The Alarming Decline In The Quality Of Financial Reporting And Upsurge In Securities Fraud

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I want to discuss a serious problem affecting our securities markets – the dramatic decline in the quality of financial reporting by public companies during the last several years, and the upsurge in securities fraud. An explosion of new, smaller "high-growth" public companies, including the Dot-Com IPO craze, plus a virtually universal executive compensation and annual bonus system based on meeting pre-determined earnings and stock price appreciation targets, with stock options to be exercised and sold quarterly, created very powerful incentives to falsify results – exacerbated by corporate executives' knowledge that a stock market dominated by momentum investors will instantly crush a stock for missing the "whisper" earnings number by just a penny or two. Add to this mix the fact that it now turns out that the "independent" accountants were routinely violating independence rules while pocketing lavish consulting payments that outweighed their audit fees many times over – creating powerful incentives for these "watchdogs" to accommodate their corporate clients.

All these factors have created a "race to the bottom" in financial reporting, which, unless reversed, will undermine a core value in our capital markets – the integrity of public company financial reporting, which is essential to informed investor decisions, investor confidence in our markets, and the efficient allocation of capital to honest entrepreneurs whose efforts will create long-term economic job growth and positive investor returns.

While we have always had high-profile financial frauds – Equity Funding, U.S. Financial, National Student Marketing and Miniscribe come to mind – these were, for the most part, isolated instances. Historically, public company accounting in this country has been of high quality and one of the major factors that has led to investor confidence in our markets, made them the envy of the world and helped fuel the strong capital formation and economic growth we enjoyed here for many years.

However, over the past several years, important changes occurred which have resulted in a massive increase in fraudulent financial reporting. Over 9,000 new public companies were created by the IPO boom of the 1980s-1990s – more than half of all existing public companies today. Many of these new public companies were smaller high-growth high-tech or bio-tech companies where the pressure to show earnings growth is intense. Others were Dot-Com enterprises which have no earnings and were under pressure to show revenue increases – or create apparent profits by using so-called "pro forma" accounting to generate financial results which Generally Accepted Accounting Principles would never sanction.

Another large batch of these new public companies was in the for-profit healthcare business – where *The Wall Street Journal* described the Chief Financial Officer as an "endangered species" and where the quality of financial accounting reminds one most of the public real estate companies in the "go-go" era of the 1960s and 1970s.

Bringing these new companies public generated billions in fees for the investment bankers and gargantuan returns to venture capital investors – as well as making countless instant insider multi-millionaires.

Executive compensation has also changed. Virtually all executives now get cash bonuses only if a year's earnings reach preset targets and the company's stock performs well – and they receive stock options, not to hold for the long-term, but rather to exercise and sell each quarter for cash, most often in a trading window that opens a day or two after the company reports its closely watched quarterly numbers. And during the past decade, the amounts of money paid accounting firms by their corporate clients for consulting services skyrocketed and widespread independence violations spread through that profession.

These are important structural changes that altered the type of public companies dominating our financial markets, the relation of the auditors to their corporate clients and the incentives that shape the behavior of corporate executives and their professional assistors.

Under these circumstances, it is not hard to see the temptation to manipulate a company's reported results to meet internal targets and investor expectations – especially when the efficient market (it's really a ruthless market) will savage a stock for the slightest earnings disappointment.

Remember, Adam Smith's invisible hand guides us all. When there is so much to be gained by those who create the financial results of public companies by meeting expectations – and so much to be lost by missing them – we should not be surprised that corporate managers and their professional assistors yield to temptation.

Most investors are overwhelmed by the impressive appearance of the reams of data in corporate financial reports, where the numbers always seem to "add up" in a maze of difficult-to-comprehend small print. They defer to these financial statements as if they were the product of some rigorous scientific inquiry and discipline. But we know they are not. Virtually every number in a corporate financial report is created by judgments and estimates made by corporate insiders whose cash bonuses depend upon meeting preset earnings targets and whose ability to pocket millions from option-related stock sales is dependent upon meeting public earnings expectations and by auditors who stand to lose millions of dollars of high-margin consulting fees if they force confrontations leading to their replacement.

When is revenue properly recognized! Well, the truth is corporate managers decide when a sale or the earnings process is complete – a decision fraught with subjective determinations regarding future obligations to the customer, easily masked by side agreements for return rights, price protections, re-stocking privileges and other contingencies affecting the obligation to pay. It is oh so easy to sweeten these contingent arrangements at quarter-end to induce a "sale." What expenses have really been incurred against revenue in this reporting period? Well again, it depends upon how corporate insiders value existing inventory and product development costs. What reserves are needed for returns of products already shipped? Or where price protection has been given? How about reserves for doubtful accounts receivable from new customers with unknown credit histories or customers of dubious payment ability? Or the expenses or losses incurred but not reported of healthcare or insurance companies? And with many companies dependent on a growth-by-acquisition strategy, the ability to hide current expenses in the one-time special charges that accompany each acquisition or to over-reserve to create a reservoir to draw upon to boost future results has created other opportunities for insiders to exercise judgment in a way that has a dramatic impact on reported results of ongoing operations. And also, what are those acquisitions really worth and how are they paying off – judgments affecting what is often billions of dollars of goodwill carried on balance sheets.

