

# 1

## Assessing guilt: the Wall Street shakedown

A life-size, cast bronze bull stands incongruously in the heart of the New York financial district, poised as if to charge past the skyscrapers enveloping Wall Street and escape up Broadway, the arterial centre of Manhattan. For many of the tourists taking photographs of each other draped on the rippled bronze, the flared nostrils and aggressive stance are symbolic of the underlying strength of the American political and economic systems. The architecture that frames the shot, while dramatic, is immaterial. For the corporate and political elite, the positioning of the bull has a much darker meaning. It underscores the short distance between success and failure, honesty and graft, confidence and crisis in American governance. The fallout associated with the corporate malfeasance that has destroyed the credibility of financial reporting since the collapse of Enron in October 2001 has been subject to unprecedented investigation in two buildings in the shadow of the bull: the office of the New York State Attorney General and the Federal Bankruptcy Court.

The potential impact of the inquiries cast a heavy pall over the hubris associated with the extraordinary growth of the American economy on the cusp of the 21st century. When combined with a class action involving a claim for \$25bn currently being adjudicated in Enron's hometown of Houston, it is clear that the nature of American capitalism itself is facing an unprecedented assault. The bull market has not only been tamed but humiliated by the exposure of the sharp practice and conflicts of interest that had become

integral, but hidden, weapons in the armoury of the corporate matadors.

One of the most combative class action lawyers in the United States William Lerach, a partner with Milberg Weiss Bershad Hynes and Lerach, put the point succinctly in a recent address to Stanford Law School. The collapse of Enron, he intoned, was simply a manifestation of the unsavoury reality of the bull market: “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. What happened did not happen by accident, and a full accounting is owed to the people who were fleeced.”<sup>1</sup>

The sudden decline and fall of Enron, from symbol of strength and innovation to talisman for organizational dysfunction was played out in real time to a disbelieving world. It provided evidence that something was very seriously wrong in corporate America. How wrong would take a further year to reveal. Blue-chip companies became chipped; behind the thin veneer of respectability lurked an inter-linked business and political culture that placed greater store on maximizing revenue than in revealing the sources of that generation. Spreading outward from the corrupted core of Enron and replicating like an uncontrollable virus, the integrity of the American corporate model has been seriously undermined. Responsibility for the malaise

---

<sup>1</sup> Quoted in Carl Cannon, “Letter from Washington: Suits vs. suits”, *Forbes*, 7 October 2002. Lerach’s methods raised the ire of many in the corporate world. See, for example, Editorial, “Lerach’s Enron gambit”, *Wall Street Journal*, 6 February 2002, which likens the decision by Caplers, the Californian public pension fund, to retaining his services as a “wildebeest hiring hyenas as bodyguards”. A second editorial in April warned the Regents of the University of California that in dealing with Lerach, “when you lie down with lawyers, you catch ethical fleas.” Castigating the lawyer, the editorial asked rhetorically of the California Regents, “Do they really want to patronize Mr Lerach’s latest effort to engulf corporate America in a tide of lawsuits primarily for the benefit of the lawyers. This can’t be a good thing for the rest of the University of California’s stock portfolio.” See Editorial, “Lerach’s Enron sweep”, *Wall Street Journal*, 17 April 2002.

goes much further than the board of Enron and the other spectacular cases of material and moral corporate bankruptcy.

Faced with accusations from the New York State Attorney General Eliot Spitzer that the leading investment banks in the country effectively ran a criminal enterprise designed to mislead individual investors, a co-ordinated investigation was belatedly established among the disparate regulators of the most sophisticated securities market in the world. The wider investigations were launched in April 2002 after Spitzer had secured a \$100m settlement from Merrill Lynch for issuing “buy” recommendations for stocks that its senior Internet analyst Henry Blodget had decried in private emails as “a piece of junk”, a “dog” or, with vulgar precision, “crap”. The skill in bringing the case catapulted the issue of regulating Wall Street to the top of the agenda and the grudging admiration of senior compliance officers in the merchant banks. As the head of the legal department at one major investment bank in New York explains, there is no doubt that the Merrill case marked a watershed:

Every so often a case comes up that you just know is so important and it's so attention grabbing, so monumental that it is at the heart of something big. He found those emails, he brought this case. Everybody knew that everyone was going to get investigated and that laws were coming. It doesn't surprise me. He should get a lot of credit for it. He brought a great case back then.<sup>2</sup>

The investigation into Merrill had provided *prima facie* evidence that not only was there a direct connection between recommending stock for companies that already had investment business with the firm but the obverse was also true. Stock ratings could be reduced if the firms did not utilize the mercantile facilities. Much more seriously, ratings could change if the companies changed mercantile facilities, an effective form of blackmail. Merrill settled without admitting liability, but the release of the documents ensured that a wider investigation needed to be carried out. The potential implications of exposing the rot within Wall Street were spelled out in an address to the New York

---

<sup>2</sup> Interview, New York City, 7 February 2003.

judiciary in May 2002. Spitzer complained that there has been “a gradual dissipation of standards and ethics . . . driven by an obsessive desire to get quarterly numbers up.” For Spitzer, who has chosen negotiation rather than prosecution to clean up Wall Street, the malaise occasioned by conflicts of interest, deceit and fraud can be traced directly to “the pressures of competition”, which were exacerbated precisely because of “a lack of definable boundaries of acceptable behaviour.”<sup>3</sup>

In an attempt to redress the balance, Spitzer joined forces with the Securities and Exchange Commission (SEC) and other regulatory bodies to assess the extent of the problem and determine a “global settlement”. The investigation proved pivotal in providing a revealing glimpse of the reality behind the rise to dominance of finance as the primary motor of economic growth. It also served to expose how dysfunctional the system had become because of the asymmetrical balance of power within the corporate sectors and between it and the regulators and politicians. Just before Christmas (2002), the financial powerhouses of Lower Manhattan settled in a \$1.4bn deal designed to bring closure to the issue and to a calamitous year for the American financial services industry.

In 2002, a total of \$2.9bn was paid in regulatory fines and court settlements – enough to buy 108 of the Forbes 500 companies. The publication of the details of the joint investigation is likely to increase the legal challenge dramatically. Even if court appearances are, in all likelihood, years off, the ongoing damage to the credibility of the largest brokerage and investment banking firms in the market, in terms of further disclosure and negative headlines, is both ongoing and significant. Already Citigroup, one of the most powerful corporations in the world, has made a provision for \$1.5bn to fend off future court actions, as has JP Morgan Chase, one of the banks most exposed by Enron’s collapse.

On the same day as the regulators and the corporations sued for peace in New York, 2,000 miles to the west a decision by a federal

---

<sup>3</sup> Mark Gimein, “The enforcer”, *Fortune*, 16 September 2002.

judge threatened to undermine the deal before the ink had dried. The judge ruled that confidential documents relating to the investment decisions made by Wall Street to support Enron should be disclosed to lawyers running the class action suit. The consequences are immense. That single decision will add substantially to the pressure on an already strained system. A consortium of those with most to lose by disclosure, including the remnants of Enron, its auditors Arthur Anderson and major banking institutions – such as JP Morgan Chase, Citigroup and Credit Suisse First Boston – had claimed that the documents were privileged under client confidentiality. In rejecting the argument, the federal court not only provided significant ammunition for the class action lawyers but also raised exponentially the economic, political and financial stakes. The conflict of interest investigations and the Enron case are further intertwined because of a further aspect of the Houston challenge.

Lerach and his colleagues claimed that the structured finance deals provided by Wall Street to Enron's top executives allowed for the legitimization of tax avoidance and other forms of financial alchemy that distorted the true financial health of the company to the detriment of individual and institutional shareholder alike. At the stroke of a pen, the Houston judge had opened the floodgates to a whole new wave of litigation that threatens to deluge the financial district crammed into Lower Manhattan. With class actions securities lawyers given clearance to enter the inner sanctums of the firms, the cost in both reputational and financial terms increased dramatically.

