United States Senate

Committee on the Judiciary
Subcommittee on Crime and Drugs

"Wall St. Fraud and Fiduciary Responsibilities:
Can Jail Time Serve as an Adequate Deterrent for Willful Violations?"

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Testimony of

Henry N. Pontell
Professor of Criminology, Law & Society
University of California, Irvine
pontell@uci.edu

Chairman Specter, Senator Graham, and members of the Subcommittee. Thank you for your invitation to discuss policy issues related to the use of criminal punishment to deter financial fraud.

White-collar and corporate crimes impose an enormous financial burden on citizens, and it must be appreciated that they constitute a more serious threat to the well-being and integrity of our society than traditional kinds of street crime. As a Presidential Commission put the matter, "White-collar crime affects the whole moral climate of our society. Derelictions by corporations and their managers, who usually occupy leadership positions in their communities, establish an example which tends to erode the moral base of the law…"

There are several major themes that I want to address in this brief presentation.

First, I want to support the infliction of criminal penalties on white-collar and corporate criminals who violate criminal laws. To do so requires that the Congress enact further legislation that imposes criminal sanctions on financial actions that have been demonstrated to seriously harm the public and are known to produce such consequences by their perpetrators. The current spate of financial sanctions is no more than an additional and mildly bothersome cost of doing business.

Second, I want to emphasize that persuasive anecdotal evidence indicates that particularly for potential white-collar offenders the prospect of criminal penalties can be effective deterrents. There is no definitive empirical evidence to prove this—to mount a satisfactory experiment on the subject would violate ethical standards. But we know that upper-class businesspersons fear shame and fear incarceration and will attend to credible threats of such consequences if they knowingly break the law; they are par excellence rational calculators.

Third, I would endorse the notion that regulatory agencies, most notably the Securities and Exchange Commission, be empowered to mount criminal prosecutions with internal personnel. Too often inter-agency agendas that must be negotiated between an agency and the Department of Justice inhibit effective deterrent responses to white-collar and corporate crime.

Fourth, I believe the public is growing increasingly restive about the failure of the criminal law to be tied to the crimes of those who engaged in them. The war on drugs snared a vast horde of financially marginal people. There has been no similar war on financial thugs. Cynics suggest in fact that imprisoning some of the Wall Street malefactors might help to upgrade the way prisons are run. To make a decisive move toward deterring fraud in the higher echelons of business, a significant influx of enforcement resources is necessary to allow

investigators and prosecutors to bring major cases. Representative Marcy Kaptur has proposed legislation to do just this with H.R. 3995, the "Financial Crisis Criminal Investigation and Prosecution Act."

As a university-based criminologist, I have researched and written about white-collar and corporate crime for almost thirty years. I conducted federally-funded research on health care fraud and on the savings and loan crisis. I have also written about the role of fraud in major financial debacles, including the savings and loan crisis, the corporate and accounting meltdowns of 2002, the Orange County, California bankruptcy of 1994, the largest municipal failure in American history, and the current global financial meltdown.

Much remains to be criminally investigated and dealt with in regard to the widespread financial frauds in the mortgage industry and on Wall Street, the failure of regulatory oversight, the continued general reluctance and slow response by government to identify white-collar and corporate crimes, particularly those acts constituting insider, or "control frauds." These issues have been taken up by others in ongoing testimony before Congress. I want to concentrate on the issue of punishment and the efficacy of criminal deterrence regarding these crimes.

Given the abundant opportunities that many persons have to engage in white-collar crime, it is interesting that more people do not. The most obvious reason is their fear of punishment. Deterrence rests on the fundamental utilitarian premise that people will seek pleasure and avoid pain. So, when the potential risks associated with a white-collar crime outweigh the potential gains, a rational individual will decide against the behavior. Much of our criminal law is based on this assumption about human nature.

A central concern about white-collar and corporate crime is that the risk-reward ratio is out of balance - that is, potential rewards greatly outweigh the risks. Given the low probability of apprehension and the likelihood of no, or light punishment, white-collar crime is seen as a "rational" action in many cases. The comparative leniency shown white-collar offenders has been attributed to several factors related to their status and resources, as well as to the peculiar characteristics of their offenses, including their high educational level and occupational prestige which produces a "status shield" that protects them from the harsh penalties applied with greater frequency to common criminals. White-collar defendants' high incomes and the willingness often of corporations to pay their exorbitant legal expenses with shareholder funds enable them to secure expensive legal counsel, whose level of skill and access to defensive resources is generally unavailable to lower-class defendants. Finally, white-collar crimes frequently involve complicated financial transactions in which the victims are either aggregated classes of unrelated persons, such as stockholders, or large government agencies, such as the IRS. These victims do not engender the kind of commiseration that individual victims of street crimes can elicit from judges and juries.

