values of enhanced transparency and accountability but undermine its purpose through limited and technical acculturation. While this will also provide confirming evidence of the legislation's ultimate symbolic status, given the loss of protection that such an emasculation of regulatory authority ordains, it could be a hollow victory.

Reconfiguring the Battlefield

Despite some high-profile prosecutions, salience for the general public remains low. This makes the traction required for constant political oversight difficult to generate. It is for this reason that disclosure regimens, even one as detailed as that now implemented in the United States, are best understood as symbolic statements of intent, susceptible to erosion in substance, if not in form. The risk is that behind the symbolic shell, little of structural strength will remain; a state of affairs that preordains future ethical failure.

The unrelenting focus on the punishment of individual malefactors and the focus on boards and auditors but not the financial arena in which they operate risks further obscuring systemic flaws. These

[79] This is a matter we will address in more detail in the next chapter.

extend across the wider corporate governance model in the United States. It is the failure to deal with this complex reality that reinforces the ultimately symbolic nature of the legislation. The fact that Congress was well aware of the problem makes the oversight more troubling. Congress heard evidence that demonstrated the complicity of leading investment banks at precisely the same time as Sarbanes–Oxley was being deliberated. Major players, including JP Morgan Chase, Citigroup and Merrill Lynch, were intricately involved in the design and execution of structured finance deals similar to those that had so exercised Andersen before consultancy fees of $53 million assuaged its concern about the legality, if not the probity, of the transactions.[80]

The complaint by Donaldson that 'some managers will pursue questionable activity right up to technical conformity with the letter of the law, and some will step over the red line either directly or with crafty schemes and modern financial technology that facilitates deception' suggests continued acceptance of regulatory gaming.[81] The debate on Section 404 demonstrates the inordinate pressures at the national level to construct a hollow shell. It privileges internal control systems that serve truncated and, ultimately, symbolic purposes.

The policy difficulty is that identifying and then prosecuting white-collar crime is fraught with difficulty. As Steve Cutler, the former Director of Enforcement at the SEC explains: '[in the past] there was a general reluctance on the part of federal prosecutors to take on complicated accounting fraud cases. These are very difficult cases and require lots of resources, lots of time, [are] difficult to explain to juries and that makes for a less than ideal track record as far as a prosecutor is concerned.'[82] The arrival of Eliot Spitzer fundamentally transformed this dynamic. He took the risk of mounting prosecutions against corporations precisely because of awareness that in the current climate

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[80] See J. O'Brien above note 18, pp. 84–95.
[81] W. Donaldson, above note 63.
[82] Interview, Washington DC, 10 May 2005.

it was difficult, if not impossible, for corporations to mount defences against morally suspect but legally permissible actions. By taking this approach, Spitzer did more than any other policy entrepreneur to change the dynamics of corporate governance design and enforcement.

3

Enforcing power: the contested role of Eliot Spitzer

The prevalence of corporate scandal, coupled with the related failure of reputational intermediaries, devalued the legitimacy of self-regulation as the overarching framework for financial market governance. A changed conception of regulatory utility facilitated the resurgence of governmental agencies as the primary custodians of gatekeeper probity. The strategic response subsequently developed in the United States was heavily influenced, however, by the competing dynamics of federalism. Arguably, the State Attorney General of New York, Eliot Spitzer, played the most influential role in calibrating the corporate governance and financial regulation debate. His intervention had enormous policy implications. It challenged the supremacy of the Securities and Exchange Commission in the policing of the market. It also secured for himself an international reputation for tough enforcement.[1]

Critics declaim him as a populist cast in the mould of Robespierre. Defenestrating the prior regime and eschewing consultation over regulatory solutions led to accusations that he replaced the certainties of the *ancien régime* with chaos. In contemporaneous European

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[1] See, for example, C. Gasparino, *Blood on the Street*, Free Press, New York, 2005; J. O'Brien, *Wall Street on Trial*, John Wiley & Sons, Ltd, Chichester, 2003.

political terms, he is said to have 'Balkanized' control mechanisms in the pursuit of personal ambition.[2] Conversely, his intervention was instrumental in providing a legislative basis for reforms to the governance of conflicts of interest within Wall Street analyst research. His investigation into the personal contract negotiated by Dick Grasso, the former chairman of the New York Stock Exchange, revealed remarkable laxity in the governance arrangement of the nation's premier securities clearing house. While the methods deployed were questionable, the systemic defects were only addressed because of the discovery process underpinning the litigation. Likewise, structural issues in the insurance industry would remain unresolved (if not undetected). In short, Spitzer was instrumental in moving the locus of attention from technical gamesmanship to a much broader discussion about the intrinsic nature of the regime itself. This is not to suggest that the intervention is unproblematic. By threatening high-profile proceedings against some of the most powerful corporations on Wall Street, Spitzer opened a secondary and more invidious line of attack. His adroit use of public relations implied that the absence of similar muscularity by the regulatory agencies demonstrated a lack of resolve rather than profound differences in operational independence and governing protocols.

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[2] Many investment banking figures interviewed by the author viewed Spitzer with a mixture of irritation and admiration. The specific reference to Robespierre is attributable to a senior executive from a firm not directly targeted by Spitzer. An acerbic commentator came to a similar conclusion, see J. Willoughby, 'He's no TR', *Barron's Online*, 7 February 2005 (online edition). Other observers are more ambivalent, see, C. Gasparino, above note 1, p. 311. For largely positive profiles, see A. Ignatius, 'Wall Street's top cop', *Time Magazine*, 22 December 2002 (online edition); J. Traub, 'The Attorney General Goes to War', *New York Times Magazine*, 16 June 2002 (online edition); and J. Cassidy, 'The Investigation: How Eliot Spitzer Humbled Wall Street', *New Yorker*, 7 April 2003. Conversely, Spitzer's methods have led the *Wall Street Journal* to condemn him as 'the Lord High New York Executioner'. See Editorial, '. . . and Something Else', *Wall Street Journal*, 16 March 2005, p. A24.

Spitzer's capacity to extract such significant leverage can be traced to the confluence of three distinct but interlocking factors: the spatial concentration of the financial services industry in New York City; the particularity of the New York State constitution; and the capital value for corporations and their professional intermediary advisors of maintaining reputational advantage in an era of scandal. Each of these factors will be explored in detail throughout this chapter. First, however, it is necessary to outline the strategic importance of probity. Demonstrable evidence of its existence in institutional form has long underpinned US Sentencing Guidelines.[3] The failure of these mechanisms to impede the growth of financial reporting restatements and associated scandal signifies continued problems. While the guidelines of what constitutes effective compliance have been made much more prescriptive, there is little demonstrable evidence of their capability to calibrate reputational risk. Financial intermediaries trade primarily on reputation. Any question of its dissipation can be catastrophic. Spitzer's unique skill has been to exploit this institutional weakness. It advances an agenda, which, while undoubtedly self-serving, also reflects – and responds to – public dissatisfaction with the impoverished conception of integrity displayed on Wall Street.[4]

This is not to suggest that his success can be traced solely to the application of particular policy innovations from the New York State Attorney General's Office in Lower Manhattan, such as proprietary

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[3] For US Sentencing Guidelines creating a 'wedge' between the corporation and individual culpable employees, see F. O'Neill, I. Nagel and M. Swenson, 'The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings and Some Thoughts About Their Future' (1993) 71 *Washington University Law Quarterly* 205 at 244. See also I. Raphaelson and J. Walden, 'Effective Compliance in the Aftermath of Corporate Megascandals' (2004) 18 *Insights* 12.

[4] As such, Spitzer has become an especially adroit proponent of what Zimmerman has termed the 'innovation-diffusion' model of SAG activism; for discussion see J. Zimmerman, 'Interstate Cooperation: The Role of State Attorneys General' (1998) 28 *Publius: The Journal of Federalism* 71, at 72.

investigatory techniques or enforcement implementation.[5] Federal agencies, including the Securities and Exchange Commission and the Department of Justice, also played pivotal roles in highlighting deficiencies and bringing cases to trial. Their governing protocols, however, severely weaken their capacity to insert this success into public consciousness. Spitzer's relative freedom in this regard generated a media narrative that was difficult, if not impossible, to refute without breaching those same protocols. It is not surprising, therefore, that competing and, at times, contradictory policy agendas contributed to an unseemly turf-war over the limits of respective authority. While fragments of mutual distrust, verging on loathing, can be evidenced across all investigations, nowhere was the lack of coordination more apparent than in the sprawling investigation into the insurance industry.

Traditionally, the insurance industry was subject to state level oversight. The regulatory regime was predicated on prudential considerations. It was designed in large part to avoid the risk of scandal by negotiating quietly behind the scenes. There is nothing inherently wrong in this. Indeed, it informs the underlying dynamic of much banking supervision. Three factors made this approach unsustainable. First, significant components of the insurance industry moved into complex financial engineering for corporations listed on the primary exchanges. Second, not only did this add to the complexity of the regulatory task, it also necessitated the intervention of a competing disclosure-based regulatory approach. Third, this, in turn, collided

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[5] The role of State Attorneys General as policy entrepreneurs has become a critical component of regulatory policy. For example, see C. Provost, 'State Attorneys General, Entrepreneurship, and Consumer Protection in the New Federalism' (2003) 33 *Publius: The Journal of Federalism* 37; R. Spill, M. Licari and L. Ray, 'Taking On Tobacco: Policy Entrepreneurship and Tobacco Litigation' (2001) 54 *Political Research Quarterly* 605; L. Mather, 'The Politics of Litigation By State Attorneys General' (2003) 25 *Law and Policy* 425; T. Schmeling, 'Stag Hunting with the State AG: Anti-Tobacco Litigation and the Emergence of Cooperation among State Attorneys General' (2003) 25 *Law and Policy* 429.

with the trawl for malfeasance conducted by Eliot Spitzer, who used state legislation that predated the securities regulation architecture.[6] The primary mechanism used to justify this insertion was the Martin Act, a local statute which gives the State Attorney General almost unlimited rights to secure subpoena evidence in relation to potential fraud in the selling of securities in New York State.[7] Spitzer attributes his success to 'brushing off the accumulated dust of an old standard that has fallen out of favor.'[8] This strategic application of state law to argue for increased federal oversight significantly impacts on the dynamics of the regulatory regime in the United States and the relative power of institutional actors within it.

The increased capacity of the national government and its agencies to enforce their writ over the governance of what are increasingly global markets represents, therefore, only part of the story. Direct reference to the competing dynamic of federalism is also essential.[9] As Gerber and Teske have pointed out in the context of US regulatory politics, the 'venue of primary policy execution itself becomes a

[6] For example, the insurance conglomerate AIG had been subject to cease and desist orders from the Securities and Exchange Commission long before Spitzer turned his attention to its activities. In 2003, AIG paid a fine of $10 million to settle charges that it had inflated the earnings of Brightpoint, see Securities and Exchange Commission, 'SEC Charges American International Group and Others in Brightpoint Securities Fraud', 11 September 2003. When AIG announced in March 2005 that it was restating its accounts, in part because of Spitzer's threatened litigation, it did so because of a recognition that the earnings management extended to the corporation itself, see I. McDonald, T. Francis and D. Solomon, 'AIG Admits Improper Accounting', *Wall Street Journal*, 31 March 2005, p. A1.

[7] *New York Laws of 1921*, Chapter 649, *New York General Business Law*, §352.

[8] Interview, New York City, 10 December 2004.

[9] The widening investigation into AIG is a crucial example of this dynamic. Spitzer's demand for information relating to the use of contingent commissions has sprawled outwards to include not just the SEC and the Department of Justice but regulators in a range of countries, including the United Kingdom, Australia and the Republic of Ireland. See T. O'Brien, 'Investigation of Insurance puts Buffett in a Spotlight', *New York Times*, 28 March 2005, p. C1.

central feature in explaining the logic of political influence on policymaking.'[10] Applying this lens to the study of Eliot Spitzer allows for a more accurate mapping of the institutional position of the New York State Attorney General within the wider matrix of political and economic power.

The Pursuit of Power

Spitzer maintains that any suggestion that he is hostile to the operation of free markets misses the point. He argues that his intervention is predicated on a firm belief that effective markets cannot be sustained without robust oversight. 'I say repeatedly to Chief Executive Officers that you would have been better served to have adopted the gradual process of reform. It would have saved you from the gross excesses or the pain that you are going through right now.'[11] Just as importantly, integrity and transparency, the key themes associated with his myriad investigations into abuses of fiduciary duty on the financial markets, have allowed the Attorney General to exorcise prior doubts about his own.

Despite undoubted legal skill and proven ingenuity in the use of strategic prosecution, Spitzer's campaign for the office of New York State Attorney General was initially regarded with suspicion. Defeated in his first attempt in 1994, he was elected by a slender margin four years later. Distrust about his ambition, and the lengths he was prepared to go to achieve it, were exemplified by a campaign-financing scandal. Reluctantly endorsing the candidate in 1998, the *New York Times* described Spitzer's response to questions about the multi-million

[10] B. Gerber and P. Teske, 'Regulatory Policymaking in the American States: A Review of Theories and Evidence' (2000) 53 *Political Research Quarterly* 849, at 851.
[11] Interview, New York City, 10 December 2004.

dollar parental support provided to his campaign as 'evasive and dishonest'.[12]

Just as the events of September 11 transformed a lacklustre presidency, the implosion of corporate integrity and the failure of the regulatory agencies to tackle it, invigorated Spitzer's tenure as State Attorney General.[13] As the technology bubble collapsed, leaving behind the detritus of a boom fuelled by hubris, investor anger was accompanied by initial public inaction from self-regulatory and federal organizations. The campaign for enhanced accountability, which forms the basis for Spitzer's strategy to win the state gubernatorial contest this coming November, was forged in the exploitation of this failure.

The seminal case undertaken against Merrill Lynch demonstrates, however, just how dependent his strategy was on advancing investigations begun by others. By building on a case already before an industry arbitration panel involving defects in the research coverage provided by Merrill Lynch to a wealthy New York gynecologist, the Office of the New York State Attorney General was inserted

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[12] Editorial, 'Eliot Spitzer for Attorney General', *New York Times*, 29 October 1998, p. A30. Condemning what it termed his 'campaign trickery', the editorial argued that 'in normal circumstances, Mr Spitzer's evasions would have made it impossible to endorse him for the state's top legal position . . . Mr Spitzer, for all his dishonesty on campaign funding, does offer the prospect of an Attorney General who will not be hobbled by ideology.' Spitzer's electoral strategy has once again come into clear focus with the revelation that the internet search company Google was paid to provide a link from AIG to his gubernatorial campaign. See C. Grimes, 'Google link puts Spitzer in the line of fire', *Financial Times*, 7 April 2005 (online edition).

[13] Spitzer had not been elected when the multi-state tobacco litigation was designed. Prior to his investigations on Wall Street, his most effective litigation involved suing power plants in the Mid West for causing the pollutants that fall as acid rain on New York. See 'Spitzer Files Law Suits against Out of State Power Plants', 29 November 1999: http://www.oag.state.ny.us/press/1999/nov/nov29a_99.html. Two major utilities settled in November and December 2001. He had also secured a major settlement for environmental clean-ups in New York State in December 1999. See 'State Secures $9 million in Toxic Clean Up', 27 December 1999: http://www.oag.state.ny.us/press/1999/dec/dec27a_99.html.

into public consciousness as the intellectual custodian of regulatory policy.[14]

What differentiates Spitzer from other state and federal bodies charged with market oversight is not just the use of sensationalist statements of claim to publicly name and shame his targets. Rather, it is the way in which the price for settlement tends to incorporate an imposed governance structure for particular firms that has the potential to become a new industry standard. This underpinned the enforced self-regulation component of the settlement with Merrill Lynch over conflicts of interest in the provision of research reports. Recognition that the travails facing Merrill were symptomatic of a wider industry problem catapulted Spitzer onto the national and international media stage.[15]

Critical to his success was the one undisputed innovation in investigatory techniques. He recognized the power of email evidence to undermine a defence based on reputational integrity. Spitzer suggested, bluntly, that the research departments of premier securities houses manipulated corporate coverage for investment banking purposes. While this may have been corporate reality, the problem was providing the courts with tangible evidence. Buried deep in the hard drives, the elusive proof of systemic abuse was revealed in the dyslexic boasting of research analysts. They maintained 'buy' ratings

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[14] J. O'Brien, above note 1, p. 152; C. Gasparino, above note 1, p. 217. In an interview, the Director of Enforcement at the Securities and Exchange Commission, Steve Cutler, argued that 'the timeline demonstrates conclusively that this issue was already being addressed by the regulatory authorities' (Interview, Washington DC, 23 May 2003). Spitzer's success was in taking the issue public just as Congress was holding financial hearings into the complicity of financial institutions into the collapse of Enron. By holding Merrill Lynch to account for failures in the wider securities and investment banking industry, the authorities had little choice but to co-opt the New York State Attorney General. In Cutler' s diplomatic phrasing, up to that point the regulators had been engaging in 'the kind of parallel play you associate with toddlers.'

[15] For an assessment of the efficacy of enforced self-regulation as an enforcement tool, see I. Ayres and J. Braithwaite, *Responsive Regulation, Transcending the Deregulation Debate*, Oxford University Press, Oxford, 1992.

while privately describing stock as 'junk'.[16] In taking the case against Merrill Lynch, Spitzer alleged that research analysts were employed as 'quasi-investment bankers for the companies at issue, often initiating, continuing and/or manipulating research coverage for the purpose of attracting and keeping investment banking clients.'[17] It was not an impediment to Spitzer that this fact was both documented and accepted within the literate financial community. He saw in the erosion of Chinese Walls separating investment banking from research analysts a structural weakness that threatened the metaphorical 'small investor' who relied, erroneously, on the truth of financial communications. Two further factors solidified his advantage. First, the deepening securitization of the economy enhanced public salience by increasing exponentially the number of people who were directly investing savings into the stock market. Second, Spitzer's related ideological case was based on the premise that Washington itself was partially responsible for inculcating the malign business culture. This, he reasoned, was due to the congressional decision to change the legal framework, emasculating in the process the agencies' capacity to police the market. This critique generated sufficient political traction to render it impossible for either the market or national political leaders to question, at least in public, the wider implications of the State Attorney General's intervention.

Both the empirical content of the electronic evidence and the detailed narratives that accompanied the early statements of claim filed in the New York State Court System served strategic imperatives. First, they inferred a pathological contempt among Wall Street professionals towards ordinary investors. Second, the framing was designed to move the debate away from the business section onto the front page. Stripping the cases back to their fundamentals and providing journalists with ready-made summaries was central to the creation and maintenance of the Spitzer phenomenon.

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[16] J. O'Brien, above note 1, pp. 155–157.
[17] Ibid, p. 155.

His ability to drive the media discourse was further consolidated by the fact that New York plays host to some of the country's most influential print publications. *The New York Times*, *The Wall Street Journal* and *The New Yorker* have provided copious amounts of largely positive copy in their news pages, a process which is facilitated by an adroit media management operation conducted out of the State Attorney General's Manhattan headquarters. Spitzer has also featured on the front cover of *Time* and *Newsweek*. In 2004 he picked up the 'Person of the Year' accolade from the *Financial Times*. His capacity to capture the public zeitgeist was verified by a flattering *Vanity Fair* profile in which the Attorney General posed for the highly stylized portrait most commonly reserved in the magazine for Hollywood icons.[18]

The framing reflected the Attorney General's own self-perception as a harbinger of light amid the gloom of a system that has lost moral authority. The portrait evokes explicit comparison with the late American jurist Louis Brandeis, whose reputation was also built on confronting the danger of untrammeled corporate power. Whether Spitzer merits comparison with Brandeis, the progressive idealist or the propagandist with an unerring capacity to tack towards winning ground, is very much an open question.[19] What is unmistakable, however, is their common determination to use the application of the law to force change far beyond the narrow remits of individual cases. While Spitzer claims modesty prevents overt comparison with his political icons, he maintains that, like them, he is being vilified by vested interests: 'I operate only in the world of malfeasance and the capacity of my office to intervene involves a predicate of illegality. There has been so much misfeasance that I haven't worried about it.

[18] M. Seliger, 'Spitzer's Justice', *Vanity Fair*, January 2005.

[19] Brandeis remains a controversial figure. For contrasting perspectives, see P. Strum, *Brandeis: Beyond Progressivism*, University Press of Kansas, Kansas, 1992; see also the profile of Brandeis in T. McCraw, *Prophets of Regulation*, Harvard University Press, Harvard, 1984, pp. 80–152.

I think if we ever get to the point where we only had to deal with misfeasance we would have done quite well.'[20]

The methods deployed and the consequences have amassed considerable opposition. Typical was the blistering attack launched by Thomas Donohue, the President of the US Chamber of Commerce. In a New Year press conference highlighting priorities for the coming twelve months, Donohue accused Spitzer of spectacular abuse of office.

> 'He's the investigator, the prosecutor, the judge, the jury and the executioner. Spitzer's approach is to walk in and say, "Well, we're going to make a deal, and you're going to pay $600 million to the state and you're going to get rid of this person and that person and if you don't do it by tonight then I'm going to indict the company." What does indict the company mean? It means they're going to put you out of business. It's the most egregious and unacceptable form of intimidation that we have seen in this country in modern time.'[21]

During an address to the National Press Club on 31 January 2004, Spitzer revelled in his notoriety. Recounting how a lawyer representing an investment bank told him 'Eliot, be careful, we have powerful friends,' Spitzer scathingly commented: 'I had no choice but to file the lawsuit. I mean what was I going to do at that point? Should I back down and say: "Oh, I didn't know you had powerful friends. Now you tell me. If you only had told me that last week we wouldn't be here." '[22]

The early victory with Merrill Lynch reinforced his agenda setting capacity. Its acceptance of forced internal changes to the governance of its research department in exchange for the abeyance of charges, which, if prosecuted to a conclusion, would have caused catastrophic

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[20] Interview, New York City, 10 December 2004.

[21] Associated Press, 'Chamber Chief Attacks Spitzer', *Los Angeles Times*, 6 January 2005 (Internet Explorer version).

[22] E. Spitzer, 'Business Ethics, Regulation and the "Ownership" Society', Remarks to National Press Club, Washington DC, 31 January 2005, p. 5. Full text at www.oag.state.ny.us/press/statements.

reputational damage, created a template for wider systemic change.[23] Once the corporation acquiesced, it was inevitable that a global settlement with other merchant banking institutions would have to be reached. For Gary Lynch, then Vice Chairman of Credit Suisse First Boston and a former Director of Enforcement at the Securities and Exchange Commission, Spitzer simply out-manoeuvred the federal regulators and forced them into the public arena: 'At that point everyone [in the investment banking community] was saying "tell us what you want us to do". What people hoped to avoid, which we didn't avoid, was them saying: "No, we're not going to do that, we don't want to do that. What we want to do is to have an investigation and fine you a whole lot of money." '[24]

The eventual penalties in a global settlement, which encompassed all major investment banks, primary regulators and a consortium of State Attorneys General led by Spitzer, went far beyond financial recompense to cash-strapped state chanceries. The forced publication of the results of that joint investigation, under Spitzer's direct instruction, provided ammunition for class-action tort lawyers, whose capacity to have their case heard in either state or federal court was increased dramatically. However, having the case heard does not necessarily guarantee victory.

A class action was filed in the Southern District of New York against Merrill Lynch, using the evidence provided by Spitzer's investigation. Judge Milton Pollack ruled he was 'utterly unconvinced' by the action and castigated the 'plaintiffs [who] would have this court conclude that the federal securities laws were meant to underwrite, subsidize and encourage their rash speculation in joining a free-wheeling casino that lured thousands obsessed with the fantasy of Olympian riches,

[23] See J. O'Brien, 'Ethics, Probity and the Changing Governance of Wall Street: Cure or Remission?' (2004) 7 *Public Integrity* 43.
[24] J. O'Brien, above note 1, p. 167.

but which delivered such riches to only a scant handful of lucky winners.'[25]

By bringing the initial Merrill case and setting the agenda in relation to subsequent investigations into corporate abuse, Spitzer placed into play the contested limits of state and federal sovereignty. In the process he transcended a political and industry response predicated primarily on the challenge of how to limit the discretion of individually culpable executives through the politics of symbolic reassurance.[26] A senior compliance officer for a major investment bank, interviewed by the author in 2003 as Spitzer was negotiating a settlement with Merrill Lynch over tainted analyst research, encapsulates both the anger and grudging respect that Spitzer generates in equal measure.

> 'To be candid about it, while the states have been bringing actions for 60 years, the presence and amount of publicity they got was always somewhat contained. They were viewed as having a useful purpose but they never had celebrity status. Spitzer's case has brought glory and publicity and all this attention to state regulators, not to mention a whole lot of money to state treasuries. I think state regulators are sitting across all of the United States now saying "Wow! We have real power, we have real authority. We have a way to be very profitable. We need to flex our muscles even more in the future." This tension is going to grow. At some stage something is going to give.'[27]

An indication of the changing dynamic is the passage of the federal Class Action Fairness Act 2005, a tort-reform measure that is designed to limit the capacity of states to hear class-action suits with an aggregate value of over $5 million.[28] The passage of the act is a victory for the business lobby. Although presented as an efficacious way to

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[25] (p. 7). For full details of the ruling, see *Re Merrill Lynch & Co Inc, Research Reports Litigation Securities*,_SDNY 02 MDL 1484 (30 June 2003). The ruling was upheld on appeal. See, *Lentell et al. vs. Merrill Lynch & Co Inc and Henry Blodget*, US Federal Court of Appeals 2nd Circuit, 03 7948 (20 January 2005).

[26] For a discussion of the importance of symbolism in regulatory politics, see M. Edelman, 'Symbols and Political Quiescence' (1960) 54 *The American Political Science Review* 695.

[27] J. O'Brien, above note 1, p. 144.

[28] Public Law No. 109-2.

ensure federal oversight over interstate commerce, the law removes major tort cases from the state arena.[29] It is precisely this dynamic that many in the securities industry are now attempting to redress by curtailing the capacity of state-based politicians to intervene, even if it means accepting the remit of a reinforced, federal regulator.[30]

State–Federal Relations and the Governance of Financial Markets

Spitzer is, of course, not the first State Attorney General to face the ire of industry over alleged politicization of legal office. Like a large number of his counterparts, Spitzer has skilfully used the office of Attorney General as a platform for the pursuit of higher political office. Since 1980, more than 40% of those holding the position have run for higher office. Nor is the method deployed to force change, through the strategic application of state law, particularly innovative. Increased regulatory activism can be traced back to the scaling back of federal regulation, initiated by the Carter presidency and facilitated, or openly canvassed, by successive administrations ever since.

Prior to the Wall Street scandals, the most effective State Attorney General in advancing an overarching agenda was Michael Moore of Mississippi. Despite significant opposition within his own state and at the federal level, Moore coordinated a highly successful multi-billion dollar attack on the tobacco industry. When Spitzer launched his wider campaign, therefore, he had the makings of a very successful

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[29] D. Rogers and M. Langley, 'Bush Set to sign Landmark Bill on Class Actions', *Wall Street Journal*, 18 February 2005, p. A1; S. Labaton, 'Quick, Early Gains Embolden Business Lobby', *New York Times*, 18 February 2005 (online edition).

[30] For an assessment of these dynamics in the earlier Savings and Loans debacle, see J. Laumann and P. Teske, 'Principals, Agents and Regulatory Federalism in the Savings and Loan Crisis of the 1980s' (2003) 3 *State Politics and Policy Quarterly* 139. For a trenchant critique arguing the case for increased state competition in order to improve regulatory capacity, see R. Romano, *The Advantage of Competitive Federalism for Securities Regulation*, AEI Press, Washington, 2002.

model to replicate. By highlighting structural failings, his campaign has proved instrumental in prompting the most radical reassessment of the role that regulators should play in the policing of the markets since the securities legislation introduced by the New Deal reforms in the 1930s.

Spitzer professes that his relationship with Wall Street financiers is driven by mutual fascination and incomprehension. He is perplexed by what he sees as the moral relativism of their stated public positions on the role of ethics in the contemporary business context. Spitzer argues that the constraining nature of such an operational paradigm only reinforces problems associated with technical compliance. Business leaders, in contrast, largely refuse to accept a moral foundation in either the objectives set by the State Attorney General or the means he has chosen to deploy to achieve them. Spitzer, of course, is canny enough to defuse the rhetoric deployed by his opponents by accepting that he is personally ambitious. He answered this author's question of what drives him with the retort: 'the same thing that drives a writer to win a Pulitzer.'[31] Behind the jocularity, Spitzer made a very serious point: 'I went to dinner recently with a group of Wall Street Chief Executives. I explained to them that Merrill Lynch alone has a compliance department bigger than my entire operation. I advised them that unless there were profound changes, they would be better advised to shut it down, invest the money in a contingency fund where at least it could earn interest and use it to pay the fines for noncompliance.'

This, suggests Spitzer, is the major untreated risk to the vitality of American capitalism and against which neither the corporations, the self-regulatory industries nor the federal architecture has provided effective immunization. 'One of the things that I enjoy about going to Washington is the opportunity of testifying, chapter after chapter, that self-regulation has failed. What is it to be replaced with? I'm not sure.' The overarching regime, in Spitzer's view, fails to address

[31] Interview, New York City, 10 December 2004.

in a systemic manner the paradigmatic power of market professionals. 'The investment banks are at the vortex of all of this [malfeasance],' he claims, arguing that 'the risk–reward calculus is so clearly out of kilter with ethical behaviour. Yet no-one thought the paradigm needed to change. The solution is not more regulation but more innovative application of existing enforcement strategies.' While debate has been increasingly subsumed by discussion of the political ambitions of the messenger, differentiating the strategic pursuit of change from the tactical quest for office offers important interpretative opportunities. These allow us to understand more fully the causes of the malaise and why effective corporate control has been so elusive.

The tension over the governance of the financial markets can be traced, in part, to the rhetorical framing of 'New Federalism', which reconfigures, in ideational terms, the relationship between Washington and state capitals in much social and economic regulation.[32] This delegation of regulatory authority occurred in response to what amounted to 'a crisis of legalism and command' as a form of regulatory control.[33] The political response changed the power balance in state–federal relations in profound ways.[34] As the national government gradually withdrew from the regulatory playing field, the space opened for policy entrepreneurs to play pivotal roles in the regulation of social and economic markets. Their relative power depended on the level of interstate competition, the degree of residual federal power and its willingness to exercise it.[35]

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[32] See S. Rose-Ackerman, *Rethinking the Progressive Agenda: The Reform of the American Regulatory State*, Free Press, New York, 1992; J. Zimmerman, *Federal Pre-emption: The Silent Revolution*, Iowa State University Press, Ames, 1991. For a focus on the role of State Attorneys General within this new dispensation, see C. Provost, above note 5; and P. Teske, *Regulation in the States*, Brookings Institution Press, Washington DC, 2004, pp. 218–235.

[33] M. Moran, *The British Regulatory State*, Oxford University Press, Oxford, 2003, p. 16.

[34] For a discussion of how debates impact on capacity, see M. Sparrow, *The Regulatory Craft*, Brookings Institution Press, Washington, 2000, pp. 18–28.

[35] W. Lowry, *The Dimensions of Federalism*, Duke University Press, Durham NC, 1992.

The institutionalization of deregulation created a cross-cutting ideological dynamic at national level which reduced the capacity of the federal government to exercise its privileged use of concurrent powers. The changes in the national regulatory regime were not accompanied by a revisiting of the intergovernmental settlement. In part, this can be traced to the difficulty in pushing through complex and potentially destabilizing constitutional changes; in part to the fact that national policymakers did not factor how expanding the realm of state oversight could facilitate, in the case of New York, the serendipitous confluence of ambition, powerbase and platform. Writing just as the bear market reared its head, Spitzer gave an early indication of how deregulation impacted on his legal philosophy.

> Despite my initial skepticism, the day I awoke as Attorney General of New York, I had an epiphany – I suddenly recognized that the devolution of decision making from Washington to the states about how to enforce statutes or non statutory rights did not determine the substantive conclusion of those making decisions at the state level. Indeed, I now see this change as a tremendous opportunity for legal ingenuity and innovation on the part of state actors.[36]

Given the traditional concentration of the securities and wider financial services industries in New York, its state officials have always held the potential to exert extraordinary influence over the terms of the national debate on the control of capital markets. The use of this latent power had been honoured more in breach than observance until Spitzer began his assault on the governance of the markets in the wake of the technology crash. As Spitzer acknowledges with a glint of satisfaction, the myopic fixation with the present in contemporary American politics gave him the flexibility to build 'a coherent rationale under the political radar.'[37]

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[36] Eliot Spitzer, *The Challenge of the New Federalism*, Speech delivered on Law Day, 1 May 2000: www.oag.state.ny.us/press/statements.

