"THE CHICKENS HAVE COME HOME TO ROOST"†

How Wall Street, the Big Accounting Firms and Corporate Interests Chloroformed Congress and Cost America's Investors Trillions

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† "Chickens come home to roost" – Things you have done wrong or have failed to do will return and cause more problems later – "He got by with it this time, but the chickens will come home to roost."
The Curse of Kehama (1810).

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Two years ago, few people could have foreseen the carnage in our financial markets today. Back in the Spring of 2000, the equity bubble had not yet burst. Stock prices were at an all time high. IPOs were being poured out at more than one a day. Individual and institutional investors had increased their exposure to the equity markets to the highest level since – September 1929. The dot-coms were transforming the world. And a new high-tech driven economy was creating permanent prosperity that would drive stock prices higher.

With robust markets, large pension funds, as well as individuals' 401(k) retirement accounts, were flush – enjoying great returns. Do you remember the newsstands being filled with magazines with headlines about stocks and investing, about how everybody was going to retire in their 50s based on their portfolios? I can't help but think of Yale Professor Irving Fisher's famously ill-timed remark in mid-October 1929 that "stocks have reached what looks like a permanent high plateau."

Well, even in those halcyon days there were a few of us – viewed as cranks at the time – who warned that underneath this veneer of prosperity and profit actually lay widespread accounting rot, falsified profits, inflated asset values and executive chicanery which would collapse the system.

Shakespeare told us: "Oh how courtesy would seem to cover sin," and so did a great bull market cover financial sin – at least for a while. But collapse it did. First the dot-com implosion. Then it quickly spread out into more respectable companies. We have seen massive market declines inflicting gigantic losses on investors, leaving a NASDAQ that looks disturbingly like the Nikkei. That index has now been declining for 17 years – a decline due to the systemic dishonesty, phony accounting and lack of accountability which epitomizes the Japanese financial and legal systems and destroyed investor confidence there.

Recent accounting write-offs totaling $148 billion erased all the profits purportedly reported by NASDAQ companies in 1995-2000. According to the *Wall Street Journal*, "the companies currently listed on the market that symbolized the New Economy haven't made a collective dime since the fall of 1995." And this does not factor in the abuse of public companies in not accounting for stock option costs as compensation expense – a ploy that overstated earnings by additional billions of dollars during the last decade. In truth, much of the corporate profits of the 90s were illusions – false pictures painted by corporate insiders who then pocketed billions in cash by selling stock options or getting huge bonuses based on these false profits. No wonder the NASDAQ looks like the Nikkei.

And now the magazines have new articles called "Starting Over" as people try to figure out what they are going to do with their retirements.

Jane Bryant Quinn wrote in *Newsweek:*

> You have to start over, start over, start over. Forget what your stocks and mutual funds were worth .... That money is gone. The only question is what you're going to do next.

According to *Business Week*:

> Lulled by recent dreams of early and easy retirement, millions of Americans are suddenly facing the harsh truth that they will have a much harder time retiring.... Stripped of the illusions fed by a booming stock market, retirement is shaping up to be a nightmare of cost and complexity.

To try to understand where we are, we have to go back and see how we got here.

In the wake of the 1929 Crash and ensuing Depression, Congress's Pecorra hearings exposed the rawest kind of self-dealing, abuse and fraud by corporate insiders, Wall Street banks and the accounting firms during the 20s. Congress then quickly passed the securities acts of 1933 and 1934 and also in 1933, the

Glass-Steagall Act. These laws – which constituted the high-water mark of the new Roosevelt administration's campaign for financial reform – separated commercial and investment banking, created the SEC to oversee and regulate our securities exchanges, required accountants to be independent, required truthful disclosure by public companies and prohibited insider trading.

As time went by, federal regulation, as well as private litigation pursuant to the federal securities laws – especially after class action suits were authorized in 1967 – helped restore accountability and investor confidence. In time, the money came back out from underneath the mattresses and this culture of honesty produced the most efficient, deepest and richest markets in the world. Markets that created more wealth than all the rest of the securities markets in the world combined – many times over. Our markets became the envy of the world. The place where foreign investors wanted to place their money and where foreign companies wanted to come to raise money.

During the late 80s and early 90s, as trading volume, mergers and initial public offerings all surged to previously unheard of levels, naturally, there was an increase in securities class action suits. By the way, one of the most prominent of these suits was the securities/RICO class action arising out of the collapse of Charles Keating's fraudulent financial empire – (Lincoln Savings & Loan) where three of the nation's largest accounting firms and several prominent law firms and investment banks were involved in helping that financial psychopath fleece over 20,000 elderly persons out of their life savings. They got tagged for over $280 million.