Corporate insiders and their assistors make these judgments – in secrecy, behind closed doors. In truth, there are countless "discretionary accruals" available to corporate managers to shape reported corporate results. While we all recognize that corporate managers may "manage" their company's earnings, none of us should tolerate – and certainly our securities laws do not permit – the abuse of accrual judgments to manipulate reported results.

Stanford Professor Joseph Grundfest's and PricewaterhouseCoopers' analysis of securities suits filed since the Private Securities Litigation Reform Act of 1995 ("PSLRA") concluded that investors are alleging financial fraud and manipulation much more frequently – 53% of the cases filed last year included such allegations – suggesting a sharp increase in fraudulent financial accounting. Since my firm files about 70% of these cases, I can personally attest to the accuracy of Grundfest's and PricewaterhouseCoopers1 conclusions. But allegations by the disgruntled investors my firm represents are one thing. Objective academic studies are another. And here important new evidence seems to be stacking up strongly in support of the view that there has been a substantial increase in financial fraud by public companies. Four recent academic studies confirm that financial manipulation by corporate insiders has become widespread.

"Earnings Management and Long-Run Market Performance of Initial Public Offerings," published in 1998 by the University of Michigan, is best summed up by *The Wall Street Journal*'s headline reporting its release: "IPOs Often Come Dressed Up With Best Figures!" No kidding! This study documented that most companies boost their pre-IPO results by discretionary accounting accruals and that the companies that engage in the most aggressive pre-IPO dress-up show the worst post-IPO aftermarket performance. You still can't rob Peter to pay Paul. Of course, borrowing from future results to boost current ones only increases the pressure for further manipulations to meet investor expectations after the IPO. And so on.

That is the conclusion of a 1997 study entitled, "Earnings Management and the Performance of Seasoned Equity Offerings," by the University of California, which documented widespread earnings manipulation in front of "secondary" public offerings. Significantly, it also observed the phenomenon of statistically significant post-offering underperformance by the companies that were most aggressive in boosting pre-secondary offering financial results.

"Earnings Manipulation to Exceed Thresholds," published in 1997 by Harvard University, concluded: "[M]anagers have both the incentive and flexibility to manipulate earnings" and "we have no doubt that short-term earnings are being manipulated by many, if not all, companies." It found that "manipulation was most frequently present when needed to meet bright-line tests," *i.e.*, earnings estimates, and occurred most often in the fourth quarter – just when the supposedly independent auditors are arriving on the scene for the annual audit. What does this conclusion suggest about the effectiveness of annual audits by so-called independent accountants?

Finally, "Earnings Management to Avoid Earnings Decreases and Losses," published in 1997 by Michigan University, found that "evidence of earnings management is clear and pervasive across years and industries … (to avoid earnings decreases and losses)," noting "widespread evidence that earnings are borrowed from the future to increase current earnings."

Now, let me see if I have this right. One study says companies goose their earnings before their IPO, while another says they goose them before secondary offerings as well. The two other studies say they are manipulating their earnings higher on an ongoing basis to meet forecasted results and avoid earnings decreases or shortfalls. Isn't that all the time?

According to Fortune Magazine:

> Speaking at a recent investor-relations conference, one stock analyst, Gary Baiter of DLJ, baldly urged that companies consider "hiding earnings" "for future use. "If you don't play the game," he said, "you 're going to get hurt."

A few years ago I addressed the *Business Week* CFO Conference in Phoenix. I spoke to 100 CFOs of top U.S. companies – major American corporations. After I had challenged the quality of corporate financial reporting, the moderator used an interactive question-and-answer system to ask the CFOs to respond anonymously to the question: "Has your CEO ever asked you to falsify the financial results?" Astonishingly, 67% said yes – and 12% admitted they had done it. I later heard the SEC had sought – and obtained – the attendance list for this conference.

The popular financial press gets it. *The New York Times* ran a story headlined "Business Fraud of the 90's: 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."

In October 1998, *Business Week* ran a cover story, "Corporate Earnings – Who Can You Trust?" detailing what it called rampant "earnings hocus-pocus" – "how companies come up with the numbers they want." After *Business Week* detailed what it called the accounting "tricks of the trade" it asked, "Where Are the Accountants?"

