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PENALTIES FOR WHITE COLLAR CRIME

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BEFORE THE

SUBCOMMITTEE ON CRIME AND DRUGS

OF THE

COMMITTEE ON THE JUDICIARY
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PENALTIES FOR WHITE COLLAR CRIME OFFENSES: ARE WE REALLY GETTING TOUGH ON CRIME?

WEDNESDAY, JUNE 19, 2002

UNITED STATES SENATE,
SUBCOMMITTEE ON CRIME AND DRUGS,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The Subcommittee met, pursuant to notice, at 10:44 a.m., in room SD–226, Dirksen Senate Office Building, Hon. Joseph R. Biden, Jr., Chairman of the Subcommittee, presiding.

Present: Senator Biden.

OPENING STATEMENT OF HON. JOSEPH R. BIDEN, JR., A U.S. SENATOR FROM THE STATE OF DELAWARE

Chairman BIDEN. The Subcommittee will come to order, please. I welcome you all, particularly our witnesses, today.

By way of brief introduction, Senator Grassley is on his way. He is at another Committee at the moment. He has a keen interest in the subject we are about to discuss this morning.

I would like to sort of lay out in a very brief opening statement what we are about this morning, what I am trying to do, why I am holding this hearing, and why Senator Grassley and I have the interest we have.

To state the obvious, there is not a single member of the United States Congress who does not have his or her constituents upset about not merely Enron but what is raised as a consequence of Enron—the loss of pensions, the loss of their security, and in a sense, in the minds of many, the loss of everything they have built in their whole lives, and what can we do about that.

There is also a larger issue. When I was Chairman of the full Judiciary Committee for years, and the ranking member for even longer, I spent a lot of time dealing with the criminal justice system and am responsible for or to blame for much of the criminal law that has been written since 1978 in the United States Congress.

One of the things that we know is that white collar crime can be equally as devastating as other types of crime. We also know, though, that it is much more difficult for prosecutors to bring white collar crime cases. The fact of the matter is we are very, very concerned, and first and foremost concerned about violent crime in America. But when we get beyond violent crime, we sometimes

tend to lose the differentiation that is needed between the impact of white collar crime and simple theft.

All you have to do in any society is look at their criminal code and it will tell you what they value and it will tell you how highly they value it. In America, we value life more than anything else, so obviously if someone wrongfully takes another person's life, maliciously and with premeditation takes someone else's life, we have the death penalty in most places for that. Evidence the fact we hold that as the highest value—human life.

If a women is raped, we hold that as a very high value in most States and we say there will be a severe penalty for that. If someone were to sneak into your house and steal $5,000, it is less of a penalty than if someone accosts you in the street at gunpoint and takes $5,000, because they have put you in fear and we value our right to be free of fear. So we have a higher penalty for robbery than we do for burglary.

Now, I know this is self-evident when I say it, but I think sometimes we forget it. But the strange thing is when it comes to those who rob us with a pen, rob us with a pencil, rob us with their financial shenanigans, or they steal from us, to be more precise, they tend to go to jail less than someone who would steal the same amount of money from us in a circumstance where they broke into our house.

The person who breaks into our house and steals $50,000 from us, or if they could steal our future by stealing our pension, should go to jail for a long, long time. Yet, white collar crime in most States and in the Federal Government generally does not carry the same penalty.

A very slight digression. There are those who are concerned in the corporate community with the notion of we shouldn't have tort reform because stockholders should not be held accountable for the misdeeds of their companies in a way that causes hundreds of millions of dollars in damages.

Well, I would suggest that we can have it one of two ways. You can have the tort system the way it is or a criminal system where we lock those guys up who make those mistakes; no fiduciary burden placed upon any stockholder, but the man or woman goes to jail. Kind of a good idea, for you folks with bow ties on out there. It is a good idea for you all to think about, all those of you, like me, in suits that cost more than $100 who are sitting out front.

The second point I want to make here is that this is about values. So our Criminal Code, which I have not been the custodian of, but as one who has been an overseer of for some time, 30 years in the United States Senate, I think has to be adjusted, or we should consider whether it needs to be adjusted to reflect what we value. That is what this hearing is about.

Now, I want to make it clear. Our first panel here are people who, in varying degrees, have had their future stolen from them, not merely their money, their future stolen from them. One of the witnesses is a person who is not sure what has been denied him, but let me make it clear there is no proof of any criminal activity or intent on the part of either the companies whose pensions have gone up in smoke for their employees, either Metachem, which Mr. Deputy worked for, or Enron for our two other witnesses.

The reason for the first panel—and it goes back to this value piece—is for us to understand what the damages are to people who have lost their pension, if there later is proof that there was a criminal intent related to their loss. It is a different standard if there is negligence, and that is a different issue. That is the civil system.

So I want to make it clear that by having the three people we have here today, the purpose is not to make a case that either Enron or Metachem or any other corporation has, in fact, violated criminal law. They may have. I don't know, but that is not the premise upon which you have been invited here.

You have been invited here, just as we would and have invited victims of rape, victims of burglary, victims of robbery, victims of senior fraud, to explain to us what the consequences of losing your future, if you will, has meant to you.

Now, one other point. We are going to have a series of experts to follow this panel, and I am looking to them to tell me if this discrepancy or the difference between the penalties that flow from white collar crime generically and other crime generically should remain, to the extent they exist. And if they exist and they shouldn't remain, why do they exist in the first place?

We have to look at this. We have to look at whether the reason why there are not more prosecutions for white collar crime is because it is much more difficult. By the way, it is much more difficult. Do we have enough trained prosecutors to be able to handle these very complicated cases?

If it turns out that we should, in fact, be pursuing more white collar criminals and we are not and we agree that we should, then we have to figure out why we are not. If one of the reasons we are not is we don't have sufficient resources, we don't have enough prosecutors, we don't have enough judges, whatever it happens to be, then we should remedy that. That is my job, that is the job of the people up here.

Lastly, I would point out that there has been, in my view, some progress made by the Sentencing Commission. I am often reminded that the reason it exists is I wrote the law setting it up, and so those who dislike it very much usually remind me of that. But I think they have done a good thing here. I am not sure, quite frankly, and I am going to ask the second panel, if they have gone far enough.

In the past, the way we have dealt with the calculation of a loss is the penalty would flow from the calculation. You steal one dollar, the penalty is less than if you steal one million dollars. The way we have calculated the loss in the past has been different than is now being proposed.

In the past, the way in which we have operated is that loss not only measures the harm wrought, but also an acceptable proxy for the defendant's state of mind. Stealing more is worse than stealing less not only because it inflicts greater harm, but also because the defendant who steals more is often thought to have a more reprehensible state of mind than the defendant who steals little.

The new guidelines incorporate a much better definition of loss that takes into account the amount of harm caused by the conduct. Actual loss now means, quote, "The reasonably foreseeable pecu-

niary harm that resulted from the offense." This definition, in my view, strikes the right balance between the objective "but for" standard and the subjective inquiry into the defendant's intentions.

But it still leaves some questions, in my view. The commission determined that loss should be reduced by the money returned, the fair market value of the property returned and the services returned by the defendant. With respect to investment fraud cases, the new guidelines provide that "loss shall not be reduced by the money or value of the property transferred to any individual investor in the scheme in excess of the investor's principal investment." Well, I am not sure that should be the standard, but I want to discuss that.

So we are going to essentially bifurcate this hearing. Again, the first part of the hearing relates to examples of the impact of loss of an instrument and/or a thing of value because of fraud. So today we want to hear from the witnesses as to what they know the impact has been on their lives.

I am delighted to introduce Charles Prestwood, who has traveled quite a ways from Texas to join us here today. Mr. Prestwood spent 33 ½ years at the Bammel, Texas, gas storage facility, which later became part of Enron, working his way up from Maintenance to Operations.

Generally he would work 12-hour shifts, commuting 75-mile round-trips from his home in Conroe, Texas. Having been very proud to be part of building Enron into a powerful corporation, with the encouragement of the company's top brass he invested an abundance of his earnings in Enron stock, amassing at its peak $1.3 million worth of worth.

Like other employees, he was prevented from selling his investments when the company stock value dropped last fall, and in the end his savings dwindled to a mere $8,000. Not only will he not be able to spend his retirement traveling, as he had dreamed, but he now lives in fear that if the furnace or the microwave breaks down, it is a cost and it is serious.

Ms. Farmer, thank you for traveling from Florida to join us today. Your son is with you. I indicated to you I know we don't salute sergeants, but since they run the show, we show them great respect

Sergeant, it is a delight to have you here, and it looks like you have someone looking out for you, mom.

Janice Farmer spent 16 years working to build the Enron Corporation, spending the bulk of her tenure in the Right-of–Way Department. After having been encouraged throughout her career to invest in Enron stock, she was prevented from selling her holdings, as well, as the market value plummeted. In turn, she saw her savings drop from $700,000 to $4,000.

Is that correct? Why don't you speak up and tell me what it is?

Ms. FARMER. Twenty.

Chairman BIDEN. Twenty. I am sorry. I devalued your stock even more. I am sorry.

While she once dreamed of using her savings to take her children and grandchildren on trips around the globe, she is now at home and that dream is somewhat distant now. Accompanying her is her

son, Jeffrey, a criminal investigator in the Marine Corps. Today, by the way, is his birthday and I wish him a happy birthday.

While I regret the circumstances that brought you both here, I want to thank you for joining us.

From my home State, I am pleased to welcome Mr. Howard Deputy. He hails from the State of Delaware. He lives in Smyrna, Delaware, and he has worked as a welder and crane operator for Metachem, before the buyout of Standard Chlorine 11 years ago.

When Metachem announced bankruptcy only weeks ago, he lost a portion of his pension, as did more than 100 union and non-union employees. The employees' loss totaled more than $300,000. I understand that employees and management are currently negotiating and hopefully a settlement of these claims will come forward, but Mr. Deputy joins us today to share his story.

I welcome all of you. Thank you for your willingness to share your stories with us. Also, by the way, accompanying Mr. Deputy is Jeff James, of Middletown, Delaware, and he also worked for Metachem for 14 years.

Again, for the record, there is no evidence, there is no proof, there has been no case made, there has been no decision made by any criminal court that either of the corporations mentioned here has engaged in criminal activity or violated the criminal law.

So let me begin now with you, Mr. Prestwood, and I welcome your testimony.

STATEMENT OF CHARLES PRESTWOOD, CONROE, TEXAS

Mr. PRESTWOOD. Thank you, Mr. Chairman, for having the opportunity to appear before in front of your Committee.

Like you stated a while ago about the things that have really happened in our lives, we have had a 180-degree turnaround in our lives.

Chairman BIDEN. I hate to ask you to do this. As modern as this place is supposed to be, we are the most antiquated institution in the world. Can you pull that microphone—you have got to bring it right up to your mouth because people in the back are straining to hear what you have to say. If you could just lean into it just like I do, if you would.

Mr. PRESTWOOD. Is that better?

Chairman BIDEN. That is it; you have got it.

Mr. PRESTWOOD. All right, sir.

Chairman BIDEN. And those Texans back there understand you. Those folks from Massachusetts may need a translator.

Please proceed.

Mr. PRESTWOOD. Thank you, sir.

Like you stated a while ago about what kind of effect is this having on us, it is a tremendous effect. In other words, it is 180 degrees. It is a complete turnaround because when I retired from Enron on October 1, 2000, I had plans on doing some traveling, my fiancee and I, and we had plans of doing a lot of things, see some of this good old beautiful USA.

But since everything happened the way it did at Enron, I do good to stay home, and it is awful expensive even to stay home. I didn't have to worry if a refrigerator or water well pump or something like that went. I didn't have to worry about that because I had

some money to back it up and I could replace it. Now, it is my prayer everyday that everything will hang in there until I can get better financially if I sell a little piece of property that I own or something and kind of tie over my house note and one thing and another.

When you think about the mental end of it, that is where it really hurts you. When you go to bed at night knowing what you did have and you go to bed now knowing what you don't have, in other words, it makes you real thankful for the things that you do have. In other words, we just went back in time. There is no other way around it. We just went back in time because our lifestyle has completely changed and the stock that we had is worthless now.

The word "loyalty"—right now, I do have two definitions of that word. The one that I lived by for 33 ½ years kind of left me hanging out on a limb when I found out that the real true definition of it wasn't exactly what I was thinking.

There is one little article here I would like to read and it is in the testimony here.

"Simply stunning. That is how Chief Executive Officer Jeff Skilling described Enron's strong financial and operating performance in 2000. Every major business—pipelines, wholesale services, retail and broadband—turned in strong performances for the year that were reflected in record volumes, contract value and profitability. Revenues increased two-and-a-half times, reaching $101 billion. For the first time, Enron's pre-tax net income exceeded $1 billion, a 32-percent increase over last year, and shareholders received an 89-percent gain on the stock price. Other significant highlights were included," which we won't go into that, but it will be down there.

Enron Business met with Jeff to discuss last year's results and his outlook for 2001. Enron Business asked the question: Enron had a great 2000. How did we do it? Jeff Skilling's answered, "Every one of our businesses performed beyond our expectations."

Well, you know, the way I look at that, is if there was any truth in that, Enron would still be going strong. There was something wrong somewhere along the line; in other words, the inflated price or the process or the type or the manner of bookkeeping or whatever might have been the problem.

But, you know, every time you talk to someone and you hear someone else talk like on Committee and all, this must just be one big dream, you know, because nobody did anything wrong. If somebody didn't do anything wrong, why is Enron right now not worth $100 a share? And it would probably go for, what, 10 cents, 15 cents a share?

That is my plea. As hard as we worked, in other words, it was one of the greatest achievements in my life when I retired knowing that I helped build the seventh largest corporation in the United States. I was very proud of my company, you know, and really I am still proud of Enron. Ninety-nine and one-half percent of the people that worked for Enron are good people. They are hard-working, tax-paying, vote-toting people, just regular, common folks.

It is a shame that the little minority at the top of our list or whatever it might be has destroyed such a great corporation. To me, that is a shame. I thought we had some protection on different

agencies. Even at the Federal level, I thought that we had some protection against things like that.

But I find out that I was wrong on it because the problems that occurred with the bookkeeping or whatever the problem might have been with Enron should have been taken care of in 1997, not 2001, because if it would have been taken care of in 1997, I firmly believe that Enron would still be going strong today.

But, you know, there are so many ways that people can look at it, but really and truly for us—and I feel like I am speaking for all of the retirees, all of the ex-employees and the employees that work for Enron now that lost everything they had and lost their 401(k)s and their ESOPs, and also the ones that got laid off and didn't get the right severance pay and one thing and another like that. In other words, this is not the American way. To put it real blunt and plain, this is not the American way for things like that to happen and for people to let things like this happen.

So I would like just to take a look at what down the road looks like for me. Down the road looks real grim, real slim, you know, but I hope and pray that things get better. I hope and pray that my health holds up. If my health would hold up and I was a young person, I promise you it wouldn't be any problem. I would be out working somewhere. But I can't. I have a heart condition and stuff, you know, so I am kind of at the mercy of the world, so to speak.

I really appreciate you all listening to me and I am honored to be here.

Chairman BIDEN. Mr. Prestwood, what do they call you, Charles, Chuck, Charlie?

Mr. PRESTWOOD. Charlie.

Chairman BIDEN. Charlie, when you were a young man, did you ever think the day would come that you would know what a 401(k) was or any of that kind of stuff?

Mr. PRESTWOOD. No, sir, I sure didn't.

Chairman BIDEN. Did you feel pretty good about knowing that stuff when you got to know it?

Mr. PRESTWOOD. Yes, sir, I did, and for several years, my latter years with Enron, I didn't save any money. But I was always raised to save what you got, don't spend it, don't draw your money out and buy that new car and get one like your neighbor has or something. Keep it there, let it grow, you know. What little bit you can save, put it in there and forget it.

Chairman BIDEN. Charlie, when you were a kid, what made you more angry, the guy who—what would upset you more, the guy who came up to you and you knew wasn't your friend and tried to take you on or the guy who you thought was your friend and you found out when the fight started he was on the other side? Who are you more angry with?

Mr. PRESTWOOD. The second guy.

Chairman BIDEN. That is right.

Mr. PRESTWOOD. The one that I thought was my friend.

Chairman BIDEN. Because he took advantage of you, didn't he?

Mr. PRESTWOOD. Yes, sir.

Chairman BIDEN. I think there are a thousand old expressions that I think every legislator should understand here because they know it in their heart, too. I am going to make an analogy for you,

something I spent a lot of my life working on, and that is how women are victimized by violence.

I had a whole bunch of psychiatrists come and testify over the years here, because men say sometimes, well, why, if a woman is raped, doesn't she report it, or why can't she recover from it or whatever. All these experts came, whether they were liberal, conservative, whatever they were, and they said one thing. They said, you know, a woman who is taken advantage of walking down the street and somebody jumps out of a blind alley and drags her in and abuses her, she is scarred and that is real bad, but she can recover psychologically, mentally, with a little help.

But the woman who gets in a car with somebody she has known for 20 years, with somebody she works with, with the husband of her friend or a guy that she voluntarily agreed to go out on a date with, and he does something really bad to her, it takes her a lot longer to recover because she ends up blaming herself. She says "why didn't I know?" At least this is what all the psychiatrists tell me, all the experts tell me.

Charlie, I grew up with guys like you, which I am proud of, guys who busted their neck and thought just kind of fair play, just fair play. If you wanted to get the guys in Claymont, Delaware, which is a little steel town—if you wanted to get them up, you just take advantage of them, suck them in, get them to trust you and then violate that trust. Well, baby, then you had a problem because that is the ultimate sin where you and I come from, the ultimate sin, is to lie to me, pretend you are my friend, lie to me and take advantage of me.

Mr. PRESTWOOD. Right.

Chairman BIDEN. What happens is when it is all over, I blame myself. Why didn't I know better? Why did I do this? You lay in bed now wondering why you didn't take that money out of that account now, right? I mean, now you wish you had taken that money out five years ago, whether you bought that car or not or done something with it, bought some land, right?

Mr. PRESTWOOD. Well, yes, sir, but I don't know. I am from the old school and I still trust people. The reason I didn't take mine out is honesty. The reason I didn't is I trusted Enron.

Chairman BIDEN. That is right.

Mr. PRESTWOOD. I had full confidence in them, and then I also trusted the Wall Street people. In other words, I looked at that little computer everyday and when that Enron shop was 100 feet underwater, the analysts were still hollering, screaming, "strong buy," you know, and it is 100 feet underwater. You know, that tells me something now.

Chairman BIDEN. That is where they belong, 100 feet underwater.

I just think it is important that we understand this. This is not a minor thing. Have you ever been robbed? I don't think anybody your size, anybody would try to fool with you when you were younger, but have you ever been robbed or your car stolen or your house broken into?

Mr. PRESTWOOD. No, sir. I have been fortunate, very fortunate. Thank God for that.

Chairman BIDEN. Well, when that happens to you, unless you are wandering someplace you think you shouldn't have been, you usually go home mad. You don't go home wondering "why did I let that happen" usually. Or if you come home and your house is burglarized, it is like you are mad.

But when you say, hey, man, I will give you a ride, I will help you out, and then he takes your car, that is a real problem, right?

Mr. PRESTWOOD. Yes, sir.

Chairman BIDEN. I will come back to you if I can, Charlie.

[The prepared statement of Mr. Prestwood appears as a submission for the record.]

Chairman BIDEN. Ms. Farmer, I would like to hear what you have to say, if I could. Thank you for, as Strom Thurmond says, pulling that machine up close.

STATEMENT OF JANICE FARMER, ORLANDO, FLORIDA, ACCOMPANIED BY JEFFREY FARMER

Ms. FARMER. I learn fast.

Chairman BIDEN. I can tell.

Ms. FARMER. I do appreciate the opportunity to be here before this Committee, and I am a very proud woman and it is with extreme emotional difficulty that I come here today to share my financial plight and my personal problems. But I feel compelled to explain my situation to you, and in doing so I truly hope to be the voice of all Enron employees.

I once had $700,000 in my 401(k) savings plan, and that was in late 2000. After years of hard work and dedication, I had achieved my life's dream, enough money to retire comfortably and live independently and financially secure. It was part of my dream to leave my children and grandchildren a respectable inheritance to enrich their lives.

For all of those years, I faithfully put money into my savings plan and I fiercely protected it, never touching my savings no matter what hardship came along. In 1994, Enron had discontinued their formal retirement program and they made each employee responsible for their own retirement planning. I still tenaciously hung on to my dream and worked toward it.

Then, in 2001, at the most critical time, Enron denied employees access to our own money. The shrewdly scheduled lock-down of the 401(k) denied other employees and myself access to our money for weeks, and this was just prior to the collapse of the seventh largest corporation in the United States.

While company executives managed to sell stock worth millions, we employees were brutally forced to watch helplessly while the 401(k) lost $1.3 billion in value. As I understand it, the plan administrators had the opportunity to either lift or even postpone this lock-down and they chose not to.

I feel it is very clear that employees were not only victimized by Enron executives, we were sacrificed for their own personal gain, and what had taken me a lifetime to build was destroyed in only a matter of days. When the lock-down finally lifted and I was allowed access to sell my stock, I received a check for $20,418, and that is all that was left.

I am now 61 years old. I won't have the opportunity to recoup my losses. I suffer from degenerative arthritis of the spine, along with three ruptured discs. I am diabetic, and that has caused neuropathy of the lower extremities. I also have Plantar's fascitis, which is like having constant muscle cramps on the soles of both feet, and it is really painful and it is disabling.

I try to get by now on Social Security survivor's benefits, which is only about $500 a month, and that is after health insurance and medical prescription costs. But out of that $500, I also have to pay my car and house insurance and my property taxes. Whatever will I do if I ever get sick or if anything breaks down? I don't know.

I am afraid of my electric bill now. At night, I sit home in the dark. I use no heat during the winter time and I don't allow myself to use air conditioning. The lowest I have been able to get my bill down to is $51. There are a lot of other ways I save now. I stopped the newspaper delivery, and I was really glad when I got a $33 refund on that because that is now a week's worth of groceries.

I stopped by yard service and I try to do it myself on good days. I cut my telephone and other household services to the very minimum, and I don't shop at Publix anymore or nice department stores. I shop at discount food stores and thrift shops.

I don't mean to give the impression that I am too good for this or above any of it, but this is not what retirement was supposed to be like and it is certainly not what Enron had touted to its employees all those years. We were lied to about the financial condition of our company and the future of our company. They told us everything was great, never better, but those lies were all part of the sham and Enron had become a house of cards, and the people that knew it protected only themselves.

They took more than my money and my dream. They destroyed my pride in my whole career. I am totally ashamed that I worked for Enron. The emotional toll on myself and my family defies description. The strength and the support from my children and my close friends has been invaluable.

The executives, even this long after their criminal behavior, go scot-free. They are living their normal lives of luxury. They in no way have negatively been affected by their illegal actions, and the amount of money they took from me surely was 1 percent or less of what they already had and they took my money anyway.

To me, what a blatant and enormous testimony to corporate greed. When does it stop? If this is the way corporate America repays dedication and loyalty, how many millions do they need to feel secure? We employees, average Americans, trusted in the system. We played by the rules, and we were lied to and cheated not only by Enron but also the auditors and the Wall Street analysts.

We have done nothing wrong, but yet we suffer the greatest pain and we suffer the greatest losses. If the collapse of Enron does not show that employees' needs and lives are being swept under the carpet as mere inconveniences, what will it take?

It is my deepest hope and prayer that this Judiciary Committee can give us assistance in getting back what is rightfully ours. Give us retribution, make us whole again, give us protection, put into place measures that will help prevent such rampant white collar crime, make the punishment more appropriately severe and swift.

I truly appreciate the opportunity to participate in this victim impact panel and to make my plea to you for justice. Thank you.

Chairman BIDEN. Thank you, Ms. Farmer, for a very moving statement.

Did you have a statement to make? You are welcome to if you would like.

Mr. FARMER. Sir, I did not prepare anything for the Committee. I am solely here for moral support, although I would like to add that this morning while we three were sitting at breakfast, and listening to Mr. Prestwood, I had a one-way view of the situation that retirees were in from Enron, namely from my mother's situation. But listening to Mr. Prestwood and as we talked, I realized how many thousands more people it had affected just from the Enron employees, their families, the children of their families, everybody down the row.

I understand that it is my responsibility as a son to take care of my mother. The burden falls on my shoulders and my sister's shoulders as she gets on in years and needs our help. It would have been a whole lot easier if Enron had taken care of their employees like they should have.

I think at this point, although I am willing to accept the complete responsibility of that, I think Enron or anyone in this situation, any company that would do this to their employees, should help with the responsibility.

Chairman BIDEN. There is an old expression: you can lock your front door to keep the burglar out, but you can't lock your heart to keep the liar out.

Ms. Farmer, your son and your daughter are prepared to take care of you. Does that bother you?

Ms. FARMER. Yes, sir, it does.

Chairman BIDEN. Why does it bother you?

Ms. FARMER. Because I have always been independent. I have been a single woman since the mid–1970s and I have always taken care of myself and it has always been of utmost importance that I maintain that capability to be their support. Now, like Charles said, it has turned 180 degrees. I am now dependent on them. They come down for Christmas dinner and they bring food. It is not supposed to be like that. Everything I have worked for all my life is gone.

Chairman BIDEN. I think that is an important point to make here. My dad has been a hard-working guy his whole life. He is 87 years old and never worked for a company where they had a pension plan, and the one that did lost it before we had protection for pension plans. I am not alleging fraud or anything. The company just went under.

My dad and mom have their house, and a long time ago I authored a bill called the reverse mortgage which allows an elderly person to be able to get a mortgage and get "x" number of dollars a month to help them sustain themselves, to live in their house as long as they are alive, and when they pass away the house is sold and whatever money that was gotten to help them live is taken out of the proceeds of the house.

My mom and dad have four kids. My brothers and my sister, like me, have been very successful. So my mom and dad are in a posi-

tion where they have sort of reinsurance from their children. My dad is in pretty tough shape now physically and they are living with me, but they still have their home because we are going through this fiction that they are going to move back into their home.

My mom came to me very upset that "this reverse mortgage, honey, is using too much of the value of my house." And I said, "Mom, it is okay, so what?" She said, "I will have nothing to leave you, I will have nothing to leave you." My mother is 85 years old and my mother doesn't want to take $500 a month out of her house to supplement her Social Security because she is not going to have anything to leave me. I hope when we think about penalties, we think about consequences to people.

Now, my mom's situation is different. It is the same impact, the pride piece, but I am not suggesting any wrongdoing relative to anything that happened to my mother or father. But I think sometimes we forget you raised us to be proud.

Ms. FARMER. That is right.

Chairman BIDEN. You raised us to be independent. I am not very far behind you, by the way, in age, so it is not like we are different generation here.

[The prepared statement of Ms. Farmer appears as a submission for the record.]

Chairman BIDEN. Mr. Deputy, tell me about the deal down at Metachem. How did you lose some of your retirement? How did that happen? You are a pretty young guy. How old are you?

STATEMENT OF HOWARD DEPUTY, SMYRNA, DELAWARE

Mr. DEPUTY. I am 35.

Chairman BIDEN. Thirty-five years old?

Mr. DEPUTY. Yes, sir.

Chairman BIDEN. My staff tells me you lost a chunk of your retirement.

Mr. DEPUTY. Yes.

Chairman BIDEN. How did that happen?

Mr. DEPUTY. They filed for taxes, like a tax extension, and they said by law they could and then they closed the plant.

Chairman BIDEN. What were they supposed to do?

By the way, I understand you just got off work at six o'clock and you hopped on a train?

Mr. DEPUTY. Yes, sir.

Chairman BIDEN. I hopped on the early train, too, but I didn't work until six o'clock this morning. So obviously you feel pretty strongly if you are down here and you worked all night and you are on the train at seven o'clock in the morning to get down here.

Let me make sure I understand. How does your retirement system work at Metachem?

Mr. DEPUTY. Once a year, they would make their deposit when they did your tax.

Chairman BIDEN. So when they did their taxes, what they would do is the money you kicked in and the money that they had promised they were going to put into this pension fund—right?

Mr. DEPUTY. Yes, sir.

Chairman BIDEN. They would put it in at the time that they paid their taxes, right?

Mr. DEPUTY. Yes, sir.

Chairman BIDEN. Now, am I correct that Metachem made a yearly payment, supposedly, of 6 percent of your annual salary into an investment plan of your choosing?

Mr. DEPUTY. Yes.

Chairman BIDEN. So if your salary was $1,000, they paid 6 percent into a fund and they paid $60 into a fund?

Mr. DEPUTY. Yes, sir.

Chairman BIDEN. This year, how much were they supposed to pay for you, do you know, into this fund when they paid their taxes?

Mr. DEPUTY. It is roughly like $3,000.

Chairman BIDEN. Three thousand bucks, and that was for you and all the other employees, right?

Mr. DEPUTY. Yes, sir.

Chairman BIDEN. What did they tell you? Did they put the money in?

Mr. DEPUTY. For the first four months of this year.

Chairman BIDEN. So for 16 months, they didn't put any money in, is that right? For 16 months they didn't put any money in?

Mr. DEPUTY. No, sir.

Chairman BIDEN. Did you know they weren't putting the money into the fund?

Mr. DEPUTY. They gave us a letter right at tax time and that is when they told us.

Chairman BIDEN. And what did they tell you?

Mr. DEPUTY. It was legal, you know. That is about it.

Chairman BIDEN. And so if I have it straight now, you were supposed to have $3,000 deposited in your retirement account, the investment plan that you had chosen, right?

Mr. DEPUTY. Yes.

Chairman BIDEN. And it was supposed to take place when they paid the taxes. Tax time comes and they didn't put it in, right?

Mr. DEPUTY. They filed for an extension.

Chairman BIDEN. They filed for an extension?

Mr. DEPUTY. Right.

Chairman BIDEN. And then what did they do?

Mr. DEPUTY. Then they filed for bankruptcy.

Chairman BIDEN. So, obviously, you are kind of in the back of the line, then, now, right?

Mr. DEPUTY. Yes, sir. They took everybody's vacation, too, that you had earned from the previous year.

Chairman BIDEN. Now, it is my understanding that this once-a-year payment was made around the 15th of April of each year for the prior calendar year. For example, in 2001 Metachem made its employee contribution for calendar year 2000, and that is how it worked until this year.

This year, Metachem didn't make an annual pension payment for calendar 2001. I understand that the 2001 payment for union employees was about $140,000 they were supposed to pay in for union employees, right?

Mr. DEPUTY. Yes, sir.

Chairman BIDEN. For both union and non-union employees, it was about $300,000 they were supposed to pay in, right?

Mr. DEPUTY. Yes, sir.

Chairman BIDEN. And they didn't pay any of that in?

Mr. DEPUTY. No, sir.

Chairman BIDEN. I understand that the specific 2001 pension payment which Metachem was supposed to make into your account was, they tell me, $2,688. Is that right?

Mr. DEPUTY. Yes, sir.

Chairman BIDEN. Now, I am not aware of any evidence of fraud on Metachem's part, but I want to be clear about that. Is it correct, Mr. Deputy, that you and the other employees thought—what did you think about the timing of this? Let me ask you that way.

Mr. DEPUTY. It was fishy.

Chairman BIDEN. It was fishy. Specifically, the company told you that it could not make its annual payment because it needed a tax extension, right?

Mr. DEPUTY. Yes, sir.

Chairman BIDEN. They didn't tell you they didn't make it because they were fixing to declare bankruptcy, did they?

Mr. DEPUTY. No, sir.

Chairman BIDEN. Did you and the other employees believe, at least at the time, that Metachem refused to make the annual payment because they knew they were going bankrupt?

Mr. DEPUTY. No, sir, because we thought we were owned by Charter Oaks.

Chairman BIDEN. Now, I don't have, again, any evidence of wrongdoing on the part of Metachem in terms of criminal wrongdoing, but I want to ask you a question about penalties for other companies who defraud pensions. I want to ask all of you this.

Pensions are regulated by a Federal statute known as ERISA, the Employee Retirement Income Security Act. If a criminal violation occurs under ERISA, however, the most the pension crook can get is one year in jail. That is the most they can get, one year in jail, regardless of how much money is lost by the company's employees. Incredibly, it is possible that this white collar crime crook could even get probation if your life savings are gone forever. Now, that is under ERISA.

Were you aware of that, that you could only get one year in jail?

Mr. PRESTWOOD. No, sir.

Ms. FARMER. No, sir.

Chairman BIDEN. And that the defendant could actually get probation if they were convicted?

Ms. FARMER. No.

Chairman BIDEN. Let me ask you this: What do you think is fair? I mean, let's assume it was proven in a court of criminal law that you were defrauded. What kind of penalty do you think the people responsible for defrauding you should get?

Charlie, what do you think?

Mr. PRESTWOOD. Mr. Chairman, would you let me answer that in my point of view?

Chairman BIDEN. I sure would.

Mr. PRESTWOOD. Lifetime, with no parole. There wouldn't be too many people defrauding people then, you know. You set two or

three examples and the rest of them will take note of it, is my way of thinking.

Chairman BIDEN. What do you think, Ms. Farmer, for real? I mean, how do you think it should be dealt with? I know your instinct and your heart would say hang them from the nearest tree kind of thing, I guess, but if one year is not enough, how do you—let me give you an example.

If you steal a car, under Federal law, and you take it across the State line, you get 10 years in jail. Auto theft is a serious crime and it should be dealt with severely. So if, under ERISA, someone was convicted for violating that law, they get one year in jail. If they steal your car and take it into Georgia, they are going to get up to 10 years.

Ms. FARMER. To me, that makes no sense. I mean, there is no equilibrium there; it doesn't balance. I tell you one thing, if they get more than one year in the penitentiary, that would be fine, but I just want what is mine. I want it back. They don't deserve to have it.

Chairman BIDEN. Mr. Deputy?

Mr. DEPUTY. I think it should be the same penalty as like with a gun, you know, a stiff penalty.

Chairman BIDEN. There is not a lot of distinction to you if someone comes in and sticks a gun in your face and takes $3,000 of your money?

Mr. DEPUTY. Yes. You can't do anything about it, and the same way when they sneak it out, you can't do anything about it.

Chairman BIDEN. Well, that is one of the things we have to look at here. I am not trying to hype this, but I think it is important to just look at the equities here.

Ms. FARMER. I agree.

Chairman BIDEN. If I take your car and I take it into New Jersey, and I take your car into Georgia, and take yours into Oklahoma—I don't know why I would do that, but only a Texan would appreciate that.

Ms. FARMER. Especially if you saw my car.

Chairman BIDEN. And no matter what your car is like, by the way. Your car can be a 20-year-old jalopy or a brand new Mercedes and there is no difference in terms of if they cross that State line. It is 10 years.

Well, I want to thank you for taking the time to be here. I know it is not easy, but it is important that we put a human face on what we are talking about here. We are not just talking about dollars. We are not just talking about, in the abstract, people's futures are changed. We are talking about not only your money gone, but your pride is gone and your sense of what you think your responsibility is to your children is gone.

Ms. FARMER. Yes, sir.

Chairman BIDEN. Charlie—you know, here is a guy who busted his neck, worked hard his whole life and got things those college boys get, right? I mean, seriously, think about it, think about it. This is a big deal. It wasn't just the money, was it?

Mr. PRESTWOOD. No, sir.

Chairman BIDEN. It was the knowledge that you built this and you were part of this deal. I mean, did you ever think you would

be on a computer looking at stock prices, for Lord's sake, and quotes when you were a kid?

Mr. PRESTWOOD. No, sir. The only stock I knew of was the animals we had out in the barn.

[Laughter.]

Chairman BIDEN. That is right, exactly right. By the way, you couldn't afford to keep those animals right now, based on what you have, right?

