**Panel 2**

# The Financial sphere and criminality: a challenge for the protection of the institutions and the investors

*Moderator:*

Francisco Alvarez Molina, Member of CIFA's Advisory Board, Valencia

*Speakers:*

Prof. William K. Black, white-collar criminologist and former senior financial regulator, Associate Professor of Economics and Law, University of Missouri, Kansas City

Pierre Grumbacher, Compliance Expert and Artist, Basel

Jan L. Handzlik, Specialized Lawyer on financial crime, member of Greenberg Traurig, Santa Monica

Prosper Lamothe, President and CEO Lamothe & Zunzunegui EAFI S.L., Professor at the Universidad Autónoma, Madrid

Eliot Spitzer, New York State Attorney General (1998-2006) and former New York State Governor

"We are in a significant point in time for the profession of financial advisors and the financial sector in general", said the moderator Francisco Alvarez Molina in his introduction. "Whether we like it or not, the financial services are being the victims of accusations, and we as independent financial advisors are part of this industry." But the independence of IFAs is a crucial tool to better respond to the demands of savers and investors, he added. "This economic crisis, despite the damages it is causing, is offering us a springboard that we cannot miss."

Professor William Black, author of a book titled "*The best way to rob a bank is to own one"*, offered an insightful analysis of the mechanisms of fraud in financial institutions and the perverse incentive structures which lead to fraud, as a major cause of the current crisis. "When incentive structures are profoundly perverse, they lead to fraud epidemics and hyper inflated bubbles" he said. Taking the Savings & Loans crisis of the 1980s and 1990s in the US as a precedent, in which he was involved as a regulator, William Black said that the National commission created to investigate the causes of the crisis found that at the typical large failure, fraud was invariably present, as was the ability of the operators to "milk" the organization. "Every accounting trick available was used", said the panelist. Control fraud as a criminology concept is when the persons controlling a seemingly legitimate entity use it to defraud. "Control fraud is a sure thing", he continued, "and this form of fraud uses accounting as its weapon of choice." William Black offered a four steps recipe for a lender to optimize accounting fraud – maximizing fake record profits in the short term and real catastrophic losses in the long term: 1. Grow massively 2. Make really bad loans that have higher yields in the short run 3. Use extreme leverage 4. Make trivial general loss reserves. "The firm fails, but the fraud scheme succeeds brilliantly, and the leaders walk away rich", said William Black. He cited the work of 2001 Nobel prize winner in Economics George Akerlof in his book written with Paul Romer, *Looting: The Economic Underworld of Bankruptcy for Profit*. These perverse incentives create a criminogenic environment and echo-epidemics, where the epidemic in one sphere kicks off an epidemic in another sphere of the financial system. At law, reminded the panelist, the distinguishing element of fraud is deceit. "What that means is I create trust in a victim and I betray that trust. As a result, there is no more effective acid against trust then elite fraud. And when you have a breakdown of trust, when bankers no longer trust bankers, markets no longer clear and they collapse." Accounting abuses also provided the ultimate perverse incentive: it paid out to seek bad loans. This is the primary source of what became known as "liars loan". These incentives create a "Gresham's dynamic", where bad ethics drives good ethics out of the marketplace because bad ethics provide a competitive advantage. This creates what William Black calls the echo-epidemics, the spreading of fraud across the financial system. "Some assets make much better tools or ammunition for theses kinds of fraud, said the professor, as well as some industry which are particularly weakly regulated. It will cause the frauds to cluster in particular industries and particular asset categories. And that can cause bubbles to hyper inflate." The "contagion" of fraud epidemics works upstream, from the lenders of non-prime loans closing their eyes on quality for higher yields, flooding the system with liars loans. It also works downstream, where the investment bankers sell and buy toxic products under the financial version of "don't ask, don't tell". The trouble with liars loans is that, since there is no underwriting, an acute adverse selection is produced, meaning that the worst borrowers come resulting in a negative expected value. "You will lose money, the only issue is when it will explode", said Professor Black. "If you grow very rapidly and hyper inflate the bubble, you mask the losses for some time and make them all the greater." For William Black, the crisis didn't begin in 2007 but when the first liars' loans were made, because they were doomed to fail. "Therefore some of the metaphors that we've heard about a perfect storm or black swans are really misleading. They assume that there is some risk distribution out there that is exogenous to what happens. That is not true with perverse incentive structures. We breed the black swans when we create a criminogenic environment."