[37] Interview, New York City, 10 December 2004.

Neither the securities industry nor state and national legislators gave due cognizance to how an assertive lawyer with political ambitions could use the latent ideational power of 'New Federalism' to revisit ground once trampled by Theodore Roosevelt and his cousin Franklin Delano, the towering figures of twentieth century New York politics. Both had also used state-initiated campaigns against patronage and cartels to forge national careers.[38] In this political choreographic sense, the utilization of pre-emptive investigative techniques, focused on high-profile targets, is simply the latest manifestation of New York political theatre. It captures populist revulsion and positions the narrator as the custodian of the reform tradition. Despite the fact that the Attorney General has yet to prosecute a case involving Wall Street malfeasance to judicial closure, a cult of personality has developed which business and political opponents alike have failed to deflate.

More problematic for state–federal relations is the fact that, in the process, Spitzer has launched a direct challenge to the authority of the SEC and self-regulatory organizations. This takes us to the root of Spitzer's stated reform agenda. For Spitzer, the central problem is how to ensure that adequate controls are placed on the operation of financial intermediaries, whose capacity to game the regulatory system is based on rational decision-making processes that calculate the net benefit of noncompliance. According to Spitzer, the malfeasance progressively uncovered demonstrates intractable and insurmountable problems associated with the policy preferences of the national regulatory regime to privilege self-regulation. He argues that an 'insidious form of industry capture', linked to the cultural denigration of the regulatory profession, represents the most important causal mechanism driving control failures. 'The whole idea of self-regulation should be put in a box labelled "great idea that never worked" because the role of these industry associations became primarily the role of

[38] C. Black, *Franklin Delano Roosevelt, Champion of Freedom*, Phoenix Books, London, 2003.

rolling back reform ideas. The excesses have demonstrated serious flaws in the paradigm. I am not convinced that it can ever work.'[39]

This activism has led to profound disagreements with leading congressional legislators, including Representative Michael Oxley (R-OH), co-sponsor along with Senator Paul Sarbanes (D-MD) of the ostensibly stringent corporate liability legislation introduced in the aftermath of the collapse of WorldCom. At congressional hearings in Washington, Oxley made clear his antipathy to Spitzer. 'Grandstanding by ambitious and publicity-hungry political officials will not lead to healthy and responsible securities markets.' Spitzer retorted in testimony to the Senate Banking Committee: 'I believe that Congress and the federal government cannot have it both ways. If Congress and the Executive Branch decide to curtail federal oversight of areas such as securities, they must recognize it is the responsibility of state securities regulators such as myself to step in and protect the investing public.'[40]

The role of government, both state and federal, in regulating and defining the parameters of appropriate business standards remains a critical, unresolved issue.[41] Noting that regulators are witnessing the beginning of a sustained counter-offensive by business to delineate the range and extent of internal and external control mechanisms, Spitzer has complained that 'there has been a catastrophic failure to adhere to even basic conceptions of honest dealings and fiduciary duty in every sector my Office has looked at.'[42] The problem is not a new one, but rather the contemporary manifestation of a perennial question: can the market instil credible ethical restraint or can transparency and integrity, which are integral to confidence, be achieved only through the intervention of government? If it is the latter, can this

[39] Interview, New York City, 10 December 2004.

[40] J. O'Brien, above note 1, p. 171.

[41] For an assessment of how federal regulators view the business environment, see William Donaldson, speech to Business Roundtable, Washington DC, 14 October 2004: www.sec.gov/new/speech/spch101404whd.htm.

[42] Interview, New York City, 10 December 2004.

be achieved by the federal government acting alone? Does Spitzer's activism help or hinder that process? To answer these questions it is necessary to delineate further the dynamics of financial regulation within the unique context of a federal system.

Mapping the Changing Terrain of Financial Governance

The notoriety and traction Spitzer has achieved are linked, therefore, directly to the paradox of a collection of unitary states operating within a contested federal structure. The particularity of the New York State constitution gives its Attorney General the institutional capacity to take pre-emptive action to protect what the incumbent perceives to be the public interest.[43] In contrast to New Jersey, for example, where executive power resides in the hands of the Governor alone, there are limited gubernatorial or legislative restraints on Spitzer's capacity to initiate litigation irrespective of the will of other policy actors at state or national level. In addition, as noted above, important causal drivers have been Manhattan's geo-economic importance as a global financial and media centre, political ambition, the capacity to engineer punitive damages and headlines by setting the price for legal settlement, and public receptiveness to a socially constructed narrative based on defenestrating executive excess because of prior hubris. Seen from this perspective, the inordinate power held by Spitzer to influence the future trajectory of national financial regulatory policy comes into clear focus. In testimony to Congress in November 2004 in relation to fraud and anti-trust violations in the insurance industry, Spitzer declared unambiguously:

> 'It is clear that the federal government's hands-off policy with regard to insurance, combined with uneven state regulation, has not entirely worked. There are too many gaps in regulation across the 50 states and many state regulators have not been sufficiently aggressive in terms of supervising this

[43] *New York State Constitution*, Article 5, section 1.4, and Article 19, section 1.

> industry . . . At a minimum, federal involvement may be necessary to assure some basic standards of accountability on the part of insurance professionals.'[44]

Spitzer was careful not to suggest that federal pre-emption was the answer. Rather, his focus was on the lack of regulatory resolve, a discourse mechanism that neatly ensures the continued centrality of his investigative methods, ideological predispositions and wider political ambitions. In this there are significant further throwbacks to the juridical canon of Louis Brandeis. As early as 1926, Justice Brandeis proclaimed that 'a single courageous state may, if its citizens choose, serve as a laboratory, and try social and economic experiments without risk to the rest of the country.'[45] Nowhere is this resolve to provide a laboratory for economic engineering more apparent than in the strategic threatened prosecutions of corporations as entities and the concomitant defenestration of the hubris that governed the administration of the New York Stock Exchange under the tenure of Dick Grasso.[46]

In order to test the efficacy of Spitzer's argument that radical redesign is both necessary and viable, it is essential to place into perspective the myriad pressures placed on the Securities and Exchange Commission by the dynamics of associational governance. Spitzer maintains that the corporate governance reforms advanced in response to that crisis serve a palliative purpose, treating the symptoms but not the cause. He is supportive of the Public Company Accounting Oversight and Investor Protection Act 2002 (Sarbanes–Oxley) but suggests its primary emphasis on only one part of the associational matrix – the audit profession and corporate boards – merely displaces

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[44] Eliot Spitzer, *Statement to Senate Committee on Governmental Affairs Subcommittee on Financial Management, the Budget and International Security*, Washington DC, 16 November 2004, p. 13: www.oag.state.ny.us/press/statements.

[45] P. Teske, above note 32, p. 7.

[46] I. Demirag and J. O'Brien, 'Conflicting and Conflating Interests in the Regulation and Governance of the Financial Markets in the United States' (2004) 15 *Journal of Corporate Citizenship* 111.

the risk. For Spitzer, insufficient attention has been placed on the governance of other key intermediating forces. He believes the primary problem with the legislation lies in its intellectual roots in 'a culture of compliance and certification. There is increased individual liability, but the focus is on form rather than substance.'[47]

In the United States, this remains a critical issue. The capacity to critically determine juridical norms is based on the degree of clarity and political salience underpinning the legal framework. If laws and regulations are vague, or the detail left to regulatory bodies to negotiate with institutional actors given equal voice by the heterarchy of governance, particular intractable problems emerge. The dichotomy between appearance and reality in regulatory politics and the wider symbolic nature of law as a rhetorical device that is capable of manipulation through creative interpretation renders the governance of the financial markets particularly problematic.

The debate on how the reporting on internal controls should be viewed by regulators further demonstrates the inordinate endogenous pressures at the national level to construct a hollow shell that provides symbolic reassurance. There is a profound risk of reduced legal liability because of judicial or agency deference to an organizational response based on the institutionalization of 'rational myth'.[48] The irony is that Spitzer's trumpeting of his own reform agenda plays into this endogenous reality. The emphasis on written codes of conduct, without concomitant rigorous external monitoring to ensure that form overrides substance, can, in turn, subvert his stated policy imperatives. The critical importance of the Merrill Lynch settlement lay in the fact that Spitzer drew up the terms of reference and played an oversight role by having a veto over the appointment of a compliance officer. The countervailing pressure from New York SAG serves simultaneously to add to the squeeze on SEC capability and

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[47] Interview, New York, 10 December 2004.

[48] See, L. Edelman, C. Uggen and H. Erlanger, 'The Endogeneity of Legal Regulation: Grievance Procedures as Rational Myth' (1999) 105 *The American Journal of Sociology*, 404, at 447.

offer a mechanism to deliver effective enforcement. By allowing what he had termed the organized crime cartel of the insurance industry to settle on much more favourable terms, Spitzer has devalued the importance of his office at precisely the moment he has gained most leverage.

There can be no doubt that Spitzer is an exceptionally adroit political animal. With a talent for public relations and backing from establishment figures within the New York Democrats, Spitzer launched a gubernatorial campaign at the Sheraton Hotel and Towers in Manhattan on 9 December 2004. In one stroke, Spitzer raised $3 million and positioned himself as heir apparent for the Democratic nomination. Basing his campaign strategy on a revitalization of the successful outreach beyond the Democrats' core constituency that defined the Clinton era, Spitzer averred that he would 'take what's best from liberalism and conservatism to solve problems in practical ways.'[49]

Spitzer's ingenuity lies in his unerring capacity to capture the political zeitgeist concerning public unease and revulsion at the excesses associated with the once deified icons of the business world. Despite a series of criminal trials litigation has proved exceptionally problematic as a mechanism to transform corporate practice. The process may generate headlines but it does not necessarily ensure improvements to governance. Spitzer has, however, ensured that the terms of the debate have widened. On balance that represents a normative improvement.

[49] M. Slackman, 'Fund-Raiser Provides $3 Million for Spitzer Campaign', *New York Times*, 10 December 2004.

recantation. Colleagues, business partners and institutional actors recognized that self-preservation mandated both regime change and a public, if limited, acceptance of culpability. The jury's verdict formalized the total recanting of the mythical status of the Chief Executive Officer, if not the gatekeepers on whom the 'narcissists' of the age relied for validation.[2] The figurehead may have been replaced, but not necessarily the system of unrealistic and unrealizable growth management on which the imperial reign was based.[3]

This chapter provides an overview of the criminal cases resulting from the malfeasance scandals. The second section assesses the dynamics involved in the management of complex corporate criminal cases and the policy preference of the main prosecutorial agencies to stave off institutional charges against viable concerns. The third section links this preference back to the successful attempts by Judge Denis Cote of the Southern District of New York to force those players involved in the WorldCom debacle still active in the marketplace to agree a civil settlement on the grounds of public interest. I question whether such an approach, in the absence of enforced self-regulation to be discussed more fully in the next two chapters, can transcend the legal gaming of the system that tax-deductible guilt free settlements pre-ordain.

Tabulating Guilt: The Empire Collapses

From unlikely roots in Mississippi, WorldCom had grown to become one of the biggest players in the North American telecommunications market. When it descended into bankruptcy in 2002, the court-appointed examiner ascribed its initial phenomenal success not

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[2] See M. Kits de Vries and K. Balazs, 'Greed, Vanity and the Grandiosity of the CEO Character', in R. Gandossy and J. Sonnenfield (Eds), *Leadership and Governance from the Inside Out*, John Wiley & Sons, Inc., Hoboken, 2005, p. 54.

[3] For an acerbic critique, see K. Cools, 'Ebbers Rex', *Wall Street Journal*, 22 March 2005, p. B2.

to a 'predefined strategic plan, but rather opportunistic and rapid acquisitions of other companies. The unrelenting pace of these acquisitions caused the company constantly to redefine itself and its focus. Its unceasing growth and metamorphosis made integration of its newly acquired operations, systems and personnel much more difficult. This dramatic growth and related changes also made it difficult for investors to compare the company's operations to historical benchmarks'.[4]

Thornburgh opined there were 'serious and troubling issues' relating to the corporation's 'culture, internal controls, management, integrity, disclosures and financial statements'.[5] He concluded that 'WorldCom personnel responded to changing business conditions and earnings pressures by taking extraordinary and illegal steps to mask the discrepancy between the financial reality at the company and Wall Street's expectations.'[6]

Facilitated by its external auditors and investment bankers and unimpeded by the primary financial (Securities and Exchange Commission) or industry (Federal Communications Commission) regulators until it was too late, WorldCom had wreaked serious havoc on the infrastructure of the telecoms market long before its eventual implosion.[7] The symbiotic relationship between the financial community and WorldCom was predicated on the transactional basis of the business.[8] The danger associated with this strategy was explicitly acknowledged by the bankruptcy court examiner:

> 'The story of WorldCom's rise and of its fall into bankruptcy can be written in terms of its transactions. They epitomize the course of WorldCom's fortunes for the simple reason that, during its entire history through mid-2002, one of the

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[4] D. Thornburgh, 2002, above note 1, p. 6.

[5] Ibid, p. 6.

[6] Ibid, pp. 118–119.

[7] See generally, J. Sidak, 'The Failure of Good Intentions: The WorldCom fraud and the Collapse of American Telecommunications after Deregulation' (2003) 20 *Yale Journal of Regulation* 207 at 227.

[8] O. Malik, *Broadbandits*, John Wiley & Sons, Ltd, Chichester, 2003, p. 33.

> most distinguishing characteristics of the company was that it was constantly and even feverishly in 'deal mode' . . . The term 'transactions' as used here is intended to be all-encompassing. It includes acquisitions, mergers, issuances of equity and debt securities, outsourcing transactions, exchanges and repurchases of securities and financing instruments of every kind, and transactions involving employee retirement plans. An obvious reason for this broad definition is the total strain that is placed on the multiple systems of an organization and its personnel when the sheer volume of activity involved reached the extraordinary proportions that it did in this case.'[9]

WorldCom, like Enron before it, was a 'faith' stock, whose success was linked directly to the booming market and the sustained support of its primary investment bankers, who failed to carry out effective due diligence. They did not act alone. Each link in the fiduciary chain relied on the other for approval and justification. As it grew to become one of the lucrative underwriting assignments for Wall Street, there was a concomitant erosion of the strength of the ethical chain anchoring WorldCom's financial projections to reality. The corrosive nature of the malaise was intensified by the interaction of two powerful factors: a 'diffusion of responsibility' and 'bystander apathy'.[10]

Over a two-year period, hundreds of millions of dollars were inappropriately accounted for. The deception ranged from the relatively mundane reclassification of operating costs as capital investment and transferring reserves to revenue to much more sophisticated attempts to inflate earnings. The incremental nature of the process serves as a profound warning of the dangers inherent in the securitization of a knowledge-based economy. In evidence to the House Financial Services Committee in June 2004, a former chairman of the SEC outlined the crucial dilemmas that a reliance on professional judgement in the absence of professional integrity involves.

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[9] D. Thornburgh 2002, above note 1 at 58.

[10] R. Gandossy and J. Sonnenfield, *Leadership and Governance from the Inside Out*, John Wiley & Sons, Inc., Hoboken, 2004, pp. 7–9.

> 'We have a knowledge-based economy whose assets are determined in large part by the judgments, the assumptions, the estimates made by management, with some oversight by the auditors. It is not the bricks and mortar economy of the past, where historical costs were used to fix those values. So management today has had much greater discretion in fixing the values used in their financial statements.
>
> As management became more innovative in developing their values, the FASB, the Financial Accounting Standards Board, created ever more complex accounting standards and even more complex interpretations of those standards. Accountants to some degree became rule-checkers, and to a large extent the basic audit became a commodity. The growing maze of rules became a magnet for the fertile minds of lawyers, bankers and consultants who created these complex corporate structures that wended their way through the maze of rules, satisfying maybe the letter of the rules, but certainly not the spirit.'[11]

The difficulty was that this erosion, while recognized, was not a priority until the collapse of WorldCom finally prompted Congress to act.[12] As regulators built up a catalogue of deception in WorldCom and elsewhere, the US Attorney for the Southern District of New York pushed home the advantage in the prosecution of the corporate leadership of WorldCom and, in particular, targeted Ebbers. When charges against Ebbers were finally laid, the defence failed in its attempts to move the trial to Mississippi. Ebbers's legal team had reasoned that his prior corporate largesse would be recalled and homespun business philosophy would continue to resonate.[13] Although leniency was not promised, five former executives within the firm agreed to cooperate, providing prosecutors with a greater degree of granulation about who, precisely, was responsible for the fraud. Although that evidence was capable of being contested, it created an

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[11] See R. Hills, 'Sarbanes–Oxley: Two Years of Market and Investor Recovery', *Hearing before the Committee on Financial Services, US House of Representatives*, July 22 2004. Serial No. 108-106. Prepared testimony, p. 6.

[12] See A. Levitt, 'Corporate Governance and the Culture of Seduction' in R. Gandossy and J. Sonnenfield, above note 2.

[13] This factor also influenced the successful attempt by the defence to game the venue for the trial of Richard Scrushy, the former Chief Executive of HealthSouth.

upward dynamic for executives to cooperate in order to minimize their own culpability.

Most significantly, on the eve of his own trial, the former Chief Financial Officer of WorldCom, Scott Sullivan, provided crucial confirmation that he had been ordered by Ebbers to falsify deliberately the accounts. He provided evidence that this was done to ensure that Wall Street's expectations of earnings growth could be met. Sullivan testified that Ebbers 'looked at the information and didn't say a lot, and then he looked up and said: "We have got to hit our numbers".'[14]

For the prosecutors, the most difficult obstacle was whether the jury would find the evidence tainted. The trial could essentially be parsed down to two basic questions: who was culpable and who had intent? Ebbers's legal team's strategy was predicated on the argument that the prosecution could not prove criminal intent. They further suggested that the chief executive was the unwitting victim of accounting machinations that were presented at the time as legal. Finally, they argued that Sullivan's testimony could not be relied upon. Throughout the early stage of the investigation, Sullivan had strenuously denied wrongdoing and maintained that Ebbers was not involved in accounting deception. But in accepting the guilty plea he changed tack and accepted the criminal nature of his infractions, albeit for company, rather than personal, gain. This immediately raised credibility questions. In cross examination, Sullivan was challenged: 'If you believe something is in your interest, you are willing and able to lie to accomplish it, isn't that right?'[15] Sullivan admitted that he had lied; that he had 'misled the board . . . [however, he claimed sardonically in mitigation that] a lot of people weren't even awake, so there wasn't a lot of challenge'.[16]

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[14] See 'WorldCom Ex-Finance Chief Says He Told CEO of Accounting Issues,' *Wall Street Journal*, 9 February 2005 (online edition).

[15] See 'Ebbers Lawyer Paints Sullivan as Chronic Liar', *Wall Street Journal*, 17 February 2005, p. C1.

[16] Ibid.

In his evidence, Ebbers maintained ignorance was a justifiable defence. 'I know what I don't know, and I to this day don't know technology, don't know finance and accounting, but I thought I knew how – actually I always thought I was a pretty good coach, and coaching and supervising salespeople and marketing people is really like coaching, and so I focused on the area that I thought that I could handle. I also was responsible for human resources and legal and public policy, which I also enjoyed very much.'

As the jury deliberated, the reinsertion into public consciousness of Kenneth Lay, the former Chief Executive and Chairman of Enron, served to highlight the public policy consequences of such a defence. Three days before the verdict, Lay gave an exclusive interview to the prestigious CBS flagship current affairs series 60 *Minutes*. Lay announced that he would be replicating the defence offered by his WorldCom counterpart. Lay maintained that he, too, was a victim of an avaricious, Machiavellian Chief Financial Officer whose evidence could not be trusted. 'I have to take responsibility for anything that happened within its businesses. But I can't take responsibility for criminal conduct of somebody inside the company . . . I think the primary reason for Enron's collapse was Andy Fastow [the CFO] and his little group of people and what they did.'[17]

The fact that the jury in the Ebbers trial rejected this generic represented a considerable success for prosecutors. Despite the undoubted importance of the Ebbers prosecution – and indeed Lay's conviction earlier this year – it is essential, however, that these convictions be placed in perspective. While the nature of the testimony heard in diverse courtrooms across the United States demonstrates graphically the endemic occurrence of misfeasance, mounting successful prosecutions before a jury on substantive issues has proved more problematic than initially implied by the television pictures of handcuffed executives arriving at arraignment hearings.

[17] See CBS 60 *Minutes*, 'Enron's Ken Lay: I was fooled,' 13 March 2005.

Form Over Substance: the Limits of Criminal Trials

Five years after the collapse of the dot.com market, the complexity surrounding the malfeasance and misfeasance crisis has increasingly relegated coverage to the business pages. The broadcast media had given up almost entirely until the release of Martha Stewart in early March 2005 coincided with the denouement of the Ebbers trial. As the WorldCom jury finished its deliberations, Stewart went to the Appeals Court in an attempt to quash the limited stain on her character. Press reports gleefully added that a trouser suit hid the electronic tagging device that she must wear for another six months. Stewart used an online message forum to complain how it inhibited her exercise routine; a fact picked up in the coverage. It represented a telling indication of how personality-driven journalism privileges voyeurism over analysis. It is important, however, to remember the limited nature of the Stewart conviction.[18] Stewart was imprisoned for lying to prosecutors, not the more serious charges of securities manipulation or insider trading. As Shaw has argued 'in many respects this is a case of celebrity justice designed to bolster the reputation of the prosecution, who at the same time claim they are trying to extend the limits of securities law.'[19] Frank Quattrone, one of the most successful investment bankers of the dot.com era was convicted, on a second attempt, on 3 May 2004 of obstructing a federal investigation, not the rigging of the lucrative Initial Public Offering market. On the first day of his retrial in April 2004, a lawyer for Quattrone's employers, Credit Suisse First Boston, admitted that investment banking played a role in determining the allocation of shares. It provided a motive for the obstruction allegations and the prosecutors with a useful line of questioning. (Quattrone had downplayed, but not denied, his role in the allocation in the initial mistrial).

[18] For useful overviews, see N. Shaw, 'Cloning Scapegoats: Martha Stewart Does Insider Trading' (2003) 77 *Social Text* 451; see also J. Toobin, 'Lunch at Martha's,' *New Yorker*, 2 February 2003, p. 38.
[19] N. Shaw, above note 18 at 65.

In a statement released after the verdict, the lead prosecutor, David Kelley, claimed: 'The Government's ability to fully and fairly investigate allegation of wrongdoing in our financial markets depends on the integrity of the Grand Jury and [Securities and Exchange Commission] investigations. When we learn of efforts to obstruct justice or interfere with those investigations, we must, and we will, prosecute those cases to the fullest extent permitted by law.'[20] Yet, this is the opposite of what happened in this case. It renders questionable the argument that prosecutors demonstrate resolve to stamp out abuse. The legal department within CSFB failed to ensure that documents were adequately stored and Quattrone himself was only tried after his damaging emails were leaked in January 2003.[21]

The CSFB case is an exceptionally neat example of the conflicts of interest problem on Wall Street. A disciplinary action taken by the National Association of Securities Dealers noted that Quattrone had developed a model at Deutsche Bank based on exploiting the synergy between underwriting and research. According to the initial complaint, this 'amounted to a firm within a firm. Quattrone structured this operation so that the heads of corporate finance, mergers and acquisitions and research all reported to him'.[22] When appointed to CSFB he replicated the model.

The corporation's acceptance of the model amounted to an open contempt for the Chinese Walls constructed in order to justify the recombination of investment and commercial banking. It also meant that the potential to distort the research function was built into the model from the very beginning. The difficulties of effective supervision were magnified because Quattrone based his operation on

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[20] See D. Ackman, 'Quattrone Prosecutor Plays Fast and Loose,' forbes.com, 4 May 2004. Available online at: http://www.forbes.com/2004/05/04/cx_da_0504topnews.html.

[21] See 'CSFB's Quattrone Faces Civil Charges by NASD,' *Wall Street Journal*, 31 January 2003; and 'CSFB Email Urged Bankers to Delete IPO Documents,' 30 January 2003.

[22] See J. O'Brien, *Wall Street on Trial*, John Wiley & Sons, Ltd, Chichester, 2003, p. 213.

the West Coast. This gave him almost complete autonomy from the corporate headquarters in New York. It will be recalled that a similar separation facilitated the junk bond operation run by Michael Milken for Drexel in the 1980s. The senior management of CSFB recognized the historical parallels when it appointed Gary Lynch Vice Chairman to help the company through the Quattrone investigation. Lynch had been Director of Enforcement at the SEC during the Milken era. In an interview conducted in New York as the former investment banker was being tried, Lynch made clear that structural change was essential.

> You ask research analysts how dramatic it is going to be, it is a different way of doing business . . . To a certain extent it is going back to the way it was in the 1970s and 1980s, where you didn't have the star analysts, where analysts were the green eyeshade types who crunched numbers and weren't that important to investment banking clients.'[23]

The successful prosecution of Quattrone was short-lived, however. The conviction was overturned on appeal in March 2006; the Securities and Exchange Commission rescinded a lifetime ban placed on him by the National Association of Securities Dealers citing a lack of due process; NASD itself dropped the civil case against Quattrone in June.[24] The difficulties of securing successful substantive prosecutions have been magnified by the maladaptation of the criminal law. As we have seen, much of what occurred in the bubble of the 1990s and since, particularly by executives and professional intermediaries in whom fiduciary trust was placed, was morally dubious but not in itself proscribed by the criminal code. The distinction, lost in a culture that demands scapegoats, is an important one. Malfeasance refers to an illegal deed, while misfeasance can be defined as a morally questionable, but legal, act.

This uncomfortable reality was evidenced by the spectacular collapse of the initial Dennis Kozlowski grand larceny and securities

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[23] Interview, New York City, 7 February 2003.

[24] See R. Smith, 'Regulators Drop Case Against Quattrone', *Wall Street Journal*, 2 June 2006, p. C1.

fraud trial in early April 2004. Following six months of testimony in what was billed as the corruption trial of the century, the judge ruled a mistrial because of fears that a juror had been intimidated. Profound disagreements had emerged as to whether the prosecution had proved 'criminal intent' in the alleged abuse of the Tyco company loan scheme. Significant media coverage concentrated on the perceived intransigence of one juror, a retired lawyer from the Upper East Side. The case also highlighted why government securities lawyers prefer the lower standard of proof required in civil cases.

As noted above, defendants are likely to elude conviction unless criminal intent is proved alongside culpability.[25] In the Tyco case the defence was premised on the fact that the executives were open about the uses to which they put corporate money. While unedifying, the collapse demonstrates that it is nonetheless extremely difficult to make a successful case out of moral superiority alone. The veteran District Attorney of New York, Robert Morgenthau, was forced to release a terse six-line statement expressing his regret and commending his 'trial team for their diligence and hard work'.[26] It was an ignominious end to proceedings that gave parallel insights into both the extent of corporate excess and the overweening ambition of misplaced prosecutorial zeal.

In its editorial commenting on the prosecutorial strategy, the *Wall Street Journal* lambasted the Manhattan District Attorney's office for playing 'up the affairs and bacchanals of former CEO Dennis Kozlowski, as if wretched excess by itself were a crime. Some jurors have said this tactic insulted their intelligence, and it may well have damaged the prosecution's credibility on the key question of criminal intent.'[27] Likewise, in the Adelphia Communications case,

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[25] See S. Simpson, *Corporate Crime, Law and Social Control.* Cambridge University Press, Cambridge, 2002, p. 51.

[26] See R. Morgenthau, Press Release issued by Manhattan District Attorney, New York, 2 April 2004. Text available online at www.manhattanda.org/whatsnew/index.htm.

[27] See Editorial, *Wall Street Journal*, 5 April 2004.

the prosecutorial strategy was based on evidence produced by ten former employees who had reached agreements to cooperate in exchange for leniency. As with the Kozlowski and Ebbers cases, the familial executives who were accused of looting the company suggested no criminal intent can be adduced. Despite the egregious nature of the evidence, it took a New York jury two weeks to reach a guilty verdict, an indication of the difficulties in proving malfeasance. Kozlowski was convicted on the second attempt after a long jury deliberation (see Table 4.1).

Taking 'low to high' cases to trial in the absence of plea arrangements with cooperating witnesses, however, poses a much more problematic dynamic. Juries can be loath to convict for actions mandated or tacitly accepted as standard corporate practice. This was underlined by the unsuccessful prosecution of four executives at Qwest Communications in a trial that was presented as talismanic of enforcement resolve.

Civil and criminal charges had been filed against the four executives in February 2003. The process was, in essence, an indictment of financial engineering. On the day charges were brought, the Chairman of the SEC, William Donaldson, and the Secretary of Justice, John Ashcroft, held a joint news conference. They vowed to 'pursue aggressively anyone and everyone who has participated in an illegal effort to misrepresent a company's financials and mislead the investing public'.[28] The public relations management of the initial indictments was indicative of the need to construct a political spectacle. According to the SEC's indictment, Qwest's business model, formulated by senior management and endorsed by the board, was predicated on earnings management. It 'placed extraordinary pressure on their subordinate executives, managers and employees to meet or exceed those earnings objectives at all costs'.[29] The trial ended in April 2004 with two

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[28] See J. O'Brien, above note 22, p. 59.
[29] Ibid.

Table 4.1 Tabulating guilt

	ADELPHIA	BANK OF AMERICA	CSFB	ENRON	MARTHA STEWART	MERRILL LYNCH	QWEST	TYCO	WORLDCOM	
Prosecuting authority	DOJ	DOJ/NYAG	DOJ	DOJ/CIVIL	DOJ	NYAG/DOJ	DOJ/SEC	DANY	DOJ	CIVIL
Criminal prosecution	Rigas family	Theodore Shipol	Frank Quattrone	Kenneth Lay, Jeffrey Skilling	Martha Stewart	Settled pre-trial/Dan Bayley		Dennis Kozlowski	Bernie Ebbers	Directors Arthur Andersen underwriters
Level of prosecution	High	Low level	Talismanic	High	High	Talismanic	Mid level/ High level	High	High	High
Charge	Theft	Market timing	Obstructing a federal investigation	Accounting fraud/Lack of due diligence	Lying to prosecutors	Market manipulation		Theft	Theft	Complicity Lack of due diligence
Verdict	Guilty	Not guilty	Mistrial Guilt conviction quashed; underlying complaint now rescinded	Guilt by plea to Andy Fastow; jury conviction of Ken Lay and Jeff Skilling	Guilty on appeal	Settled/Guilt	Not guilty Civil case announced by SEC	Mistrial Guilty (June 2005)	Guilty	Settled
Underlying issue	Accounting fraud	Market manipulation	Market manipulation	Accounting fraud	Insider trading	Market manipulation	Accounting fraud	Executive excess	Fraud	Fraud/Market manipulation

acquittals, a partial acquittal on a third defendant and deadlocked on a fourth accused of manipulating earnings.

Buoyed up by the conviction of Ebbers, the SEC announced on 15 March 2005 that it was launching civil proceedings against the Qwest senior management team for their role in orchestrating what was termed a 'a multi-faceted fraudulent scheme designed to mislead the investing public about the company's revenue and growth. As a result of that scheme, Qwest had fraudulently recognized over $3 billion of revenue and excluded $71.3 million in expenses'.[30]

The decision to proceed with a case targeting named individuals in the company, including its former Chief Executive and Chief Financial Officer, followed a separate settled injunctive action in which the company agreed to pay a $250 million fine. The Qwest case demonstrates the policy preference to ensure that enforcement action against corporations is limited. A similar dynamic pertains within the Department of Justice, which indicates both the strengths and the limits of criminal deterrence. Its first success in using the criminal code to prosecute white-collar crime came within weeks of the passage of the Sarbanes–Oxley legislation on corporate liability. It centred on HealthSouth, a Birmingham, Alabama, based conglomerate that defied convention in health services provision by generating large profits in a traditionally low-margin industry. One of the key reforms mandated chief executives to certify the accuracy of company accounts, a move that precluded CEOs from denying responsibility for accounting irregularities.

In the HealthSouth case, no less than 15 executives agreed to plead guilty to fraud that dates back to the mid-1990s. According to the prosecutors, the fraud, estimated at $3 billion dollars, was designed to boost earnings to meet Wall Street expectations. Several have testified that the CEO, Richard Scrushy, orchestrated, or at least knew of and tacitly condoned, the fraud. In a repeat of a familiar pattern, class

[30] See Securities and Exchange Commission, 'SEC Charges Former Qwest CEO Joseph Nacchio and Eight Others with Massive Financial Disclosure Fraud,' 15 March 2005.

action lawsuits were lodged in Memphis in early January 2004 accusing the auditors and investment banks of complicity in the fraud.