Empirical evidence supports the leniency hypothesis. A study of persons suspected by federal regulators in Texas and California to be involved in serious financial crimes during the savings and loan crisis of the 1980s revealed that between only 14 percent and 25 percent were ever indicted. The study also examined the sentences imposed in S&L cases involving mean losses of a half-million dollars and found that the average sentence was 3 years - significantly less than the average prison terms handed to convicted burglars and first-time drug offenders tried in federal court.

The U.S. Sentencing Guidelines can enhance penalties for financial crimes based on losses attributable to fraud, the number of victims, whether the fraud involved special skills or sophisticated means, and whether the defendant worked in the investment business or as an officer or director of a public company. Critics argue that such penalties can have a chilling effect on productivity. In fact, some financial writers have labeled past reactions of politicians to corporate scandals as "hysterical," arguing that "penalties for failure are not merely lower earnings, but lawsuits, prosecution, huge fines, and long prison terms." They may be correct about failure causing lawsuits and even fines; but they're mistaken about prosecution. Long prison terms are not caused by mere failure; they are caused by serious criminal behavior.

Certainly, the risk-reward ratio is central to capitalism. Economist John Maynard Keynes was a proponent of risk-taking, which he called "animal spirits." Historian Walter A. McDougall maintains that the U.S. economy was built by "scramblers, gamblers, scofflaws, and speculators." But there are many ways to define acceptable risk-taking, and that must be seriously addressed by Congress in terms of outlawing practices that involve blatant conflicts of interest and the willful gaming of regulations in order to gain unfair advantage.

A central problem that underlies deterrent strategies is that despite some high profile cases, the government has trivialized criminal fraud to the point that it is routinely dealt with at the lowest offense levels, and when larger cases are discovered they are more likely to be pursued civilly and not criminally. We can look at a key example in the current crisis. The FBI publicly announced in 2004 that there was likely to be "an epidemic of mortgage fraud," yet Attorney General Michael Mukasey declined to create a task force to investigate the roots of the subprime debacle, while likening the problem to "'white-collar street-crime' that could best be

handled by individual United States attorneys' offices." The lack of government response after the alarm had been sounded by federal agents stands in direct contrast to the government's response to the savings and loan crisis; *a financial disaster that was approximately one-thirtieth the size of the one we are currently experiencing*.

New laws that impose tougher penalties on white-collar criminals might well deter some potential offenders. Adhering to the new guidelines would also serve to redress the sentencing imbalance between white-collar and traditional "common" criminals. A federal prosecutor has declared: "You [should] deal with white-collar crime the same way as street crime. You try to raise the likelihood they will be caught and punished."

Current laws likely fail to deter satisfactorily because white-collar offenders are aware of the absence of vigorous enforcement. The central issue here is *proactive policing*. With most traditional crimes, the fact that an offense has occurred is readily apparent; with most corporate crimes, the effect is not readily visible. Once the offense becomes known, however, apprehending suspects of corporate crime is almost always easier than apprehending those involved in traditional crime. When a house is burglarized or a car is stolen it is often difficult and costly for police to find the thief. If it is discovered that a company engaged in bribery to secure a defense contract, there is no need for police to set up roadblocks or print "Wanted" posters to find the corporate suspect. Unless, of course, the white-collar malefactor packages his ill-gotten gains and heads for a country with which the United States does not have a satisfactory extradition treaty.

Some scholars believe that we do not need "more" regulation; rather, we need "smarter" regulation. Simply applying harsher laws to corporations and individuals, they argue, will only produce a subculture of resistance within the corporate community "wherein methods of legal

resistance and counterattack are incorporated into industry socialization." Regulation works best when it is a "benign big gun" - that is, when regulators can speak softly but carry big sticks in the form of substantial potential criminal penalties.

Joseph T. Wells, the founder and former chairman of the Association of Certified Fraud Examiners, has offered a newer strategy: *executive transparency*. Wells argues for a law requiring corporate executives to open up their own personal bank accounts to scrutiny by auditors and regulators. The rationale is that in many of the high-profile corporate fraud cases, the crime is not discovered until *after the money has been spent*, often for wildly luxurious and frivolous things. Wells cites the huge "loans" Bernie Ebbers gave to himself so that he could buy hundreds of thousands of acres of timberland and the biggest cattle ranch in Canada; the profligate spending by the Rigas family, including the construction of their own private golf course; the millions of dollars embezzled by Mickey Monus to finance his personal basketball league; and the grotesque self-indulgence of Dennis Kozlowski. As Wells notes, major corporate fraud cases almost always begin at the top.