What can be done to prevent such fraud epidemics? Just like in medicine, markers of fraud can be identified. "This is what we did as regulators after the S&L crisis: we looked for markers, things that would not be done by an honest firm, and we targeted specifically those institutions that showed these markers. And we put them out of business while they were still reporting record profits and minimal losses." What are these markers? Inflating appraisal value, for one. "There is no honest reason for a secured lender to either inflate appraisal values or to permit widespread inflation of appraisal values. Yet we know from surveys of appraisers that this was the norm, I repeat the norm, in the United States. There are strong empirical evidences of that." Second, negative expected value, deriving from adverse selection. "Honest firms do not create negative expected value, they will fail. And it doesn't make any sense to reduce your general loss reserves while risk is exploding. And for five years in the US, in the heart of this crisis, general loss reserves fell every year to record lows." And this, said M. Black, flows directly to income and compensations. "Compensation is used to suborn appraisers, rating agencies or outside auditors immensely successfully, because it is much easier to manipulate short term accounting income", said the panelist, referring to exhaustive research done by Bebchuck and Fried in their book *Pay without performance: the unfulfilled promise of executive compensation*."

Eliot Spitzer, as a lawyer, addressed the question of how to deal with the fraudulent environment described by William Black as a matter of criminal prosecution. "The issue I had to deal with as an Attorney General looking at the financial fraud was: why is it both emotionally and factually in our judicial system more easy to prosecute the author of a traditional theft than that of a financial crime." Even if financial fraud involves amounts of money vastly more important than regular crime, "we find it unbelievably difficult to actually prove to a jury that the institutions and individuals who developed the very business models that William Black just described, very cleverly using accounting systems and business judgment exceptions to perpetrate vast frauds, have committed a crime", said the panelist. Why is that, he asked? Because physical theft is easily proven, there is no subjective issue at state, whereas the issue with financial fraud is providing the subjective state of mind of the individual who is engaged in this type of crime. "We had to prove that these individuals, such as the analysts who were misrepresenting, had intentionally lied. Because being wrong is not a crime." The pervasive defense of the perpetrators of financial fraud was to apologize and say they were wrong, that they thought the market was continuing on a certain trajectory and that they made an egregious mistake. "They were cleverly therefore pushing the responsibility back to a generally accepted premise about where the economy and the markets were going. And the difficulty we then have as prosecutors is proving that they were lying and not simply that they were wrong." It was a difficult thing to do, Eliot Spitzer said, because the liars loans, diminished loan reserves and other "markers" described by William Black are just as readily explained by being wrong rather than lying. The lies are most evident with respect to people lowest down in the organization, he added, so that is why prosecutors have a reasonably easy time proving these people are perpetrating fraud: an individual appraiser clearly inflating the value of a piece of property, or an individual applying for a loan misrepresenting income. Or individuals at the mid-level of an organization who desperately want to issue more mortgages, because of the incentive in their compensation, and therefore play games with the numbers. "But by the time you get to the executive suite, that direct demonstration of lies and misrepresentation is often absent", said the speaker. In the recent crisis, unlike the Savings & Loans crisis, we haven't seen convictions of powerful top executives of financial institutions. Because those at the top shroud themselves in all sorts of layers of defense, in the form of three professions: lawyers, accountants and investment bankers. "These professions have become the facilitators of fraud, because they have come to understand their job to be to protect their client, and therefore envelop them in all sorts of memoranda, justifications, rationalizations that create the illusion of propriety surrounding what they do." Eliot Spitzer cited in this respect the example of Lehman Brothers, who's executives travelled across the Atlantic to find a law firm that would give them the legal memo that justified their use of Repo 105 as a mechanism to misrepresent their underlying condition. "So the lawyers, investment bankers and accountants have created a context in which those at the top can create an environment where the misrepresentations are not easily attributed to them", concluded the former Attorney General of the State of New York. The panelist noted that in the last two years there has been a dramatic shift in ideology, from libertarianism to a world where people are demanding, and rightly so he said, government intervention and regulation of a magnitude never before imagined. He recalled that back in 1999 when he began to make his famous "Wall street cases" against major investment banks and would declare in front of an audience that self-regulation of the financial sector does not work, he was viewed as a heretic. Whereas now this idea has now become so widely accepted that people now even doubt that anybody would possibly think that self-regulation does work. "The good news if that we have gotten rid of an ideological framework that was deeply flawed. But what we have not established yet is an intellectual foundation for what we are doing, this is the challenge we are facing", he said.