The logic behind the Department of Justice's current strategy suggests that the corporation itself be charged as a criminal enterprise. This is politically difficult, if not impossible. As a senior judicial manager told the author: 'there is no benefit to be accrued by the government gaining control via forfeiture of a busted company. A balance had got to be struck'.[31] Even where enterprise corruption has featured on the indictment, as in the prosecution of the former Tyco Chief Executive, Dennis Kozlowski, it has not made it into the jury room. Even in stripped down guise there are considerable problems encountered in mounting a successful prosecution. The jury in the Scrushy trial maintained that the government did not prove its case and acquitted him of all charges.

The verdict on renewed prosecutorial activism is, therefore, at best mixed. The difficulties in transcending ethical failure can be traced back to three interlinked crises: the limited applicability of the criminal justice code to white-collar or corporate crime; the asymmetrical, dynamic and contingent relationship between the actors that create and recalibrate regulatory policy, particularly within the relatively closed subset of corporate governance design; and the scope, nature, locus and behaviour of regulatory and judicial actors. These issues are to be explored more fully below; first, it is necessary to examine whether civil cases provide a viable alternative.

Scrambling for Cover: The Cost of WorldCom

The Ebbers trial reached its denouement just days before jury selection in the class action against WorldCom's banks was about to begin. Some of the most powerful names in American finance queued in an adjacent courtroom to cut deals in order to avoid the threat of

[31] Interview, Paris, 20 April 2003.

a civil action (Table 4.2). Even before the jury retired to consider the verdict, the legal teams representing the major banks involved in underwriting bonds for WorldCom had realized that the risk of being conjoined in a civil action was too great. The fact that the lead plaintiff was representing the pension interests of the New York

Table 4.2 Counting the cost of due diligence failure

	CLASS ACTION	DATE SETTLED IN PRINCIPLE	UNDERWRITING MAY 2000/2001
ABN AMRO	278.4	March 9	LEAD MANAGER 2001
Bank of America	460.5	March 3	2000
BNP	37.5	March 9	2001
Caboto	37.5	March 10	2001
Citigroup	1457.5 (Bonds)	May 10, 2004	LEAD MANAGER
(Salomon Bros)	1192.5 (Stock)		2000
(Salomon Smith Barney)			BOOK RUNNER 2000/2001
Credit Suisse First Boston	12.5	March 4	2001
Deutsche Bank	325	March 10	2000/2001
Goldman Sachs	12.5	March 4	2000
JP Morgan (Chase)	2000	March 16	LEAD MANAGER 2000 BOOK RUNNER 2001
Lehman Brothers	62.7	March 4	2000
Mitsubishi	75	March 4	2001
Mizuho	37.5	March 4	2001
UBS Warburg	12.5	March 4	2000
West LB	75	March 10	2001

State Common Retirement Fund provided confirming evidence of the risk.

In this they were merely following the lead of Citigroup, the corporation with probably the most exposure to a civil action. Citigroup had agreed a settlement of $2.58 billion the previous May to cover the liabilities of its subsidiaries, Salomon Smith Barney and Salomon Brothers. At the time, Charles Prince, the Chief Executive of the conglomerate, stated: 'We are taking a leadership position in bringing to a close this difficult era in the history of our industry and our company'.[32] In reality it had little choice. Such was the egregious nature of the charges and the central involvement of Jack Grubman and his employers at Smith Barney that a negotiated deal was the only strategic option open to the parent.[33] According to the consolidated complaint:

> Grubman was more of a strategic advisor or merger broker to the companies he covered, rather than an objective analyst. In its August 7, 2002 letter to the House Committee on Financial Services, Citigroup disclosed that since 1997, Grubman had attended at least ten meetings of the board of directors of Salomon's top investment banking clients, including at least two meetings of WorldCom's board of directors. Most of these meetings (frequently held at the invitation of Salomon's investment bankers or top executive officers) related to these companies' key mergers and acquisitions, including WorldCom's acquisition of MCI and its proposed acquisition of Sprint, in which Salomon played the role of financial advisor. Indeed, the minutes for the two WorldCom board meetings at which those transactions were approved (September 29, 1997 for MCI and October 4, 1999 for Sprint) identified Grubman as among those in attendance as 'financial advisor to the Company.' Grubman also served as a proxy solicitor on WorldCom's behalf in connection with the MCI merger.[34]

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[32] See Citigroup Annual Report 2004.

[33] See A. Longstreth, 'Taking Citi to School,' *American Lawyer*, November 2004 (online edition).

[34] See *Re WorldCom Securities Litigation*, 02-CL-3288 (S.D.N.Y.) Consolidated Complaint, at 98–99.

The global settlement involving all of the major investment banks allowed for the publication of a number of damaging emails. The disclosure demonstrated that the difficulties were known within Salomon. Management ignored a succession of internal and external red flags. The settlement had the benefit of being tax deductible. More importantly, it provided little ammunition for further class actions because the penalty was not accompanied by an admission of wrongdoing. None of the other fourteen institutional actors followed suit, despite being offered broadly similar terms. JP Morgan offered a desultory payment of $100 million and complained publicly that Citigroup had overpaid.[35] As the date for the class action trial approached, with Ebbers's dissembling playing badly in the court, a strategic realignment of interest occurred. Bank of America was the first to break cover. It announced an agreement in principle with the New York State Comptroller on 3 March 2005. This deal was followed in quick succession by agreements with smaller members of the banking consortia responsible for offerings to the market in separate years. When the jury in the criminal trial went out to deliberate, the cost of settlement soared. By delaying, Deutsche Bank paid a 17% premium. By waiting for the verdict, JP Morgan, the second largest financial institution in the country, paid an even greater price. In a statement, the chairman, William Harrison, said: 'Given recent developments, we made a decision to settle rather than risk the uncertainty of a trial.'[36] If it had settled at the same time as Citigroup, the financial penalty would have been set at 1.37 billion. Seeking another roll of the dice cost JP Morgan Chase $637 million.

Given the fact that the jury disbelieved a chief executive with little formal training and whose defence was predicated on the fact that he relied on the expertise of his advisors, the JP Morgan Chase Chairman made a shrewd, if belated, calculation. The WorldCom board of directors, which had not figured on any

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[35] See 'JP Morgan's $630 Million Error', *Wall Street Journal*, 24 March 2005 (online edition).

[36] See 'JP Morgan Settles WorldCom Suit for $2bn', *Washington Post*, 17 March 2005.

criminal indictment but which had been publicly castigated by a devastating investigation commissioned from Richard Breeden, had already signified its willingness to make personal financial recompense. This rectitude was accepted by the plaintiffs in the class action lawsuit before the bench of the Southern District, if not by the judge. She ruled that in the absence of an agreement with the underwriters, the provisions were excessively lenient. JP Morgan's eventual settlement paved the way for an agreement. The former Chairman, Bert Roberts, however, refused to agree to the terms. On 21 March he relented, making a payment of $4.5 million. The settlement made the former auditors Arthur Andersen the sole defendant. The fact that it is no longer trading makes the case academic. More seriously, it is certainly arguable that the decision by the underwriters to settle, even without admitting liability, was prejudicial to the Ebbers trial. Andersen itself subsequently settled its liabilities in relation to the WorldCom audit for $65 million.

Bernie Ebbers, who had been lionized for his audacity during the boom in telecommunications in the 1990s by both Wall Street and the media, saw his reputation disintegrate in the Federal Courthouse of the Southern District of New York. The cheerleading orchestrated by Jack Grubman, who had become a market phenomenon by pronouncing the value of turning conflicts into synergies, had faded as Ebbers left the courthouse. Unlike Grubman, who has retreated into relative obscurity, Ebbers is now facing a potential life sentence.

Conclusion

While the complexity of modern finance can make the detection of criminal or ethical wrongdoing prior to systemic failure inordinately difficult, some of the most egregious cases to have emerged in recent years were not unexpected. If the publicly available company documents were adequately parsed, they represented, to paraphrase Marquez, chronicles of corporate deaths foretold. In the heady days of the last great bull market, these considerations were simply not factored into investment decisions. The collapses of WorldCom and Enron fit into this pattern.

The travails within the Italian dairy foods conglomerate and the alleged complicity of US intermediaries in the provision of bond offerings also conform to the structural design fault. While significant defects in its growth strategy should have been apparent if more than rudimentary due diligence had been carried out, leading underwriters continue to maintain that they, too, were victims. Following a claim for $10 billion lodged in New Jersey state court and a separate hearing in Parma, Citigroup has now gone on the offensive. It has countersued in New Jersey and alleges in both jurisdictions that it was hoodwinked by nefarious executives within the Italian group. This bullish stance should not be taken at face value. The defiance is inextricably linked to the current position in the court cycle.

If Citigroup adopts a similar strategy to its prior responses to the allegations of complicity in Enron and WorldCom, the likelihood is that it will settle. The pressure to capitulate has intensified precisely because Citigroup has been embroiled in such high levels of global scandal. While its management team has made the pursuit of higher ethical ambition a corporate priority, its leverage to convince either cross-jurisdictional courts or regulatory bodies has diminished because of a plethora of outstanding actions in the United States and elsewhere (matters explored in detail in the next chapter). The imperative to settle has increased dramatically precisely because of a belated decision by the Federal Reserve to exercise a public rebuke. It has barred Citigroup from any further significant merger activity until plans to overhaul the corporation's compliance structure have been implemented.

> The [Federal Reserve] Board expects that management at all levels will devote the necessary attention to implementing its plan fully and effectively and will not undertake significant expansion during the implementation period. The Board believes it important that management's attention not be diverted

> from these efforts by the demands that mergers and acquisitions place on management resources.[37]
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> Federal Reserve 2005, p. 265

The Federal Reserve announcement was buried deep in a ruling giving Citigroup permission to buy First American Bank, a small Texan concern. The ruling not only puts Citigroup on public notice of regulatory concern at serious deficiencies in its risk management and compliance departments, it also provides the first public acknowledgement that these deficiencies were subject to investigation by specific agencies within the rubric of the wider regulatory system. Just as significantly, the Federal Reserve did not comment on the outcome of those private investigations. The public nature of the rebuke could also be read as a criticism of the institutionalization of compliance that lies at the heart of the current corporate governance regime.

[37] Federal Reserve, *Legal Developments Bulletin*, Spring 2005, p. 265. Full text available online at www.federalreserve.gov/pubs/bulletin/2005/spring05_legal.pdf.

5

Corporate governance and the institutionalization of compliance

The design, implementation and monitoring of effective internal and external controls to minimize the risk of fraud, misrepresentation and ethical failure is central to the study of corporate governance. Their capacity to engineer cultural change, however, is minimized by terms of reference that privilege existing power relations within the four primary means of ensuring control in publicly quoted corporations. The first centres on the primary method of securing corporate finances, capital markets in dispersed-ownership systems or banks in their concentrated counterparts. The second focuses on the product market in which a corporation operates. In this case public dissatisfaction, linked to episodic scandal, such as the exposure of child labour, can significantly damage corporate reputations. The third method is linked to the regulatory environment, the efficacy of which is largely dependent on the robustness of the oversight regime. The fourth, and most dominant, are the internal controls designed and managed by the corporate board of directors.

The difficulties in securing accountability are magnified by deficiencies in the dominant corporate governance paradigm, which takes an unnecessarily restrictive view of the public duties of a corporation and its responsibilities to shareholders as well as a wider range of constituent stakeholders.[1] As a result, ethical failure in some of the world's most powerful corporations remains a seemingly intractable issue. Its continued presence can be traced to the coalescence of socially constructed norms of what constitutes acceptable standards of behaviour, opportunity and motive.

The introduction and recalibration of compliance systems has been the traditional method of ensuring continued and more effective disclosure. Its utility has been undermined by the narrow application of corporate law. The contractual basis of much corporate governance theory – based on the concept of shareholders as the vanguard in a line of defence that is, in turn, predicated on a functioning market for corporate control – views the governance of a corporation as an essentially private affair to be externally disciplined by market mechanisms, best designed and implemented by professionals.[2] This tends to locate and restrict intervention to within the corporation itself. Although corporate failure is a global phenomenon, the situation is much more pronounced in countries in which equity markets represent the dominant form of capital formation.[3] Given the role

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[1] As this book was going to press, an emergent scandal revealed a widespread practice of options grants being made to senior executives at the lowest price in a quarterly or yearly cycle, see D. Reilly, 'Accounting Regulator Urges Closer Look at Options Dating,' *Wall Street Journal* 29 July 2006, p. BS.

[2] C. Stone, 'Cracking the Corporate Shell,' *The Nation*, 2 August 1975, p. 72. For an account that disputes the notion of shareholders as owners, see P. Ireland, 'Defending the Rentier: Corporate Theory and the Reprivatization of the Public Company', in J. Parkinson, A. Gamble and G. Kelly (Eds), *The Political Economy of the Company*, Hart Publishing, Oxford, 2000. For an assessment of how 'profit maximization' discourse seeks to insulate business from wider societal obligations, see T. Jones, 'Ethics Considerations in Business: Theoretical Considerations' (1989) 13 *Organizational Behavior Teaching Review* 1. The emergence of stakeholder theory, linked to wider concepts of corporate social responsibility, challenges the narrow governance agenda; for a review see J. du Plessis, J. McCovill and M. Bagaric, *Principles of Contemporary Corporate Governance*, Cambridge University Press, Melbourne, 2005, pp. 363–386.

[3] The terms of reference in the construction of corporate governance codes of best practice and legislation centre primarily on the legal protection of shareholders. This has the effect of globally reinforcing a minimalist conception of the duties of the corporation in law and practice.

that fiduciaries play as guarantors of effective market oversight, it is both a corporate and public policy priority to extend the control debate into the wider governance of the market. Despite the surge in regulatory, legislative and juridical activism within these markets, the underlying reactive premise to scandal remains one in which malfeasance and misfeasance are perceived to originate primarily from corrupted actors.[4]

The contemporary debate on corporate governance design within dispersed-ownership systems stems from the relative value of two competing discourses. The first argues that corporations should be governed through generic principles, in which individual firms decide on how to implement 'best-practice' guidelines on a 'comply or explain' basis. While offering the advantage of tailoring governance structures to the specific needs of an individual corporation, this enabling framework lacks the enforceability of contract, against which the corporation can be held to account. Despite putative advances in the transformation of corporate law into a law of corporate governance, enormous wriggle room remains in which to present alternative, and equally legitimate, understandings of what the underpinning principle actually means.[5]

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[4] For a critique of the corrupted actors vs. corrupted system dichotomy and the dynamic relationship within and between discreet networks, see D. Brass, K. Butterfield and B. Skaggs, 'Relationships and Unethical Behaviour: A Social Network Perspective' (1998) 23 *Academy of Management Review* 14, pp. 15–17. As noted in Chapter 2, the accountancy profession has lost the most independence in the current wave. It has arguably also gained the most in terms of increased audit fees. The investment banks and the legal profession have been left largely, but not completely, unscathed by Sarbanes–Oxley and related reforms announced globally.

[5] For the 'productive disintegration of private law', see H. Collins, *Regulating Contracts*, Oxford University Press, Oxford, 2002, p. 59; for its application to corporate governance more generally, see A. Corbett and S. Bottomley, 'Regulating Corporate Governance' in C. Parker, C. Scott, N. Lacey and J. Braithwaite, *Regulating Law*, Oxford University Press, Oxford, 2004, pp. 61–62; on the 'justiciability' of modern corporate governance, see J. Farrar, *Corporate Governance: Theories, Principles and Practice*, Oxford University Press, South Melbourne, 2005, pp. 387–389.

The second approach, which has received tangible backing from the United States, is to mandate corporations, through both legislation and listing requirements on the primary exchanges, to incorporate into their articles of association particular governance forms, including ethical codes of practice. This more prescriptive approach has the benefit of clarity but suffers from the possibility that self-interested actors will game the regulatory system by engaging in technical rather than full compliance. In a telling speech, the former Chairman of the Securities and Exchange Commission, William Donaldson, warned that reformers were facing 'an uphill struggle'. He attributed this to the propensity of managers 'to pursue questionable activity right up to technical conformity with the letter of the law, and some will step over the red line, either directly or with crafty schemes and modern financial technology that facilitates deception.'[6] Donaldson further highlighted the emergence of a concerted fight-back from industry that centred on the increased cost to business of prescriptive compliance. He was silent, however, on the inherent flaws of a regulatory design that relies on self-certified compliance alone as a mechanism to inculcate higher ethical standards.[7]

The problem is made much more difficult to resolve because of the way in which both approaches to corporate governance tend

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[6] See W. Donaldson, Chairman of the Securities and Exchange Commission Speech to Business Roundtable, Washington DC, 14 October 2004. Full text available at www.sec.gov/new/speech/spch101404whd.htm. The timing of the speech was particularly significant. It occurred just as the New York Attorney General, Eliot Spitzer, uncovered further systemic conflicts of interest in the mutual fund and insurance industries.

[7] As Doreen McBarnet has observed, it is, perhaps, time to recognize that the emphasis on compliance as a solution is itself part of the problem, irrespective of whether it is rooted in a prescriptive or an enabling framework, see D. McBarnet, 'When Compliance Is Not the Solution but the Problem: From Changes in Law to Changes in Attitude' in V. Braithwaite (Ed.), *Taxing Democracy*, Ashgate, Dartmouth, 2003.

to focus exclusively on the inter-relationship between the board, the management and the shareholders.[8] Even when that relationship is extended to encompass the interests of stakeholders – including employees, the communities in which it operates (actualized through corporate social responsibility programmes) or wider society – there is a privileging of rights and concomitant ordering of legal priorities that places the shareholder first. Relatively little attention is placed on the rationale for such an approach in much of the law and economics literature.[9]

Delivering shareholder value through profit maximization, expressed through share price, is not necessarily an indication of the underlying health of the firm, as indicated to devastating effect by the spectacular collapse of Enron and other major enterprises. This model nevertheless continues to provide the intellectual foundations of the corporate governance movement in the United Kingdom and the United States. It argues that the introduction of a raft of

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[8] The increased interest of political economists marks significant theoretical advances in the study of the dynamics underpinning corporate governance design. The most sophisticated approach is to be found in P. Gourevitch and J. Shinn, *Political Power and Corporate Control: The New Global Politics of Corporate Governance*. Princeton University Press, Princeton, 2005. Gourevitch and Shinn explicitly state that their analysis fails to take into account the separate interests of financial intermediaries. For an examination of their role as policy entrepreneurs, see P. Cerny, 'Power, Markets and Accountability: The Development of Multi-Level Governance in International Finance', in A. Baker, D. Hudson and R. Woodward (Eds), *Governing Financial Globalization*, Routledge, New York, 2005.

[9] This is particularly true in relation to discussion of the passage of Sarbanes–Oxley. For alleged lack of rationale, see R. Romano, 'The Sarbanes–Oxley Act and the Making of Quack Corporate Governance' (2005) 114 *Yale Law Journal* 1521; for Sarbanes–Oxley as a path-dependent knee jerk response, see L. Ribstein, 'Bubble Laws' (2004) 40 *Houston Law Review* 77. For a contrasting approach linking the changes to the strategic imperatives of the Securities and Exchange Commission, see R. Karmel, 'Realizing the Dream of William O. Douglas, The Securities and Exchange Commission Takes Charge of Corporate Governance' (2005) 30 *Delaware Journal of Corporate Law* 79.

improved procedural measures will solve the agency problem.[10] In a limited sense this is true. Two of the most effective provisions within Sarbanes–Oxley specifically address the danger associated with a lack of transparency. The first calls on corporations to deposit a copy of their ethics programme with the Securities and Exchange Commission. The second mandates corporations to inform the SEC if they change or derogate from its provisions. The publication of the filings allows the market and other interested parties access to crucial relevant information. As such, this important reform represents a move from mere reporting to true disclosure and should be welcomed. The emphasis on voluntary and compulsory compliance programmes, if properly enforced, has the potential to minimize the risk of corporate corruption.

They act as early warning systems, guarding against catastrophic damage to corporate reputation, and provide the market with confidence that risk management systems are in place. Equally, flawed reform agendas can legitimize conflicts of interest. Behind the illusion of fundamental change lie control mechanisms that may be devoid of substance. This can lead to a suboptimal allocation of resources in the fight against corporate malfeasance and misfeasance. The critical question is whether the existence of a compliance programme should be regarded as sufficient evidence in itself of a commitment to responsible corporate citizenship. If, as argued, this is insufficient, how does one design an oversight system that has the capacity to deliver more effective control? In the next section of the chapter I trace and apply within the context of financial market governance the transformative model of ethical management developed by Rossouw

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[10] Here, it is interesting to note that the off-balance-sheet transactions formulated by the former Chief Financial Officer of Enron, Andrew Fastow, required the board of directors to derogate twice from its own ethical framework. This derogation was not publicly announced, leading to a lack of transparency and the degradation of the idea that an ethics programme could constitute an effective control mechanism.

and van Vuuren.[11] I highlight how the emphasis on form over function stymies rather than encourages movement towards the higher levels of moral development identified in the Rossouw and van Vuuren model. To ascertain its efficacy, I then apply this model to a brief case study involving Citigroup, the largest single integrated investment banking and financial services conglomerate.

A Model for Managing Ethics

As a consequence of systemic failings, the management of ethics has moved from the periphery of organizational decision-making. The imperatives include the need to regain trust, manage investor expectations, ensure the integrity of financial reporting, impose restrictions on executive compensation and develop an ethical tone at the highest levels of the organization.[12] The capacity of the corporation as a moral agent is as contested as the debate over its public function.[13] One consequence of this debate, however, is that behaviour not necessarily countenanced as moral is condoned by situating it within the corporate 'rules of the game'.[14]

In an important article, Russouw and van Vuuren sidestep these normative issues. Instead, they conceptualize ethics as an essentially pragmatic matter, with application determined by self-interest. They argue that changes in moral behaviour are causally linked to the interaction between the priorities set by the board and methods

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[11] See G. Rossouw and L. van Vuuren, 'Modes of Managing Morality: A Descriptive Model of Strategies for Managing Ethics', (2003) 46 *Journal of Business Ethics* 389.

[12] See, for example, Business Roundtable Institute for Corporate Ethics, 'Mapping the Terrain', 8 June 2004. Full text available at http://www.darden.virginia.edu/corporate-ethics/news/map_060804.htm.

[13] For an overview, see S. Wheeler, *Corporations and the Third Way*, Hart Publishing, Oxford, 2002.

[14] For an overview, see S. Greem, *Lying, Cheating and Stealing, A Moral Theory of White Collar Crime*, Oxford University Press, Oxford, 2006.

deployed by executive management. Crucially, this interaction does not exist in a vacuum. It is determined by the relative power of internal and external factors to introduce or block change. Using an heuristic device to manage 'corporate morality', they trace five key modal stages in cognitive development. This process starts with a self-referential approach to corporate responsibility that can be construed as 'immoral'. External stimuli prompt movement to the second stage in development, which the authors define as 'reactive'. The third level is associated with compliance. Further pressure, through the articulation of revised market norms, listing requirements or enhanced oversight may, in turn, force an upward movement to the higher stages of corporate responsibility, which are defined as 'integrity' and, finally, a 'totally-aligned approach' to managing ethics.

Movement from one mode of ethics management is not necessarily upward. The absence of pressure can see corporate behaviour slip. Equally, change can take reactive or proactive forms within and between each stage of development. It can be put forward by either an individual corporation or by an industry consultative panel as the latest manifestation of best practice. These, in turn, can derive from internal factors, such as the failure of existing strategies. Alternatively, they can represent a strategic industry response to that crisis in order to retain existing privilege and thereby stave off prescriptive external oversight. Thus, the shift to a reactive model can be triggered by the threatened or actual enforcement of corporate governance regulation or the need to minimize extant or future litigation exposure.[15] It is often characterized by the design of corporate codes of ethics, the

[15] Scandal has been the main driving force for corporate governance reform in the United Kingdom as well as the United States. In each jurisdiction, industry has attempted to introduce more muscular enforcement regimes to stave off formal oversight, with differing degrees of success. In the United States, this role was played mainly by the Conference Board, which suggested that the scandals were the result of a 'perfect storm', a formulation which had the advantage that none faced direct responsibility, see Conference Board, *Commission on Public Trust and Private Enterprise*, New York, 2003. Such an approach, however, could not trump the political need for

effectiveness of which are hampered by their symbolic, rather than integral, purpose.

At the second level, reactive organizations remain susceptible to scandal precisely because of loopholes in design, monitoring or implementation. The dissonance between stated objectives and corporate reality also creates public relations problems, leaving the corporation vulnerable to damaging leaks from disgruntled employees. Public, media or legislative censure, in turn, drives the dynamic towards compliance mode, where refashioned codes of ethics become the standard against which the company measures its own ethical performance. This mode is informed by a conscious public decision to regulate ethics and eradicate unethical behaviour. This can be achieved through high-profile sackings and public pronouncements by both the regulated and the regulator of the centrality of ethics to organizational decision-making. The authors suggest this stage is typically accompanied by training, individual signature validation of specific codes of practice and the formal induction of all new employees.

Within the compliance mode, ethics takes on a distinctly transactional character. The code of practice becomes a set of internal rules. Although they have the capacity to act as the foundation stone for an entrenchment of ethical values, they tend to be imposed rather than internally negotiated. As with all rules-based solutions, there is a profound risk that this approach can breed functional compliance, with interested parties transacting their way around explicitly internally sanctioned or illegal activities. Within investment banking, in particular, this is highly problematic.

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congressional action. In the United Kingdom, by contrast, the capacity of business to retain a resemblance of control has been much more successful. For the development of corporate governance in the United Kingdom, see A. Cadbury, *Corporate Governance and Chairmanship*, Oxford University Press, Oxford, 2002. For a critical analysis, which suggests that this can be derived from attempts to maintain existing privilege, see M. Moran, *The British Regulatory State*, Oxford University Press, Oxford, 2003; see also, more generally, M. Moran, *The Politics of the Financial Services Revolution*, Macmillan, London, 1991.

Legal and compliance departments are traditionally cost centres, which have limited organizational power to compete with aggressive performance targets based on the design of innovative products for which no case law exists. In this context, locating the locus of moral control within a submissive cost centre with little corporate power provides the basis for transactional amorality and risks a downward dynamic.

The 'integrity' approach attempts to deal with these problems by internalizing values and standards. Central to its potential success in changing corporate culture is the introduction of a dialogical exchange of views that informs the basis of the ethics code. This involvement of specific business units in ethics codes, through a process of enfranchisement has real potential to provide internal commitment to corporate policies. It also creates an internally recognized and accepted level of the limits of corporate activity. To be successful, the process requires the corporation to engage in a significant examination of the real reputational risks associated with particular business lines. Systems for rewarding and evaluating ethical success – and punishing deviance – need to be introduced through material incentives and disincentives. In the final phase, 'totally aligned organizations' are characterized by the fact that the ethics function is dispersed across and between horizontal and vertical structures, with individual managers empowered 'on all levels to integrate ethics in their repertoire of managerial skills and actions.'

The critical value of the framework derives from its capacity to trace the conflicting dynamics that accompany changes to specific ethical management systems. When applied to the politics of financial services reform its value comes into clear view. Perhaps the most spectacular example of ethical failure within investment banking centres on the long-running problems faced by Citigroup. By examining its response to crisis, one can see the contingent and inherently political basis on which claims by the corporation to higher ethical standing have been made. Crucially, it also allows for a much more precise evaluation of the relative advantage of rooting normative improvements in governance on compliance.[16]

Held to Account: The Case of Citigroup

In November 2004 Citigroup placed an advertisement on its website for the position of Director of Ethics. The appointment represented tangible evidence of the public determination by Charles Prince, the Chief Executive of Citigroup, that his tenure should be judged by improvements in the corporation's ethical standards. In this regard, the wording of the advertisement is instructive. The candidate would 'help ensure business activities are consistent with ethics policies'. According to the criteria, it was essential that applicants should understand 'regulatory guidelines, applicable laws and ethics in a business context'. While the position underscores the critical importance that ethics now places in the management of reputation, therefore, the terms of reference subjugates it to merely the appropriate application of reactive policies designed to comply with legal and regulatory instruments. This subservience is further underlined by the need to contextualize ethical behaviour within a distinct operating environment.

The proposed appointment came as the conglomerate crisis-managed the fallout from a range of ethical failures across its global operations. These began with an investigation by the New York State Attorney General, Eliot Spitzer, into systemic conflicts of interest on Wall Street in 2002. Since then, Citigroup's business model, and in particular its ethical framework, has come under sustained criticism. Powerful and integral business units have been shown to be intricately involved in the design and marketing of aggressive financial

[16] It is important to state explicitly at the outset that there is no evidence that the current leadership of Citigroup is less than sincere in its stated objectives to improve the ethical performance of the corporation. The analytical question is whether the response has the capacity to inculcate the desired level of change.

engineering products in New York; allegedly complicit through due diligence failures in the collapse of Parmalat; and found guilty of failing to control traders in London who engaged in a multi-million dollar trading coup undermining the Eurobond market. To add insult to the reputational damage, Citigroup suffered the ignominy of having its prestigious private banking arm unceremoniously thrown out of Japan, following accusations of market abuse. As this book goes to press, Citigroup Global Capital Markets in Sydney is defending a landmark insider-trading case taken by the Australian Securities and Investments Commission.

Given Citigroup's global dominance, alleged or real defects in its underpinning governance structure have profound implications for the governance of finance markets generally, as the Sydney insider-trading case demonstrates.[17] It is a responsibility Citigroup itself explicitly acknowledges in both external corporate communications and internal codes of conduct. Bearing public witness to the need for a sound ethical grounding, the company proclaims the need to capture the high moral ground: 'We live by our values and expect all who work for us to live by them as well'.[18]

To demonstrate this renewed emphasis on compliance, Citigroup released a new code of conduct to demonstrate that the problems

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[17] The corporation vigorously denies the claim. By taking the case, ASIC is on a collision course not just with Citigroup but also with the wider industry. Both sides are now locked in an escalation imperative. The regulator has staked its reputation on this case and to resile now would be exceptionally damaging. Citigroup's room for manoeuvre is probably constrained. Its capacity to settle is diminished because of the lack in Australian law of a mechanism to accept the claim by the regulator without admitting liability. As a consequence, a settlement would leave Citigroup open to a potentially enormous derivative action claim. Industry sources in Sydney suggest that the case represents an attempt by the regulator to introduce rules through litigation. Irrespective of the outcome, what is clear, however, is that relations between the regulator and the regulated within the financial markets in Australia have been significantly damaged by the case. One source suggested it would take 'up to ten years' to rebuild relations. Interviews, Sydney, 16–23 June, 2006.

[18] Citigroup Code of Conduct, p. 3. Full text available at: www.citigroup.com.

of the past have been overcome. The redesign highlights three key corporate aspirations. It strives to be a company with the highest standards of ethical conduct; an organization that people can trust; and dedicated to community service. Within the conglomerate, the code establishes codified limits of acceptable behaviour, offers guidance to concerned employees, provides hotlines and emphasizes the need for both professional integrity and personal responsibility. Rooted in a cultural framework that emphasizes the importance of compliance, it signals to employees and regulators that credible risk management structures have been put in place. In large respect, the code is a paragon of industry best practice.

Further refinements to the model were introduced in February 2005, with the announcement that key executives would be mandated to take part in what Citigroup termed 'franchise training'.[19] In a memo to staff, the Chief Executive, Charles Prince, outlined the key priorities: 'grow responsibly, minimize mistakes and ensure that when mistakes occur, they are handled appropriately'.[20]

The Citigroup management team's campaign to foster ethical improvements was further underscored by the release on 1 March 2005 of a video charting the corporation's history. Every employee was mandated to watch the video as part of a five-point action plan that includes compulsory ethics training. In an interview with the *Wall Street Journal*, timed to coincide with the video release, Prince refused to accept that the corporation had a corrupt culture: 'We emphasized the short-term performance side of the equation exclusively. We didn't think we had to say: "And by the way, don't violate the law." There were unspoken assumptions that need to be spoken'.[21] The gloss of change was scratched by the manoeuvring, reported elsewhere in the paper that day, to minimize the fallout from the Eurobond

[19] 'Citigroup Plans "Ethics Hotline" for Feedback on Bosses,' *Financial Times*, 17 February 2005.

[20] Ibid.