Worth Magazine ran a story, "Taking the Lies Out of Earnings," which concluded, "earnings are becoming an increasingly less reliable tool for investors, as changes in executive compensation and accounting practices give corporate officials both a reason to bend the rules and greater leeway in doing so." *Pensions and Investments* wrote in an editorial entitled: "A Numbers Game – Manipulation Becoming Commonplace":

> In recent years, probity has eroded…. [A] significant and growing number of otherwise high-grade 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"….

Even *Forbes* and *Fortune* get it. Under the headline "Pick A Number, Any Number," *Forbes* noted: " [I]t's getting to the point where reported earnings in many cases are whatever management wants them to be." *Forbes* concluded, "accounting tricks are always going on… what's changed is the companies are getting away with more now. It's been a great bull market. One that's full of dangers and getting more dangerous all the time." In an August 1999 article entitled "Lies, Damned Lies, and Managed Earnings," *Fortune* noted:

> [T]he continual eruption of accounting frauds… keeps suggesting that beneath corporate America's uncannily disciplined march of profits during this decade lie great expanses of accounting rot, just waiting to be revealed.

Bloomberg Personal Finance, in "10 Ways Earnings Lie," borrowed from Gilbert and Sullivan to conclude: "Things are seldom what they seem. Skim milk masquerades as cream. Storks turn out to be but logs. Bulls are but inflated frogs." I'm afraid that our revered Generally Accepted Accounting Principles ("GAAP") have increasingly turned into Cleverly Rigged Accounting Ploys (I'll let you figure out the new acronym).

Shakespeare told us: "Oh how courtesy would seem to cover sin," and so did a great bull market and economic boom times cover financial sin – at least for a while. But now we have witnessed – and this was occurring long before the horrendous events of September 11, 2001 – a massive asset bubble burst leaving a NASDAQ stock chart that looks disturbingly like the Nikkei Index. (You will recall that that index has now been declining for 17 years – a decline many attribute to the systemic dishonesty, phony accounting and lack of corporate and professional accountability present in the Japanese financial and legal systems, which has helped destroyed investor confidence in that market.)

The Wall Street Journal reported that due to recent inventory and accounting write-offs which totaled $148 billion, all the profits purportedly reported by NASDA Q companies in the last five years have been erasedl According to the *Journal*, "the companies currently listed on the market that symbolized the New Economy haven't made a collective dime since the fall of 1995." "Nasdaq Companies' Losses Erase 5 Years of Profit," *The Wall Street Journal*, August 16, 2001. And this does not factor in the shameless abuse of public companies in not accounting for billions of dollars of stock option costs as an expense of operations and charge against earnings – a ploy that overstated earnings by additional billions of dollars during the last decade. No wonder the NASDAQ looks like the Nikkei.

In truth, billions of dollars of reported profits during the last half of the 1990s were little more than ploys of corporate insiders and their accountants tempted by the huge financial gains their bonus and stock options programs and consulting fees promised if internal and public expectations of corporate results were met. According to Richard Walker – the SEC's enforcement chief – "If we had nothing else to do, the accounting investigations alone would keep us busy for the next five or 10 years." "SEC List of Accounting-Fraud Probes Grows, Stretching Agency's Resources," *The Wall Street Journal*, July 6, 2001.

Something is very wrong here. Even a casual reader of *The Wall Street Journal* will have noted the massive upsurge in accounting restatements by public companies in the last few years. When I began representing investors some 25 years ago, you could count the number of accounting irregularities or restatements in a year on the fingers of one hand. Today, in some weeks you would use up the fingers on both hands. According to the SEC and Financial Executives International, there have been 464 financial restatements in the last three years that wiped out more than $31 billion in market capitalization following those restatements. "Fuzzy Accounting Raises Flags -Crafty Accounting Can Steer Investors Wrong," *USA*

Today, June 22, 2001. Since a restatement is an admission that the previously reported numbers were false when issued, these are truly shocking numbers!

Accounting irregularities have become the order of the day. How about Cendant? Its $100 million restatement caused its stock price to plunge $17 in one day, vaporizing $15 billion of shareholders' equity, and subsequent revelations have confirmed a widespread falsification of results going back several years, resulting in a $3 billion cash settlement of a securities fraud class action. I recently read that Cendant's Board of Directors repriced (lowered) the stock option exercise prices for its top executives, some of whom were present when that huge accounting fraud was perpetrated, no doubt to retain them and incentivize them for another round of stock-boosting antics.