But the Republican sweep in 1994 produced the first Republican majorities in both houses of Congress in decades. Republicans – who had years earlier vigorously resisted the Roosevelt administration's efforts to reform and regulate the securities markets – now moved quickly to cut back the securities laws and especially curtail securities class action suits by defrauded investors.

Sensing their first opportunity in decades to roll back the securities laws, corporate interests, the accounting oligopoly and the Wall Street bankers descended on Congress with a massive political lobbying and public relations campaign to seek enactment of what came to be known as the Private Securities Litigation Reform Act of 1995 ("PSLRA").

Demand for passage of the PSLRA was greased by millions of dollars of lobbying fees and political contributions from corporate and financial interests. This tsunami of special-interest money was flavored by anecdotal tales of woe by high-tech corporate executives who were paraded by the handlers before Congressional committees to whine about how frivolous class action suits by avaricious lawyers resulted in "blackmail" settlements which injured public companies, diminished productive activities, such as the development of new products, and undermined economic growth.

After a bitter political fight, the massive lobbying campaign of the corporate and financial community succeeded. The PSLRA was enacted on December 22, 1995, when the Senate overrode President Clinton's veto by just a few votes. The corporate and financial interests got:

- An onerous pleading standard requiring a victim of securities fraud – without the benefit of any discovery – to plead particularized facts showing a "strong inference" that each defendant acted with an intent to defraud – unlike that required in any other civil litigation.
- Elimination of joint-and-several liability.
- Elimination of liability for even intentionally and knowingly false financial projections and forecasts.
- Elimination of use of the federal racketeering statute and its treble

damage provision to remedy securities fraud, no matter how terrible the fraud.

- Limitations on the damages a defrauded investor can recover.

To make matters worse, in 1994, the Supreme Court, in a 5-to-4 decision, capped a decade of pro-corporate decisions in the securities area by overturning 60 years of unanimous Court of Appeal precedents to issue an incredible ruling. Over the protests of the SEC, the Supreme Court ruled that law firms, accountants, investment banks and others who knowingly "aid and abet" a securities fraud are not liable to victims! Then in 1998, as investors returned to state court to pursue remedies under state law for securities fraud after their federal remedies had been curtailed, the corporate and financial interests hurried back to Washington and got Congress to preempt (*i.e.*, forbid) securities class actions under state law, making investors' now impaired federal remedy their exclusive remedy.

Finally, in 1999, the corporate-dominated Congress delivered another long-sought gift to Wall Street – the repeal of the Glass-Steagall Act, which Congress had originally enacted to separate investment banking and commercial banking, after the banks' abuses in dealing in the stocks of public companies during the 20s and their role in the massive stock manipulation that led to the 1929 Crash were exposed.

With regard to matters legal, the last five years of the 20th century were a nuclear waste dump for investors and a long wished-for bonanza for corporate interests, Wall Street bankers, the accounting oligopoly and their big law firms.

The proponents of the PSLRA promised that if the anti-investor legislation they wanted was enacted, frivolous suits would be eliminated, capital formation would be enhanced, new product development would accelerate, employment would increase and investors and the U.S. economy would benefit.

In fact what happened was quite the opposite. Just five years after corporate lobbyists got Congress to pass the PSLRA, "the chickens have come home to roost." After these powerful interests achieved their longed-for goal of curtailing the ability of investors to sue and hold them accountable for securities fraud, there has been a massive upsurge in securities fraud.

The results are now clear for all to see. Every metric to measure fraud in our markets has soared. Financial scandal after financial scandal – accounting restatement after accounting restatement – has surfaced. The huge market bubble has burst, leaving investors holding a multi-trillion dollar bag. Corporate layoffs sky-rocketed. Capital formation has collapsed. Reality has overtaken deceit.

The carnage is not complete. While the market collapse probably has further to go, to date it has inflicted trillions of dollars of losses on investors who have watched the exposure of the rigged IPO market, the auditor independence fiasco, surging broker dishonesty and the massive upsurge in financial fraud with dismay. Now they find that their ability to sue to recover damages under the federal securities laws – which were supposed to provide effective remedies for cheated investors – has been severely hobbled by pro-corporate judges who use the PSLRA's anti-investor provisions to shield perpetrators of securities fraud from the kind of legal accountability needed to deter misconduct, protect investors and boost investor confidence that they are protected against abuses in the financial markets and will be protected by the legal system.

For instance, in the Ninth Circuit Court of Appeals (which covers the high-tech and venture capital havens of California), that court has thrown 17 consecutive securities fraud suits by investors out of court. Seventeen times in a row, using the PSLRA, that court has sided with corporate interests and closed the courthouse door to defrauded investors.

Can you imagine that the stockholder suits against WorldCom and Ebbers and Tyco and Kozlowski were thrown out of court by federal judges? And so was the shareholder suit against Oracle and Larry Ellison, where Ellison sold off $900 million of stock just a few weeks before Oracle revealed financial reversals and the stock collapsed.