Anyway, I promise you we are going to try to come up with an equitable way in which to deal with this because this has to be fair. I want to tell you I can think of not a whole lot, other than your physical safety, that I think we should value more than your financial security.

The good news for Howard is he is 33 years old and he has a whole life ahead of him. He is going to get a kick in the teeth from this, whether there is criminal activity or not, because of the bankruptcy, but I think he is going to be wiser for it and know what is going on.

And I don't think it is a good thing for you, by the way. Every time something lousy happened in my life, people would say it builds character. And I would say I have got enough character, I don't need any more character. I am not suggesting you need any either, but in the case of our other two witnesses, although they are not that old, for physical reasons and others, their options are limited.

Charlie and Janice, to be blunt with you, I am not sure there is anything we are going to be able to do to get you back your money. That is another question, but I do think that we have to consider what you both said that if there were adequate penalties, maybe these guys would have thought twice about what they did or didn't do when they were making these judgments, if, in fact, penalties are deterrents, and I think in this case they may very well be.

So I thank you all. If you have any closing comment any one of you would like to make, I am happy to have it. I know you probably got up early and you probably want to get going, but I say to both of you my staff is available. Why don't you all come around, and because you came a long way, unless you already have plans, we will arrange for you to eat in the Senate dining room or get you something to eat here. I mean, this has been a real sacrifice to come up just for an hour or so, so we will take care of that. I am not saying the Senate will. I will. I want to make it clear I am not spending the taxpayers' money here. This is not the taxpayers' money, okay?

Ms. FARMER. Thank you.

Chairman BIDEN. So we will just make arrangements if you all need any because I know it was an inconvenience.

Howard, I will see you at home, but if you need anything while you are here, too, I invite you to come into this room and my staff will be there if you need any assistance or would like any, or would like us to arrange to make sure you get some lunch here, if that is okay.

Ms. FARMER. Thank you. That is a generous offer.

Chairman BIDEN. Well, thank you very much for being here.

Yes, Charlie?

Mr. PRESTWOOD. Mr. Chairman, you know, looking at that little chart up there, you take that car that would cost about $30,000 and the criminal offenses over here could reach up to maybe $2.2 billion. There is a difference there. Something is wrong with the law or something, it looks to me like.

Chairman BIDEN. Well, I think you are right, Charlie, and we are going to try to fix that.

Ms. FARMER. I agree.

Mr. PRESTWOOD. I thank you, sir. It is an honor to be here.

Chairman BIDEN. Thank you. It is an honor to have you here. While our first panel is clearing out, I want to again thank them for being here.

Our second panel is James B. Comey, who was recently appointed the United States Attorney for the Southern District of New York. He attended the College of William and Mary and the University of Chicago Law School, and later clerked for Federal District Judge John M. Walker, Jr., in Manhattan.

As Assistant U.S. Attorney in the office he now heads, he prosecuted members of the Gambino crime family. Before being appointed to his current position, he served as Assistant U.S. Attorney in Richmond, Virginia, where he earned praise as a prosecutor. As head of an office that handles an enormous amount of white collar crime work, we look forward to his testimony today.

Glen B. Gainer, III, serves as the West Virginia State Auditor and Chairman of the National White Collar Crime Center. He is a trustee for the National Coalition for the Prevention of Economic Crime, and chairs the Audit Committee of the West Virginia Investment Management Board. He is on the Executive Committee of the National Association of State Comptrollers and is Vice President of the West Virginia Consolidated Public Retirement Board.

Mr. Gainer, welcome to Washington.

Mr. BRADLEY W. Skolnik is the Securities Commissioner for the State of Indiana and Chairman of the Enforcement Division of the North American Securities Administrators Association, an organization over which he presided from September of 1999 to September of 2000.

Mr. Skolnik earned his bachelor's degree at Michigan State University in East Lansing and his law degree at the Indiana University School of Law in Bloomington. He began his legal career as a law clerk in the office of a prosecuting attorney in Michigan and went on to clerk for the Indiana Court of Appeals. We look forward to his testimony, as well.

Frank O. Bowman, III, is an Associate Professor of Law at Indiana University School of Law in Indianapolis, where he teaches evidence, criminal law, and criminal procedure. Following his graduation from Harvard Law School in 1979, Professor Bowman entered the U.S. Department of Justice as part of the Honors Graduate Program. He spent three years as a trial attorney in the Criminal Division in Washington.

From 1983 to 1986, he was deputy district attorney in Denver, Colorado, and he also spent three years in private practice in Colorado. In 1989, Professor Bowman joined the U.S. Attorney's Office in the Southern District of Florida, where he was deputy chief of

the Southern District Criminal Division, specializing in complex white collar crime.

In 1995 and 1996, he served as special counsel to the United States Sentencing Commission, in Washington, D.C., and in 1998 to 2001 he served as academic adviser to the Criminal Law Committee of the United States Judicial Conference.

Welcome, Professor.

Paul Rosenzweig is a Senior Legal Research Fellow at the Heritage Foundation's Center for Legal and Judicial Studies. He attended Haverford College, in Pennsylvania, a great school, and the University of Chicago Law School, after he which he clerked for the Eleventh Circuit Court of Appeals. He worked for seven years as part of the Justice Department's Environmental Crimes Section, and then for a time as the Chief Investigative Counsel for the House Committee on Transportation and Infrastructure. Most recently, he was senior litigation counsel and associate independent counsel under Ken Starr. We look forward to his presentation today, as well.

I thank you all for being here. If we could, if you would begin and try to keep your statements relatively short, your entire statements will be placed in the record.

If we begin in the order that I introduced you, Mr. Comey.

STATEMENT OF HON. JAMES B. COMEY, JR., UNITED STATES ATTORNEY, SOUTHERN DISTRICT OF NEW YORK, NEW YORK, NEW YORK

Mr. COMEY. Thank you, Mr. Chairman. Thank you for inviting me here today. I welcome the opportunity to appear before this Subcommittee on behalf of the Department of Justice to discuss these important issues and the penalties for white collar crime.

As you have said, Mr. Chairman, the swift and certain punishment of financial crimes is essential to protecting this country's economy. The prosperity of our great country and all the good that flows from it are made possible by the Federal, State and local laws that bring a degree of order and predictability to commerce and that protect citizens from the predation of criminals who use a pen or a computer and not just a knife or a gun.

But as you also know, the real and immediate prospect of significant periods of incarceration is necessary to give force to those laws. Nothing erodes the deterrent power of our laws and breeds contempt, frankly, for obeying the law more quickly than if certain criminals appear to receive punishment not according to the gravity of their offense but according to their social or economic status.

The Department of Justice is committed to the vigorous enforcement of laws against all forms of financial crime, and our position on this issue is straightforward and we hope inarguable.

White collar criminals have broken serious laws. They have done grave harm to real people like the real folks who were seated at this table before we sat down, and they should be subject to the same type of retribution that we accord all serious crimes—a significant chunk of jail time.

We have made significant progress in recent years, especially in improving the Federal Sentencing Guidelines. We are very pleased that the Sentencing Commission amended the Guidelines for white

collar offenses to raise the penalties on those who are responsible for significant financial loss, although the penalties were decreased to some extent for the smaller-time crooks.

Both the Department and the Commission will be closely examining the effects of those recent amendments on cases that are just now being prosecuted and coming through our offices, and we will pay particular attention to what happens at the lower-end cases which make up a large proportion of the cases prosecuted by U.S. Attorneys.

We remain concerned with amendment proposals that have been made to the Commission in past years that could undermine the progress that has been made so far. We are pleased that the Commission has seen fit to reject efforts to reduce punishment for the most serious offenders.

White collar offenders are generally better educated, in the experience of U.S. Attorneys, and more sophisticated than most criminals. They commit their crimes not in a fit of passion or out of addiction or a craving, but with cold and careful calculation. They are, in my experience, the most rational of offenders and are more likely to weigh the risks against the anticipated rewards of committing a crime.

They can be deterred, but the penalties must be certain and significant. They have to fear going to jail. If you ask a criminal defense attorney who represents a white collar defendant, they will tell you the thing they are most afraid of is going to jail. People like that with a lot to lose are exquisitely sensitive to the pain of deterrence because they don't want to go to jail.

The certainty of these significant penalties in white collar cases also fosters trust in our criminal justice system, which is the bedrock of the system. If drug defendants and violent offenders are routinely sent away for long stretches, while white collar offenders routinely get probation or home confinement or a halfway house, people are going to start to think that felons with wealth or privilege or education or the right color are not held to the same standards as "regular criminals" and that people are above the law. We believe that white collar sentences to jail can and will lead to restitution to the victims of their crimes. There is nothing inconsistent about a jail term and restitution.

Lastly, I just want to add a word about downward departures. Because Congress intended the Sentencing Guidelines to cover nearly every factual circumstance in a criminal case, judges are only rarely supposed to depart from the sentence range that the Commission has set out.

We U.S. Attorneys are very concerned about the increasing number of non-substantial assistance departures in white collar cases, in particular. It sometimes appears that Federal judges don't want to put white collar defendants in jail, and that they work to eliminate or reduce that jail time because of the defendant's civic work or charitable work or his great employment record or his big family or his health problems, or a whole host of factors that the Guidelines say are discouraged, but that judges find are present to a degree outside the heartland, and therefore it justifies sending this guy home or to community confinement. These departures can be found by a good defense lawyer in almost every case, and we think

they erode the already less onerous penalties in the white collar area.

In conclusion, we think that white collar offenses are situations where punishment and severity are vitally important, as important as in the cases you mentioned, the drug and violent crime cases. We appreciate the work of the Sentencing Commission in bolstering the offense punishment for major offenders. We hope that the Commission will continue to stand strong against proposed changes that would undermine that progress, and we look forward to working with the Commission and this Subcommittee to ensure that Federal sentencing is designed to reduce crime in the most efficient possible way.

That concludes my prepared remarks, Mr. Chairman. I ask that the full text of my remarks be incorporated into the record.

Chairman BIDEN. Without objection, they will be.

[The prepared statement of Mr. Comey appears as a submission for the record.]

Chairman BIDEN. Mr. Gainer?

STATEMENT OF GLEN B. GAINER, III, WEST VIRGINIA STATE AUDITOR, AND CHAIRMAN, NATIONAL WHITE COLLAR CRIME CENTER, MORGANTOWN, WEST VIRGINIA

Mr. GAINER. Chairman Biden, I come to you wearing two hats today, first as the State Auditor of the State of West Virginia and its Commissioner of Securities, but also as the Chairman of the Board of Directors of the National White Collar Crime Center.

I am going to depart from my prepared remarks, since they will be included in the record, and just speak briefly to a few issues.

As a regulator of the securities industry and serving at the National White Collar Crime Center, I see first-hand many of the issues and problems that we are facing dealing with this issue.

Too few resources. The National White Collar Crime Center, as you probably are aware, is funded by the Congress through the Department of Justice and Bureau of Justice Assistance. The funding is greater than it has ever been in the past, but it is still too few dollars to meet the great needs that we are trying to achieve.

We have over 1,000 member agencies, representing attorneys general, securities commissioners, State police, State and local law enforcement, as well as prosecutors across this country. We try to provide them support not only in financial crimes training, prosecutors training, computer crimes training, but we also try to provide them research and analytical support.

Our research section has found through our last nationwide study that most Americans view economic crime, or what we would consider white collar crime, to be every bit as important and deserve equal time and prosecution as traditional street crime, though we know from our past history that is not the case.

We can look back to the 1990s when we had the savings and loan scandal, where the average sentence for the folks involved in that in excess of $100,000 received 36.4 months in jail. You have already used the example of car theft. At that time, car theft received 38 months in jail, traditional burglary received 55 months in jail, and drug offenders received over 64 months in jail. As we can see, the sentencing is not equal.

Another area that we have identified, and I will say as a securities regulator I find somewhat disheartening, is the complexity of economic crime and the investigation required to do that takes an expertise that is difficult to find. When you do find that expertise, having the funds and the ability to maintain that staff is difficult.

But even more disturbing is when you do put a case together and you are successful in putting a case together, taking it to the Federal prosecutors many times falls on deaf ears. I am not criticizing the system. I understand the system. I understand the burden and the crimes that they are trying to deal with. Many times, white collar crime is looked at as a low priority.

From the standpoint of sentencing, why would a prosecutor want to put in thousands of hours on a case, only to get a conviction of perhaps parole or maybe a few months in jail? I can understand their situation, but as a regulator I find it difficult to deal with on a day-to-day basis.

I have to answer, as do you, to my constituencies in the State of West Virginia. If we have Federal leadership in strengthening the law, I believe that it will go a long way in helping to prevent economic crime in this country. We must take a strong stand.

Not only do economic criminals in this country need to understand that they are going to be prosecuted, but there will be severe penalties for that violation of the law. Many of them right now in the environment that we exist in are willing to take the gamble that if they are caught, they will not be convicted, or if they are convicted, they will probably receive probation or a very light prison sentence. This is truly an issue that we must deal with and it has already been talked about by the previous panel.

Thank you.

[The prepared statement of Mr. Gainer appears as a submission for the record.]

Chairman BIDEN. Thank you.

Commissioner Skolnik?

STATEMENT OF BRADLEY W. SKOLNIK, INDIANA SECURITIES COMMISSIONER, AND CHAIRMAN, ENFORCEMENT SECTION, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., WASHINGTON, D.C.

Mr. SKOLNIK. Thank you very much, Mr. Chairman. I am Brad Skolnik, Indiana's Securities Commissioner, and Chairman of the Enforcement Section of the North American Securities Administrators Association. I commend you for holding this hearing today and thank you for the opportunity to appear.

Our country has undergone a historic transformation. In just the past generation, we have become a nation of shareholders. Today, half of all households are invested in the stock market, and State securities regulators realize we have an increased responsibility to make sure that Wall Street is a safe street for Main Street investors.

Given all the news of late, which sometimes make the business pages read like a police blotter, Congress, regulators, and the industry must act to restore confidence in the integrity of our markets, and we feel we can help do that by holding those who defraud investors accountable for their crimes.

The strongest deterrent to white collar crime, I believe, as we have heard today, is criminal prosecution and prison time, but there are significant hurdles we face. Prosecutors, juries, and the media understand street crime like robbery, assault, and murder. Somehow, securities fraud and other white collar crimes seem sanitized, bloodless, and technical.

Many people, including some in law enforcement, view securities fraud as an essentially victimless crime that involves as much gullibility on the part of the victim as it does culpability on the part of the perpetrator. But we know white collar crimes aren't victimless crimes. Just like street crime, securities fraud ruins lives, destroys families, steals hopes, and kills dreams.

Oftentimes when faced with a problem, the temptation is to propose new legislation. In my opinion, to protect investors we need to make better use of the laws already on the books. This means bringing more criminal actions against white collar crooks.

One problem is that securities cases are complex, costly, and time-consuming, and these are serious deterrents to law enforcement agencies with limited personnel and budgets. The prosecution of complex white collar criminal cases take time and money, lots of money. It is critical that prosecutors and law enforcement officials be provided with the resources necessary to investigate and prosecute these cases.

The truth is some prosecutors shy away from them because the subject is complicated and difficult to understand. A prosecutor's willingness to undertake a complicated and technical securities case also depends on other cases competing for attention. Murders, other forms of violent crime, and drug-related cases are sometimes easier to argue to a jury and don't require the amount of staffing or special expertise often required for criminal prosecution of a complex securities case. But from my perspective as a State securities regulator, white collar criminals who commit securities fraud deserve time just like thieves, muggers, and murderers.

There are some ways my colleagues can help. State securities regulators can and do provide resources to prosecutors to assist with the investigation and prosecution of these cases. We can develop cases fully and hand them over to prosecutors, both Federal and State, reducing the burden on them substantially.

Moreover, when criminal convictions are obtained in white collar cases, the sentences imposed are often insufficiently severe, considering the amount of harm inflicted. Think about it. If someone steals your car, they go to prison. If some con artist steals the money your parents need for retirement, they get fined. That is just not right.

I also think it is important for us to stop using euphemisms when we talk about white collar crime. White collar criminals are cold, calculating, and vicious. All too many are serial violators, career criminals. It is probably way past time we called a crook a crook and put more of them in jail.

On the legislative front, State securities regulators support S. 2010, the Corporate and Criminal Fraud Accountability Act of 2000, and believe it sends a powerful message that wrongdoers in the securities markets will be punished.

Unfortunately, white collar crime is not as high on our national agenda as it needs to be. However, the problems in this area can be successfully addressed if law enforcement officials, regulators, Congress, and others work together on solutions. I am optimistic that the battle against white collar crime is winnable, given the will and the right amount of resources.

Again, I thank you for holding this hearing and would be pleased to provide any additional information you may need.

[The prepared statement of Mr. Skolnik appears as a submission for the record.]

Chairman BIDEN. Thank you, Commissioner.

Professor?

STATEMENT OF FRANK O. BOWMAN, III, ASSOCIATE PROFESSOR OF LAW, INDIANA UNIVERSITY SCHOOL OF LAW, INDIANAPOLIS, INDIANA

Mr. BOWMAN. Chairman Biden, thank you very much for inviting me to be with you here today. My name is Frank Bowman and I am a professor at the Indiana University School of Law in Indianapolis.

As you were kind enough to mention, before becoming a teacher I practiced law for a good 17 years and served for roughly 13 years as a prosecutor in State and Federal courts. In 1995 and 1996, I was detailed by the Department of Justice to serve as special counsel to the U.S. Sentencing Commission, and during that detail I became involved in the Commission's long project of rethinking and revising the Sentencing Guidelines governing economic crimes, a project which finally came to fruition in May of 2001, when the Commission passed its so-called economic package of guidelines amendments.

When I left the Government to teach in 1996, I began to write about sentencing, and in particular about the sentencing of Federal economic crimes. I continued to work in the political realm and in the policy realm on economic crime sentencing reform.

During the five-year process of rewriting the Federal economic crime sentencing guidelines, I had the honor to work closely with all of the groups most interested in the reform: former colleagues in the Justice Department, representatives of the defense bar, the Criminal Law Committee of the U.S. Judicial Conference, and of course the Sentencing Commission itself. The lessons I learned during the last five years inform much of what I have to say this morning.

The question for today is whether we are tough enough on white collar crime. I want to make four points.

First, the average sentence imposed on a defendant convicted of an economic crime, defined broadly, in Federal court is certainly significantly lower than the average sentence in any other major crime category. Economic crime defendants, broadly defined, get probation far more than any other sort of defendant. I have included in my written testimony a chart which reflects the precise figures for fiscal year 2000.

However, I want to emphasize that I think this comparison of categories is probably misleading. Most Federal prosecutions categorized as economic crimes are simple crimes that involve rel-

atively small sums of money. For example, in 1999 half of the defendants sentenced for theft crimes and 22 percent of those sentenced for fraud stole less than $10,000. That is not a minor amount of money, but in the scheme of the kinds of frauds that we have been discussing this morning, it is relatively small.

Moreover, a big chunk of the Federal economic crime caseload consists of thefts or misappropriations of Government benefit checks, thefts of Government property, simple embezzlements from federally-insured banks, and similar matters.

Prosecution of these kinds of cases is certainly necessary particularly where the Government itself, and thus the taxpayer, become the victim. But there is, I think, little evidence that crimes of this sort are under-punished. Therefore, I think that sentencing averages for all Federal economic crimes don't tell us very much about the appropriateness of the punishments imposed on the kind of folks that you, Senator, were presumably thinking about when you scheduled this hearing—people I will call serious white collar offenders, people who stole a whole lot of money in a reasonably complicated way.

The second point I want to make is a historical one, and that is across the board for both routine, small-fry types of thieves and for serious white collar offenders, Federal economic crime penalties are now markedly higher than they used to be.

Prior to the enactment of the Federal Sentencing Guidelines in 1987, probationary sentences were the norm in Federal economic crime cases, often in serious white collar cases involving significant financial losses. The original Sentencing Commission consciously sought to change this. They wrote guidelines that effectively mandated prison sentences, absent departures at least, for all defendants who stole more than roughly $120,000 or so.

In addition, by tying increases in sentence length to increased amounts of loss, and by adding sentencing enhancements for factors like abuse of trust, the guidelines began routinely generating multi-year prison sentences for white collar defendants who, before the guidelines, would have escaped with probation or a term of mere months.

Chairman BIDEN. I might add that was one of the reasons why I wrote the legislation. Everybody thinks it was only the violent criminals, but we had a lot of hearings and that was one of the big issues back then.

Mr. BOWMAN. Senator, although many people are not great fans of the guidelines, I for one am, and I want to thank you for your good work in helping——

Chairman BIDEN. Well, thank you. I didn't intervene for that, but thank you.

Mr. BOWMAN. I want to go on to say that even though the guidelines raised the historical level of white collar offenses, in the years after the guidelines were adopted many judges, probation officers, and prosecutors felt that sentences for serious white collar offenders were still not high enough.

As a result, one element of the Sentencing Commission's 2001 economic crime package was an increase in sentences in cases with larger loss amounts. So the effect of the guidelines on white collar criminals has been to put more of them in prison for longer, and

the effect of the new 2001 economic crime amendments to the guidelines will be, I think, to increase white collar sentences still more, at least for high-loss cases.

Therefore, another way of framing the question being asked here this morning might be: we have gotten tougher on white collar crime, yes, but have we gone far enough? Now, of course, there is no objective or empirical way of deciding how much punishment is enough.

For example, in my own view, comparisons to other dissimilar types of crime may not be very helpful. People often remark on the substantial difference between economic crime sentences and drug sentences, but one has to ask whether the lesson to be drawn from this comparison is that economic crime sentences are too low or maybe that drug sentences are too high, or maybe the differential is just right because they are not comparable types of crimes.

I think about the best we can do is to make some necessarily imprecise judgments about whether prevailing punishment levels are likely to act as effective deterrents to crime, while at the same time being neither undeservedly lenient or undeservedly harsh.

In my written testimony, I have provided some examples of the sentences that both the old and new guidelines would produce for some hypothetical white collar criminals who steal sums in the range of, say, $750,000 to $1 million or $2 million.

Depending on the particular circumstances in such cases, other than loss amount, such defendants now would be sentenced to prison anywhere from 2 ½ to roughly 17 years. Lower loss figures would produce slightly lower sentences. Higher losses would produce higher ones.

As just an interesting aside perhaps, I did a quick calculation during the testimony of the previous panel. Assuming that facts were to arise giving rise to criminal liability for people involved in the Enron scandal, which produced losses presumably much in excess of $100 million, and if such persons were to be brought to trial and convicted, they would now receive sentences in excess of 20 years.

My third point, therefore, is this: Sentences at this level may be a bit too low in some cases and a bit too high in others, but I find it fairly hard to assert categorically that sentences in this general range are obviously unreasonable. Indeed, I suspect that in most cases, most people would probably conclude that the sentences now prescribed by the economic crime guidelines closely approximate rough justice.

At a minimum, I think that current economic crime sentences are not so obviously low that Congress should command the Sentencing Commission to enact a blanket increase applicable to all economic crimes, or maybe even to all economic crimes above a certain loss amount.

I would like to suggest further that Congress should be especially cautious about pressing for any across-the-board white collar sentencing increases less than a year after the Commission, in conjunction with all of the interested parties, including the Justice Department, passed its economic crime amendments. The sentence increases in that package have really basically not even come into ef-

fect yet and it will be some years before we can determine what is really happening there.

There may be specific types of economic crime or specific aggravating factors that the Commission has not properly accounted for and which deserve additional sentencing enhancements. In my written testimony, I note several such factors mentioned in Senator Leahy's bill, S. 2010, and I am particularly interested in the proposed enhancement which I think may be particularly appropriate, given the testimony we have heard today, for causing victim insolvency.

Fourth, and finally, the last point I would like to leave you with is that toughness on crime, and economic crime in particular, should not be measured solely by the length of the sentences we impose on the white collar defendants whom we catch and convict, but by the resources we devote to ensuring that all those who commit serious white collar crime are caught and are punished.

For reasons that have to some extent been laid out here today and which I explore more in my written statement, in the United States the Federal Government is the primary, and in some jurisdictions virtually the sole investigative and prosecutive authority for complex economic crime.

I would submit that the most valuable thing that this Subcommittee and this Congress could do to fight white collar crime in America would be to appropriate and dedicate additional funds for the Justice Department and the regulatory and investigative agencies who fight white collar crime.

[The prepared statement of Mr. Bowman appears as a submission for the record.]

Chairman BIDEN. Thank you for a very thoughtful statement. I appreciate it.

Mr. Rosenzweig?

STATEMENT OF PAUL ROSENZWEIG, SENIOR LEGAL RESEARCH FELLOW, CENTER FOR LEGAL AND JUDICIAL STUDIES, THE HERITAGE FOUNDATION, WASHINGTON, D.C.

Mr. ROSENZWEIG. Thank you, Mr. Chairman. As you have said, my name is Paul Rosenzweig and I work at the Heritage Foundation. I am also an adjunct professor at George Mason University, where I teach white collar and corporate crime, so this is a subject near and dear to my heart.

I also find myself quite comfortable as last on this panel because that position will allow me to be brief. I find myself in agreement with much of what has been said already. I concur wholeheartedly that some of the problem is the lack of devotion of resources appropriately to the prosecution of white collar crime.

I agree, as well, that part of the problem is the intricacy and difficulty of proving those crimes, and that is perhaps something inherent in the nature of white collar crime that no act of Congress or the Sentencing Guidelines and no devotion of greater resources can or ever will solve.

When and if there is ever a trial of a fraud of the size alleged potentially against Enron, that trial will occupy a court and a dozen prosecutors for nigh on six months, and still may be impen-

etrable to either the judge or the poor jury obliged to sift its way through the intricacies of the finances there.

I also agree with Professor Bowman that for the most part the Sentencing Guidelines have moved substantially in the direction of making more equivalent white collar and street-type crimes.

The two points that I would add that are perhaps different than those that have already been brought forth are these: First, to some degree I think we need to absolve the courts of responsibility for such disparities as remain. Much of the cause of that lies not with them, but either here in Congress or in the guidelines themselves.

In my written statement, I have provided you with some information about the rates of imprisonment that are given to defendants in situations where judges have discretion to choose either imprisonment or some non-imprisonment type of punishment—home detention, community service, probation, that sort of thing.

If we look at that data, we see that in those situations where discretion remains in the district court judges doing sentencing, for the most part the rates at which they impose imprisonment don't vary that much based upon the nature——

Chairman BIDEN. Is that your chart on page 6?

Mr. ROSENZWEIG. That would be the one on page 4 that I am looking at, the rates of imprisonment.

We do see that drug traffickers get——

Chairman BIDEN. I guess I have a different pagination.

Mr. ROSENZWEIG. Okay, it may very well be. I submitted it by electronic mail and the pagination may have changed.

Chairman BIDEN. Is it the first chart you have where it says "Crime Type," "Rate of Imprisonment," "Fraud," "Larceny," "Immigration," et cetera?

Mr. ROSENZWEIG. Yes.

Chairman BIDEN. Okay.

Mr. ROSENZWEIG. But as you can see, that applies to only some 11,000 individuals in fiscal year 2000, out of roughly 60,000 who were sentenced. So this is only one-sixth, more or less, of the total number of people sentenced. For most situations, either some congressional enactment, a mandatory minimum sentence for a drug offense or some operational guidelines, didn't afford the courts any discretionary opportunity.

The other area in which we might expect or we might think that we would see a bit of disparity would be in the rates of departure. If the guidelines command sentencing, we might ask whether judges are, for example, preferentially departing more frequently in white collar cases than they are in street crime cases. That would be the third chart I have, again "Rate of Departure," and there again there are some variations amongst the various types.

But when I went and pulled this data down, I was actually fairly comfortably surprised to find that the rate of departure for robbery is not appreciably different from the rate of departure for fraud.

Chairman BIDEN. For fraud, you have 9.2 percent; robbery, 12.7.

Mr. ROSENZWEIG. That is right, so in 12 percent of the cases where the crime of conviction is robbery, nationwide judges are departing from the guideline range.

Chairman BIDEN. Now, when you say "depart," did you make a distinction of departing up or down?

Mr. ROSENZWEIG. These are downward departures. There were so few upward departures——

Chairman BIDEN. I just wanted to make sure I had the facts. That is all.

Mr. ROSENZWEIG. The data I am reporting are for downward departures, and I should add are exclusive of substantial assistance departures, which are the predominate method by which departures are found. A defendant provides substantial assistance to the Government and then the Government moves with for a departure from the guidelines. These are departures for other reasons, ranging from extraordinary circumstances to——

Chairman BIDEN. I understand. I just wanted to make sure I understood.

Mr. ROSENZWEIG. So, taken together, these two pieces of data say to me, at least, that when judges are exercising some form of discretion or choice, they are winding up not making too much of a distinction in the way that they exercise and the frequency with which they exercise discretion between white collar offenses and street crime, blue collar offenses.

So that brings me back to the converse point, which is that then the disparity in sentencing which remains that in the chart above that, it is quite clear robbery sentences, drug trafficking sentences are getting substantially longer mean and median sentences than environmental sentences or antitrust sentences.

Those must be the product of the operation of either statutory maximums or potentially the way the guidelines themselves are structured. I agree with Professor Bowman that the amendments from 2001 which are designed to alter the way we calculate loss may go some way toward changing that, and I agree as well that it is too early to tell.

The point I would add to the testimony of Mr. Skolnik is I agree that a large fraction of this is a lack of resources for these difficult cases. I am not so sure that it is necessarily that we are focusing exclusively on street crime. I think sometimes we are also mis-focusing our efforts within the white collar crime area.

Professor John Coffee has talked about the technicalization of criminal offenses, and therefore criminalization in areas which are more appropriately treated civilly. Plainly, the situations that we are discussing here today, the allegations against Enron, if proven, don't fit in that category. They are classic common law frauds that are and ought to be punished severely if indeed proven to be true. But part of it is that within this complex area, we sometimes misfocus the resources in areas where we are not being as effective.

I would urge this Subcommittee, if it could do one thing, to try and ask the Federal agencies responsible for criminal law enforcement to make a better effort at assessing their effectiveness, assessing whether or not their resources are being used productively in areas where, in fact, we are going to get the biggest bang for the buck.

To date, we don't try and measure that. We never try and draw a line between enforcement and increased regulatory compliance, for example. We count beans, we count numbers of prosecutions. As

I said in my written testimony, that would be as if the Metropolitan Police Department counted murder indictments without ever asking whether or not they are actually lowering the murder rate. That is our goal, that is everybody's goal, is to deter crime and lower the incidence of white collar crime.

I thank you for the opportunity to testify.

[The prepared statement of Mr. Rosenzweig appears as a submission for the record.]

Chairman BIDEN. Thank you very much. I think the last point you make is a very good point. In fact, we do that all the time. We have Texas talking about the number of death penalties without ever examining whether or not they have impacted at all on the murder rate, which they haven't. So it is always an issue.

I would like to begin with you, Mr. Rosenzweig. I agree with the bulk of what you had to say. I would like you to expand on what you did not spend enough time on because of trying to accommodate me, the distinction between—you touched on it, but I would like you to be more graphic, if you would—the distinction you make in your written statement between the type of white collar offenses, the white collar offense that is the one that basically is the Enron type, which, as you say, could be referred to as a definition of fraud by another name, and then the white collar offenses which you argue are quite different that involve prosecution for violation of rules and regulations that are part of a larger statutory structure.

Can you amplify on that a little bit?

Mr. ROSENZWEIG. Yes, I would be happy to. What I have in mind is a trend that has grown increasingly in the criminal law over roughly the last 50 years, in which we have seen basically a diminution of criminal standards of intent for some regulatory offenses and in increasing trend toward prosecuting what I would perceive as technical violations, to the detriment of looking at the more significant frauds.

Later in the testimony, I cited one example where some of this is actually quite frequent in Medicare fraud. There are plainly two types of Medicare fraud out there. There are instances plainly in which HMOs and individual doctors are deliberately lying about what services they are providing, taking Federal money as a result. When caught, they deserve, like any other thief, to be prosecuted in the same way.

Contrast that, however, with many doctors, some of whom are leaving the profession because of this, who are genuinely confused as to proper coding. There are literally 100,000 pages of Medicare regulations. The average doctor gets 35 pounds of them on his desk each year, in which he is supposed to code correctly.

The key, to my mind, to distinguishing between those lies in definitions of criminal intent. We have historically punished people with specific intent to do a wrongful act harshly, and they deserve such punishment. But, increasingly, we have adopted rules of construction that presume for small businessmen, doctors, knowledge of the regulatory environment. And they, either through ignorance, mistake——

Chairman BIDEN. Negligence.

Mr. ROSENZWEIG.—fail to come up to snuff. It is a bad use of our resources, first off, because the true frauds don't get prosecuted. I

think it also diminishes respect ultimately for the criminal law because we look at people who don't have that same degree of moral culpability and are deserving of punishment. Dr. Vargo is not one of those people.

Chairman BIDEN. I appreciate the distinction. I think it is worth keeping in mind.

I would like to ask all of you to respond now to the various questions I am going to ask. Each of you need not respond to every question, but you are welcome to if you like.

The professor just indicated that depending on which crimes we pursue and how we pursue them and what offenses we pursue, we either enhance or diminish respect for the law. I remember as a law student reading Jerome Frank's *Law and the Modern Mind* and this notion of a judicial myth and this idea that it matters that people think that the system is fair. It matters that people think that judges are totally objective. It matters when things occur intentionally or unintentionally that lead people to believe that neither exists, that it is neither fair nor that the judge is objective.

I think that applies here because the thing that you hear most often here stated, whether it is true or not—and I think the testimony of our last two witnesses indicates that the disparity, at least at the Federal level, is not nearly as extreme as it is perceived by the average person. Having held so many hearings over the years on criminal justice issues, how many times have we discussed this issue of prosecutorial discretion as it relates to plea bargaining?

What I would like to raise with you, particularly former and present prosecutors—and I would start with you, sir—is there any data that indicate that white collar prosecutions are either pled down considerably, allegations of white collar crime, either indictments or even failure to seek indictments are treated with any less diligence than drug-related crimes or crimes of violence or other economic crimes that the average person thinks of as non-white collar crime—burglary, robbery, et cetera.

Can anyone comment on that?

Mr. COMEY. Senator, I don't know if a data set exists on that, and I am sure we can check and get back to you, but it ought not to happen. Under a longstanding Department of Justice policy, the guidelines are supposed to be as restrictive for the prosecutor as for the judge.

As I have told my people, if you don't like the guidelines, that is too bad. They should channel your discretion because you can't fact-bargain and you can't charge-bargain. The Department of Justice policy since the so-called Thornburgh memo in 1989, which is still in force, is that you must charge the most serious readily provable offense and the plea must be to that offense, and all relevant conduct that is provable must be included in the sentence. So there shouldn't be any jacking around on the prosecutor's end, which is not to say it doesn't happen.

Chairman BIDEN. I understand. It is an important point.

Mr. Skolnik, you look like you wanted to respond.

Mr. SKOLNIK. I think the question is a very good one, Mr. Chairman. A lot of the data we seem to cite tends to be anecdotal and may or may not be accurate in looking at the big picture.

It is my impression at the State level that there are instances, and I can recall some from my own State, where prosecutors have been reluctant to take cases because of the significant burden that it would impose on them. When we are talking about county prosecutors in many smaller communities, their staffs are really not that large. Oftentimes, they even rely upon part-time deputy prosecutors.

So I think from an anecdotal standpoint, it is my perception that if a State securities commissioner brings a county prosecutor a rather complex, resource-intensive securities fraud case that you oftentimes will encounter some level of concern by the prosecutor and they probably are going to wish that you would take it someplace else, if not to the Federal level, maybe to a larger county.

Chairman BIDEN. Professor Bowman, you have been a State prosecutor and a Federal prosecutor and you know the Federal system well. I am not sure if the last panel or this panel indicated that, for good or for ill, sometimes we set a standard here. We raise the Sentencing Guidelines and it puts pressure on every State in the Nation to raise sentencing guidelines because people come along and say, well, look, if this were in Federal court, they would go to jail.