Informix, a large software seller, incurred over $200 million in restatements and paid $145 million to settle class action suits. Waste Management, a New York Stock Exchange company, restated results and paid $220 million to settle class action suits. Then Waste Management did it again – only worse. Its stock fell from over $60 to under $15 and it is again mired in stockholder suits. Livent, a large Canadian company, admitted years of financial irregularities. Rite-Aid, the huge drug store chain, also restated. Vesta Insurance in Georgia coughed up several quarters of accounting irregularities and the stock was down 24 points in a day. Then there is Sunbeam – where it turns out that loud-mouthed Al Dunlap's "turnaround" expertise was more due to accounting tricks than management skills, and the company went bankrupt. And how about Dollar General, which will be restating three years of financial statements due to the Company's improper accounting for leases, and Lernout & Hauspie, which restated for three years and saw its shares suspended.

Columbia HCA, MedPartners, FPA Medical and Oxford Health symbolize a for-profit medical care industry where reported results reflect reality only by accident. Then there was the sub-prime automobile lending industry – that's the Mercury Finance-type companies, almost all of which have restated earnings, causing their stocks to crash and resulting in numerous bankruptcies.

McKesson HBOC, ConAgra, Sybase, S3, Fine Host, Versatility, Physicians' Computer, Medaphis, Centennial Technology, Norland Medical, Premier Laser, Altris Software, Micro Warehouse, Transcrypt, Paracelsus, DonnKenny, RasterGraphics, Covad, TriTeal, and the list could go on and on and on – remember, there are 464 of them!

The Dot-Com phenomenon took this foolishness to even new heights. Billions of dollars in underwriting fees have been made from IPOs of Dot-Com companies that instantly created thousands of 20-year-old multi-millionaires and enabled venture capitalists to reap returns measured in thousands of percent – literally billions of dollars. And yet it is now clear that many of these "new-economy" companies were engaging in age-old tricks to create phony revenues and boost operating margins – premature revenue recognition, use of gross, not net revenues, and swaps and barter transactions. And let's discuss for a moment the rise of pro forma accounting, the non-GAAP calculations used by companies in their press releases, conference calls and analyst communications to show favorable results, even large "profits" – but not in their SEC filings, where GAAP prevails and large losses are shown. *Business Week* recently (May 2001) ran a cover story entitled "The Numbers Game – Companies Use Every Trick to Pump Earnings and Fool Investors" – "The latest abuse: 'Pro Forma' reporting."

Amazon.bomb excludes interest payments on over one billion dollars of convertible debt – debt convertible into Amazon stock at $50-$75 per share - to report more favorable looking pro forma results. But the last time I looked, Amazon stock was a hat size – meaning that Amazon's convertible debt will never be converted and the cash interest payments will have to continue to be made until that debt comes due in some seven years. What kind of accounting is this?

And then there is JDS Uniphase, which reported pro forma profits by excluding the impact of goodwill charges arising from its raft of acquisitions. But JDS Uniphase recently wrote off over $40 billion in goodwill resulting in the largest quarterly loss in that – or any – company's history. What kind of accounting is this? How did this farce come to pass? Why did the accounting firms and Wall Street analysts

bless such dubious practices that exclude items like interest on debt and goodwill charges in computing and reporting corporate performances?

During 1995-2000, we have seen one of the greatest wealth transfers in history from public investors to Wall Street financiers, venture capitalists and corporate entrepreneurs in the dot-con IPO boom. And it was accomplished, in large part, via phony financial reporting.

Now remember! These shenanigans occurred in the midst of the longest, most successful economic expansion in our history. What will happen now as the economy implodes? What antics will these corporate insiders resort to when the true weight of an economic slowdown bears down on their operations – as undoubtedly has begun.

One must ask – why does this kind of misconduct go on? Well, one reason is the structural changes discussed earlier that have altered the incentives for and pressures on corporate managers to engage in this kind of behavior. But also in the mix with these pressures is the fact that corporate managers have had friendlier faces looking over their shoulders as they prepare their financial results.

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

- Independence violations occurred involving two-thirds of the firms' SEC audit clients.
- Fifty percent of the firm's U.S. partners owned stock in companies the firm audited.
- Six of eleven senior partners who oversaw the firm's independence program violated it.
- All twelve regional partners who oversaw the firm's independence program violated it.
- Thirty-one of forty-three partners on the firm's Board of Partners violated the independence rules.
- Overall, 86% of the firm's partners violated the independence rules.

Now, even conceding that many of the independence violations were "technical," these findings remain shocking – especially since the SEC concluded that that firm "made little or no effort to comply with independence rules." *Business Week* concluded in February 2000: "This scandal changes everything." But not so far. And note the accounting profession's reaction – no apologies or *mea culpa*. No. Rather, the independence rules are "outmoded" and too technical or restrictive. The SEC is trying "to bomb the profession back into the Stone Age." Again, the race toward laxity and away from principle is evident. *Business Week* editorialized – "Why The Auditors Need Auditing," writing:

> Instead of cleaning up their act, at least some of the big accounting firms are using political clout to get the SEC off their backs….
>
> The accounting profession needs to shape up. The first step is for the firms themselves to create a set of sensible rules and internal controls concerning investments and consulting. Clear lines must be drawn up against possible conflicts of interest to guarantee independent audits.