No wonder corporate executives have become emboldened and investors dismayed! If victims of securities fraud perceive that they have lost their ability to hold perpetrators responsible, that has to undermine investor confidence.

It wasn't as if Congress wasn't warned. Testimony from consumer and investor groups warned that the drastic cutback on investor protections and remedies for securities fraud embodied in the PSLRA, and reduction of corporate executives' and securities professionals' accountability for misconduct that would follow from that legislation, would inevitably result in an increase in securities fraud and investor losses. Ultimately, this would impair investor confidence, harm capital formation and our economy. Not only was the PSLRA opposed by major consumer, worker and investor groups, but the vast majority of America's newspapers editorialized against the PSLRA, warning that it would grant those best positioned to profit from stock inflation a license to lie and result in a massive upsurge of fraudulent conduct and investor losses.

It is worth asking how, in the light of overwhelming consumer, labor and investor group opposition and widespread editorial warnings, could this special-interest legislation have possibly been enacted? In truth, the fault lies not with the corporate and financial interests which used their financial and political power to obtain this legislation. After all, they were only exercising their First Amendment rights to advance their interests. The real responsibility lies with those in positions of public trust who defaulted, who gave in and even actively assisted these special interests to help get this legislation passed when they were in a position to – and, in my view, had a responsibility to – stop it.

Notable among those who defaulted was then SEC Chairman, Arthur Levitt, the quintessential man of Wall Street who became the first SEC Chairman in history to actively support legislation curtailing investor protection against, and corporate executive accountability for, securities fraud. While the Levitt of late has become a prominent and articulate critic of corporate and financial abuse (and he deserves credit for this), in truth, he abandoned the investors he was supposed to protect when the corporate and financial interests besieged Congress in 1993-1995. Next comes Senator Chris Dodd from Connecticut, the purported progressive, who so energetically championed the accounting firms and insurance and Wall Street interests, i.e., his contribution base, which all benefited so handsomely from his efforts in making their attempt to gut the securities laws appear to be "bipartisan." He actually led the veto override efforts to enact the PSLRA – blind to all the warnings of the of the carnage to come. And finally, Rep. Chris Cox of Orange County, California, an alumnus of a major corporate law firm which defends corporations, banks and accounting firms in securities fraud suits and who himself had been sued for his participation in a securities fraud which bilked investors out of over $100 million. This is a cautionary tale how money, power and special interest legislation can harm America's workers and investors.

In a free-market economy, entrepreneurs and corporate executives respond to the economic incentives created by legislation and legal rules. The PSLRA and judicial decisions protecting corporate executives encouraged securities fraud because they made it much more difficult for defrauded investors to hold perpetrators responsible.

According to Richard Walker of the SEC:

> The current increase in financial fraud … is partially attributable to court rulings limiting corporate liabilityfor financial fraud and the Private

> Securities Reform Act of 1995, which removed joint-and-several liability … With such restrictions on the ability of shareholders to go after companies, Mr. Walker says, "there was an increase in these kinds of frauds"

And, according to Columbia Law professor Harvey Goldschmid, the former general counsel of the SEC:

> Forward-looking statements are especially important… Now that many of the more grandiose projections of the 1990s have fizzled, some people are wondering whether Congress gave Silicon Valley a little too much protection. "The big question is whether the safe harbor in the 1995 Act provided protection for baseless earnings projections"

According to *The New York Times*:

> Corporate law experts and investor advocates say some of the same people who are now professing moral outrage over Enron's collapse and the $60 billion-plus loss to investors, and who are groping for legislative and regulatory fixes, actually helped create a legal climate for Enron and Arthur Andersen to push the envelope.
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> First, in 1995, the group of lawmakers and lawyers pushed successfully for legislation that shielded companies and their accountants from investor lawsuits… The group includes the current chairman of the Securities and Exchange Commission and three House and Senate committee chairmen now involved in the cleanup who have been among the accounting industry's largest campaign recipients.
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> "It was the ultimate in special-interest legislation" said James D. Cox, a professor of corporate law and securities regulation at Duke University.
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> The law, passed after heavy lobbying from Andersen, the rest of the accounting industry and Silicon Valley, shielded executives from liability for making dubious financial projections. Since its passage, the high-technology bubble has burst and a record number of corporations have restated their earnings, costing investors billions.
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> "The 1995 law," [said Barbara Roper, director of investor protection at the Consumer Federation of America], "made it not only possible but likely that something like Enron would occur."
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> Sarah Teslik, executive director of the Council of Institutional Investors, which represents many of the nation's largest shareholders like pension funds and labor organizations, agreed. "It is absolutely clear from their record that neither the regulators nor Congress has been looking out for investors," she said.[1]

Also in the mix here is the failure of the SEC – the supposed "cop on the beat" – to do its job. To be fair, the resources of the SEC have long been outstripped by our surging markets. But despite some public "jawboning" and an aggressive public relations program casting former SEC Chairman Levitt as an investors' champion, after the SEC was turned over to that alumnus of Wall Street, the SEC was anything but aggressive in cracking down on financial manipulation and executive insider trading.