[21] R. Smith, 'Citigroup CEO Pursues Culture of Ethics', *Wall Street Journal*, 2 March 2005 (online edition).

manipulation by suggesting that internal controls were lacking in substance.[22] The announcement that very day that Citigroup had agreed to pay $75m to settle a class action relating to research defects in its coverage of Global Crossing gave rise to the suspicion that the timing of ethical renewal could be construed as an astute form of media management designed, in part, to spin the news agenda.

This is part of the problem, as demonstrated in the section of the revised code of ethics for those engaged in the delivery of structured finance. The impetus within the compliance model articulated by Citigroup is for the clients to properly account for their activities. At surface level the code seems to present a clear policy imperative:

> Each of our clients must commit to disclose promptly to the public the net effect of any financing transaction proposed to be executed by Citigroup that is material to the client and not intended to be accounted for as debt in the client's financial statements. If a client does not commit to make the disclosures required by our policy, Citigroup will not execute the covered transaction.[23]

This formulation, designed to separate cause and effect, can be justified on the grounds that malfeasance by a third party should not be used to tar the reputation of a service provider of a service that is technically compliant with legislation. It also, however, transfers responsibility outside the corporation, absolving the financial designers of misfeasance of moral side-restraints by situating the creative accounting of structured finance within acceptable rules of the game and externalizing the material and moral costs of non- or creative-compliance. Within this narrow prism, responsibility for subsequent deception is not in the design of an aggressive and, if misapplied, potentially fraudulent instrument, but rather its inappropriate application. This narrow libertarian approach, most closely associated with the late economist Milton Friedman,

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[22] 'Citigroup May Admit To Lax Controls', *Wall Street Journal*, 2 March 2005 (online edition).
[23] Ibid, p. 18.

significantly reduces the capacity of ethics to provide a significant restraining force.[24] Within this operating framework, ethics, if applied at all, can only be justified if it adds to the bottom line.

To be an effective change agent, a code of ethics requires 'penetration' across 'policies, processes, programs, structures, systems and objectives'.[25] In order to assess the efficacy of the Citigroup approach, it is therefore imperative to distinguish between 'form', 'implementation' and 'administration', both in terms of design and ultimate purpose. Immediately apparent from the Citigroup examples sketched above and given more granular expression below, are the profound difficulties associated with institutionalizing ethical restraint. These can be traced, in turn, to the absence or misapplication of normative ethical terms of reference *outside* of, or more accurately capable of *over-riding*, the restrictive confines of 'a business context'.

The Citigroup Code of Conduct, for example, makes clear that employees should 'determine when fiduciary duties arise and keep in mind that a fiduciary has a legal duty to act in the best interests of its clients – putting its clients interests ahead of its own interests or the interests of its affiliates or employees.'[26] An investigation by the Japanese Financial Services Authority found evidence that the

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[24] M. Friedman 'The Social Responsibility of Business is to Increase its Profits' *New York Times Magazine*, 13 September 1970, pp. 32–33, 122–126. For a critique suggesting the perennial opposition of market and virtue, see W. Baumal, *Perfect Markets and Easy Virtue: Business Ethics and the Invisible Hand*, Blackwell, New York, 1991, p. 9.

[25] M. Schwartz, 'A Code of Ethics for Corporate Codes of Ethics' (2002) 41 *Journal of Business Ethics* 27.

[26] Citigroup above note 18, p. 8. This suggests that investment bankers are held to account by fiduciary duties in law, akin to the professional obligations of accountants and corporate directors. However, in law, no such obligation exists. Whether it should is another matter entirely, see A. Tuch, 'Investment Banks as Fiduciaries: Implications for Conflicts of Interests' (2005) 29 *Melbourne University Law Review* 478. Within the United States, the remnants of Enron itself have sued for recovery from the merchant banks, including Citigroup, see R. Smith, 'Shell of Enron in Houston Is Now About Creditors, Not Oil; Suing "Enablers"; Selling Units', *Wall Street Journal*, 1 February 2006, p. C1.

Citigroup operation in Tokyo fell far short of this lofty ideal. The situation was made even more problematic because of the failure to even identify some of the clients to whom it was offering complex derivative-based solutions. This left the firm susceptible to charges that it could have abetted, if inadvertently, money laundering. Appearing before a parliamentary investigation in Tokyo on 30 November 2004, the Head of Citigroup in Japan, Douglas Peterson, could only manage a contrite apology. 'There was an aggressive sales culture whereby attention was not paid to the rules, even if those involved knew what the rules were. We acknowledge there was a fundamental flaw in our organization involving a weak culture of compliance and internal controls.'[27]

These failures did not just apply in the far-flung corners of the global empire. Control failures also infected operations across Manhattan. The conflicts of interest investigation into analyst research led by Eliot Spitzer revealed hubris, poor judgement and egregious control failures. It destroyed the career of Smith Barney's Chief Analyst, Jack Grubman; tarnished the standing of the corporation's Chief Executive, Sanford Weill; and thoroughly undermined the credibility of the early warning systems deployed within Citigroup to monitor ethical lapses.

As Grubman was bringing in astronomical investment banking and commission charges, he felt immune from oversight. When an internal survey of retail brokers revealed serious complaints, Grubman shrugged it off. Writing to an associate, he boasted: 'I never worry much about review. For example, this year I was rated last by retail (actually had a negative score) [Attribute] that to [the] . . . carnage in the new names [technology stocks]. As the Global Head of Research was haranguing me about this I asked him if Sandy [Weill] liked $300 million in

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[27] 'Citigroup Promises to Compensate Japanese Clients', *Financial Times*, 1 December 2004 (online edition).

trading commission and $400 million in banking revenues. So, grin and bear it.'[28]

Senior management was aware of the retail problem but did not prioritize it, nor did it factor in the derision that the lucrative Private Client Group felt about the quality of the analyst reports. Its director, Jay Mandelbaum, explicitly told the Head of Global Equities Research, John Hoffman, that the 'research was basically worthless'. Such was the anger felt by the PCG that Mandelbaum threatened to suspend its 25% share of the cost of providing research. Despite these concerns, in his annual review of group performance, Hoffman noted only that 'there is a legitimate concern about the objectivity of our analysts that we must allay in 2001'. He went on, however, to indicate that the primary group concern was to 'better integrate our research project with the business development plans of our constituencies, particularly investment banking'.[29] This integration stands in marked contrast to the assurances given by the securities industry in 1999 when self-regulation was ceded.[30]

The deliberate occlusion within the Citigroup subsidiary to the reputational consequences of Grubman's actions did not apply only to his line manager but extended to the entire personnel directorate. The compensation package offered to Grubman reflected his importance, rising from $11.8m in 1998 to $17.8m in 2000. The compensation for 2000 is exceptionally problematic. Grubman's personnel file notes explicitly that in the space of one year, he 'had gone from the most popular analyst ever to the most unpopular analyst ever'.[31] There is no record that anyone in the human resources department or

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[28] See J. O'Brien, *Wall Street on Trial*, John Wiley & Sons, Ltd, Chichester, 2003, p. 276.

[29] Ibid, p. 278.

[30] During the debates over the Financial Modernization Act that allowed for a recombination of investment and commercial banking, it was proposed that 'Chinese Walls' would separate research and investment banking departments. Across Wall Street, however, from the beginning, research primarily served a quasi-investment banking function. For details, see Chapter 3.

[31] J. O'Brien, above note 28, p. 277.

senior management board of either Salomon Smith Barney or the parent company, Citigroup, questioned why the comments sheets on Grubman's performance expressed so much personal and professional vitriol. There was no attempt to triangulate the decline in confidence with the exogenous collapse in technology stock and the benefit accruing to investment banking by constant attempts to ramp the stock of favoured corporations still prepared to buy their way out of trouble. Despite, or because of, this discrepancy, Grubman received a pay increase of $3 million.

The code notes that 'any attempt by a Citigroup representative to manipulate or tamper with the markets or the prices of securities, options, futures or other financial instruments will not be tolerated.'[32] Yet, this is precisely the charge muttered *sotto voce* by concerned central bankers over a series of controversial trades that disrupted the Eurobond market in August 2004. In a trading coup mounted over multiple markets conducted simultaneously across diverse trading platforms, the corporation netted millions of dollars while simultaneously destroying the credibility of the market. As much as 70% of the platforms used belonged to MTS, which is owned by a consortium of banks, including Citigroup. One trader quoted in the *Sunday Times* likened the raid to 'stealing a car in the street because its doors are open and the keys are in the ignition'.[33] While the Financial Services Authority in the United Kingdom found no evidence of market manipulation, it is exceptionally hard to square this practice with the corporation's annual report, which states, in part, 'importantly in 2003 we continued our thorough re-examination of the way we do business, with an eye towards developing standards that are not merely "common industry practice" or "letter of the law"

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[32] Citigroup, above note 18, p. 16.

[33] Insight, 'Bond Raiders', *Sunday Times*, 15 August 2004 (online edition). Citigroup initially denied any wrongdoing. It was eventually fined £4m and forced to disgorge further profits of £10m by the Financial Services Authority in the United Kingdom, which stated that the bank failed to supervise its traders, see D. Reilly, 'Citigroup To Take $25m Hit In Dr Evil Case', *Wall Street Journal*, 29 June 2005, p. C3.

but the best practices in a given area. We need to be clear about this subject; because of our size and scope, because of our position of business leadership, we are held to a higher standard. We accept this responsibility.'[34]

The critical question is why the framework developed to advance these objectives has proved so unsuccessful. As the Japanese case demonstrates, the malaise continued despite knowledge of specific guidelines. In addition, the fact that the compliance regimen introduced by Citigroup has many of the features associated with compliance best practice suggests that the problem extends beyond the particular institutional culture of the investment bank. The search for a solution, therefore, needs to address paradigmatic flaws within the wider terms of corporate governance in both its 'rules' and 'principle' based forms.

Complying with Fiduciary Duty: Towards a New Framework for Corporate Control

Technological advances and increased synergies in global markets reinforce the asymmetrical informational advantage given to financial intermediaries. It is, therefore, a corporate and public policy priority to ensure transparent and accountable markets. This is best achieved by redressing a cost–benefit calculus that is tipped in favour of the simultaneous elevation of misfeasance by default. We are living in an age of global markets, governed by antiquated, inadequate and inappropriate national regulatory structures. This presents an opportunity and a challenge for corporations and regulators. A vibrant, well-administrated corporate sector is vital for economic development, social and political cohesion, and access to global sources of capital. While the specific concerns facing each national jurisdiction differ,

[34] Citigroup Annual Report 2003. Full text available at http://www.citigroup.com. Charles Prince, the Chairman and Chief Executive of the firm, accepted that the Eurobond trading was 'knuckle-headed', see Smith above note 21.

underpinning all policy innovation must be the need to enhance transparency and accountability within corporations and the markets in which they operate. Adroit policy redesign has the potential to recalibrate the corporate response towards the intersection between the compliance and integrity mode through more imaginative and proactive policing of the market.

It is imperative that the tone is set at the highest levels of the corporation and that appropriate structures are put in place in order to convince employees and the wider market that the corporation is governed within ethically defined parameters. A functioning ethical framework systematizes and rationalizes corporate thinking within a normalized rule structure. To be effective it must be situated within a matrix that gives due cognizance to the competing and, at times, conflating imperatives of culture, law, ethics and accountability.[35] It must have the capacity to evolve in response to the application of external stimuli. The formal legislative and best practice code reforms have failed to deliver traction precisely because of an inordinate emphasis on the form of rules rather than their function. Meaningful change must also link cultural and organizational factors. It is only through weaving ethics into the corporate identity by aligning the programme with material incentives that the basis of credible restraint is inculcated. The obverse is also essential: any derogation from the ethics programme, even if financially lucrative, must be punishable by

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[35] The measure fits within the accountability model pioneered by Fisse and Braithwaite: 'Corporations have the capacity but not the will to deliver clearly defined accountability for law-breaking; courts of law, obversely, may have the will but not the capacity. Hence, the solution may lie in bringing together the capacity of the firm's private justice system – to identify who was truly responsible – with the will of the public justice system to demand accountability that is just rather than expedient', see B. Fisse and J. Braithwaite, *Corporations, Crime and Accountability*, Cambridge University Press, Cambridge, 1993, p. 15. It also meshes with earlier calls for law to formally alter lines of authority within private firms and ensure the continual disclosure of how decisions are made, see C. Stone, *Where The Law Ends: The Social Control of Business*, Harper & Row, New York, 1975, pp. 217–227.

non-payment or claw-back of bonuses. Sharp practice that complies with the law but causes reputational damage should be penalized.

In this context the most important innovations track back to Eliot Spitzer's conflict of interest probe into systemic defects in the governance of research analysts. It mandated a global settlement and advanced significantly moves in the United States towards the introduction of 'pre-trial diversion' as a means to strengthen the capacity of compliance and the responsibility of corporations and their advisors to police it more rigorously. This is not to say that it is not problematic. It is to an evaluation of the mechanism we now turn to ascertain whether the most significant redesign of financial regulation represents a panacea or a dangerous threat to the certainty required for effective market regulation.

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The efficacy and pitfalls of pre-trial diversion

The search for more effective strategies to control the corporation has extended beyond the regulatory core to encompass policy transfer from the criminal arena. After a period of retreat, occasioned by ideological and theoretical assault, punitive deterrence has re-emerged, strengthened by the hubris of self-regulation.[1] Global scandal has prompted a re-examination of the effectiveness of mechanisms to instil ethical restraint designed by the market in conjunction with – or enfranchised by – self-regulatory agencies. Changed enforcement priorities demonstrate the extent of failure. Civil sanctions for regulatory breaches through cease and desist orders are written off

[1] For an overview on the United States, see S. Simpson, *Corporate Crime, Law and Social Control*, Cambridge University Press, New York, 2002; on the United Kingdom, see R. Baldwin, 'The New Punitive Regulation' (2004) 67 *Modern Law Review* 351; on defects within the self-regulatory paradigm using primarily Australian sources, see C. Parker, *The Open Corporation, Effective Self-Regulation and Democracy*, Cambridge University Press, 2002; on efficacy of enforceable regulatory undertakings pioneered by the Australian Competition and Consumer Commission, see K. Yeung, *Securing Compliance, A Principled Approach*, Hart Publishing, Oxford, 2003; M. Nehme, 'Enforceable Undertakings in Australia and Beyond' (2005) 18 *Australian Journal of Corporate Law* 68; more generally, see B. Fisse and J. Braithwaite, *Corporations, Crime and Accountability*, Cambridge University Press, Cambridge, 1993; on explicit linkage between criminology and regulation literature, see J. Braithwaite, *Restorative Justice and Responsive Regulation*, Oxford University Press, Oxford, 2002; and J. Gobert and M. Punch, *Rethinking Corporate Crime*, Butterworths, London, 2003.

as the cost of doing business. Profit disgorgement represents an ineffective restraint, particularly for financial services firms. As noted in the previous chapter, the potential for compliance programmes to inculcate values has been undermined by three interlinked imperatives. First, the emphasis on maximizing share value privileges an instrumentalist view of ethics.[2] Second, this normative worldview is constrained only by an exceptionally narrow interpretation of legal restraints.[3] Third, the internal dynamic of corporate law itself reinforces this by concentrating on mediating disputes within the corporation rather than how it intermediates with wider society, a formulation derided by one scholar as a 'default of the imagination'.[4] Adversarial legal systems, in turn, privilege a rules-based approach to compliance that is all too easily transacted around.[5] Organizational structure and corporate culture can create a reflexive environment that encourages derogation from publicly stated codes of ethics and other restraining forces provided by the articles of association as well as internal procedures.[6]

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[2] D. Quinn and T. Jones, 'An Agent Morality View of Business Policy' (1995) 20 *Academy of Management Review* 22, at 25.

[3] The classic account remains M. Friedman, 'The Social Responsibility of Business is to Increase its Profits', *New York Times Magazine*, 13 September 1970, pp. 32–33, 122–126.

[4] C. Stone, 'Cracking the Corporate Shell', *The Nation*, 2 August 1975, p. 72. Paradoxically, while theoretical developments suggest an augmentation to the solid legal core, the prosecutorial imperative emanating from the United States Department of Justice bypasses the legal system entirely, see below.

[5] For how this manifested itself in the United States, see F. Bowman, 'Drifting Down the Dneiper with Prince Potemkin: Some Sceptical Reflections About the Place of Compliance Programs in Federal Criminal Sentencing' (2004) 39 *Wake Forest Law Review* 671.

[6] The failure of these mechanisms became abundantly clear in the Wall Street conflicts of interest investigations, particularly within Citigroup, the single largest financial services conglomerate, see J. O'Brien, *Wall Street on Trial*, John Wiley & Sons, Ltd, Chichester, 2003, pp. 275–281. For a review of the literature, see C. Parker, above note 1, pp. 32–37. For a critique of the corrupted actors vs. corrupted system dichotomy and how a dynamic relationship within and between discreet networks reinforces or corrodes ethical integrity, see D. Brass, K. Butterfield and B. Skaggs,

As a result, leaving aside the most egregious and obvious examples of larceny, placing prosecutorial focus on the incarceration of individual executives may be both ineffective and inappropriate.[7] It may also prove exceptionally problematic from an ethical perspective.[8] Such an approach may assuage emotive demands for action without actually addressing, much less solving, the underlying problem of unethical behaviour.[9] The practical problem of identifying causal responsibility within complex organizational forms is augmented by conceptual incoherence. The artificiality of corporate personhood renders *mens rea* a logical impossibility. Without the additional restraining effect of vicarious liability, a standard not accepted in individual criminal prosecutions, the use of criminal law itself is exceptionally problematic.[10] The cumulative effect of recent financial reporting scandals questions continued doctrinal faith in whether the corporation with 'no soul to damn and no body to kick' or incarcerate is capable of being governed ethically, let alone controlled within the terms of the current paradigm.[11] What then can be done? Should we

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'Relationships and Unethical Behaviour: A Social Network Perspective' (1998) 23 *Academy of Management Review* 14, at 15–17.

[7] For the 'theatrical value' of the criminal trial as deterrence, see J. Coffee, 'No Soul to Damn, No Body to Kick: An Unscandalized Inquiry Into the Problem of Corporate Punishment' (1981) 79 *Michigan Law Review* 386, at 424; for criminal sanctions to be effective only if applied to both corporations and executives, 'with equal fervour', see G. Geis and J. Dimento, 'Should We Prosecute Corporations and/or Individuals?', in F. Pearce and L. Snider (Eds), *Corporate Crime: Contemporary Debates*, University of Toronto Press, Toronto, 1995, p. 85.

[8] T. Lauricella and P. Davies, 'Spitzer Retreats From Another Fund Prosecution', *Wall Street Journal*, 22 November 2005, p. C1.

[9] J. Braithwaite, above note 1, p. 16. For Braithwaite, punitive retribution without taking due cognizance of underlying problems is not only counterproductive but also 'corrosive'.

[10] See W. Laufer, 'Corporate Bodies and Guilty Minds' (1994) 43 *Emory Law Journal* 647. Attempts to shoehorn theory into reality include imputing intent from a corporate culture that tolerates recklessness and negligence, see J. Gobert and M. Punch, above note 1, pp. 87–97.

[11] See Coffee, above note 7.

accept, as Galbraith has suggested, that the corporate form is out of control?[12]

Emerging practice from the United States suggests that the deployment of negotiated prosecutions within the financial services sector provides the basis for much more effective control.[13] Their effectiveness is predicated on the *threat* rather than *application* of criminal sanction to institutionalize the wider inculcation of operating and ethical norms.[14] In exchange for a decision to defer criminal or civil prosecution or sentencing, the corporation admits wrongdoing, agrees to a narrative provided by prosecutors, provides evidence to secure convictions against identified executives, makes traditional financial restitution and, crucially, in most cases agrees to significant governance reforms.[15]

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[12] See J. Galbraith, *The Economics of Innocent Fraud: Truth For Our Time*, Houghton Mifflin, Boston, 2004. The fraud identified by Galbraith includes the very appellation 'market system' (pp. 15–21).

[13] *Corporate Crime Reporter*, 'Crime Without Conviction: The Rise of Deferred and Non-Prosecution Agreements,' Washington DC, 28 December 2005 (http://www.corporatecrimereporter.com/deferredreport.htm). The report suggests their expansion 'undermines the general deterrent and adverse publicity impact that results from corporate crime prosecutions and convictions' (at 3). For a contrasting perspective, see B. Greenblum, 'What Happens to a Prosecution Deferred? Judicial Oversight of Corporate Deferred Prosecution Agreements' (2005) 105 *Columbia Law Review* 1863.

[14] The measure fits within the accountability model pioneered by Fisse and Braithwaite: 'Corporations have the capacity but not the will to deliver clearly defined accountability for law-breaking; courts of law, obversely, may have the will but not the capacity. Hence, the solution may lie in bringing together the capacity of the firm's private justice system – to identify who was truly responsible – with the will of the public justice system to demand accountability that is just rather than expedient.' See B. Fisse and J. Braithwaite, above note 1, p. 15. It also meshes with earlier calls in the United States for law to formally alter lines of authority within private firms and ensure the continual disclosure of how decisions are made, see C. Stone, *Where The Law Ends: The Social Control of Business*, Harper & Row, New York, 1975, pp. 217–227.

[15] These were all facets of the 'accountability model', see B. Fisse and J. Braithwaite, above note 1, pp. 138–154.The requirement not to contradict the narrative provided by the prosecuting authority reframes ownership but not the concept of proposals canvassed by Professor John Coffee in 1981, see Coffee, above note 7, p. 431.

In the United States in particular, more than forty of these agreements have been brokered. The expansion of their use has generated a number of innovative forms of 'punitive probation'. Of particular interest to the academic is the occasional forcible endowment of business ethics chairs or wider education initiatives. It has also generated a multiplicity of variation. There does not appear to be any underpinning rationale in terms of application. When deployed against individuals, the pre-trial diversion mechanism is subject to substantial court precedent.[16] In contrast, within the corporate community no restrictions have been formalized, leaving significant discretion in the hands of regulators.

From a regulatory perspective, the negotiated prosecution offers a range of advantages for controlling the corporate form. First, individual executives are made amenable to the courts. This serves the public policy imperative of individual legal accountability. Second, the corporation is forced to ensure that control deficiencies highlighted by the investigation are addressed adequately. Third, the regulatory authority is given explicit operational veto over implementation. This is achieved by the requirement that the corporation accepts ongoing (but time-limited) external monitoring and adjudication of effectiveness.[17] Fourth, by committing to the process, the corporation is shielded from uncertainty and ongoing negative publicity, and the courts from congestion. Fifth, through the demonstration effect, the pre-trial diversion triggers a dynamic nonprescriptive process that has the potential to advance ethical acculturation.

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[16] For detailed examination of the constitutionality of the measure and court cases limiting its use against individuals in the United States, see D. Landis, 'Pre-Trial Diversion' (2005) 4 *American Law Reports 4th* 147.

[17] See C. Stone, above note 4. For Stone, 'to the executive and his business community peer group, losing a law suit does not involve the same loss of face as does a new model that does not sell' (p. 73). He suggests instead 'selective intrusion' (p. 75) into enabling frameworks to require meaningful disclosure.

Despite these strategic advantages, the deployment raises a series of interconnected questions over the limits of regulatory authority.[18] Does the mechanism enhance levels of compliance or subvert democratic accountability?[19] How can the rights of the corporation be protected from the twin threats of executive malfeasance and misfeasance and prosecutorial ambition?[20] The emphasis on

[18] For a trenchant critique by the attorney credited with its first application in the United States, see 'Interview with Mary Jo White', 19 *Corporate Crime Reporter* 48 (11) 12 December 2005. 'Prosecutors need to exercise their discretion wisely and with restraint and not have their power go to their head.' White was responsible for negotiating a deferred prosecution with Prudential Securities in 1994. The background to the case can be found in K. Eichenwald, *Serpent on the Rock*, Broadway Books, New York, 2005.

[19] This, in turn, feeds but further bifurcates the debate on the relative merits and limits to the capacity of coercion, negotiation and punishment in securing meaningful compliance. For the benefits of negotiation from a regulatory approach, see the classic K. Hawkins, *Environment and Enforcement*, Clarendon Press, Oxford, 1984; see also C. Hood, H. Rothstein and R. Baldwin, *The Government of Risk*, Oxford University Press, Oxford, 2001; on the benefits of enrolment, see J. Black, 'Enrolling Actors in Regulatory Systems, Examples from UK Financial Services Regulation' (2003) *Public Law* 63. The criticism of Justice Neville Owen of the enforcement priorities of ASIC and APRA prior to the collapse of HIH suggests the need for a prudential mix of measures: 'Consultation, inquiry and constructive dialogue should be balanced by firmness in its requirements and a preparedness to enforce compliance with applicable standards,' see HIH Royal Commission, *The Failure of HIH*, Commonwealth of Australia, Canberra, 2003, Recommendation 26. For the implications of the report on enforcement priorities, see J. du Plessis, 'Reverberations After the HIH and Other Recent Australian Corporate Collapses: The Case of ASIC' (2003) 15 *Australian Journal of Corporate Law* 225.

[20] J. Baker, 'Reforming Corporations Through Threats of Federal Prosecution' (2004) 89 *Cornell Law Review* 310. The measure has also been applied with considerable success and with similar criticism in the context of Australian competition law, see K. Yeung, above note 1, pp. 191–214. As Yeung points out, there is no legislative basis for the ACCC to seek to set financial penalties. While the ACCC now has the capacity to utilize criminal law, its prosecutorial role remains limited. The Department of Public Prosecutions retains the sole right to take criminal cases. Even in civil cases, the ACCC is limited to the role of plaintiff to the court for recovery in response to a judicially determined breach (p. 106). For the current position, which recognizes the 'challenges' deriving from the

cooperation can mask disproportionate prosecutorial leverage. This advantage extends throughout the process, particularly in the United States, where the prosecutorial agency investigates potential crime (with the complicity of the corporation) but also adjudicates on guilt and determines the penalty without reference to culpability scoring under the US Sentencing Commission Guidelines. In addition, as noted above, the lack of clarity on the limits of application generates excessive discretion. The agency retains the right to determine whether to offer deferral and is not obligated to disclose the rationale for refusal. It can also scope the extent of internal change required and mandate the degree of subsequent external oversight. Furthermore, in many of the agreements, the prosecuting authority alone determines whether a breach has taken place. The US Department of Justice accepts this is the mechanism's most useful attribute: 'We also retain enormous leverage over the company, because we reserve the right to prosecute if it fails to comply with the agreement – again, armed with the company's admissions. And we can still include virtually any combination of payments and remedial measures.'[21]

Crucially, the entire negotiation takes place outside the formal juridical arena. The expectation by the Department of Justice in Washington that corporations should waive client–attorney privilege and work-product protection to demonstrate cooperation

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introduction of corporate criminal liability for breaches of the Trade Practices Act but also states that an increase in the litigation budget was 'carefully calculated' to enhance the agency's flexibility to prosecute 'even marginal cases', see G. Samuel, 'The Enforcement Priorities of the ACCC' (2005) 21 ACCC *eJournal* 1, at 2–3 (http://www.accc.gov.au/content/index.phtml/itemId/714138/fromItemId/8973). On how this shift contrasts with earlier aversion to use of legal measures to induce compliance, see P. Grabosky and J. Braithwaite, *Of Manners Gentle, Enforcement Strategies of Australian Business Regulatory Agencies*, Oxford University Press, Melbourne, 1985.

[21] C. Wray, 'Remarks to the American Bar Association White Collar Crime Luncheon Club', Washington DC, 25 February 2005 (http://www.usdoj.gov/criminal/press_room/speeches/2005_3853_rmrkCrimLuncheon030205.pdf).

is jurisprudentially and constitutionally problematic.[22] Critics suggest that it may amount to an extrajudicial contract that serves to foster 'a climate of suspicion' within the organization and between it and its counsel.[23] Others suggest it reinforces the emergence of an inquisitorial prosecutorial system lacking countervailing and necessary checks and balances.[24] In addition, there are concerns about the corrosive impact of 'reverse whistleblowing' on requisite levels of trust required for organizational development.[25] While the negotiated prosecution enhances capacity, therefore, it also threatens (if misapplied) to institutionalize a discriminatory mechanism that undermines due process.

This chapter tracks the development of the mechanism in the United States, where its application has been most enthusiastically embraced. The exposition elucidates the ubiquity of the practices under investigation. Second, it assesses the jurisprudential implications. Third, it evaluates how the introduction of sanctions not explicitly mandated by either the legal framework or industry-driven principles impact on corporate governance reform. The chapter concludes that in order to avoid enhanced authority leading to a reduction in legitimacy, it is essential to delineate the range of negotiated prosecution. I argue this is best achieved through the articulation of much clearer guidelines governing how and when each variant should be deployed. Such a refinement is necessary if the

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[22] Ibid, 'Waiving the privilege is *not* a requirement or a litmus test for cooperation. But it *is* a very valuable and helpful action that goes a long way toward persuading us that a company's cooperation is authentic (emphasis in original).'

[23] B. Greenblum, above note 13 at 1865, 1881. For the 'informally' contractual nature of regulatory enforcement more generally, see J. Freeman, 'The Contracting State' (2000) 28 *Florida State University Review* 155, at 191.

[24] G. Szott Moohr, 'Prosecutorial Power in an Adversarial System: Lessons From Current White Collar Cases' (2004) 8 *Buffalo Criminal Law Review* 165, at 167.

[25] See W. Laufer, 'Corporate Prosecution, Cooperation and the Trading of Favours' (2002) 87 *Iowa Law Review* 643; for discussion on the changed role of external counsel, see A. Longstreth, 'Double Agent', *American Lawyer*, 1 February 2005 (online edition).

integrity of the wider legal system is to be protected. This must be accompanied by the introduction of formal legal oversight at a much earlier stage in proceedings. In its absence, the risk is that the public policy cycle will shift inexorably. Allegations of business scandal will be replaced by the scandal of regulatory overreach, thereby destroying the efficacy of creative enforcement.

The Impact of Sarbanes–Oxley on Criminal Deterrence

Despite wide-ranging capacity to impute criminal corporate liability, enforcement coherence has traditionally been particularly problematic in the United States.[26] Multiple institutional actors operate with competing policy objectives and variable degrees of political freedom. The conceptual and practical difficulties associated with financial reporting cases gave dominance to a single division of the Department of Justice – the Southern District, New York – which concentrated primarily on episodic and (increasingly ineffective) monetary fines as the key driver of success.[27] The collapse of Enron and other major corporations changed the cost–benefit calculus throughout the enforcement firmament. This was particularly apparent within the Department of Justice, which was given the remit to establish

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[26] The defining case is *New York Central & Hudson River Railroad Co v. United States* (1909) 212 US 481. It introduced the concept of criminal vicarious liability by imputing to the employers actions committed by the employee (p. 494). This was justified on public policy grounds because otherwise there could be no possibility of holding the corporation accountable. The logic was extended to situations when the employee explicitly disregarded policy, see *United States v. Hilton Hotels* (1972) 467 F.2nd 9th Circuit 1000; on attempts to ingratiate with management to gain promotion, see *United States v. Automated Medical Laboratories* (1985) 770 F. 2nd 4th 399.

[27] The key driving force of the accountability agenda in the 1990s was predicated on the failure to hold individual executives accountable and the propensity to settle rather than prosecute corporate cases through the courts, see B. Fisse and J. Braithwaite, above note 1.

a Corporate Crime Task Force.[28] In large measure this refocusing on corporate enforcement can be traced to the criminalization imperatives of the legislative response to the financial reporting scandals.

Academic focus on the Public Company Accounting Reform and Investor Protection Act (Sarbanes–Oxley) and its global impact has centred primarily on whether the financial reporting provisions will necessarily result in increased performance. A secondary lens contrasts the relative benefits of adopting the alternative facilitative 'comply or explain' approach advanced by the United Kingdom and other common law jurisdictions as well as the European Union and the OECD.[29] The strategic refocusing of enforcement capacity, however, is of even more importance.[30]

Chief Executives and Chief Financial Officers are mandated to attest to the truthfulness of corporate accounts in order to minimize any future defence based on ignorance.[31] Penalties for failure to certify are increased to US $5 million and up to twenty years' imprisonment. Engaging in a scheme that fraudulently misrepresents material facts to the marketplace is now punishable with a prison term of up to twenty-five years.[32] The penalty for obstruction, including, but not limited to, document shredding, is increased to twenty years.[33] There

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[28] G. Szott Moohr, above note 24 at 189.