Sometimes, I have been responsible for that and it has had a positive effect and sometimes it has not been as positive an effect. I am sure it exists here, except the one place that I wonder about is—and I am going to get to the resource question in a minute and I would like you all to speak to that.

Since I have just begun this, I don't have enough data to make the kind of case I would ordinarily make or to make a judgment. My impression is that the allocation of resources at the Federal level, even though they may be disproportionately low to other allocations of resources in the criminal justice system—and that is arguable and I want to get to that issue in a moment—are considerably more than they are at the State level in most States.

Am I on the right track, Frank? Is that your experience, or do you have any evidence from your academic endeavors to support that?

Mr. BOWMAN. I have no data, Senator, but I think your observation is undoubtedly correct as a generality. As I indicated in my written testimony, I was a deputy district attorney in Denver for a number of years. In fact, I was for a while the only person in the office who was specifically dedicated to doing anything remotely related to white collar crime.

The basic attitude of my office and of the police department—and I am not criticizing this; it is just the culture that prevails—was that paper crimes aren't real crime; they are civil matters, regardless of the intent involved, and so forth and so on.

Some of that is cultural, and it is understandable when you are in an office where the bulk of your work is, and is perceived to be, response to crimes like murder and rape and robbery which have so much more emotional appeal. Part of that response has to do with a lack of expertise. Very few local prosecutors' offices have the expertise to engage in complex white collar prosecution.

Part of that is limitations on tax dollars that flow to them. Some of that probably is political in the sense that if you are an elected

district attorney, the mileage is in the high-profile murder case and probably in some relatively obscure group of financial crimes.

But for a lot of reasons, all of which I am sure you are very familiar with in your many years of work on this area, local prosecutors tend not to do this kind of work, and therefore it becomes particularly incumbent, in my view, on the Federal Government to take the lead because in most places and most times we are the only game in town.

For most local prosecutors, if they come across a big case and they really perceive that it has some criminal value, their instant reflex is to call the U.S. Attorney's Office and say this is your job, guys, you take it.

Chairman BIDEN. That is my experience. My son is a Federal prosecutor, although he was on the criminal side in Philadelphia, which is a gigantic office, as you know, Mr. Comey. The gentleman sitting behind me was a Federal prosecutor at the Justice Department for some extended period of time.

One of the things I would like to raise—and these are not accusations. I want to make that clear because this is a dangerous—I quite frankly wrestled with whether to have this hearing, in light of Enron and a lot of other things, because I want to be as sober about this as I possibly can, which I hope I have been on other matters relating to the criminal justice system. My impression is there is another factor.

I know, Professor, you may have wanted to comment on that last point, and if you will hold the thought, I just want to pursue this one piece.

One of the reasons why local law enforcement and local prosecutors may not proceed and assume that it is the Federal Government's job, and I raise this as a question—is in some States and localities, proceeding against the county's largest employer or proceeding against the county's most prominent citizen who has donated everything from the playground to the opera house, especially since it is an uncharted area and not knowing how to proceed very well, is a place people tend to not want to go, my instinct tells me.

I would like your opinions on that. Is there sort of a limiting aspect to the instinct to proceed at a local level or even at a State level? For example, I bring down frequently the lead Medicare fraud folks we have at the Justice Department. We have one of the best in Philadelphia, I mean really a first-rate team, and we have one in California and the Southern District. There are some that are particularly well-known and you use around the country. I actually bring them down to do seminars for local law enforcement and for senior communities as to what to look for.

There is not a lot of reluctance to go after Dr. Smith, who has billed falsely 3,000 mammograms or whatever. There is a reluctance to go after the xyz hospital, which is sometimes the biggest employer in a community, in a city, in a county. I wonder whether or not that plays. How would you guys factor this in?

The reason I bother to ask you this is I am not looking to indict local officials in any way, but figure out the resource allocation here. Should we be, for example, kind of like the crime bill, which you probably don't like—the Heritage Foundation, I mean—should

we be out there saying to local law enforcement and local prosecutors that at the Federal level, so not everything bubbles up to us, we will have an amendment to the crime bill—I am not suggesting one—to provide you "x" number of dollars to hire prosecutors to pursue white collar crime?

Or should we be saying to Main Justice we want to enhance your budget, so that we are going to increase the funding that provides you the ability to hire "x" number more prosecutors, investigators, accountants, and the various technical people you need in order to be able to pursue white collar crime?

That is why I am asking these questions, so you don't think it is just an exercise in futility here, to try to get the best sense of which way, if at all—and maybe we shouldn't be doing anything more; that is, we who sit up here in the Congress, in terms of either changing the penalties, changing the guidelines, changing the allocation of resources. So that is why I ask the question. Sorry for the long prelude.

So can you comment for me instinctively on what you think, based on your experience? We will start with you, Frank, and then I know, Professor, you had something you wanted to say, and anyone else who wants to respond. If you have no response, that is okay, too.

Mr. BOWMAN. Two quick observations. One, I think your instinct that, again, as a broad generalization and supported by no data and only my own personal experience—one way or another, I have been either an actual, full-time or special assistant U.S. Attorney in three different districts around the country, and I have been a deputy D.A. in Denver, and so forth and so on.

Based on my limited personal experience, I think your perception that local officials sometimes feel constrained to bring white collar and other types of cases, including, for example, public corruption, feel more constrained than perhaps their Federal counterparts might—I think that is, as a generalization, probably not at all unfair.

I think that Federal prosecutors sometimes see themselves—I certainly did—as sort of the force of last resort to deal with sometimes locally intractable problems. So I think that your instinct is certainly consistent with my experience, though I can't prove that that is true.

The second part of your question I take to be sort of from a resource perspective what would be the best thing to do if we had the money and the will to do it. My own sense is that certainly at the Federal level, the Federal effort would benefit from an increased allocation of resources.

There is always, of course, the problem with which you are certainly more familiar than I of making sure that money that is appropriated in Congress is spent for the purpose for which you wish it spent. But I think there are some models historically with respect to the Department of Justice in the white collar area to which you might look—the additional sums that were allocated in the wake of the savings and loan scandal, the additional sums that were allocated to beef up the health care fraud initiatives in the Department.

I am not familiar with the specifics of the legislation, but my understanding is that certain restrictions were placed on how the Department allocated those funds.

Chairman BIDEN. They were.

Mr. BOWMAN. That is obviously a model to which one could look, although in this particular case what we are talking about, it seems to me, is a somewhat broader question, white collar crime more generally, and how you would craft that legislation to get the money to the place you want it to go is beyond my competence.

Chairman BIDEN. That has never slowed up any Senator.

Mr. BOWMAN. The last suggestion you make is an interesting one which I had never thought of before, the notion of some sort of funding passing through the Department or some other entity to States.

Chairman BIDEN. We have done it clearly on the violent crime side of the equation. We have done it clearly in other areas, so it is not unique.

Mr. BOWMAN. It sounds like a tremendously intriguing idea, and thinking completely off the top of my head and spontaneously the only impediments perhaps that one might see are, at least in the violent crime area if you are giving local prosecutors more money, you are giving them more money to do something they already know how to do.

Chairman BIDEN. Correct.

Mr. BOWMAN. They know how to do it and they know how to train people to do it. If you give them more money to do something they don't know how to do, they may be a little bit more reluctant.

I also think that perhaps it may be difficult to give them sufficient funding to train and keep the kinds of people with the kinds of skills that you need to do this kind of crime and keep over the long term, because people who develop those kinds of skills become very valuable in the marketplace and may be easily drawn away from the relatively low-paid positions in local D.A.s' offices.

Chairman BIDEN. Let me give you all a statistic and invite you all to comment on that point, but just a statistic that relates. There were about five of us who held extensive hearings in different Committees during the late 1980s and 1990s about the extent of health care fraud, for example.

Depending on whose model you pick, it is somewhere well above $500 billion and as a high as $1.1 trillion. I mean, it is a lot of money, it is a lot of money. Some estimates indicate that the losses to fraud were as great as 10 percent of—let me be precise. I am sorry. In 1999, health care expenditures in the United States were $1.1 trillion. I misspoke.

The estimates are that about 10 percent of that expenditure was as a consequence of fraud. So we passed an Act that was called the Health Insurance Portability and Accountability Act, in 1996, which made funds available for more FBI agents and attorneys designated specifically to investigate and prosecute health care fraud cases. We thought this may be a place for savings because we are worried about Medicare costs.

As a consequence, the FBI, from 1996 on, increased the number of agents assigned to health care fraud from 112, in 1992, to 500 in 1999. The number of active health care fraud investigations in-

creased from 592 to over 3,000, and convictions increased from 116 to 548.

Now, while these numbers are impressive, we should obviously be cautious about how we interpret this data in terms of how it relates to other things. But I cite that to indicate what I know you know, Mr. Comey, and others that this is not the first time that this idea has crossed my mind about the possibilities of how to do this. I think it is more complicated here, but it is just something I wanted to raise with you.

Does anyone want to comment on anything that has been said so far? Mr. Skolnik?

Mr. SKOLNIK. Mr. Chairman, I would like to comment on the question you asked regarding the possible reluctance of local prosecutors or investigators to take on a case when it may involve a prominent citizen or a corporate citizen within their community.

It is my impression that local and state prosecutors or enforcement agencies are more apt to be constrained by a lack of resources than any local pressures in terms of why they don't bring a case. For example, I have always made it very clear to my staff that we don't shy away from a case just because it involves a prominent member of the community or a local corporate citizen. I think that is something generally law enforcement throughout the country does very well.

If I may differ with my fellow Hoosier here, Professor Bowman, I do believe that, if appropriately funded and provided adequate resources, local and state prosecutors and investigative agencies such as mine can do the job in terms of developing and investigating white collar crime cases.

Chairman BIDEN. I would connect the two comments you made and again invite comments on this. I would connect the lack of resources and the reluctance to go after the big fellow because you don't want to wound the bear. It is one thing if you go after somebody who is viewed as a charlatan in the community and is not responsible for the employment of a lot of people. And you are not sure you have the investigative tools to get the job done, but there is a tendency to be willing to start it.

But if you don't have the investigative tools and if you don't have the resources, you sure don't want to go after xyz corporation, where the corporate leadership sits on the board of the cathedral and the symphony or whatever. That is all I meant. I wasn't suggesting that I think local prosecutors or regulators sit and say, oh, my God, I don't want to take on xyz corporation.

I just think it is related to resources because like I said, you just don't want to miss. If you miss with somebody who already doesn't have much standing in the community, then the criticism to you and your department is much less severe than if you take on an entity that is a vaulted entity. That is all I meant. I wasn't going to motive about resolve or political courage.

Mr. Comey, you indicated and accurately stated that every U.S. Attorney's office sets guidelines that direct its attorneys' prosecutorial decisions. For example, in many instances these guidelines contain dollar amount limits that effectively discourage prosecution of economic crimes that result in dollar losses below a certain amount.

That is a legitimate thing for the Federal Government to do. I mean, we shouldn't be handling every nickel-and-dime crime. I am not suggesting that, but I want to make sure we know what we are talking about here. Let's say the dollar amount is $100,000.

Investigators take their cues from prosecutors' offices. If a case will not be prosecuted, you don't have the FBI or the local folks in that area investigating the case. So I am concerned about the type and the number of cases that, as a consequence of decisions not to prosecute, potentially fall through the cracks. It may be a case much bigger than $100,000, but if it just appears on the surface that that is the extent of the loss, the investigation that may uncover a greater cancer out there is not undertaken.

A $100,000 loss to the two people who were here in front of us today—granted, they are part of a larger whole, but a $100,000 loss to them is the beginning, middle, and end of their existence, in their view, but may not be significant enough to get us into the deal. It is these relatively smaller dollar amount frauds that are the most widespread out there. Hopefully, pray God, we will not find out that they are all of Enron proportion not in terms of guilt, but in terms of dollars.

So what happens in the cases that don't get the attention of federal prosecutors? Are they picked up by State prosecutors?

We always talk about it going one way. We on the Federal side, people like yourself and my staff members who were prosecutors and my son, talk about the local authorities coming to them saying, hey, look, this is a big deal, we need your heft here.

But how often do we go the other route? How often does, say, an FBI agent or an investigator come to a U.S. Attorney or an Assistant U.S. Attorney and say, look, I think we have got a scam going here and they are defrauding a whole lot of people, but is not prosecutable under our guidelines here? How often does somebody pick up the phone and call the district attorney, the county attorney, the county prosecutor, the State prosecutor?

Does the question make any sense here?

Mr. ROSENZWEIG. In my experience, when I was with the Department of Justice, it was a fairly common two-way street. I think, frankly, it will depend a great deal upon the particular relationships between a U.S. Attorney and a county prosecutor in various localities, which could easily turn on a whole host of factors that are utterly unrelated to the merits.

On a number of occasions that I found cases that didn't seem to warrant Federal concern, where I found there were still apparent violations of State and local law, both I and the investigators I worked with were happy to put them over.

Chairman BIDEN. Does anyone else have a view on that?

Mr. COMEY. Mr. Chairman, that is my experience, as well, both in a small U.S. Attorney's office and now in a very big one, that there are often cases moving in both directions. The Federal prosecutors need to be sensitive in doing it because they don't want their State colleagues to think that a smelly dog goes to the State and something that is significant goes to the feds.

Every good U.S. Attorney's office uses those guidelines as just that, guidelines. If the FBI says what you just said, which is there may be a lot of victims here and it may go farther, any AUSA

worth his stripes is going to take that case, regardless of what the loss amount looks to be on its face.

Chairman BIDEN. I have trespassed on your time a lot here. I promise you will be out of here by one, okay? It is ten of.

What about this notion of resources? Everyone I have ever spoken to comes back to a place where they say, hey, look, the more complicated the case, the greater the resources needed.

Look, let's face it. You guys have a problem right now and it is not of your doing. We are reallocating—and we should, no disagreement—a lot of investigative resources to terrorism. At the same time, if you are able to overcome the disagreement with the paradigm that the Federal Government should be involved in local law enforcement through a crime bill and through funding cops, et cetera, we are also cutting substantially, essentially eliminating, money for local law enforcement.

You are going to have fewer cops. You are going to have less money for Byrne grants. You are going to have less money for investigative tools on the law enforcement side; considerably less, I might add, about 80 percent fewer dollars, flowing from the Federal level directly to hiring of cops, et cetera.

At the same time as we pull 570 FBI agents, or whatever the number is, out of violent crime task forces, which your guys rely on a lot—I mean, they have been very helpful and you have done very well, in my view, at Justice—I think we have a resource problem that is further complicated by the plight our country faces now in dealing with terror and terrorism.

So I am a little concerned here—this is kind of above all of our pay grades here, but I am a little concerned that we continue to think we can do more with the same resources. That is the argument being made, by the way, today by many: We really don't have to increase the number of FBI agents, we don't have to increase the number of DEA agents, we don't have to increase the number of CIA agents; we just do it better and we are going to cover all of these areas.

So when you take whatever the number is, 500-plus, FBI investigators out of violent crime task forces and other areas—they are obviously not going to white collar crime and I am not arguing they shouldn't go to terrorism—and the FBI makes the judgment that we are not going to be in the business of dealing with local law enforcement issues as much as we did before—i.e., interstate car theft, bank robbery, et cetera, local issues—and we are not going to fund to the tune of well over $1 billion a year local law enforcement any longer, if that prevails, I think we have a problem sitting here talking about white collar crime resources.

Can my staff put up the number of white collar crime cases?

If you look at the number of white collar crime cases referred by the FBI since 1993, it has dropped from 21,000 to under 13,000. Now, that may be because there is a lot less white collar crime out there. My instinct tells me that is probably not true. I have no data to prove that is not true.

I see you looking as if that may be wrong.

Mr. BOWMAN. I don't know whether it is wrong or not. It strikes me as an odd graphic only because last night I was looking at the number of convictions reflected in Sentencing Commission data be-

tween 1992 and the present, and although the number hasn't gone up by a lot, it has gone up. So I think you have about maybe 2,000 more convictions in the year 2000 than you did in 1992 for crimes broadly under the economic crime rubric.

Chairman BIDEN. Well, it may very well be that with the 21,000 cases—this is what I am trying to get at here—the 21,000 cases referred in 1993 were so complex they couldn't make the case and they have gone down to 13,000 because now they are taking much less complex cases and increasing the allocation of resources available to focus on those cases and make the case.

Again, I ask staff, is there any doubt that this statistic is correct? And there is that old admonition that there are three kinds of lies—lies, damn lies, and statistics.

This statistic is correct, and the only explanation I could come up with because I am aware, also, that the number of convictions is up, is it is very possible that there is more cherry-picking going on here, that we are picking those cases that are easier to make, or are hard to make, but we have fewer resources focusing on them.

But the bottom line is either one of two things has happened—or three. The statistic is wrong, number one. Number two, the cases that were being referred were frivolous in 1993 and we are now down to a realistic area. Or, three, there has been a conscious decision to only refer cases that reach a certain threshold and allocate the resources to the cases that reach that threshold. There may be other explanations, but there needs to be an explanation, it seems to me.

Now, the percentage of offenders receiving probation in fiscal year 2000—again, we are talking the percentage receiving probation. We are not talking about those who got sentenced, whether the sentence they received is as disparate as the probation is.

But as I understand it—and this is at the Federal level, the Federal Sentencing Commission—1.5 percent, robbery; 5.2, immigration; 7.8, burglary; embezzlement, 41 percent; fraud, 33 percent; larceny, 56 percent. For larceny cases, for example, before the Federal Government, under the Sentencing Guidelines, 56 percent of them convicted of larceny got probation.

Now, again, I am not looking to make a case. I am looking to explain the circumstances because I am going back to this notion that if the public thinks that the system is not fair, that people who steal from them are not getting the same kind of time if they wear a white collar—and it is not necessarily all white collar, although most of it, I suspect is—are not getting the same treatment as somebody who burglarizes their home, then there is a bit of a problem.

Yes?

Mr. ROSENZWEIG. Well, I have the same data. First, in general, that is right. I think it is important to note that in defining the number of people who have gotten probation in the white collar area and in the non-white collar area, the data you present combines the number of people who get only probation with the number of people who get both probation and a term of confinement.

Chairman BIDEN. Important point.

Mr. ROSENZWEIG. So it slightly overstates in all six things the number of people who are receiving straight, pure probation.

Chairman BIDEN. The same standard was applied to all, though.

Mr. ROSENZWEIG. Yes, the same standards apply to all.

Chairman BIDEN. But it is an important point.

Mr. ROSENZWEIG. So as a gross number, it is a bit misleading as a gross percentage. The other point I would make is that I think this goes back to what I was testifying about earlier, which is from my perspective the real reason that there is a very low number in the non-white collar area is that the guidelines prohibit probation for most of those offenses and they make it available in a large number of white-collar offenses.

Chairman BIDEN. Which is the larger point. The other point here is that according to the 2000 Sourcebook for Federal Sentencing Statistics, the mean in terms of months for robbery is 108.1 months; for burglary, 26.5 months; auto theft, 46.6 months; larceny, 7.9 months; fraud, 13 months; embezzlement, 7.2 months.

So, again, the point Professor Rosenzweig was making: It may fall to us here and/or the guidelines, not to the judges, as to whether or not this discrepancy exists, to the extent that it exists.

What I am going to do, in the interest of keeping my commitment to you on time, is submit some questions to you, if I may, not a lot, to try to flesh this out a little bit more; that is, this notion is it really, in fact, appropriately balanced here.

Lastly, one of the things we didn't speak to and I would be interested in your comments on—and I will let you go with this—is you gave us mean numbers for the Nation nationally and the extent to which discrepancy exists. But if we look at the Federal fraud offenses from various districts, the districts vary widely.

Now, I don't know enough to tell you whether or not these fraud offenses vary so widely because the enormity of the offense varies widely. Do you follow me? I don't know enough to know that at this point. That may be part of it. Again, this is not to make a case; this is to raise a question.

For example, in Rhode Island, the average in terms of the number of months for Federal fraud convictions in 2000 was 12 months. In northern Indiana, it was 32 months. Again, we may be comparing apples and oranges. I would like to just take Rhode Island and Indiana, just those two jurisdictions, and I am going to ask my staff to go back and compare the type of fraud offenses and whether or not they are the same, on balance.

I will start with you, Mr. Comey, as the guy who has folks all over the country in every jurisdiction. Do you find that there is a difference, that the standards vary fairly considerably?

Mr. COMEY. In terms of intake of cases?

Chairman BIDEN. In terms of average prison terms for similar cases.

Mr. COMEY. My sense is that it does. It may be a number of people contributing to that, including the court. There are number of circuits in this country that depart at a much greater rate than my former circuit. For example, the Fourth Circuit; you don't get a downward departure in the Fourth Circuit.

But it may also, as you pointed out, Senator, depend upon the case mix. It may be that certain jurisdictions are responding to a rash of small embezzlements by tellers, and so there have been a

lot of fast-track bank cases. Indiana may have done a couple of huge cases and devoted their resources to that.

Chairman BIDEN. There are a number of reasons this departure could take place, and that is why I am going to submit these questions. The number of cases prosecuted in Rhode Island, for example, is only 18. The number of cases prosecuted in, for example, the Western District of New York was 48. Larger districts have larger budgets that enable them to have special task forces. The paucity of white collar crime and the predominance of other threats in certain districts.

So there are a lot of reasons, but I guess what I am trying to do here—and I hope it is obvious to you because I know this is a very serious panel—is trying to do this in a sober and thoughtful way so that we don't have a cure that is worse than the problem out there.

I am a cosponsor of S. 2010. I agree with you that it makes some good sense, but I think, if nothing else, one of the jobs that we should exercise here is to educate the public. If it turns out that there isn't this vast discrepancy as perceived, then we should let people know that, again because I think it is very important that there is this sense of the average person thinking the system is fair and the system treats people equally and equitably.

So this is just our first hearing. This is not going to be dragged out for any extended period of time, but I have to figure out where the inequities lie here, and in the process, if it turns out there is not this vast discrepancy, then make sure the public knows it and the press knows it so that we can reinstate some confidence in the system, and if there is a vast discrepancy, fix it.

I have some questions for my two colleagues from Indiana and West Virginia, who have positions of authority there, that I will put in writing relative to resources and whether or not you think there is any Federal role that we have here.

I also am going to ask you, Mr. Comey, some questions, obviously you will have to kick upstairs, about resources at Justice. And I am prepared to ask all of you this—I don't want to put work on you, but I would ask the two colleagues at the end of the table here, Mr. Bowman and Mr. Rosenzweig, about the notion of deterrence.

Again, the general impression most people have is a white collar criminal is usually deterred by their first offense, if they get jail. And the argument I have heard often, and I have heard prosecutors make it, is, hey, look, this person had standing in the community and the mere fact that they have been convicted is enough of a deterrence and they are never going to do it again, even though they don't go to jail, whereas you may have to put the guy who clunked somebody on the head and took their wallet in jail for a long time because he has done it three more times and the recidivism rate is so high. That is why we make the penalty higher.

So I have some questions drafted and I would like to talk about deterrence, recidivism, and severity of the punishment, and whether there is or should be a relationship. I am going to ask that to the Justice Department, as well.

I am sorry. It is eight minutes after, but I apologize. I am truly thankful that you all are here. You are first-rate panel, and with

your permission I may trespass on your time again before this is all over, if you are willing. Gentlemen, thank you very, very much.

There is a statement for the record by Senator Breaux, who is Chairman of the Special Committee on Aging. He has been engaged in issues that relate to the elderly population. I want that in the record.

Senator Grassley has a statement, as well, and some questions.

We also have statements by Senator Leahy and Senator Hatch. And they may, I warn you, have a few questions for you, but we are not going to try to make too much work for you.

We are adjourned.

[Whereupon, at 1:09 p.m., the Subcommittee was adjourned.]

[Questions and answers and submissions for the record follow.]

QUESTIONS AND ANSWERS

Response to Written Questions Following Hearing of June 19, 2002 Senate Judiciary Committee Subcommittee on Crime and Drugs

Frank O. Bowman, III
Indiana University School of Law – Indianapolis

QUESTIONS FROM SENATOR BIDEN

Question #1(1): What are the consequences of the lack of uniformity of penalties for federal economic crimes?

I am not sure that this lack of uniformity has much concrete, day-to-day consequence in the era of the Federal Sentencing Guidelines. Most criminal law scholars and interested observers of the federal criminal law agree that it would be desirable for Congress to perform a complete overhaul of the federal criminal code, streamlining its many overlapping provisions, providing uniform definitions of terms, and setting up a grading scale for offense severity such as that found in most state criminal law. Efforts to achieve such a recodification were made repeatedly and ultimately unsuccessfully throughout the 1970's and early 1980's. In the end, the substitute for recodification of the substantive federal criminal law was the creation of the Sentencing Commission with its mandate to create sentencing guidelines. At least in terms of criminal penalties, the Guidelines act as a de facto recodification of federal criminal law. In the current regime, the fact that statutory penalty ranges for federal economic crimes vary so widely means very little in practical fact because, within the ranges set by statute, the sentences actually imposed on defendants are determined by the application of the Guidelines. The Guidelines impose the consistency lacking in statutory law.

Question #1(2): Are there particular categories of economic crime cases that are "underpunished" – either as a consequence of gaps in the Sentencing Guidelines or because the underlying criminal statute imposes a maximum penalty that is comparatively too low?

There are two issues here. First, are there categories of bad economic behavior that are not presently crimes but which should be subject to criminal penalties under federal law? In other words, should Congress define some new economic crimes? Second, within the broad range of economic conduct that is (or might under pending legislation be) criminalized under federal law, are there categories that are underpunished?

On the first point, existing federal law is already quite broad. The mail and wire fraud statutes, 18 U.S.C. §§ 1341 and 1343, criminalize any "scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises" so long as such schemes involve a use of the mails or of an

interstate wire communication. Similarly thefts and frauds against federally insured banks and financial institutions are crimes punishable by 30 years in prison. 18 U.S.C. §§ 656 and 1344. Frauds against health care benefit programs are punishable by 20 years in prison. 18 U.S.C. § 1347. Fraud against the U.S. government is punishable under numerous statutes. *See, e.g.*, 18 U.S.C. § 371. Credit card fraud is separately punishable. 15 U.S.C. § 1644. Securities fraud is a serious federal crime. And false statements to government investigators or entities are also criminal under 18 U.S.C. § 1001.

As a former federal fraud prosecutor, my impression is that few, if any, forms of serious fraudulent activity are beyond the reach of current federal criminal law. The mail and wire fraud statutes alone are sufficiently flexible to reach virtually any serious fraud. That said, I see no powerful objection to provisions such as those in Senator Leahy's bill (S. 2010, now incorporated by amendment into S. 2673) that create new offenses for types of conduct not explicitly addressed under other more general provisions. For example even if records destruction of the sort covered by the Leahy proposal might in many instances be covered by a broad interpretation of other provisions of federal law, it is both helpful to judges and prosecutors and fairer to prospective defendants to have the reach of federal law in such cases set out in plain, specific statutory language.

The second point relating to possible underpunishment of those who commit a federal economic crime has two aspects:

(a) One might say that a crime is "underpunished" because the statute provides an insufficient maximum penalty, thus precluding a sentencing judge from imposing a sentence of appropriate length. In economic crime cases, this is virtually never a problem under existing law. Even though the statutory maximum sentence for a single count of, say, mail or wire fraud may be only five years, the apparent limitation on judicial sentencing authority is illusory. Any serious theft or fraud will be chargeable in multiple counts. Indeed most serious frauds could theoretically be charged in dozens, hundreds, or even thousands of counts because every mailing or wire communication in furtherance of the fraud is a separate count. The maximum possible sentence in a multiple-count conviction is the sum of the statutory maximum sentences for all counts of conviction. Therefore, the government has more than adequate discretion to structure both indictments and plea agreements to achieve appropriate sentence severity. Thus, the provisions in both the House and Senate accounting reform bills that raise statutory maximum sentences for various economic offenses are of symbolic importance, but will effect no change in actual criminal sentences for economic offenders.

(b) In the era of sentencing guidelines, changing the actual sentences imposed on convicted defendants requires changing the Guidelines (or passing a statutory minimum mandatory sentence). As I explained in my June 19, 2002 testimony, I see no reason to increase white collar guidelines generally, but some reason to consider specific guideline amendments addressing

particular offense characteristics that may under current law be unaddressed or underpunished.

As a general matter, Congress probably acts wisely when it gives the Commission only general directives regarding specific sentencing factors. The Commission was created not only to create a set of guidelines in the first instance, but also to study the operation of those guidelines and to act as the principal drafting entity for guideline changes (while reserving to Congress the final authority to ratify or reject changes). The Commission is the entity best suited to convert legitimate congressional concern over white collar, securities, and accounting fraud into guidelines language.

That said, Congress might profitably consider directing the Commission to consider specific enhancements for the particular types of conduct that have given rise to the current focus on white collar crime. For example, the provision in the Leahy amendment directing the Commission to consider an enhancement "for a fraud offense that endangers the solvency or financial security of a substantial number of victims" seems particularly germane to the harms at issue in the Enron case.

Similarly, the Judiciary Committee might invite comment about the usefulness of a sentencing enhancement for a defendant whose criminal conduct causes or significantly contributes to the bankruptcy or significant devaluation of a publicly traded corporation. I express no opinion on whether such an enhancement would be appropriate, or if so, how it should be worded. However, such an enhancement would be narrowly targeted at the type and degree of conduct now exciting national concern, and it would be analogous to an existing enhancement for "substantially jeopardiz[ing] the safety and soundness of a financial institution." U.S.S.G. § 2B1.1(b)(6) (2001).

In general, I am suggesting that the Judiciary Committee and the Congress avoid sweeping with too broad a brush. Rather, Congress should consider carefully the particular characteristic(s) of current corporate wrongdoing that it considers either new or especially worthy of punishment and, after appropriate hearings and consultation, Congress should direct the Commission to consider whether enhancements for such characteristic(s) would promote the general purposes and objectives of sentencing.

Question #2: Regarding health care fraud

I am not an expert on health care fraud or its prosecution and therefore do not feel comfortable in providing detailed answers to your particular questions. The only observation I can offer is my personal experience as a former Assistant U.S. Attorney. Beginning in the early 1990's when Congress first began placing increased emphasis on health care fraud prevention and prosecution, the addition of targeted investigative and

prosecutorial resources did produce a marked increase in focus on health care fraud cases in the FBI and the Department of Justice. More detailed lessons from this experience could doubtless be suggested by current and former DOJ personnel with more intimate knowledge of health care fraud work.

Question #3(1): To what extent does our penalty structure consider non-economic costs to victims and society in sentencing white collar criminals?

The current sentencing structure takes account of some non-economic effects on victims in three ways: First, there are some specific sentencing provisions that provide upward adjustments or the possibility of an upward departure in the presence of particular facts. For example, Chapter 3A of the Guidelines contains a variety of victim-related adjustments. Likewise, certain frauds against charitable institutions receive a 2-level increase. U.S.S.G. §2B1.1(b)(7)(A). Second, the current economic crime guideline contains an encouraged departure for offenses that "caused or risked substantial non-monetary harm." U.S.S.G. 2B1.1 app. note 15(A)(ii). Third, we often forget that the result of a guidelines calculation is not a particular sentence, but a range of months within which the judge will set the final sentence. The top of the range is, on average, 25% higher than the bottom. A judge has virtually unchecked discretion to sentence a defendant anywhere in the guideline range. Non-economic considerations relating to victim harm are plainly among the factors that judges consider in setting sentences within the range.

The second and third considerations mentioned above should not be lightly discounted. Not all factors relating to sentencing can be easily translated into definitions or quantities suitable for creating a guidelines enhancement. The very real, but highly variable, non-economic effects to which you allude may be such factors. Moreover, we need to give judges some credit and some authority. The guidelines are a useful innovation insofar as they guide and channel judicial sentencing discretion, but unless we leave some sentencing considerations undefined the important discretionary function of judges will be eliminated from sentencing.

Question #3(2): Ought we to give more consideration to non-economic factors in sentencing economic crimes?

As my previous answer may suggest, I think the Guidelines do account for some non-economic considerations. Whether current are provisions are adequate is, of course, debatable. Nonetheless, for the reasons proffered in my previous answer, I would be cautious about trying to create specific guidelines factors for non-economic considerations beyond those already in the Guidelines.

[Answers to questions from Senator Grassley will be provided in a separate document.]

Response to Written Questions
Following Hearing of June 19, 2002
Senate Judiciary Committee
Subcommittee on Crime and Drugs

Frank O. Bowman, III
Indiana University School of Law – Indianapolis

QUESTIONS FROM SENATOR GRASSLEY

Question # 1: *Why is the comparison between the length of drug sentences and white collar sentences not particularly useful in determining the proper length of sentence for either category of crime?*

I am not suggesting that the marked differential between average economic crime sentences and average drug sentences is irrelevant to the question of proper sentence levels for these crimes. What I would caution against is drawing any easy lesson from the differential.

Those who view drug sentences as too high tend to use the lower sentencing levels for economic crime as a talking point for reducing drug penalties. Their argument usually sounds something like this: "Under federal law, a nineteen-year-old African American kid caught selling five grams of crack gets five years in prison, while a middle-aged white banker who embezzles $250,000 gets half that sentence.[1] Therefore, since selling a small amount of drugs is far less blameworthy than the breach of trust inherent in the banker's embezzlement, drug sentences should be lowered." By interesting contrast, those who would raise white collar sentences say virtually the same thing – they agree that the embezzler is as or more culpable than the drug dealer, but their solution is to increase the white collar offender's sentence to something approaching parity with the drug dealer's sentence. The fact that both drug-sentence-lowerers and white-collar-sentence-raisers seize on the same comparison as a rhetorical device – and find it effective in policy debates – is important because it suggests that most people hearing the comparison feel intuitively that there is something wrong with a penalty structure that produces this result.

The difficulty of course is that an intuitive sense that at least some drug sentences are too high relative to at least some economic crime sentences doesn't help you very much in devising particular policy prescriptions to fix the perceived problem. First and foremost, observation of a disparity does not tell us whether the solution is to raise

[1] Without going through all the guidelines calculations in detail, this comparison is roughly accurate. Possession or sale of five grams of crack triggers a mandatory minimum five -year sentence. And under current guidelines, a banker who embezzled or misappropriated $250,000 in bank funds would probably receive a sentence somewhere between two and three years if he pleaded guilty and was not subject to one of a number of special aggravating factors.

economic crime sentences or to lower drug sentences. To make that determination requires that we decide whether it is drug sentences that are too high or economic crime sentences that are too low, or alternatively whether both need to be adjusted.[2] And this determination in turn requires a judgment about whether drug sentences or economic crimes sentences (or perhaps neither) are currently about right.

Neither the sentence-raisers or the sentence-lowerers customarily offer any standard for determining how one would identify an appropriate, just, efficacious range of sentences for either type of crime. This decision is more complicated than the 5-gram-crack-dealer vs. embezzling banker comparison would suggest. Both those who would raise economic crime sentences and those who would lower drug sentences support their preferred outcome by comparing the most low-level, sympathetic drug criminal subject to the most controversial mandatory minimum provision in federal drug law to a white collar offender with a loss amount carefully chosen to generate a guideline sentence less than five years. It serves the rhetorical interests of both drug-sentence-lowerers and white-collar-sentence-raisers to compare caricatures in this way, but the comparison obscures all sorts of complexities.