With Enron itself bankrupt, it is Lerach, through his role as lead plaintiff in the multibillion dollar lawsuit claiming damages against Enron and its bankers, who will reap the benefit.<sup>4</sup> One sensed that the lawyer could almost hear the cash registers when he spoke to reporters outside the Houston court. "This decision confirms the validity of our legal claims against the major defendants, and leaves in the case

---

<sup>4</sup> For full details of the claim against the investment banks see *Mark Selby et al. vs. Enron Corp*, Consolidated Claim against Violation of Securities Law, pp. 340–401. The claim alleges that the banks actively colluded in insider-dealing (p. 343).

defendants with resources to pay substantial compensation to the class. It also should open the way for discovery, which has been stayed pending the decision to commence.”<sup>5</sup> A leading New York bank managed to escape the opening of discovery, enabling one of its senior legal officers to provide this telling assessment of the likely outcome:

Once the judge turns down the motion to dismiss and allows discovery you settle. If the judge dismisses, you uncork the champagne and have a party; if it rules discovery you have to start talking settlement because you cannot afford – whether you are liable guilty or not – to have these plaintiff lawyers raid your offices.<sup>6</sup>

Two diametrically opposed possibilities therefore present themselves: a new beginning or a recurring nightmare? How this pivotal question is answered will help determine, in part, the future of American politics. If the system was as corrupted as the extent of the fine hammered out in New York implied, how did it become so? This in turn leads to a much more destabilizing query: To what extent can the failure to regulate the economy effectively be traced back to partial and self-serving decision-making made with due cognizance of the views of the corporate interests that fund the American political system?<sup>7</sup> For William J. Flynn, the influential Chairman of Mutual of America, one of the country’s most powerful pension providers, the crisis is one of the systematic corruption of the American ideal:

An enormous tragedy has befallen capitalism. It is the most serious crisis in its history. It is the consequence of a calamitous collapse of trust in our tax system, fueled, quite frankly, by corporate greed. There is a lack of faith in our investment banks, executives, our accountants and law firms and ultimately Congress, which repealed the legislation that allowed it to happen. No one

---

<sup>5</sup> Dan Ackman, “Big banks must still reckon with Enron”, *Forbes Online*, 23 December 2002: [http://www.forbes.com/2002/12/23/cx\\_da\\_1223\\_topnews.html](http://www.forbes.com/2002/12/23/cx_da_1223_topnews.html) (accessed 4 January 2003).

<sup>6</sup> Interview, New York City, 7 February 2003.

<sup>7</sup> See John Nofsinger and Kenneth Kim, *Infectious Greed, Restoring Confidence in America's Companies* (Prentice Hall, Upper Saddle River, NJ, 2003), pp. 248–53.

trusts people in the corporate boardrooms. Regulation has failed and the result is clear: The system has been systematically corrupted.<sup>8</sup>

As the diverse threads of the Enron scandal further unravel, it is impossible to avert one's gaze from the fundamental nature of the system that has caused the ruination of so many. Deeply embedded within the machinations of a complex structure are the internal contradictions that have done much to erode confidence. Reprising the chicanery that had fuelled the speculative excesses of the 1920s, the perennial character flaws of modern American capitalism are once again exposed. "Wall Street," remarked the influential economist J. K. Galbraith in his seminal study of the 1929 Great Crash, "is like a lovely and accomplished woman who must wear black cotton stockings, heavy woollen underwear, and parade her knowledge as a cook, because, unhappily, her supreme accomplishment is as a harlot."<sup>9</sup> By the end of the century the financial devices deployed by the tease merchants in Lower Manhattan to lure the greedy and the incautious were significantly more advanced than trading on margin. The basic premise of the oldest profession, however, and the forbidden fruit it promised, remained substantially unchanged.

Galbraith wrote his classic account of the 1929 Crash to mark its 25th anniversary. He reasoned that understanding why the calamity occurred was "our best safeguard against the recurrence of the more unhappy events of those days."<sup>10</sup> But just as the New York speculators in 1929 failed to internalize the lessons of previous collapses, for contemporary investors in the same market the passage of time had served to dull memories. The immunizing effect of past failure had become defective in the face of an avaricious bull market, nurtured and manipulated by those who controlled the market. What differentiated the crisis, progressively revealed from 2000 onward, from previous waves of scandal, such as the junk bond and asset-stripping mania of the 1980s, was the revelation of the structured and sustained

<sup>8</sup> Telephone interview with William J Flynn, New York, 6 March 2003.

<sup>9</sup> John Kenneth Galbraith, *The Great Crash 1929* (Penguin, London, 1992), p. 46.

<sup>10</sup> *Ibid.*, pp. 28–9.

involvement of some of the most respected corporate names in the financial firmament.<sup>11</sup> As such, the consequences, for the equities market in particular, extend well beyond the collapse of Enron.

The susceptibility of the sober investment houses to stoking the irrational giddiness in the marketplace is one of the key defining elements of the American crisis. Suspension of disbelief by those consumed with greed did not mean that the laws of gravity could equally be ignored by reputable funds, which charged a premium for their knowledge. The consequences of the investment decisions made through ignorance, or negligence, about the underlying reality are profound: auditors had signed off fantasy figures to protect lucrative consultancy business; merchant banks provided public analysis that differed sharply from internal communications; regulators failed to regulate; and the politicians, in need of the corporate backing required to fund increasingly expensive electoral campaigns, feted corporate financiers who, in turn, distributed largesse to a supplicant legislative class. It represented a sordid marriage of self-interest and wilful neglect in which decency was replaced by greed and confidence by betrayal.<sup>12</sup>

The recent publication by Transparency International of the Global Corruption Index rightly emphasizes the importance of the Enron scandal in highlighting the global importance of corruption within the private sector.<sup>13</sup> Enron represents, however, much more than that. It is symptomatic of the problem rather than the cause. It underscores the need to combat the ability of major corporate interests to impact on governance through a corrosive compact that distorts the deliberative process by virtue of its financial contributions to the political system. With the 10 biggest economies in the world

---

<sup>11</sup> The most detailed account of the junk bond scandal is to be found in James B. Stewart, *Den of Thieves* (Touchstone, New York, 1992).

<sup>12</sup> See Margaret M. Blair, "Post-Enron reflections on comparative corporate governance", Working Paper 316663, Georgetown University Law Centre, [http://papers.ssrn.com/paper.taf?abstract\\_id=316663](http://papers.ssrn.com/paper.taf?abstract_id=316663)

<sup>13</sup> Jermyn Brooks, "A large dose of Enronitis", in *Transparency International, Global Corruption Report 2003* (Profile Books, London, 2003), pp. 80–2.

today belonging to corporations rather than countries, it has become increasingly clear that the mechanics of international contemporary capitalism are themselves potentially seditious to the needs of domestic governments. Nowhere is the case more pressing than in the United States, the prime exporter of the model.

Institutional investors in the United States control 59.7% of total equity investment; pension funds alone control 35.1% of the market, making the investment decisions taken by the fund managers crucial to the financial health of all those with defined pension benefits.<sup>14</sup> A survey of institutional investors, published after the corporate scandals had reached their apex, demonstrated the extent of deterioration in confidence. Greenwich Associates polled 51 institutions with a combined investment portfolio of \$775bn, while the investment banks and American regulators were negotiating a global settlement on conflicts of interest with Wall Street's major players in December 2002. According to Greenwich, the general response to the crisis and the ability of reforms to change the situation was "marked by disillusionment, cynicism, even despair."<sup>15</sup>

This sullen acceptance can be traced back to the power of corporate interests to reduce the range of effective enforcement options available. By successful lobbying of Congress, vested interests can prevent the introduction of new legislation. More insidiously, legislators, whose world view correlates with the special interests that contribute to their campaign war chest, can threaten the budgets of regulatory agencies if the result of systematic investigation is a further decline in confidence in the probity of the market. For John Moscow, Deputy Chief of Investigations at the office of the District Attorney of New York, two key regulatory changes paved the way for systemic failure of oversight:

---

<sup>14</sup> See Marco Becht, Patrick Bolton and Ailsa Roell, "Corporate governance and control", European Corporate Governance Institute Finance Working Paper No.2/02, October 2002, p. 11 (accessible online at <http://www.ecgi.org/>)

<sup>15</sup> Quoted in Gary Silverman, "Investors unmoved by analyst reforms", *Financial Times*, 17 December 2002.