[29] D. Kershaw 'Evading Enron: Taking Principles Too Seriously in Accounting Regulation' (2005) 68 *Modern Law Review* 594. For an international perspective, see J. O'Brien (Ed.) *Governing the Corporation, Regulation and Corporate Governance in an Age of Scandal and Global Markets*, John Wiley & Sons, Ltd, Chichester, 2005.

[30] A similar imperative is evident in Australia, where the expansion of corporate criminal liability for breaches of the Trade Practices Act and introduction of immunity has significantly enhanced the power of the ACCC. Other regulatory bodies have been seeking to mirror this increased muscularity. The shift in enforcement dynamics formed the central theme of an Australasian Compliance Institute Conference, 'Protecting the Public: The Regulator's Toolkit', Grand Hyatt Hotel, Melbourne, 26–27 April 2005.

[31] US Public Law 107–204, s. 302; s. 906.

[32] Ibid, s. 807.

[33] Ibid, s. 802; s. 1102.

is recognition that management may pressurize the auditor. It becomes a federal offence for a director or other officer of the corporation to attempt fraudulently to influence, coerce, manipulate or mislead any accountant involved in the audit.[34] The expansion of tariffs reconfigures the interest of the Department of Justice in the policing of the corporation. It now has the capacity to endorse – or override – the enforcement priorities of the Securities and Exchange Commission. Increased capacity within the deterrence model, however, does not necessarily enhance effectiveness or cohesiveness unless accompanied by criminal appellation and sustained application.[35]

In the aftermath of Enron, prosecuting high profile cases not only generated headlines. The public unease at accusations of systematic misfeasance also provided prosecutors with the opportunity to display ingenuity in carving out what amounts to new crimes.[36] The complexity and cost of mounting prosecutions is no longer a deterrent. The custodial enhancement impacts decisively on prosecutorial calculations of efficacy.[37] The renaming of the Enron Task Force as the Corporate Crime Task Force formalizes the transition from a piecemeal reactive approach to one that contains a significant prophylactic component.[38] The prosecution of individual

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[34] Ibid, s. 303.

[35] For a critical review, see A. Ogus, *Regulation: Legal Form and Economic Theory*, Second edition, Hart Publishing, Oxford, 2004, pp. 79–98; on the instrumental value of characterizing regulatory infractions as criminal, see C. Wells, *Corporations and Criminal Responsibility*, Second edition, Oxford University Press, Oxford, 2001.

[36] This was particularly apparent in the prosecution of Martha Stewart, who was accused of securities fraud because she defended herself against accusations (which did not appear in the indictment) of insider trading, see J. Hasnas, 'The Politics of Crime: Ethics and the Problems of White Collar Crime' (2005) 54 *American University Law Review* 579, at 605.

[37] For institutional prosecutorial imperatives, see R. Hollander-Blumoff, 'Getting To Guilty: Plea Bargaining as Negotiation' (1997) 2 *Harvard Negotiation Law Review* 115, at 134.

[38] For a review suggesting that a systematic approach to securities fraud has been adopted, see K. Brickley, 'Enron's Legacy' (2004) 8 *Buffalo Criminal Law Review* 221, at 275.

executives in the Enron case itself, however, also highlighted the limitations of focusing on individuals when dealing with systemic problems.[39]

Tackling Corporate Recidivism Through the Demonstration Effect

The scale of the Enron and WorldCom bankruptcies meant that declination was no longer politically viable. Public policy imperatives now emanating from the primary enforcement agencies, as well as policy entrepreneurs such as Eliot Spitzer, the New York State Attorney General, have generated an uneasy but productive coalescence of purpose.[40] Each has decreed that effective market policing requires the development of mechanisms to provide public legal standing to private norms. An enforced iteration of the compliance function was identified as the best option to achieve this goal. Despite its early promise, compliance had become a largely symbolic window dressing exercise, devoid of real power, particularly within investment banking, where governance proved emasculatory in both theory and practice.[41]

In order to send a clear message to the corporate community, the United States Deputy Attorney General, Larry Thompson, suggested it had become a public policy imperative to charge the corporation itself for demonstration effect. According to Thompson, given 'the

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[39] See Chapter 1.

[40] J. Macey, 'Wall Street in Turmoil: State–Federal Relations Post-Eliot Spitzer' (2005) 70 *Brooklyn Law Review* 117. This reversal challenges the ideational power of an emergent legal paradigm, see O Lobel, 'The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought (2004) 89 *Minnesta Law Review* 262.

[41] For compliance as symbolic, see L. Edelman, S. Chambliss and H. Erlanger, 'Legal Ambiguity and the Politics of Symbolism' (1991) 13 *Law and Policy* 73; Edelman *et al.* derive theoretical underpinnings from the classic M. Edelman, 'Symbols and Political Quiescence' (1960) 54 *American Political Science Review* 695.

substantial risk of great public harm' caused by financial fraud 'there may be, therefore a substantial federal interest in charging the corporation.'[42] The publication of the Thompson Memo provided the impetus and broad authorization to consider charging, deferring or offering a non-prosecution deal with conditions.

The Memo explicitly states that the adoption of an exceptionally broad definition of corporate criminal liability 'often provides a unique opportunity for deterrence on a massive scale.' Nine specific factors are entered into the prosecutorial calculus:

> 'The nature and seriousness of the offence; the pervasiveness of wrongdoing within the corporation, including the complicity in, or condonation of, the wrongdoing by corporate management; the corporation's history of similar conduct, including prior criminal, civil and regulatory enforcement actions against it; the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney–client and work product protection; the existence and adequacy of the corporation's compliance program; the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution and to cooperate with the relevant government agencies; collateral consequences; the adequacy of the prosecution of individuals responsible for the corporation's malfeasance; and the adequacy of remedies such as civil or regulatory enforcement actions.'

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[42] L. Thompson, *Principles of Federal Prosecution of Business Organizations*, Department of Justice, Washington DC, 20 January 2003 (http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm). For an analysis see C. Couden, 'The Thompson Memorandum: A Revised Solution or Just a Problem?' (2005) 30 *Iowa Journal of Corporation Law* 405. Couden, however, suggests that if the US Department of Justice is to use the additional power, deferral is preferable to actual deployment (at 423). The Memorandum should be read in conjunction with the revised US Sentencing Commission Guidelines, see *United States Federal Sentencing Guidelines* 2004, Chapter Eight, 'Sentencing of Organizations'. (http://www.ussc.gov/2004guid/tabconchapt8.htm). In a recent ruling, the United States Supreme Court held that the guidelines are not mandatory, see *United States v. Booker* (2005) 125 Supreme Court 738, at 746.

The muscular approach adopted by the US Securities and Exchange Commission was facilitated by this transition. Its former Director of Enforcement, Steve Cutler, was a driving force in scoping prosecutions for wider demonstration effect. For Cutler, effective deterrence requires both punitive fines and the capacity to engineer wider cultural change through court appearance.[43]

> 'We bring 600 cases a year. One of our objectives has to be to make those cases relevant to a much larger community. One of the ways in which you can do that is by setting forth a template, and I think that is a perfectly rational law enforcement response to misconduct. No police force is going to catch every crime but what you want to do is to create an environment where it is less likely that people will commit crimes.'[44]

The debacle surrounding the implosion of Arthur Andersen graphically illustrated the collateral consequences of adopting such a policy.[45] Cognizance of job losses in the already disadvantaged southern region, for example, was central to the criminal litigation management by prosecutors of HealthSouth, the first financial

[43] Cutler was appointed to the post in October 2001.

[44] Interview, Washington DC, 10 May 2005. This builds on guidance released by the SEC in 2001 on criteria to be used when deciding whether to charge a corporation. The guidance explicitly refers to the need to combat 'a tone of lawlessness set by those in control of the company' and the degree to which compliance programmes either existed or were capable of minimizing errant behaviour, see *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, 23 October (http://www.sec.gov/litigation/investreport/34-44969.htm). The ACCC in Australia adopts a broadly similar rationale, see Samuel, above note 20 at 8–9. In addition, the ACCC determines whether the conduct under investigation is 'industry wide or is likely to become industry wide'.

[45] R. Bartley, 'Andersen: A Pyrrhic Victory?' *Wall Street Journal*, 24 June 2002, p. A17.

reporting case taken since the passage of Sarbanes–Oxley.[46] Plea agreements with senior executives demonstrated, as with Enron, systematic corporate complicity in earnings manipulation.[47] The Department of Justice was concerned that a corporate criminal conviction would leave it in control over (and responsible for) what one senior manager referred to as 'a busted flush'.[48] If competing public policy priorities invalidated prosecuting a mid-sized industrial conglomerate, it was inconceivable that the demonstration effect principle could be extended to financial intermediaries. Given the potential reputational damage to the wider integrity of US capital markets, such an extension was politically impossible.[49] Likewise, despite collecting record amounts in fines, the SEC Enforcement Division has found its punitive appetite come under attack from the media and from the Commission itself.[50] Intermediate steps were

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[46] The strategy of using coerced witnesses was similar to that in the Lay trial. The Chief Executive Officer, Richard Scrushy, was acquitted on 28 June 2005. As Fastow was giving evidence, Scrushy made a surprise appearance at the Houston court, where he opined that the Task Force had cooperating witnesses 'under the thumb'. He suggested that Lay was a good man betrayed by Fastow, who, because of his criminality, was not a credible witness, see G. Farrell, 'Ex-HealthSouth CEO Scrushy Drops In', *USA Today*, 9 March 2006 (online edition).

[47] Under the US Sentencing Guidelines, there was clearly a case to answer in both instances. 'Pervasiveness [is] case specific and [will] depend on the number, and degree of responsibility, of individuals [with] substantial authority . . . who participated in, condoned, or were willfully ignorant of the offense. Fewer individuals need to be involved for a finding of pervasiveness if those individuals exercised a relatively high degree of authority', see US Sentencing Guidelines §8C2.5, comment. (note 4).

[48] J. O'Brien, above note 6, p. 283.

[49] Much scholarly and commercial output tends to concentrate on problems within the firm rather than wider systemic issues. The complicity of financial intermediaries is subject to considerably less analysis. For exceptions, see R. Lowenstein, *Origins of the Crash*, The Penguin Press, New York, 2004; N. Prins, *Other People's Money*, The Free Press, New York, 2004.

[50] For an account of a battle of moral wills involving the SEC and a lay Mormon preacher, see J. Anderson, 'A CEO Who Wouldn't Say I Settle',

therefore required to stave off formal appearance in court or reliance on increasingly ineffective fines.

The first was to reformulate corporate governance as the manifestation of corporate conscience.[51] While the introduction of conscience into an inanimate object adds a further level of conceptual confusion, it does offer practical opportunities to widen the scope and rationale of corporate governance beyond the maximization of shareholder value.[52] Within this construct, enhanced individual levels of corporate surveillance can deliver firm-specific and wider market reputational performance. The SEC now conducts compliance examinations with an explicit focus on corporate culture. It is presented as an attempt to help identify control weaknesses rather than acting as a precursor to enforcement action. It is also based on a changed conception of regulatory function. Self-policing is regarded as acceptable only if there is demonstrable evidence that the corporation has disclosed promptly, taken remedial action (by sacking errant executives) and cooperated with law enforcement officials.[53] A

New York Times, 19 March 2006 (online edition); for internal criticism within the SEC of its appetite for headline grabbing fines, see P. Atkins, 'Charles Hamilton Houston Lecture', George Washington University, 4 April 2005 (http://www.sec.gov/news/speech/spch040405psa.htm). According to Cutler, 'At the end of the day the division of Enforcement has a client, the Commission, and the client consists of five votes and so if there are three Commissioners saying that is the direction to go, then that is the direction that the Division will take.' Interview, Washington DC, 10 May 2005.

[51] See C. Glassman, 'Remarks at the Darden Distinguished Speaker Series,' University of Virginia, Charlottesville, 26 March 2003. Full text online at: http://www.sec.gov/news/speech/spch032603cag.htm.

[52] See T. Gabaldon, 'The Story of Pinocchio: Now I'm a Real Boy' (2004) 45 *Boston College Law Review* 827, at 843. Gabaldon suggests the need for a specific Board committee to assess levels of compliance with internal and external codes of practice. The playful use of the Pinocchio metaphor and the equation of an holistic risk management committee as 'a corporate Jiminy Cricket' should not detract from the proposal's value. In the fairytale, it will be recalled that Jiminy does not have the capacity alone to force behavioural change; it requires external oversight from the omniscient, if benign, Blue Fairy.

[53] For a detailed account, see M. Gadziala, 'Rebuilding Ethics and Compliance in the Securities Industry,' NYSE Regulation First Annual Securities Conference, New York,

similar dynamic informs the inspection regimen over the accountancy profession in the United States established by the Public Company Accounting Oversight Board.[54] Inspections routinely ascertain the extent to which adherence to corporate and professional codes of ethics inform individual audits.

In certain key respects, this represents the practical application and refinement of 'enforced self-regulation.[55] Tracing its origins to transactional economics, 'enforced self-regulation is [deployed] as a form of sub-contracting regulatory functions to private actors [because] in particular contexts it will be more efficacious for the regulated firms to take on some or all of the legislative, executive and judicial regulatory functions.'[56] The model differs dramatically from deregulation or coregulation in that 'an important part of making [enforced] self-regulation effective is to embed self-regulation in schemes of escalating interventions.'[57] This requires significant sanction threats, which are capable of delivery through an 'enforcement pyramid'.[58] According to the model, effective regulation begins with persuasion and extends to licence revocation. It is predicated on the need to compel individual corporations to 'write a set of rules tailored to the unique set of contingencies facing that firm.'[59] The regulatory agency reserves the right to withhold endorsement. By using statutory regulatory defaults as the baseline

23 June 2005 (http://www.sec.gov/news/speech/spch062305mag.htm). This creates a powerful dynamic towards transcending compliance when combined with the threat of criminal proceedings from the Department of Justice. See C. Wray, above note 21.

[54] See W. McDonough, 'Accountability in an Age of Global Markets', in J. O'Brien, above note 29, p. 65. The most controversial section of Sarbanes–Oxley rests on the quality of internal controls regarding effective risk management (Section 404). When read in conjunction with the requirement that all publicly listed corporations have an ethics programme (Section 607), effective internal controls can be construed as ensuring that all transactions explicitly comply with the code.

[55] I. Ayres and J. Braithwaite, *Responsive Regulation, Transcending the Deregulation Debate*, Oxford University Press, Oxford, 1992.

[56] Ibid, p. 103.

[57] Ibid, p. 103.

[58] Ibid, p. 35.

[59] Ibid, p. 106.

for minimum acceptable standards, corporations are empowered to develop particular control mechanisms most appropriate to their particular circumstances.

To be effective, what is required is 'governmentally monitored internal enforcement of internally written rules.'[60] The political debate on regulation transcended the framework suggested by Ayres and Braithwaite precisely because the global emphasis on market control concentrated attention at the lowest slopes of the pyramid. Its failure now opens the opportunity for fundamental reappraisal. The emphasis on verifiable internal control mechanisms mandated by Sarbanes–Oxley enhances the efficacy of enforced self-regulation. Some critics have argued this serves merely to facilitate the emergence of a surveillance state.[61] Nonetheless, the information-gathering capacity also provides the basis through which corporations and their advisors can be held accountable. It also legitimizes the most effective and most controversial mechanism introduced: the negotiated prosecution against the corporate form itself. For both regulator and regulated, rationale and application have the potential to transcend the pitfalls of slavish implementation of legal instruments.[62] This reformulation has profound consequences for the internal governance of corporations. It also undermines the enabling framework of state-based company law in favour of more rigorous societal controls over the corporate form. In return for the benefits of incorporation, entities are required to do more than obey legal rules, but also instil corporate virtue.[63] One

[60] Ibid, p. 118.

[61] See L. Cata Backer, 'Corporate Surveillance After Sarbanes–Oxley' (2005) 26 *Company Lawyer* 3.

[62] For a practitioner perspective, see T. Mirvis, J. Savarese and C. Miller, 'The New Regulatory and Enforcement Environment' (2005) 10 *Securities Reporter* 3, at 9.

[63] This centres on acculturation imperatives, see A. McIntyre, *After Virtue*, University of Indiana Press, Notre Dame, 1984. Institutional investors have been recruited as deputy enforcement agents within this rubric, particularly state pension funds, such as CALPERS and its New York counterpart, see W. Greider, 'The New Colossus', *The Nation*, 28 February 2005, p. 13.

consequence, however, is the introduction of nebulous, and therefore contestable, normative requirements.

Called to Account: The KPMG Settlement

The increased muscularity of the enforcement regime in the United States has been most apparent in the investigation and prosecution of KPMG over the sale of abusive tax shelters. Marketed as investment strategies, the shelters involved systematic collusion between KPMG, its legal advisors and two investment banks, HVB and Deutsche Bank.[64] The accountancy and tax consultancy firm had initially mounted a robust defence of its actions when the Internal Revenue Service began investigating in 2000. KPMG declared that none of the more than 500 products offered in its tax-mitigation portfolio constituted a shelter. It cast dispersions on the credibility of an internal whistleblower and cited privilege to justify its refusal to provide the IRS with the documentation necessary to adjudicate on the status of the products.

The confluence of endogenous and exogenous factors conspired to gradually transfer the balance of power to the prosecutors, who, in return for deferral, forced KPMG to acquiesce in its own defenestration.[65] The negative publicity associated with congressional investigation, an exponential increase in liability arising from a legal morass involving the IRS, and investors who sued KPMG for fraudulent negligence after negative tax investigations left the partnership exposed. To demonstrate compliance with the law – and

[64] For full details of the shelters and their operation, see US Senate Permanent Subcommittee On Investigations, Committee on Governmental Affairs 'U.S. Tax Shelter Industry: The Role Of Accountants, Lawyers, and Financial Professionals', 108-34 (November 18, 2003), p. 5. See also the Statement of Facts eventually accepted by KPMG as part of a deferred prosecution deal signed on 28 August 2005 (http://www.usdoj.gov/usao/nys/Press%20Releases/August%2005/KPMG%20Statement%20of%20Facts.pdf).

[65] L. Cohen, 'Prosecutors' New Tactics Turn Companies Against Employees', *Wall Street Journal*, 4 June 2004.

the requisite degree of remorse to satisfy the Southern District of the Department of Justice – KPMG changed its senior leadership and provided evidentiary support (on the advice of newly retained corporate lawyers) to buttress the prosecutorial case. It progressively distanced itself from the partners implicated. Although the shelters were designed and executed with explicit corporate sanction, a financial cap was placed on the funding of individual defence representation. In addition, the KPMG partnership predicated defence cost subvention on continued individual cooperation with the external investigation.[66] The directive came into force even if withdrawal was on the direct advice of legal counsel that continuation was contrary to Fifth Amendment protection against self-incrimination.[67]

The personal jeopardy was increased through three further interlocking developments. KPMG formally ended joint-defence strategies; extenuated the risk of criminal and civil liability in subsequent class action lawsuits by waiving client–attorney privilege and work-product document protection; and demonstrated its proto-enforcement role by alerting the Department of Justice of specific document requests made by the legal representatives of those partners to whom it denied the corporate defence umbrella protection. The casting adrift of those who enriched KPMG underscores, as never before, the vagaries of working in corporate America in the new era of enforcement.[68]

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[66] As such the partnership broke standard operating procedure. This formed a critical component in a civil action taken by the executives against the partnership for breaching an 'implicit contract', see P. Davies, 'KPMG Employees Sue for Fees', *Wall Street Journal*, 13 July 2006, p. C5. For text of complaint, see *Jeffrey Stein et al v. KPMG* (2005). Full text available at http://online.wsj.com/public/resources/documents/Complaint-kpmg-20060712.pdf

[67] It also prompted a scathing rebuke from a federal court judge who ruled that the Department of Justice had acted 'unconstitutionally' by 'putting a proverbial gun to [KPMG's] head', see L. Cohen and P. Davies, 'Court Says Prosecutors Pressure White-Collar Defendants Unfairly', *Wall Street Journal*, 28 June 2006, p. A1.

[68] A total of nineteen people associated with the transactions orchestrated by KPMG have now been charged in what the Department of Justice describes as 'the largest

The extent to which KPMG found itself outmanoeuvred was made manifest by a plaintive statement released in June 2005 just as details of negotiations with the Department of Justice leaked to the media: 'KPMG looks forward to a resolution that recognizes the significant reforms the firm has already made in response to this matter while appropriately sanctioning the firm for this wrongdoing.'[69] This involved placing staff on administrative leave and sacking those under most sustained examination before due process had been completed. Even more remarkable was the fact that the admission of wrongdoing was secured against activity, which has not been explicitly proscribed or

criminal tax case ever filed,' see Press Release, 'Superseding Indictment Filed in KPMG Criminal Tax Fraud Case', Department of Justice, Washington DC, 25 October 2005. Among those indicted are Jeffrey Stein, former Deputy Chairman of KPMG; John Lanning, former Vice Chairman of KPMG in charge of Tax; Richard Smith, former Vice Chairman of KPMG in charge of Tax; Jeffrey Eischeid, former head of KPMG's Innovative Strategies Group and its Personal Financial Planning Group; Philip Wiesner, former Partner-In-Charge of KPMG's Washington National Tax Office; John Larson, a former KPMG senior tax manager; Robert Pfaff, a former KPMG tax partner; Raymond J. Ruble, a former tax partner in the New York office of Sidley Austin, Brown and Wood; and Mark Watson, a former KPMG tax partner in its Washington National Tax Office. According to US Attorney, Michael Garcia, 'this was an orchestrated case of deliberate tax evasion, and not legitimate tax planning. Professionals – including lawyers, accountants, bankers, so-called investment advisors and their firms, as well as taxpayers – are all on notice that they will not succeed in what has been nothing less than highway robbery on the tax system.' The defendants filed several motions to dismiss in January 2006. Among the grounds were 'prosecutorial misconduct' in withholding material information on what constitutes economic substance defence from the Grand Jury, see L. Browning, 'Defendants File a Flurry of Motions Challenging the KPMG Tax Shelter Case', *New York Times*, 13 January 2006, p. C1. Eischeid's lawyer claimed 'each of the strategies was repeatedly approved by KPMG after an exhaustive vetting process, and the company's approval of the strategies was communicated widely within KPMG.' This was central to the government's own case, see 'Statement of Facts', above note 64, p. 5.

[69] A. Crenshaw and C. Johnson, 'Regretful KPMG Asks for a Break', *Washington Post*, 17 June 2005, p. D1; see also L. Browning, 'KPMG Says Tax Shelters Involved Wrongdoing' *New York Times*, 17 June 2005. The statement was prompted by a well-sourced article the previous day, which highlighted possible criminal prosecution, see J. Wielke, 'KPMG Faces Indictment Risk on Tax Shelters', *Wall Street Journal*, 16 June 2005, p. A1.

formally adjudicated to have crossed the line separating misfeasance from malfeasance.[70] While the eventual deferred prosecution agreement, signed on 28 August 2005 ensured its ultimate survival, the extent of governmental interference into the KPMG board and executive structure extend dramatically the template governing state reach over private corporate entities. Unlike previous pre-trial agreements, such as the Merrill Lynch agreement in 2003, which centred on one discrete operation, the DPA involving KPMG implicates (and therefore emasculates) the business direction of the entire partnership.[71] Reviewing the DPA, one senior litigator suggested the white-collar bar had been reduced to 'negotiating from a position of extreme vulnerability for leniency from a powerful, largely unaccountable, government adversary.'[72] Conversely, the threat of criminal sanction was demonstrably the pivot in forcing KPMG to back away from a sustained, somewhat cavalier, approach to its legal obligations, the intention of the legislature and the courts' capacity to adjudicate.[73]

The corrosive culture within KPMG can be traced directly to the subservience of legal and ethical considerations to the development of innovative tax product marketing. As KPMG eventually conceded, there was a failure to prevent 'improper and illegal conduct because of inherent weaknesses in the system of internal controls, and because those controls that were in place were overridden.'[74] This insouciance extended throughout the entire period in which the partnership

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[70] For how the changed enforcement dynamic extends the definition of fairness in a corporate governance persepctive, see M. Stateman, 'Fairness Outside the Cocoon' (2004) 60 *Financial Analysts Journal* 34, at 39.

[71] See http://www.usdoj.gov/usao/nys/Press%20Releases/August%2005/KPMG%20dp%20AGMT.pdf.

[72] See J. McPhee, 'Deferred Prosecution Agreements: Ray of Hope or Guilty Pleas By Another Name?' (2006) Winter *Inside Litigation* 1; on the ripple effect of the settlement, see S. Michel and K. Thorn, 'Deferred Prosecution Agreements: Implications for Corporate Tax Departments', *The Tax Executive*, January–February 2006, p. 52.

[73] On KPMG's complicity in its own downfall because of arrogance and evasion, see S. Reisinger, 'Mr Clean', *Corporate Counsel*, 1 November 2005 (online edition).

[74] Statement of Facts, above note 64, p. 1.

offered tax shelters. From the design and marketing of the products to the justification of their deployment when faced with congressional and regulatory investigations and court proceedings, managerial unease and legal advice was either ignored or tailored to deceive.[75] This self-belief was only punctured when the partnership realized that its adversary in the Southern District was prepared to press ahead with a criminal trial irrespective of the collateral consequences.

The explication of how KPMG was eventually humbled generates significant insights into the dynamics of the deferral process. It demonstrates graphically how the disclosure obligations of Sarbanes–Oxley and the increased power the legislation cedes to the Department of Justice have been harnessed to force compliance in a manner that the previous regulatory regime appeared powerless to counteract. Tracking the changes to KPMG's negotiating position also reveals the relative strength of specific driving forces and allows for a more considered evaluation of whether ethical restraint can be introduced within the context of a business operating paradigm that remains wedded to an instrumentalist view of the requirements of complying with the law.

The Route to Deferral

Throughout the 1990s, the development of tax products was recognized across the industry as a potential growth area. The booming information technology sector vastly augmented the pool of executives earning more than twenty million dollars per annum. They had a vested interest in minimizing the tax exposure associated

[75] Ibid, p. 6. Internal expert advice concluded that the transactions were at best frivolous and would not withstand legal scrutiny. Rather than discontinuing, the partnership took evasive action to 'conceal the transactions under the veil of sham attorney–client claims.' KPMG also wilfully ignored internal legal advice that failure to register a tax shelter amounted to criminal conduct (p. 6). See also S. Reisinger, 'Where Were the Lawyers?', *Corporate Counsel*, 1 November 2005 (online edition).

with their newly acquired wealth. The audit function provided the accountancy firms seeking to diversify into this lucrative market a perfect opportunity to gain direct and continuing access to executives. The transactions, which also required the sustained involvement of external counsel and investment banking, posed enormous internal ethical problems. They generated external conflicts of interest that were difficult to either justify or reconcile. KPMG audited each of the primary investment bankers used to generate 'turnkey packages', which served to compromise the integrity of the relationship. Furthermore, its recruitment of external counsel to generate standard opinion letters suggesting a legal basis for the tax products undermined the independence and, therefore, the credibility of the advice.[76] KPMG was among the first to take advantage of the synergies involved; it was also the most aggressive in defending its ground against attempts by the IRS to close down the operation.[77]

[76] A congressional investigation analysis of one product found that KPMG and its lawyers exchanged copies of drafts, eventually offering two allegedly independent opinion letters that contain numerous, virtually identical paragraphs', see US Senate Report, above note 64, p. 12.

[77] Of the major accountancy firms involved in aggressive tax product development, KPMG alone had held out against accusations that it had promoted potentially abusive shelters. Ernst & Young settled charges with a censure and a fine of $15 million. The Ernst & Young Vice Chairman, Mark Weinberger, made clear that the collateral costs of fighting the case were excessive, see D. Cay Johnston, 'Ernst & Young to Pay $15m in Tax Case', *New York Times*, 3 July 2003, p. C1. One week later the government upped the stakes by filing lawsuits against KPMG and another mid-sized firm, BDO Seidman, accusing them of failing to comply with requests for discovery. This prompted other accountancy firms to settle outstanding cases, see D. Cay Johnston, 'PriceWaterhouse and IRS Settle Tax Shelter Dispute' *New York Times*, 28 July 2002, p. C2. The case involved a product known as a Bond Option Sales Strategy, which was similar in substance to the KPMG portfolio. The amount of the settlement was described in the statement of fact as 'substantial', a description that PriceWaterhouse challenged on the basis of annual revenues in excess of $22.3billion. KPMG's decision to fight a protracted battle, therefore, was the first major miscalculation and made it an easy target for Congress.

The scale of the deception became clear with the appearance of a young lawyer at a Senate Finance Committee hearing in late 2003.[78] Mike Hamersley was an unlikely whistleblower. A high flying lawyer he had joined the Los Angeles Mergers and Acquisitions Tax Practice after a stint at the National Tax Center in Washington DC. Hamersley testified that a coercive and aggressive environment had been fostered in which the pursuit of profit trumped professional integrity. A year earlier, just after being nominated for elevation to partnership, Hamersley was placed on administrative leave after acknowledging to the partners that he had communicated his concern to federal investigators. It was particularly telling that the grounds for imposing disciplinary action centred on his alleged breach of a confidentiality agreement.[79] An increasingly acrimonious dispute provided significant traction for a burgeoning investigation that, by this stage, involved two separate congressional committees, the Internal Revenue Service and the Department of Justice.[80]

Hamersley told the Senate Finance Committee that he personally witnessed a host of abusive tax shelter practices in Los Angeles. The city was a key hub for KPMG as it pursued high-worth individuals with the requisite asset base to invest in complex tax-mitigation transactions.[81] He accused his former employers of not only tolerating the exploitation of loopholes but also distorting and concealing

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[78] See D. Cay Johnston, 'Wide Range of Tax Shelters Draws Senate Inquiry', *New York Times*, 22 October 2003, p. C1.

[79] Written Testimony of Michael Hamersley, Senate Finance Committee, Washington DC, 21 October 2003. Full text online at: http://finance.senate.gov/hearings/testimony/2003test/102103mhtest.pdf. Hamersley cautioned against optimism that others within KPMG would come forward. He suggested that Sarbanes–Oxley was an ineffective cloak against 'the use of confidentiality agreements, mandatory arbitration agreements, blackballing of whistleblowers, intimidation and legal maneuvers to stifle meritorious claims, sealing of court documents, and the like' (p. 8).

[80] Hamersley filed a suit alleging victimization for taking advantage of the whistleblowing protections afforded in Sarbanes–Oxley. The case was later settled out of court.

[81] Hamersley, above note 79.

material facts to ensure that both the individuals – and by extension the product – evaded IRS scrutiny.[82] According to Hamersley, these practices included 'abuse of privilege by using attorneys as conduits to facilitate fact concealment and providing false representations about business purpose.'[83]

Hamersley then threw down a gauntlet to both his employers and to Congress: 'A deliberate distortion of the tax law by a tax practitioner is surely unethical and unprofessional, but it rarely rises to the level of criminal behavior, and such intent is not easily proven. In contrast, a deliberate distortion of fact by a tax practitioner or taxpayer can often constitute criminal conduct. The promoters who engage in such behavior demonstrate an utter disrespect for the law, and those who make and enforce it.'[84] The importance of the testimony extended immediately beyond the congressional investigation. The accusation fed directly into a case taken by the IRS, which demanded that KPMG disclose information relating to its tax product portfolio. As an internal whistleblower, Hamersley was providing evidential support that one of the most important accounting and tax consultancy firms in the world was actively flouting the law.[85]

The public unravelling of the tax practices was further exposed by a report commissioned by Carl Levin, the ranking Democrat

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[82] Hamersley's evidence was confirmed by KPMG through the deferral agreement. Attorneys were routinely copied into email correspondence 'in an effort to conceal information contained in those communications and memoranda from the IRS and others'. See Statement of Facts, above note 64, p. 8.

[83] Hamersley, above note 79, p. 4.

[84] Ibid, p. 5.

[85] Hamersley is in no doubt of the value of the inside information in forcing KPMG's hand. 'It's nearly always impossible, certainly with a jury, to convict tax practitioners, because they have to understand tax; and then you have to prove what's inside their heads, and you're never going to do that', see J. Robins, 'Nick

on the influential Senate Permanent Committee on Investigations. The highly critical report focused on four discrete products, three of which had been declared by the IRS to be potentially abusive and which had already spawned a legal morass.[86] It demonstrated clearly the benefits accruing to KPMG and its partners. Significantly, it also provided compelling insights into how compliance had been corrupted.

