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Subcommittee on Crime and Drugs

Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?

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Good morning Chairman Specter and Ranking member Graham and members of the Committee. My name is Damon Silvers, I am the Policy Director of the AFL-CIO and Special Counsel to President Trumka. I also serve as the Deputy Chair of the Congressional Oversight Panel for the Troubled Asset Relief Program (TARP). My testimony before this Committee is on behalf of the AFL-CIO and not on behalf of the Congressional Oversight Panel, its staff or its chair.

The financial crisis that began in 2007 and reached its peak, hopefully, in the fall of 2008, together with the global economic crisis that followed in its wake, had a devastating effect on working Americans. The U.S. economy lost eight million jobs, during a period when just keeping up with population growth required that our economy create 3 million jobs. Pension funds saw their asset values decline close to $3 trillion, a drop of 30%, driven by broad equity market declines in the 40% range. A wide variety of investment products turned out not to perform as advertised—from debt instruments that turned out to be tied to subprime mortgages, to hedge funds that turned out to offer beta performance at alpha prices, to lifestyle funds that turned out not to be protected from market risk any more than an all-equity fund. Recent market gains have yet to restore funds to their pre 2007 levels.

Mass home foreclosures, which not so long ago were a distant memory of the Great Depression, now seem to be a permanent feature of American life. According to the Congressional Oversight Panel's April report, more than 6 million homes are at risk of foreclosure as of February, 2010, with foreclosure filings running at a rate of close to 3 million a year and showing no signs of slowing down.

Finally, the American public had to foot the cost of rescuing the financial system. That rescue took the form of the TARP, almost free credit from the Federal Reserve System, and Federal Reserve System purchases of a variety of long term notes, most prominently mortgage backed securities issues by FNMA and FHLMC ("Fannie and Freddie"). It is difficult to price the full cost of government support for the financial system. While estimates of the cost of TARP from the CBO have shrunk from an initial estimate of more than $356 billion to currently less than $110 billion, there is no question in my mind that in part this is a consequence of setting short term interest rates at effectively 0%, combined with allowing banks and other financial actors to be less than aggressive in writing down impaired assets such as mortgage backed securities and second mortgage loans. It seems likely to me that while this approach makes TARP more profitable, it harms our economy at significant cost to the public.

Effectively, in the space of about a year and a half, we went from a period when financial institutions were contributing 40% of the total profits of the S&P 500, to a moment when the nation's large financial institutions were (with a few exceptions) effectively insolvent. The nature of financial institutions is that they are not short term entities. The asset side of their balance sheets contain a wide variety of long term obligations, together with reserves to account for the losses associated with those assets. Thus a sudden change in the state of the banks from hyper-profitability to bankruptcy strongly suggests that there were problems with the banks' financial reporting during the period of hyperprofitability.

As a general matter, the AFL-CIO believes that proper structuring and implementation of financial regulation is key to protecting the public from the consequences of financial boom and bust cycles. We have always been skeptical of the line that we heard from then President Bush after Enron that everything was fine, just a few bad apples in the barrel that needed to be weeded out and prosecuted. We said then, and we repeated during this most recent and most severe financial crisis that the real problems were structural—the rise of unregulated shadow markets in first energy and then credit derivatives, the dismantling of the protective structures of Glass Steagall, the weakening of our system of investor protections through the Central Bank of Denver case that gave effective immunity to investment banks from civil securities litigation, and the rise of unregulated market actors like hedge funds and private equity funds. In that sense jail time, or the threat of jail time, for willful acts is not an adequate deterrent for financial misconduct, nor is the criminal law in and of itself adequate to police our financial system.

However, we also believe that the fundamental fairness of our society is at issue when we look at the application of the criminal law to securities fraud and other types of business cases. Most Americans live in a world where the criminal law is a real form of accountability looming in the background. We incarcerate more Americans as a percentage of our population than any other advanced economy. We imprison significantly more Americans than we did in 1970 as a percentage of our population. Yet there is a public perception in the wake of the events of 2008 that a small number of wealthy and powerful Americans did vast damage to our country and to the lives of millions of families with relatively no personal consequences.