The securities industry persuaded Congress to concentrate regulatory power with the SEC in 1996 taking a lot of regulatory power away from the states. Having concentrated with the Commission and having made enforcement exclusive to the Commission, they then cut the Commission's budget. Then the securities industry obtained the repeal of Glass-Steagall. Our regulators were used to dealing with commercial banking or with securities or with investment banks and they all felt differently. It got to the point where I don't think that the regulators had the manpower trained in each discipline in sufficient numbers to deal with the problem.<sup>16</sup>

The complexity of the modern business world and the growing financialization of the post-industrial economy, oiled by deregulation, is an ancillary driving motor of the cynicism. "I think there was an awful amount of game playing. I don't know if it was impossible to control the markets but they weren't controlled."<sup>17</sup> Globalization and the international migration of finance have further weakened the ability of regulators to enforce compliance. The massive expansion in the use of offshore holdings has not simply reduced the tax liability of major corporations, it also ensures that enforcement is all but impossible to achieve in the absence of a corporate meltdown, forcing a fundamental reappraisal of how the system actually works as opposed to how it should work.<sup>18</sup> In a perceptive analysis of the threat posed by financial muscle to the power of the nation state to preserve its tax base, John Plender has recently argued that modern capitalism is facing a profound crisis of legitimacy. For Plender, the Enron fiasco is symptomatic of "the whole culture of Anglo-American finance [which] is increasingly subversive of regulation, taxation and democratic values, even where it remains within the law."<sup>19</sup> Nowhere was this challenge more acutely exemplified than in the Congressional Joint Committee on Taxation report into the financing of Enron, released in early February 2003.

---

<sup>16</sup> Interview with John Moscow, New York City, 9 April 2003.

<sup>17</sup> Ibid.

<sup>18</sup> A. Larry Elliot and Richard J. Schroth, *How Companies Lie* (Nicholas Brealey, London, 2002), p. 77.

<sup>19</sup> John Plender, "The hijack that made Enron happen", *Financial Times*, 28 January 2003. The theme is further developed in John Plender, *Going off the Rails, Global Capital and the Crisis of Legitimacy* (John Wiley & Sons, Chichester, UK, 2003).

The report was scathing in its deconstruction of the tax strategies adopted by the corporation. “Enron came to view the role of its tax department as more than managing its Federal income tax liabilities. Rather, Enron’s tax department became a source for financial statement earnings, thereby making it a profit centre for the company.”<sup>20</sup> Citing a systematic breakdown in ethics, the report suggested Enron “excelled in making complexity an ally.” The corporation had “an incentive and the ability to engage in unusually complicated transactions in order to preclude meaningful review.” This aggressive and essentially duplicitous approach to corporate reporting, designed to minimize tax liabilities, presents major problems that extend well beyond the corporation:

Corporations like Enron have an inherent advantage over the IRS [Internal Revenue Service]. Enron relied on advice from sophisticated and experienced lawyers, investment bankers, and accountants. Assertions of attorney–client privilege hinders the ability of the IRS to obtain many of the most instructive documents, which impedes the IRS’s ability to audit the transaction. Enron’s activities shows [sic] that the IRS cannot minimize the importance of loss [making] companies because to do so would ignore a breeding ground for tax-motivated transactions that also could be used by taxpaying companies.

Enron’s aggressive interpretation of business purpose, the cooperation of accommodation parties, the protection provided by tax opinions, the complex design of transactions, advantages over the IRS – all were factors that contributed to Enron’s ability to engage in tax-motivated transactions. Until the costs of participating in tax-motivated transactions are substantially increased, corporations such as Enron will continue to engage in transactions that violate the letter or the spirit of the law.<sup>21</sup>

The aim of the structured transactions was quite simple: the subversion of the tax code to enhance revenue, which in turn was translated on the bourse as a higher stock price, setting in motion a classic pyramid scheme. None of these transactions served bona fide business

<sup>20</sup> Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities regarding Federal Tax and Compensation Issues, and Policy Recommendations*, JCS-3-03, February 2003, p. 8.

<sup>21</sup> *Ibid.*, p. 16.

purposes, but were constructed to generate income through the manipulation of financial accounting. According to the congressional investigation, “nearly all of the reviewed transactions are vulnerable to attack under judicial or administrative anti-abuse and anti-avoidance doctrines.” The conclusion reached by the committee was devastating. “Enron’s behaviour illustrates that a motivated corporation can manipulate highly technical provisions of the law to achieve significant unintended benefits. Remarkable in many respects was Enron’s ability to parse the law to produce a result that was contrary to its spirit and not intended by Congress or the Treasury Department.”<sup>22</sup>

The collusion of leading investment banks, lawyers and accountants in the provision of tax shelters was central to the evasion that enabled Enron to book over \$2bn in immediate profits while underestimating its federal tax exposure by a similar amount over a six-year period. Bankers Trust, a firm now controlled by Deutsche Bank, was paid \$40m for its work in helping to establish shelters, which were routed through the Caymans. Some of the most eminent legal firms in the United States signed off on the transactions, despite the suspicion that the structures were primarily designed as accountancy ruses. The combination of complexity and speculative mania gripping the markets successfully hid the alchemy throughout the boom years. In 2000 and 2001, Enron, despite booking revenue of \$2bn, paid just \$63m in federal tax. This degradation of tax revenue has raised serious structural questions about the role of the corporation in modern American society, a fact acknowledged by the highly influential District Attorney for New York, Robert Morgenthau. Speaking at the Brookings Institution last June, the Attorney argued that the risks of tax havens undermined the rule of law:

In a democracy such as ours, where we rely largely on voluntary compliance with the tax laws, the tax system must not only be seen to be fair, it must be perceived to be fair. The unfairness of allowing citizens to avoid paying their fair share of taxes erodes confidence in the tax system and the voluntary

---

<sup>22</sup> *Ibid.*, p. 22.

compliance on which the system is based. In addition, permitting some businesses to gain unfair tax advantages in offshore venues destroys the level playing field on which our system of free enterprise depends . . . Finally, and perhaps most important, the obvious inequity of a system that allows certain individuals and companies to hide their financial affairs in offshore havens undermines respect for government and the rule of law.<sup>23</sup>

Senator Charles Grassley, Chairman of the Senate Committee on Financing, noted that the report read like “a conspiracy novel, with some of the nation’s finest banks, finest accounting firms and some of our best attorneys working together to prop up the biggest corporate farce of this century.”<sup>24</sup> Senator Grassley stated that “the unbridled greed and blatant disregard for the law of fairness” was staggering.<sup>25</sup> The lack of moral fibre demonstrated by Enron, its executives and the coterie of advisors paid over \$87m in fees, was, however, merely the visible manifestation of a wider viral problem of corporate greed inculcated in the boom and facilitated by systematic tax evasion strategies, according to John Moscow, Deputy Chief of Investigations at the District Attorney’s Office in New York:

Tax laws provide that certain things are legal and certain things are illegal. Tax laws operate without morality. You pay what is due, not a cent more. If a lawyer or an accountant says, “if I interpret the tax code correctly you can do this transaction,” the implication is you can do anything within the code. However, we have had a collection of wise guys who say, “As I understand the Internal Revenue Service they will not be able to follow this trail if you do the following things.” Therefore you can violate the tax code with impunity. That is not the same thing as a tax shelter, that is mischievous. And when people’s deference to the law is whether they will be caught and whether there will be means to defeat . . . not to justify legally the conduct . . . but to defeat the investigation, that is what I am talking about – gaming the system. You are engaging in conduct, which you know to be

<sup>23</sup> Cited in Frank Vogl, “The U.S. business scandals: Perspectives on ethics and culture at home and abroad”. Paper presented to the *TransAtlantic Business Ethics Conference*, September 27, 2002, Georgetown University, Washington, DC.

<sup>24</sup> Deborah Solomon, “Enron report urges penalties for corporate tax abuse”, *Wall Street Journal*, 14 February 2003.