The Bond Linked Premium Structure (BLIPS) alone was estimated to provide revenues of between \$59–80m, while the Offshore Portfolio Investment Strategy generated between \$28–50m, and a third product, the Foreign Leverage Investment Program, which emerged after KPMG decided to discontinue OPIS, generated

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or Cheat', *The Lawyer*, 3 October 2005, p. 23. According to Michael Halpert, who coordinated the investigation on behalf of the IRS, 'the information developed in this examination thus far leads me to conclude that KPMG is actively flaunting the statutes and regulation requiring transparency, organization and marketing of tax shelters', see Declaration by Michael Halpert in *United States v. KPMG* (8 July 2002) (http://files.findlaw.com/news.findlaw.com/hdocs/docs/irs/kpmg/petition/uskpmg12_31.pdf), p. 18. A review of the documentation by the judge found that, from a random sample, only 13.3% of the documents on which KPMG declared privilege were protected. He referred the matter to a Special Master who issued a final report to the court on 10 October 2003. That report formed the basis for a highly critical ruling the following May, at which stage KPMG had already begun to back away from an absolutist position.

[86] For the potential abusive nature of FLIP and OPIS, see IRS Notice 2001-45 (2001-33 IRB 129)(8/13/01); for BLIPS, see IRS Notice 2000-44 (2000-36 IRB 255)(9/5/00); for the IRS case against the partnership, see *USA v. KPMG* 02MS00295 (DDC 9 June 2002); for individual investors suing the promoter, for OPIS, see *Jacaboni v. KPMG* 6-02-CV-510 (MD Fla 9 April 2002); for FLIP and OPIS, see *Thorpe v. KPMG* 5-030CV-68 (ED NC 27 January 2003). The IRS estimated that FLIP and OPIS were marketed to 160 individuals. Its analysis was limited to 57 cases, which aggregated losses of \$1.4 billion from investments totalling \$114 million. The earlier BLIP aggregated \$1.28 billion in lost revenues, see Halpert, above note 83, p. 16.

$17m.[87] A fourth device known incongruously as the S-Corporation Charitable Contribution Strategy, generated between $26–30 m.[88]

Internal documents subpoenaed by the investigation demonstrated that the Tax Department calculated the cost of recidivism.[89] An email sent from the head of tax-development strategies to the Tax Practice partner argued against disclosure on purely pragmatic grounds. Intelligence provided by former IRS personnel now working in the development unit indicated that the risk of detection was negligible because of the agency's lack of willingness or capacity to enforce potential breaches. Second, the net cost of fines was insignificant in

[87] A BLIP transaction typically involved an individual borrowing money from an offshore bank to buy currency, which would then be sold back later to the same bank, generating a loss which could then be used to offset capital gains tax in the United States. It was generally structured and marketed as a seven-year investment programme, although was usually completed within 60 days. FLIP and OPIS involved a similar strategy but were linked to investment warrants rather than currency. For internal discussions within KPMG on the reasons behind the discontinuance, see Email Memo from Jeff Stein, Head of KPMG Tax Practice, 14 March 1998. The memo argues that the problem with FLIP stemmed not from innovation but because there was insufficient economic risk attached. Furthermore, the stock option purchase deal 'stuck out like a sore thumb because no-one in his right mind would pay such an exorbitant sum for such a warrant.' He further attested that the investor representation letters, suggesting the rationale for the arrangement, were of 'dubious quality'. The memo was not designed to address these issues, rather to smooth internal rivalries about ownership of the successor. (http://www.pbs.org/wgbh/pages/frontline/shows/tax/schemes/11.htm).

[88] S-Corporation refers to charitable institutions governed by Chapter S of the US Federal Tax Code. The report found that the product was so aggressively sold through the telemarketing department that it became one of the partnership's most lucrative earnings streams in 1999. Methods used included reverse psychology by suggesting the product was withdrawn to bait the corporation into thinking it had been provided exceptional service.

[89] The Tax Practice's contribution to overall earnings grew from $829m to $1001m from 1998 to 1999, an increase of 20.7%. The following year, earnings increased by 18.3% to $1184m before dropping to a 4.6% increase in 2001 to $1239 million. Overall it represented cumulative growth of 45.5%, see 'KPMG Innovative Tax Solutions Internal Presentation', 19 July 2001 (http://www.pbs.org/wgbh/pages/frontline/shows/tax/schemes/62.html).

relation to the profits. According to KPMG's own analysis of 'the applicable penalty sections, we conclude that the penalties would be no greater than $14 000 per $100 000 in KPMG fees. . . . For example, our average [OPIS] deal would result in KPMG fees of $360 000 with a maximum penalty exposure of only $31 000.'[90] The author also suggested that this exposure 'assumed 100 per cent of the penalty', an unlikely scenario given that the legal advisors and investment banks would also have to carry liability.

Ambiguity within the tax code provided a further rationale for nondisclosure. Under the revised code, a tax shelter offered to corporate clients had to be registered if the significant purpose of the transaction was either avoidance or evasion.[91] It also stated, however, that the provision would come into operation once guidance had been offered. Since no guidance had been forthcoming, the KPMG legal and tax team argued that it would be counterproductive to register.[92] For the Development Unit, compliance with IRS regulations could have an enormous impact on the firm's capacity to develop the 'tax-advantaged products market', an inelegant euphemism for white-collar crime.

As with the structured finance transactions central to the accounting manipulation at Enron, which were subject to intense investigation by Congress the previous year, the design and execution of the shelters required the complicity of other intermediaries, particularly the legal firm Brown & Wood and Deutsche Bank. An internal memo stated clearly the degree of coordination required for strategic expansion: 'The objective is to brand the Practice

[90] Memo from Greg Ritchie, head of Tax Shelter Development Working Group to Jeff Stein, Head of KPMG Tax Practice, 26 May 1998, cited in US Senate Investigation, above note 64, p. 13.

[91] Internal Revenue Code 1997, s. 6111.

[92] See KPMG Memo: 'Strategic Direction of the Business', 30 August 1998. The memo, written by Randy Bickham from the Silicon Valley office, noted minimal market penetration and suggests a concerted marketing strategy aimed at high-end individuals could generate a $100 million business within three years http://www.pbs.org/wgbh/pages/frontline/shows/tax/schemes/91.html).

as being one which is KPMG-centric with concentric strategic alliances . . . The existing alliances with Deutsche Bank and Brown & Wood exemplify this approach. We have used the existing OPIS product as the mechanism for establishing close strategic relationships with Deutsche Bank and with Brown & Wood at both an institutional level and with key individuals within the organizations. In that the product development focus is on products, which require the use of relatively complex financial securities and third party financing, these relationships are critical to our future success.'[93]

The report revealed damaging details for how external legal opinion buttressed the internal counsel view that the transactions were compliant with the tax code. Investment banks provided the mechanism to transfer money through multiple accounts to generate paper losses that could then be used to write off tax liability in the United States.[94] As the KPMG partner in charge of marketing the product proclaimed in a draft marketing strategy document: 'this is a turnkey investment program that integrates the services of various parties including the investment advisor, legal/drafting, banking, and KPMG tax opinion.'[95]

The political salience of the investigation was linked to the fact that the transactions revealed an aggressive proactive strategy designed to evade internal controls and external compliance with industry codes of best practice. Effective control mechanisms require the existence of adequate checks to minimize the risk of inadvertent criminal

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[93] See KPMG Memo, above note 90. Crucially, the sales pitch included erroneous and fraudulent advice that the opinion letters provided by KPMG and its legal advisors, Brown & Wood, would provide adequate legal protection in the event of an IRS court challenge. See US Senate Report, above note 64, pp. 8–9.

[94] See L. Browning, 'Banks Deny Making Improper Tax Loans', *New York Times*, 21 November 2003, p. C3.

[95] See email from Jeffrey Eischeid, Head of Personal Financial Planning, KPMG, 21 July 1999. The strategy made clear that the products were to be marketed to individuals with a net worth in excess of $20million. The relative advantage of linking up with the Innovative Strategies team was its capacity to 'mitigate an individual's income tax.' http://www.pbs.org/wgbh/pages/frontline/shows/tax/schemes/16.html.

prosecution. The Development Unit not only recognized the risk but also advised that KPMG set up a contingency fund for just such a purpose. 'Any financial exposure that may be applicable can easily be dealt with by setting up a reserve against fees collected. Given the relatively nominal amount of such potential penalties, the firm's financial results should not be affected by this decision.'

The starkness of the memo gives credence to the concern expressed in the report that the problem was systemic and linked to a 'deeply flawed' incentive structure that failed to calculate the reputational cost associated with running such risks with the firm's reputation.[96] The strength of the report lay in its assertion that the corrosion of ethical grounding extended outwards to corrupt an entire sector in which other key participants were willing partners in manipulating the tax regime.[97] The report concluded: 'dubious tax shelters are no longer the province of shady fly-by-night companies with limited resources. They are now big business, assigned to talented professionals at the top of their fields and able to draw upon vast resources and reputations of the country's largest accounting firms, law firms, investment advisory firms, and banks.'[98]

In a written statement, KPMG defended the shelters as aggressive tax avoidance schemes designed to take advantage of complexity and ambiguity in the underlying tax code. The statement asserted that

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[96] US Senate Report, above note 64, p. 7; see also the personal considerations by the progenitor of OPIS in the KPMG strategic memo.

[97] The benefits for the banks were just as significant, Deutsche Bank alone earned \$44m from advancing \$7.8 billion in 56 separate BLIPS between September and October 1999. It generated \$35 million from 62 OPIS loans totalling \$3 billion from June 1997 to March 1999. The transactions were approved by the bank's Chief Operating Officer and Shearman & Sterling, a law firm in New York. Deutsche Bank called its loans 'financial activities performed by the bank in the ordinary course of business.' The group even asked the bank's tax department 'not to create an audit trail' for the loans, according to a July 30 1999 email message from a member of the group. HVB also defended its transactions as traditional banking services see L. Browning, above note 94.

[98] US Senate Permanent Subcommittee, above note 64, p. 5.

the products were 'complex and technical, but were also consistent with the laws in place at the time, which were also extremely complicated.'[99] The second line of defence suggested that the products were offered primarily to sophisticated investors rather than the general public. It noted that minimizing tax exposure was a legitimate business line, which was both buoyant and exceptionally competitive: 'In each step of the process, KPMG made it very clear to the clients that they were undertaking complex transactions on which the law was ambiguous and often had not been clarified by either the IRS or the courts.' In order to buttress its case, KPMG further noted: 'It is important to note that no court has found them to be inconsistent with the tax laws.' Even if the shelters were challenged (on either legal or ethical grounds), KPMG suggested that as it offered only a 'more likely than not opinion' on the legality of the transactions, it should not be liable.

The partnership portrayed its internal control mechanisms as sufficiently robust. It argued that tax products did undergo intensive and thorough review at KPMG – a review process that resulted in vigorous, sometimes even heated, debate internally.' This was presented as evidence that the partnership took any risk to its reputation, integrity or credibility exceptionally seriously.[100] It also implied that the shelters were not adjudged to impact negatively on these criteria. This emollient tone is hard to square with an email sent by a key technical reviewer in 1999: 'I don't like this product and would prefer not to be associated with it [but] I can reluctantly live with a more-likely-than-not opinion being issued for the product.' A second email published by the Senate Investigation is even more

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[99] Statement of KPMG Before Permanent Subcommittee on Investigations, Committee of Governmental Affairs, US Senate, 18 November 2003 (http://hsgac.senate.gov/_files/111803weisner.pdf).

[100] The most damaging allegation in the report suggested the corrupting of charitable organizations. It argued that 'some charitable organizations have participated as essential counterparties in a highly questionable tax shelter developed and sold by KPMG, in return for donations or the promise of future donations', see US Senate Subcommittee, above note 64, p. 4.

damaging. One senior tax official surmised: '(1) Have we drafted the opinion with the appropriate limiting bells and whistles? . . . and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? . . . My own recommendation is that we should be paid a lot of money here for our opinion, since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit.'[101]

A conciliatory approach was conceded towards the end of the prepared script: 'We have learned important lessons from the past practices of our firm and the tax services profession.' The formulation provided defensive and strategic ends. It suggested that the exploitation of legal loopholes was acceptable and that if the 'rules of the game' were to change, Congress should leave it to the market to decide on the limits of acceptable business practice. Without conceding liability, it further noted a number of innovations that implied self-diagnosis of deficiencies as a causal factor.

The written statement set the scene for two days of intense questioning about the legality of the product, which the Senate staff tabulated as representing a loss to the exchequer of $1.4 billion between 1997–2001.[102] The Republican chairman of the Committee, Norm Coleman, argued that the 'ethical standards of the legal and accounting profession have been pushed, prodded, bent and, in some cases, broke, for enormous monetary gain.'[103]

KPMG recognized early on that the shelters could be politically embarrassing. Jeffrey Eischeid, the partner designated to represent its interests in the hearings, was given coaching in advance of his testimony on how to provide dissembling evidence that minimized the risk. KPMG tried initially to weather the storm, but it was becoming impossible to hold the line over the tax shelter investigation.

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[101] Ibid, p. 7.

[102] The Statement of Facts accepted by KPMG in the final deferred prosecution agreement increased the loss to the exchequer to $2.5 billion.

[103] D. Cay Johnston, 'Skeptical Hearing for Audit Firm', *New York Times*, 19 November 2003, p. 3.

As a grand jury investigation continued, it made some senior management changes. One of the senior partners involved was placed on administrative leave, the first public sign of the internal trauma within the firm. On 13 January 2004, it released a statement saying that KPMG remains committed to 'fill its role as a responsible corporate steward.'[104] In May, the IRS won a hugely important ruling from the federal court demanding further disclosure of evidence needed to evaluate the tax shelters. The judgement was highly critical of the legal strategies deployed by KPMG. 'The Court comes to the inescapable conclusion that KPMG has taken steps since the IRS investigation began that have been designed to hide its tax shelter activities. In doing so, KPMG has cast doubt over its privilege assertions . . . KPMG appears to have withheld documents summoned by the IRS by incorrectly describing the documents to support dubious claims of privilege.'[105] Mark W. Everson, the IRS Commissioner, said, in a statement, that: 'slowly but surely, we are unmasking the false claim of privilege made by those who are merely promoting generic abusive tax products.'[106]

Changes were also being made within the legal partnership that advised KPMG and Deutsche Bank on the tax shelters. Sidley Austin Brown dismissed its top lawyer, Raymond Ruble, after government investigators told the firm that an obscure investment firm had siphoned millions of dollars into a private trust that was controlled by the lawyer and domiciled in Delaware. The legal firm said it sacked him for breach of fiduciary duty rather than opinion itself.[107] Ruble had declined to testify at the Senate hearings in November, citing the Fifth Amendment. He had provided 600 affirmative legal opinions on

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[104] D. Cay Johnston, 'Changes at KPMG After Criticism of its tax shelters' *New York Times*, 13 January 2004, p. C1.

[105] *US v. KPMG* 0200295 (TFH) Dis. DC, at 12-13.

[106] L. Browning, 'KPMG Ordered to Disclose Data on Tax Shelter Buyers', *New York Times*, 5 May 2004, p. C8.

[107] L. Browning, 'Top Tax Shelter Lawyer No Longer at a Big Firm', *New York Times*, 30 June 2004, p. C1.

13 shelters and charged the firm $50 000 for each. A KPMG memo called Ruble part of its working group.[108]

> Having reviewed the Brown & Wood 'opinion letters' through the lens of the newly discovered evidence, the Court finds these opinion letters to be boiler-plate templates that are almost, if not completely, identical except for date, investor name, investor advisor, and dates and amounts of investment transactions. There is little indication that these are independent opinion letters that reflect any sort of legal analysis, reasoned or otherwise. In fact, when examined as a group, the letters appear to be nothing more than an orchestrated extension of KPMG's marketing machine.[109]

The court rulings fundamentally weakened KPMG's capacity to defend itself on the wider case taken by the Department of Justice. In January 2005, KPMG appointed Sven Erik Holmes as Chief Legal Officer, with responsibility to oversee ethics and compliance and act as counsel to both the Chairman and the board. In an interview, Holmes suggested that 'it doesn't get more challenging than this. Everything interesting in law, public policy and business whirls around these issues.' Its prior management of the case had been instrumental in strengthening the resolve of prosecutors. It was no surprise then that they would take advantage of the sweeping powers available through the pre-trial diversion mechanism to ensure that KPMG would be held fully to account.

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[108] Furthermore, Ruble was deemed in a report commissioned by the Special Master for Judge Hogan to be compromised. 'The lawyer referred to in the emails is one with whom KPMG had a business or marketing arrangement and not a true attorney–client relationship. Moreover, nothing in the exchange discloses any facts or opinion from or to a lawyer. The attorney–client privilege has not been shown to exist. Furthermore, the document has not been shown to have been prepared by a lawyer, much less to have been prepared in reasonable anticipation of litigation so as to be protected by the work-product privilege. Lastly, the document does not contain tax advice or opinion to a taxpayer client.' See *US v. KPMG*, above note 103 at 14.

[109] *US v. KPMG*, above note 103 at 16. The judge concludes: 'The Court has lost confidence in KPMG's privilege log since it has been shown to be inaccurate, incomplete, and even misleading regarding a very large percentage of the documents' (p. 24).

The Expansion and Changing Nature of Deferral

The 'war against corporate crime' raises important and unresolved questions about its prosecution.[110] As with any conflict, the legitimacy of the governmental response is predicated on its proportionality, appropriateness and the clarity of the rules of engagement. From a rights perspective, not only should the outcome be governed by the principle of fairness, so too should the procedures.[111] While strengthening one aspect of the regulatory system, the use or threat of criminal sanction to achieve ethical goals opens multiple arenas for disputation. Maladroit application opens, in turn, the ideational space for policy reversion on practical and ideological grounds.[112] The failure to define precisely the legal determinants of what constitutes acceptable ethical conduct enhances uncertainty and threatens to undermine prosecutorial and regulatory appeals to authority and legitimacy.[113] The recent lodging of a lawsuit by a small accountancy firm against the US Public Company Accounting Oversight Board, alleging unconstitutional practice in appointments procedure, is symptomatic of the ending of business quiescence.[114] Tracking the policy transfer process of methods used in policing the governance of legitimate business brings into sharp contrast the contours of the ideational battlefield.

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[110] The disquiet in the academic community is seeping into the media discourse, see J. Hasnas, 'Department of Coercion', *Wall Street Journal*, 11 March 2006, p. A9.

[111] See J. Rawls, *A Theory of Justice*, MIT Press, Cambridge, Massachusetts.

[112] See Bartley above note 45; see also, L. Cata Baker, 'Corporate Surveillance After Sarbanes–Oxley' (2005) 26 *Company Lawyer* 3.

[113] See G. Imperato, 'Corporate Crime and Compliance: What Does the Government Expect?' (2005) 52 *Federal Lawyer* 25.

[114] *Free Enterprise Fund and Beckstead and Watts v. PCAOB* 1:06CV00217 7 February 2005 (http://www.cei.org/pdf/PCAOBComplaint.pdf). The suit is partially based on a highly critical Competitiveness Enterprise Institute research paper arguing that the capacity for the SEC to nominate and confirm board members without Senate approval was unconstitutional, see H. Bader and J. Berlau, 'The Public Company Accounting Oversight Board: An Unconstitutional Assault on Government Accountability,' Washington DC, CEI, October 2005 (http://www.cei.org/gencon025.04873.cfm).

The measures introduced by an invigorated, if disparate, enforcement community to undertake surveillance over legitimate business relate directly to the methods traditionally deployed in the fight against organized crime. In 1992, the District Attorney's Office in Manhattan prosecuted the Gambino crime family for running a cartel in the Garment District in New York. In return for a non-prosecution deal, the Gambino family paid a fine of US $12 million and consented to the appointment of a Special Master to dispose of two trucking companies.[115] The innovation had clear applicability to the wider business environment. It was picked up to resolve a case taken in 1994 against Prudential Securities by the Southern District US Attorney, Mary Jo White. The Prudential–Bache Energy Income Partnerships proceedings involved systematic collusion by senior management in the selling of high-risk investment products to more than 120 000 retirees. The government lacked the resources to investigate all of the partnerships. Many of those directly affected by the collusion settled a class action the previous year for US $90 million, which paid a desultory eight cents in the dollar. Under the terms of the settlement they could not apply to the restitution fund set up by the US Department of Justice.[116]

The case encapsulated the difficulties associated with prosecuting to a conclusion a case against a financial services firm. On the one hand, the victims were among the most politically active constituency

[115] The main prosecutor in the case was Eliot Spitzer, see J. O'Brien, above note 6, pp. 149–150. An agreement brokered by Spitzer's office in 2002 with Merrill Lynch formed the template for a global settlement reached the following year in a concerted investigation involving a consortia of State Attorneys General, the SEC and the Department of Justice, see J. O'Brien, above note 6, pp. 165, 205–209. For an early review of the use of prophylatic mechanisms against organizations and the dangers associated with a lack of clarity in the limits of application, see F.J. Warin and J. Schwartz, 'Deferred Prosecution: The Need for Specialized Guidelines for Corporate Defendants' (1997) 23 *Journal of Corporate Law* 121, at 131-33. On how the expansion of pre-trial diversion enhances 'disparate and uneven' application, see F.J. Warin and P. Jaffe, 'The Deferred Prosecution Jigsaw Puzzle: Some Modest Proposals for Reform,' (2005) 19 *Andrews Litigation Reporter* 12.

[116] See K. Eichenwald, 'Brokerage Firm Admits Crimes in Energy Deals', *New York Times*, 28 October 1994, p. A1.

in the United States; on the other, the collateral damage associated with a criminal conviction was enormous. If successfully prosecuted, it was doubtful that Prudential could have withstood demands for immediate licence revocation.[117] Despite the capacity of federal law to decapitate the corporation, it was deemed counterproductive. Instead, a deferral was offered. White suggested at the time that this was a creative and aggressive approach to criminal enforcement: 'I don't think other companies looking at this will say that it was a lenient disposition of the case. I think they will be very concerned about it.'[118]

In return for deferral, Prudential consented to the payment of more than US $330m in fines and the establishment of an independent ombudsman.[119] The ombudsman had an obligation to report any future misconduct directly to prosecutors. In addition, the firm was forced to appoint an independent law firm to review the corporate compliance programme and suggest improvements. Two years later, a similar agreement was reached with Coopers & Lybrand. Despite the innovative capacity, the measure fell into abeyance until the collapse of the technology bubble demonstrated the full extent of the fraudulent measures undertaken to inflate earnings.

For the financial sector, the most influential of the recent settlements involved Merrill Lynch. The investment bank agreed a remarkable degree of external oversight in exchange for non-prosecution over its involvement in financing off-balance-sheet

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[117] In 1992, the Department of Justice declined to prosecute Salomon Brothers for this reason. It justified the decision on the remedial action taken, see *Corporate Crime Reporter*, above note 13 at 52. See also N. Getnick and L. Skillen, 'Structural Reform: The Front Line Fight Against Business Crime (1995) 1 *New York Litigator* 2, footnote 14 (http://www.getnicklaw.com/media/article_22.html).

[118] S. Walsh and J. Mathews, 'Prudential Accused of Fraud, Gets Chance to Avoid Trial', *Washington Post*, 28 October 1994, p. 2.

[119] This was in addition to the US $371 million in civil penalties imposed by the SEC the previous year.

transactions at Enron.[120] For a twenty-one-month period, the company was precluded from engaging in, or acquiescing with, creative accounting, unless specifically approved by a newly created Special Structured Products Committee. The committee included senior representatives from various disciplines (Head of Group or experienced designee) including market risk, law and compliance, accounting, finance, tax and credit. To proceed, transactions required unanimous approval, with due cognizance given to legal and reputational risk.

The company was explicitly precluded from engaging in any form of structured finance in which any term of the transaction related to risk transfer (whether or not legally enforceable) was not reflected in the written contractual documentation. Furthermore, if a transaction was deemed suspicious, a review was mandated of all relationships with that third party. Independent auditors were retained to oversee the work of the committee. In addition, a copy of all documentation was forwarded to the Department of Justice, which had sole discretion in ascertaining whether the terms of the agreement had been broken. While the agreement had a sunset clause, any future infraction does not preclude the Department from initiating proceedings on matters covered by the agreement.

The compromise had a number of advantages for both the Department of Justice and the corporation. Accountability through 'punitive probation' was achieved, which, while potentially costly in terms of governmental interference, was more likely to change the internal calculus for assessing reputational risk.[121] Merrill Lynch avoided a criminal indictment and therefore an implosion of integrity; for the government, enormous leverage was gained to prosecute the individuals concerned, providing a talismanic political spectacle. Under the terms of the agreement, Merrill was obligated to provide full and truthful disclosure about all aspects of the Nigerian barge

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[120] See J. O'Brien, 'Ethics, Probity and the Changing Governance of Wall Street: Cure or Remission?' (2004) 7 *Public Integrity* 43.

[121] B. Fisse and J. Braithwaite, above note 1, p. 43.

contract, which the former employees were indicted on, and to provide the federal Enron Task Force with professional help to prosecute its case.[122]

The normative benefits of the settlement pivot on the acculturation of ethical restraint as a form of risk management. There is, however, an apparent lack of consistency on whether the pre-trial diversion should be deployed and, if so, which variant. Merrill Lynch and CIBC were forced to accept a non-prosecution deal and significant explicit restrictions in their capacity to offer structured finance transactions. No such criminal sanction was even threatened against either Citigroup or JP Morgan, both of which had significantly greater exposure to, and complicity in, facilitating the Enron earnings management phenomena.[123] Secondly, the proportionality of monetary fine to loss or profits associated with the alleged deception is haphazard.

The non-prosecution agreement reached by Symbol Technologies with the Eastern District is more onerous than the deferred arrangement brokered by the Criminal Division with American Electric Power. Similar discrepancies exist on the extent of culpability that must be admitted and the extent of ancillary requirements not necessarily germane to the conduct under investigation. While the

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[122] The case was the only clear success at jury trial involving the prosecution of senior executives involved in an earnings management transaction with Merrill Lynch, see J. Emshwiller and K. Scannell, 'Merrill Ex-Officials' Sentences Fall Short of Recommendations', *Wall Street Journal*, 22 April 2005 (online edition). The Justice Department had canvassed for sentences of between 15 and 33 years. The judge sentenced the former Head of Investment Banking to a thirty-month prison term and the former Head of Structured Finance to forty-six months. He described the crime as 'benign' in comparison to the scale of the bankruptcy. The imprisonment is now raising media traction and adverse comment; see L. Thomas, 'Deals and Consequences', *New York Times*, 20 November 2005 (online edition).

[123] For discussion, see General Accounting Office, 'Investment Banks, the Role of Firms and their Analysts with Enron and Global Crossing', GAO 030511, March 2003.

US $5 million fine paid by Tyco Technologies to settle accounting charges taken by the New Hampshire State Regulator was set aside for corporate governance and investor education generally, Bristol-Myers Squibb was forced to endow a Chair of Business Ethics at a university attended by the prosecutor because of attempts to mislead investors over sales figures that resulted in excess inventory not being accounted for.[124]

MCI, the remnant of WorldCom that survived the implosion, was not prosecuted by the Department of Justice, but a deferred agreement was entered into with the Oklahoma State Attorney General, Drew Edmondson, in exchange for the promise of 1600 jobs over a ten-year period. The agreement not only stipulates when the jobs will be phased in but also the salary entitlements.[125] Edmondson was explicit about the rationale: 'If we took this case to trial and won, the company would likely go out of business and we would likely be stuck at the end of the bankruptcy line. This economic development agreement is restitution in a different form.'[126] As noted above, HealthSouth was not prosecuted, despite considerable evidence that the earnings management was pervasive, suggesting in this case an acute awareness of collateral damage to the economy of rural Alabama. Advancing a prosecutorial strategy according to such

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[124] S. Saul, 'Fraud Case Filed Against Ex-Officers of Bristol-Myers Squibb', *New York Times*, 16 June 2005, p. C1. When the scheme was first exposed, Bristol-Myers Squibb was forced to restate revenue by US $2.5 billion and lower its profits by US $90 million.

[125] The settlement also saved the state over US $15.4 million in subsidies that would have been paid under the Oklahoma Quality Jobs Agreement. Furthermore, MCI has mandated to repay US $1.5m in existing subsidies, even though there was no evidence that the fraud was orchestrated or executed in the Oklahoma area. Full text of the agreement is available at: http://www.oag.state.ok.us/oagweb.nsf/0/5bc3baa6bebfa1d786256e550062044d/$FILE/CPU%20WorldCom%20Econ..pdf

[126] W.A. Drew Edmondson, 'State to Gain 1600 Jobs From WorldCom Agreement', 12 March 2004 (http://www.oag.state.ok.us/oagweb.nsf/0/5BC3BAA6BEBFA1D786256E550062044D!OpenDocument).

political imperatives not only tarnishes the judicial system, it also provides confirming evidence to executives under investigation that prosecutors have been overreaching.

Nowhere is this more apparent than in the requirement that a corporation under investigation demonstrates its resolve to cooperate with investigators by dispensing with either errant employees or, more seriously, senior management, against which there is no direct evidence of involvement. Again, there is remarkable disparity in application. Marsh and McLennan and AIG were both forced to change their leadership to stave off state action launched by the New York State Attorney General. Bristol-Myers Squibb had to change its chairman and appoint a non-executive chairman acceptable to the Newark prosecutor's office. No such requirement was explicitly required in the KPMG settlement, although it did have to concede to a former chairman of the Securities and Exchange Commission overseeing significant governance reform measures. The erosion of rights of due process is augmented by the increasing requirement that corporations waive client–attorney privilege.[127]

Four distinct advantages are provided to prosecutors by asking for the internal investigation.[128] First, the investigative material provides a 'road map' to navigate and truncate the discovery process, irrespective of whether a decision is taken to defer, offer a non-prosecution deal or decline. Second, it acts as a 'net-widening

[127] The effective waiving of client–attorney privilege and the need to cooperate violates the Sixth Amendment right to effective representation at every stage of the prosecutorial process, see *Johnson v. Zerbst* (1938) 304 US 458; and *Powell v. Alabama* (1932) 287 US 45. Mary Jo White traced its emergence to the decision by Warren Buffett to waive privilege during the Southern District's investigation into Salomon Brothers in 1992, see J. Caher, 'NY State Bar Task Force to Address Waiver of Privilege', *New York Law Journal*, 11 January 2006 (online edition).

[128] See V. Blum, 'Justice Deferred: DOJ Gets Companies to Turn Snitch', *Legal Times*, 25 March 2005 (online edition). For a quotation from a leading defence attorney suggesting 'a grotesque imbalance of power' provided to the government in the course of an investigation, see G. Passarella, 'Ebbers Lawyer: White Collar Bar Rolled Over', *Legal Intelligencer*, 16 September 2005 (online edition). For a view of the bar, see L. Post, 'Deferred Prosecutions on the Rise in Corporate Bribery Cases', *National Law Journal*, 17 August 2005 (online edition)

mechanism' that has the potential to enhance accountability and limit internal deception.[129] Third, if it can be demonstrated that executives misled an internal investigation, the evidential basis is provided for a simpler case to try (in evidential and policy terms). In 2005, this is precisely what happened with the indictment of senior executives within Computer Associates for accounting manipulation.[130] Fourth, ongoing capacity to shape the nature of internal investigations is provided. Regulators have not only recruited the legal profession, they have also gained significant traction in scoping the work practices of an emerging subdiscipline of the white-collar defence bar.[131]

More perniciously, lack of cooperation is now regarded as an indication that the corporation is actually hiding something, rather than defending its own self-interest or the rights of employees. As individual partners within KPMG found to their acute discomfort, should the corporation seek to limit the flow of material to government investigators, corporate legal jeopardy is increased. In a telling speech, then Associate Attorney General, Christopher Wray, pushed home the prosecutorial advantage.[132] He spelt out what the US Department of Justice requires (without legal authority) under this new dispensation. It includes providing witnesses without subpoenas, actively persuading employees to cooperate and terminating the contracts of those who don't, providing access to external audit material, reconfiguring internal investigations to 'suit our needs', accepting 'attorneys and accountants of our choice' and 'handing over interview memoranda and other materials generated in their internal investigation notwithstanding any claim of privilege they might have.'[133]

[129] This enhances dramatically the capacity of transparency to act as a 'shaming' mechanism, see B. Fisse and J. Braithwaite, above note 1, p. 224.
[130] For the investigating lawyer as 'a fact-finder with a badge – the newest (and highest paid) government agent', see A. Longstreth, above note 25.
[131] Ibid.
[132] C. Wray, above note 21, p. 5.
[133] Ibid.