As a conclusion, the speaker recalled an episode from a case he brought against Merrill Lynch in the late 1990s as Attorney General of the State of New York. During a meeting with the firm's senior lawyers, after the case was filed and they had seen the evidences and the arguments, Eliot Spitzer recalls being shocked by the line of defense put forward by the bank's lawyers: "They did not do what lawyers ordinarily do, which is to say 'Eliot you misunderstand the evidence, you have taken it out of context, you will do great harm to the economy, you have no idea what you are doing.' Instead, they told me: 'Eliot, you are correct, but we are not as bad as our competitors. And they thought that was a suitable defense! They believed that there was a moral justification that somebody else was worse than them! What this said to me was that competition was driving behavior down to a level that did not comport with our standards of ethics. And that the only entity that can intervene to elevate that level of ethics was the government through regulation." Since then we have made real progress ideologically, concluded the panelist, but we still not have put into place the structure to ensure that we do not laps back into kind of behaviors.

Pierre Grumbacher discussed crime prevention and what asset managers and financial advisors have to do in this respect. "It is part of our job to prevent financial crime and money laundering", he said. And the questions anyone in the profession must ask: is there a criminal intent? Is there a predicate offence? Is it something you have to report to the authorities? To do his job correctly and make sure not to be associated with crime, an asset manager or financial advisor must start by controlling his own actions, starting with the owner, the management and the employees. "Obviously every effort will be frustrated if the crooked way starts from the top", said the speaker. "That's where every control and every action within the firm fails." When the top is crooked, it is difficult for middle layers to do any effective prevention. Another area of caution must be the clients one chooses to be associated with. "If you are associated with the wrong type of client, then obviously you are at risk as an IFA. So it is very important to know your clients, know what they do, find out who they are. And I should claim this is more of an art than a science", said Pierre Grumbacher. He recalled that in his compliance experience the real big issues where not found out by forms or by following procedures. They came out thanks to intelligent people reading between the lines, knowing the markets, their clients, and what can be true and what can be wrong. "If something doesn't seem true, doesn't seem to work, then you have to see to it, but it is not evident, said the panelist. Criminals have cover stories, and they are quite good at it. And they have more leeway for creativity than any asset manager or banker has." Then on the product side, the advisor has to know the products and understand them before selling them to clients. And the speaker argued even that the investment bankers should understand what they are creating before they put it to the market. "At the bottom, it boils down to the fact that we must avoid misselling, with the clear obligation to serve our clients. Clients trust us, so let's not abuse that trust due to ignorance, or even worse, to criminal intent."

There are two aspects to prevention, said the speaker: due diligence, which he referred to as "mandatory housekeeping", but then the residual risks have to be considered as well. "Are they acceptable? And if so, we have to be transparent about it and tell the truth to clients." Time to market is also important, continued Pierre Grumbacher. "This is what everybody strives for, because the first on the market as we all know is the one who reaps most benefits. So it is always a balance to have due diligence done in time to get to the market first." As for money laundering, "it happens after the crime", noted the speaker. "Let's face it: every time something happens, at the end of the day the people who must, by their profession such as IFAs, identify money laundering, will be investigated by law enforcement agencies to see if they did their job right. This means that any institution has to put up a track record of forms and auditable stuff to make sure thy can prove their innocence in case of investigation." This frustrates the creativity of identifying money laundering, said the panelist: "I think this is one of the challenges in prevention, that law enforcement encourages people to think rather than just fill out a form. Because those who think well but have the form wrong will be prosecuted, but those who get the form right and do the wrong thing have a better chance of getting away."

Pierre Grumbacher then discussed the cost aspect of crime prevention, highlighting the rather low rate of actual indictments out of the suspicious activity reporting for money laundering. "I believe it is important for law enforcement entities and regulators to look critically back at the systems we had in place at times when computers did not exist, and to see whether it is really important to process all this data with computers or whether we should put more effort into thinking and creativity to make the crime prevention model more efficient." He described the form filling activity like copying a painting rather than creating one. "Is this what we are doing in the financial industry in terms of crime prevention, just looking at the old masters and copying them, or should we encourage people to come up with new things. My take is that we are rather in the copying business, while we leave the whole field of creativity to criminals."