For example, if one raises the loss amount of the hypothetical embezzler to a figure over $1 million, or if one assumes that the banker's crimes endangered the solvency of his bank, then his sentence would likely exceed five years, perhaps by quite a lot. Similarly, as I pointed out in my June 19, 2002 testimony, if cases like Enron or WorldCom involve criminality, the loss figures involved in those cases would generate sentences in the 20-year range. It is somewhat difficult to argue that sentences at this level are "too low." Moreover, the majority of "economic criminals" sentenced under federal law are low-level thieves of a few thousand dollars, and not rich embezzling bankers or dishonest CEO's. Likewise, only a relative few federal drug defendants are misguided minority youths caught with minimal quantities of crack. A great many federal drug defendants are greedy, violent, predatory, and rich. The point is that, even if one can show that some undesirable disparities exist between some pairs of economic and drug criminals, that does not necessarily establish that all drug sentences are too high relative to economic crime sentences or that all economic crimes sentences are too low relative to drug sentences.

I do not suggest that the problem of deciding whether to raise or lower economic or drug crime sentences is insoluble. After all, making these sorts of imperfect, value-laden choices is what Congress does, and in the criminal law context, this is precisely the task for which the Sentencing Commission was created to aid Congress. My point is merely

[2] My own view is that, overall, drug sentences are probably somewhat higher than necessary to achieve the utilitarian sentencing objective of crime prevention. There is some good evidence that the front-line sentencing actors in the federal criminal system share this view and have given effect to it by gradually lowering the average sentence imposed on drug offenders during the period 1992-2000. *See* Frank O. Bowman, III and Michael Heise, *Quiet Rebellion II: An Empirical Analysis of Declining Federal Sentences Including Data From the District Level*, 87 IOWA L.R. 477 (2002); Frank O. Bowman, III and Michael Heise, *Quiet Rebellion? Explaining Nearly a Decade of Declining Federal Drug Sentences,* 86 IOWA L.R. 1043 (2001).

that the existence of a perception of unjust sentence disparity between some drug defendants and some white collar defendants is only the beginning of the process of deciding what, if anything, to do about that disparity.

Question #2: *Which white collar criminal activities are currently underpunished?*

See my response to Senator Biden's Question 1, part 2.

Question # 3: *Should Congress appropriate more money for investigation and prosecution of white collar offenses or can the number and quality of such prosecutions be increased through better training and application of technology?*

I have no doubt that better training and technology would assist any law enforcement effort. Certainly, in my time as a white collar prosecutor in Miami, it seemed to me that we were behind the curve in the use of information storage and retrieval technology in complex cases. However, I have been out of the Department of Justice for over six years and lack any accurate sense of the state of training or of technology usage among white collar investigators and prosecutors.

That said, I do not believe that any significant new initiative in white collar investigation and prosecution will be successful unless Congress is prepared to commit significant financial resources to the effort. For example, if Congress wants those engaging in securities and accounting fraud detected and prosecuted, then Congress should be prepared to increase substantially the staff of the SEC and those components of the Department of Justice that prosecute such cases criminally. Similarly, no initiative against white collar crime generally is likely to be successful unless Congress allocates, and specifically dedicates, additional funding to the Justice Department and the FBI for that particular purpose. Increasing criminal penalties to a jillion years per count will accomplish nothing unless white collar crimes are investigated, detected, and prosecuted to conviction. That takes money.

Question #4: *Re: information sharing among federal agencies and between state and federal agencies.*

I agree that increased information sharing is desirable. I have insufficient knowledge to comment on specific ways in which information sharing could be improved.

U. S. Department of Justice

Office of Legislative Affairs

Office of the Assistant Attorney General

Washington, D.C. 20530

November 26, 2002

The Honorable Patrick J. Leahy
Chairman
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are responses to written questions from Committee members following the Judiciary Committee's Subcommittee on Crime and Drugs hearing entitled, "Penalties for White Collar Crime Offenses: Are We Really Getting Tough on Crime?" This hearing was held on June 19, 2002. We hope our responses are helpful.

If we may be of additional assistance, please do not hesitate to call upon us. The Office of Management and Budget has advised that there is no objection from the standpoint of the Administration's program to the presentation of this material.

Sincerely,

Daniel J. Bryant
Assistant Attorney General

Enclosure

cc: The Honorable Orrin G. Hatch
Ranking Minority Member

RESPONSES TO QUESTIONS SUBMITTED BY MEMBERS OF THE COMMITTEE

Question 1. Statutory Maximum Penalties For Economic Crimes

1. What are the consequences, if any, of this lack of uniformity?

In theory, the lack of uniformity in statutory maximum sentences can result in a wide variation in potential sentences, depending on the statute under which an individual is prosecuted rather than the seriousness of the offense. However, the Sentencing Guidelines are intended to reduce or eliminate most of these theoretical variations, and generally accomplish that goal in practice.

Recently-enacted criminal statutes tend to have longer statutory maximum penalties, while statutes enacted long ago, which address offenses of equal or greater seriousness, may have lower statutory maximum penalties that have not been updated to reflect contemporary views on the seriousness of the conduct. Uniformity in statutory penalties sends a clear message concerning the seriousness with which the offenses are viewed, potentially leading to greater deterrence. More uniform, longer, statutory sentences insure that the statutory maximum penalties do not restrict or act as a cap on the applicable sentencing guidelines; *i.e.* preventing the statutory maximum from falling below the guideline penalty which would otherwise be imposed for the offense.

In instances where statutory maximums differ for crimes of similar gravity, the Sentencing Commission has grouped similar statutory offenses into categories which are treated in a more uniform fashion, without strict correlation to the varying maximum statutory penalties of the individual offenses assigned to each group. As a case in point, the Sentencing Commission has crafted sentencing guidelines for economic crimes, irrespective of the fraud-related statutory charge and the statutory maximums, based on the approximate amount of financial harm (while allowing for appropriate upward and downward adjustments for other factors that may be pertinent in particular cases). Thus, while many financial institution fraud offenses (*e.g.*, financial institution fraud under 18 U.S.C. § 1344, and mail fraud affecting a financial institution under 18 U.S.C. § 1341) carry a 30-year statutory maximum, the recently-revised fraud guidelines, as reflected in USSG §2B1.1(b), treat the loss from a financial institution fraud no differently from the loss from a telemarketing fraud scheme. At the same time, section 2B1.1 of the guidelines contains separate enhancements suited to each of those types of offenses (e.g., the two-level increase under section 2B1.1(b)(2)(A)(ii) for the use of mass-marketing, and the four-level increase under section 2B1.1(b)(12)(B) for substantially jeopardizing the safety and soundness of a financial institution).

2. While a blanket increase in penalties may not be justified, are there categories of cases that are "underpunished" – either as a consequence of gaps in the Sentencing Guidelines or because the underlying criminal statute imposes a maximum penalty that is comparatively too low?

One of the top priorities of this Administration is ensuring that corporate "white collar" criminals serve jail time rather than receive probation or some other alternative to incarceration. We believe that the likelihood of imprisonment for business crimes and other types of fraud serves as a significant deterrent. We are pleased that major steps have been taken in recent months towards strengthening penalties for white collar crimes, although there remains much work to do. In early 2001, the Sentencing Commission adopted an "economic crime package." These guidelines amendments, which became effective November 1, 2001, significantly increased the punishment for high-loss fraud cases. However, these amendments reduced penalties for fraud cases involving less than $70,000. Under the revised guidelines, defendants who have embezzled or otherwise obtained by fraud relatively "small" amounts (*e.g.*, less than $70,000) are not likely to receive incarceration under U.S.S.G. §2B1.1, at least insofar as they are first-time offenders or have a minimal criminal history, as is the case with most white-collar offenders. We believe that the guidelines should be further revised to increase the probability that defendants responsible for relatively "small" frauds – which nonetheless cause significant harm to victims – will be imprisoned. The recently-enacted Sarbanes-Oxley Act of 2002 directs the Commission to re-examine various parts of the guidelines pertaining to "white collar" crimes, including fraud, and determine whether the sentences dictated under the guidelines are sufficiently strict given the increased maximum penalties and other provisions of the Sarbanes-Oxley Act. At the express direction of the Attorney General, the Department has been actively working with the Commission in this effort; we have recently provided the Commission with our detailed recommendations as to how the guidelines can be improved to reflect the priorities of Congress and the President which were incorporated in the Sarbanes-Oxley Act.

Another category of cases that we believe may be "underpunished" is identity theft, where the actual dollar amount of loss may not reflect the overall harm that is caused. Although identity theft is integral to many types of fraud, and to other crimes such as terrorism, identity theft cases tend to be "underpunished," because they do not necessarily involve direct financial losses by defrauded persons, but may involve significant hardships for the identity theft victims who must try to repair the damage that the criminal may have caused to their financial standing, security and reputation. This is one of the reasons that the Department of Justice is supporting S. 2541, introduced by Senator Feinstein in May. That bill would establish a separate offense of aggravated identity theft, for which an additional two years imprisonment would be imposed (or five years imprisonment for certain terrorism-related offenses) where identity theft was involved. S. 2541 would also broaden the identity theft offense, 18 U.S.C. § 1028(a)(7), by prohibiting not just the transfer or use of another's identity information, but also possession of such information in conjunction with the requisite criminal intent. In addition, the maximum penalties for identity theft would be increased and an even higher maximum penalty would result for identity theft used to facilitate acts of domestic terrorism.

Question #2. Penalties for Pension Fraud

1. Do you think that Congress needs to revisit some of these penalties? Specifically, should the criminal penalties for ERISA violations be raised (even if there may be

cases when other federal white collar felony statutes may be available)?

The Department of Justice believes that in general, the penalties authorized for criminal abuse of employee pension plans, pursuant to statute and (accordingly) under the Sentencing Guidelines, should be more severe. Under the relevant statutes, including embezzlement (18 U.S.C. § 664), false statements in required records, reports, and other documents (18 U.S.C. § 1027), and bribery and graft (18 U.S.C. § 1954) involving employee pension benefit plans covered by ERISA, the maximum imprisonment is 5 years for embezzlement and false document offenses and 3 years for bribery or graft payments. We are reviewing these statutes to determine whether legislative revision of these penalties would be appropriate, and we look forward to sharing with the Committee any recommendations we may make in this regard.

We note that since this hearing occurred, the Sarbanes-Oxley Act became law, and made some important changes to statutory maximum penalties in the ERISA area. Section 904 of the Sarbanes-Oxley Act amended the crime punishing the willful failure to file reports and keep records required by ERISA by elevating the offense from a misdemeanor, punishable by imprisonment not to exceed a term of 1 year, to a felony punishable by a period of imprisonment up to 10 years. ERISA, section 501, 29 U.S.C. § 1131 (hereafter "section 1131") . The intention of the amendment's congressional sponsors was to increase the penalties for the criminal depletion of employee pension benefit plans subject to ERISA, as contrasted with reporting and disclosure crimes. See remarks of Senators Biden and Hatch at Cong. Record S6546 (daily ed. July 10, 2002). We agree with that goal.

Under existing sentencing guidelines, a theft by a first offender, even by a non-fiduciary, of more than $1 million from an employee pension or welfare (health) benefit plan serving a "large number of persons" results in a sentencing range of 51 to 63 months of imprisonment. See Application Notes 1 and 9 at U.S.S.G. § 2B1.1(b)(12)(A) (2001) . Under existing law that range meets and exceeds the maximum authorized sentence of imprisonment (60 months) permitted by 18 U.S.C. § 664 or the false statement offense at 18 U.S.C. § 1027. For example, in United States v. Krimsky, 230 F.3d 855 (6th Cir. 2001), the defendant, an employer and plan trustee, was convicted of embezzling $2 million from his employees' pension plan in violation of 18 U.S.C. § 664 and falsifying reports filed under ERISA in violation of 18 U.S.C. § 1027. Although the sentencing guideline offense level was calculated at level 26, resulting in a guideline range of 63-78 months' imprisonment, the defendant's sentence of imprisonment was capped at the statutory maximum of 60 months' imprisonment. Id. at 858.

The offense level under the sentencing guidelines for a bribery or gratuity offense in violation of 18 U.S.C. § 1954 is increased on the basis of the value of the prohibited payment, or the value of the improper benefit to the payer, whichever is the greater value. U.S.S.G. § 2E5.1(b)(2). The enhancement has little deterrent effect where the amount of a pension-welfare bribe, or resulting benefit, for a first time offender exceeds approximately $120,000 because the statutory maximum sentence of 36 months' imprisonment may not be exceeded. See U.S.S.G. § 2E5.1(a)(1) (bribery base offense of 10) and § 2B1.1(b)(1) (table for value of bribe or resulting benefit).

2. Do you think that the 5-year maximum term of imprisonment for violations of statutes most often used in pension fraud cases is enough?

In general, no; as mentioned, the Department is undertaking a review of whether further legislative action is necessary. Again, Section 903 of the Sarbanes-Oxley Act increased the maximum penalty of imprisonment for mail and wire fraud (18 U.S.C. § 1341 and § 1343) from 5 to 20 years' imprisonment; however, not all schemes to deplete employee benefit plans can be shown to have used the mails, interstate wire transmission or commercial carriers in furtherance of the scheme as required by the mail or wire fraud statutes. See United States v. LaBarbara, 129 F.3d 81, 85 (2d Cir. 1997) (reversing mail fraud conviction of employee benefit plan trustee because government's evidence was insufficient to negate the possibility of hand-delivered documents in furtherance of the fraud scheme).

3. Do you think that the five-year maximum term of imprisonment for violations of statutes most often used in pension fraud cases is enough?

See previous responses.

4. The current penalty for both conspiracy (18 U.S.C. § 371) and mail and wire fraud (18 U.S.C. § 1341 and 1343) is only 5 years. Do you agree that Congress should consider raising those penalties to at least 10 years?

Section 902 of the Sarbanes-Oxley Act increased the penalty for conspiracy to violate any statute in chapter 63 of Title 18, United States Code, to the same penalty prescribed for the substantive offense within chapter 63. Moreover, as noted above, section 903 of the Sarbanes-Oxley Act increased the penalties for violations of the mail and wire fraud statutes. As mentioned, the Department is working with the Sentencing Commission to craft appropriate guidelines revisions to ensure that applicable penalties are commensurate with the Act's increased maximum penalties for these crimes involving fraud.

Question #3. White Collar Crime Investigations

1. Please elaborate on the difficulty of investigating these sorts of crimes. Specifically, what is it about investigating investment fraud that is different from (and more complex than) a murder investigation?

Although there may be some murder investigations which approach the complexity of investment and other white collar fraud investigations, these fraud cases can routinely present far more complex investigative challenges. After all, the heart of such fraud is typically concealment, deception and the insulation of the ill-gotten gains from detection and forfeiture. The typical white collar criminal is smarter, cagier, and more calculating than the typical homicide defendant. The victims of the fraud may in fact be so successfully deceived, that they

may write off losses as a consequence of the "risk" in the marketplace without realizing they have been swindled, thereby delaying initiation of an investigation.

White collar investigations are also difficult because of the volume of documentary evidence that investigators and prosecutors must review, including often tremendous numbers of electronic communications. Because of this volume of documentary evidence, there is also a great risk of shredding and/or falsification of documents and records by examiners, auditors and regulators, for example. And the flow of large sums of money, often going back many years, must be tracked and reconstructed.

In many white-collar crimes, the defendants may try to argue that they operated in good faith and simply were inartful or poor businesspeople rather than deliberate criminals. As a result, agents and investigators may require hundreds, even thousands, of hours amassing evidence that will allow a jury to infer that the defendants had the requisite specific intent to defraud and were not acting in good faith. In addition, where there is no readily available record of defrauded investors (*e.g.*, brokers' lists of people who purchased a publicly traded stock that was the vehicle for a "pump and dump" scheme), individual investors may be too embarrassed about their losses to report the fraud to law enforcement authorities. The longer individual victims take to report the crime to authorities, or agents take to find additional victims, the longer it may take for investigators to understand the true scope and extent of the scheme if at all and to amass the necessary proof of the fraudulent nature of that scheme.

In addition, many business fraud investigations become world-wide investigative undertakings. Even with the refinement of many "Mutual Legal Assistance Treaties," attempts to extract needed financial and documentary evidence from foreign jurisdictions is time consuming and not always successful. Further, there still remain some foreign jurisdictions from which such evidence cannot yet be obtained. Transactions and assets may be dispersed among hundreds of shell corporations in multiple jurisdictions, all of which must be identified, analyzed and fitted into the larger investigative puzzle. Complex legal proceedings may be required to repatriate assets concealed overseas. Finally, in addition to these investigative challenges, it is also difficult to interview corporate employees who may have been witnesses to the fraud. For example, when corporate fraud is involved, the Department often finds it difficult to interview corporate employees in an expeditious manner because counsel for the corporation demands the right to be present at all interviews.

2. What are the most striking impediments to effective investigation of these crimes?

The Sarbanes-Oxley Act addresses the need for whistleblower protection. However, because of the McDade Amendment (28 U.S.C. § 530B), federal law enforcement authorities may not be able to communicate directly with whistleblowers. Section 530B subjects federal prosecutors to the ethical and professional standards established by state bar associations with which they are affiliated. While the Department of Justice appreciates the need for the highest

ethical standards, and has internal mechanisms to ensure that its attorneys and investigators comply with them, some state bar associations have provisions regarding impermissible contacts with represented persons, which impede swift and efficient investigations in those instances in which a lawyer claims to represent all employees of a target of an investigation.

Two previously mentioned factors are the time required to amass evidence to prove specific intent, and the delay in self-reporting by fraud victims. While the Department and other federal agencies are more than willing to draw on the resources of complaint databases such as the FTC's Consumer Sentinel and the Internet Fraud Complaint Center, delays by fraud victims in filing complaints tends to mean delays in the successful investigation of those frauds. Other previously mentioned factors include the delays inherent in conducting investigations in multiple jurisdictions and foreign jurisdictions.

3. The Washington Post .... With that in mind, to what extent would the investigative process be served by expanding the number of investigators available and trained to handle white-collar crime like investment and securities fraud?

The Department strongly supports expansion of training for investigators at all levels of law enforcement to handle investment and securities fraud cases. Organizations such as the National Advocacy Center, which provides basic- and advanced-level training on various white-collar crime topics for federal, state, and local prosecutors, and the National White Collar Crime Center, and the FBI Training Center in Quantico, Virginia, which provide training for federal, state and local law enforcement authorities, need to continue to develop and present courses that will equip law enforcement with the necessary tools to investigate securities, accounting, and investment fraud cases more effectively. As appropriate, through the development of federal, state, and local, inter-agency task forces, the Department will succeed in multiplying the resources brought to bear on detecting and prosecuting these crimes.

Question 4. White Collar Crime Referrals

1. To what do you attribute this steady drop in the number of white collar crime referrals, especially in light of data that suggest white collar crime is actually increasing?

2. To what extent do the declining FBI referrals reflect signals from federal prosecutors about the type (including dollar amount) of cases they pursue? In other words, if investigators know prosecutors will not pursue certain charges (for whatever reason), they are less motivated to investigate and refer these cases.

The Department's efforts against corporate fraud have been aggressive. Since the beginning of this Administration, we have initiated 454 corporate fraud investigations, have obtained criminal charges against 573 defendants, and have obtained 242 convictions or pending pleas. On July 9, 2002, the President created the Corporate Fraud Task Force, led by Deputy

Attorney General Larry Thompson. Since then, we have initiated 119 corporate fraud investigations, have obtained criminal charges against 183 defendants, and have obtained 46 convictions or pending pleas.

We therefore disagree that there has been an overall decrease in the number of white collar cases being prosecuted and defendants being convicted during the past two years, apart from a temporary "dip" resulting from a reorganization of priorities in the wake of September 11.

The term "referrals" as used in this question appears to include more than just fully-investigated cases "referred" to the United States Attorney's Office for prosecution. The Executive Office of United States Attorneys has been working with the FBI to further refine the definitions used in reporting matters originally opened for investigation and fully-investigated matters referred for prosecution. We do not believe that the Department has declined to prosecute any significant number of meritorious white collar cases referred for prosecution. In fact, in terms of matters opened by the Department of Justice, in FY 2001 the number of matters opened in connection with white collar crime cases (12,792) was consistent with prior years (e.g., 12,812 in FY 2000 and 12,654 in FY 1999). It is true that there has been some decrease in white collar prosecutions since September 11, 2001, a trend due primarily to the shift in resources to terrorism-related cases. Some of these resources have been redirected back to white collar cases in the past several months.

In addition, data from the U.S. Sentencing Commission, the Administrative Office of U.S. Courts, and the Department of Justice all show, however, that the number of fraud convictions has been steadily increasing since FY 1990. For example, according to the Commission, in FY 2000 there were nearly 6,300 fraud defendants sentenced in the federal system compared to approximately 4,500 in 1994. (Between 1997 and 1998, there was a small spike in the number of fraud convictions, which may be attributed to the termination of various cases filed by the Financial Institution Task Forces, such as the New England Bank Fraud Task Force, which implemented the Department's Financial Institution Fraud Enforcement Strategy in the mid-1990s.)

Fraud Defendants Sentenced by Fiscal Year

US Sentencing Commission Data		US Courts Data
Fiscal Year	Defendants Sentenced	Defendants Sentenced (Includes Tax Offenses)
2001	Not Available	9,490
2000	6,286	9,416
1999	6,199	9,618
1998	6,330	9,576
1997	6,929	9,908

1996	6,028	8,891
1995	5,909	8,256
1994	5,697	8,174
1993	5,602	8,511
1992	4,490	7,824
1991	3,452	------
1990	2,730	7,800

Question 5. Prosecutorial Charging Decisions

1. For the record, can you outline for us how decisions about the charges a prosecutor will bring may affect the need for a trial and the ultimate sentence?

Long-standing Departmental policy generally has required prosecutors to bring the most serious, readily provable charges. In fraud cases, pursuant to U.S.S.G. §2B1.1, sentences are based upon the loss attributable to a defendant's criminal behavior. By charging all criminal acts, including the most serious readily provable conduct, prosecutors have a more compelling case to present to a jury and meet their responsibilities to victims pursuant to the Mandatory Victim Restitution Act of 1996. With respect to sentencing, the scope of the conduct charged is more significant than the count(s) of conviction. Through the operation of the Sentencing Guidelines, regardless of the statutory crime of conviction, the sentencing court is empowered to consider all relevant conduct in determining sentences in fraud cases. The Sentencing Guidelines allow consideration of a number of other factors, which can also affect the final sentence, for example, the timeliness and the extent of cooperation of a defendant, the number of vulnerable victims, the risk the crime posed to the viability of a financial institution, or the type of leadership role assumed by the defendant in the crime. The two greatest strategic factors affecting a defendant's decision whether to go to trial are most often the credit he receives for acceptance of responsibility under the Guidelines and the possibility that his cooperation will result in a reduced sentence.

2. What are the merits and demerits of charging white collar offenders according to the number of individual victims? Is this type of individual charging currently within the scope of U.S. Attorneys' authority?

Because U.S.S.G. §2B1.1 bases a fraud defendant's sentence upon the loss attributable to his acts, the losses of multiple victims are aggregated by the district court in order to calculate loss as a specific offense characteristic under the Guidelines. The current statutory sentences for white collar crimes generally do not vary in proportion to the number of the victims of the crime. However, the Sentencing Guidelines allow for consideration of that factor when calculating a sentence in certain crimes, for example fraud. As mentioned, the Guidelines allow consideration of a number of other factors that can affect the final sentence (e.g., the timeliness and the extent of cooperation of a defendant, the number of vulnerable victims, the risk the crime posed to the viability of a financial institution, and the type of leadership role assumed by the defendant in the

crime). Although sometimes an imperfect indicator, the Guidelines' longstanding use of monetary loss does vary in many white collar cases with the number of victims affected by the criminal activity. However, were the criminal statutes revised to allow different maximum penalties depending on the number of victims involved, additional elements of proof would be interjected which could substantially increase the time and resources necessary to bring a defendant to trial and complete the trial. For example, while only a limited number of victims need testify under current law to establish the occurrence of the crime, if the criminal statutes became tiered for the number of victims, then this could require presentation of multiple victim witnesses and proof of their loss. Under the current Guidelines, this information concerning "relevant conduct" against other victims can be presented during the post-trial, or post-plea, sentencing hearing, for consideration by the sentencing court. Therefore, we believe the current system adequately enhances the punishment of criminals who cause harm to a large number of victims.

3. What happens to these cases that do not get the attention of federal prosecutors? Are *all* of them picked up by state authorities? To what extent are criminal charges forgone entirely?

Under any circumstances, the Department will have limited resources with which to investigate and prosecute white collar crimes. Accordingly, the Department constantly seeks to maximize the effectiveness of the resources it has at is disposal. Consequently, each United States Attorney's Office, of necessity, has developed resource guidelines which insure that the most egregious and pressing matters are pursued.

As noted in the response to question #1 and in recent DOJ witnesses' written testimony, this Administration has been very concerned with ensuring that white collar criminals get prosecuted, and that those who would commit fraud or other corporate crimes face the real prospect of incarceration in federal prison. Both investigators and prosecutors – as well as members of the public, including crime victims – run the risk of becoming disillusioned when those convicted of fraud escape without serious consequences (*i.e.*, real prison time) for their acts. In those instances where a fraud defendant receives a term of probation and an order to pay restitution, what Congress attempted to criminalize is converted to little more than a civil collection action – after the Department and investigative agencies spend significant time and resources uncovering and prosecuting a serious crime. For some types of crimes, such as Internet fraud or identity theft, some federal prosecutors may choose to bring cases even if the dollar amounts are less than some general threshold that the prosecutors' office may use as a guide, so long as the case otherwise merits prosecution. In addition, where federal, state, and local authorities have established a multi-agency task force to address a particular type of crime (*e.g.*, telemarketing fraud or identity theft), task force members can discuss which agencies ought to handle particular cases that the task force has investigated. The task force approach therefore can increase the chances that one of the participating prosecutors' offices will handle a matter, regardless of whether the amount of loss in that matter might fall below some threshold that one of those offices uses as a factor in case intake.

It is very difficult to generalize about the capacity of state and local law enforcement. It can be said that there are varying levels of sophistication from office to office. It cannot be said that cases declined by federal authorities will always be pursued by state and local authorities, and we cannot quantify the number of cases forgone. That being said, we believe that federal agents and prosecutors are generally better equipped to handle complex, major white collar cases, and we seek to prioritize our resources to focus on the most significant criminal schemes, which are the ones which inflict the most harm. Further, State and local law enforcement authorities have a much broader portfolio than federal authorities. This, coupled with the often interstate reach and the expenditure of resources required by a white collar investigation, favor the active involvement of federal law enforcement.

Question 6. Alternative Punishments

1. Do these alternative forms of punishment, on their own, adequately deter future abuses?

The Department strongly advocates incarceration as a punishment and a deterrent. Our experience is that white collar criminals want to avoid jail at all costs; they have much to lose by going to jail, and the sight of one of their own being incarcerated, we believe, presents a powerful deterrent message to others contemplating criminal conduct. Probation, home arrest and community confinement are toothless punishments. Some white collar criminals also receive sanctions from the market place, with convictions affecting their lifetime earnings and community standards. Nonetheless, we have found that supplemental forms of punishment – including forfeiture, loss of license, and debarment from participating in federal grants or contracts – provide the most effective sentencing policy. Ultimately, we believe it is the certainty of punishment which is the greatest deterrent. Many will not be deterred by non-criminal monetary sanctions or by the mere threat of embarrassment, because the returns from their criminal activities are so great that they can calculate fines or other non-criminal monetary sanctions as part of the "cost of doing business." Even if non-prison sanctions provide specific deterrence for some individual defendants, general deterrence is set back when citizens perceive that fraud crimes do not equal incarceration.

2. At one time, self-supervision by investment firms was the first defense against fraud and central to the regulation of American financial markets. Is that still the predominant regime? What are the limits of self-regulation?

Given this nation's free-market economy, self-regulation must continue to be a principal component of the regulatory regime for American business. This depends on the effectiveness of market forces in disciplining firms and their participants. It also depends upon the specific abilities and incentives of the self-regulatory organizations (SROs). For example, the SROs that operate under the federal securities laws are organized principally to oversee the broker-dealers who comply with SEC regulations and standards, as well as the trading activity in particular securities markets. These SROs are not organized or equipped to oversee directly or audit the

financial decision-making and accounting practices of publicly traded companies. The SROs are empowered to oversee, regulate and sanction, only those companies (and their employees) which are members of the SROs, when the investment fraud may reach outside of this circle. As you know, these are issues currently under review by the SEC and others. As stated earlier, the Department supports the Sarbanes-Oxley Act and the oversight reforms within it.

Question 7. Health Care Fraud

1. In your view, what can we legitimately take from [health care fraud-related] data? Are we really doing a better job of catching and convicting health care fraud offenders?

2. How might the infusion of money and the designation of agents and prosecutors who work solely on health care cases skew the data results?

3. Overall, has the "health care fraud" designation model been a positive or a negative development? Should we attempt to replicate that model in the white collar crime context?

4. What, if anything, in the "health care fraud" example can we apply to our efforts to minimize investment and pension fraud?

The increase in the number of convictions and the amount of recoveries in health care fraud cases is the result of increased resources devoted to the health care fraud enforcement effort, as well as the enhanced expertise of federal health care fraud investigators and prosecutors. The increase in resources for health care fraud enforcement has enabled the investigators and prosecutors to focus on health care fraud cases, thereby giving them an ability to develop expertise in this area. As we gain expertise in a complex enforcement area, such as health care fraud, we are able to be more successful. In addition, as a result of the enhanced resources, we have been able to give investigators and prosecutors specialized health care fraud training and resource materials. The resources available to the health care fraud initiative have also been substantially enhanced through the formation of federal, state and local interagency task forces which have facilitated a greater sharing of case responsibilities. These resources — when provided with the necessary flexibility to adapt personnel to ever-changing white collar fraud – are invaluable. However, if resources are earmarked for one type of prosecution, prosecutors may be hamstrung in their ability to react quickly to newly emerging types of fraud.

Question 8. From Senator Grassley

1. Mr. Comey, thank you for your testimony today and for your work combating white collar crime. Over the last decade there has been a steady decline in the prosecution of white collar criminals. What is the Department of Justice doing to increase the prosecution of these white collar fraud offenders?

As stated above, data from the Department of Justice, the U.S. Courts, and the Sentencing Commission do not support the proposition that there has been a steady decline in the number of white collar crime prosecutions by United States Attorneys' offices. According to the Department's data, in 2001, there were about 6,380 white collar crime cases filed in federal court, with the number of cases fluctuating up and down slightly over the recent few years. Although there were fewer defendants charged with white collar crimes in 2001 (8,756) than in 1992 (9,409), the number of defendants convicted increased from 6,937 in 1992 to 7,212 in 2001, an increase from 85.7% to 90.3%. More importantly, there was a significant increase in the number of defendants sentenced to prison in 2001 (4,456) from the number sentenced to prison in 1992 (3,464), an increase from 49.9% to 61.8%.

Many United States Attorneys' offices participate in task forces that focus on the investigation and prosecution of white collar crimes, such as health care fraud, bankruptcy fraud and identity theft. Additionally, the Department expects the Corporate Fraud Task Force initiative to significantly increase the white collar crime workload in areas such as securities fraud, accounting fraud, mail and wire fraud, debt collection, asset forfeiture, money laundering, bankruptcy and other forms of financial fraud. In support of white collar crime prosecutions, numerous training sessions of hundreds of investigators and prosecutors are held every year at the Department of Justice's National Advocacy Center, including Basic and Advanced White Collar Crimes; Securities Fraud; Bankruptcy; Health Care Fraud; Accounting; Cybercrimes; Internet Fraud; Intellectual Property; and Complex Prosecutions. The Executive Office for United States Attorneys, through its Office of Legal Education, also produces training materials for prosecutors, such as the book-length manual Prosecuting Intellectual Property Crime (available on the DOJ Website), and the U.S. Attorneys' Bulletin which comes out quarterly (for example, the March 2002 edition focused on white collar crime).

Senate Judiciary Subcommittee on Crime and Drugs
Hearing on
"Penalties for White Collar Offenses:
Are We Really Getting Tough on Crime?"
June 19, 2002
Senator Joseph R. Biden, Chairman

Written Follow-up Questions

Responses to Questions for Chairman Glen Gainer – July 9, 2002

Question # 1

There is evidence suggesting that the number of victims of investment and pension fraud, for example, is increasing - but that many of these victims are not reporting the crimes. In a survey published by the National Institute of Justice, it was estimated that as few as 15 percent of fraud victims actually report the fraud to the police or other law enforcement agencies. Similarly, the National White Collar Crime Center has concluded that "only a fraction of victims ever report to an enforcement agency for assistance." This shockingly low rate of reported frauds comports with my private discussion with agency officials, who estimate that the super-majority of white collar crimes are never reported. In my view, the lack of reporting only fuels the perception among some white collar criminals that there will be few consequences for their wrongdoing.

1. *To what do you attribute this apparent underreporting? Is it because the unlawful behavior is difficult to detect, or because the victims are unknowing (i.e., do not realize that they've been victimized)?*

Research by both the National Institute of Justice (NIJ) and the National White Collar Crime Center (NW3C) has found that rates of reporting among individuals who knew they had been victimized by a white collar crime were between ten and fifteen percent. Likewise, research looking at businesses that have been victimized by comparable financial crimes finds very similar reporting trends. This contrasts sharply with reporting for other types of crime. According to the National Crime Victimization Survey (sponsored by the Bureau of Justice Statistics), 48% of violent crime victimizations and 36% of property crimes were brought to the attention of police in 2000. When these populations of white collar crime victims are taken with populations of individuals who do not even realize they've been victimized, the overall reporting rates are most likely significantly lower than ten percent.

To what can we can attribute underreporting among individuals who are fully aware that they have been victimized by a white collar crime? Non-reporting and underreporting of fraud in the financial services industry is very common, for several reasons. As we have learned from Enron, top managers may be responsible for the fraud or actively enabling it. There may be a culture of non-compliance and corner-cutting that encourages fraud. There may be no whistle-blowing procedure and no internal investigation procedure. Compliance and legal personnel may be mid-level administrative staff without the authority to identify or investigate fraud. They may have no ability to communicate directly with top management about endemic fraud problems in the organization. Among business victims, non-reporting has long been a way to avoid incurring

additional financial losses that would result if the crime were made public. For example, a perceived vulnerability might erode confidence among stockholders and both current and potential customers. Competitors may even further advertise this incident to lure away business. Moreover, the company may develop the reputation as an 'easy target' and make itself more susceptible to future crime. Unrelated to the negative public perception that such a disclosure might generate, some companies are unwilling to report to law enforcement because they lack confidence that the criminal justice system has the training and resources to successfully investigate and prosecute those responsible for the crime. Instead, these victims are turning to private sector resources to help them discretely address the problem.

The statistics you quoted in your first question come from research focused on individual (not affiliated with a defrauded organization) victims of white collar crime. While it is alarming that only one in ten report their incident to law enforcement agencies, the prevalence of white collar crime victimization is even more startling: according to NW3C research published in 2000, one in three households has experienced some form of white collar crime. This translates into millions of fraudulent crimes that go unreported to those agencies tasked with protecting the public. There are a number of reasons why these incidents do not make their way to the attention of law enforcement. First, because of small monetary losses or because no additional physical or financial harm was incurred, many people feel the crime is not worthwhile to report. The unfortunate part about this is that they may be one of hundreds, if not thousands, of victims, and their information may be the piece of the puzzle that enforcement agencies need to move a case forward. Second, victims may not realize the matter is one for law enforcement. Research shows higher rates of reporting to better business bureaus, non-enforcement consumer protection agencies, and businesses somehow involved in the crime (e.g., individuals might file a complaint with eBay if they have been the victim of an online auction fraud). Because there is not a consistent flow of information sharing between various public and private entities, these complaints often do not get in the hands of law enforcement agencies. Third, it is our experience that many victims of white collar crime put partial blame on themselves for letting the crime happen. There exists a public stigma that such individuals fall prey to such scams because of greed or naivete. These internalized feelings of guilt and shame (i.e., a person may ask themselves "how could I have been so stupid to let this happen?") often lead victims to shy away from seeking out help from law enforcement or other assistance agencies.