[1] A recent PBS documentary, "Bigger Than Enron," detailed the sordid tale of how corporate and financial interests' political money caused Congress to abandon investors in favor of corporate interests and the resulting upsurge in accounting, financial and corporate fraud.

Now, the SEC is headed by a lawyer who championed passage of the PSLRA and, most recently, represented the big accounting firms, Wall Street banks and some of the corporations which are among those whose credibility has been tarnished and many of which are under regulatory scrutiny. Incredibly, this new head of the SEC early on signaled a "gentler" relationship with the accounting profession and that the SEC might actually seek to further restrict corporate liability for false forecasts. Most recently, in a belated response to the upsurge in corporate fraud, he has put forth laughably meek reform proposals. This would be humorous, if it weren't so sad.

Listen, if you will, to what the noted financial writer and economist Ben Stein said in *TheStreet.com*:

> It now is clear that the worst stock market debacle in the history of postwar America did not just happen by chance or by the greed of the masses (although they were invaluable participants, as the sucker always is) but happened in large part because of conspiracy, greed in high places, incredible ignorance by those in high places, and a federal regulatory failure of unique proportions.
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> [I]n the Internet/high-tech boom, completely worthless companies, with no prospect of earnings, were flogged insanely by the very people who should have been labeling them as unsound, the "analysts" and "market gurus" of the big investment banks. Companies that existed as no more than dreams and fantasies were touted as multi-billion dollar entities by people and investment houses whose job was to defend against exactly such viruses.
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> What happened did not happen by accident, and a full accounting is owed to the people who were fleeced.

But while America's investors have lost trillions, corporate insiders, venture capitalists, the accounting oligopoly and Wall Street's investment banks, who took advantage of the running room the anti-investor legislation and pro-corporate court decisions gave them, have pocketed billions:

- Grieve not for the venture capitalists and their "dot.con" entrepreneur, 30-something friends who pocketed billions of dollars by selling grossly overvalued – if not worthless – securities to investors.
- Grieve not for the investment bankers who pocketed billions of fees while foisting the all but worthless "dot.con" securities on the public and also rigging the IPO game, while these new issues were put out to public investors.
- Grieve not for the accounting oligopoly. With the demise of Arthur Andersen, their immensely profitable worldwide operations remain intact, entrenched and now with less competition, will be more profitable than ever. They thrive and prosper even though we have seen the exposure of an astonishing number of financial frauds and restatements – while learning that the supposedly "independent" accountants were violating their sacred independence rules all along, pocketing tens of millions of high profit consulting dollars that dwarfed their auditing fees.
- Grieve not for America's corporate executives. They pocketed billions in risk-free stock-option trading proceeds and billions more in cash bonuses based on falsified profits, benefiting from the inflated profits and stock prices their hype and financial manipulations helped create – making

> a mockery of our nation's prohibitions against insider trading.

In addition to the legislators and regulators who sold out and the federal courts which abandoned investors to pursue a pro-corporate agenda, there is a lot of fault to go around here.

Corporate executives were clearly emboldened by the reduction in their legal responsibility and accountability that took place during the 90s. And whether driven by greed or envy – or perhaps both – it is clear now that an increasingly lavish –crazy – stock option compensation system incentivized corporate executives to do whatever –and I mean whatever – had to be done to meet street earnings expectations – so that they could achieve corporate earnings targets to trigger their performance bonuses and boost the stock price so that their options could be exercised and they could sell stock at high prices.

Have no doubt that corporate financial results have been manipulated. *The New York Times* ran a story headlined "Business Fraud of the 90s: Falsifying Corporate Data," noting a sharp resurgence of fraud in financial accounting, saying "the motive for tinkering is clear. The pressure to deliver ever-higher earnings can be intense, because rising earnings translate into rising stock prices, and missing a Wall Street earnings-per-share estimate by as little as a penny can send stocks into a free fall."