The model based on process and procedures enforces discipline, not effectiveness. And it makes the whole system predictable for criminals, claimed the panelist. "Regulations like Sarbanes Oxley actually make the industry more vulnerable to crime", he stated. In his view the prevention efforts should concentrate more on the early stages and not try to provide the full evidence in court. Taking the example of a sculpture, he explained that after 20% of the work you already see the shape and form it will take, while the finishing takes up the full remaining 80% of effort. "The trend I have seen in regulation is that on the preventive side we are going more and more towards providing 100% of evidence. And I think we should scale back, provide simplicity so that financial firms and IFAs can stop their preventive work at the early stage and handle it further to the authorities, rather than having to spend a lot of efforts into the polishing of the sculpture with no real added value overall, and rather focus on the next early stage case."

Prosper Lamothe put his remarks in the context of what happens to a financial advisor when he comes across situations which are uncomfortable and he has doubts as to what a financial institution is doing with customers or prospects. "There are many different ways of harming clients, some of which can be classified as crimes and can be prosecuted by criminal law, whereas others can be classified as bad practices. However, in my understanding, sometimes the line between crime and malpractice is very thin. And as a member of the financial industry, I would kindly request regulators to give us a hand in defining that line", said the panelist.

What are the problems that clients or financial institutions come across? Pyramid schemes for instance, especially in the world of hedge funds. But these are easy to detect if you do your due diligence homework, said M. Lamothe. But there are certainly abuses in other types of alternative investments. "Maybe I will write a book about products that have been created which make absolutely no sense to investors, yet have been placed and sold massively, with investors then losing 75% of their capital." Obviously this is malpractice, said the speaker, and in some cases even goes beyond malpractice. "When I hear horror stories of clients, I could never think that derivatives could be so wrongly used under the disguise of products, especially hedging products, which have been sold to clients", he noted. The problem is not the derivatives, but the fact that these products are criminal. Some companies and individuals are losing huge amounts of money as a result of the sale of fraudulent derivative products. "As financial advisors, our job is to analyze the products, to determine what type of risk a company needs to hedge. But more and more we find ourselves having to tell the clients they need to find a lawyer to bring the issuer of such products to court." The panelist therefore made an appeal to regulators to give the financial advisors the right tools to prevent this kind of situation. "It is really not optimal for us to have to advise our clients to sue the institution which created a fraudulent product, but sometimes it is the only thing we can do, and hopefully prosecuting these institutions will help curbing these malpractices or criminal behaviors, which cause a lot of harm to many small companies and sometimes even puts them out of business."

As a lawyer specialized in financial criminality, Jan L. Handzlik emphasized the crucial role of legal deterrence in curbing criminal behaviors, taking as an example the role played by the prior Panelist Eliot Spitzer during his tenure as Attorney General of the State of New York since 1998: "the impact that Eliot Spitzer brought to the Attorney General's office in the state of New York shook Wall street and really extended across the country. I think we can learn lessons from that. First, during that time, companies and individuals always knew there was someone looking over their shoulder. And they knew that if they took a misstep, they might get away with it but there were good chances that they wouldn't. The second motivating element was fear. The individuals and entities who might have had the idea that they could play fast and loose with other people's money, commit fraud and create the sort of institutional organization that Bill Black talked about, were held back by fear. They were afraid of the subpoena from the Attorney General's office in New York, more than the SEC or the US Attorney." But during the period of time when the mortgage crisis built up and erupted, bringing the financial system to the break of disaster, there were no regulators either in New York or elsewhere to fulfilling that role, noted the panelist. This key element of the system was lacking, and the regulators who were supposed to be the overseers of Wall street and prevent fraud seem to have operated in a "brainless" way during this period, he added.