<sup>25</sup> David Cay Johnston, “Wall St. firms are faulted in report on Enron’s taxes”, *New York Times*, 14 February 2003.

unlawful, where your strategy is to defeat the investigators, regulators, criminal justice system, whatever. When that is done by powerful multinational corporations, it brings the law into disrepute and makes a hash of corporate governance.

The confluence of systemic flaws – the inability to detect illicit management decisions and the pathological capacity of firms to cover their tracks – and the ending of the euphoria associated with the boom have made the task of disentangling causes and consequences exceptionally problematic.<sup>26</sup> The official explanation for the largest stock market bubble in history was that coined by the Chairman of the Federal Reserve Alan Greenspan, who, as early as 6 December 1996, referred to it, somewhat euphemistically, as “irrationally exuberant”. Greenspan’s warning came when the New York Stock Exchange (NYSE) index was less than half the level at which it eventually ran out of altitude. In reality, it was a confidence trick that played on what psychologists term “cognitive dissonance”. The official history of the period, which posits the positive role played by the stock market in incubating a technological revolution that allowed the United States to escape global recession, is falsified by economic data. The increasing dominance of financial instruments served to hide a multitude. According to an analysis carried out by Robert Brenner, when the boom is measured based by output levels, productivity and unemployment, rather than the price of equities, “performance in the supposedly sensational five-year period between 1995 and 2000 barely matched the levels achieved in the twenty-five year period between 1948 and 1973. The growth of labour productivity, the most important indicator of economic dynamism, was a full 20% lower. Taking into account the whole business cycle of the decade 1990 to 2000 and not just the five good years at the end, the average annual rate of growth of GDP per person was a meagre 1.6%, compared with 2.2% for the hundred-year period 1989–1999. Even by 2000, real hourly wages for production and non-supervisory

---

<sup>26</sup> See Bill Witherall, “Corporate governance and responsibility”, *Observer*, OECD No. 234, October 2002, pp. 7–9.

workers were still palpably below, and the poverty rate above, their 1973 best.”<sup>27</sup>

Perpetrated by the manipulation of a corrupted system, gullible investors and pension fund administrators who should have known better were divested of their money with consummate skill in a structure that was characterized by a devaluation of business and personal ethics. Risk was successfully transferred from investment banks and over-leveraged corporations to the pension funds with ongoing deleterious consequences. The result was what the leading British economist Will Hutton terms a Faustian bargain between US managers and Wall Street, “corporate America now no longer principally seeks to innovate, build and marshal resources over time to create value. It tries to extract value by financial engineering.”<sup>28</sup>

Like any pyramid investment, the entire edifice relied on confidence and that was already weakening before Muhammad Atta and his colleagues boarded four airliners on September 11, 2001, to launch the most audacious terrorist attack in history against what they saw as the degeneracy of American economic and foreign policy. The physical ruination of the World Trade Center and its environs by the al Qaeda terrorist network served to obfuscate the obdurate reality that the financial system itself was already morally compromised from *within*. Six weeks later, the precipitate decline into bankruptcy of the seventh largest company in the United States provoked a similar sense of confusion.

The terrorist attacks in New York, Washington and Pennsylvania on 9 September may have demonstrated the vulnerability of the last superpower, but the betrayal of trust occasioned by the corporate governance scandals, progressively revealed as the country came to terms with the violation of once impregnable defences, therefore has exposed a wider and deeper malaise. The systematic evaporation of trust in corporations, the regulatory framework and the political

<sup>27</sup> Robert Brenner, “Towards the precipice”, *London Review of Books*, 6 February 2003.

<sup>28</sup> “Wall Street’s Faustian pact”, *Investors Chronicle*, 30 May 2002. The theme is developed further in Will Hutton, *The World We Are In* (Little, Brown, London, 2002).

establishment has fundamentally weakened the three pillars of integrity upholding public trust.<sup>29</sup> The asymmetrical relationship inherent in “fiduciary trust” was skewed both by the corrupt behaviour of executives within corporations and the myopic rationality on behalf of the professional lawyers and accountants who did not question the ethical consequences of allowing egregious behaviour. Mutual trust between the corporation and its shareholders was comprehensively eroded, as was mutual trust between overworked and under-resourced regulatory bodies and corporations determined to evade rigorous policing at the same time as they inculcated a political culture in keeping with their world view. And social trust as a form of what Thomas terms “social capital” was devalued.<sup>30</sup> As such, the destruction wrought by corporate malfeasance is likely – in the long term – to have a more deleterious effect on the American political psyche than the fundamentalist delusions of the al Qaeda network.<sup>31</sup> Taken together, these two very different – but interlinked – seismic occurrences have transformed the political landscape in the United States, the aftershocks of which continue to be felt across the globe. The American response to the crises was scathingly condemned by the influential financier George Soros:

I see a parallel between the Bush administration’s pursuit of American supremacy and a boom or bust process or bubble in the stock market. Bubbles do not grow out of thin air. They have a solid basis in reality but reality is distorted by misconception. In this case the dominant position of the US, the pursuit of supremacy, is the misconception. Reality can reinforce the misconception, but

---

<sup>29</sup> Craig W. Thomas, “Maintaining and restoring public trust in government agencies and their employees”, *Administration and Society*, Vol. 30, No. 2, May 1998, p. 170. For Thomas the three pillars of fiduciary, mutual and social trust are “interwoven and mutually supportive. Mutual trust, generated through microlevel and interpersonal relationships gives rise to and shapes the character of social trust. In turn, social trust enhances the ability of individuals to develop mutual trust. Social trust also buttresses the sense of moral obligation that sustains fiduciary trust” (p. 178). It is precisely for this reason that the forsaking of trust at all levels represents such a serious crisis for the entire financial model.

<sup>30</sup> *Ibid.*, p. 176.

<sup>31</sup> See Paul Krugman, “The great divide”, *New York Times*, 29 January 2001.

eventually the gap between reality and its false interpretation becomes unsustainable.<sup>32</sup>

The economic, political and security crises have served to reinforce each other: the result is increased global insecurity, a disastrous and self-replicating decline in confidence in the integrity of the stock market and the consequent erosion of trillions of dollars in share prices. In a country that boasts the world's highest percentage of small-time investors, the resulting collapse of confidence in the merchant banks, the regulators and, ultimately, the politicians has thrown into sharp relief the integrity of a system that is hard-wired to protect the interests of the top 1% of the population, who, in turn, still hold a controlling interest of 40% in the overall structure.

Statistics compiled by the Securities Industry Association demonstrate that 84 million Americans owned stock in 2002, double that of 1983. Many of these investors are unable to read complicated financial statements and are reliant on the stock picks of corporate analysts who have a vested interest in producing rose-tinted research in order to boost investment-banking clients.<sup>33</sup> Michael Lewis, a former broker with Salomon Brothers, once noted that sustained periods of growth in the stock and bond markets requires “a fool”, whose ignorance or greed could be manipulated. In the context of the 1980s it was saving and loan chief executives who needed to remortgage billions of dollars of loans in order to keep their jobs.<sup>34</sup> In the 1990s the number of fools in the market had intensified exponentially.

With crucial design flaws inherent in contemporary capitalism, the destruction of the Twin Towers and the pre-eminent symbol of that system provided merely confirming evidence of an already structurally unsound blueprint. As David Ellis of *Moneywise* observed, on the first anniversary of the attacks, “this month, those who died in Washington and New York will be solemnly remembered, and the

<sup>32</sup> George Soros, “Bush’s inflated sense of supremacy”, *Financial Times*, 13 March 2003.

<sup>33</sup> Scot J. Paltrow, “The dark side of the Street, where scandals often erupt”, *Wall Street Journal*, 23 December 2002.

<sup>34</sup> Michael Lewis, *Liar’s Poker* (Coronet, London, 1990).

symbolism of the smoking, ruined financial power centre will never be forgotten. But as the history of the financial markets in the wake of the tragedy continues to be written, a bitter irony is emerging. In the end, old fashioned greed did for the markets what the terrorists never could.”<sup>35</sup>

The excesses progressively exposed by the recent corporate governance scandals were distinguishable only by their size: greed has long been an essential feature of corporate practice. But greed alone is an insufficient rationale for the betrayal of trust occasioned by the collapse of Enron, WorldCom et al. and the interlinked crisis of confidence in the role played by market professionals, particularly research analysts. A corporate culture, inculcated during the long years of bullish growth, began to display its deadly symptoms only after the markets took a pummelling from those who hijacked the United and American airliners over the north-east coast. By that stage the condition of the markets was already terminal.