As the big accounting firms increasingly look to consulting fees rather than audit and accounting fees as their principal source of revenues, auditors are more reticent than ever to disagree with corporate managers on financial reporting issues. As Douglas Carmichael, an accounting professor at Baruch College, stated, "the pressures to keep the clients are now so powerful" that auditors are abandoning their traditional role as "watchdogs" to become advocates for their clients' accounting positions.

As a result of new regulations forcing companies to disclose previously secreted information, we now are learning how much companies pay their supposedly independent auditors for consulting services as compared to fees for "independent" audit work. The SEC had guessed consulting fees would run 25%-40% more than audit fees. Guess again! According to "Big Companies Pay Audit Firms More for Other Services," *The Wall Street Journal*, April 10, 2001:

> The nation's biggest companies last year paid far more money than previously estimated to their independent accounting firms for services other than auditing, newly disclosed figures show, renewing questions about whether such fees create conflicts of interest for auditing firms.
>
> Consider these examples: Last year, Sprint paid Ernst & Young $2.5 million for audit services but $63.8 million for other services …. General Electric paid KPMG $23.9 million for auditing work and $79.7 million for other services. Meanwhile, J.P. Morgan Chase paid PricewaterhouseCoopers $21.3 million in audit fees, but $84.2 million for additional work.
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> *   *   *
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> [The amounts paid] auditing firm[s] last year for services other than auditing… were nearly three times as big as the audit fees. Specifically … companies paid a combined $909 million last year for auditing work, compared with $2.65 billion for other services ….
>
> … SEC Chief Accountant Lynn Turner… says the magnitude of the nonaudit fees raises difficult issues for auditors faced with tough calls on their clients' accounting practices. "I'm a firm believer that economics does have a firm impact on people's behavior," he says.

In fact, it turns out of total corporate payments to auditors only about 27 cents of every dollar is for audit work – the rest is for consulting services. "Auditors Exposed! Cozy Deals Alleged! How 'Independent' Are These Book Checkers?" *U.S. News & World Report*, July 23, 2001.

There is no question these huge consulting fees have undermined the independence of the big accounting firms. According to *The Wall Street Journal*, "Study Faults Work of Auditors Who Consult":

> Auditing firms are more likely to compromise and stretch the bounds of accepted accounting practices when they are receiving substantial consulting fees from the firms they audit, according to an academic study …. The study – by professors at Massachusetts Institute of Technology, Michigan State University and Stanford University – is one of the first to pore through financial filings to answer empirically one of the key questions facing the accounting industry: How objective can an accounting firm be in an audit when it is also making millions of dollars providing the same client with other services? … "Our study suggests that paying an accounting firm more for nonaudit services impairs auditor independence and reduces the quality of earnings," said Karen Nelson, a co-author and accounting professor at Stanford.

Let's face it, as Itzhak Sharav, professor of accounting at the Columbia Business School, concluded, "[f]or auditors, consulting is a professional disease." *Barron's*, April 13, 1998.

And while the SEC and NYSE have encouraged public companies to have independent audit committees, in truth, corporate audit committees provide little protection against financial manipulation. In the words of *The Wall Street Journal*, they are "toothless tigers." The new chairman of Waste Management – on inheriting that accounting debacle – said when the CEO picks the audit committee members they are "willing to go along with the flow – and not rock the boat too much." Disappointingly, virtually every one

of the some 500 companies involved in the recent rash of restatements had audit committees! They simply are not doing their jobs.

Also in the mix here is the failure of the SEC – the supposed "cop on the beat" – to do its job. The resources of the SEC have long been outstripped by our surging markets. And 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 quintessential corporate man from Wall Street, the SEC was anything but aggressive in cracking down on financial manipulation or executive insider trading. After all, this debacle occurred on Levitt's watch! Now the SEC is headed by a lawyer who used to represent the big accounting firms who fought to continue to conceal the billions in consulting fees they were pocketing from their corporate clients while certifying billions in phony profits. And, incredibly, the new head of the SEC has signaled a "gentler" relationship with the accounting profession and that the SEC might actually seek to further restrict corporate liability for false forecasts. "SEC Chief: 'Gentler' Agency; Pitt Reaches Out To Accountants," *Washington Post*, Oct. 23, 2001 (reporting on speech of SEC Chairman to AICPA Governing Council). This would be humorous, if it weren't so sad.