Recently we have seen action by the Securities and Exchange Commission on a major case related to the financial crisis involving Goldman Sachs, and the press is reporting that the Justice Department has opened a criminal investigation. The legal arguments associated with this case have revealed a paradox with implications for the criminal law. Many Americans seek financial advice from their stock brokers in much the same way we seek legal advice from our personal attorney or medical advice from our doctor—in the expectation that the advice given will be in our interest as client or patient. Yet the reality is that the legal obligations of a broker are simply limited to recommending securities that are suitable and reasonable to their clients—not putting their clients' interests first. There is also no obligation for brokers to avoid or disclose conflicts of interest.

The AFL-CIO supports a clear fiduciary standard for both broker dealers and investment advisors. I have attached to this testimony a letter from the Chairman of the Securities and Exchange Commission to Chairman Dodd of the Senate Banking Committee which discusses this issue in further detail.

In the context of adopting such a clear uniform standard, Congress should adopt companion language in the criminal code addressing willful breaches of fiduciary duty by brokers, much as the criminal code addresses willful acts of securities fraud or intentional breaches of fiduciary duty in the ERISA context.

There is another gap in our system of accountability for Wall Street, a gap you Mr. Chairman have taken the lead in addressing—and that is the area of aiding and abetting securities fraud. Up until the Supreme Court's decision in the Central Bank of Denver case in the mid-1990's, investors had the right to seek damages from investment banks and others who helped public companies commit securities fraud.[1] Following that decision, the lower courts found that in cases of heightened culpability, called "scheme liability" cases, third party actors could still be held accountable by their victims. This position was overturned by the Supreme Court in its Stoneridge decision, leaving a legal landscape where a person may be sued for aiding and abetting a hold up of a gas station but not for aiding and abetting a multi-billion fraud like Enron that cost thousands of people their jobs and retirement savings.[2]

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[1] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A. 511 US 164, 114 S. Ct. 1439, 128 L.Ed. 2d 119 (1994).

[2] Stoneridge Investment Partners v. Scientific Atlanta, 552 U.S. 148, 128 S.Ct. 761, 169 L.Ed.2d 627 (2008).

While the aiding and abetting problem is a civil issue and not a criminal issue, it has consequences for the enforcement of the criminal securities laws. Throughout the history of the securities laws, the Securities and Exchange Commission has recognized that its resources and those of the Justice Department are inadequate by themselves to police the vast U.S. securities markets. Consequently, effective deterrence of both civil and criminal acts has always been in part reliant on the ability of investors themselves to pursue those who defraud them, and thus to draw the attention of the Securities and Exchange Commission and the Justice Department. This chain of events simply does not occur when private parties have no ability to pursue investment banks and other third party actors in securities fraud cases.

These two holes in our system of investor protections—the lack of fiduciary standard for brokers and the lack of aiding and abetting liability for securities fraud—are part of a larger pattern of Swiss cheese regulation of our financial markets that developed over a generation. The Wall Street Accountability Act of 2010 seeks to close a large number of the loopholes in this system, but it does not include either of these matters. These are areas where the Act should be strengthened.

The AFL-CIO has long taken the view that the financial system needs to be regulated not with an assumption that the system is populated neither by saints or villains, but by ordinary people subject as all of us are to economic and organizational pressures. Strong, comprehensive regulation is the right approach to such a system today as it was in the days when our securities laws were enacted. Criminal law is a necessary part of such a system, and it is important that it cover willfully dishonest conduct comprehensively, and be backed up by a fair civil regime that allows the victims of such acts to obtain compensation from those who victimized them.

The AFL-CIO hopes this Subcommittee will be able to act to remedies these holes in the fabric of our securities laws in the light of the painful experiences of the last few years. Please let us know if we can be of further assistance to the Committee. Thank you for the opportunity to testify before you today.