2. *I understand that, under current law, only financial institutions must report fraud. Is this true? Would our efforts to fight white collar crime be aided by a requirement that more broadly mandates the reporting of fraud?*

In addition to financial institutions' obligations to report suspicious transactions and other frauds, we are aware of reporting requirements imposed by federal or state securities regulations, and those placed on miscellaneous other business entities, such as franchisors and insurers. However, to our knowledge, business entities are under no general duty to disclose to law enforcement or to remediate frauds that are committed internally except as they are required to do so under the duties of care they owe to their shareholders or partners.

Efforts to fight white collar crime would be enhanced in certain respects by broader fraud reporting mandates. This would give law enforcement a more complete picture of the incidence and dimensions of economic frauds and perhaps facilitate earlier and more uniform systemic responses.

3. *What are the consequences of a failure to report corporate fraud? For example, I understand that frequently companies may address fraud by terminating the employment of the wrongdoer (as opposed to filing a complaint or otherwise reporting the wrongdoing). Under such a circumstance, offenders may be allowed to continue their wrongdoing at a new place of employment (in part because the former employer may be hesitant to mention the fraud charges where it failed to report the crimes in the first place). Please comment on this and other consequences of non-reporting of corporate fraud.*

For the institution, the resources and costs of a lengthy internal investigation are high, and unless the facts are clear, it is easier to let the employee resign and become someone else's problem. Other employees may be reluctant to provide information against a current co-worker or may worry about their own liability. The disclosure of fraudulent activity may cause the public to lose confidence in the company or it may precipitate a loss of clients or customers if the company appears to be mismanaged.

In the banking industry, regulators for many years not only did not require disclosure of defalcations, they actually prohibited them in order to prevent a run on the bank. Now banks are required to report defalcations but the tendency to ease the employee out unless the facts indicating fraud are obvious and clear still remains. Fraud is often masked or excused as bookkeeping or judgment errors.

In the securities industry, the Central Registration Depository, maintained by the National Association of Securities Dealers, Regulation (NASDR) requires registered firms to disclose disciplinary events such as termination of employees for cause. If the employee resigns, the firm can avoid the adverse report and the bad publicity of having a problem employee.

With no integrated databases for fraud among financial services industries and no reciprocal barring of individuals who have committed fraud from being licensed, it is possible for an individual to commit bank fraud one year, securities fraud the next year, insurance fraud the year after that, and keep moving from industry to industry with none of the new employers being aware of their past record unless they voluntarily disclose it.

Question # 2

As you know, the criminal sanction is only one of many punishments that might be imposed on white collar offenders. Conceivably, the criminal justice system could opt for (and has historically relied on) a range of penalties – including fines or other monetary penalties, suspensions, temporary shutdowns of brokerages, and "shaming."

1. *Do these alternative forms of punishment, on their own, adequately deter future abuses?*

Historically, alternative forms of punishment, on their own, do not adequately deter future abuses. Extensive research on initiated and enforcement actions over a period of years against corporations shows that fines, penalties, and other forms of sanctions do not deter future corporate misconduct. In fact, during the first half of the twentieth century, many of the

regulatory and administrative violations were not illegal, and did not afford prosecutors the option of pursuing criminal sanctions, such as prison time. In 2001, the Securities and Exchange Commission (SEC) took in nearly $2.5 billion in fees, disgorgements, and penalties. While this is a sizable amount, monetary penalties often pale in comparison to the profits that are generated from the criminal act. That we continue to see a steady stream of white collar offending, despite these enforcement efforts, is a testament to the fact that alternative punishment alone is not the answer. As has been suggested this week in legislation introduced by Senator Leahy, an effective solution must combine monetary penalties with prison sentences that are both certain and severe enough to drive home the point that white collar misconduct will no longer be tolerated.

2. *At one time, self-supervision by investment firms was the first defense against fraud and central to the regulation of American financial markets. Is that still the predominant regime? What are the limits of self-regulation?*

Regulators are outmanned and outgunned by the industries they have to regulate. Law enforcement has many other problems to address besides financial fraud. Pre-emption of regulations over financial products and financial professionals in the name of uniformity and competitiveness has taken away more and more of the front-end protection over the years, leaving regulators and law enforcement to react to fraud that has already done its damage.

Self-regulation is an essential part of the regulatory structure in the financial services marketplace, because self-regulatory organizations leverage the limited resources of public regulatory and law enforcement agencies. Self-regulation allows industries to impose their own standards and enforce them out of fees from the industry, but industry self-regulatory organizations are always going to be more protective of their industries than independent regulators or government entities. As membership organizations, the worst penalties they can impose are expulsion from membership and barring them from the industry. They cannot impose civil or criminal penalties, and the number of referrals to law enforcement and prosecutorial agencies is a very small percentage of the cases they bring.

Question # 3

Chairman Gainer, you make the point in your written testimony that there is "documented relationship" between terrorism and white collar criminal activities. You explain that "some groups have used ill-gotten gains from fraudulent schemes to fund the operation of their organizations."

1. *Can you say more about the link between white collar crimes and terrorism? How has the relationship been documented? Are you aware of any specific examples of terrorist-organized financial schemes?*

While there is a clearer relationship between such white collar activities as identity theft and money laundering in facilitating the activities of terrorist-organized groups, there is a smaller verifiable body of knowledge regarding specific examples of how these groups have used such crime to generate ill-gotten gains and continue to fund their operations. Al-Fuqra is a violent Muslim extremist sect with cells situated in various rural locations in the domestic United States.

The Al-Fuqra came to the attention of law enforcement officials primarily due to the fact that they have sought to carry out a self-declared policy of "jihad" or holy war, by taking violent action against their perceived enemies (generally other minorities or other Muslims who do not agree with their teachings). Past activities by Al-Fuqra have been linked by law enforcement to terrorist violence in Colorado, Arizona, Pennsylvania, Oregon, Canada, and the 1993 World Trade Center bombing. In 1989, a Colorado Springs storage locker was discovered containing a hoard of Al-Fuqra documents and weapons. The search of the locker turned over explosive compounds, handguns, military-style publications, and silhouette target practice forms. Of the greatest interest however, was detailed evidence of phony documents including blank birth certificates, blank social security cards, several sets of Colorado drivers' licenses (each with the same picture but different identities). Apparently these documents had been used to defraud the Colorado Department of Labor and Employment of over $350,000 between September 1984 and January 1992 in fraudulent worker's compensation claims. Some of the fraudulently obtained workers' compensation funds were directly traced to payments for a parcel of land near Buena Vista that was later used by the group as a residence compound and training site. In California, investigations continue as to state money fraud related to the Al-Fuqra operated Quranic Open University in Los Angeles, which has received over $1.5 million over the past two years in charter school funding.

In addition to the Al-Fuqra example, testimony by the Federal Bureau of Investigation before a House Committee on Financial Services, Subcommittee on Oversight and Investigations, revealed that terrorists trained at Al Qaeda sponsored training camps in Afghanistan were encouraged to use fraudulent schemes to fund terroristic activities. In South America, pirated CD's are sold to raise money for al-Moqawama, an extremist arm of the militant Islamic group Hezbollah in southern Lebanon. While there may be terrorist-organized criminal involvement beyond fraud, counterfeiting, identity theft, and money laundering, (involvement such as securities or investment crime, tax evasion, or insurance fraud), there has not been enough research into these issues to establish verifiable proof.

2. *Are you suggesting that terrorists are in essence taking advantage of our lax treatment of these crimes to finance terrorism?*

The commission of white collar crime, as opposed to other types of crime, is a preferred way to generate revenue because of the difficulties associated with discovering, investigating, and ultimately prosecuting such offenses. Terrorists, and other organized criminal enterprises, are not encouraged by the lax punishment once caught; rather it is the high level of reward coupled with the low levels of detection and apprehension that makes the commission of these crimes lucrative.

SENATOR GRASSLEY'S QUESTIONS FOR PANEL TWO

Questions for Bowman and Gainer

1. *I agree with both of you that the sentencing disparity isn't just a result of lower sentences. It is also caused by a long history of not enforcing these crimes at the same level that we enforce violent and drug crimes. You link the lack of enforcement to*

insufficient resources. Is the problem that there isn't enough federal money to bring these cases, or is it that there needs to be more training of financial crime investigators and federal prosecutors? How would better technology help increase the enforcement of financial crimes?

To answer your first question, we suggest a balanced approach. Perhaps the greatest need is for more federal funding support for antifraud cases, but such moneys ought to allow agencies the flexibility to determine whether their immediate needs are best addressed through more or different training or through more personnel or equipment, or a combination of these. In addition, federal resources devoted to addressing this problem should encompass assistance for law enforcement and prosecution efforts at the state and local level. Besides investing in training, equipment, and staffing for federal investigative and prosecution agencies, we must recognize the necessity of effectively pursuing these cases at the state and local levels as well. By allowing federal agencies to set their funding priorities as well as bolstering law enforcement and prosecution at the state and local level, we enable our system to respond to incidents not only from the top down, but also from the bottom up. Financial crime task forces comprising of federal, state, and local investigators and prosecutors would greatly assist in the effective, efficient, and economical use of funding, personnel, and non-personnel resources and the sharing of information to address financial crime.

Better technology would enhance investigators' and prosecutors' abilities to keep up with the bad guys—to detect, analyze, and offer up the evidence of financial crimes. Law enforcement has found that offenders are making wide use of computers and digital devices as tools of their wrongdoings or as storage devices. Investment and securities frauds, and sophisticated corporate frauds in general, are examples of those commonly planned and carried out by means of high technology. Law enforcement and the prosecutor need the ability and capability to take advantage of present and future technology. This would enable them to utilize sophisticated software tools and technological detection devices to combat the fraud and other cybercrime investigations, which increasingly rely on technology and the high-tech means of presenting their findings to judges and juries in a convincing and understandable manner.

According to the survey *Prosecutors in State Courts, 2001*, there are 2,341 chief prosecutor offices handling felony cases in state courts of general jurisdiction. Over 40% have already had experience prosecuting some form of computer-related crime, including those involving credit and other business frauds. Yet we also know, from our observations generally and anecdotal evidence, that all too many of our local prosecutor offices in particular (and even some state level prosecution agencies) lack even relatively rudimentary computer equipment. Many are still operating with electric typewriters and can only hope for the day when they can afford to invest in state-of-the-art equipment and receive the training they will need to fully take advantage of it.

2. *I was glad to see in Mr. Gainer's testimony the recognition that there needs to be improved sharing of antifraud information between various enforcement and regulatory agencies. My colleagues on the Judiciary Committee have heard me give statement after statement saying that there needs to be improved information sharing between the various federal and state law enforcement agencies. In what ways can information sharing on antifraud investigations be improved?*

There are several levels of information—public record information, non-public investigative and intelligence information, and non-public complaint information. Before Congress explores ways to improve the sharing of intelligence and investigative information, it should promote a centralized database for the collection of public action information from every local, state, and federal public agency in the United States and the ability for law enforcement and the public to query this data.

Presently, the only way an investigator or a member of the public can find out if an entity or an individual has been subject to a public anti-fraud order, injunction, or criminal penalty is to call every public agency in the United States. Having dozens, if not hundreds, of disparate public action databases makes no sense in this age of technology. We must leverage resources to facilitate data sharing through increased accessibility of the information/intelligence provided, and strive to take a more proactive approach to data sharing (i.e., the use of intelligence to identify fraudulent patterns before large scale losses are incurred), rather than using this information solely as a reactive investigative tool.

214 Massachusetts Avenue, N.E.
Washington, DC 20002
Phone: 202/608-6190
Fax: 202/547-0641

July 12, 2002

Senator Patrick Leahy
Chairman, Committee on the Judiciary
United States Senate
Washington, DC 20510-6276

Dear Senator Leahy:

Thank you very much for the opportunity to appear at the United State Senate Judiciary Committee's Subcommittee on Crime and Drugs hearing entitled "Penalties for White Collar Crime Offenses: Are We Really Getting Tough on Crime?" I am pleased to be able to respond to written questions from Senators Biden and Grassley

[For convenience, and to avoid burdening the record of this Hearing I do not repeat the Senator's questions in full in this response. Rather I summarize them, append the questions to this response, and incorporate them in full by reference.]

Senator Biden's Questions

1) Citing the increase in health care fraud prosecutions and investigations following the passage of the Health Insurance Portability and Accountability Act of 1996, Senator Biden asks how the data on increased prosecutions might be interpreted and whether there are any lessons to be learned from the implementation of HIPAA that can be applied to efforts to minimize investment and pension fraud.

In my view the data on increased health care fraud prosecutions should be treated with some measure of caution and skepticism. There can be little doubt that an infusion of money and a statutory mandate to increase criminal health care prosecutions has resulted in the increased numbers we have seen – that is the nature of the Federal bureaucracy and its relation to Congress. But the simple increase in the gross number of agents, investigations and prosecutions, in my view, begs the question.

The proper question to ask, as I testified, is whether we are achieving the optimal level of enforcement by targeting our resources at significant health care fraud both within the health care context and outside of it. Thus, before relying on the health care legislation as a model for further change I would encourage the Committee to examine the nature of the increased prosecutions: Do they represent a large number of small-scale defendants who

might equally be treated civilly or do the prosecutions involve defendants who committed large-scale fraud and are deserving of criminal punishment? What evidence is there that the increased prosecution of health care fraud has had any effect on crime rates? And, thinking more broadly is health care fraud of such significance that we should devote substantial resources to it to the detriment of prosecuting other significant criminal activity?

By all accounts the answer to these questions is, at best, indefinite. There is, for example, no way of knowing whether in response to Congressional demands the FBI has, in effect, "cherry picked" easy cases against individual doctors for technical violations rather than focusing their efforts on larger (and more difficult) investigations of significant fraud. In reviewing the reported literature it is hard, indeed, to identify a large number of substantial health care fraud prosecutions against large HMOs or their officers.

Moreover, there is some evidence that the sustained effort has not been effective in reducing criminal fraud. At a gross level, as Senator Biden notes, in 1999 the estimate of fraud losses in the health care industry was 10%. While I am skeptical of the accuracy of this number,[1] the broader issue is: If the number is accurate why, after several years of effort required by HIPAA, does it remain so high?

More fundamentally, there is some substantial basis for questioning the necessity for so sustained an effort. As Dr. Robert Walker, has said: "The public has been led to believe that the Medicare program is ridded with fraud, when, in reality, complexity is the root of the problem. . . . We must have zero tolerance for real fraud, but difference in interpretation and honest mistakes are not fraud."[2]

Thus, there is some suggestion in the data that the reductions in mistaken Medicare payments that we do see are not attributable to increased criminal enforcement. According to HHS, Medicare's erroneous claims were reduced to $12.6 billion in 1998 from $20.3 billion in 1997. An audit conducted by the Office of Inspector General at HHS in 1999 demonstrated that these reductions in the amount of fraud resulted primarily from a big drop in "documentation errors." Such errors were 44 percent of Medicare overpayments in 1996 but only 16.8 percent in 1997. The "documentation error" decline contributed to $8.7 billion of the $10.6 billion reduction in "improper" Part A and B payments.[3] Moreover, as former AMA President Nancy Dickey observed at the time, the government estimate of "improper payments" of $12.6 billion was based upon a review of claims that were filed for

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[1] According to the GAO the portion of improper Medicare payments "attributable to fraud" is unknown. *See* GAO, *Federal Health Programs: Comparison of Medicare, the Federal Employees Health Benefits Program, Medicaid, Veterans' Health Services, Department of Defense Health Services, and Indian Health Services*, GAO/HEHS-98-231R, Aug. 7, 1998, at 23.

[2] Testimony before the National Bipartisan Commission on the Future of Medicare, Aug. 10, 1998.

[3] June Gibbs Brown, HHS Inspector General, *Improper Fiscal Year 1998 Medicare Fee for Service Payments,* Office of Inspector General, Department of Health and Human Services, February 1999 (A-17-99-00099), p. 7.

600 Medicare patients, or 0.0015 percent of Medicare's 39 million beneficiaries.[4] Thus, we should be skeptical of the efficacy of criminal enforcement -- it may, as I testified, that criminal enforcement is best used as a tool for truly egregious fraud and that our resources are better directed to regulatory reform as well as counseling and compliance assistance programs that would produce greater gains in protecting Medicare.

In short, in light of the data just cited, it appears that increased prosecution has yet to have a significant effect. This may reflect either inadequate resources or, more likely in my view, resources not well directed at deterrable crime.

Finally, in addressing crime in this manner – *i.e.* through Congressional directive – we must consider the substitution effects. The resources to be devoted to criminal prosecution are not infinite. Any new directive to maximize the prosecution of investor or pension fraud necessarily implies a reduction in some other effort. In the present circumstances, it is unlikely that such a reduction will be seen in counter-terrorism efforts. Where then, will the reduction occur? In prosecution of violent crime? Plainly it is not for me to say what the appropriate trade-offs are – that is Congress's prerogative. I would urge, however, that Congress expressly consider the question so that its judgment is an informed one.

2) Citing National Institute of Justice statistics regarding the non-economic harms suffered by victims of fraud, Senator Biden asked whether the penalty structure for white-collar crimes adequately addresses non-economic costs.

To a substantial degree, existing fraud sentencing guidelines already take into account some victim related effects. Thus, the guidelines enhance penalties if the victim is "vulnerable," U.S.S.G. § 3A1.1(b)(1), or if the victim is an official victim, *id.* § 3A1.2. Moreover, the current fraud guidelines, which tie the penalty directly to the dollar value of the fraud, are already explicitly tied to the harm caused. Though the dollar values are only a portion of the harm caused – as Senator Biden notes there are often other non-economic harms involved – they are, generally, a useful, readily measurable proxy for the non-economic aspects of the harm. It is, for example, unlikely that a small value fraud will cause health or emotional problems or lost time from work. Thus, as I see the fraud sentencing guidelines, they already implicitly incorporate non-economic harms into the consideration of fraud sentencing through the substitute of monetized harm.

In general, of course, there is no constitutional barrier to consideration of victim impact in sentencing. Thus, if the Committee wanted to go beyond the current monetized sentencing schema it would be free to do so.

We should, however, be cautious in expanding the use of victim impact in imposing sentence along these lines for two reasons: First, such secondary impacts will be exceedingly difficult to measure and therefore very burdensome on the courts and the probation office

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[4] Nancy Dickey, M.D., "Government to Grandpa: Rat on Your Doctor," *The Wall Street Journal*, Feb. 24, 1999.

to implement. How, for example, is the probation officer to judge whether a fraud had a "substantial emotional impact" on a victim? When we impose such burdens on the court we should do so in a manner that does not impose too significant a cost on the administration of justice.

Second, the criminal law generally limits punishment to those results that are reasonably foreseeable consequences of particular criminal actions. Monetary loss is plainly a foreseeable (indeed, intended) consequence of fraud in every case. Non-economic injuries will not always be so readily foreseeable or intended – obviously they will be in some instances but not in others. To the extent we expand consideration of these impacts in sentencing we will be diverging from the classic model of criminal law – a step not to be taken lightly.

Thus, while I am certainly exceedingly sympathetic to the plight of victims injured by the wrongdoing of corporate officers, it seems to me that to a large degree they are adequately compensated through the tort system that provides damages for intentional torts. We should be cautious about further systematic rules blurring the line between tort and criminal law.

Senator Grassley's Question

Why has there been an increase in the use of criminal law as a substitute for what I believe should be governed by civil law?

Social behavior in a free society is governed by norms that broadly distinguish three kinds of wrongful acts: 1) Crimes, which require such elements as malicious intent and harm, and which are treated as offenses against the state rather than merely against an individual; 2) Civil wrongs, which are torts against persons or property, are more loosely defined, typically carry lesser penalties or no penalties, and are adjudicated under less-rigorous procedural rules; and 3) Moral wrongs that are neither crimes nor civil wrongs and are usually redressed informally through peer pressure, social ostracism, and so on.

These categories can be used to characterize two parallel trends in American law that run contrary to the principles of freedom and personal responsibility. Both trends are a kind of "bracket creep" of wrongful acts from one category into another.

The first trend transfers mere moral wrongs into the realm of civil law. This accounts in large part for the well-known explosion in civil litigation. The schoolyard cut-up who was traditionally hauled before principal and parents is now sued for some arcane variety of "harassment." This litigious trend has spawned a nationwide movement for tort reform.

The second trend, identified in my testimony, elevates civil wrongs and even mere moral wrongs to the status of crimes. This trend is often driven by the political popularity of causes, by the need for elected officials to appear responsive to their constituents, and by government bureaucrats interested in increasing their own power.

In recent years, this trend of criminalizing relatively ordinary conduct has accelerated at an alarming rate. It's causes are several: (1) Politicians want to prove they are "doing something" about the perceived problem du jour; (2) agency officials are looking for new authority and expanding their bureaucratic power; (3) prosecutors seek publicity, and (4) public interest groups see the criminal arena as an area of alternative enforcement to be used when civil suits are unavailing. All these factors have joined together to create and support criminal sanctions for an expanding list of regulatory wrongs and socially undesirable acts. Although state legislatures and administrative bodies have contributed to this trend, the federal government has increased the scope of its criminal reach at an even greater rate.

A recent report by the ABA Task Force on Federalization of Criminal Law lists approximately 3,000 statutory crimes at the federal level.[5] The great majority of these criminal statutes have been enacted since the Civil War, and of these, more than 1,200 were passed since 1970. Only a fraction of the 3,000+ statutory federal crimes are traditional crimes such as bribery, theft, and counterfeiting. Under federal law, it is now a crime to fraudulently use the 4-H club emblem, use the flag for advertising purposes, and wrongfully disclose certain health care information,[6] just to list a few examples.

This list of federal statutory crimes also underestimates the number of distinct offences because Congress sometimes makes criminal the violation of future agency regulations that include numerous possible acts or omissions. This type of legislation is the most troubling because it delegates to the regulatory agencies the power to define for themselves – either by regulation or on an ad hoc basis – what is and is not criminal, including the violation of an individual permit. *See, e.g.*, 33 U.S.C. § 1481 (punishes violations of any regulations issued under the maritime pollution statute); 33 U.S.C. § 1415 (makes criminal any violation of a condition or limitation in a permit to dredge or fill a waterway).

James Madison quoted Montesquieu in *Federalist No. 47* that "There can be no liberty where the legislative and executive powers are united in the same person." This fear is greatest when the state invokes its power under the criminal law to imprison citizens and mark them as felons for life. Yet, this is precisely the situation when a legislature delegates a broad regulatory goal to an agency and gives it both the power to define regulatory crimes (through formal regulations, vague wetlands guidelines, or permitting decisions) and the power to enforce its own criminal prohibitions.

The expansion of criminal law to regulatory areas is exacerbated by the parallel trend in the legislature and the courts of making it easier for prosecutors to obtain convictions. In the case of many regulatory crimes, the essential proof of criminal intent has been fictionalized, and a defendant need only be shown to have intended to act as he did without any reason to know that his conduct was wrongful. Thus, even the traditional requirement of criminal intent is eliminated. As a retreat from the traditional distinction between crimes and other civil wrongs, many of the newer regulatory crimes do not require proof that anyone or

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[5] See "The Federalization of Criminal Law," Task Force on Federalization of Criminal Law, ABA Criminal Justice Section, Appendix C (1998).

[6] 18 U.S.C. § 707; 4 U.S.C. § 3; and 42 U.S.C. § 1320, respectively

anything was harmed. Even if it is unlikely that a jury would convict an individual where there was no harm, few people can endure the cost, stress, harm to reputation, and even remote risk of conviction of a criminal trial.

The result is that ordinary citizens and business managers are subjected to criminal investigations and potential criminal sanctions for conduct they could not have reasonably known was criminal and for which no one was conceivably harmed.

* * * * *

Thank you very much for the opportunity to testify and for the opportunity to respond to these additional written questions. If I may be of any further assistance to the Committee, please do not hesitate to contact me.

Sincerely yours,

Paul Rosenzweig
Senior Legal Research Fellow

cc: Sen. Joseph Biden
Sen. Charles Grassley

Commissioner Bradley Skolnik's Responses
Senate Judiciary Subcommittee on Crime and Drugs
Hearing on "Penalties for White Collar Offenses:
Are We Really Getting Touch on Crime?"
June 19, 2002

Question #1

1-1. The difficulty of investigating white collar crimes is best exemplified by the recent Baptist Foundation of America case in Arizona. The investigation began in the fall of 1998, and portions of the case continue today. The case involved numerous off-balance sheet transactions that were pieced together from documents numbering over one million. All the documents were catalogued on a database, a process that took four clerical employees several years and is still ongoing. The Arizona Securities Division dedicated one attorney, one CPA, and a paralegal full time for four years to unravel this 600 million dollar fraud that affected over 11,000 investors. In addition, the Arizona attorney general's office devoted attorney and investigator time to a related civil case against Arthur Andersen LLP, and criminal actions against eight individuals. The difficulty in a case such as this is that key evidence might be found in one memo, or one letter, stashed among the hundreds of thousands of documents. Also, a murder may have one victim, whereas a white collar crime usually involves many victims, often necessitating numerous interviews, communication, and further collection of documents.

1-2. One of the most striking impediments in large white collar cases is that there may be several defendants, each with attorneys, opposing the state, all with a talent for filing motions or other actions, frivolous or otherwise. In contrast, the resources of the state are more limited and one attorney may encounter the overwhelming effect of several large law firms with the ability to paper the state to death, thereby delaying the prosecution. Lack of resources is the most serious impediment to effective investigation of white collar crime.

1-3. On a state level, having more investigators tends to lead to better enforcement. But more prosecutors would also be needed, so that there were no bottlenecks for getting indictments and results.

Question #2

2-1. Investors tend to still live under the *caveat emptor* era. They do not know the right they have to full disclosure of information. They blame themselves for not asking the right questions. Quality investor education programs, coupled with strong and visible enforcement, are the best deterrent to white collar crime. Investors also tend to be embarrassed when an investment goes bad, especially if the hook used to sell the investment involved a higher than usual return. They feel foolish about looking greedy or stupid, and as a result, may not report their loss. Senior citizens, who frequently fall prey to white collar crime, are especially hesitant to report such crimes out of concern that family members will regard the incident as evidence of mental incompetence.

Other factors also play a part. In some cases, the perpetrator is a friend or fellow church member and victims do not want to report them to authorities. Victims also may fear that reporting the crime will do no good, or worse, will even deprive them of any chance of recovering at least a portion of their losses. Generally speaking, the problem does not appear to be one of victims' not understanding that they have been defrauded.

2-2. I am only aware of financial institutions having reporting requirements. Requiring other institutions to report fraud may help in the fight against white collar crime, but the approach also raises questions. What institutions would be subject to the requirement and to what degree would they comply? At a minimum, serious consideration should be given to requiring accountants and tax preparers to report fraud. Here too, though, questions arise, such as the tension between a reporting requirement and the obligation of these professionals to maintain client confidentiality. However, some reporting standards in the securities industry might prevent widespread damage if information is given to regulators at an earlier date than it is typically discovered.

2-3. Failure to report fraud is a problem. For example, as the question suggests, there does seem to be a growing trend among corporate employers not to disclose information about employees that are terminated for misconduct. To address these situations, the problem of liability for defamation may have to be addressed.

Question #3

3-1. Yes. The key is strong criminal remedies for financial crimes. Outside of investor education, it appears to be the only effective way to stop the activity.

3-2. Criminals are not threatened by loss of assets. Fines are often imposed but not collected. White collar criminals have learned to hide assets in other peoples' names, or off-shore. Even if they are collected, they are the cost of doing business for many financial operations. They are confident about their ability to begin anew and con people all over again. A long prison sentence is the most effective deterrent, both in terms of preventing violations in the first instance and in terms of preventing a recurrence.

3-3. Business and financial crimes have *not* been over criminalized. The highly publicized instances of alleged fraud by companies, accountants, and brokerage firms, which have come to light over the last year, suggest just the opposite – more than just fines are necessary to deter white collar crime.

Question #4

4-1. The alternative forms of punishment noted in the question are not by themselves sufficient to address the problem of white collar crime. The traditional criminal sanctions are a critical element. In combination, all available sanctions do provide the necessary tools to combat this form of crime. The key is making sure that all sanctions are applied vigorously and in the right combination according to the facts of each case.

Simply taking licenses away or shutting down a brokerage, will not deter a person who is bent on making a fortune through fraud. It will just drive them to sell off-market products – partnerships, promissory notes, viaticals, etc. Many of these products are currently sold by insurance agents, financial planners, or the guy next door.

4-2. It's unclear whether self-regulation is the predominant regime for policing fraud, but it certainly remains a significant component. Self-regulation poses several limitations. First, there can be conflicts between internal compliance officers and the departments of a firm they are supposed to oversee: business agendas do not always coincide with compliance agendas in corporate culture. Second, there is a perception problem: many members of the public undoubtedly harbor doubts about the effectiveness of self-regulation. And recent headlines about scandal on Wall Street only reinforce this public skepticism. Other problems include the fact that there is no subpoena power for the SROs; they are too reliant on funds to operate from their membership; and their jurisdiction only extends to their membership, not other participants, such as aiders and abettors.

Question #5

5-1. With respect to the emotional and other non-economic costs of crime, the federal sentencing guidelines may shed some light on the issue. In general, criminal penalties are assessed after sentencing hearings in which the victims have an opportunity to talk about the emotional and psychological harm that has been done. The resulting sentences reflect that information.

5-2. These types of harm should certainly be considered by courts when sentence is imposed.

Question #6

6-1. The relationship between local, state, and federal officials can generally be characterized as cooperative. The states have worked with the FBI, the Postal Service, the IRS, the SEC, U.S. Attorneys Offices, and the CFTC in bringing joint cases on white collar crime. Their jurisdictions and priorities differ to some degree. State regulators have served on federal/state task forces to address particular problems, such as fraudulent boiler rooms. Sharing of information is one form of state/federal cooperation. Much of the relationship is based on having the right people on board who are dedicated to the issue and willing to put energy into a joint effort.

6-2. A problem that stands out is that the information flow tends to be more from the state and local authorities to the federal authorities, and less so in the other direction. For example, the IRS' inability to share any information with state law enforcement is a problem. It produces a one-way street of information, but doesn't necessarily assist the state in obtaining indictments. There is also no centralized communication system between state and federal authorities. The result is that a state may be investigating something that a federal agency is also investigating, with neither party aware of the other's activity.

6-3. The states have historically handled matters that are more localized such as point-of-sale fraud, unregistered securities, unlicensed sellers and a host of fraudulent scams. Federal regulators tend to focus more on corporate finance accounting crimes, exchange-related violations, market manipulation, and insider trading. These delineations are largely the result of the historical evolution of the law, differing statutory jurisdictions, and resource limitations. States have generally left prosecution of reporting companies to the federal authorities. However, many state administrators, will take on cases of national scope when their state is seriously impacted. Or states will band together to address issues impacting investors in every state (such as the Lloyds of London fraud.) There is no specific division of responsibility.

6-4. Federal enforcement actions are most effective and helpful when conducted in cooperation and consultation with local officials.

Grassley Question

1. State prosecutors can be assisted through training, sharing of information, additional state/federal task forces, and federal funding for state law enforcement initiatives. In some years, the states have brought far more criminal cases against white collar criminals than the federal authorities. Many state securities agencies have built strong relationships with their prosecuting authority and have brought criminal charges resulting in sentences that far exceed those that are handed down even under more stringent federal sentencing guidelines.

SUBMISSIONS FOR THE RECORD

Senate Committee on the Judiciary

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Penalties for White-Collar Offenses: Are We Really Tough On Crime?

Statement of Frank O. Bowman, III
Indiana University School of Law – Indianapolis

Frank Bowman is Associate Professor of Law at Indiana University School of Law – Indianapolis. He is a graduate of Colorado College and Harvard Law School. He served as a Trial Attorney for the Criminal Division of the U.S. Department of Justice (1979-82), a Deputy District Attorney in Denver, Colorado (1983-87), and an Assistant U.S. Attorney in Miami, Florida (1989-96). While a Deputy District Attorney in Denver, he was in charge of criminal prosecutions in the Consumer Fraud Division. While an Assistant U.S. Attorney in Miami, he specialized in white-collar crime. Professor Bowman was Special Counsel to the U.S. Sentencing Commission in 1995-96. Since entering teaching, he has co-authored a treatise on federal sentencing law, written extensively on federal economic crime sentencing, and was intimately involved in drafting the extensive revisions of the Federal Sentencing Guidelines relating to economic crime which took effect on November 1, 2001.

Are the penalties imposed on white-collar offenders by federal criminal law tough enough? Although the question sounds simple, it is extraordinarily difficult to answer because a truly full answer would require resolution of some of the most intractable problems in criminal law and public administration: What are the purposes of punishment, and which are the most important? Should the objective of punishment be crime control? Or should punishment be meted out according to the defendant's deserts, regardless of how it affects his future behavior or that of other prospective criminals? How do we know if punishment has achieved its stated purpose? How should we rank the severity of different crimes and the deserts of different offenders? And given the scarcity of federal criminal justice resources, on which sorts of offenses and offenders should we concentrate our investigative, prosecutorial, judicial, and penological

resources?

I can't answer these big questions, but I hope the remarks that follow will give the Subcommittee some useful information on the history and current state of federal economic crime sentencing. I have also ventured some tentative opinions about whether Congress should enhance current white-collar crime penalties, and perhaps more importantly, whether Congress should augment federal law enforcement resources devoted to detecting and prosecuting white-collar crime.

I. On Average, Federal Economic Crime Defendants Receive Much Lower Sentences Than Defendants in Any Other Major Crime Category

If we consider federal economic crime defendants as a group, they unquestionably receive lower sentences than defendants in any other major crime category. As indicated in Table 1, in FY 2000, defendants convicted of larceny, embezzlement, fraud, and counterfeiting who were sentenced to federal prison received average (mean) sentences of 15.6 months, 9.9 months, 18 months, and 17 months respectively. By contrast, robbery defendants received 110.6 months, drug defendants 75.3 months, and firearms offenders 64.1 months. Even the average immigration sentence was 27.8 months, ten months longer than the average fraud penalty. Moreover, federal economic crime defendants receive sentences of probation at dramatically higher rates than virtually any other class of defendant. More than one-half of all larceny defendants and one-third of all fraud defendants receive probation.

TABLE 1[1]

FY 2000 Sentencing Data

	Larceny	Embezzl ement	Fraud	Counter-feiting	Robbery	Drug Trfck	Firearms	Immigrn	All other
Average (mean) Sentence (mos.)	15.6	9.9	18.0	17.0	110.6	75.3	64.1	27.8	49.5
Percent probatn	54%	40.6%	32.8%	38.4%	1.4%	3.8%	9.2%	5.1%	30.4%

One might conclude that the question that brings us together today is answered by the figures in Table 1. Plainly, economic crimes are punished less severely than any other sort of federal crime, and perhaps we should proceed immediately to increasing economic crime sentences. But, of course, the problem is not that simple. There are reasons, many of them entirely sound, why average economic crime sentences are low relative to other kinds of federal crime.

First, non-violent property crimes have traditionally ranked rather low on the scale of crime seriousness. By contrast, robbery and firearms offenses are violent crimes, or potentially so, and crimes of violence have traditionally ranked at the top of the crime seriousness scale. Relatively high drug sentences are the direct consequence of repeated congressional determinations that drug offenses are of the utmost seriousness, meriting commensurate punishment. Even the fact that the average immigration sentence is now ten months higher than the average fraud sentence is the result of legislation raising sentences for immigration crimes, particularly those involving aliens with criminal records.