> To head off the financial rape of public corporations, I would suggest a law that requires selected company insiders to furnish their individual financial statements and tax returns to independent auditors. They should also sign an agreement allowing access to their private banking information. The data should be available in cases where suspicions arise.

Executives of public corporations have a fiduciary duty to act in the best interests of shareholders, and Wells' call for "transparency" seems entirely consistent with that duty.

A hierarchical structure of corporate sanctions also has been proposed, in which the first response to misconduct consists of advice, warnings, and persuasion; then escalates to harsher responses culminating in what is termed "corporate capital punishment" or the dissolution of the offending company. The goal of this model is compliance which is understood within a dynamic enforcement routine where enforcers try to get commitment from corporations to comply with the law and can back up their negotiations with credible threats about the dangers they face if they choose to go down the path of non-compliance. The strength of such a system is that it works at multiple levels and holds all the actors involved - executive directors, accountants, brokers, legal advisers, and sloppy regulators - accountable for criminal misconduct.

Besides considering harsher penalties, Congress needs to seriously consider having *chief criminologists and fraud experts as central officers of regulatory agencies*, just as there currently are chief legal counsels and economists. A fraud analysis should be conducted before any new regulatory legislation is enacted so that we can avoid repeating mistakes of the past which included ignoring both the potential for widespread fraud that acted as an accelerant for expanding economic bubbles, and the creation of “criminogenic environments” where conflicts of interest and regulatory loopholes allowed opportunities for fraud to flourish with impunity.

Strong laws carrying substantial penalties are necessary. I would also argue that regulatory agencies be given prosecutorial powers so that they can operate more directly and effectively when suspected criminal activity surfaces. This would avoid the all-too-common historic problems and inefficiencies associated with communication, coordination and inter-

agency competition between regulatory and prosecutorial agencies. For deterrence to be effective against powerful individuals and large corporations there needs to be more than merely token criminal cases, and that will take a rather large government effort to accomplish in light of the resources and determination of potential defendants to avoid a criminal conviction.

In August 2009, for instance, Maurice (Hank) Greenberg, former AIG chief executive officer and Howard Smith, the company's former chief financial officer, paid $15 million to the SEC to settle the charge that they had misstated the financial condition of the company. Had the truth been revealed, AIG would have failed to meet key earnings and growth targets. Regarding the dynamics of white-collar crime, it was noteworthy that Greenberg did not admit guilt (but why else would he pay the financial penalty?) and insisted that had he been charged criminally with securities fraud he would have fought the case rather than settle. This might be regarded as a piece of evidence favoring the view that the most effective tactic against white-collar offenders is the criminal charge. They find notably onerous and oppressive the stigma associated with a criminal label, while a financial penalty can be written off as not more than the relatively small price of doing business—especially monkey business.

Thank you again for the opportunity to present these ideas before the Subcommittee, and I am happy to answer any questions.

Biography

Henry N. Pontell is professor of criminology, law and society and of sociology at the University of California, Irvine. He is a past vice-president of the American Society of Criminology, a past president of the Western Society of Criminology, and is a fellow of both organizations. Among other awards and honors, he is a recipient of the Donald R. Cressey Award for lifetime contributions to fraud detection and prevention from the Association of Certified Fraud Examiners, and the Albert J. Reiss, Jr. Distinguished Scholarship Award from the American Sociological Association. He received his B.A., M.A., and Ph.D. in sociology from Stony Brook University in New York.

His published work spans a number of areas in criminology, criminal justice, and the sociology of law, including white-collar and corporate crime, health care fraud, criminal deterrence, financial fraud, identity theft, cyber crime, and comparative criminology. He has worked with numerous federal agencies including the FBI and the U.S. Secret Service, and has testified before Congress on financial institution fraud. He's lectured at government offices and universities around the world, and has held visiting and honorary appointments at the Australian National University, Waseda University (Tokyo, Japan), the University of Melbourne, Texas Christian University, the University of Macau, the University of Virginia, and the University of Hong Kong. His most recent books include *Social Deviance* (McGraw Hill), *Profit Without Honor: White-Collar Crime and the Looting of America* (Prentice Hall), and *International Handbook of White-Collar and Corporate Crime* (Springer).