Pensions & Investments wrote in an editorial entitled: "A Numbers Game: Manipulation Becoming Commonplace":

> In recent years, probity has eroded… [A] significant and growing number of… managers … have come to the view that it's OK to manipulate earnings to satisfy what they believe are Wall Street's desires. Indeed, many CEOs think this kind of manipulation is not only OK, but actually their duty… To pump the [stock's] price,… when operations don't produce the hoped-for result, these CEOs resort to unadmirable accounting stratagems. [They] … manufacture the desired "earnings"…

Stock option abuse and insider trading by corporate executives reached unparalleled levels. Cisco's insiders sold $605 million of stock before that stock collapsed from $82 to about $10. JDS Uniphase's insiders and controlling shareholders sold $1.9 billion of stock –that's right, billion – before JDS Uniphase's multi-billion dollar write-offs of goodwill wiped out every dollar of profit it ever reported and then some and its stock became a $3 stock, down from over $150 per share. Qwest insiders sold over $2 billion of their stock – that's right, billion – which is now at $5 per share. Ebbers of WorldCom and Watson of Dynegy both secretly unloaded hundreds of millions of dollars of their companies' stock by taking out margin loans when their stocks were high priced. Sun Microsystems' insiders unloaded $690 million of that stock before it collapsed and Amazon.com insiders sold off over $250 million in Amazon.com stock before those stocks became hat sizes. Enron insiders sold off over a billion dollars worth of their now worthless Enron stock at as high as $85 per share. And Larry Ellison at Oracle really takes the cake – selling almost $900 million of his Oracle shares just a few weeks before Oracle fessed up to missing its numbers by a country mile and scaled back its growth forecasts and that stock became a hat size.

And, most recently, the disgraceful example of prestigious medical doctors and immunologists selling off millions and millions of dollars worth of their ImClone Systems stock – and tipping their relatives and friends to do the same – after submitting a defective new drug application to the FDA and secretly learning that it was going to be rejected.

And while the recent arrests in the ImClone situation have made a lot of headlines, I want to remind you that of the billions and billions of dollars of highly questionable, if not illegal, insider trading profits of corporate insiders that has been

exposed in recent years, so far as I know not one dollar of it has yet been disgorged! Remember – when crime pays, you get a lot of crime.

Simply put, the behavior of many –not just a few – corporate executives has been abominable. There is no excuse for their greedy and dishonest behavior while so many Americans – honest people – work so hard for so little.

And the corporate executives' allies – the accountants – corrupted by huge consulting fees, that we now know, as we had suspected all along, dwarfed their auditing fees, helped falsify corporate profits by billions of dollars, have turned our beloved Generally Accepted Accounting Principles ("GAAP"), into Cleverly Rigged Accounting Ploys. And I'll let you figure out the acronym on that one. Well OK – it's C-R-A-P.

We also now know that the independent accountants have been a lot less independent than we thought or at least hoped – or than SEC rules require. According to the SEC, it turns out that PricewaterhouseCoopers – perhaps the most prestigious accounting firm in the world – grossly violated the independence rules:

- Independence violations occurred in two-thirds of the firms' clients.
- 50% of the firm's partners owned stock in audit clients.
- 6 of 11 partners who oversaw the firm's independence program violated it.
- All 12 regional partners who oversaw the firm's independence program violated it.
- 31 of 43 members of the firm's Board violated the independence rules.
- 86% of the firm's partners violated the independence rules.

Think about these numbers. These findings are shocking – especially since the SEC concluded that that firm "made little or no effort to comply with independence rules"

And we had an unbelievable IPO boom driven by Wall Street bankers, which amounted to a massive wealth transfer from investors to the bankers, the "vulture capitalists" and the "Dot.Con" entrepreneurs, from the sale of stock in what we now know were all but worthless companies – stock offerings accomplished via a rigged IPO market. And now we know the supposedly independent analysts were, in fact, in on it all along – getting paid to hype stocks they knew were of about the same quality as their financial reports. To become an analyst in the 90s, you had to have the word "sell" removed from your vocabulary. Turns out many analysts' greatest skill was putting "lipstick on pigs."

The truth is – and it's a sad truth –that we're in the midst of the greatest upsurge of financial fraud since the 1920s.

Over 700 accounting restatements in three years – 900 in five years. Not to put too fine a point on it, that's more accounting restatements than in the history of the world up to now. The result has been trillions of dollars lost by investors due to fraud – not just market declines.

The real tragedy is that this accounting rot was not confined to a few fly-by-night "Dot-Cons." The real tragedy is how many supposedly respectable companies became implicated in these scandals – Cendant, Waste Management, RiteAid, Lucent, Sunbeam, Informix, JDS Uniphase, WorldCom, McKesson, Global Crossing, Computer Associates, PNC Financial, WorldCom, Nortel, Qwest, Adelphia, Boeing, CMS, 3Com, Reliant, Xerox, Tyco – / could go on and on and list 100 major companies –"blue chip" companies – which cooked their books.

Well, of course, there is Enron, the poster child of corporate excess in the current era. In the interest of the new spirit of full disclosure, I'm "long" the Enron fraud because my firm is

lead counsel for the shareholders in the Enron stockholder litigation in Texas.