[1] The data in Table 1 is drawn from U.S. Sentencing Commission, 2000 Sourcebook of Federal Sentencing Statistics, App. B (National Data) (2001).

Second, the rubric of "economic crimes" covers a literal multitude of sins, many of which are pretty small potatoes. The mental images of "white collar criminals" that gave birth to this hearing are probably those of crooked corporate tycoons, document-shredding Big Five accountants, and devious fat cats with offshore accounts. Such folks surely exist and sometimes find themselves as unwilling guests of the Bureau of Prisons, but the rank-and-file federal economic felon is usually a much less interesting fellow. For example, in FY 1999, about half of the defendants sentenced under the theft guideline, U.S.S.G. §2B1.1 (2000), stole less than $10,000, and 35% fell below $5,000.[2] In the same year, approximately 22% of all fraud defendants caused victim losses less than $10,000, and 15% fell below $5,000.[3] A great many of the larceny, embezzlement, and fraud cases sentenced in federal court involve Treasury checks stolen from the mail, small embezzlements by tellers from federally insured banks, so-called "dead payee check cases" (in which a relative of a person receiving Social Security or veteran's benefits neglects to inform the government of the beneficiary's decease and continues to cash the checks), and similar matters. These are certainly crimes, and many of them are prosecutable only in federal court. Indeed, in the aggregate such offenses cost the taxpayer many millions of dollars and must be pursued if the public fisc is to be protected. Still, it is hard to argue that the law ought to be changed to require the Widow Smithers to do a long stretch in prison if she continues cashing her dead husband's Social Security checks for a year or two.

II. Are Serious White Collar Offenders Punished Enough?

[2] Catharine Goodwin, *The Case for Revising the Economic Crime "Loss" Tables,* 13 Fed. Sent. Rep. 7, 12 (2000).
[3] *Id.*

Thus, I would submit that the question is not so much whether the relatively low-level felons who make up much of the pool of federal economic crime defendants are under-punished, but whether those who commit more extensive, and expensive, frauds and swindles are punished enough. To answer this question requires some historical perspective. As relatively low as average economic crime sentences may seem, their current levels represent a marked increase over those prevailing fifteen years ago. When the original Sentencing Commission drafted the first Sentencing Guidelines, they sought to replicate pre-Guidelines sentencing levels for most types of crime, the notable exceptions being increased sentences for drug offenses and economic crime. The increase in drug sentences was essentially mandated by legislation such as the Anti-Drug Abuse Act of 1986.[4] However, the Sentencing Commission made the independent determination that white-collar sentences ought to increase. The Commissioners were plainly concerned that probationary sentences had been too common for economic crimes, and that the Guidelines' objectives would be better served by the imposition of "short but certain terms of confinement for many white-collar offenders...."[5] As Marvin Frankel put it, "[T]he Commission produced guidelines that actually increase the overall severity [of federal sentences] taking particular aim at so-called white-collar offenders whom the Commission found (perhaps correctly) to have been treated with undue solicitude."[6]

It is, I think, undeniable that since 1987 the Guidelines have sent to prison thousands of white-collar criminals who would previously have been given straight

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[4] Pub. L. No. 99-570.
[5] Stephen Breyer, *The Federal Sentencing Guidelines and the Key Compromises Upon Which They Rest*, 17 Hofstra L. Rev. 1, 20 (1988).
[6] Marvin E. Frankel, *Sentencing Guidelines: A Need for Creative Collaboration*, 101 Yale L. J. 2043, 2047 (1992).

probation. Nonetheless, as the years passed even the new higher white-collar Guidelines sentences began to seem inadequate to some observers. As the Subcommittee is doubtless aware, last year the U.S. Sentencing Commission passed (and Congress accepted) an "economic crime package" of amendments to the federal sentencing guidelines governing theft and fraud offenses.[7] The package had a number of objectives, but one important one was to respond to concerns expressed by judges, probation officers, and prosecutors that sentences for at least some serious economic crime offenders were notably low.

The position of the judges is particularly noteworthy. As a group, federal judges have not been avid fans of the Sentencing Guidelines, and many judges have been pointedly critical of what they perceive to be unduly high sentences for some offenses, particularly drug crimes. Nonetheless, in the long debate that produced the 2001 economic crime package, the most influential advocates for raising white-collar sentences were the judges of the Criminal Law Committee of the U.S. Judicial Conference. In the end, a key element of the 2001 economic crime package was a modification of the economic crime guideline which introduced a graduated series of sentence increases for defendants found to have inflicted losses in excess of $70,000.[8]

Thus, one way of framing the question for today becomes: did the Sentencing Commission do enough in 2001? There is, of course, no objective method of measuring

[7] For a description and analysis of the 2001 economic crime amendments to the Guidelines, see Frank O. Bowman, III, *The 2001 Federal Economic Crime Sentencing Reforms: An Analysis and Legislative History,* 35 Indiana L.Rev. 5 (2001).

[8] *See* Goodwin, *supra* note 2, at 9. In addition, the definition of "loss" in economic crime cases was modified. *See* U.S.S.G. §2B1.1, app. note 2 (2001). Some of these modifications will increase the loss amount attributable to some defendants, thus increasing the sentence imposed.

how much punishment is "enough," either in absolute terms or in comparison to those who commit other sorts of crimes. Still, some illustrations may be helpful.

CASE #1: The president of a medium-sized, federally insured bank defrauds his bank of $750,000 and conceals the money in an offshore account. If the bank president pleaded guilty to the offense, his sentencing range under the Guidelines in effect prior to November 1, 2001 would probably have been 30-37 months.[9] Under the current Guidelines, his sentencing range would probably be 37-46 months.[10] Of course, adding or subtracting facts from the example would change the results markedly. Had the banker not moved the money offshore or otherwise used sophisticated means to commit the crime, his old guideline range would drop six months to 24-30 months, and under the new guidelines, his range would decline to 30-37 months.[11] On the other hand, had he stolen $1 million, rather than $750,000, and had that loss jeopardized the safety and soundness of the bank, his sentencing range under the old guidelines would increase to 57-71 months, and under the new guidelines to 70-87 months.[12]

CASE # 2: A swindler sets up a "boiler room" operation which makes fraudulent telephone solicitations to elderly persons to invest in phony securities. He succeeds in bilking over one hundred seniors out of $2.5 million. Under the 2001 Guidelines, this

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[9] This assumes a base offense level of 6, U.S.S.G. §2F1.1(a) (2000); an increase of 10 levels for loss amount, §2F1.1(b)(1)(K); a 2-level increase for more than minimal planning, §2F1.1(b)(2); a 2-level increase for sophisticated means, §2F1.1(b)(6); a 2-level increase for abuse of trust, §3B1.3; and a 3-level reduction for acceptance of responsibility, §3E1.1(b).

[10] This assumes a base offense level of 6, U.S.S.G. §2B1.1(a) (2001); an increase of 14 levels for loss amount, §2B1.1(b)(1)(H); a 2-level increase for sophisticated means, §2B1.1(b)(8); a 2-level increase for abuse of trust, §3B1.3; and a 3-level reduction for acceptance of responsibility, §3E1.1(b).

[11] *Compare* U.S.S.G. §2F1.1(b)(6) (2000) *with* U.S.S.G. §2B1.1(b)(8) (2001).

[12] *Compare* U.S.S.G. §2F1.1(b)(8) (2000) *with* U.S.S.G. §2B1.1(b)(12) (2001).

[13] This assumes a base offense level of 6, U.S.S.G. §2B1.1(a) (2001); an increase of 18 levels for loss amount, §2B1.1(b)(1)(J); a 4-level increase for more than 50 victims, §2B1.1(2)(b), and a 3-level reduction

defendant's sentencing range, if he pleaded guilty, would probably be 57-71 months.[13] If he employed five other co-conspirators, his sentencing range would increase to 87-108 months.[14] If he also committed the offense from an offshore location or used sophisticated means, his sentencing range would increase further to 108-135 months.[15] And if, in addition, the court determined that his elderly victims were "particularly vulnerable," his sentence could go as high as 168-210 months.[16]

Thus, depending on the particular facts, we can say with reasonable assurance that a banker who steals between $750,000 and $1 million will now receive a Guidelines sentence of between 2 ½ and seven years in prison. And a swindler who defrauds the elderly of $2.5 million will receive a Guidelines sentence of between 5 ½ and 17 ½ years. Are sentences in this general range "tough enough"? The answer probably depends on what yardstick one uses.

History: As noted, by historical standards federal economic crime sentences are at an all-time high, both in terms of the prevalence of prison sentences as opposed to probation and in terms of the length of the sentences imposed on those who go to prison.

Comparison with other federal offenses: It is difficult to escape the conclusion that some considerable part of the perception that economic crime sentences are "low" results from comparisons to the sentences now customary for other types of offenses, notably drugs. I am certain, for example, that the judges' support for higher white-collar sentences arose in some measure from the cognitive dissonance induced by the routine

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for acceptance of responsibility, §3E1.1(b).
[14] U.S.S.G. §3B1.1(a) (2001).
[15] U.S.S.G. §2B1.1(b)(8) (2001).
[16] U.S.S.G. §3A1.1(b)(2) (2001).

experience of being legally obliged to sentence young, often minority, drug defendants to five or ten or more years, and then finding that the Guidelines dictate a sentence of a year or two for educated professional defendants who steal significant sums. Even judges who view current drug sentencing levels as too high were surely moved by this disparity.

The real question, however, is what lesson one should draw from the fact that drug sentences are now much higher than, say, fraud sentences. Ought we necessarily to conclude that fraud sentences are too low? Or might the problem be that drug sentences are too high? Or perhaps there is no problem. Perhaps current drug sentences are and should remain much higher than economic crime sentences because drug crimes are so much more serious than economic crimes. In the end, I do not find the comparison between drug sentences and white-collar sentences to be particularly useful in determining the proper level of either.

Just deserts: As a general matter, a criminal sentence should be no longer than can be morally justified by principles of just deserts. How much punishment any defendant "deserves" is customarily determined by assessing the degree of harm he caused and his blameworthiness for that harm (which in turn usually involves an evaluation of the defendant's mental state). A strong argument can be made that the punishments traditionally imposed on white-collar offenders reflect a persistent under-evaluation of both harm and blameworthiness.

The harms inflicted by economic crime can be substantial. Theft and fraud are never victimless crimes. Unlike, for example, narcotics offenses in which one can at least argue that the crime consists of a willing seller providing a willing buyer with a desired

commodity, no one wants to be swindled. Moreover, the harm inflicted by economic offenses often extends far beyond monetary losses to loss of jobs, homes, solvency, access to health care, or financial security in retirement. At the macro level, recent events remind us that economic crime can destroy businesses, injure entire professions, cause loss of confidence in markets, and damage both local and national economies.

In addition, true "white collar" economic crimes impose unusual costs on the criminal justice system. They require police and prosecutors with special skills, skills that take time and training to develop. Such crimes are often expensive and time-consuming to discover and prosecute. When they go to trial, and sometimes even if they do not, they consume disproportionate amounts of judicial resources.

As for blameworthiness, it bears emphasis that economic crime of the truly "white collar" variety – that is, frauds and swindles of substantial sums by educated members of the business and professional classes – are particularly reprehensible. Such crimes are customarily crimes of greed rather than need. They are committed by persons with significant personal advantages, usually with substantial careful planning.

In my own view, significant white-collar offenders often deserve lengthier sentences than virtually any other category of offender, even including some defendants who resort to unpremeditated violence. Who, after all, is more deserving of punishment, a fellow who gets in a bar fight and concusses his opponent with a bottle in the heat of the moment, or a corporate executive who over a period of months coolly swindles his shareholders out of several million dollars?

Unfortunately, while the foregoing considerations may solidify the conclusion that

white-collar crimes should be punished with some stringency, neither singly nor together do they answer the question of whether present sentencing levels are tough enough.

Crime control: We punish people not only, and perhaps not even primarily, because they deserve punishment, but also, and perhaps more importantly, in order control criminal behavior. Punishment is thought to reduce crime by deterring the punished defendant from offending again, by frightening and thus deterring other prospective criminals who witness the punishment, by incapacitating offenders disposed to recidivate, and also by reinforcing with public examples the general moral code of the community. In the pre-Guidelines period, federal white-collar penalties may have achieved very few of these objectives. When most white-collar criminals, even if caught, receive probation, the disincentives to crime are low and respect for the law is diminished.

It was frequently argued in former days that actual imprisonment of white-collar offenders was superfluous because the collateral consequences of a felony conviction to a person in business or professional life are so uniquely devastating – destruction of a career, disqualification from a profession, destruction of family relationships, collapse of standard of living and social standing, etc. Indeed, such arguments remain a staple of defense sentencing arguments in the Guidelines era. As a matter of equity and social justice, I generally find such arguments both elitist and distasteful. The inability to secure a position in the building trades because of a felony record is certainly no less a hardship for a poor man than disbarment for a felony is for a rich one. Likewise, the shame of visiting with one's family through Plexiglas is no less acute for a blue-collar than for a

white-collar criminal. That said, it is doubtless true that the collateral consequences of a felony conviction are a substantial deterrent to white-collar crime.

Although it is not clear that the general public or even the community of potential white collar offenders realizes it, the days of automatic probation or de minimis sentences for significant white-collar crime ended with advent of the Guidelines. Moreover, the economic crime package of 2001 increased penalties still further. I do not know whether this fundamental transformation has had any impact on the incidence of white-collar crime. Indeed, I am not sure how that correlation could be tested. However, if general and specific deterrence have an effect in the real world, the penalty structure currently in place certainly has a better chance of reducing white-collar crime than the state of affairs that existed before the Guidelines, or even before November 1, 2001.

Conclusion on sentence severity: Overall, my sense is that the range of penalties now in effect for moderate to serious white-collar offenses is not unreasonable. Certainly, one can no longer look at white-collar sentencing and immediately pronounce it a travesty which reflexively favors defendants whose backgrounds look like those of the judges who sentence them. And I see no persuasive evidence that would justify a blanket injunction from Congress to the Sentencing Commission to raise economic crime sentences across the board.

That said, there may nonetheless be classes of cases which current law systematically underpunishes. My recommendation to this Subcommittee would be to consider whether there are such classes of cases and, if so, to instruct the Sentencing Commission to consider crafting appropriate enhancements to account for them.

Two potential examples of such enhancements are included in the bill Senator Leahy has recently introduced (S. 2010):

1. Section 5 of Senator Leahy's bill would direct the Sentencing Commission consider adding a sentence enhancement "for a fraud offense that endangers the solvency or financial security of a substantial number of victims." The present economic crime guideline provides that a judge may depart upward where '[t]he offense endangered the solvency or financial security of one or more victims."[17] However, a judge need not depart in such circumstances. Adding a sentence enhancement, as distinct from a departure consideration, would require an upward adjustment upon a finding of endangerment of solvency or financial security.

Senator Leahy's proposal is very much akin to one I put forward several years ago. It was and remains my view that the amount of loss caused by a defendant is an important indicator of offense seriousness, but that the loss of the same sum of money can mean very different things to different people. The loss of $100,000 to Bill Gates is an entirely different matter than the loss of the same amount to a retiree for whom this amount represents a large percentage of his life savings. Consequently, I suggested a two-level upward adjustment "if the offense caused significant financial hardship to any victim." The term "significant financial hardship" was defined as one which causes a victim

"to file for personal bankruptcy protection, to suffer foreclosure on or

[17] U.S.S.G. §2B1.1 app. note 15 (A)(v) (2001).

> eviction from his primary residence, to be terminated from employment which was a significant source of the victim's income, to suffer the closure, bankruptcy, or loss of ownership interest in any business that was a significant source of the victim's income, to lose health insurance protection for a period of six months or more, or to pay significant medical expenses during any period in which health insurance benefits were terminated or unavailable to the victim as a result of defendant's conduct, to lose a significant portion of his pension or retirement benefits, or to suffer any financial deprivation similar in scope and effect to the examples listed above."[18]

2) The November 1, 2001 Guideline amendments added two- and four-level enhancements in fraud cases involving 10-50 and more than 50 victims.[19] Section 5 of Senator Leahy's bill would direct the Sentencing Commission to consider whether some additional enhancement might be appropriate in cases where "the number of victims adversely involved is significantly greater than 50." I would not be disposed to prejudge the matter, but the number of victims is certainly an important indicator of the extent of harm caused by an offense, and there are some offenses in which the number of victims is very much larger than 50.

III. Does White-Collar Crime Go Unpunished for Lack of Federal Resources?

I would respectfully suggest that the Subcommittee should consider, not only whether penalties are adequate for white-collar criminals who are caught and convicted, but also whether a great many white-collar offenders are never caught and punished at all because federal prosecutors and investigative agencies lack the resources to pursue cases worthy of federal intervention.

In the United States, both state and federal law criminalize theft and fraud, and the same case is often theoretically prosecutable by either federal or local authorities.

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[18] Frank O. Bowman, III, *Coping With "Loss": A Re-Examination of Sentencing Federal Economic Crimes Under the Guidelines,* 51 Vanderbilt L. Rev. 461, 502, 572, 577-78 (1998).
[19] U.S.S.G. §2B1.1(b)(2) (2001).

However, in practice in most places, prosecution of significant white-collar offenses has become the nearly exclusive province of the federal government. There are a variety of reasons for this state of affairs.

Local police and prosecutors customarily view their primary responsibility to be the apprehension and prosecution of those who commit crimes against persons – murders, rapes, assaults, robberies, and the like. Property crimes that garner their attention tend to be offenses that involve physical intrusions in homes, offices, or vehicles – burglaries, criminal trespass, auto theft. And in recent years, drug offenses have assumed a larger profile in state criminal courts. With a relatively few exceptions in some large metropolitan areas, local police and prosecutors give low priority to financial crimes, particularly significant white-collar offenses.

As a former Deputy District Attorney in Denver, I can attest that, at least in my era, the cultural ethos of both police and prosecution was that paper crimes were "civil matters" and were not thought of as "real" crimes.[20] This attitude was reinforced by the fact that neither the police department nor the District Attorney's Office had any significant expertise in financial crimes. I think it fair to say that both this culture and similar resource constraints remain the norm in most, if not all, local police departments and prosecutor's offices.

Therefore, in most states and localities, the only Sheriff in town for white-collar crimes is the federal government. Federal agencies -- the FBI, the IRS, the SEC, and others -- have developed expertise in the investigation of economic offenses, while the

[20] I understand that in recent years the Denver District Attorney's Office has developed an aggressive white-collar crime unit.

Fraud and Tax Sections of Main Justice and Assistant U.S Attorneys across the country have become the nation's experts in financial crime prosecution. To a large extent, this de facto division of labor is entirely appropriate. White-collar prosecution is resource intensive and the federal government has resources that local and state governments often lack. Moreover, much white-collar crime is multi-state in character and impinges on interests peculiarly federal in character. And in any event, whether one likes it or not, the federal government is and will remain the primary enforcer of laws against complex economic crime.

Therefore, if this Subcommittee would like the federal government to be tougher on economic crime, it should consider ways of giving federal law enforcement agencies the resources to investigate and prosecute more white-collar offenders. After all, one can be tough on crime by catching only a few of the villains at large in society and imposing harsh penalties on them as an example to the rest. Or one can show toughness by giving law enforcement the tools to ensure that most wrong-doers will be caught and subjected to appropriate, even if not draconian, punishment.

I recognize that the allocation of law enforcement resources is particularly ticklish in the current state of national uncertainty. In a time of "dirty bombs" and the "War on Terrorism," it may seem almost frivolous to be talking about beefing up law enforcement units devoted to ferreting out mail fraud, health care swindles, or crooked stock manipulation. Nonetheless, the dedication of additional money and manpower to uncovering and prosecuting white-collar crime would be the surest sign of congressional commitment to true toughness.

United States Senate
SPECIAL COMMITTEE ON AGING
WASHINGTON, DC 20510-6400
(202) 224-5364

Statement of Senator John Breaux before the Committee on the Judiciary, Subcommittee on Crime and Drugs

June 19, 2002

Mr. Chairman and Members of the Subcommittee, it is my great pleasure to submit a statement for the record of the Subcommittee today. I want to thank you for the opportunity. The issue that the Subcommittee considers today is an extremely important topic for many Americans. I commend the Subcommittee for its efforts in this regard.

White collar crime affects many Americans on a daily basis. It is extremely important that these matters be prosecuted and that appropriate penalties be imposed to punish the perpetrators and deter future crimes. I share your concerns about white collar crimes involving pensions. This is one of the most insidious crimes in that it impacts our retirees at a time in their lives when they should be enjoying the fruits of their efforts. To the extent they are robbed of their pensions by white collar criminals, their lives may be destroyed. Moreover, the impact on our society and infrastructure, although more difficult to quantity, is clearly substantial. At the end of the 106th Congress, the Special Committee on Aging examined protections of pension funds at the Pension Benefit Guaranty Corporation that serves millions of retirees. The protection of those retirement funds is more critical than ever given the recent events at Enron, a company that has pension plans insured by the PBGC. PBGC also insures this country's airlines, all of which were seriously impacted by the terrorist attacks. It is all the more important to keep vigilante oversight of the solvency of PBGC's retirement trust funds in this current environment. The trust funds should be available when the retirees need them. My Committee will continue to oversee the protection of those retirement funds during my Chairmanship.

In my capacity as the Chairman on the Special Committee on Aging, I have held several hearings on the subject of white collar crime, and other crimes and abuses, committed against seniors citizens. Seniors can be a particularly vulnerable segment of our population in certain instances. I counted no less than 20 hearings by the Special Committee on Aging on various abuses of the elderly in the past three Congresses. There have been many other hearings held by other committees in the House and Senate over the years on these topics, too. Included with my written testimony is a copy of a time line of hearings held by the Special Committee on Aging

and the prior House Select Committee on Aging on elder abuse and crimes against the elderly. In short, Congress has held hearings on these subjects since at least 1979. Yet, there is no legislation to address these problems.

Financial exploitation, or financial fraud, has existed in some form since the beginning of time. It does not affect only the elderly, but certainly the elderly, under certain conditions, are often highly susceptible to promising offers, investments, and companionship that can result in destitution or worse. Moreover, financial exploitation of the elderly is often aggravated by violence or the threat of violence. The elderly tend to be more trusting and less cynical than younger people in dealing with fraudulent salesmen and other scam artists. Many senior citizens come from a time when a handshake, not a contract, was all it took to conclude a deal. Certainly, the concept of "buyer beware" is as useful today as it has always been. However, in too many instances vulnerable senior citizens are no match for scam artists and are robbed of their life savings, their retirement funds, or worse.

The United States has 45.8 million persons age 60 or older. There is too little data on how many senior citizens are being financially abused. Yet, persons over 50 control at least 70% of the nation's household net worth. Accordingly, it is no wonder the elderly are targets of financial crimes and will only increase as targets as Baby Boomers age. The FBI does not even have a category in its Uniform Crime Reporting System to monitor elder financial crimes.[1] Most police officers and prosecutors are not trained to spot financial abuse or refuse to investigate it, claiming it is "a civil matter."

The National Center on Elder Abuse (NCEA) conducted the most extensive study on elder financial abuse in 1998, sampling incident reports made to state adult protective services agencies. The NCEA National Elder Abuse Incidence Study found that out of 450,000 substantiated reports of all types of elder abuse, approximately 40 percent, or 220,400, involved some form of financial abuse. Unfortunately, this study sampled only 15 states with 20 out of 3,000 counties nationwide represented. Nonetheless, the report estimates conservatively that only **one out of every five financial abuse cases is reported**. Other experts interviewed believe that there are even more unreported cases. Therefore, experts estimate conservatively that 3-5 million senior citizens are financially abused annually. The NCEA report states that officially reported cases are only the "tip of the iceberg."

Elder financial abuse ranks third behind neglect and psychological abuse[2] as the most prevalent form of elder abuse. In fact, while approximately 30% of crimes against the elderly

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[1] Generally, the only details found in the UCRS regarding victims relate to murder. The new National Incidence Based Crime Report (NIBCR) is expected to detail the victim and more, if it is universally implemented. Accordingly, it would be easier to analyze elder crimes.

[2] Physical and sexual abuse in nursing homes was the subject of the Special Committee on Aging's March 4, 2002, hearing.

involve financial abuse, 25% represent physical abuse. The remaining are a combination of neglect, psychological, sexual, and other abuses.[3] Since persons over 50 control at least 70% of the nation's household net worth, they are frequent targets for exploiters, especially if they are homebound and disabled in some way. It is estimated that the elderly will control approximately $10 trillion in assets within the next 10 years. This figure makes it all the more urgent that action is taken to address this growing problem before the Baby Boomers become senior citizens.

Federal definitions of elder abuse, neglect, and exploitation appeared for the first time in the 1987 Amendments to the Older Americans Act. However, the definitions are merely guidelines for identifying problems and not guidelines for enforcement purposes. Primarily, elder abuse is defined by state laws. These definitions vary among the states with regard to what constitutes abuse, neglect, or exploitation of the elderly. There are three basic categories of elder abuse: (1) domestic elder abuse; (2) institutional elder abuse; and (3) financial exploitation. The reason I raise the types of elder abuse is because it is almost impossible to separate these forms of abuse from one another. Almost invariably, there are multiple forms of abuse and neglect at play when financial abuse is present.

Take for example the stories of several elderly victims told at the Special Committee on Aging's May 20th hearing. First, let me describe the case of Marie Bobo. I have included photos of Ms. Bobo's condition when she was found and the condition of her home with my written statement. Marie Bobo, 81 years old, lived in a single family home in Tacoma, Washington. She retired from her civil service job 20 years ago and lived solely on her retirement check. On January 14th, her daughter Margaret, made a 911 call to the Fire Department asking for assistance with her mother who had fallen in the house. The Fire Fighters had to remove the outer door from the hinges and climb over stacks of household trash that in places went from floor to ceiling. They found the elderly victim literally stuck to the trash by her own feces. Pieces of her skin were pulled from her body as they lifted her for transport to an area hospital. The home was filled with human feces and rodents. The home's other rooms were accessible only by crawling over piles of trash. In addition, she had been in the fetal position for so long that it was believed that her arms and legs would have to be amputated. Recently, the decision was made to sever her tendons so that she could at least sit upright in a wheelchair for the rest of her life.

You may ask what does this story have to do with white collar crime. In fact, Ms. Bobo's daughter was keeping half of her small, monthly retirement stipend and clearly not using the other half for Ms. Bobo's medical and daily care. There was no record of utilities being paid or medical appointments made or even food being purchased for Ms. Bobo. She was only given

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[3] The National Elder Abuse Incidence Study, NCEA, 1998. The Report provided the following percentages for types of elder abuse: Neglect (48.7%); Emotional/psychological abuse (35.4%); Financial/material exploitation (30.2%); Physical abuse (25.6%); Abandonment (3.6%); Sexual abuse (0.3%); Other 1.4%). It should be noted that total percentages do not equal totals across abuse categories, because more than one substantiated type of abuse was often reported for an incident.

a bowl of food and water once a day, like a pet. The week before the hearing Ms. Bobo's daughter was convicted of mistreatment of an elder and abandonment. That was the best statute available to the local prosecutors for charging the daughter. She faced a possible sentence of 14 months. The prosecutor sought 5 years. In any event, the judge just decided to sentence her to 90 days, time that was already served. This is one of the more egregious cases of financial abuse, as well as physical abuse, neglect and abandonment that I can remember encountering. Yet, the perpetrator received a particularly light sentence in this instance. This is the type of case that should be addressed by the enhanced penalties that you are discussing today. Moreover, I believe that we must find a way to provide training, not only to law enforcement and social service workers in the states, but to the judiciary. We must send a message that abuse of the elderly will not be tolerated.

Another witness, Carl Fiosche, testified at the May 20th hearing about organized efforts by a group of itinerant criminals who prey on the elderly. In about four months, he lost $70,000 to this group in retirement monies, plus his house worth more than $109,000. The damage would have been worse, but he received help from Adult Protective Services and filed bankruptcy. In this case, no investigation took place, no charges were filed, so there has been no sentence to impose and certainly no restitution. However, that does not detract from the enormity of the impact on the life of Mr. Fiosche.

In my own state of Louisiana, a senior citizen by the name of Enid Hebert who passed away in November, was financially exploited by her private caregiver. Her caregiver, Amanda Broussard, was hired to attend to her needs but quit working when her various schemes to obtain money from Ms. Hebert were discovered. Ms. Broussard systematically took retirement monies from Ms. Hebert over approximately three years, totaling approximately $100,000 of monies needed for her retirement. Ms. Hebert would have lost her house to this caregiver but for the intervention of Ms. Hebert's family. Due to the condition of Ms. Hebert, the family agreed to a plea bargain, so Ms. Broussard pled guilty to three counts of attempted exploitation of the infirmed. She was only ordered to pay $250 per month in restitution for five years. Yet no one that I have consulted believes that she will make the restitution payments. Clearly, the sentence carried out did not equal the gravity of the damage done to Ms. Hebert and her family.

Another hearing witness described crimes in Manassas, Virginia, right in the backyard of Congress. Vaughn Blevins, a Virginia senior in his mid 70s, was conned out of nearly $400,000 by convicted felon, Larry Henderson. Mr. Blevins' cousin has identified 200 elderly victims of Larry Henderson at a loss of approximately $3 million to those retirees. In the case of Larry Henderson, he was convicted on state and federal charges and is serving a lengthy sentence in prison. However, the restitution ordered will probably never benefit these 200 senior citizens who are now destitute.

These cases illustrate the need to address complicated social issues involving elder crimes in our sentencing guidelines. There are no easy answers. However, it is clear that we have to send stronger messages in imposing penalties in some instances, and we have to find creative

alternatives to prison sentences in other instances.

Two pension scams that have come to my attention include pension investment managers who in Oregon and New York profited richly from the pensions of others by taking people's retirement money. I am referring to the Capital Consultants case in Oregon and the Alan Bond case in New York. In both of these cases retirees were cheated out of millions of dollars in pension funds by pension fund administrators.

I could recite story after story to this committee. However, suffice it to say that the seniors citizens of this country deserve more than this. It's time for the sentences to equal the crimes.

It is with crimes and abuses like the ones we are discussing today in mind that I will soon be introducing the Elder Justice Act of 2002. It is my hope that with this legislation, we can begin to address these matters once and for all. My hope is that the legislation will elevate elder abuse, neglect and exploitation, as well as crimes against the elderly to the national stage in a lasting way. Crimes against seniors need to be elevated to the level of child abuse and crimes against women. I learned that there is **not one single federal employee working full time on elder abuse, neglect and exploitation**.

In addition, **elder justice is about prevention and intervention** - It funds projects to make older Americans safer in their homes and neighborhoods, to enhance long-term care staffing and to stop financial fraud before the money goes out the door.

Elder Justice is about detection - It creates forensic centers and develops expertise to enhance detection of the problem.

Elder Justice is about treatment - It funds efforts to find better ways to mitigate the complex needs and devastating consequences of elder mistreatment.

Elder Justice is about collaboration - It requires ongoing coordination at the federal level, among federal, state, local and private entities, law enforcement, long-term care facilities, consumer advocates and families.

Elder Justice is about prosecution - It assists law enforcement and prosecutors to ensure that those who abuse our nation's frail elderly will be held accountable, wherever the crime occurs.

Elder Justice is about helping consumers - It creates a resource center to assist family caregivers and those who are trying to make decisions about different types of long-term care providers.

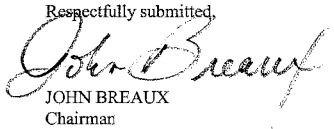
We have pulled together – the Congress and the nation – to face the ugly truth of other

types of abuse and neglect. But we have not yet faced up to elder abuse and crimes against the elderly. We must face this problem now so that we have, in place, the infrastructure, the knowledge, the services and the resources to deal with this problem as America ages.

Lastly, Mr. Chairman I would like to add that I have examined your bill to create a national center for criminal background checks. I applaud you for that effort and believe such a center would be very beneficial to protecting seniors. It complements my Elder Justice proposal. I would like very much to discuss this with you further and consider ways to work together toward these ends.

Thank you for allowing me the opportunity to submit a statement for the record.

Respectfully submitted,



JOHN BREAUX
Chairman

TESTIMONY OF JAMES B. COMEY,
UNITED STATES ATTORNEY FOR THE SOUTHERN DISTRICT OF NEW YORK
BEFORE THE SUBCOMMITTEE ON CRIME AND DRUGS
COMMITTEE ON THE JUDICIARY, UNITED STATES SENATE

June 19, 2002

INTRODUCTION

Chairman Biden, Senator Grassley, Members of the Subcommittee –

I thank you for the invitation and very much welcome the opportunity to appear before this Subcommittee today to discuss the important issue of penalties for white collar crime.

Mr. Chairman, as you know, the swift and certain punishment of financial crimes helps protect our country's economy. The prosperity of the United States is, in part, made possible by the federal, state, and local laws that bring a degree of order and predictability to commerce and protect citizens from the predation of criminals who use a pen or a computer, rather than a knife or a gun. But as you also know, the real and immediate prospect of significant periods of incarceration is necessary to give force to law. Nothing erodes the deterrent power of our laws -- and breeds contempt for obeying the law -- more quickly than if certain criminals appear to receive punishment not according to the gravity of the offense, but according to their social or economic stature. We think it absolutely critical – not only to maintain trust and confidence in our economy and in our criminal justice system, but also for the sake of justice itself – that there be appropriate and stiff penalties for what we commonly call "white collar" criminals. We thank

you for your leadership in convening this hearing and for raising the important issues being discussed today.

The Department of Justice is committed to the vigorous enforcement of the laws against all forms of financial crime. Our position on this issue is straightforward, and, we hope, inarguable: White collar criminals who have broken serious laws and who have done grave harm to real people – like the people who just testified -- should be subject to the same serious treatment that we accord all serious crimes: substantial periods of incarceration. While we have made significant progress on some issues in recent years, especially in improving the applicable Sentencing Guidelines, we believe that current federal penalties for white collar offenses should be toughened. We are pleased that last year the United States Sentencing Commission amended the Sentencing Guidelines for these offenses to raise penalties on white collar offenders who are responsible for significant financial loss, although penalties were decreased to some extent for criminals who are responsible for less serious offenses. Both the Department and the Commission will be closely examining the effects of those recent amendments on cases that are just now being prosecuted, and we at the Department will pay particular attention to what happens with the lower-level cases, which constitute a significant number of prosecutions. We also remain concerned with amendment proposals that have been made to the Sentencing Commission in past years – and which may be made again – that could undermine federal sentencing policy for white collar offenders. We are pleased that the Commission has so far seen fit to reject such proposals, and we hope to work with this Subcommittee and with the

Commission in the coming months and years to insure that penalties for white collar offenses are appropriately severe.

WHAT IS A WHITE COLLAR OFFENSE?

Of the nearly one thousand criminal offenses listed in the Statutory Index to the 2000 Federal Sentencing Guidelines, approximately twenty-five percent get sentenced under the theft and/or fraud guidelines. Frank O. Bowman, III, The 2001 Federal Economic Crime Sentencing Reforms: An Analysis and Legislative History, 35 INDIANA L. REV. 5, 17 (2001). The Department's definition of white collar crime sweeps more broadly. While we consider securities fraud, tax fraud, and antitrust violations to be white collar cases, we also believe that bankruptcy fraud, bank fraud, health care fraud, federal program fraud, and many other crimes committed by the use of deception for the purposes of economic gain fit comfortably within the category of white collar crime. This definition encompasses the significant problem of corruption in the private, as well as the public, sector. Private industries can be prey to bribery and kickbacks in exchange for contracts or other benefits. This corruption corrodes the integrity of business dealings and gives an unfair competitive advantage to those willing to pay. As the previous witnesses have told us, corruption also harms average Americans – those people who devote their careers to a corporation with the expectation of a secure job and a comfortable retirement, and those who invest their hard-earned savings in a company that claims to be sound. Just as the Internet and other technologies have improved our ability to communicate, to learn, and to trade, these innovations have also enabled criminals to more easily, and more creatively,

commit crimes, and also to harm a much greater population than could ever have been imagined before. We believe our broad definition of "white collar crime" gives us added flexibility in identifying, investigating, and prosecuting these high-tech thieves and fraudsters.