Yet despite the fact that there were abuses as described by William Black, "we all know that there are also good companies", said the panelist, companies that are ethical, responsible, with good people who are committed to good governance, strong professional ethics and a sense of doing things right. "These are of course the majority of companies", argued the speaker. Some are bigger, some are smaller, but in his view the majority of financial companies can be described as honest, or at least, even if they are not fully effective in term of compliance, they want to do the right thing. "Fear again is a great motivator I suppose, but nonetheless they are excellent companies committed to compliance." The issue, he said, is what do you have to look for as a financial advisor in order to prevent fraud effectively? What should you be careful about? What are the things you should do before you advise your client or even after you have advised them when you monitor an investment? "One of the things I believe is exceptionally important, and I see it all the time in my experience, is that responsible companies are the ones that hire the right people internally, that set the right tone at the top and have strong risk management systems. "I believe that about 97% of all the risk management factors are based upon the quality of the individuals at the company. You can have the best code of conduct in the world, but you need people in place in key positions who are responsible individuals. Enron had the best compliance program I have ever seen, but it was not executed properly and was only a nice window."

While risk is always an issue, the risk management in a company is a key element." So in advising clients, when analyzing investment opportunities, IFAs should look for companies with strong risk management components, strong internal code of conduct, adequate internal accounting controls and a lack of conflict of interest, said M. Hanzlik. "As the old saying goes, if an investment opportunity seems too good to be true, it probably is". So in addition to a strong compliance program, IFAs should look for a strong code of conduct and a robust law compliance program in their potential counterparts. These information are often easily available, even the web site of these companies can give a fair idea of their commitment to good governance, said the speaker. Another crucially important factor to look for is the independence of the people at the company responsible for compliance and risk management: "an audit committee that is disinterested and composed of people who hopefully have an accounting background", said the speaker. "Many of the major companies which got into trouble in the early part of this Millennium had audit committees which were pretty much window dressing." The general council and law department of companies should also be independent, continued M. Hanzlik. Which means not driven by concerns about the stock price of the company, not letting bad news out, but rather committed to rooting out fraud and corruption, lack of ethics, and doing a thorough internal investigation of punishing the persons who are responsible and helping to set the right tone at the top. And finally, adequate internal accounting controls must be in place in the company. These controls must be able to prevent fraud from happening in addition to catching fraud if it takes place. In the end, the panelist emphasized again a point made by other speakers as well: the crucial factor of the tone set at the top of the company, large or small. "Without a strong leadership committed to ethical behavior and solid risk management and fair dealing, Without the proper tone set by the CEO, the board and other major officers of the company, fraud prevention is not going to work", concluded M. Hanzlik.

*****

## QUESTIONS & ANSWERS

Question

With all this due diligence work to do, how much time do we have left for our clients? If we spend all our time checking what should be obvious from the providers, if we have to go further and further and be 100% sure – who can be 100% sure of what you are selling to anybody? Nobody can, and I cannot be responsible for the make-up of Enron or the others. Sure there was due diligence to be made for Madoff, but obviously there are limits to it. I am very concerned that I have to quit my business in these conditions, the time spent doing due diligence for the benefit of client is just going to kill our trade.

Jan L. Handzlik

I would respond briefly by recalling what was said yesterday. That the attention of regulators and prosecutors is turning to the advisors, to the individuals who assist clients and other individuals in making investments. The fact of the matter is that, if the US model is used by the regulators here to go after financial advisors, then I am certain of the fact that the more due diligence you do, and the more responsible you are in terms of advising your clients, the better of you will be. But I can't speak about the amount of time that it might take.

Eliot Spitzer

I actually have thought that there is an opportunity for somebody who will create the top-tier due diligence outfit for non-traditional investments in the market place. And this struck me after the Madoff case where I think we all thought even the most minimal due diligence would have revealed that there was a fundamental problem. It is mind boggling that those who had investigated Madoff didn't see anything. I m not saying this to catch blame, but asking for one day of trades and taking one look briefly at the documentation for one discrete day of trade, and then see who had actually custody of the shares and say "show it to me", and the whole thing would have collapsed. So there is a market opportunity I think for a due diligence entity for non-traditional hedge funds and private equity investments, which would do the accounting, do the drill down, and become the good housekeeping seal of approval for that sphere. The other thing I would say is that most of the time it doesn't take as much as you would expect to protect yourself and your clients. You spend an hour with somebody who is in the financial world and really push them on what they are doing and how they are doing it. I would say 90% of the time you know if they are for real or not. And so I don't necessarily agree with you about the time it takes if you actually sit down with the right people within a company to understand their business model.