In almost none of the high profile restatement cases mentioned earlier has the SEC taken enforcement action. Yet private class action suits have recovered billions in damages for defrauded investors and will recover billions more. How about AOL? AOL falsified eight quarters of results to report profits rather than losses in 1995-1996 as insiders sold $95 million of their AOL stock. AOL then restated to wipe out all those profits. A private class action suit successfully recovered millions for investors. Five years later, the SEC got a meaningless consent decree and a tiny $3.5 million penalty payment from AOL – not the insiders! Today, the SEC both speaks softly and carries a small stick.

But, most importantly, this kind of conduct goes on because of the failure of people in positions of responsibility to behave responsibly. A 1996 study in *The Journal of Business Ethics* put corporate executives in play-acting roles and found that 80% of them were willing to commit fraud by understating charges that cut earnings in order to meet targets which impacted their cash bonuses or stock options – an academic finding consistent with the responses at the *Business Week* CFO Conference that, in the real world, 67% of CEOs pressed their CFOs to cook the books.

It is now time to ask whether the 1995 amendments to the securities laws ("PSLRA") – which made it so much more difficult for investors to hold corporate executives and accountants liable for securities fraud – contributed to this upsurge in financial fraud by breeding increased arrogance among corporate executives and their professional assistors, who now feel more insulated from the threat of liability under the securities laws. I suggest the answer is it did.

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

- A punitive pleading standard requiring the victim of a securities fraud – without the benefit of any discovery – to plead particularized facts showing a "strong inference" that each defendant acted with "scienter," *i.e.*, an intent to defraud or its legal equivalent – an onerous pleading standard, unlike that required in any other federal civil litigation.
- Elimination of joint-and-several liability, except for "knowing" securities fraud.
- Immunity for false forward-looking statements such as projections and forecasts.
- Elimination of use of the federal racketeering statute and its treble damage provision to remedy securities fraud, no matter how terrible or deliberate.
- A stay on discovery so long as a motion to dismiss is pending – another statutory anomaly in federal civil litigation.

- Limitations on the damages a defrauded investor may recover.
- A mandatory sanction provision requiring a court to impose the entire cost of the defense of the case on plaintiffs' counsel if any allegation in the complaint was found to lack an adequate basis.

Passage of the PSLRA was greased by millions of dollars of lobbying fees and political contributions from corporate insiders, Wall Street investment bankers and the big accounting firms. This tsunami of special-interest money was then flavored by anecdotal tales of woe by high-tech corporate executives who were paraded before Congressional committees by their handlers to whine about how unjustified class action suits by avaricious plaintiffs' lawyers were resulting in "blackmail" settlements which injured their companies and the U.S. economy. Supposedly those executives were rendered insecure and sleepless and were distracted from productive activities such as the development of new products and creating job growth by the burden of frivolous class action suits.

Well, the PSLRA was sure a dose of bitter medicine for investors. But the proponents of the PSLRA promised that if the anti-investor legislation they offered was enacted, frivolous securities class action suits would be eliminated, capital formation would be enhanced, new product development would be accelerated, employment would increase and investors, corporations and the U.S. economy would benefit. Yet, five years after their special-interest protective legislation was adopted, securities and accounting fraud has surged – the huge market bubble that followed the enactment of the PSLRA has burst, leaving investors holding a multi-trillion dollar bag, while corporate layoffs are skyrocketing and capital formation is down. Reality has overtaken deceit.

"I told you so." I know they are the four worst words in the English language. And I know it is arrogant to speak them. But, forgive me – with respect to the PSLRA – "I told you so." Only a few years after lobbyists for high-tech companies, their venture capitalist pals, the big accounting firms and Wall Street interests got Congress to pass the PSLRA, their chickens have come home to roost.[1] Just five years after these powerful interests achieved their longed-for goal of curtailing the ability of investors to sue to remedy and hold them accountable for securities fraud, there has been a massive upsurge in securities fraud. In a free-market economy, entrepreneurs, business people and professionals respond to the economic incentives created by legislation. The PSLRA encouraged securities fraud because it made it much more difficult for defrauded investors to hold the perpetrators responsible. The results – just five years later – are clear for all to see.

Every metric to measure the extent of fraud in our financial markets has soared. Financial scandal after financial scandal – accounting restatement after accounting restatement – has surfaced and, as *The Wall Street Journal* reported, the NASDAQ-listed companies, in fact, actually made no real profits during those five years.