Taken together, the pressure to conform to the new regulatory reality significantly weakens the capacity of the corporation to defend itself against future civil litigation.[134] This places a board of directors of a company in an untenable situation. By cooperating with an investigation, the corporation itself is providing evidence that can be used in subsequent class action cases that may otherwise not have amassed the evidence to pass the barrier required for disclosure. While we live in a society in which the power of the corporation is rightfully questioned, it is also appropriate to delineate much more precisely the power of the class action bar and its capacity to engage in frivolous suits.

Towards Accountable Governance: Scoping the Limits of Authority

Precisely because financial reporting cases are difficult to mount, the efficacy of the deferred prosecution method rests primarily on the capacity of a single example or precedent having wider application. While the Merrill Lynch settlement, for example, attracted significant public animosity on Wall Street, behind the scenes the regulatory dynamic did shift. One prominent investment banker, who asked for clarification from the SEC about whether the deal had industry wide implications, was told, rather ambivalently, 'not necessarily.'[135] In an interview with the author, the former Director of Enforcement at the SEC suggested that over the course of 2004–2005 a number of leading investment houses privately presented to the agency the findings

[134] The lack of judicial clarity and consistency in protecting the nondisclosure of confidential information provided to federal agencies amplifies the problem. For a discussion, see D. Zornow and K. Krauker, 'Over the Brink: Further Reflections on the Death of Privilege in Corporate Criminal Investigations' (2005) 20 *Andrews Litigation Reporter* 1; see also earlier review, D. Zornow and K. Krauker, 'On the Brink of a Brave New World: The Death of Privilege in Corporate Criminal Investigations' (2000) 37 *American Criminal Law Review* 147.

[135] Interview, New York City, 17 November 2003.

of internal systems reviews.[136] This unreported reality represents an exercise in 'enforced partnership' not government fiat. It also helps reposition strategic priorities within both the investment houses and the SEC itself. In the process, certain instrumental advantages are gained, including the enforced application of ethical imperatives.[137]

Although it is presented as an exercise in negotiation, the mechanism is better understood as a return to (and refinement of) command and control regulation. It also enhances the power of the state. As such it fundamentally transforms the regulatory and corporate governance landscape. Most significantly, the policing function is transferred to the corporation itself, which through the self-preservation of its controlling minds – the board of directors – becomes an unwilling participant in its own emasculation. This dynamic has profound implications for the enabling framework of corporate law in the United States. Taken alongside the mandatory governance provisions of Sarbanes–Oxley, the use of negotiated prosecution limits significantly the business judgement coda that informs the Delaware Court of Chancery.

Many of the key actors associated with vigorous enforcement, including Steve Cutler and Christopher Wray, have returned to

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[136] Interview, Washington DC, 10 May 2005.

[137] The approach taken in the Merrill Lynch settlement corresponds to the influential four-stage model of effective business ethics pioneered by Jones. This involves recognition (of a problem), judgement (in terms of whether a decision corresponds to the ethical code), establishment of intent (as to how to proceed) and finally engagement (action), see T. Jones, 'Ethical Decision-Making By Individuals in Organizations: An Issue Contingent Model' (1991) 16 *Academy of Management Review* 366. It is also a reflection of a governmental idea that corporations remain largely wedded to an instrumentalist view of compliance obligations. The pre-trial diversion is designed to push corporate behaviour to higher levels of collective moral behaviour through an enhancement of compliance function. For an exceptionally useful heuristic model, see G. Rossouw and L. van Vuuren, 'Modes of Managing Morality: A Descriptive Model of Strategies for Managing Ethics' (2003) 46 *Journal of Business Ethics* 389.

private practice.[138] William McDonough has left the PCAOB for a board position at Merrill Lynch. It remains to be seen whether the coordination and resolve evident in the recent cooperation between the US Securities and Exchange Commission and the Department of Justice will prosper in the medium term. Equally, the exercise of regulatory power is contingent on a constantly shifting nexus of internal and external forces. Scandal is one of the key driving forces of regulatory change in the United States. Scandal can also take the form of regulatory overreach. Unless much clearer guidelines are introduced, there is a profound risk that this exercise in policy transfer will not (nor should not) survive the departure of its primary architects from public service.

As with the deployment of enforceable undertakings in Australia, negotiated prosecutions in the United States have enormous potential to secure corporate accountability. The demonstration effect principle transforms the risk calculus and, therefore, the importance of compliance programmes. The emphasis on reputational risk management has enormous benefits for the corporation as well as the wider community. For the corporation, it maximizes the potentiality of early warning systems; for the regulatory agency, it minimizes the cost of investigation. Further expansion requires, however, much more considered analysis of the drawbacks associated with injudicious and inappropriate application.

Effective compliance design requires considered analysis of particular risks facing individual corporations with distinct corporate cultures. The corporation itself remains best placed to identify the specific framework. The initial promise of compliance was captured by creative legal and accounting stratagems. These paid lip service to best-practice voluntary codes but transacted around their spirit.

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[138] The departure of the Chairman, William Donaldson, and Harvey Goldschmidt, the ranking Democratic nominee, in 2005 significantly changed the balance of power within the SEC. Cutler resigned in May 2005, weeks after one of the Commissioners complained publicly about the failure of the Enforcement Division to consult prior to the announcement of settlements, see P. Atkins, above note 50.

The privilege of self-regulation has been eroded by unwillingness and incapacity to internalize societal demands for restraint. Many of the ideas surrounding pre-trial diversion do have the capacity to engineer meaningful change. The legitimacy of new forms of creative enforcement must not be relinquished, however, through ill-thought out, unrealistic and unfair procedures. Irrespective of whether the corporate form is regarded as a private entity with no wider responsibilities to society or a reversible privilege, the foundational principle of limited liability remains intact. The legal protection afforded to the corporation must not be compromised in the pursuit of publicity or an escalation imperative. To do otherwise debases the legitimacy of the wider polity.

7

Global markets, regulatory enforcement and the dynamics of corporate crime

The design of effective corporate governance and prudential financial regulation is an essentially political process. This chapter extends the primary analysis beyond the United States to demonstrate the inherent difficulties associated with exercising holistic control of global markets. It concentrates on how loopholes in the governance of reinsurance facilitated securities fraud on a global basis. It reveals the systemic risks associated with fragmented oversight. It tracks the intractable difficulties in fashioning a coherent response to market abuse by financial intermediaries with applicability across multiple jurisdictions.[1]

The explication raises enormous implications for policy calibration. Does muscular enforcement engender confidence or risk precipitating

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[1] For a review, see J. O'Brien (Ed.), *Governing the Corporation: Regulation and Corporate Governance in an Age of Scandal and Global Markets*, John Wiley & Sons, Ltd, Chichester, 2005. For assessments of the debate on convergence, see G. Davis and C. Marquis, 'The Globalization of Stock Markets and Convergence in Corporate Governance', in V. Nee and R. Swedberg (Eds), *The Economic Sociology of Capitalism*, Princeton University Press, Princeton, 2005. For a robust model suggesting that both corporate governance form and extent of convergence is dependent on capacity to influence domestic political coalitions, see P. Gourevitch and J. Shinn, *Political Power and Corporate Control: The New Global Politics of Corporate Governance*, Princeton University Press, Princeton, 2005.

capital flight from emerging financial centres? Is the most effective approach prosecuting an individual scapegoat? Could the more systemic inculcation of values into value be achieved by holding those responsible for the design of financial products equally to account? If so, can this be achieved in the context of fragmented regulatory authority subject to diverse and competing political imperatives? Precisely because the deployment of offshore entities to design and execute the transactions under investigation masks differentials in accounting treatment, is it conceivable that national or sub-national regulators, no matter how diligent, can amass the intelligence necessary to provide a sufficient bulwark? Can convergence offer the mechanism to neutralize the shortcomings identified by fragmentation?

The case studies at the core of this chapter are drawn from Australia and the United States. They call into question whether supervision priorities have converged to a sufficient degree to guarantee effective control. I then assess relative national capacity to influence reform trajectories outside territorial borders. This, in turn, reveals significant reservations about perceived continued internal regulatory failure within a third jurisdiction, the Republic of Ireland, where the products in question originated. The unease expressed about Ireland's position threatens to undermine not just its own credibility but also that of the EU Communication on Preventing and Combating Corporate and Financial Malpractice.[2] This calls into question the capacity of the European Union to deliver on its commitment to ensure global cooperation through 'supervision and oversight, and law enforcement.'[3]

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[2] European Union Commission, 'Communication from the Commission to the Council and the European Parliament on Preventing and Combating Corporate and Financial Malpractice', COM 211, 2004. Full text online at: http://europa.int/internal_market/company/financial-crime/index_en.htm.

[3] A. Schaub, 'European Responses to Corporate Governance Challenges', in J. O'Brien, above note 1, p. 65.

The analysis comprises distinct but overlapping components. First, finite reinsurance, the mechanism through which the reinsurance industry expanded into structured finance, is critiqued. The next two sections detail how finite reinsurance manipulated the capital market valuations of two major corporations in Australia (FAI and HIH) and one in the United States (American International Group). In the fifth section, the response from the Republic of Ireland, where the transactions were executed, is critiqued. Sixthly, I assess the extent to which Irish priorities impact on the debate at European and global levels on regulatory function and capacity. I conclude by arguing that the problem of abuse within the reinsurance sector extends beyond corrupted actors within corporations facing significant levels of distress or the auditing profession alone. Without immediate and concerted action, the integrity of the wider financial system, in which and through which effective corporate governance must be nested, risks being called into further question.

Finite Reinsurance and Accounting Manipulation

While the interplay of factors leading to major dysfunction is case specific, the complicity of intermediaries has been common to many. The involvement of the investment banks and the accountancy profession in facilitating this process, particularly in the United States, has been a central issue within this book. It continues to fill the pages of the international business press. The most recent, and most spectacular, has seen the collapse of the leading commodities brokerage, Refco. It disintegrated within weeks of its public launch, one of the largest Initial Public Offerings since the millennium corporate scandals.[4] The ongoing gaps in market or regulatory

[4] See L. Armistead, 'Caught in a Storm', *Sunday Times*, 16 October 2005, p. B5; R. Smith, 'Refco, Wall Street's New Implosion', *Wall Street Journal*, 15 October 2005, p. B3; D. Wighton, 'From High to Low in Just Seven Days', *Financial Times*, 15 October 2005, p. 21.

oversight were underscored by the failure of either the external audit by Grant Thornton or due diligence processes undertaken by the principal underwriters, Goldman Sachs and Credit Suisse First Boston, to uncover an alleged US $430 million deception. The Refco Chief Executive, who now faces criminal charges in the United States, orchestrated this. While the debt to Refco was repaid, the related party transaction forced the corporation to issue a statement saying that its accounts for the past four years cannot be relied upon. The disclosure prompted a disastrous run and a rash of class action suits. It also fuelled an acrimonious dispute between the auditors and underwriters over causal responsibility for detection failure.[5] For Goldman Sachs, the discovery was acutely embarrassing. Goldman's investment banking arm alone had just posted third quarter profits of over US $1.02 bn, the best result in four years.[6]

Similar oversight shortcomings governed the policing of the insurance industry by regulatory and market participants alike. These oversight failures enabled the widespread use of 'finite reinsurance' to manipulate reserve levels. As will be explored below, the difficulties are magnified because the industry tends to be regulated according to 'prudential' rather than 'disclosure' based criteria. It is important to state at the offset that finite reinsurance is legal if there is a genuine risk of loss. If risk is not transferred, however, 'finite reinsurance' represents an abusive form of financial engineering. It allows loans between insurance companies to transform balance sheets by masquerading as additional business. For corporations facing significant distress, finite reinsurance can artificially create or sustain share price valuations.

The capacity of finite reinsurance to 'smooth' earnings rests on two interlocking mechanisms. First, the terms can exceed one calendar year. This protects the receiver against any sudden upsurge in claims provision arising from cyclical, climatic or financial shock. It can also mask loss-provisioning levels by giving the appearance that any claim

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[5] Lex Column, 'Underwriters vs. Auditors', *Financial Times*, 18 October 2005, p. 20.
[6] D. Wells, 'Goldman's Earnings Up By 84% to a Fresh High', *Financial Times*, 21 September 2005, p. 21.

could be offset by recovery under the reinsurance contract. Much more seriously from a policy perspective, finite reinsurance has the capacity to neutralize the possibility of regulatory inspection. It can distort the financial records to suggest a degree of solvency that is unwarranted in substance. As such, it represents a more sophisticated gaming of the regulatory system than the corporate sleights of hand that generated the off-balance-sheet partnerships at the heart of the Enron debacle or the fraudulent accounting treatments within WorldCom. In both cases examined here, the commercial value of finite reinsurance was predicated on its capacity to manipulate financial reporting requirements. This was achieved by utilizing multiple contracts across multiple jurisdictions. Each individual contract appeared to suggest that risk was being transferred, but sidebar transactions – usually with or through a third party based in a separate jurisdiction – cancelled terms.

While the danger of manipulation has been recognized by the leading consortia of insurance regulators, it has proved impossible to engineer a coherent and cohesive policy response to the issue of finite reinsurance.[7] Complexity, the lack of enforcement capacity, resolve or coordination and the extensive use of offshore havens to act as circuit breakers, play key enabling roles in restricting both transparency and accountability.[8] This, of course, is not constrained to the finite reinsurance sector of the market. In 2002, the Financial Stability Forum argued that the 'lack of adequate transparency and public disclosures in the reinsurance industry make it difficult to assess the potential impact on the insurance sector as a whole and on the stability of the

[7] See International Association of Insurance Supervisors, *Global Reinsurance Market Report 2003*, BIS, Basel, 2004. Full text online at: http://www.iaisweb.org/050303_Global_reinsurance_market_report.pdf. The IAIS announced in March 2005 that a paper would be drawn up and circulated which would include a survey on regulatory problems and outcomes, with an anticipated adoption date of October 2006. See Press Release, 'IAIS to develop supervisory guidance on finite risk insurance', 17 March 2005. Full text online at: http://www.iaisweb.org/050317_Final_Press_-_Finite_risk_reinsurance_(2).pdf.

[8] *Global Reinsurance Market Report*, above note 7, p. 15.

other segments of the financial sector, should industry problems arise in the future.'[9] Attempts by the International Association of Insurance Superintendents to aggregate the size and scope of the market in response to this criticism forced the global consortium of regulators to concur. 'In the longer term, it is clear that significant harmonization in both regulation and reporting are necessary in order to make significant improvements in the transparency of the reinsurance industry.'[10]

For the IAIS, the systemic risk pivots on the risk of failure associated with overexposure to certain kinds of liability. Given the fact that finite reinsurance represents a minimal threat to the underlying financial strength of the reinsurer, it is not regarded as material in reporting terms to the regulators. This, in turn, influences the risk calculus of prudential regulators. In seeking to stave off collapse rather than provide effective policing of the capital market, enforcement strategies differ from those followed by disclosure-based regulators. In the absence of catastrophic failure, the impact of such divergent strategies can be occluded. The cases below demonstrate the deleterious consequences of this intersection of corporate and prudential regulatory myopia.

The Fall of HIH Insurance

The HIH Insurance Group was one of the most powerful, if controversial, corporations in Australia, with significant holdings in the United States and the United Kingdom.[11] Given its dominance in the Australian professional indemnity sector, its collapse on 15 March 2001 (note here again the Ides of March) had immediate

[9] Ibid, p. 5.

[10] Ibid, p. 46.

[11] F. Clarke, G. Dean and K. Oliver, *Corporate Collapse: Accounting, Regulatory and Ethical Failure*, Cambridge University Press, Cambridge, 2003, pp. 222–225. A detailed account of the rise and fall of HIH can be found in A. Main, *Other People's Money: The Complete Story of the Extraordinary Collapse of HIH*, Harper Collins, Sydney, 2005.

and devastating consequences. Not only did it represent the largest single bankruptcy in Australian history, its collapse impacted on a wide range of powerful interest groups. The furore that ensued created the political and media traction necessary to force a Royal Commission of Inquiry. This, in turn, mandated a fundamental reassessment – within Australia at least – of the control mechanisms required to ensure effective prudential regulation.[12]

The collapse of HIH owes its origins to myriad causes. These include greed, mismanagement and incompetence. Common to many corporate collapses, the Royal Commission found an inattentive board allowing management to act in unaccountable ways. The situation was exacerbated by an emphasis on form over substance in the corporation's internal risk management systems. This preordained tactical and strategic failures in the design and execution of corporate policy. However, blaming the excess solely on corrupted management and a somnambulant board is a superficially attractive, but ultimately inadequate, explanation. The Royal Commission adjudicated that the internal and external failure of gatekeepers to act on the visible warning signs was inexcusable. For the Commission, it was this aspect of the failure that called into question the integrity of the market system itself.

Before its eventual collapse, HIH attempted to mask its deteriorating financial position by embarking on an aggressive acquisitions strategy. Its institutional share base deteriorated. This, in itself, was a clear sign that the key sectors of the market were unconvinced that the acquisitions served a strategic purpose beyond short-term survival. Yet, for the financial intermediaries facilitating these purchases, another imperative intervened; this was reflected in the fee income associated with the merger and acquisition boom that HIH generated in the Australian capital market. Effective due diligence was neither carried out by the corporation nor demanded of

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[12] HIH Royal Commission, *The Failure of HIH Insurance*, Vols 1–3, Commonwealth of Australia, Canberra, 2003.

it by the market. Its single most important acquisition was the purchase of rival FAI in 1999. This helped the conglomerate post a 112% rise in profits the next year. At surface level, FAI's revenue stream had the potential to add to the suitor's bottom line.[13] The problem was that the operating profits were illusory. Goldman Sachs, which acted as advisor for the sale, explained to the FAI board in October 1998 that the company was worth between AUS $157–287m. It omitted to disclose to either the board or the wider market that it had previously valued the corporation at a desultory US $20m when contemplating taking FAI private the previous year.[14]

FAI was kept afloat through a series of reinsurance contracts. The most important were negotiated in 1998 with National Indemnity, a subsidiary of Berkshire Hathaway and Cologne Re, which itself was to become part of the Warren Buffett trading empire in 2000. The Cologne Re transaction was designed and executed through the reinsurer's Dublin-based 'Alternative Solutions Unit', with personnel in Australia performing a secondary advisory role. The transactions served a dual purpose. First, they had a material effect on FAI's solvency levels. As such, they made the corporation appear much less susceptible to collapse. This provided erroneous reassurance to the Australian Prudential Regulatory Authority.[15] APRA demonstrated a profound lack of institutional understanding of the commercial ramifications of how corporations designed products to transact their way around legal prescription, regulatory guidance on implementation of principles and industry norms. These failings are acknowledged

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[13] F. Clarke, G. Dean and K. Oliver, above note 11, p. 227.

[14] A. Main, above note 11, pp. 141–150.

[15] General Cologne Re paid an AUS $27.2m fine to the liquidator of FAI Insurance as part of an enforceable regulatory undertaking with the Australian Securities and Investment Commission. The undertaking comprises compliance agreements and mandatory ethics training. See 'ASIC Secures $27.2m for the creditors of FAI', No. 04-128. Full text online at: http://www.asic.gov.au/asic/asic_pub.nsf/byheadline/04-128+ASIC+secures+$27+million+for+the+creditors+of+FAI?openDocument.

by Keith Chapman, General Manager of the Diversified Institutions Division at APRA.

> 'Ignoring the niceties of individual contracts, the big message as a regulator that we have learned is that you cannot take senior people with experience in the industry at face value. Philosophically the big change that has come through in that process is really one of testing assertions by doing much more detailed supervision work.'[16]

Secondly, the transactions fooled the marketplace. They transformed a significant loss into an operating profit. According to the Royal Commission, 'a wide array of practices were employed to achieve these ends, among them the use of side letters setting out arrangements that negated the transfer of risk, the backdating of documents, the inclusions of sections of cover not intended to be called upon and the use of "triggers" for additional cover that were unrealistic. The word audacious comes to mind.'[17]

The sidebar letters in the Cologne Re contract were not reported to the board by the most senior financial officers nor were they shown to Arthur Andersen, the external auditors. Ignorance of the side letters does not, however, mitigate the degree of responsibility that must be shouldered by Andersen. A junior member of the audit

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[16] Interview, Sydney, 17 August 2005. In this there are remarkable parallels to the role played by the Bank of England in its failure to regulate effectively Barings before its collapse in 1995. The Bank erroneously placed excessive trust in an elite institution. The regulatory failure was instrumental in the creation of the Financial Services Authority, an overarching single agency combining prudential and disclosure functions, which usurped the Bank of England's role in policing the market, see M. Moran, *The British Regulatory State: High Modernism and Hyper-Innovation*, Oxford University Press, Oxford, 2003. The HIH Royal Commission fell short of stripping the Australian prudential regulator of power, not because of the intrinsic merits of a dual-agency approach but rather because there had already been major structural reform. The Commission noted, however, that 'regulation based on behind the scenes intervention is now less justifiable in an environment where public policy increasingly mandates disclosure by corporate entities'. See HIH Royal Commission, above note 12, Section 8.3.

[17] HIH Royal Commission, above note 12, pp. xxix–xxx.

team lodged formal disagreement with the accounting treatment only to be overruled by senior members of the practice after briefings from FAI and its reinsurers that the transactions conformed to industry norms.[18]

Once the transgression came to light, HIH did not disclose the material effect on its own liabilities. To do so risked precipitating exactly the kind of run that accompanied the collapse of Refco referred to above. Instead, HIH's management sought to conclude two similar, but larger, contracts with Hanover Re. They were facilitated in so doing by Arthur Andersen, which performed the external auditing function for HIH as well as FAI. Memos to Arthur Andersen supplied to the Royal Commission by Peter Thompson, the head of reinsurance at HIH, suggest that the accountancy firm's failure to audit FAI effectively severely compromised its independence in questioning audit practices within HIH itself.[19]

[18] See A. Main, above note 11, pp. 116–117.

[19] Ibid, pp. 126–127. Thompson was disqualified from serving as a director of a general insurer by the Australian Prudential Regulatory Authority in a ruling released on 20 September 2005. See 'APRA Announces Further HIH Disqualification', No. 05.47. Full text available online at: http://www.apra.gov.au/media-releases/05_47.cfm. Since the beginning of 2005, APRA has disqualified a number of senior executives associated with the reinsurance contracts. John Tuckfield, a broker with Guy Carpenter & Co., who participated in the backdating of documentation relating to a contract between National Indemnity and FAI (9 February No. 05.08); Charles Abbott, an alternative non-executive director at HIH as well as Deputy Chairman for nondisclosure of conflicts of interest (2 March No. 05.13); Geoffrey Trahir, an actuary with FAI and subsequently at HIH, for failing to disclose pertinent data to PricewaterhouseCoopers, the external actuaries about the degree of underprovisioning (2 March No. 05.13); Roger Colom, Reinsurance Manager at FAI, who APRA found to be 'incompetent or negligent' (16 March No. 05.14); Terence Cassidy, Managing Director of Australian Operations at HIH, for acting dishonestly and without diligence (16 March No. 05.14); Frederick Lo, Company Secretary at HIH, for his role in negotiating the Hanover Re contract (16 March No. 05.15); George Sturesteps, Deputy Chief Executive and Member of Reinsurance Committee at HIH, for demonstrating a 'lack of knowledge, competence or diligence' (13 April, No. 05.20); Raymond Gosling, Group Reinsurance Manager at HIH, for failing to disclose the true terms of the Hanover Re contract to either the HIH board or APRA (12 May, No. 05.26); and Dominic Fodera,

The effect was to stave off the day of reckoning until, appropriately enough, HIH's final collapse on 15 March 2001; this was coincidentally also The Ides of March – the date associated with overweening hubris since the assassination of Julius Caesar. Justice Owen's use of the Shakespearean epigram to preface his damning report demonstrated a biting sarcasm. A highly placed source close to the Inquiry maintained: 'It is fair to say that the reinsurance aspects probably disturbed [Justice Neville Owen] more than any individual issue that arose during the Royal Commission. They had such a capacity to distort the accounts and they did distort the accounts and did it in a way that the regulators had [not] a clue that it was a practice that was going on.'[20]

The reinsurance contracts did not cause the collapse. They did, however, maintain the fiction of underlying strength and allowed the corporation to trade while insolvent. Critically, the rise and precarious maintenance of HIH's share value could not have been sustained without the execution of structured finance transactions. Deploying a metaphor from the property market, the highly placed source from the Commission equated those responsible with 'skilful interior designers [disguising structural flaws] . . . Underneath the paper were cracks. In fact there were gaping holes rather than cracks.'[21]

The Royal Commission explicitly acknowledges the need for concerted action on a global basis to address the deficit in accountability associated with the reinsurance market. Furthermore, its determination that the search for effective governance has been stymied by the proclivity to frame the debate in terms of technical compliance with form over substance captures nicely the global nature of the problem of finite reinsurance design, execution and oversight. The Commission and subsequent regulatory and criminal investigations also highlighted, however, the relative powerlessness

Chief Financial Officer and Chief Operating Officer at HIH, for failing to disclose material information to either the board or the external auditor (28 July No. 05.37).

[20] Interview, Perth, 11 August 2005.

[21] Interview, Perth, 11 August 2005.

of the Australian regime. Barring revocation of licence, they had little capacity to influence the behaviour of financial groups operating outside the jurisdiction but with significant power to manipulate the valuations of major corporations traded in the primary markets of Melbourne and Sydney. This subjugated position was made manifest by the behaviour of the ultimate owners of Cologne Re. Berkshire Hathaway, one of the most influential insurance conglomerates in the world, upheld the right of senior executives in the 'Alternative Solutions Unit' to disregard requests to give evidence to the Royal Commission.

When the executives were subsequently banned from the Australian securities and insurance industries for life, they were allowed to remain in place in executive positions in both Dublin and London.[22] This confirmed to two senior investigating counsels to the Commission that the primary problem is one of supply not demand. According to one, it was clear from the email evidence that the contracts were constructed with 'consummate ease. You got the sense that they were writing these every day of the week.'[23] The second argues that if one were to transpose the case to the criminal arena, the Alternative Solutions Unit, 'would equate to the drug dealer, with HIH and FAI akin to drug addicts dependent on the next financial fix to survive.'[24]

John Houldsworth, the principal of the 'Alternative Solutions Unit', avoided prosecution in Australia primarily because of his failure to attend the legal hearing. The Australian regulatory authorities did, however, notify their Irish counterparts of the scope and outcome of their investigations. Nothing was done with this information. He could not avoid, however, the reach of the United States Department of Justice, which has significantly enhanced its enforcement capacity

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[22] 'APRA disqualifies GCRA individuals on "fit and proper" grounds', No. 04.37, 14 October 2004. Full text online at http://www.apra.gov.au/media-releases/04_37.cfm.
[23] Interview, Sydney, 12 August 2005.
[24] Interview, Sydney, 12 August 2005.

in the wake of domestic corporate scandal.[25] Following a joint investigation with the Securities and Exchange Commission, the corporate defence that the problem lay not in the design of the product but the use to which it was deployed by the issuer, has been thoroughly discredited. In a partial and self-serving manner, the war on financial crime has moved to 'The Street', a move which has uncharted implications for regulatory control on a global basis.

Insuring Failure: The Case of American International Group

The apparent disdain for the judicial process in Australia stands in sharp contrast to Berkshire Hathaway's response to the emergent scandal in the United States involving General Re's relationship with American International Group. The transaction at the core of the investigation was designed and executed through the General Cologne Re office in Dublin. When the executives initially refused to cooperate with competing federal and state investigations, they were placed on administrative leave and later sacked. Berkshire Hathaway's Chairman, Warren Buffett, was recruited as a cooperating witness by the New York State Attorney General, Eliot Spitzer, in the prosecution of the case against AIG's former chief executive.[26] In the

[25] See United States Federal Sentencing Guidelines 2004, Chapter Eight, 'Sentencing of Organizations'. Full text available online at: http://www.ussc.gov/2004guid/tabconchapt8.htm. The guidelines follow on from a 'memo' released by the Deputy Attorney General that suggested that charging corporations for demonstration effect had become departmental policy, see L. Thompson, *Principles of Federal Prosecution of Business Organizations*, Department of Justice, Washington DC, 20 January 2003. See Chapter 6.

[26] See J. O'Brien, 'The Politics of Enforcement: Eliot Spitzer, State–Federal Relations and the Redesign of Financial Regulation' (2005) 35 *Publius, The Journal of Federalism* 449; S. Pulliam, 'How Buffett Gave a Tip That Led to Greenberg's Fall', *Wall Street Journal*, 8 April 2005, p. AI.

past, this level of cooperation could be enough to secure immunity from prosecution, as demonstrated in the Sotheby's–Christie's price-fixing scandal.[27] Buffett, however, found the Berkshire Hathaway conglomerate caught up in a separate turf war between the SEC and the Department of Justice and the New York Attorney General's office over ownership of the regulatory enforcement agenda.

The alleged deception again centres on the inappropriate use of finite reinsurance. While there was no prospect of collapse in the absence of the transactions, as in the FAI and HIH cases, value was predicated on capacity to manipulate share price valuations. The effect was to fundamentally distort the market for corporate control. Specifically, the finite reinsurance contract was designed to curtail analyst criticism at deteriorating levels of loss reserves within AIG. This displeasure had been instrumental in causing a 6% fall in share price after the corporation released its third quarter filings on 26 October 2000. To stem this flow – and to protect his own personal investment in AIG – the Chief Executive, Hank Greenberg, approached his opposite number in General Re. He wanted to book US $500m to cushion against future earnings reports. Greenberg explicitly stated, however, that he did not want to transfer risk. The executives at General Re knew what their largest single customer expected. They also recognized the underlying unlawful purpose. General Re headquarters also knew exactly who to approach: John Houldsworth, head of the 'Alternative Solutions Unit' in Dublin. Telephone records between Richard Napier, the Vice President at General Re responsible for handling relations with AIG, Elizabeth Monrad, the reinsurer's Chief Financial Officer, and Houldsworth make clear that the critical question was not whether the deal should be consummated but how it could be:

[27] See C. Mason, *The Art of the Steal: Inside the Sotheby's–Christie's Auction House Scandal*, G.P. Putnams, New York, 2004.

Houldsworth: There is clearly no risk transfer. You know there is no money changing hands.

Monrad: [AIG] may have a tough time getting the accounting they want out of the deal that they want to do . . . They are not looking for real risk . . .

Napier: [W]hat would happen if we just did this where there was no risk. I mean we just charge them a fee for doing this deal?

Houldsworth: . . . I think to give them a deal with no risk in it and just charge them a fee you can assume their auditors are being pushed in one direction, but I think that's going too far. [Without introducing some risk] I would be staggered if they get away with that.

Napier: Then the way to do this, if there is a risk in this, the way to become whole requires [the AIG chairman] and [the Gene Re CEO] to have a handshake.[28]

Houldsworth and his colleagues calculated that the transaction could slip beneath the market and regulatory radar. This was despite its highly unusual nature, which saw a reinsurer buying the product from its main customer. Designed to be executed over two successive quarters, the indictment by the New York State Attorney General alleges that 'GenRe did not pay premiums. And in fact AIG did not reinsure genuine risk. To the contrary, AIG paid GenRe US $5 million, and the only genuine service performed by either party was

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[28] *Securities and Exchange Commission v. John Houldsworth and Richard Napier* 05 CV 5325. Full text of complaint available at: http://www.sec.gov/litigation/complaints/comp19264.pdf.

that GenRe created false and misleading documentation to satisfy Greenberg's illicit goals'.[29]

As noted above, the cooperating witness status provided to Berkshire Hathaway in the New York State Attorney General's suit did not extend to other branches of government in the United States. A criminal indictment was brought by the Department of Justice in Virginia. The Securities and Exchange Commission lodged an accompanying civil case in New York. Houldsworth pleaded guilty to charges of securities manipulation and of creating false records. He is awaiting sentencing, with the term of imprisonment determined on the level of cooperation with the expanding investigation. In the event, the Department of Justice asked for a deferral until the completion of the prosecution of more senior executives within the firm, including the Chief Financial Officer, Elizabeth Monrad. The SEC complaint paints a graphic picture of corporate malfeasance.

> This case is not about the violation of technical accounting rules. It involves the deliberate or extremely reckless efforts by senior corporate officers of a facilitator company (General Re) to aid and abet senior management of an issuer (AIG) in structuring transactions, having no economic substance, that were designed solely for the unlawful purpose of achieving a specific, and false, accounting effect on the issuer's financial statements.[30]

Email records published in the criminal and civil cases provide *prima facie* evidence that the transaction had the explicit sanction of senior management in General Re headquarters in the United States. Those implicated include the Chairman, Ronald Ferguson, and the Chief Financial Officer. Specific guidance from Ferguson stated, for example, that the file was to be 'confidential and consequently kept in a locked desk at all times'. The thoughts of Elizabeth

[29] *New York v. American International Group, Maurice Greenberg and Howard Smith* Complaint, at 10. Full text available at http://www.oag.state.ny.us/press/2005/may/Summons%20and%20Complaint.pdf.