To state the obvious, Enron was a colossal fraud. Hundreds of millions in bogus profits. $1.2 billion in illegal insider trading. Thousands of jobs lost. Retirements ruined. $80 billion in market cap wiped out.

But, let's look beyond the short-term bloodshed for a minute and see if we can get a broader perspective on Enron. To try to do that, I want to ask some questions and give you my thoughts on them.

First, let's ask the fundamental question – how did the Enron fiasco occur? How could the seventh largest company in the U.S., with a hundred billion dollars in yearly revenue, a billion dollars in annual profits and an extremely prestigious Board of Directors, with its books audited by a prestigious accounting firm, the company represented by a prestigious law firm and with its securities underwritten by prestigious Wall Street investment banks, blow up like this? How could it happen?

Well, you cannot structure business deals based on the trading value of the company's stock. There are already enough insidious, indeed corrupting, pressures on management to keep the stock price up that we all know exist. To then also structure business deals based on the value of the company's stock is insanity. But Enron did that all the time.

Enron created an extraordinarily fragile corporate structure with billions of dollars of business deals dependent on the price of Enron's stock – deals using Enron stock to "hedge" gains on assets Enron had "sold" to third parties. This meant that the first bad news that caused the stock to fall triggered massive stock issuance obligations. When the stock decline continued, the financial structure of Enron vaporized in a matter of weeks.

Number two, the Enron debacle happened because of a complete breakdown of the corporate governance and professional gatekeeper systems we have so long relied upon to ensure compliance with the securities laws and the corporate stewards' fiduciary duties. A fraud of this duration, of this size and of this scope, could not have been perpetrated by a few corporate executives no matter how dishonest or how energetic they may have been. It took the complicity and active assistance of other important actors.

First, the Board. To say that the Enron Board failed is to state the obvious. But let's learn something from this. A prestigious pedigree does not assure skeptical independent oversight. If we were today back before the Enron debacle broke and looking at Enron's Board and its governance structure, it would have looked great. Almost a model. It had all the right committees, all the right procedures and apparently, the most prestigious people.

But, in fact, the use of massive political contributions to friends and allies of the Directors, large charitable contributions to institutions the Directors were associated with and a lavish equity package for the Directors, either chloroformed or corrupted Enron's Board. Amazingly, three times in 12 months, Enron's prestigious Board waived the corporation's conflict of interest policies to permit Fastow, the CFO, to manage partnerships that Enron would sell billions of dollars of assets to. That's something my seven-year-old son, Dillon, knows you shouldn't do. Are we surprised that an Arthur Andersen partner returning from an Enron Board meeting wrote an e-mail, once destroyed but now recovered, asking " Why would any Director sign off on such a scheme?"

The SEC and NYSE have long encouraged public companies to have independent audit committees – and Enron had one headed by a prestigious accounting professor from Stanford. But, in truth, audit committees have provided little protection against financial manipulation. In the words of the Journal, they are "toothless tigers." The new chairman of Waste Management – on inheriting that debacle – said when the CEO picks the audit committee members they are "willing to go along with the flow – and not rock the boat." Incredibly, the Chairman of Enron's Audit

Committee, when asked what his job was, said: 'To support management." Disappointingly, virtually every one of the some 700 companies involved in the recent rash of restatements had audit committees!

Directors are supposed to be like school principals. They are supposed to say no when those they watch over want to do something that's not right. America's corporate directors have to be more skeptical, react more quickly to storm signals and, most of all, learn to say no more often.

Even more important than the failure of Enron's Board, is the failure of Enron's professional gatekeepers. Of course Arthur Andersen failed, we all know that. It is easy to fault them and they deserve it. Awash in $27 million in consulting fees on top of $25 million in audit fees, Andersen, as business consultants helped structure the very transactions that they were to later audit. The fact of the matter is, they surrendered to strong-willed insiders who would no more take no for an answer from Andersen than they would from Enron's Board.

Let's learn this – for auditors consulting is a professional disease. It is too much money. People simply cannot maintain their independence when this kind of money changes hands. No one can. We ask too much if we expect it. Let's also learn that you cannot expect anybody to independently and skeptically audit a complex business transaction that they helped put together. Something has to be done about this going forward. Once consulting services are separated from auditing, auditing service becomes a commodity service – almost like a public utility. It's time to find a way to rotate public company auditors every 5-7 years. That way, an auditing firm won't have to prostitute itself to keep the client, because in a few years that client is going elsewhere to be replaced by one rotating away from another firm. And the client will know that in a few years a new, fresh set of eyes will be shortly coming on the scene to review its finances.