Pierre Grumbacher
About outsourcing the due diligence, we have seen this with outsourcing the due diligence on credit risk with the rating agencies. We saw the benefits and the risks of it. And I think whilst that business proposition is certainly interesting, the risks are then that it is a cyclical business. Second, about your question about the work involved, there are two issues: one is, as an advisor to your client, you have a freedom of choice as to what you offer them. That aspect of specialty and all the work behind it is one of the key issues when you formulate your proposition. My third point, which is related to that, is what I tried to say during my presentation. Obviously, if the regulation forces us to do detailed investigation up to a level of providing evidence for a trial, then I should claim that the workload and the burden transferred to the private industry is too high. This is the point I tried to make in my last slide. We should try to reduce it to a level where the due diligence is done so that you have a clear picture, and to make the analogy to abstraction, which is basically leaving everything out which is not essential. This is the art part of it, to say what do you leave out to get the real picture and to focus on the real value. I think this is the challenge at the end of the day. The private industry, the regulators and law enforcement have really to cooperate to get that right. I should claim that in the past we got that wrong.

William Black
Picking up on what Eliot said, I think of it as an opportunity in some sense. What value are you adding? And why should a customer come to you? Enron was a classic case of "too good to be true". And even if you look at the security disclosure of Enron, you would have found on a cash basis that they had been negative for years. So that's what you would like to offer to your clients I would think in many ways, the ability to do those kinds of analytics. You don't have to travel to Houston to interview them to find those things out.

Question
I do not agree with those points. The independent financial advisors are not there to spend their time to make due diligence and to analyze the validity of products, which normally are already controlled by the internal services and the internal due diligence and compliance services, by the external regulators and compliance services and by the rating agencies. If we have to spend our time to be detectives in order to find out if the entities with which we are working are honest or not, well then I don't think that we have any place or any added value at all. It's not possible!

William Black
There are three simple statements to consider in finance: 1. If it's too good to be true, it's too good to be true and run away from it. 2. Diversify, diversify,diversify. And 3. Never trust a rating agency. So if there's is anybody in this room that relies on rating agencies, I would not be paying them money.

Remark
I just want to add something. I have a company based in Luxemburg and we looked at cash management products back in July 2007. We looked at the performance of those cash management fund managers from January to June. We found that some made 6% and some made 2% at the same time. So we thought there must be

something wrong there. How can a bank keep on board two fund managers, one doing three times better than the other one? So we chose the lower route and put our clients on the 2% track, and we are happy for that. We did our due diligence and we applied it, that was just common sense. But there is a failure of the system and that has not been taken into account at all. It's not only the rating agencies, it's the "too big to fail" institutions which are luring people into bogus investments.

William Black

I think we agree there that inherently, if you are trying to rely on hundreds of thousands of people doing the same due diligence extraordinarily well, it is at a minimum inefficient. It would be far better to have reliable sources, whether that came from a private sector that didn't have perverse compensation, the way the existing rating agencies did, or whether it came from a public service agency, where instead of just saying regulation fails we would work to say how do we make regulation more effective.

Question

I think what we are talking about is two different types of business models between our French colleagues and us in the UK. If I ask why clients seek an independent financial advisor in the UK, it is about advise, not about selling products. Five or ten years ago, the role of an IFA was to be the gateway to products. Looking into the future, if the role of an independent financial advisor is to be a gateway to product, then we are trying to say that we are as good as a search engine in a suit. The internet is available 24/7, and it is an awful lot more consistent. So actually why do clients come to us? It is because we do the due diligence! We read all the way through the prospectus, we look for the difference between the marketing literature and the detailed term conditions in the back, and then we ask some probing questions about the investment managers, the management performance, and what's going on underneath in the derivative. Now that has added substantially to the costs of running an IFA firm in the UK. I wouldn't try to pretend for a moment that it hasn't. But it means that we are increasingly viewed as a profession, as earning and deserving the fees that we charge, so the remuneration base is different. So it is a very different business model to others that I have seen in other parts of the UK market and other European members states. I think perhaps that's some of the tension we noticed in the debate; its just a different way of doing business. But looking to the future, the advice-based business, for me, is the one that will have more value.