PRINCIPLES OF PUNISHMENT FOR WHITE COLLAR OFFENDERS

We begin with the principle that the certainty of real and significant punishment best serves the purposes of deterring white collar criminals, in fact to a greater extent than this principle applies to other types of offenders. People with a lot to lose, especially people who have never been in trouble with the law before, don't want to go to prison. On the other hand, enforcement can be undermined when criminals perceive the risk of incarceration as minimal and view fines and probation merely as a cost of doing their criminal business. We believe that if it is unmistakable that the automatic consequence for one committing a significant white collar offense is prison, then many will be deterred. White-collar offenders are generally better educated and more sophisticated than most criminals. They tend to commit their crimes not in a fit of passion, but with cold, careful calculation. Accordingly, they are the most rational offenders and are more likely than most to weigh the risks of possible courses of action against the anticipated rewards of criminal behavior.

The certainty of incarceration for white collar offenses in Sentencing Guidelines Zone C and above increases the prospect of significant cooperation by defendants who are (as in many, if not most, white collar cases) part of broader conspiracies. White collar criminals, oftentimes

more than other types of criminals, engage in concealment, deceit, and coverups as part and parcel of their criminal schemes. They depend on each other to maintain a "cover story" to explain away the criminal implications of their actions. The prospect of added cooperation, encouraged through the likelihood of significant periods of imprisonment, goes a long way towards piercing such cover stories -- in effect, efforts to obstruct justice -- and successfully prove the full extent of white collar conspiracies.

Just as importantly, the certainty of real jail time in white collar cases fosters trust and confidence in the criminal justice system. If drug and violent offenders are routinely sentenced to long prison terms while white collar offenders are routinely sentenced to probation, people will draw the conclusion that felons with wealth and influence are not held to the same standards as those without; that there is a double standard; that perhaps certain people are above the law. This is unacceptable in our republican form of government and corrosive to societal order.

In addition, contrary to what some have argued, certain and significant punishment can foster restitution. Some may argue that a white collar offender sentenced to prison is not likely to make restitution. This is wrong. We believe that, if structured properly, white collar sentences that include imprisonment can and will lead to restitution for the victims of the crime. The Sentencing Guidelines appropriately provide incentives for defendants who reveal and turn over all of their assets in order to pay restitution to their victims – something a defendant who does not face incarceration, but only probation or a halfway house, may not feel compelled to do.

Legislation passed by Congress in recent years has helped to insure that restitution is always a top priority of federal sentencing policy.

RECENT DEVELOPMENTS IN SENTENCING POLICY FOR WHITE COLLAR OFFENSES

Over the past several years, the Justice Department has worked closely and constructively with the Sentencing Commission on sentencing policy for white collar offenses. As I mentioned, the current sentencing guideline penalty structure for many white collar offenses is new – a product of many years of debate and compromise that culminated in last year's amendments to the Sentencing Guidelines. The so-called "Economic Crime Package," passed by the Commission in April 2001, and which went into effect in November 2001, consolidated the Sentencing Guidelines for theft, property destruction, and fraud offenses, revised the definition of "loss" – a key element of such guidelines – and increased penalties for offenses involving moderate and high losses. The package reduced penalties on some lower level offenses. The amendment also provided a revised loss table for tax offenses that provided for higher penalty levels for offenses involving moderate and high tax losses. The new tax table did not, however, generally reduce any sentences with lower loss amounts.

We believe the Economic Crime Package generally improved and furthered federal sentencing policy, and both we and the Commission are now monitoring the impact of the Package to see what the real impact of the amendments will be. As mentioned, we remain concerned about the effect of the Package's changes to sentences for lower-level defendants –

roughly those defendants responsible for less than $70,000 in financial loss to the victim or victims. Plainly, to most people $70,000 is a lot of money, and in many areas of the country federal prosecutors bring cases against criminals based on those amounts. We also want to see if defendants who face lesser sentences in such cases will be more willing to roll the dice and go to trial rather than plead guilty. Because the amendments were prospective only, it may be some time before complete data are available to evaluate fully the impact of the Package. Notwithstanding these concerns, we believe that the changes made by the Package are consistent with the principles of appropriate certainty and severity and are generally a step in the right direction.

We also remain concerned with proposals that have been made to the Commission in past years for changes to federal sentencing policy that we believe would have the unintended effect of benefitting white collar offenders. In fact, some of these proposals would, if enacted, undermine the progress embodied in the Economic Crimes Package, the goals of certain and real punishment for white collar offenders, of compensating victims, and various important white collar enforcement programs. Fortunately, the Commission has rejected such proposals in the past, but some of them seem perennial and we may see them again in future years.

For example, some amendments that have been proposed to the Commission in recent years would have increased the availability of probation to low-level offenders with few or no prior criminal convictions or arrests. Such proposals typically are meant to address situations involving young, first-time drug offenders facing significant jail time. However, the effect of

such proposals on white collar defendants – who also commonly have little or no prior experience with the criminal justice system – would be to greatly increase the eligibility of such criminals to serve no jail time at all, or to be eligible to serve home detention or some other "alternative to incarceration." Such proposals seem to us inconsistent with the Commission's historical treatment of white-collar offenders. The Commission has regularly recognized the need to deter white-collar and other similar offenses and to provide proper sentences for those who commit such offenses. It was for this reason that the Commission, when drafting the initial guidelines during the Eighties, explicitly excluded white collar offenses – which have historically received modest (and oftentimes probationary) sentences – from its early focus on past sentencing practice and deliberately raised penalties for such offenses from low historical levels. It was for this reason that the Commission deliberately changed sentencing policy and increased penalties for tax offenses on several occasions to insure appropriate punishment for such offenders. And it was for this reason that the Commission considered and increased penalties recently for antitrust offenses. On the other hand, the Commission has considered many proposals over the years – of the kind I just described – to "increase flexibility" for judges in sentencing these offenders by expanding the availability of sentences other than incarceration.

There may be legitimate concerns about judicial discretion and its role in sentencing under the guidelines, and an important role of the Commission is to explore and evaluate the issue of judicial discretion in sentencing. But reducing the certainty of punishment for white collar offenders, we believe, is an inappropriate way to address these concerns. Congress created the Sentencing Guidelines to cabin judicial discretion. While changes to the balance of

discretion in the system may be appropriate, cabined discretion is still the baseline, unless Congress says otherwise.

One important example of where these issues can significantly affect enforcement and compliance with the law is in with criminal tax enforcement. Creating more flexibility for judges in tax cases – where again, defendants typically have never been in trouble with the law before – would devastate tax enforcement. One of the proposals considered by the Sentencing Commission during the 2001 - 2002 amendment cycle would have expanded the availability of home detention and other alternatives to incarceration. Under that proposal, a probationary sentence would have been available to a defendant with a "tax loss" in a single year of up to $30,000. Under the guidelines, assuming, for example, that a taxpayer is married, files a joint return, and is in the 35% marginal tax bracket, a $30,000 tax loss equates to $85,715 in unreported taxable income. Thus, a taxpayer who failed to report up to $85,000 in income would have been eligible under that proposal for a purely probationary sentence, without any imprisonment time whatsoever.

The picture under the proposal was even worse when the likelihood of a sentence reduction for acceptance of responsibility (elsewhere in the guidelines) was considered. Most people charged with federal crimes enter guilty pleas rather than going to trial, and in most such circumstances the guidelines permit a downward of adjustment for "acceptance of responsibility." In fiscal year 2000, approximately 89% of the defendants in tax cases received an acceptance of responsibility adjustment (64.4% received a two-level reduction and 24.4%

received a three-level reduction). See United States Sentencing Commission, 2000 Sourcebook of Federal Sentencing Statistics, Table 19 (Offenders Receiving Acceptance of Responsibility Reductions Sentencing Options in Each Primary Offense Category (Fiscal Year 2000)). This means that a number of defendants responsible for major "tax losses" would be likely to receive a reduction for acceptance of responsibility. Under the alternatives to incarceration proposal, such defendants would not have faced any mandatory prison time and could escaped with a probationary sentence only.

Moreover, according to the most recently available statistics, almost 90% of the taxpayers who filed returns in tax year 1999 had an income of $95,000 or less. Internal Revenue Service, Statistics of Income (SOI) Bulletin, Fall 2001 (Table 1, Individual Income Tax Returns, 1999). This means that nearly 90% of the taxpaying public would have been eligible for a probationary sentence under these proposals if they willfully failed to report any of their income for three consecutive years -- quite aside from any reductions for acceptance of responsibility. (Using the Tax Code's tables for 2002, a married taxpayer filing jointly with taxable income of $95,000 would be in the 27% marginal tax bracket and would face a tax liability of about $19,450.)

This proposal was flatly inconsistent with Commission's own stated view as to the critical importance of deterrence in enforcing the criminal tax laws:

> The criminal tax laws are designed to protect the public interest in preserving the integrity of the nation's tax system. Criminal tax prosecutions serve to punish the violator and promote respect for the tax laws. Because of the limited number of criminal tax prosecutions relative to the estimated incidence of such violations,

> deterring others is a primary consideration underlying these guidelines. Recognition that the sentence for a criminal tax case will be commensurate with the gravity of the offense should act as a deterrent to would-be violators.

USSG Ch.2, Pt.T(1), intro. comment.

The deterrence message is substantially undercut by proposals that reduce the likelihood that tax violators and other white collar offenders will spend some time in prison for their crimes. Common sense tells us that the realistic probability of imprisonment acts as a powerful deterrent to someone who is weighing the costs and benefits of cheating the IRS. In criminal tax cases, however, a large number of violators do not face that risk. In fiscal year 2000, 46.2% of tax defendants received some form of probation, and half of that number (23.1%) received a sentence of straight probation. See United States Sentencing Commission, 2000 Sourcebook of Federal Sentencing Statistics, Table 12 (Offenders Receiving Sentencing Options in Each Primary Offense Category (Fiscal Year 2000)). While we acknowledge that the percentage of probationary sentences in criminal tax cases has been decreasing since 1995,[1] we are very concerned that the expansion of alternatives to incarceration would increase the pool of tax and other white collar violators eligible for a probationary sentence and send the message that white collar violations are not likely to result in any prison time.

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[1]The 46.2% of criminal tax defendants receiving probationary sentences in Fiscal Year 2000 marks the first time since the guidelines' inception that probationary sentences were less than 50%.

Obviously, increasing judicial flexibility does not in and of itself result in more probationary sentences. It simply increases the number of defendants eligible for probationary sentences and gives sentencing judges discretion to impose such sentences in a wider array of cases. Our experience as prosecutors – and the Commission's own data – suggest that if white collar defendants are eligible for probation, they likely will receive probation. Unfortunately, this seems to be especially true in the my own district, the Southern District of New York, which is home to our financial capital.

Problematic Non-Substantial Assistance Downward Departures in White Collar Cases

Because Congress contemplated that the Sentencing Guidelines would cover nearly every factual circumstance that could be anticipated in criminal cases, judges are rarely supposed to depart from the sentence range prescribed by the guidelines in a particular instance. In those cases where the facts were unique and not previously addressed, a judge could depart upward or downward to reflect the unusual gravity of the crime or the inordinate extremity of the punishment compared to similarly-situated defendants. Appropriately, the guidelines also permit judges to grant downward departures for "substantial assistance," rewarding a defendant's willingness and ability to cooperate with law enforcement in prosecuting more serious crimes – to use a classic example, the hit man can get a reduced murder sentence for testifying against the mob boss. However, the pattern now seems clear that federal judges are using downward departures frequently, in some cases nearly routinely, as a way of getting around the prescribed guidelines sentences. This phenomenon is just as detrimental to the overall goal of deterring and

equitably punishing white collar crime as the related problem I previously discussed of judges' using additional flexibility *within* the guidelines to sentence white collar defendants to probation rather than jail. Further exacerbating the problem, the more deferential standard of review announced by the Supreme Court in Koon v. United States, 518 U.S. 81 (1996), has impaired the government's ability successfully to challenge district court departures. This Administration is very concerned about the type and increasing number of non-substantial assistance downward departures. The impact of these departures in white collar cases cannot be overstated.

Although the Supreme Court adopted a deferential appellate standard of review in Koon, the Court also noted that in developing the guidelines, the Sentencing Commission contemplated that departures based upon grounds not mentioned in the guidelines would be "highly infrequent." Unfortunately, in some districts, non-substantial assistance downward departures are anything but infrequent (9,286 non-substantial assistance downward departures were made in 2000). In 2000, districts without large illegal alien caseloads reported large downward departure percentages (e.g., E.D. Washington (43.6%), Connecticut (31.9%), Vermont (30.7%), E.D. Oklahoma (29.2%), W.D. Washington (24.1%), Massachusetts (22.8%), and Minnesota (20.3%)). In contrast, only one district within the Fourth Circuit exceeded 10% non-substantial assistance downward departures, and the districts in that Circuit averaged 5%. In fraud cases in 2000, 11.6% (669) of the defendants received non-substantial assistance downward departures. Sentences for money laundering (13.9%), tax crimes (14%), and embezzlement (13%) shared similar statistics for non-substantial assistance downward departures. In contrast, none of the upward departure rates for these categories exceeded 1.1%. While available analyses do not

detail the bases of these departures in white collar cases, a number of district judges appear to believe that white collar defendants should not be incarcerated in order to facilitate payment of restitution and fines. Of course, this is at odds with the view that incarceration can deter such crime in the first instance.

Further, departures made pursuant to U.S.S.G. §5K2.0 - - civic or charitable work (§5H1.11), aberrant behavior (§5K2.20), employment record (§5H1.5), family ties (§5H1.6), post-offense rehabilitation, diminished capacity (§5K2.13), mental condition (§5H1.3), and other departures not mentioned in the guidelines, but construed as outside the heartland of the guideline in question (i.e., "Koon paradigm" departures) - - are fodder in virtually every sentencing of a white collar defendant given the community standing and background of most white collar defendants. These departures further erode the relatively less onerous guideline ranges in white collar cases.

It may be useful for the work of the Subcommittee to learn of some recent cases emblematic of the problem faced by the government in white collar sentences.

White collar defendants oftentimes attempt to buy their way out of incarceration. Although the guidelines specifically preclude the use of socioeconomic factors (see U.S.S.G. §5H1.10 (socioeconomic status is "not relevant in the determination of a sentence")), in a recent case in the Western District of North Carolina, a defendant received a ten-month downward departure for "extraordinary restitution" because he liquidated his inheritance to pay $500,000 to

a victim. In other cases, this has been termed "extraordinary acceptance of responsibility". See United States v. Bean, 18 F.3d 1367, 1368-69 (7th Cir. 1994). As I mentioned, the guidelines do encourage defendants to pay full restitution to their victims, and will permit the court to grant leniency if that occurs under compelling circumstances. However, this should not become a routine avenue to grant downward departures to any wealthy defendant who can write a check to pay back his ill-gotten gains.

In a recent case in the District of Kansas, a defendant was found guilty following a jury trial of conspiring to offer to pay remuneration in exchange for Medicare and Medicaid referrals and of offering or paying remuneration to induce such referrals in violation of the Medicare Antikickback Act, 42 U.S.C. § 1320a-7(b)(2)(A), (B). Although the presentence report indicated that his total offense level was 13 and that the sentencing range was 12-18 months without the possibility of probation given its classification as a Zone D offense, the defendant was sentenced to three years probation, including six months of home detention, and fined $30,000. The government asserted that the offense conduct required at least a total offense level of 23 and a sentencing range of 46-57 months. The court made a downward departure for aberrant behavior and extraordinary family circumstances, which allowed imposition of the sentence of probation and home confinement with electronic monitoring. The court also commented on the defendant's community service.

In a recent Ninth Circuit opinion, United States v. Britt, 2001 WL 1587596 (9th Cir. 2001) (unpublished), the government unsuccessfully appealed the district court's four level downward

departure in a bankruptcy fraud case. The specified guideline range called for a sentence between 21-27 months (Offense Level 16, Criminal History Category I). The departure appears to have been based upon the fact that the defendant's "plans to start a new career as a lawyer have been dashed, and the record reflects that she was under considerable mental stress as a result of her divorce and custody battle." Instead of mandatory incarceration, Ms. Britt was eligible for a split sentence under Zone C.

The Subcommittee may also wish to review United States v. Ruttner, 2001 WL 138308 (2nd Cir. 2001) (extraordinary acceptance of responsibility); United States v. Gee, 226 F.3d 885, 902-03 (7th Cir. 2000) (home confinement instead of incarceration because of physical condition although the government argued that the Bureau of Prison's medical services are adequate to address defendant's needs); United States v. Vitale, 159 F.3d 810, 812-13 (3rd Cir. 1998) (in a wire fraud and tax fraud case involving more than $400,000 in wire fraud and $1.2 million in tax fraud, the district court departed downward for extraordinary acceptance of responsibility, restitution efforts, community service, and post-offense rehabilitation and sentenced the defendant to 30 months incarceration, a 21 month departure from the bottom of the applicable range; the district court did not depart upon defendant's theory that diminished mental capacity created a compulsion to purchase antique clocks); United States v. O'Kane, 155 F.3d 969, 971-75 (8th Cir. 1998) (in a mail fraud and money laundering case, the defendant's adjusted offense level was 16, a Zone D classification which would have required 21-27 months incarceration; the district court made a four level departure for "unusual acceptance of responsibility, and sentenced the defendant to five months community confinement and five months home arrest); United

States v. Yang, 281 F.3d 534 (6th Cir. 2002) (in case involving conspiracy to steal trade secrets in violation of the Economic Espionage Act, the district court made 14 level downward departure based upon the victim's participation in the prosecution); United States v. Coble, 2001 WL 431529 (4th Cir. 2001); and United States v. Yeaman, 248 F.3d 223 (3rd Cir. 2001). Some of these cases reflect successful results for the United States in the Courts of Appeals. Nevertheless, these cases are instructive in terms of the treatment of white collar defendants by district courts. Our experience suggests that similar departure decisions by the district courts are allowed to stand, because the record from the sentencing hearing does not allow the government to prove an abuse of discretion under Koon.

These cases demonstrate what the Sentencing Commission knew in the 1980's and attempted to address in the original guidelines: for a variety of reasons, federal judges are hesitant to incarcerate white collar defendants. If past is prologue, even though the economic crime amendments of 2001 increased penalties for these crimes, departures will be used to undercut the purposes of the new provisions.

For further support of the argument that white collar defendants do not receive adequate incarceration, consider the number of defendants who are sentenced at the low end of the applicable guideline range. 64.5% of all cases were sentenced within the guideline range in 2000. 62.7% of these defendants received the guideline minimum. White collar cases receive comparable treatment when measured with other crimes. Defendants in fraud cases received the guideline minimum in 61.4% of the cases. Defendants in tax cases received the guideline

minimum in 76.1% of the cases. Embezzlement and money laundering defendants received the guideline minimum in 68.1% and 69.1% of the cases respectively.

CONCLUSION

For white collar offenses, certainty of punishment and appropriate severity are vitally important. We appreciate the work of the Sentencing Commission in promulgating the Economic Crimes Package and believe that principles of certainty and appropriate severity are being served through its enhanced penalties. We look forward to continue working with the Commission and this Subcommittee to insure that federal sentencing policy is designed to reduce crime in the best manner possible. But we also reiterate what then-Acting Deputy Attorney General Robert Mueller said in his testimony to the Commission last year regarding a proposed Amendment, ultimately disapproved by the Commission, that purported to increase "flexibility" in sentencing:

> At a time when vigorous white collar crime prosecution is needed, these flexibility options and changes to the sentencing zones send entirely the wrong message. After all, many white collar defendants have generally benefitted from society, have strong educational backgrounds and are often successful professionals. When these individuals break the law, they should not be excused from serving a prison sentence simply because they did not commit crimes of violence. The public has a right to expect that people with privileged backgrounds who commit crimes will not be exempt from the full force of the law and will not be treated with inappropriate leniency. Accordingly, the Department strongly opposes these amendments.

Mr. Chairman, that concludes my prepared remarks. I would be glad to answer any questions the Subcommittee may have.

Dear Members of the Judiciary Committee

I am Janice Farmer, an Enron retiree, from Orlando, Florida. I am a very proud woman. It is with extreme emotional difficulty that I come before you today to share my financial plight and personal problems. However, I feel compelled to explain my situation to you. In doing so, I truly hope to be a voice for all Enron employees.

I once had close to $700,000 in my 401K Savings Plan. That was in late 2000. After years of hard work and dedication, I had achieved my life's dream - enough money to retire comfortably, to live independently with financial security. It was part of my dream to leave my children and grandchildren a respectable inheritance to enrich their lives. For all of those years, I faithfully put money into the savings plan and fiercely protected it. Never touching my savings no matter what hardships came along.

In 1994 Enron discontinued it's formal retirement program, making each employee responsible for their own retirement planning. I still tenaciously worked toward my dream. Then in 2001, at the most crucial time, Enron denied employees access to our own money. The shrewdly scheduled lock-down of the 401K denied other employees and myself access to our money for weeks just prior to the collapse of the seventh largest company in the United States. While company executives managed to sell stock worth millions, employees were brutally forced to watch helplessly while the 401K lost $1.3 billion in value. As I understand it, the plan administrators had the opportunity to lift and/or postpone this lock-down, but chose not to. I feel it is very clear that employees were not only victimized by Enron executives, we were sacrificed for their own personal gain. What had taken me a lifetime to build was destroyed in only a matter of days. When the lock-down was finally lifted and I was allowed access to sell, I received a check for $20,418. That was all that was left.

I am now 61 years old and will not have the opportunity to re-coup my losses. I suffer from Degenerative Arthritis of the spine along with three ruptured discs. This causes constant and severe pain. I am diabetic which has caused neuropathy of my lower extremities. I also suffer from Plantars Fasciitus, which is like having constant muscle cramps on the soles of both feet. This too is painful and very disabling.

Now, I try to get by on Social Security survivor's benefits, about $500.00 a month after health insurance and medical prescription costs. Out of that $500 I must pay my car and house insurance, plus my property taxes. Whatever will I do if anything breaks down or if I should get sick?

Now, I am afraid of my electric bill, so at night I sit in the dark. I used no heat during the winter months. I use air conditioning only on the very hottest and most humid days, or when I have visitors. The lowest I been able to reduce my monthly bill to is $51.00. I try to save money wherever possible, and to name

just a very few:

- I stopped the newspaper delivery and was glad to get a refund of $33.00. That is now a week's worth of groceries.
- Stopped the yard service and try to do it myself on my good days.
- Cut my telephone and other household services to the barest minimum.
- I no longer shop at Publix or nice department stores. Instead, I shop at discount food stores and thrift shops.

I do not mean to give the impression I am too good for, or above any of this. But, retirement was not supposed to be like this. It is certainly not what Enron had continually touted to its employees. For years we were lied to about the financial condition and the future of our company. They told us everything was great, never better, but these lies were all part of the sham. Enron had become a house of cards and the people that knew it, protected only themselves.

They took more than my money and my life's dream. They destroyed my pride in my career. I am now very ashamed that I worked for Enron. The emotional toll my family and I have suffered defies description. The strength and emotional support from my children has been invaluable.

The executives, even this long after causing the collapse of Enron by their criminal behavior, go scot-free and are living their normal lives of luxury, in no way negatively affected by their illegal actions. The amount of money taken from me was surely less than 1% of what the Executives already had – and yet they took it anyway. What a blatant and enormous testimony to corporate greed, and when does it stop? Is this the way corporate America repays dedication and loyalty? How many millions do they need to feel secure?

We employees, average Americans, trusted in the system. We played by the rules. Yet we were lied to and cheated not only by Enron, but also the auditors, and Wall Street analysts. We have done nothing wrong and yet we suffer the greatest pain and the greatest losses. If the collapse of Enron does not show that employee needs and lives are just being swept under the carpet as mere inconveniences – what will it take?

It is my deepest hope and prayer that you, the Senate Judiciary Committee, can give us assistance in getting back what is rightfully ours. Give us retribution. Make us whole again. Give us protection. Put into place measures that will help prevent such rampant white-collar crime. Make the punishment more appropriately severe and swift.

I truly appreciate the opportunity to participate in this Victim Impact Panel and make my plea to you for justice.

Thank you.

TESTIMONY OF GLEN B. GAINER, III

West Virginia State Auditor
Chairman, Board of Directors
National White Collar Crime Center

Chairman Biden, Ranking Member Grassley, and members of the Subcommittee:

I am Glen Gainer, West Virginia State Auditor and Chairman of the Board of Directors for the National White Collar Crime Center (NW3C), a non-profit corporation that provides nationwide support services for enforcement agencies involved in the prevention, investigation, and prosecution of economic and high-tech crime. I commend you for holding this hearing, and I am pleased to appear before you today to discuss the issue of penalties for white collar criminals, particularly as it relates to investment and securities fraud.

Before starting any discussion of punishment, it is important to outline the magnitude of the problem. Like many other types of economic crime, those individuals involved in securities and investment fraud represent a cross-section of society. The Securities and Exchange Commission (SEC) and state and federal courts have imposed both civil and criminal sanctions upon such diverse groups ranging from organized criminal enterprises to high school students. These offenders also include industry professionals, such as corporate officers, stockbrokers, promoters, accountants, and lawyers. The types of behaviors that fall under the umbrella of securities and investment fraud can also widely vary. These 'areas' of crime include, but are not limited to, market manipulation, affinity fraud, telemarketing fraud, foreign currency fraud, entertainment scams, investment

adviser and financial planner fraud, abusive sales practices by brokers and agents, and ponzi and pyramid schemes.

The economic costs are difficult to quantify, but securities regulators and other prominent groups have estimated that securities fraud alone totals $40 billion per year. This is compared to $10 billion in estimated annual economic loss from 'street' crime, according to the FBI's Uniform Crime Report (UCR). Keep in mind that the dollar amount lost as a result of securities fraud does not measure the financial impact resulting from the volatility of the financial markets themselves, as over 50% of households in the United States now invest either directly or through pension funds and mutual funds. Another potential cost to consider is the documented relationship between terrorism and white collar criminal activities which directly impacts on our national security interests; some groups have used ill-gotten gains from fraudulent schemes to fund the operation of their organizations.

Despite the potential and visible impact associated with securities and investment fraud, a great disparity exists in punishment of white-collar and conventional crime offenders. This disparity exists at many levels, including likelihood of incarceration, and the length of the prison sentence imposed. In fact, due in part to mandatory drug-sentencing laws, the federal white-collar inmate population decreased in proportional terms, from 2.8% of the total in 1985 to 0.6% in 2001. During 1999, in cases terminated in U.S. District Courts, nearly 60% of offenders convicted of a fraudulent offense were incarcerated. This compares to 65% for burglary and 70% for motor vehicle theft. When looking at their

prison sentences, the white-collar offenders received an average sentence of 22 months, while the burglary and motor vehicle theft offenders received 31 and 27 months, respectively. However, most of these white-collar criminal offenders were involved in smaller scale frauds and investment schemes, and are not reflective of the group of crimes that may net millions of dollars in profits at the expense of hundreds or thousands of innocent victims. And what do statistics regarding this group of offenders show us? For the year 2000, federal prosecutors indicated they charged 8,766 defendants with a white-collar crime. Of the 4,000 individuals who went to prison, only 226 were involved in securities fraud cases. From 1992 to 2001, SEC officials felt that 609 of its civil cases warranted criminal charges and were referred to U.S. Attorneys for consideration. Of these SEC referrals, only 142 defendants of 525 disposed cases were found guilty. Eighty-seven of these individuals went to prison. In terms of sentence length, research conducted in the early 90's clearly demonstrates the disparity between offenders. Those incarcerated for losses in excess of $100,000 or more as a result of the savings and loan scandals received an average of 36.4 months in prison. During the same time period, those nonviolent federal offenders who committed burglary got 55.6 months, car theft received 38 months, and first-time drug dealing averaged 65 months. While some of this disparity may have been corrected by revisions to the federal sentencing policy for economic crimes, disparate sentencing can still be seen between 'white-collar' cases involving substantial monetary loss, and other crimes with similar financial impact.

These unfavorable trends in punishment persist in an era where there is a strong public sentiment against white-collar crime. Recent data collected by the National White Collar

Crime Center demonstrates that Americans view this type of behavior as more costly and problematic than 'traditional' or 'street' crime. Furthermore, many feel the punishment does not fit the crime. While most individuals feel white collar offenders should receive a tougher sentence, the consensus is that the criminal justice system is more likely to hand out lengthier prison terms for street crime offenders. These findings have been brought to light in recent months in the wake of the Enron and Andersen debacle, as the public continues to express frustration that more serious punishments are not meted out for corporate fraud and greed.

The conclusion we can safely draw from this body of information is that white-collar criminals, particularly those involved in large, complex frauds that impact hundreds, if not thousands of victims, do not receive punishment that is proportionate to the harm that they cause. This is not to say that all such offenders walk away from their actions with no repercussions from the criminal justice system. In May, Donald Allyson Williams was sentenced to 15 years in a California state prison as a result of a boiler room operation that would contact elderly individuals and eventually convince them to invest in speculative, high-risk oil and gas partnerships, partnerships that were purportedly safe. The result? These elderly investors lost $7.2 million, while Williams spent the bulk of the money on a lavish lifestyle.

What makes this case unique is not the nature of the crime -- unfortunately we see this type of behavior on a regular basis from individual and corporate entities alike. The unusual aspect of this example is that we had a successful conviction at all. For every

Donald Allyson who serves time for investment or securities fraud, there are dozens of others people similar crimes who will not spend a day in court, let alone a day in prison. It is not merely enough to examine disparities in white-collar punishment from a sentencing perspective. It is also imperative that our enforcement agencies and our courts properly investigate, prosecute, and convict these individuals. Certainly sentences must deter criminal activity and protect the public. When weighing the low probability of conviction with the reality of a probationary period or minimal prison term, many white-collar offenders see these risks as an acceptable cost of doing business. We must change these attitudes and work toward sending a clear message to others who might be involved in, or who are planning, similar fraudulent activity. Research has clearly demonstrated that the most effective deterrent to crime is not only to increase the severity of punishment, but to increase the certainty of punishment. This two-pronged approach to the punishment issue is where our focus must be.

The difficulties of investigating and prosecuting securities and investment frauds are a result of the increased globalization of fraud, the complexity of the cases, and the limited resources of regulators and law enforcement officials. Prosecutors are often unwilling to bring forward economic crime cases that involve complex legal issues and extensive paper trails; following such trails becomes much more difficult because of the time that often elapses between criminal offending and discovery and subsequent investigation efforts. This is a problem inherent in many types of financial crime. For example, interviews with identity theft victims have found that several years may pass before the crime is discovered. Because the statute of limitations is often based on the date of the

criminal occurrence rather than date of discovery, many criminals never face a judge because of the overwhelming task of gathering extensive evidence. The gap between the criminal act and its discovery also allows offenders to effectively cover tracks and destroy information that may otherwise prove invaluable to the investigative efforts.

In addition to a lack of resources as it relates to unraveling the complex underpinnings of an investment or securities fraud, criminal cases are not being brought because state and local law enforcement and prosecutorial agencies lack the technology and training to effectively investigate and prosecute them. In economic crimes, the attribution of responsibility, the development of facts, the tracing of funds, the establishment of the criminal fraud elements and the presentation of evidence are much more difficult to achieve than conventional crimes. Prosecutor's look to the referring agency for continued investigative, accounting and legal support in the case, which may be in the form of certificates of search, jury instructions, co-counsel, investigative support, accounting support, case funding, subpoenas, search warrants or expert witnesses. Often, this assistance is inadequate because the law enforcement and judicial systems are not prepared to deal with serious multi-jurisdictional white-collar crime cases. Preparation will require not just more criminal justice personnel devoting more time to such cases, but the commitment of ingenuity, technology, and training to develop the expertise for effecting ways of expediting the investigation, processing, and prosecution of such cases.

Coming back to the topic of this hearing, it is time for me to answer the question, are we really tough on white-collar offenders? Over the past several years, there have been a

number of criminal convictions involving high-profile individuals who abused their positions of trust with stockholders, employees, and individual investors for their own financial benefit. And while most of the information I have shared with you today has focused on criminal enforcement issues, punishment continues to be handed out as a result of civil actions. In 2001, the SEC took in nearly $2.5 billion in civil fees, disgorgements, and penalties. However, these remedies, often sporadic and rarely commensurate with the monetary and emotional damage inflicted on victims, fail to send the resounding message that financial injustices against honest consumers will not be tolerated. Stiffer penalties and longer prison sentences are but part of the solution. We must also provide support for enforcement efforts that get defendants before a judge and jury. As recent events have shown us, our ability to fight crime relies on our ability to effectively leverage the resources of local, state, and federal agencies. We live in a time when technological advances have made white collar crimes more easy to commit on a widespread basis and, in some instances, more difficult to investigate and successfully prosecute. It has been said that fraudsters upgrade their equipment on the average every six months, while government agencies upgrade every four years. We must make investments in technology and training to provide for the type of analytical and investigative support an investment fraud case requires. As I alluded to before, white-collar crime is a multi-jurisdictional crime. This means we must enhance networking at the state and federal levels by fostering the sharing of antifraud information between various enforcement and regulatory agencies. To accomplish this, enforcement has to use technology to successfully combat the "mobile information era criminal fraudster." Information and the timely sharing of it are key ingredients to ensure a successful fraud

investigation. When enforcement does not have access to the vast sources of electronic data to combat crime, it is equivalent to the law enforcement officer using a revolver against a criminal with a pistol. In either case, there is no excuse for allowing this disparity to continue if we are serious in addressing this ever-increasing fraud, which crosses states and international borders. And, it is important to remember that white-collar offenses are not crimes of passion; innocent individuals are the victims of these premeditated offenses. Not only must we raise the costs of committing fraud but also we must, through ethics training and other awareness efforts, communicate the seriousness of this behavior to industry leaders of today and of tomorrow. Without admitting or denying SEC findings of fraud, a 15-year old high school student from New Jersey agreed to return $285,000 from an Internet-based "pump and dump" scheme that netted him almost a million dollars. Both the teenager and his parents felt he had done nothing wrong, which clearly indicates a lack of moral duty and obligation.

For people to take these fraud issues seriously, we must continue to treat these fraud issues seriously, and strengthening the response from our criminal justice system is crucial to our efforts. I pledge the support of the National White Collar Crime Center to work with you and provide any additional information or assistance you may need. Thank you for the opportunity to testify before you today.

SENATOR GRASSLEY'S STATEMENT
SUBCOMMITTEE ON CRIME AND DRUGS
"PENALTIES FOR WHITE COLLAR OFFENDERS: ARE WE GETTING TOUGH ENOUGH"
JUNE 19, 2002

Mr. President, thank you for holding this hearing on penalties for white collar offenders. In light of the United States Sentencing Commission's recommended changes to the guidelines for white collar crimes, it's a good time to focus on how severely we need to punish those who commit white collar crimes.

I understand that Senator Breaux has introduced a statement for the record regarding his Elder Justice bill. ~~Senator Breaux, I am glad to see that you've joined us this morning~~. As a former Chairman of the Special Committee on Aging, I appreciate all the work that Senator Breaux has done on elder abuse issues. Over the years, many Congressional hearings have been held on crimes and scams which target the elderly. I chaired a number of such hearings myself, starting as far back as when I was Chairman of the Subcommittee on Aging of the Committee

on Labor and Human Resources from 1983 to 1986. More recently, as Chairman of the Special Committee on Aging, I held a number of hearings dealing with different forms of elder abuse. Having been in ~~your~~ his shoes, I know that the work ~~you do~~ he does on that Subcommittee is critical to bringing to the forefront problems that our elderly citizens are facing today.