The collapse of the dotcom market in the two years prior to 9/11 was, in retrospect, a chronicle of a death foretold. The introduction of technology shares, created as a result of deregulation of the telecommunications market through the 1996 Telecommunications Act, created a displacement effect that prompted a change in the investing environment. In the scathing assessment of John McCain, a major promoter of campaign finance reform in the Senate, “all the interests were at the table except the public interest.”<sup>36</sup> The rush to take advantage of the deregulation spawned the listing on the market of major new corporations, such as MCI, which later merged with WorldCom. The subsequent collapse of WorldCom, under \$9bn in unsustainable debt, marked the nadir of the crisis. Its demise was an unthinkable prospect at the start of the boom, as the new economy produced prodigy after prodigy. As deregulation created new companies, mobile telephony created real-time communication and the introduction of broadband technology presented opportunities for a

---

<sup>35</sup> Cited in the *Guardian*, 14 September 2002.

<sup>36</sup> Elizabeth Drew, *Citizen McCain* (Simon & Schuster, New York, 2002), p. 3.

revolution on a scale to equal industrialization itself, Wall Street, Washington DC and Silicon Valley combined to offer investors ground-floor access to the citadels of wealth.

The cycle from boom to bust was exacerbated by the vast expansion in monetary supply, primarily through banking credit, which was then used to finance speculative activities. The touchpaper was lit by the irresponsibility of deregulating without introducing adequate institutional safeguards to prevent abuse. Nationwide gambling was decreed legal via the government's decision to allow pension holders to invest a larger percentage of their benefits on the stock market through corporate 401(K) pension plans than prudence would suggest. The introduction of this liquidity turned the entire bourse into an online casino, in which bets were taken on a corporation's daily positioning, rather than underlying performance. And none were more successful in tapping into the speculative zeitgeist than the mutual funds and hedging operations that sprung up to manage the vast increase in the money supply now locked into the securities market. In a remarkable but telling outburst, the chief executive of the British-based Threadneedle Investments, one of the largest retail schemes operating in the UK, suggested the avarice and stupidity of investors were as much to blame. "We encourage them to be even more stupid. I think the fire is already there: we've probably thrown a little bit of petrol – rather than water – but I think [the fire] does come from the greed of the individual."<sup>37</sup> In a staggering statistical survey, *The Economist* estimated that 90% of the venture capital distributed with such abandon during the boom years had been wasted on companies whose business models were untested and unworkable.<sup>38</sup>

Powered by hype and sold on the basis of past performance, mutual funds now account for 20% of all shares, with a capitalization greater than that held in the banking system. The shift to intangible assets managed by mutual funds, which even in the bull market failed to

---

<sup>37</sup> Simon Targett, "UK fund manager hits at 'greedy investors'", *Financial Times*, 3 February 2003.

<sup>38</sup> "The new-economy vultures", *The Economist*, 8 December 2001.

keep pace with the overall performance of the markets, was itself merely symptomatic of the wider problem. In a scathing letter to shareholders, Warren Buffet, one of America's shrewdest investors, castigated the mutual funds industry for its poor performance and the hypocrisy permeating the industry that front-loads costs to investors for undeserved executive pay. "For the most part, a monkey will type out a Shakespeare play before an 'independent' mutual-fund director will suggest that his fund look at other managers, even if the incumbent manager has persistently delivered substandard performance. When they are handling their own money, of course, directors will look to alternative advisors – but it never enters their minds to do so when they are acting as fiduciaries for others."<sup>39</sup>

Management fees and taxes were poorly explained, exit routes made difficult by restrictions on access without penalty, leaving investors little safeguard against corrections in the market. Agency problems abounded with fund managers buying personal stock and then using fund capital to drive up the price, making short-term profit for the manager. Across Wall Street, investors found similar pitfalls. Brokers, working on commission based on the number of trades rather than performance of the stock in a given portfolio, had a vested interest in maximizing trading activity, particularly in the issuance of secondary offerings where the level of commission was five times that of initial offerings. Internet trading and the running ticker on financial television served to add to the frenzy as the United States developed the attributes of a qualitatively different form of trading nation.

The situation was further exacerbated by the use of stock options to reward executives. The unhealthy relationship began to demonstrate

---

<sup>39</sup> *Berkshire Hathaway Annual Letter to Shareholders*, p. 17 (released 8 March 2003, full text available online at <http://www.berkshirehathaway.com/letters/2002.html>). Buffet announced that, despite major losses charged against its derivative business General Re, his fund posted earnings of \$4.279bn and outperformed the S&P 500 by 32.1%. Buffet had the humility to point out, "there will be years in which the S&P soundly trounces us. That will in fact almost certainly happen during a strong bull market, because the portion of our assets committed to common stocks has significantly declined. This change, of course, helps our relative performance in down markets such as we had in 2002" (p. 3).

corrupting tendencies as early as 1992, in part occasioned as a result of a decision by the incoming Clinton administration to limit chief executive pay to \$1m. The result was an exponential increase in stock options to reward executives, which, in turn, gave a rationale for fraudulent cooking of the books. If the corporate pay was determined by the rise in stock value, it was in the executives' own self-interest to boost share value by fair means or foul.<sup>40</sup> By the time of Enron's collapse, its chairman Ken Lay had options valued at over \$168m. By way of contrast, the options package accrued by Sandy Weill, the chief executive of Citigroup, had risen to over \$1bn. The consummation of this marriage of convenience reached its apogee in the financing facilities offered to Enron and the telecommunications giant WorldCom and the de facto bribery involved by the "spinning" of lucrative initial public offerings (IPOs) to executives in order to gain lucrative underwriting contracts.

Providing stock options, which did not appear as expenses, fundamentally warped any assessment of a company's real value. Designed to resolve what economists have termed the "principal-agent dilemma" by providing management with a vested interest in the profitability of a company, it succeeded only in boosting corporate pay while doing little to safeguard the interests of the shareholders. In 1992 average compensation for chief executives was \$1.8m. By 2000, it had reached \$6.1m. A survey by *Business Week* found that CEO pay rose by 340% over a 10-year period, compared with an average of 36% for employees.<sup>41</sup> The justification for such increases rested on the creation of a business etiquette that placed an inordinate emphasis on driving up the stock market valuation without paying due cognizance to the underlying economic performance.<sup>42</sup> This systemic

---

<sup>40</sup> See Peter Peterson, "A personal postscript", *Conference Board Commission on Public Trust and Private Enterprise*, 9 January 2003, p. 6. Peterson argues that setting limits on executive pay as a means of dealing with the crisis would risk repeating the "iatrogenic" failure of the Clinton administration.

<sup>41</sup> "How to fix corporate governance", *Business Week*, 6 May 2002.

<sup>42</sup> See Alex Berenson, *The Number, How the Drive for Quarterly Earnings Corrupted Wall Street and Corporate America* (Simon & Schuster, New York, 2003).

problem exacerbated the temptation to effectively cook the books, according to a former enforcement lawyer with the SEC and now a director at a leading European-controlled investment bank:

The system in the US has evolved over recent years such that every quarter you put out earnings guidance and you have to make your numbers. If you don't make your numbers, if you don't meet what you projected you would meet for that quarter, if you miss it by as much as a penny a share, your stock will get hammered, absolutely hammered and it is a weird dynamic. I don't know if the system should function in that way. I don't know if it is artificial but our system has developed in such a way that it is. Corporate officers panic that they are not going to meet the quarterly numbers because if you don't make the quarterly numbers the stock price is going to plummet, so the incentive is built into the system that you meet the numbers, which drives people to become bad actors to meet the numbers.<sup>43</sup>

As a result, companies were grossly overvalued, saddled with wholly unrealistic price–earning ratios that created, in turn, irrational longer term profit expectations. To make matters worse, the extent of these stock options did not appear on company accounts, thereby precluding any real analysis of their impact on the true values of the company concerned and reducing the shareholders' knowledge of just how much profits the executives were siphoning off. Rather than solving the agency problem, the widespread use of stock options served merely to enhance the relative power of executives, whose recompense was determined by moving up the stock price by whatever means possible.<sup>44</sup> It is a point recognized in Wall Street:

Incentive-based compensation is a second systemic problem. I don't think there is anything essentially wrong with incentive based compensation. I think it has a lot of benefits; it aligns the interests of senior management, and officers and directors with shareholders; it ensures that people stay around for a number of years, they don't leave promptly because if you do you forfeit these options, it

---

<sup>43</sup> Interview, New York City, 7 February 2003.