Enron's lawyers also failed miserably. Vinson & Elkins and Kirkland and Ellis were there day in and day out. These were no Atticus Finches practicing out of storefront offices providing routine law work in return for groceries. These were sophisticated firms, like investment bankers, helping to structure transaction after transaction that created billions of dollars of false profits. Inside Enron, Vinson and Elkins was known as "Vinson and Enron." And Kirkland and Ellis, which supposedly represented independent third parties, was apparently paid by Enron and inside Enron became known as "Fastow's lawyers."

Few bogus deals were done without the help of these law firms – allegedly aware of secret side letters and no loss guarantees used in transaction after transaction, contrivances that stripped the participants in the transactions of independence and the transactions themselves of any economic substance. And while it is easy to criticize Arthur Andersen for the $27 million of consulting fees they took a year on top of $25 million a year in audit fees, let's remember that that $52 million was less than 1% of Arthur Andersen's revenues worldwide. Vinson & Elkins' direct revenues from Enron alone exceeded 7% of its annual revenues.

But more than anybody else, it was the banks that were behind this colossal fraud at Enron. This is the still untold story of Enron. Enron, in fact, was a gigantic Ponzi scheme. It generated reported profits via bogus deals repeatedly abusing "mark-to-market" accounting–the ultimate in "cash-less" profits. But the more they committed this sin, the faster they had to peddle the bicycle to keep up the growth in reported profits. Since Enron's profits created little cash, Enron, of course, constantly needed fresh capital to stay afloat as it grew larger and larger. So, with the help of Wall Street banks, Enron raised $10 billion in fresh capital from investors in just three years –including pulling off an astonishing $1.9 billion zero coupon note offering just a few months before the company blew apart.

Instead of playing their traditional role as underwriters – gatekeepers to protect the public – these prestigious firms, J.P. Morgan Chase, CitiGroup, CS First Boston, Merrill Lynch, CIBC, Deutsche Bank, Barclays Bank and a few others, became business partners with Enron, intertwining themselves in every aspect of Enron's business. These banks were not just peddling Enron's worthless securities. Post-repeal of Glass-Steagall, these banks were also Enron's commercial lenders, its commercial joint venture partners, its investment bankers and its derivative trading counterparties and, all the while, were constantly issuing cheerleading analysts reports about Enron to push the stock price ever higher.

The banks were part of a vicious cycle. Enron borrowed money short-term to keep going. Then it and the banks went to the markets all the time to raise money from the public to repay themselves to lessen their risk.

Enron had to show a controlled debt level to maintain its investment grade credit rating. This was very important to the rating agencies, Enron's trading partners and the financial markets. So a few of Enron's banks made $6 billion in concealed loans to Enron. They disguised these loans as commodity trades and swaps so they were not shown on Enron's balance sheet. But as a "fee" for accommodating Enron in that deceit, the banks charged interest rates on those $6 billion in concealed loans 300 basis points above normal interest rates. Do the math. That's $180 million a year the banks were getting for accommodating deceit.

But here's the *pièce de résistance.* Do you know that top officials of the banks – individual bank officers – secretly invested with Enron in the partnerships Fastow ran and which did billions of dollars of deals with Enron, which created hundreds of millions of dollars of bogus profits and also enabled the partnerships to loot Enron? They secretly took equity positions in those partnerships which self-dealt in Enron's assets. These partnerships produced fantastic returns for these investors. The lowest return on a deal was 150%. The highest was 2,500%. Skilling, when grilled by the SEC recently, has admitted that those huge returns could only have been achieved if these transactions were non-arm's length and defrauded Enron.

Let's learn this. Wall Street is dishonest and the repeal of Glass-Steagall has exposed American investors to further risk of this kind of self-dealing dishonest conduct. It only took a few years after Glass-Steagall was repealed for commercial and investment banks to morph into the huge financial services colossi they are today and to do what they did with Enron. Is Enron an isolated incident resulting from the misconduct of a few bad apples or is it evidence of rot across the system? I wish I could say it was the former. But it's the latter. It is not only Enron. Adelphia, Dynegy, Global Crossing, Tyco and Qwest are largely products of Wall Street also. Watch for others that are coming.

Let's learn this additional lesson. Well-educated and aggressive people in a free-market competitive economic system – i.e., our financial system – respond quickly and ruthlessly to changes in economic and legal incentives, *i.e.*, risks and rewards. I have no doubt the passage of the PSLRA in 1995 to curtail investor rights via the worst rollback of the federal securities laws in 60 years – together with Congress' later denial of investors' access to state law, the Supreme Court's *Central Bank* decision eliminating aiding and abetting liability, followed by repeated lower court decisions by pro-corporate judges throwing investors' fraud suits out of court, the repeal of Glass-Steagall and the SEC being far from as aggressive as it should have been for years – had an accumulated impact over time that really tilted the playing field in favor of corporate insiders and their professional assistors. As this lessened the risk of misconduct, it necessarily increased the potential rewards from misconduct. And, in time, "the chickens came home to roost."