Eliot Spitzer

I think it is a very obvious point that the demands of your clients necessarily have changed over the last two years. Three or four years ago, when markets only moved in one direction, when everybody was happy and the concerns of downside risk had basically disappeared, when security was not an issue you spoke about on a regular basis, concerns about due diligence were simply not as omnipresent. These days, the first thing that people are going to ask is "what do you really know about these guys?" And obviously that is going to move in inverse correlation to the magnitude of the investment. It's one thing to do due diligence on buying shares of Exxon Mobil, it is another for some small hedge fund that nobody knows about. So obviously the degree to which you are expected to be doing due diligence will move relative to a multitude of factors, but I think as a generic matter concerns about due diligence have increased exponentially over the last two years, with good cause on the part of clients who have seen even big name, hedge fund type investment, disappearing into the ether.

William Black

The markers I mentioned are of enormous value to you, and when they are present, they are actually fairly easy to spot. They make no sense for honest companies. Think of it as a diagnostic tool. And fraud losses are extraordinary. You put your client into an Enron, you lose 95% of the investment. That's a real threat to you. Whether you should do due diligence or not, your client is going to be unhappy. At the end of the day, you want to avoid that. The more you know about these markers, and can identify these places easily, the better off you are. It is just a practical thing for your business.

Question

Can I ask the panel a practical, present day question. Enron we know about, S&L we know about, the interesting question to me is whether Goldman Sachs is a criminal organization or a very decent, highly ethical investment bank of the highest reputation? So let's not test on what you told us theoretically, and give us your advice of what you think about Goldman Sachs? Or UBS!

William Black

We can only know about the places we look. Here are the places that have been looked at in the US in the last five weeks. Washington Mutual, the largest bank failure in US history. And it was a front to back control fraud, absolutely classic, there are copious public record everyone can look at. You will see that it's exactly what was described in the slides today. Lehman: we have the bankruptcy examinary report on it. Yes, it has the stuff about the Repo, but far bigger than that it shows that Lehman was the largest seller of liars loan. When you look into that, you find that when they did internal surveys they found fraud levels of more than 50% and they sold the product under reps and warranties that there were no frauds. You see that when their key official made a criminal referral, he was fired, because he talked to the FBI, which of course is his job. You see that one of their senior accountant was fired when he blew the whistle on the Repo transaction. The third one is Citicorp: the top credit guy in mortgages, Mr. Boen, testified before the Angelides Financial Crisis Inquiry Commission for Congress, and said that 80% of the mortgages that Citi sold to Fanny Mae and Freddy Mac were under false reps and warranties. 80%! And he wrote specifically to Robert Rubin, to warn him about this when it was 60% fraudulent. And nothing was done. It went up to 80%. The fourth case is Goldman Sachs. The fifth are the rating agencies. And the sixth and seventh are Fanny Mae and the SEC, I was an expert witness for the government in the case against them. So we have looked in seven major settings at elite world players and we found strong evidence of fraud in each one. Now does that mean that everyone is fraudulent? No! But we are talking about a Gresham's dynamic. In the US, the average CFO tenure is three years. Now its vain to think about long term perspectives when the average CFO tenure is this short. But think of the Gresham's dynamic. If I don't do non-prime loans, or purchase the CDO's that have the high nominal fake yield in the early years, and my boss doesn't get his bonus, am I going to last three years? Probably not, or at least they often fear that they are not. This is the perverse dynamic that drives things, and again we have know this at least since the Akerlof article in 1970s, which explicitly raises Gresham's dynamic in the context of lemons markets. So any of you who studied economics is familiar with this.

Eliot Spitzer

I just want to add one thing. With respect to Goldman specifically, of what I saw of the recent Senate hearing, the most remarkable moment was the simple question for each of the four witnesses in the first panel: Can you tell us that you always act in the best interest of your client? And they could not answer that question with a directive affirmative YES. Now why is that? Because these institutions have become so wrought with conflicts, they don't even know who the client is. And when you don't know with great specificity who your client is, you of course cannot mediate the conflicts that exist. Is it the investors in the product? Is it the fellow who is paying you a fee? Is it your own proprietary trading desk? There is so much going on within this multipurpose institutions that the tensions cannot properly be negotiated. And that leads either to outright fraud or to such tensions that nobody knows what they are supposed to be doing. And that's why as a client, I would be hard pressed to imagine that I would ever go to them and expect the fidelity to my interest that I would want from somebody whom I am paying a fee.

* * * * *