<sup>44</sup> See Gretchen Morgenson, "Time to look at stock options real costs", *New York Times*, 21 October 2001. For an extended analysis of the deleterious effect played on economic viability by the non-recording of stock options see Robert Brenner, "Towards the precipice", *London Review of Books*, 6 February 2003.

ensures that you have great motivation to think long term and to think long term to drive up the stock price because you will benefit economically. That is all good but the bad is your whole focus in life becomes that stock price can't go down because if the stock price goes down my options will expire valueless and I am going to lose x amount of dollars. So I think it has been another incentive that has been built into the system for CFOs or other officers to ensure that numbers are met, that their options and other incentive based compensation end up rewarding them handsomely.<sup>45</sup>

The pressure to meet those numbers was exemplified in February 2003 with the criminal and civil cases filed in Denver against mid-level executives working in the Global Business Markets Unit of the telecommunications company Qwest Communications International. The SEC brought a case alleging that the company inflated its earnings by \$144m in two specific instances to meet quarterly numbers. The Justice Department simultaneously filed criminal charges against four executives in relation to the fraudulent booking of profits for one of the projects, which was designed to network the Arizona school system. The US Attorney for Colorado John Suthers termed the activity “true accounting fraud.”<sup>46</sup> The firm is alleged to have delivered hardware to the School Board prior to its agreed delivery so that it could book profit. An email discovered in the course of the investigation suggested concerns about the facts of the plan “hanging together”, an indication, according to the government, of a premeditated plan to deceive the market.

According to the SEC suit, “to support immediate recognition of revenue for the sale of the equipment, the defendants prepared false letter agreements for ASFB [Arizona School Facilities Board] and a fraudulent internal memorandum.” The fictitious revenue allowed Qwest to meet its expected revenues. Without it, the company would have fallen short of its 12–13% growth forecast. The SEC suit provided further evidence of a concerted campaign to meet the market numbers, at whatever cost. A separate transaction involving

---

<sup>45</sup> Investment Bank counsel, New York City, 7 February 2003.

<sup>46</sup> Dennis K. Berman and Deborah Solomon, “Ex-executives are indicted in federal probe of Qwest”, *Wall Street Journal*, 26 February 2003.

an Internet service provider Genuity Inc. ensured that the company “improperly recognized \$100m in revenue” in two complex and interconnected contracts. The first involved Qwest charging inflated prices for equipment, which was then in a second contract bought back through Qwest assuming “all risk of loss and obsolescence on the equipment purportedly sold pursuant to the first contract.”<sup>47</sup>

For the SEC, the activity was symptomatic of the aggressive strategy adopted by Qwest as it sought to redefine itself on the capital markets from a “stodgy, old-style telephone company” into a financial powerhouse. The court filing spoke of a business model that “placed extraordinary pressure on their subordinate executives, managers and employees to meet or exceed those earning objectives at all costs.”<sup>48</sup> In a post facto indictment of the financial engineering imperative, the Commission explicitly sought “an order pursuant to the equitable authority of the court requiring each defendant to disgorge all ill-gotten gains from their participation in the fraud including all benefits derived from their employment at Qwest such as salary, bonuses, stock and other remuneration.”<sup>49</sup> In an attempt to gain the moral high ground, the prosecutions were accompanied by news conferences in Washington, DC. The Chairman of the SEC William Donaldson made clear that the prosecution marks the beginning of a process. “Accurate financials are the bedrock of our capital markets. This agency will pursue aggressively anyone and everyone who has participated in an illegal effort to misrepresent a company’s financials and mislead the investing public.”<sup>50</sup> This aggressive policy contains an escalation imperative that has profound implications for the regulators and the Department of Justice itself. The unanswered question was whether the political will existed to move beyond individual

---

<sup>47</sup> SEC Press Release 2003-25 (accessible online at <http://www.sec.gov/news/press.shtml>).

<sup>48</sup> *SEC vs. Joel M. Arnold et al.*, District of Colorado, Civil Action No. 03-Z-0328 (OES), p. 8.

<sup>49</sup> *Ibid.*, p. 4.

<sup>50</sup> SEC Press Release 2003-25 (accessible online at <http://www.sec.gov/news/press.shtml>).

actors and indict the corporations that facilitated such egregious behaviour through the adoption of a policy of wilful ignorance.

Given that Qwest has already announced a restatement of \$2.2bn, it is only a matter of time before responsibility for inculcating the model moves further up the corporate ladder.<sup>51</sup>

Tracking executive pay to the performance of the bourse rather than to individual company performance may have been illogical, but an unholy alliance militated against exposure until the bear began to roar, sending the corporate giants scurrying to the bankruptcy court, but not before the exercise of lucrative stock options, netting billions of dollars.<sup>52</sup> Insider-trading ensured that these “barons of bankruptcy” squeezed every droplet of profit before discarding their worthless companies.

Financial alchemy deployed by auditors, beholden to management for lucrative consultancy tenders, grossly overstated profits by utilizing dubious, and in some instances illegal, accountancy measures. The business model aggressively promoted by Bernie Ebbers, the Chief Executive of WorldCom, and his CFO Scott Sullivan rested on an uncomplicated manoeuvre that treated operating costs as capital investment. As with Enron, the auditor was Arthur Anderson. The failure of the audit process, while not endemic, was however condoned, infecting not just the voracious ambitions of Enron, WorldCom and their ilk but also contaminating established corporations, including the pharmaceutical corporation Bristol-Meyers Squibb, which restated its accounts to the tune of \$2.5bn because of what it termed, somewhat innocuously, “errors and inappropriate accounting.”<sup>53</sup> Outright fraud was alleged at the photocopying giant Xerox and its auditors KPMG.

---

<sup>51</sup> Barnaby J. Feder, “Charges filed in Qwest case”, *New York Times*, 26 February 2003.

<sup>52</sup> A survey published by the *Financial Times* found that over \$3.3bn in stock options were siphoned off by executives in the companies under investigation. See Ien Cheng, “Survivors who laughed all the way to the bank”, *Financial Times*, 31 July 2002.

<sup>53</sup> Reed Abelson, “Bristol-Meyers lowers revenue by \$2.5bn in restatement”, *New York Times*, 11 March 2003.

In April 2002, Xerox agreed to pay a record \$10m fine for posting more than \$2bn in bogus profits in the period 1997–2000. On 29 January 2003 the SEC went further, filing a civil fraud complaint against its auditors KPMG.<sup>54</sup> One of those named in the suit was Michael Conway, a senior partner in the firm and one of the foremost auditors in the United States. According to the suit, “instead of putting a stop to Xerox’s fraudulent accounting, the KPMG defendants themselves engaged in fraud. There was no watchdog at Xerox. KPMG’s bark sounded no warning to investors; its bite was toothless.”<sup>55</sup>

The censure of KPMG by the SEC was only the second time that a major accounting firm has been directly accused of fraud. The previous culprit Arthur Anderson has been consigned ignominiously to the history books. The partnership could not withstand the opprobrium heaped on the once-venerable institution because of its role in the obstruction of the Department of Justice investigation. Anderson was already on a final warning from the SEC because of major deficiencies in previous audits involving Waste Management in Chicago and Sunbeam in Florida. It fell on its own sword and dissolved itself rather than face SEC censure. KPMG called the suit “entirely unjustified” and claimed that “at the very worst, this is a disagreement over complex professional judgements.” The firm proclaimed that it was pressure from the auditors themselves that forced Xerox to restate; an assertion disputed by the SEC.<sup>56</sup>

Crucially, little action was taken to address the systemic flaws at the time. In a bull market that fed the self-fulfilling myth of the efficacy of the American business and political model, none seriously questioned the implications of inaction<sup>57</sup> – until, that is, it was too late:

---

<sup>54</sup> For full details see *SEC vs. KPMG LLP, Joseph T. Boyle, Michael A. Conway, Anthony P. Dolanski and Ronald A. Safran*, Civil Action No. 03 CV 0671 (S.D.N.Y.) (29 January 2003), Litigation Release No. 17954/January 29 2003. See also Accounting and Auditing Enforcement Release No. 1709/January 29 2003 (available online at <http://www.sec.gov/litigation/litreleases/lr17954.htm>).