Stock option abuse and insider trading by corporate executives reached unparalleled levels. Did you know: Cisco's insiders sold $605 million of their Cisco stock before that stock collapsed from $82 to about $10. JDS Uniphase's insiders and controlling shareholders sold $1.9 billion of their stock – that's right, billion – before its multi-billion dollar write-offs of goodwill wiped out every dollar of profit it ever reported and its stock became a single-digit item, down from over $ 150 per share. And Sun Microsystems' insiders unloaded $690 million of their stock before the stock collapsed. At Amazon.com insiders sold off over $250 million before that stock became a hat size. 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 the newest scandal – Enron – where that company has reported billions of dollars of writedowns and shareholder equity reduction due, in part,

[1] 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).

to secret self-dealing transactions with corporate insiders – corporate insiders who also sold off over a billion dollars worth of their Enron stock – stock that sold at over $80 in 2000, but is $15 now.

The IPO market has been exposed to be a rigged insider's game – part of a larger scandal of securities analyst corruption, where analysts get multi-million dollar bonuses for helping to generate investment banking clients and public offering fees for the investment banking side of the business. Turns out Wall Street's so-called "Chinese Wall" was just as illusory as the notion of auditor independence.

Internet stock fraud has soared. Broker/dealer fraud is at an all-time high. We have witnessed the creation and bursting of the largest stockmarket bubble since 1929 – epitomized by the disgraced "dot.con" phenomenon, which fleeced American investors out of trillions of dollars. According to SEC officials: "Investor losses from corporate accounting fraud have snowballed to more than $100 billion …." *Bloomberg*, April 3, 2001.

Listen, if you will, to what the noted financial writer and economist Ben Stein said in *The Street.com* after reviewing the NASDAQ crash and what he called "a very, very low dishonest 1998 … 2000:

> 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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> But in a clear case of *quis custodiet custodies*, the guards turned out to be the worst thieves of all: a few brokerage houses and their investment banks brought to market utter garbage, had men and women of high degree praise it, got immense commissions on the sale, got "cheap stock" and then touted it further to make their gains obscene.
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> It didn't happen by accident. Some people got fantastically rich from the fraud, and people do not usually get rich from fraud by accident.
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> But while all this was happening, where was the SEC? The SEC, with unequivocal broad oversight powers over brokers and investment bankers to stop any scheme or artifice to defraud, to supervise illegal payoffs and bar them, to make sure all lawful disclosures are made, slept soundly. There was no SEC in the late 1920's when the last wild corruption soiled Wall Street. Surely what has happened in the last phases of the bubble of 98-99 is the worst securities misconduct since the SEC was created, yet the Commission has more or less completely escaped responsibility for its uniquely spectacular failures.
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> After the Crash of 1929-33, there was The Pecora Commission to study wrongdoing that led to the Crash. Why not another one right now? Why not one to write a book about how this debacle happened, with subpoena power over witnesses?

> What happened did not happen by accident, and a full accounting is owed to the people who were fleeced. This is law and decency.

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

How in the face of such overwhelming consumer, worker and investor group opposition and such editorial warnings and condemnation predicting the harm this special-interest legislation would have could it have possibly been enacted. You know, in truth, the fault lies not with the corporate and financial interests which used their financial and political muscle to obtain this legislation. After all, they were only exercising their First Amendment rights to advance their economic 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 – and, in my view, had a responsibility – to stop it.

Notable among those who defaulted was SEC Chairman Levitt – that man of Wall Street who became the first SEC Chairman in history to actively support legislation curtailing investor protections against and executive accountability for investor fraud – guided by an SEC general counsel, Simon Lome, who was a partner from a big pro-corporate law firm.[2] Next comes Senator Dodd from Connecticut, who so energetically sponsored the PSLRA to benefit the interests of the insurance companies from his state and his Wall Street investment banker friends and contributors, who all benefitted so handsomely from his efforts. And finally, forget not Rep. Chris Cox of Orange County, California, an alumnus of a major corporate law firm which defends corporations and accounting firms in securities class action suits, who was personally sued for his alleged participation in a securities fraud which bilked investors out of over $ 100 million and who accepted thousands of dollars of contributions from companies (and executives of companies) which had been sued for securities fraud. The enactment and resulting consequences of the PSLRA is a cautionary tale of political and financial power getting special-interest legislation.

Have no doubt. Reducing corporate executives' (and accountants') exposure to liability for securities fraud contributed to this fiasco. According to Richard Walker of the SEC:

> The current increase in financialfraud… is partially attributable to court rulings limiting corporate liability for financial fraud and the Private Securities Reform Act of 1995, which removed joint-and-several liability except when there is a knowing violation of law. 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 earning projections" ….

[2] For a scathing critique of Levitt's SEC tenure see "Securities Fraud," *Council of Institutional Investors Newsletter*, Vol 14, No. 1, January 2001.