There's a fundamental problem in our legal and financial systems. There is not enough individual accountability. If Enron's

top insiders walk away with hundreds of millions of dollars with their portfolio of ski homes intact, what will it matter if their reputations are ruined? What will investors think? A lot of people are willing to have their reputations ruined if they can put $100 million in their pockets. Even a lot less. As *Fortune Magazine* has demanded, some of these executives have to actually go to jail. If the guy in the office next to you gets hauled out in handcuffs – not to return –it changes your behavior. Then there might be some deterrence.

With Andersen's conviction for destroying evidence, the likely indictment of Enron insiders, the ImClone arrests and RiteAid indictment, perhaps change is in the wind. I often think of a cartoon I saw several years ago. Two prisoners in their striped suits are in a jail cell, one on his bunk, the other standing and saying:" You know, it turns out that those Generally Accepted Accounting Principles weren't quite as generally accepted as I thought." Corporate executives – and their accountants – ought to keep in mind the old Biblical admonition: "What would it benefit a man to gain the whole world and lose his own soul?" – or, I might add, "even his own freedom"

Another lesson to learn. While deregulation has benefits, it can have costs as well. I'm really concerned that investor psychology has suffered a very serious blow in recent months. Strong financial markets depend on healthy investor psychology. If you don't have that, you get the money under the mattress syndrome. Recent articles in *Business Week*, *Financial Times*, *The New York Times* and even respected voices from Wall Street attribute the apparent inability of our stock market to get its legs underneath it and to stage any sort of a lasting rally –notwithstanding an apparent economic recovery – to the fact that investors are so offended by what they have seen regarding corporate fraud that they are not willing to put their capital at risk anymore. It appears that investors are voting with their wallets and, in effect, "revaluing" the market downward to reflect their perception of real corporate profitability, trust and credibility. More and more investors find that money market fund returns of one-half percent are a lot more appealing than the equity of WorldCom, Sprint, Enron, Dynegy, Xerox – you get the point!

Let's face it, the history of American finance – whatever its successes – remains the history of financial fraud and chicanery. While most entrepreneurs and financiers in every age may be honest –periodically, the fraudsters and charlatans gain prominence, excesses rage and burned investors shy away from the markets. We are seeing that today.

You know, the more our markets start to look like the Bulgarian stock market, the more people will treat them like the Bulgarian stock market. We surely do not want to have here the same kind of investor confidence and capital formation they have there.

And, I must say that the reaction of the financial community to suggestions for legislative or regulatory improvement –which by the way is very modest indeed –is quite telling. The head of Deloitte Touche has called for a "cap" on accountant's liability. Corporations have resisted the SEC's proposal to speed up financial filings. Federal legislative initiatives appear to be completely stymied. And Wall Street actually has the chutzpah to try to get Congress to curtail the ability of state securities regulators and Attorneys General to go after them to prevent further embarrassing revelations and to pay back New York Attorney General Spitzer for his exposing the corruption of Wall Street analysts.

If, after all of these revelations, all this scandal and these tremendous losses, the outcome is no meaningful reform and just more of the same, we may find that a whole generation of investors are going to stay away from the equity markets. That will hurt capital formation. And that will hurt economic growth.

My last point. Enron was a horrible corporate governance failure. We have to do

something about corporate governance. It's not going to happen by way of legislation, either federally or in Delaware. It just won't happen. Corporate interests and their allies have more than enough political power to prevent any legislative reform of corporate governance at the federal level. And Delaware remains a playground of corporate interests as it has been for decades. The Department of Corporations there has neither oversight nor enforcement powers. It consists of a window to collect hundreds of millions of franchise taxes each year. Delaware, a domestic Liechtenstein, sells its corporation law to America's corporate officers and directors, who then hide behind it, protected by Delaware's pro-corporate courts.

As bad as the PSLRA was for investor rights and remedies, it did empower pension funds and institutional investors to become more active in securities litigations – by encouraging such investors to act as the so-called "lead plaintiff and control the prosecution of securities class action suits. At first it did not happen. Then, as financial fraud ballooned, institutional investors started to come forward. Who has suffered the bulk of the huge losses from the carnage we witnessed? The pension funds, public and Taft-Hartley, because they had the most at stake. Now institutional investors are involved in almost every securities class action case. I spend a lot of time with institutional investors. They are furious. Mad as hell. And not in a mood to take it anymore. Pension funds that would not have considered litigation five years ago – not even considered it – today are willing to march into federal or state court to assert their rights as shareholders.

If the corporate community does not respond voluntarily by substantially improving governance structures in light of what we have seen, I suspect they are going to see a lot more adversarial action – including litigation – by the true owners of America's corporations, to force the stewards of those companies to do their jobs.