<sup>55</sup> Floyd Norris, “SEC says KPMG helped Xerox inflate profits”, *New York Times*, 30 January 2003.

<sup>56</sup> *Ibid.*

<sup>57</sup> See John Cassidy, “The greed cycle”, *The New Yorker*, 23 September 2002, pp. 64–77.

I knew during the bubble that we were going to be in trouble. I told Robert Morgenthau a year before the bubble burst that, if the market collapsed, if the prices went down thirty per cent, I would resign because I couldn't handle the kind of volume of complaints we were going to get. In fact the markets have gone down more than thirty. I haven't resigned, but I can't handle the volume of complaints that we have got, and some of them are well founded and that is separate from knowing about Enron or any one of them. You just know that at a time of unbridled growth . . . uninhibited reporting of peculiar statistics . . . you know that the fraudsters are going to make a killing, and when the thing comes tumbling down you will be left with a number of people screaming bloody murder. It was predictable that it was going to happen, we just didn't know which company it was going to be. In fact we were all shocked by how bad it was and how pervasive false accounting was, but we just missed it. I think that someone who knew the market better could have predicted it.<sup>58</sup>

The entire basis of modern American capitalism has been undermined by deficiencies in the key areas of accountability, openness and vigilance – the key areas identified by the World Bank as essential to good governance and economic growth. The paradox for the American economy is that the long years of bullish growth in equity value represented not only “the economics of the madhouse”, it hid a multitude.<sup>59</sup> As Galbraith once remarked, recessions catch what auditors miss.

In a forlorn and belated attempt to restore confidence, the Conference Board (a trade grouping of CEOs) created a Commission on Public Trust and Private Enterprise to examine the fundamental causes for the explosion in corporate crime. The Commission released a number of reports examining the role played in the crisis by excessive compensation and lax corporate governance structures. Taking the title of a George Clooney disaster movie as a comparator, the Commission concluded that “there has been a *Perfect Storm* – a confluence of events in the compensation area which created an environment ripe for abuse . . . These factors may have fostered what appears to be a vicious cycle of increasing short-term pressures to manipulate

<sup>58</sup> Interview with John Moscow, New York City, 9 April 2003.

<sup>59</sup> John Plender, *Going off The Rails, Global Capital and the Crisis of Legitimacy* (John Wiley & Sons, Chichester, UK, 2003), p. 43.

earnings in order to bolster stock price in order to cash in on stock options.”<sup>60</sup> The Conference Board Commission concluded that greater use should be made of performance-related pay based on actual performance rather than stock market trends and endorsed a compensation formula that had “a clear correlation between the costs of the increased compensation and the expected benefits to the corporation.”<sup>61</sup>

In short, the economic downturn has exposed a crisis in corporate governance of monumental proportions, which in turn makes it even more difficult to inject confidence into the system. Writing in the *Financial Times*, the paper’s chief economics analyst Martin Wolf noted that “everything is made far worse by a plethora of conflicts of interest: financial conglomerates are more concerned with pleasing corporate management than with maximising the value of the funds they control; outside directors owe more loyalty to the managers who choose them than to the shareholders they represent; and accountants owe more to the people who employ them than to the investors who rely on their work.”<sup>62</sup> Wolf could also add the role of the business press itself.

While the financial media has played a major role in analysing just what has gone wrong since the collapse of Enron, it remains remarkably silent about its own culpability in failing to provide non-institutional investors with any sense that the system was stacked against them at each end of the market.<sup>63</sup> Scepticism, the last refuge of the investigative journalist, was missing as it reported on the rollercoaster rise to dominance of Enron, a company that was making up the rules as it went along and disregarding them as the

---

<sup>60</sup> *Conference Board Commission on Public Trust and Private Enterprise Findings and Recommendations*, 17 September 2002, pp. 4–7 (available online at <http://www.conferenceboard.org/>).

<sup>61</sup> *Ibid.*, p. 5.

<sup>62</sup> Martin Wolf, “Why it is so hard to fix the flaws of modern capitalism”, *Financial Times*, 20 November 2002.

<sup>63</sup> A rare exception is Richard Lambert, former Editor of the *Financial Times*, who noted that Enron was also a failure of journalism. See Richard Lambert, “Enron and the press”, *Prospect*, March 2002.

search for profit took ever more esoteric, if not ludicrous turns. In a scathing indictment of her own journalistic charges, the Chairman of Pearson, owner of *The Economist* and the *Financial Times*, told the *Royal Journal of Arts* in a recent interview that business reporting had failed: “We could have done a lot more digging. But business journalists often don’t know a lot about business.”<sup>64</sup>

The problem was that conflicts of interest ensured that outside the rarefied heights of the Wall Street skyscrapers, true knowledge of the impending change in the environment within the corporations affected was deliberately occluded. Those who relied on impartial analysis found that a dangerous admixture of pride and ignorance, deceit and greed, permeated the research departments of the brokerage houses who could not or would not admit to a failure to analyse the small print. Compensation packages within the major investment banks guaranteed the payment of bonuses to their specialist researchers according to their ability to rate stock and garner further investment business rather than assess specific intrinsic worth.

Nowhere was this corruption made more manifest than in the practice of “spinning” IPOs. Incestuous exclusivity determined access to the lucrative IPOs of market capitalizations, which were then heavily promoted, making those who invested initially substantial profits on the greed of those who wished to join the club. In return for hefty allocations, investment houses agreed informally to become what is termed “after-market players”, meaning that they would actively trade the stock after its launch, which ensured that it was noticed and continued to rise. In August 2000 the SEC specifically banned the solicitation of after-market orders because of the danger that it manipulated the market. “Tie-in agreements are a particularly egregious form” of prohibited transactions that “undermine the integrity of the market.” The then Chairman of the SEC Arthur Levitt told the *Wall Street Journal* that the linkage “erodes public confidence because it suggests that the process is rigged in favour of some over the interests of the individual.” There was also a structural imperative

---

<sup>64</sup>Quoted in John Cassy, “Let’s not do lunch”, the *Guardian*, 6 January 2003.

for the underwriters. It artificially stimulated demand and therefore boosted prices and with it the underwriter's commission.<sup>65</sup>

This fraudulent manipulation was merely the tip of the iceberg. Not only was it common practice for firms to ramp up the share price, allocations were made to favoured clients on the basis of securing future underwriting business, and, in a particularly damaging case, brokers at Credit Suisse First Boston recouped some of the profit by charging exorbitant fees on trades, thereby making a mockery of legislation. In a settlement that was to do much to unleash the resentment at the activities of the investment banks, Credit Suisse agreed to pay a \$100m fine to bring closure to an 18-month federal investigation into alleged abuses of the manner in which it allocated and valued initial offerings.<sup>66</sup> The fine represented less than 15% of the \$717.5m the firm had earned in promoting IPOs in the period 1999–2000.

The avarice associated with the IPO market was fed by the “buy” recommendations from analysts working on the initial capitalization. The need to buttress the stock valuations occurred at every stage of the process: from the conception of a business plan to managing the slide into, or out of, bankruptcy. Fear of incurring the wrath of the issuer and therefore curtailing access to information was a further inhibiting factor according to Gary Lynch, Vice-Chairman of Credit Suisse First Boston and a former Head of Enforcement at the SEC:

Retribution from issuers to analysts is also going on. They just cut you off from the flow of information. Unfortunately, all the focus has been on the investment banks and regulating the investment banks themselves. On a daily basis companies and issuers are still punishing analysts who downgrade them. There are other things happening out there in the world that maybe regulators are powerless to act on that affect an analyst's view. Analysts are going to remain

---

<sup>65</sup> Susan Pulliam, “Seeking IPO shares, investors offer to buy more in after market”, *Wall Street Journal*, 6 December 2000.