All this has been with real cost. While it is too early to tell how severe the recession our Nation was plunging into even before the events of September 11,2001 will be, no one can deny that significant economic harm has occurred due to collapse of our securities markets. Financial and accounting scandals have plunged corporation after corporation into crises leading to many bankruptcies. Investor losses run into the trillions of dollars – the reverse "wealth effect" rules. Massive layoffs abound. Capital formation has been impaired as burned investors shun the IPO market and new public offerings to raise capital plunge.

Have you noticed how the airport magazine racks are no longer filled with magazines with covers touting articles about early and lush retirements fueled by stock investment profits? Financial writer/advisor Jane Bryant Quinn wrote in *Newsweek*, "Time to Look at Your Retirement Strategy from Scratch":

> You have to start over, start over, start over. Forget what your stocks and mutual funds were worth a year and a half ago. That money is gone. The only question is what you're going to do next. To update a phrase from the laid-back '60s, this is the first day of the rest of your investment life.

Take a look – now the cover stories push articles advising baby boomers on what to try to do next now that their retirement plans have been decimated by the impairment of their retirement savings. According to "Retirement Gets Scary for Baby Boomers," *Business Week*, July 30, 2001:

> 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…. Those with lots of high-tech company stock in their 401(k)s may be in the worst shape…. Stripped of the illusions fed by a booming stock market, retirement is shaping up to be a nightmare of cost and complexity.

But while investors have lost trillions of dollars due to this fraudulent behavior over the past several years, corporate insiders, venture capitalists, the accountants and Wall Street's investment bankers took advantage of the running room the anti-investor PSLRA legislation they paid for created to pocket billions of dollars:

- The venture capitalists and their "dot.con" entrepreneur, 30-something friends pocketed billions of dollars by foisting grossly overvalued – even worthless – securities on investors.

- The investment bankers pocketed billions in fees to unload the all but worthless "dot.con" securities on the public and also rigged the IPO game, all so they could pocket huge fees, while they let their favored customers pocket countless millions of quick trading profits in these new issues before they were distributed out to naive and unknowing public investors, who got left holding a multi-billion dollar bag.

- The accounting industry's immensely profitable worldwide oligopoly remains intact and as entrenched as ever – even though we have seen the exposure of an astonishing number of financial frauds and restatements, while learning that the supposedly "independent" accounting profession was grossly violating their sacred independence rules all along and pocketing tens of billions of high profit consulting dollars that dwarfed their auditing fees.

- And America's corporate executives pocketed billions in risk-free stock-option trading proceeds, benefitting from the inflated stock prices their hype and financial manipulations helped create, making a mockery of our Nation's prohibitions against insider trading.

Well, all good things do come to an end. It is worth remembering that one of the excesses of the 1920s which contributed to the 1929 Crash was the widespread falsification of corporate earnings. One of the first ideas of Roosevelt's brain trust was to nationalize public accounting and have it performed by employees of the Federal Trade Commission. We would all agree that probably the only thing worse than

the situation we now have would have been to have government bureaucrats auditing the books of public companies.

The accounting professionals avoided nationalization by going to Washington on bended knee, begging for forgiveness and promising to be public watchdogs and remain independent from their clients. Spared, the Big Five accounting firms built a massive and incredibly profitable worldwide oligarchy over accounting work for public companies. Whether the accounting industry kept its end of the bargain with American investors is more dubious.

The truth is, the integrity of public company financial reports became badly undermined at the very time the IPO boom and the greatest bull market in history roared on – attracting all-time record levels of individual investors and their retirement savings. By 2000, 60% of American households' financial assets were in stock – a level not seen since early 1929 – and double the less than 30% in 1990. Now the party – if it's not over – that punch bowl looks awfully low!

While the catastrophic 2000-2001 market collapse probably has further to go, even the collapse to date has inflicted $15-$20 trillion in losses on investors who have watched the exposure of the rigged IPO market, the auditor independence fiasco, surging broker/dealer dishonesty and the massive upsurge in financial fraud with dismay, finding that their ability to sue to recover damages under the federal securities laws – which were originally supposed to punish this type of misbehavior and provide liberal remedies for cheated investors – is severely hobbled by pro-corporate judges who use the PSLRA's uniquely difficult pleading standards and rules that prohibit discovery of evidence of wrongdoing to protect corporate and financial interests and perpetrators of fraud from the kind of legal accountability which, if it were allowed to be effective, would help to deter misconduct by insiders and protect investors.

The accumulating weight of these financial frauds has played a major role in the increasing instability and fall of our securities markets. Only time will tell – but if this kind of widespread dishonesty and fraud is not curtailed and further undermines our markets' reputation for core honesty, recent scary stock market declines could be looked back upon with fondness. If that happens there will be calls for the heads of those who appear to be responsible – and to have profited. Remember, in the wake of the 1929 Crash and resulting exposes, the head of the NYSE ended up in Sing-Sing.

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 soull" – or, I might add, "even his own freedom."