[30] *SEC v. Houldsworth and Napier*, above note 28 at 4.

Monrad are recorded in a damning telephone conversation with Houldsworth:

Monrad: I will tell you any way we structure it it's got to look more like deposit because they are not really looking to take risks. Well, I think if we spend a lot of time trying to figure out how to transfer $500m of risk, we won't get this deal done in the time they want.

Houldsworth: Yeah, I mean as you say, if there's enough pressure on their end, they'll find ways to cook the books won't they [Monrad laughs]?[31]

What is surprising is that there has been no public comment from the Irish regulatory authorities on the decision by Houldsworth to plead guilty. Nor has there been any discussion of the implications, if any, this poses for the reinsurance market in Dublin. In briefings provided to the author in Dublin, regulatory authorities expressed considerable dismay about the implications of the case for the credibility of the Irish market. They argued first that the transactions were properly a matter of regulatory authorities elsewhere. Second, they maintained that effective remedial action, which included a full investigation, would take place. When pressed, however, it transpired that the investigation was one by General Re itself.[32] It is certainly arguable that the proceedings in the United States, when combined with the investigative process in Australia, severely compromise the reputation of Ireland as an emergent financial services centre. Given this risk, the critical question is why Dublin has adopted such a low-key response.

[31] Ibid, at 12.
[32] Interview, Dublin, 4 April 2006.

Trading at the Frontier

Globalization and financial liberalization in the late 1980s and 1990s facilitated the emergence of networked centres to rival the traditional offshore havens. Each sought to take advantage of the synergies between investment and commercial banking, securitization and the growing interdependence of capital markets. Relative success was dependent on capacity to attract the critical mass to sustain the 'network advantage' of accounting and legal services.[33] The fungible nature of financial products makes the entire sector, however, vulnerable to the risk of capital flight. As a centre develops, the views of its most influential members become increasingly influential, therefore, in public policy calibration. The implicit threat of exit attenuates the potential subservience of the state to the demands of industry for light touch regulation. With states engaging in a 'competition in laxity', those jurisdictions with emergent financial centres can find significant obstacles to either the creation or the deployment of effective regulatory instruments if they wish to attract or retain significant market share.[34]

In evaluating why an industry centres its operation in a particular jurisdiction, it is necessary, therefore, to differentiate the form of control over process regulations and the substance of actual implementation. This mandates that significant attention is placed not simply on regulatory structure, but also on how political processes (including the nature of domestic institutions) mediate the salience of particular risks. Thus, while there may be an awareness of systemic risks associated, for example, with the design, marketing and execution of finite reinsurance, adopting a punitive regulatory strategy can conflict with other public policy objectives. The role of the Dublin-based

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[33] See D. Murphy, *The Structure of Regulatory Competition: Corporations and Public Policies in a Global Economy*, Oxford University Press, Oxford, 2004.
[34] Ibid, p. 107.

subsidiary of General Re in the execution of illegal finite reinsurance contracts for major corporations in Australia and the United States highlights the systemic risk associated with the fragmentation of regulatory authority in an age of global markets. The risk is magnified because Ireland trades heavily on its access to the European market and on its reputation as an enthusiastic supporter of EU economic integration.

The preference for private contracting in reinsurance within a business-to-business framework was evidenced by industry responses in Dublin to the investigation by the *New York Times* into how the AIG and HIH transactions were facilitated.[35] The Irish Financial Regulator (then the Irish Financial Services Regulatory Authority) took an equally sanguine position. In its only public comment on the finite reinsurance scandal, the Irish Financial Services Regulatory Authority played for time: 'We find out the facts before we act. We're not a regulator that reaches for the gun and shoots people down before we know what the real situation is.'[36]

Ireland has proved exceptionally successful in attracting leading banking and insurance concerns to base operations at the International Financial Services Centre (IFSC). By 2003, 10% of the reinsurance market was underwritten through Dublin, the vast majority of the operation outside of direct regulatory oversight. The success of

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[35] B. Lavery and T. O'Brien, 'For Insurance Regulators, Trails Lead to Dublin', *New York Times*, 1 April 2005 (online edition).

[36] In comments to journalists, IFSRA admitted that it knew of Australian concern but argued that because Houldsworth had relinquished a directorial position, it was not in a position to investigate. It did say, however, that it was satisfied with General Cologne Re's response. See A. Beesley, 'IFSRA Endorses Cologne stance on Executives', *Irish Times*, 31 March 2005 (online edition). In a later interview, the Chief Executive implied that IFSRA had cooperated fully with its Australian counterparts, an assertion disputed in Sydney. Secondly, he claimed that IFSRA had 'ensured that the executives were not in a position of power in Dublin'. Again this is a highly questionable assumption. See S. Creaton, 'IFSRA Chief Aims to Clean Up Wild West Image', *Irish Times*, 6 May 2005 (online edition).

the IFSC in attracting major components of the reinsurance industry is predicated on a triangulated model based on light touch regulation, low corporation tax and the reputational advantage of providing a trading domicile at the heart of the European Union. As recently as September 2005, the president of the European Central Bank suggested that Ireland should serve as a template for financial services reform across Europe.[37] The former Irish Finance Minister, Charlie McCreavy, went further. Now European Commissioner for Internal Markets, McCreavy used a speech in Dublin in October to call for further regulatory liberalization.[38]

The critical importance of the speech rests in the fact that it was the first public opportunity since the Houldsworth guilty plea in the United States for the EU Commissioner in charge of financial services reform to comment directly to the Irish regulatory authorities. Significantly, Commissioner McCreavy ignored both this and other domestic failings. These include the belated discovery of an illegal offshore banking operation centred in the offices of one of the country's most important industrial concerns and used by a 'Golden Circle' of the business and political elite, including the former Prime Minister, Charles Haughey[39]; the revelation that the entire mainstream banking sector facilitated systematic tax evasion[40]; and a cavalier approach to corporate governance optics, as demonstrated by the appointment of one of the most controversial businessmen in Ireland to Vice Chairman of the Bank of Ireland Court as he was being

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[37] M. Coleman, 'Trichet Cites Republic as Example of Growth', *Irish Times*, 21 September 2005, p. 17.

[38] C. McCreavy, 'Speech to Financial Regulator', Dublin, 17 October 2005.

[39] See C. Kenna, *Haughey's Millions: Charlie's Money Trail*, Gill & Macmillan, Dublin, 2001; J. O'Brien, *The Modern Prince: Charles J. Haughey and the Quest for Power*, Merlin Publishing, Dublin, 2002.

[40] C. Kenna, *The Ansbacher Conspiracy*, Gill & Macmillan, Dublin, 2003; P. Appleby, 'Corporate Regulation in Ireland', in J. O'Brien. above note 1, p. 255.

investigated over alleged corruption.[41] Instead, McCreavy harked back to a more uncomplicated time.

The speech deserves airing at length because of the insights it reveals into the Irish political establishment's response to regulation and corporate governance more generally. Much more importantly, it also reveals an ideological predisposition towards substantially looser regulatory oversight. This stands in stark relief to the public positions adopted by the Internal Market Directorate bureaucracy.

> 'Many of us in this room are from the generations that had the luck to grow up before governments got working and lawyers got rich on regulating our lives. We were part of the "unregulated generation" – the generation that has produced some of the best risk-takers, problem-solvers and inventors. We had freedom, failure, success and responsibility and we learnt how to deal with them all. My appeal to you today is when regulating to give due weight to the need to strike the right balance between prudential and investor protection considerations and the need for competitiveness and innovation in financial services. Don't try to protect everyone from every possible accident. Concentrate on the big

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[41] The businessman Denis O'Brien was awarded a lucrative mobile phone licence in 1995 in controversial circumstances, which remain under investigation by the Moriarty Tribunal of Inquiry. The Tribunal has uncovered allegedly corrupt payments to the then telecommunications minister, Michael Lowry, from accounts controlled by O'Brien. Just as remarkable as the announcement of his elevation to the highest echelons of the Bank of Ireland Court was its timing, see S. Creaton, 'Bank of Ireland Selects Denis O'Brien as Deputy Governor', *Irish Times*, 15 September 2005 (online edition). The announcement was made a week before the Tribunal was to make an interim ruling on whether that phase of the inquiry would be curtailed. The timing demonstrated either startling naivety or startling arrogance. The Bank calculated, correctly as it turned out, that irrespective of the Tribunal ruling, the appointment would raise no objections from either institutional actors, the media or the wider political community. On 29 September 2005, the Tribunal ruled that sufficient 'apparent deviations' from confidentiality existed to continue investigating, see C. Kenna, 'Moriarty to Press on with Phone Licence Inquiry', *Irish Times*, 30 September 2005, p. 1. At no stage in that day's coverage did the *Irish Times* refer back to Denis O'Brien's banking promotion the previous week. Instead, its Business Section highlighted Mr O'Brien's role as chairman of the judging panel for the televised Ernst & Young Entrepreneur of the Year award.

things that really matter. And leave industry with the space to breathe and investors with the freedom to learn from their mistakes'.[42]

Mr McCreavy argued that 'the benefits [of regulation] are sometimes more imaginary than real.' The EU Commissioner stated that rather than advocating the 'excessive gold-plating' of regulatory restrictions, he favoured a political philosophy 'based on giving people freedom. That includes freedom to make money and freedom to lose it.' He concluded with a rousing call for further expansion of financial services reform, which, if captured, could position Ireland at the forefront of change.

'Member States have a shared responsibility to deliver an integrated pan-European financial market that will boost growth and jobs. Given the present state of our economy and the fierce competition, which takes place worldwide, we cannot afford a collection of 25 middle-sized markets made up of second league champions. But what we can have is specialization in centres of excellence and I am quite confident that Ireland can be one of those centres of excellence in different niches. If we address the priorities I have set out, and if we continuously and convincingly explain the benefits of the Internal Market to our citizens, I am confident that we can equip the EU with the modern, efficient and competitive financial sector it needs.'[43]

Outside Ireland, and indeed the European Union, a much less sanguine view is coming into clear focus.[44] The charge in the *New York Times* that Dublin is fast becoming the 'Wild West of European finance' resonates with off-the-record briefings provided to

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[42] C. McCreavy, above note 38.

[43] Ibid.

[44] The speech was given front-page treatment by the premier business newspaper, the *Sunday Business Post*, but it failed to make the connection between McCreavy's role in regulating the European market and the responsibility of General Cologne Re in facilitating capital market manipulation, see E. Quinn, 'McCreavy Warns Regulators About Financial Red Tape', *Sunday Business Post*, 16 October 2005, p. 1. This failure is endemic in the Irish press and indeed the wider polity, which recognizes the enormous financial benefits the IFSC brings in terms of tax revenues, see L. Slattery, 'A New Era is About to Dawn at IFSC', *Irish Times*, 14 October 2005, p. S5.

the author by senior regulators in Australia and the United States throughout August 2005. One expressed 'shock and dismay that Ireland had abdicated its responsibilities for short-term advantage.' Another suggested that behind the scenes pressure was being exerted on the Irish regulatory authorities through international networks, such as the International Association of Insurance Superintendents. According to this source: 'good luck to Ireland if it thinks it is going to get away with it, but it won't.' While it is arguable that the reticence of the Irish regulatory authorities could be linked to the fact that prosecutions are taking place elsewhere, the absence of wider debate undermines the credibility of this defence. The chief executive of the Financial Regulator suggests that the oversight of the reinsurance industry is not just effective but matches, if not exceeds, international best practices.[45]

Dr Liam O'Reilly based his assertion on the fact that Ireland will shortly transpose into domestic law a European directive on reinsurance. He argues: 'regulation must be robust and appropriate and the watchwords must continue to be reputation, integrity and transparency'. These are lofty and indeed laudable ambitions. The problem is that no tangible evidence is offered to support the claim. Inculcating higher ethical standards and accountability requires much more than rhetorical commitment. It also requires credible supervision and a demonstrable willingness to prosecute. To date this has been notable by its absence. The controversy comes at an exceptionally difficult time for the reinsurance industry and oversight system. Both have been subject to withering international criticism. A scandal facilitated by one of the largest reinsurance companies operating in Dublin has led to growing international perception of regulatory failure. My reporting of this reality in the *Irish Times* attracted the ire of both Dr O'Reilly and Sarah Goddard, the Chief Executive of the Dublin International Insurance and Management Association

[45] L. O'Reilly, 'IFSC Works Under a Robust Regulatory Structure', *Irish Times*, 16 January 2006; see also J. O'Brien, 'Evidence of Robust Regulation Sadly Lacking', *Irish Times*, 24 January 2006.

(DIMA). Ms Goddard maintained that it was inappropriate to place the 'Wild West' appellation on the regulation of the finite reinsurance market because of the behaviour of one firm, Cologne Re, that is no longer active.[46] Dr O'Reilly concurred.

He suggested it was misleading not to highlight that Cologne Re's collusion in the manipulation of share prices in New York and Sydney was 'orchestrated' overseas. This, however, is not true. The transactions were orchestrated and executed through the Dublin office. Furthermore, the Australian transaction involved the FAI general insurance, not, as Dr O'Reilly suggests, the HIH insurance group. It is also inaccurate to suggest that the Irish authority 'publicly and forcefully' dealt with the criminal activity of John Houldsworth, a former senior executive of Cologne Re in Dublin who pleaded guilty in a US court last June to securities fraud. Until now, there has been silence. The briefing provided to me gives an indication of why the Irish regulator was not keen to discuss what form its own investigation has taken, the extent of its remit and the remedial measures introduced. Given the centrality of Dublin to the scandal, it is surely imperative that structured changes are publicly announced and adequately debated.

The credibility threat facing the Dublin International Insurance and Management Association makes its stance even more remarkable. Houldsworth, whose activities formed the central focus of my initial article for the paper, is its former chairman.[47] He continued operating in Dublin long after a Royal Commission of Inquiry in Australia, which he refused to attend, critically examined his transactions. Indeed, he remained in place after the Australian authorities banned him from operating in its markets. It should not have escaped Ms Goddard's attention that this ban raised fundamental questions. Even if it did, should his guilty plea before a US federal court not have prompted open discussion of industry and regulatory failure? Yet, there is no

[46] Letters, *Irish Times*, 13 January 2006.

[47] See J. O'Brien, 'IFSC Seen as Financial Wild West', *Irish Times*, 9 January 2006.

evidence whatsoever that this is the case. On the day that the *Irish Times* published DIMA's response to my article, media reports from the United States suggested that federal and state authorities were close to sealing a settlement with the insurer AIG. This cannot be brushed aside as an event in a faraway land.

What is now at issue is whether the rapid transposition of the EU framework directive will guarantee more effective regulation. Article 45 gives specific clearance to vary crucial terms, including internal control mechanisms, risk management, and accounting, prudential and statistical information requirements. This gives substantial latitude to regulatory regimes attempting to engage with and retain business in an increasingly competitive marketplace. Transparency is limited to communicating the end result of national law, not the process by which it is constructed. Dr O'Reilly suggests we can have confidence because the new Irish structure will go further than the directive, 'in line with IAIS standards'. It is unclear to which International Association of Insurance Supervisors standards he is actually referring. The IAIS has avoided a prescriptive stance. It provides guidance that ranges from self-policing to a ban on finite reinsurance. The draft Irish Statutory Instrument states only that the Central Bank 'may from time to time make rules'. Regulated entities 'shall comply with the rules (if any)' – in other words 'we may make some rules and if we do, you have to obey them'. DIMA says it has not been lobbying the government. In a bulletin, however, Ms Goddard suggested that the organization 'has been working closely with Government and the Irish financial regulator over the course of 2005 to ensure that a comprehensive regulatory regime will be implemented in 2006'. We could divine, perhaps, intentions from DIMA's website. Curiously, the site itself remains closed for 'redesign'. The old website linked competitive advantage to a pro-business regulatory environment. The prominent placement of the IDA logo gave this tacit governmental approval. The archive contained a remarkable opinion piece. Written by Houldsworth while chairman, he salivated at the prospect of Dublin becoming the next Bermuda. While accepting the inevitability of regulation, he suggested that a responsive regulatory environment gave Dublin a unique edge. 'Strong corporate governance can help avoid abdications of management responsibilities,' opined the executive we now know was orchestrating securities fraud on a global basis. The lack of public comment from the EU Commissioner towards the interlinked investigative and criminal investigations in the United States and Australia further threatens, rather than enhances, Ireland's reputation. It also serves to undermine the credibility of financial services reform within the European Union as a whole.

Transcending Regulatory Failure

A regulatory system can be usefully mapped as a regime. Using the navigational aid developed by Hood, Rothstein and Baldwin, a regime denotes 'the complex of institutional [physical and social] geography, rules, practice and animating ideas that are associated with the regulation of a particular risk or hazard.'[48] While Hood, Rothstein and Baldwin limit their analysis to risk, the tripartite mesotheoretical framework developed has applicability to wider questions of regulatory governance. The model's descriptive, explanatory and prescriptive power lies in its 'cybernetic' conception of regulation: an interconnected but bounded system characterized by a degree of continuity. The authors argue that in order to adequately explain regulatory dynamics, it is necessary to first differentiate context, including degree of media and public salience, from content, which is defined as 'the policy settings, the configuration of state and other organizations directly engaged in regulating the risk and the attitudes, beliefs and operating intentions of the regulators.'[49]

Change within this system is determined by a confluence of 'sudden climacterics as well as their incremental adjustments and steady

[48] C. Hood, H. Rothstein and R. Baldwin, *The Government of Risk*, Oxford University Press, Oxford, 2004, p. 8.
[49] Ibid, p. 21.

trends.'[50] Hood, Rothstein and Baldwin argue that viable control mechanisms are predicated on the critical interaction between how a regulatory agency gathers information, its degree of emphasis on the setting of minimum standards and its propensity or reluctance to advance strategies based on modifying behaviour. They conclude that 'regulatory assessment that focuses exclusively on standards but not [on how information is gathered or] on the effect of enforcement or behaviour-modification activity may be easier to do against tight deadlines but will fail to capture how the regime works.'[51]

The priorities governing prudential regulation that have been outlined in this chapter make manifest the dangers associated with the emaciated conception. Common to other prudential regulators, recruitment and career advancement within the Australian Prudential Regulatory Authority privileged knowledge of the rules. In response to withering criticism in the Royal Commission of Inquiry final report, APRA has adopted a much more muscular approach to compliance. Excessive deference, misplaced trust in the illusion of probity cultivated by the sector and lack of insight about the functional purpose of finite reinsurance has been replaced by systemic risk evaluation. For Ross Jones, the recently appointed Director of Enforcement, in the identification and examination of risk, APRA recognizes that it needs 'to be much more discerning when people come through the door.'[52] While agency ignorance created the particular circumstances for systems failure in the oversight of HIH, the structural failings identified transcend the confines of the Australian regulatory state.

Fragmented regulatory authority and capacity converged with libertarian conceptions of ethical responsibility to facilitate regulatory gaming through technical or 'creative compliance'. In the United States, capacity was further reduced by the delegation of authority over the regulation of the insurance industry to state commissions.

[50] Ibid, p. 9.

[51] Ibid, p. 180.

[52] Interview, Sydney, 17 August 2005.

They lack the resolve to police beyond their borders the expertise to track complex transactions involving multiple jurisdictions and the international networks of significant national power to mandate cooperation. The failures associated with insurance supervision make it susceptible to pre-emption, further extending the reach of the federal government over business regulation and with it the power of the Securities and Exchange Commission.[53]

Even when that function is centralized, as in APRA and its Irish counterpart, the newly renamed, but unreconstructed, Financial Regulator, coordination problems abound. For Steve Cutler, former Director of Enforcement at the SEC, the first step must be global convergence on what constitutes systemic risk:

> 'We, over the last decade, have done a nice job in establishing and maintaining very good relations with our counterparts overseas, but that level of cooperation and that kind of close working relationship can only exist if our laws bear some relation to one another. And if we end up prosecuting something that my counterpart in London thinks is crazy for us to be prosecuting because it is perfectly OK, then they are not going to provide a lot of help I wouldn't think, and vice versa. And ultimately, as our markets go more and more global, the more pressure there is on the free market communities to arrive at something that approaches convergence.'[54]

Despite the fact that the transactions at the heart of the HIH investigation involved a US subsidiary operating in Ireland, the regulatory enforcement priorities in the Republic did not extend to intensive consultation with either APRA or the Australian Securities and Insurance Commission. This is doubly surprising given that another transaction, involving Cologne Re's dealings with Zurich Financial Services Australia, led to a stringent enforceable regulatory undertaking in 2005.[55] The fact that the designer of both products has pleaded guilty in the United States of using similar products to

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[53] J. Zimmerman, 'Congressional Pre-emption: Removal of State Regulatory Powers' (2005) 38 *Political Science and Politics* 375, at 377.

[54] Interview, Washington DC, 10 May 2005.

[55] See 'Zurich Admits Deliberate Misrepresentations to APRA', APRA 05.31, 26 May 2005. Full text online at: http://www.apra.gov.au/media-releases/05_31.cfm.

manipulate the value of AIG, renders the Irish apparent lack of interest in the substance of its export market hard to justify. Confidential sources in Dublin maintain that while there is recognition of a major problem, the lack of traction and the fact that blame, if posited, could be placed on the now defunct IFSRA, have curtailed the urgency in dealing with the implications of the scandal.

This cuts across the muted attempts by the IAIS to introduce principles on minimum requirements for supervision and a supervisory standard, which anticipate 'a global approach to the supervision of reinsurers that will be anchored in the home jurisdiction, and thus constitute a significant first step towards harmonizing supervisory practice for the global reinsurance industry.'[56] Underpinning this putative regime is the requirement for fit and proper testing and on-site inspection as well as corporate governance and exchange of information.

This lack of interest extends to the series of benchmarking and structured processes introduced in Australia. On the contrary, significant industry actors, including the Dublin International Insurance and Management Committee, have been lobbying to ensure that in transposing the European directive on reinsurance into domestic legislation, the responsive nature of Irish regulation is not lost.[57]

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[56] *Global Reinsurance Market Report 2003*. Above note 7, p. 15.

[57] A search of the Financial Regulator website shows that no codes or requirements governing the reinsurance industry are posted. Accessed 19 October. See http://www.ifsra.ie/frame_main.asp?pg=%2Fpublications%2Fpu%5Frecs%2Easp&nv=%2Fpublications%2Fpu_nav.asp. This makes it difficult to assess the relative efficacy of the Irish regulatory response. Nor is there any information in the FAQ section or speeches. A search on the website did uncover an insightful speech given by the Chief Executive on 29 September 2005. Liam O'Reilly argued: 'By promoting good principles in financial services, I believe we will, in the long term, enhance the competitive advantage for Ireland as a market of high reputation by changing the way we behave.' He gave no indication of how precisely the regulator would inculcate the change other than suggesting that a rules-based approach would not be effective. The Annual Report, released on 26 July 2005, is also silent on the reputational damage associated with the General Re scandal.

Conclusion

There are striking parallels between the HIH case and how the toleration of the abuse of structured finance by those exercising gatekeeper functions corrupted the US capital markets. The WorldCom securities law class action, for example, which received court validation in September 2005, suggests a total abdication of fiduciary responsibility on the part of the investment banks. In designing and offering products to companies in distress, such as Enron, the guiding principle of due diligence had been interpreted as diligence to the banks' profit capacity. As the HIH scandal intimated and the emergent scandal involving American International Group in New York now confirms, a similar imperative governed product development in the insurance industry.

The chief progenitor of the FAI and HIH schemes, John Houldsworth, was far from a rogue trader. A senior executive in the Dublin office, he had developed close connections to the corporate hierarchy in the United States. The 'Alternative Solutions Unit' was instrumental in orchestrating a global network of transactions that fundamentally distorted the market for corporate control. The new-found enthusiasm by the Department of Justice, as expressed in the statement that 'those who cheat, however, by engaging in complex sham transactions – whether they be executives in the boardroom or facilitators at other companies – will be held accountable and brought to justice'[58] makes for effective rhetoric. The reality, however, is that the US regulatory authorities were as equally aware as the Irish of the role played by General Re and only intervened when it impacted on a domestic company, and then only because it played into domestic political imperatives. Crisis, rather than strategic management, remains the underpinning rationale; this is a state of affairs that preordains future scandal.

[58] Press release, 'Gen Re Executive John Houldsworth Pleads Guilty in Fraud Scheme, Agrees to Cooperate with Investigation,' US Department of Justice, Washington DC, 9 June 2005.

8
Transcending compliance

While the business scandals in the USA owed their emergence to problems within the sector, the underlying conditions that allowed them to flourish can be traced directly to the weakness of the regulatory system to inculcate either respect for the law or moral restraint. A number of explanatory factors can be put forward for this structural imbalance. At the overarching political level, significant changes throughout the 1990s progressively undermined the authority of the primary regulatory agency, the Securities and Exchange Commission. The dependence of politicians on corporate donations to finance the ever-increasing cost of election campaigns reinforced the bipartisan ideological retreat from governmental interference in the market just as it was beginning to demonstrate signs of irrational exuberance. While the accountancy profession failed, so too did a range of other reputational gatekeepers, including the legal profession and, most significantly, the investment banks.

From the 'spinning' of the Initial Public Offering (IPO) market, to subsequent bond issues, to the design of the arcane financial instruments used to manipulate quarterly earnings, the structured and sustained involvement of the investment banking system is the defining characteristic of the 2000–2005 crisis. This led to a profound fracturing of the trust on which the successful operation of the market is predicated. This, too, did not exist in a vacuum. It was only achievable because of a recombination of investment and commercial banking and the concomitant dismantling of the protections ushered in following the 1929 crash.

Despite this erosion, the securities market in the USA remained the most codified in the world. Sarbanes–Oxley extends this process in a number of fundamental areas. Of critical importance has been the move away from an enabling jurisdictional framework to a federal mandatory one, with prime responsibility for ensuring effective governance transferring to the Securities and Exchange Commission. It also signifies a qualitative improvement in the standing of the SEC.

The stated preference of the Department of Justice for 'pre-trial diversions', seen most recently in the settlement with KPMG over abusive tax shelter design, provides confirming evidence that an enforced self-regulation paradigm is beginning to emerge that challenges many of the core assumptions of governance, both in theory and in practice. The implications of replacing regulators with prosecutors is, however, profound and far from unproblematic not least because of the presence of overt political agendas. It suggests that stability can only be vouchsafed if accompanied by a graduated application of regulatory muscle.

Critical to this dynamic has been the intervention of the New York State Attorney General, Eliot Spitzer. The relationship between Spitzer and his federal colleagues has always been strained. It is likely to remain so until his expected elevation to the Governor's mansion in Albany in November 2006. In part this can be attributed to the populist narrative that Spitzer has furnished to advance his own political self-interest. It positions him as one key actor taking on the alchemists of Wall Street and their backers in Congress and forcing a 'captured' Securities and Exchange Commission to be much more aggressive. This, in turn, however, places pressure on the protocols governing the Securities and Exchange Commission, according to its recently departed Director of Enforcement, Steve Cutler.

> 'We have different ways of conducting investigations; we have different ways of bringing cases. I think that this place [the SEC] has been well served by some of the traditions and protocols that it has maintained, but it does cause angst and consternation. Eliot has a different way of going about things, and

> the frustration for some of my soon-to-be former colleagues here is that some of those traditions mean we are going to end up looking like we are not doing something when in fact we are.'[1]

As an institution, the SEC had been most regularly in the sights of Spitzer, whose success, in large measure, is predicated on spotting and dealing with new forms of malefaction before the agency. Federal policy imperatives necessitated his cooption to limit the embarrassment caused by multi-million dollar settlements with Wall Street from corporations not in a position to risk court proceedings, even on flimsy evidence of criminal intent. Cooption carried risks as well as benefits for the agency, especially the Directorate of Enforcement. As hinted in the above quotation, the unease about Spitzer now extends across and between key actors within the regulatory arena, most notably the Securities and Exchange Commission itself. In part this can be attributed to pique; in part empire conservation; and in part genuine concern about the sanctity of due process. For Cutler, the lack of common history and conflicting ethos combined to strain relations.

> 'We have had a very good relationship with federal prosecutors. With some of the state securities regulators and state prosecutors, certainly over the past few years, it has been a lot bumpier. Part of that is a lack of history. In any relationship, history and a track record tends to bind people during difficult times. Inevitably there are difficult times when two agencies work together. Not everything is going to go smoothly. There are going to be communications [problems]. What it takes to smooth over those bumps in some ways is that track record: "Hey we have done this before, we've come through this issue before and whatever issue we might have, there is a fundamental level of trust there"[2]

Spitzer, too, faced the risk that cooption could equate to capture. Spitzer determined not to be stymied by his involvement with the agency, preferring instead to widen the regulatory radar. Investigations were launched, publicized (or hijacked) into subjects as diverse

[1] Interview, Washington DC, 10 May 2005.
[2] Ibid.

as payola, life insurance, bank loans to minorities and now the ratings agencies. As the settlements increased in monetary terms, an escalation imperative took hold. With the Commission sharply divided as to the wisdom of cooption, let alone trying to compete with Spitzer, the Directorate of Enforcement found itself the target of internal ire. Cutler, the long-term Director of Enforcement, left shortly afterwards. When interviewed at his office in the SEC, surrounded by packing crates and empty bookshelves, Cutler diplomatically referred to 'philosophical differences' with his client.

> 'The Chairman and the Commission set the agenda and the tone for this place. I would like to think that I was making recommendations that made sense, and sometimes lawyers make recommendations that at first blush might be beyond where a client would want to go and sometimes vice versa. Sometimes lawyers are more cautious than their clients and so there are all kinds of ways that lawyers deal with clients, but at the end of the day the Commission makes the decisions and we have to be conscious of that and cognizant of that. And we are cognizant of the kind of Commission that we have and what the Commission is telling us. Once you go to the Commission and make a recommendation and the Commission says no, that is going to inform what you do the next time, clearly.'

Spitzer's key contribution has been to accelerate the use of innovative strategies to secure compliance that far exceed the minimum required by law. By instituting qualitative improvements in the design and operation of particular corporate governance arrangements, they seek to utilize the 'demonstration effect' to enhance the baseline of what constitutes effective compliance. They avoid conceptual difficulties in charging the corporation by bypassing the court system until negotiations are completed and sanctions agreed. Conversely, the degree to which negotiated prosecution represents an agreed compromise underplays the asymmetrical advantage provided to prosecutors. This advantage extends throughout the process. First, the agency can determine whether to offer deferral. Second, the prosecutor alone can scope the extent of internal change required. Third, the agency can mandate the degree of subsequent external oversight. The lack of opportunity for independent review causes significant problems relating to both the nature and extent of accountability in the new regulatory regime. While the negotiated prosecution enhances capacity, therefore, it also threatens, if misapplied, due process. The danger is that misapplication offers the capacity for organized interests to launch an effective counterattack. Already there are signs that this is beginning to happen, which will see the narrative change from one of business scandal to a scandal of regulatory overreach. Hank Paulson, another temporary evacuee from Wall Street to the federal government, used his first public speech as Treasury Secretary, to criticize the pendulum shift towards invasive regulation. He called for 'a period of readjustment' to reassert competitiveness.[3] The choice of language mirrored that of the Commerce Secretary, Carlos Gutierrez, who also maintained that the executive response lacked balance. This suggests a window of opportunity for reform in the immediate aftermath of the November mid-term elections. Sarbanes–Oxley and the related reforms, therefore, do not represent an end point in market governance, but a temporary and contingent victory for regulatory authority.

As this book has demonstrated, the contested interrelationship between the actors involved in corporate governance design and control must be mapped to understand the dynamics behind shifting power relations within economic governance in general and the financial markets in particular. The analysis of corporate failure and subsequent response must also take into account the wider structural architecture and the environmental impact on that structure of specific cultural and behavioural mores. This analysis must take place at a number of levels: within the corporation; within the market; within the regulatory bodies; and, ultimately, within the political system itself, which legislates and therefore legitimizes both the terms of the debate and the realm of acceptable conduct. It is only through a more granular understanding of corporate governance dynamics that we can begin the process of inculcating the cultural change that has the capacity to subordinate value to values.

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[3] E Luce and D Wighton, 'US Treasury Chief Hints at Reform of Sarbox', *Financial Times*, 2 August 2006, p. 1.

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