<sup>66</sup> Susan Pulliam, Randall Smith, Anita Raghavan and Gregory Zuckerman, “CSFB will pay \$100 million to settle inquiry into firm's IPO distribution”, *Wall Street Journal*, 11 December 2001.

reluctant to downgrade issuers rather than simply talk to them or express caution because if you put a sell on issuers they treat you differently than if you have a buy on them.<sup>67</sup>

While there is considerable merit in Lynch's argument it is also undoubtedly the case that investment banks stood to gain valuable consultancy fees from grandiose expansion programmes only if the stock market value and debt rating – that is, the corporation's ability to repay debt – remained high, an uncomfortable fact either not included or minimized in research reports. This was, in short, a very imperfect market in which power rested on knowledge, and knowledge was a chargeable commodity.

The analytical framework itself was fatally flawed from the outset. Too often reports merely recited the company figures rather than subjecting them to a thorough critique. Little attention, if any, was placed on “fundamental issues such as the corporation's liquidity and borrowing capacity; the adequacy of its lines of credit ratings on new or outstanding bond issues; and the contingent liabilities reflected in

---

<sup>67</sup> Interview with Gary Lynch, New York City, 7 February 2003. A graphic example of this pressure surrounded the treatment of Heather Jones, an analyst for BB&T Capital Markets during a tele-conference with Fresh Del Monte Produce. Miss Jones had recently downgraded the valuation of Del Monte from “buy” to “underweight”. When she asked what were perceived to be hostile questions, the Del Monte executives cut the line. See Richard Gibson, “Del Monte flap is opposite of ‘cozy analyst situations’”, *Wall Street Journal*, 17 February 2003. Similar pressure was exerted on Christopher McFadden, a pharmaceutical analyst with Goldman Sachs. See Kate Kelly, “Goldman analyst learns that candor doesn't pay”, *Wall Street Journal*, 5 February 2003. In the international arena, pressure from governments can also impact on investment banking capabilities. In March 2003, the Philippines government banned UBS for participating in future bond issues because of the release of a highly critical research report, timed to coincide with a rights issue. According to UBS the government has “banned it from all sovereign and sovereign-related fund raisings, which are expected to reach at least \$3 billion this year; suspended its fixed-income, foreign-exchange and bullion dealings, which make up a big chunk of the bank's Asian revenues; and withdrawn about \$180 million in central-bank funds from its asset-management arm.” See Karen Richardson, “UBS banned in Philippines”, *Wall Street Journal*, 26 March 2003.

the footnotes.”<sup>68</sup> The use of pro forma company releases to enhance stock and the sports commentary style of financial television, in which profits were gained by advertising, inculcated a business media culture that mirrored the corporate ethos it fed off.

Its leitmotif was Consumer News and Business Channel (CNBC), a misnomer if ever there was one, and in particular its casino-style early morning programme *Squawk Box*. As the *Washington Post*'s media consultant Howard Kurtz has commented, “back in the heady days of a stampeding bull market CNBC was a driving force, a cultural phenomenon, a ratings success, the play-by-play announcer for America’s new pastime . . . What CNBC did, along with the rest of the business press, was buy into an interlocking system – now widely viewed as flawed and in some cases corrupt – in which all the key players had an incentive to push stocks.”<sup>69</sup> Those analysts who played the game, suggesting hot picks and feeding the gambling frenzy, were rewarded with repeat appearances, which in turn added to their fame and to their own marketability. Bluntly, there was a bias against understanding for corporate gain.<sup>70</sup> That gain was not inconsiderable. In 2000 the value of mergers and acquisitions and new share issues reached \$3.5tn. This in turn generated no less than \$28bn in fees for the mercantile class, who controlled access to the market.

American capitalism sailed into “the perfect storm” with the passengers unaware that the vessel had not been satisfactorily inspected to ensure its seaworthiness. As Lynn Paine, Professor of Ethics at Harvard Business School, pointed out to the *Financial Times*, the perfect storm analysis put forward by the denizens of corporate America usefully downplays structural weaknesses in the craft put to sea. “One of the most common explanations [for the scandals]

---

<sup>68</sup> Henry Kaufman, “A straighter path for Wall Street”, *Financial Times*, 4 December 2002.

<sup>69</sup> Howard Kurtz, “On CNBC, boosters for the boom”, *Washington Post*, 12 November 2002.

<sup>70</sup> For a further discussion on the role of the financial media see A. Larry Elliot and Richard J. Schroth, *How Companies Lie* (Nicholas Brealey, London, 2002), pp. 118–29.

is the perfect storm: a confluence of unusual forces. But when I look at it, I'm more inclined to go back to the underlying ideology that legitimised certain management practices."<sup>71</sup>

The perennial claims of monetarist economists that the markets act rationally and that destabilizing speculation is a contradiction in terms have been comprehensively falsified, technical justification by reference to "insiders" and "outsiders" notwithstanding:

The insiders destabilize by driving the price up and up, selling out at the top to the outsiders, who buy at the top and sell out at the bottom when the insiders are driving the market down. The losses of the outsiders are equal to the gains of the insiders, and the market as a whole is a standoff . . . But the professional insiders initially destabilize by exaggerating the upswings and the falls, while the outside amateurs who buy high and sell low are less price manipulators than the victims of euphoria, which infects them late in the day. When they lose, they go back to their normal occupations to save for another splurge.<sup>72</sup>

The corporate governance crisis demonstrates that one did not have to break the law to rake in millions of dollars from overvalued stock. Corporate accounts were rendered indecipherable because of opaque accounting that allowed firms to book potential future profits against losses, skewing the real bottom line:

Bill Clinton came up with the greatest line to describe the kind of thinking that got us into this kind of trouble in the first place when he said, it all depends on what is, is. A friend of mine, a long time investment banker says you can't afford to teach the bean counters that it all depends on what is, is. The beans are either there or they are not there. When you start to get esoteric in fundamental accounting you turn out to be building unreal structures. When people get the idea that this word game is a sufficient substitute for economic activity you get the kind of bubble that we have had that we are now trying to clean up from.<sup>73</sup>

The accountancy revision was deemed necessary to value new technology companies, whose worth was measured not in equipment but

<sup>71</sup> Andrew Hill, "Has corporate America learned its lesson", *Financial Times*, 30 December 2002.

<sup>72</sup> Charles P. Kindleberger, *Manias, Panics and Crashes, A History of Financial Crises* (John Wiley & Sons, New York, 2000), pp. 29–30.

<sup>73</sup> Interview with John Moscow, New York City, 9 April 2003.

in intellectual capital. Over time, this gradually became the standard for all major publicly quoted enterprises. The move away from tangible assets was accompanied by a massive growth in the trading of complicated financial derivatives, ostensibly designed to help companies manage risk. The problem was that few understood either the nature of the risk or the complexity of the ruses: not the boards of directors, not the financial analysts, not the financial press and certainly not those at the bottom of the food chain who believed what they were told and suspended disbelief in the “irrationally exuberant” mania that gripped America. Enron was truly the epicentre of the perfect storm, prior to which the meteorologists had gone on strike.<sup>74</sup>

The quest to ascertain who was responsible for the malaise and to what extent its creation is owed to a wider failure of governance has been lost in the maelstrom surrounding the terrorist attacks on New York and Washington on September 11, 2001, an event seared into global collective consciousness. But as the list of corporate failures intensified, after Enron’s collapse into bankruptcy on 2 December 2001, the initial temptation by policy-makers to blame individual greed looked increasingly like an acute manifestation of self-deception and self-preservation in equal measure. As a consequence, Wall Street itself is on trial.

---

<sup>74</sup>For a damning assessment of the risks associated with derivative trading see Warren Buffett, “Avoiding a mega-catastrophe”, *Fortune*, 17 March 2003. The full text of Warren Buffet’s annual newsletter is available online at <http://www.berkshirehathaway.com/letters/2002.html>