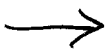
~~Additionally, I understand that my staff has been talking with your staff about the~~ on the Elder Justice bill. Hopefully we will be able to work together to provide enhanced protections to shield seniors from financial and physical abuse.

Looking into how we punish white collar offenders, many of whom defraud pension and investment funds, is a good step toward protecting seniors. Since strong criminal penalties serve to deter future crime, it is important that we ask the question, "Are white collar criminals punished less severely than other criminals?"

Many legal scholars and others believe that white collar offenders are rarely prosecuted. According to one professor, it is even rare that these offenders are charged with a crime. If that's true, we need to discuss why that is and what we can do about it.

Part of the problem could be due to the FBI's declining focus on white collar crimes. According to the Transactional Records Access Clearinghouse at Syracuse University (TRAC), the white collar crime percentage of all FBI referrals to U.S. Attorney's offices have steadily declined since 1993. In 1993, 40.5% of all FBI referrals were for white collar crimes. Last year, that figure was 32.9%. This is a decrease of 7.6 percentage points. If the Bureau isn't bringing these cases to the U.S. Attorneys, it makes sense that they can't charge the white collar offenders.

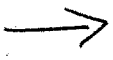
In those cases where white collar offenders are prosecuted and convicted, many argue that they receive



lighter penalties for their crimes. And when incarcerated, they do less time in prison than other criminals.

A snapshot of last year's federal white collar crime statistics illustrates the reason we are having this hearing today. According to TRAC, of the 12,835 referrals the FBI made to federal prosecutors, only 5,031 prosecutions were filed. That means that less than one third of the referrals were prosecuted. Of that number, only 3,992 offenders were convicted and only 2,598 of those offenders were incarcerated. The median sentence for those offenders was only 8 months.

To address the problem of light sentencing for white collar crime offenses, the U.S. Sentencing Commission has recommended the following four changes to the sentencing guidelines for white collar crimes: (1) that the theft and fraud guidelines be combined, (2) that the loss table be modified and simplified so that low-loss offenders receive reduced sentences, while high-loss offenders receive

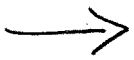


increased sentences, (3) that the definition for loss be broadened, and (4) that the money laundering guidelines be revised so that they are tied to the underlying crime from which the money was derived.

Today we're here to talk about whether these changes go far enough. A message needs to be sent that white collar crime, especially as it relates to fraud, is serious crime and carries significant penalties. I think this is an area where we need to be tougher on criminals.

It is good to have U.S. Attorney Jim Comey from the Southern District of New York with us today. Since the U.S. Attorneys across the country are responsible for enforcing federal white collar laws, it's important that we hear their views on how severely we should be punishing those they prosecute. Thank you for coming Mr. Comey.

Because I believe it is important for this subcommittee to hear from a diversity of voices, I asked that Paul



Rosenzweig from the Heritage Foundation testify this morning. Mr. Rosenzweig is the Senior Legal Research Fellow in the Center for Legal and Judicial Studies at The Heritage Foundation, where his research interests focus on issues of criminal law, law enforcement, and legal ethics. Mr. Rosenzweig is also an Adjunct Professor of Law at George Mason University School of Law, teaching Criminal Procedure and an advanced seminar on White Collar Crime.

Having served as a Trial Attorney in the Environmental Crimes Section of the Department of Justice and as Senior Litigation Counsel in the Office of the Independent Counsel during the investigation of the Madison Guaranty Savings & Loan Association, he has some experience that warrants our hearing his views. Although I may not agree with Mr. Rosenzweig on every point regarding how we sentence white collar offenders, I am glad he was willing to testify today.

I look forward to hearing all of today's testimony. Mr. Chairman thank you for holding this important hearing.

NEWS RELEASE

ORRIN HATCH

United States Senator for Utah

June 19, 2002 Contact: Margarita Tapia, 202/224-5225

Statement of Senator Orrin G. Hatch
Ranking Republican Member
Before the Senate Committee on the Judiciary
Subcommittee on Crime and Drugs

Penalties For White Collar Offenses: Are We Really Getting Tough On Crime?"

Mr. Chairman, thank you for scheduling this hearing to review the adequacy of current penalties for white-collar criminal offenses. We spent some time just a few weeks ago considering the penalties for crack and powder cocaine offenses. I think it is equally important and productive for us to reassess the adequacy of penalties for white collar offenses.

If our criminal laws are to bear credibility and provide deterrence, they must adequately reflect the severity of the offenses. A person who steals, defrauds or otherwise deprives Americans of their life savings – just like the criminal who peddles dope on a corner – should be held accountable under our system of justice for the full weight of the harm that he has caused. Innocent lives have been devastated by the crook who squanders the assets of a retirement account, the charlatan who sells phony bonds, and the confidence man who runs a Ponzi scheme. These sorts of criminals should find no soft spots in our laws or in their ultimate sentences. In fact, I recently sponsored legislation with Senator Leahy that directs the United States Sentencing Commission to review whether a number of fraud, obstruction of justice, and corporate misconduct guidelines should be increased.

In the wake of some accounting and corporate irregularities that have shaken our financial markets and caused billions in losses to innocent investors, it is time to take a hard look at the penalties associated with all types of white collar offenses – from antitrust violations, bankruptcy fraud to securities fraud. For this reason, I am thankful to the Chairman for scheduling this hearing, and look forward to hearing from the highly knowledgeable witnesses who we are fortunate to have here today.

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U.S. SENATOR PATRICK LEAHY

CONTACT: David Carle, 202-224-3693 VERMONT

**STATEMENT OF SENATOR PATRICK LEAHY,
CHAIRMAN, COMMITTEE ON THE JUDICIARY:
"PENALTIES FOR WHITE COLLAR CRIME OFFENSES:
ARE WE REALLY GETTING TOUGH ON CRIME"
JUNE 19, 2002**

I want to begin by commending Senator Biden for holding this subcommittee hearing. As we both know, the adequacy of the current sentences in white collar prosecutions, especially securities fraud cases, is of particular concern to the American people. That is why I introduced S. 2010, the Corporate and Criminal Fraud Accountability Act of 2002, of which Senator Biden is a cosponsor.

This hearing continues to demonstrate that S. 2010, which contains stiff new criminal penalties for securities fraud and was ordered reported unanimously by the Judiciary Committee on April 25, 2002, merits swift action on the Senate floor.

Our federal criminal sentencing system is all about accountability. In response to an era during which many thought that sentencing was uneven and unfair, we adopted the United States Sentencing Guidelines. But the guidelines did not fix all the problems with uneven federal sentencing – nor were they intended to. One glaring problem that remains is the public perception that well funded, white collar criminals are treated differently than other defendants under the law – that the criminal who puts on a mask and robs a bank of $500 gets twenty years in prison, while the criminal who hires highly paid professional accountants to help juggle the books and defraud investors out of millions receives a much lighter punishment. As the Enron case demonstrates, in order to have true accountability in our federal sentencing system, we must ensure that all those who violate our laws are held accountable. The Enron matter first came to light almost a year ago, and continues to shake the confidence of the investing public in the integrity of our public markets.

Department of Justice Enforcement: Accountability begins with making white collar crime an enforcement priority. I was glad to note that in his planned reorganization of the FBI, Director Mueller made it clear that the investigation of complex financial crime would continue to be a top priority. This is important because as a former prosecutor I know that the FBI and the Department of Justice are uniquely equipped to investigate and prosecute complex financial crime. Unfortunately, data assembled by the Transactional Records Access Clearinghouse at Syracuse University ("TRAC") shows that, in the year 2002, the number of white collar referrals from the FBI to federal prosecutors has significantly decreased, while referrals in cases involving

drugs, bank robberies, and less complex bank fraud cases (such as credit card fraud) have remained constant. As the study, which was released last week, states:

> During the last five years, bureau referrals for what the department classified as white collar crime have hovered around 33% of the total of all referrals, down from 40% in the mid-90s. During the first six months FY 2002 the proportion of white collar crime matters sent to the prosecutors dropped to 29.6%.

Thus, in FY 2002, the number of white collar referrals dipped below 30% for the first time in 15 years. I ask unanimous consent that the TRAC data be placed in the hearing record, and I hope that these 2002 numbers do not suggest the beginning of a new trend, but merely amount to a blip on the chart due to September 11. The Department of Justice can and must continue to exhibit leadership in the investigation and prosecution of sophisticated fraud schemes such as the Enron case. The American people must be assured that the laws will apply equally to everyone regardless of their economic status.

S. 2010 and the Arthur Andersen Trial: The recently completed criminal trial of Arthur Andersen, LLP ("Andersen") further demonstrates the need for reform. While the hard-working prosecutors at the Department of Justice deserve congratulations for the verdict, the Andersen case demonstrates the importance of quickly passing S. 2010. Prosecutors face significant and unwarranted hurdles in obtaining white-collar convictions, even in cases with apparently obvious criminal infractions. Loopholes in current criminal statutes may be exploited to confuse relatively straightforward issues.

Under current law, the prosecutors were forced to charge Arthur Andersen with "corruptly persuading" others to destroy evidence, rather than simply with the act of the destruction itself. According to press accounts, this legal quirk was used repeatedly by the defense attorneys who attempted to divert attention from Andersen's massive shredding. Making comparisons to the children's game, the defense argued that the government had not identified the "corrupt persuader" and repeatedly asked government witnesses "Where's Waldo?" S. 2010 creates two tough new anti-shredding felonies to close such loopholes. When a corporation destroys thousands of documents in order to obstruct federal regulators, the law should provide clear direction to courts and juries, not prompt jury questions and lengthy deliberations. The current language of these two new anti shredding measures is the result of a bipartisan amendment offered by Senator Hatch and myself in the Judiciary Committee.

When the government brought the Andersen case, many legal commentators observed that it would be the easiest of the cases in the so-called "Enron debacle." They said that shredding documents was a fairly clear cut violation, and they were surprised that Andersen chose to fight the charges against them.

The experts were half right. Under current law, the shredding case against Andersen *was* among

the easiest of the cases facing the government in looking at these complex transactions. Unfortunately, under current law the Andersen prosecution team also faced unnecessary legal hurdles which the defense attorneys hired by Andersen were able to exploit repeatedly in the courtroom. The Leahy-Daschle-Dubin bill closes such loopholes.
In addition, S. 2010 directs the United States Sentencing Commission to review the current sentencing guidelines relating to obstruction of justice and to provide appropriate enhancements in cases where evidence is actually destroyed and to consider appropriate specific offense characteristics for particularly egregious cases.

Enhancing Criminal Penalties for Securities Fraud: The Leahy bill also provides additional tools and tough new criminal penalties for those who defraud investors. Specifically, it creates a new 10 year felony specifically aimed at securities fraud, which is modeled after the bank fraud and health care fraud statutes that already exist. This new crime will free prosecutors from dependence on the general mail and wire fraud statutes with their five year maximum penalties and eliminate technical requirements in the securities fraud laws. Any "scheme or artifice" to defraud investors in publicly traded companies will be covered under S. 2010. Senator Hatch and I also worked to ensure that S. 2010 would increase the penalties for those who commit the kind of large scale fraud that we saw in the Enron case. The current guidelines simply do not adequately punish those who defraud thousands of people or those whose crimes result in financial devastation.

These changes will hopefully lead to more white collar prosecutions across the nation, which serves as an important deterrent. As the Wall Street Journal reported, the leaders of the SEC recognize that "criminal cases are a much bigger deterrent to white-collar crime than any penalties the SEC can impose" because "[t]here's nothing that speaks as loudly ... [as] the prospect of jail time." S. 2010 both raises criminal penalties and creates a new crime specifically aimed at securities fraud along the lines of the current bank fraud and health care fraud provisions. It will result in more securities fraud prosecutions and longer sentences. We cannot legislate against greed, but we can do our best to make sure that greed does not succeed.

Conclusion: In short, S. 2010 is going to save documents from the shredder and send wrongdoers to jail. As the difficulty in the recent Andersen trial demonstrates, even the most straightforward of these cases can be difficult. We need to remove senseless loopholes from the laws governing fraud. The American people must be assured that there is accountability for *all* who engage in criminal conduct in our country.

We cannot have one set of rules for a person who steals on the street and another for someone who steals in the corporate boardroom. We cannot punish the person who hides from the police, but not the corporation that hides the truth from regulators by shredding "tons" of documents. S. 2010 addresses those issues as well as other problems in current law. As this hearing shows, the confidence of the American public in our system of justice depends on equality of treatment for those who break the law.

I ask unanimous consent that the TRAC data and the Wall Street Journal article to which I referred by printed in the hearing record.

SEC Welcomes Prosecutions

Jail Threat Is Considered Best Way to Deter White-Collar Crime

By MICHAEL SCHROEDER

Washington

The Securities and Exchange Commission, traditionally jealous of its turf, has been openly urging more federal and state prosecutors to bring criminal cases against securities-law violators.

Changes in Leadership

- Tyco dismissed its general counsel, Mark A. Belnick. A3.
- Recruiters and consultants ponder what qualities Tyco's next leader needs, B1.

New York District Attorney Robert Morgenthau's high-profile pursuit of executives at **Tyco International** Ltd. doesn't pose a direct challenge to the SEC's civil authority, SEC officials say. The SEC for years has worked with Mr. Morgenthau's office on cases and is assisting the district attorney in his continuing probe of possible criminal securities violations at Tyco.

The SEC has welcomed prosecutors into the fray because officials at the civil agency believe that criminal cases are a much bigger deterrent to white-collar crime than any penalties the SEC can impose.

"There's nothing that speaks as loudly to all potential wrongdoers than the prospect of jail time," said Stephen Cutler, the SEC's director of enforcement.

Compared with criminal authorities, the SEC walks loudly, but carries a small stick. Its civil penalties include forcing defendants to surrender ill-gotten gains and pay fines—usually following probes that take two to three years. In addition, SEC Chairman Harvey Pitt is increasingly using tougher SEC authority to ban more senior corporate officials implicated in wrongdoing from serving in public companies.

The SEC's other weapon is the bad publicity settlements create, particularly for major public companies and senior executives who care about their reputations. In the post-Enron era, even the whiff of an SEC investigation will send a company's stock plummeting.


Robert Morgenthau

The SEC, under Clinton-era Chairman Arthur Levitt, tried to get prosecutors around the country to do more white-collar securities-fraud cases. If anything, the nation's top securities cop has been frustrated with the lack of interest by many prosecutors in such matters.

Traditionally, U.S. attorney offices and state prosecutors haven't had the expertise or manpower to do complicated, labor intensive white-collar cases. With limited resources, they have preferred to emphasize violent crime cases and organized crime.

But the burst of the market's bubble has put a new light on stock fraud, and the **Enron Corp.** collapse is accelerating the trend of more criminal cases. With the expansion of 401(k) retirement savings plans tied to the stock market, many Americans manage their own retirement funds. State and federal law-enforcement agencies now recognize the lifetime financial damage that investment schemes and stock manipulation cause to unsophisticated investors.


Eliot Spitzer

Mr. Pitt instructed all SEC regional office directors and headquarters staff to meet with prosecutors to build interest in white-collar criminal cases. Since U.S. attorneys can make political hay from big securities-fraud cases, other offices are getting into the act, in particular San Francisco, Miami and Newark, N.J.

Over the years, tough criminal prosecution has consistently come from New York—both Mr. Morgenthau's office at the state level and federal prosecutors in Manhattan and Brooklyn, most famously then-U.S. Attorney Rudolph Giuliani's pursuit of insider-trading cases in the mid-1980s.

In the late 1990s, the SEC worked closely with Mr. Morgenthau in his investigation of **Bear Stearns** Cos. In August 1999, the big **Wall Street** firm agreed to pay $38.5 million to settle prosecutors' charges involving its relationship with a small brokerage that defrauded investors. The SEC settled its own companion case in which Bear Stearns didn't admit or deny charges.


Harvey Pitt

The SEC's nationwide enforcement staff of 950 was feeling stretched even before the latest wave of securities-fraud charges. The agency is responsible for overseeing stock markets, brokers, the mutual-fund industry and the Internet.

When a prosecutor opens a criminal probe, the SEC regularly assists by providing analysis, expertise and manpower. SEC attorneys are frequently deputized to work temporarily in prosecutors' offices. In 2000, for instance, the SEC lent 20 enforcement attorneys to U.S. attorneys' offices.

Not all criminal investigations are collegial. New York State Attorney General Eliot Spitzer conducted a recent probe of conflicts of interest among **Merrill Lynch & Co.**'s research analysts, largely without SEC help, people familiar with the matter say. This is mostly because some SEC officials believe the issue of analysts' conflicts can be better addressed by the agency with new regulations and its own continuing investigation. Last month, Merrill reached a settlement—without admitting or denying any wrongdoing—with Mr. Spitzer's office and other states for $100 million.

Raw-Steel Output Rose 0.1% Last Week

WASHINGTON – Raw-steel production by the nation's mills increased 0.1% in the week ended Saturday to 1,531,000 tons from the 1,529,000 tons produced the previous week, the American Iron and

Debit-Card S
Now Can Pro
As Class-Act

By JOHN R. WILK

WASHINGTON – The Sup
opened the way for a massive a
suit against **Visa USA** Inc. and
International Inc. to proceed
class-action case.

In a big setback for Visa
Card, the high court rejected
ment their petition to review a
decision that could allow as m
million merchants to share i
ages award. The nation's larg
sued in 1996, alleging the two
companies use their credit-c
dominance to force stores to
debit cards.

The retailers are seeking
$13.1 billion to $15.8 billion,
decade of alleged debit-card
by the two companies. Under
trust law, any damages awa
court would be trebled if the
prevail in court.

David Balto, a former fede
enforcer, said any eventual aw
would be far less than the retail
ing. Even so, "this case could h
bigger pocketbook effect than a
action in decades, including
ment's case against **Microsoft**
Mr. Balto, who is now at the
White & Case here.

The court's action yesterda
case back to U.S. District Judg
son in Brooklyn, N.Y. The s
nation's largest retailers, inc
Mart Stores Inc., **Sears Roebuc**
Safeway Inc., against the big
which jointly own Visa and
At issue is whether Visa and
can force retailers to accept th
debit cards, which carry proc
that are far higher than those
tional debit cards that are linke
ers' checking accounts.

The merchants say these
charges ultimately cost consu
of dollars a year and force the m
an inferior product that is slov
cure and more costly.

Lloyd Constantine, lead co
merchants, said the alleged da
case had become so large "o
Visa and MasterCard refused
retailers who asked them, year
force them to take their debi
said the "credit-card cartel
now they'll got to trial."

Despite problems with the
terCard debit cards, banks hav
them widely, ringing up nearly
of retail sales through those
Banks like them because they
fees than conventional debit c
dinary debit cards, cash is with
a checking account immediately
tomer enters a personal identifi
ber, the Visa and MasterCard
are usually processed offline
charge slip is signed.

Visa and MasterCard said t
Court action had no bearing on
of the case, and both have said
to prevail in court. The Supre
rejection of the class-action is
latest in a series of pretrail ru
ing the retailers.

But the most significant m
the Justice Department's victory
lel case last year, in which a
federal court found that Visa a
Card acted illegally to protect t
power in credit cards. That c
give the retailers a big legal
even before trial begins.

Mr. Constantine said the nex
case is notifying the millions of
who could share in any damage
mary-judgment motions. He said
ery phase of the case, in which
depositions were taken and
pages of documents were review
sides, was completed two year
that both sides told Judge Glee
ready to go to trail.

Both Visa and MasterCard ar
pected to argue that the
rule to competition, con
sumers—not retailers—to de

WSJ 6-11-02

TRACFBI

National Profile and Enforcement Trends Over Time

Declining FBI Focus on White Collar Crimes

Fiscal Year	Number of White Collar Referrals	Percent of All FBI Referrals
1986	12,964	28.3
1987	12,725	30.8
1988	13,888	31.8
1989	14,289	32.2
1990	15,414	35.3
1991	18,109	39.1
1992	18,956	38.6
1993	20,893	40.5
1994	18,606	39.1
1995	19,642	40.1
1996	15,485	35.3
1997	13,989	33.3
1998	13,720	32.5
1999	13,952	33.1
2000	13,472	32.8
2001	12,835	32.9
2002*	4,869	29.6

* first six months only (October 2001-March 2002)

TRACFBI

National Profile and Enforcement Trends Over Time

Percent of FBI Referrals

Fiscal Year	Bank Fraud	Bank Robbery	Narcotics/ Drugs	Total	Number
1992	22.1	7.0	9.4	38.4	49,081
1993	23.2	6.7	9.2	39.1	51,557
1994	22.2	6.1	9.9	38.2	47,605
1995	22.4	4.9	11.0	38.3	48,972
1996	18.5	6.5	12.2	37.2	43,824
1997	14.3	7.6	14.4	36.3	41,948
1998	14.0	7.8	16.0	37.8	42,179
1999	15.8	6.6	17.5	39.9	42,183
2000	15.9	7.1	17.1	40.1	41,024
2001	16.1	7.6	17.3	41.0	39,060
2002*	14.1	7.5	17.4	39.0	16,432

*Percentages based on FBI referrals October, 2001 - March, 2002

Written Testimony
Charles Prestwood

June 19, 2002
Committee on the Judiciary
Subcommittee on Crime & Drugs

Thank you, Mr. Chairman, for the opportunity to appear before you today.

My name is Charles Prestwood. I am from Conroe, Texas and I am 63 years old.

I built my retirement fund over the course of a long career in the natural gas industry, most of which I spent in the field with Houston Natural Gas working on pipelines. In the 1990s, when Enron acquired HNG, all my retirement investments were automatically converted to Enron stock.

Enron stock was aggressively promoted by executives within the company. I continued to receive part of my compensation from Enron in company stock and stock options. Enron promoted employee stock ownership verbally and through internal publications. Here is a quote from an internal publication sent to all employees in early 2001:

> **Simply stunning.** That's how Chief Executive Officer Jeff Skilling describes Enron's strong financial and operating performance in 2000. Every major business — pipelines, wholesale services, retail and broadband — turned in strong performances for the year that were reflected in record volumes, contract value and profitability. Revenues increased two-and-a-half times, reaching $101 billion. For the first time, Enron's pre-tax net income exceeded $1 billion, a 32 percent increase over last year, and shareholders received an 89 percent gain on the stock price. Other significant highlights included:
>
> - Fourth quarter revenues of $40.75 billion, exceeding 1999's entire reported revenues of $40 billion;
> - 25 percent increase in earnings per diluted share to $1.47;
> - 59 percent increase in marketed energy volumes to 52 trillion British thermal unit equivalents per day; and
> - Nearly doubling of new retail energy contracts to $16.1 billion.
>
> *Enron Business* met with Jeff to discuss last year's results and his outlook for 2001.
>
> **EB**: Enron had a great 2000. How did we do it?
> **Jeff**: Every one of our businesses performed beyond our expectations.

We believed in the story in this publication and it is typical of the type of promotion by Enron executives. I recall when the company did particularly well, these types of internal publications would be circulated. I also recall attending a breakfast with Mr. Lay where he told us not to sell our Enron stock.

As a result of this type of promotion, I and many others continued to invest in Enron up until the bitter end. To me, this is the American way, loyalty to your employer.

I retired from Enron Corp. in October 2000 feeling that after a lifetime of hard work, my retirement account with Enron provided financial stability. I could no longer keep pace with the physically demanding work required in plant operations. I expected that Enron stock would support me. I worked hard to make it so. I had $1.3 million in savings, all in Enron stock, and now it is all gone.

Let me mention the lockdown. The lockdown started, to the best of my knowledge on October 17, 2001. At this point, Enron had just announced the bad news that shocked us all. Much to our chagrin, we were locked out of our accounts. So folks who bought Enron on the street could trade, but we could not.

So where does that leave me? I can tell you, without pulling punches, something stinks here. There are people at Enron who made millions selling Enron stock, while we, the rank and file, got burned. It's that simple. I am left with a tiny fraction of my $1.3 million, or about $8,000. It's too late in my life to start over to build up my funds.

If Enron hadn't gone down, I would be living a far different life than the one that I am living now. I would be able to drive my truck – but I can't do that now because it is too expensive to drive. I haven't been able to change the oil in my truck since last December. I don't even get fast-food hamburgers anymore because it's too expensive. I now have to sell 5 acres of land my grandparents willed to me in 1951, just to pay my bills for basic necessities.

I don't know the law, but I know what is right and what is wrong. There is something terribly wrong here. I thought someone was supposed to be looking out for our interests. I thought that people had to treat us honestly and deal fairly with us. My problem was that I trusted my company and my executives and now I don't have anything. In my neck of the woods, what happened is not right.

I am only one of thousands who have been wiped out. I hope you can do something about it for me and the many like me.

I and my co-workers are proud of the industry we helped build, including the work we did for Enron and its predecessors. I spent 33 ½ years building that company. For most ordinary workers, Enron's failure taints lifetimes of dedicated work as well as a striking a devastating blow to our futures.

Down the road looks real, real slim to me. Nonetheless, I get on my knees every night and thank the lord fro what blessings he has given me.

Thank you all for listening to me today.

TESTIMONY OF

PAUL ROSENZWEIG

SENIOR LEGAL RESEARCH FELLOW
CENTER FOR LEGAL AND JUDICIAL STUDIES

THE HERITAGE FOUNDATION*

214 MASSACHUSETTS AVENUE, NE
WASHINGTON, DC 20002

BEFORE THE UNITED STATES SENATE

JUDICIARY COMMITTEE

SUBCOMMITTEE ON CRIME AND DRUGS

REGARDING

SENTENCING AND ENFORCEMENT OF WHITE COLLAR CRIMES

19 JUNE 2002

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Good morning Mr. Chairman and Members of the Subcommittee. Thank you for the opportunity to testify before you today on the topic of white-collar crime enforcement and sentencing.

For the record, I am a Senior Legal Research Fellow in the Center for Legal and Judicial Studies at The Heritage Foundation, a nonpartisan research and educational organization. I am also an Adjunct Professor of Law at George Mason University where I teach Criminal Procedure and an advanced seminar on White Collar and Corporate Crime. I am a graduate of the University of Chicago Law School and a former law clerk to Chief Judge Anderson of the U.S. Court of Appeals for the Eleventh Circuit. For much of the past 15 years I have served as a prosecutor in the Department of Justice and elsewhere, prosecuting white-collar offenses. During the two years immediately prior to joining The Heritage Foundation, I was in private practice representing principally white-collar criminal defendants.

The title of this hearing "Penalties for White Collar Offenses: Are We Really Getting Tough On Crime?" poses an empirical question. But before addressing it directly allow me a few preliminary observations.

Though couched as merely an empirical question, the issues to be addressed in today's hearing are of vital importance to the American judicial system. At its core, the legal system and the rule of law are one of the unifying principles in a heterogeneous, multicultural society like the United States (and, indeed, perhaps the only one). If citizens lose faith in and have disregard for the legal system, we do significant damage to the fabric of society.

There are troubling signs of just such a loss of faith today. If public reports are to be credited, it increasingly appears that neither the victims of crime nor those whose conduct is addressed by the judicial system have confidence in the ability of the courts to do justice. As we have heard so eloquently today, victims often feel that their own injuries are not sufficiently accounted for by the punishment meted out. Conversely, with the perceived disparities between punishments for white-collar and so-called "street" crimes, we run the risk that some defendants may come to view the judicial system as biased along either racial or class lines. Similarly, as we broaden and expand our definitions of criminal offenses to include trivial matters more suitably treated as civil wrongs, those who act in good faith yet get caught by the arbitrary exercise of governmental authority perceive themselves as victims of an over-zealous regulatory state that trivializes crime (equating serious personal offenses and technical, regulatory ones), and erodes its moral footing violations. The perceptions of all three groups are, in many senses, accurate.

In some ways (if you will forgive the irreverence of the analogy), the judicial system is a bit like Peter Pan's ability to fly – it only works if everyone

believes it will. When citizens start to believe that the system is no longer just and fair, it risks crashing to the ground in an unseemly mess. The perceived disparities and arbitrariness in white-collar enforcement and sentencing are just one piece of a larger puzzle reflecting the possibility of disillusionment with the judicial system. The Subcommittee is wise to address this question in the thoughtful manner it has chosen: First, determine first whether white-collar crimes are indeed being adequately punished and then determine (if they are not) what the causes of that might be. For, as Sir Winston Churchill said, "[t]he mood and temper of the public with regard to the treatment of crime and criminals is one of the most unfailing tests of the civilization of any country."

As with so many empirical questions, the answer to the one posed in today's hearing is indefinite. The answer is, in part, "no" and in part "yes." More importantly, rather than ask whether we are getting sufficiently "tough" on white-collar crime, the proper question to ask is, are we being "effective" in addressing white-collar crime. And the answer to that question is incapable of trite and ready articulation. It is, for example, far too easy an answer to say simply that we need to increase statutory maximum sentences for white-collar crime. That, alone, will achieve little, if any reform. What is needed is a close examination of the allocation of law enforcement resources and a better understanding of their effectiveness.

The Scope of White Collar Crime

To begin with we should carefully define what white-collar crime is.

As relevant to the topic of today's hearing it is important to distinguish between two distinct forms of white-collar offense. The first type of offense is, classically, fraud by any other name. Business frauds certainly differ in the details of how they are executed, in the sophistication of those who execute them and, candidly, in the difficulty that prosecutors have in unraveling them. But at their core, business frauds are no different in kind from any common law fraud occurring on the street. The Enron allegations, if they are proven true, will fit comfortably into this classical conception of crime. They are called white-collar offenses simply because of the socio-economic status of the actors and the means they have chosen for committing their criminal offenses – not because of anything unique or inherently different in the nature of their conduct.

This sort of white-collar crime has been around for a long while. Ponzi schemes were rampant in the Depression era. And, many would argue that, viewed through the prism of today, the "robber barons" of the turn of the century were white-collar criminals. As A.B. Stickney said to 16 other railroad presidents in the home of J.P. Morgan in 1890, "I have the utmost respect for you gentlemen individually, but as railroad presidents, I wouldn't trust you with my watch out of my sight."

Fraudulent white-collar crime is no less serious today. In 1999, for example, conservative estimates suggested that losses caused by mail fraud were approximately $36 billion annually, including phony sweepstakes, overvalued merchandise, chain letters and other pyramid schemes. The Association of Certified Fraud Examiners reported a "very conservative" estimate of more than $20 billion lost annually to fraudulent property and casualty claims. The same organization also reported occupational fraud – that is the use of one's occupation for personal enrichment through deliberate misconduct, such as asset misappropriation, fraudulent statements, bribery, and corruption – as roughly $200 billion per year. By contrast, in the same year the National Crime Victimization Survey estimates for personal theft ($3.9 billion), household burglary ($4.5 billion) and household larceny ($2 billion) were substantially lower. This kind of blatant fraudulent white-collar crime is a drain on the economy and a significant concern. When it goes unpunished, respect for the rule of law is diminished.

The second type of white-collar offense is, however, quite different. It involves prosecutions for violations of rules and regulations that are part of a larger statutory structure. In modern America, as the regulatory state has grown, the number of such criminal offenses has grown apace. They involve violations of the regulations of the Health Care Finance Administration, the Occupational Health and Safety Administration, the Consumer Products Safety Commission and a host of other Federal "alphabet agencies."

Three doctrinal developments define this second type of white-collar offense and differentiate it from the classic frauds that are the focus of this hearing. First, this type of white-collar offenses involves the criminalization of conduct that, in most instances, is not inherently wrongful in the same way that fraud and bribery are. Rather, we have seen a growth in the category of "public welfare offenses" – a category first created with modest penalties and now increasingly felonized. Second, and of special significance in weighing moral culpability, the statutes involve offenses where the mental element (or *mens rea* requirement) is substantially diminished, if not eliminated. For example, we now punish as strict liability offenses the taking of migratory birds – even if done utterly by accident. Third, this type of white-collar offense increasingly involves criminal prosecutions of managerial officers for, in effect, vicarious liability. The growth in this form of white-collar criminal offenses is what Professor John Coffee has called the "technicalization" of crime. As a result, for this category of white-collar offenses, the criminal law is increasingly being used interchangeably with civil remedies.

Consider: In 1999, the ABA Task Force on the Federalization of Criminal Law noted that there were now more than 3,500 federal criminal offenses. Those offenses incorporate either directly or by reference prohibitions contained in more than 10,000 separate regulations. Remarkably, nobody knows the exact number either of criminal statutes or criminal regulations. They are so diverse

and so widely scattered throughout the federal code that they are literally uncollectable. I am told that, when it was recently asked to undertake the project, the Congressional Research Service said that the task was virtually impossible. This, too, breeds disrespect for the law and disaffection from the judicial system: When those who make the laws cannot themselves identify all the laws they have made, it borders on the arbitrary and capricious to allow prosecutors to select from among those laws and to criminalize conduct that, in the eyes of other prosecutors, might warrant only civil sanctions.

Is There A Disparity and Where Does It Come From?

With this distinction in mind, we turn then to the question posed by this Subcommittee: Is there a disparity in enforcement and sentencing for white-collar crimes (of both types) and "street" or blue-collar crimes in the federal system? As with so many things the statistics are susceptible of varying interpretations. I present the statistics first and then provide some rough interpretations.

In Fiscal Year 2000, the most recent year for which we have statistics, according to the United States Sentencing Commission, federal courts entered convictions for 58,636 individuals. An overwhelming percentage of those who were sentenced for traditional crimes received sentences requiring terms of imprisonment. For example, 94.2% of those convicted of drug trafficking were sentenced to prison. 97% of those convicted of robbery were imprisoned, as were 93% of those convicted of arson, and 97.4% of those convicted of murder. By contrast only 53.5% of those convicted of fraud and 48.1% of those convicted of embezzlement were sentenced to prison. And, using a blended rate, those convicted of technical regulatory offenses (the second type of white-collar crime) were incarcerated only 30% of the time. At first blush it looks like a disparity does exist.

But if we look deeper into the statistics we see some oddities that challenge this initial perception. In truth the data quoted are skewed because of the mandatory sentencing nature of many of our drug and other street crime statutes. If we change the question and ask, what percentage of those who are eligible under law for non-prison sentences wind up getting jail terms, we see a different picture. In other words, the data tell a different story if we examine sentencing rates but eliminate those cases where Congress has removed the discretion from the district court judge and look only at those cases where a district judge has a legal choice to make between incarceration and some non-jail alternative (community service, probation, home detention, or some other form of punishment not involving a jail term) available. Here the data are much more equivocal. According to the Sentencing Commission, the following were the national rates of incarceration for federal cases in which there were non-jail alternatives (some 11,137 individuals):

Crime Type	Rate of Imprisonment (%)
Fraud	35.6
Larceny	19.9
Immigration	84.3
Embezzlement	39.3
Drugs – Trafficking	48.5
Drugs – Simple Possession	31.2
Firearms	30.0
Forgery/Counterfeiting	29.2
Other Miscellaneous Offenses	26.3

As you can see, if we exclude the immigration category (for which there are probably some exogenous explanations), when courts have discretion much of the disparity in sentencing rates disappears. White-collar frauds, for example, are incarcerated at rates greater than those for defendants who possess drugs or firearms.

The final prism through which to attempt to assess the question of disparity lies, of course, not in imprisonment rates but in the length of imprisonment. Here the mandatory nature of certain drug offenses again is reflected in the data:

Crime Type	Mean Sentence (in months)	Median Sentence (in months)
Robbery	110.6	77.0
Drugs -- Trafficking	75.3	57.0
Drugs – Possession	18.5	6.0
Manslaughter	26.1	18.0
Larceny	15.6	12.0
Fraud	18.0	12.0
Embezzlement	9.9	5.0
Bribery	16.2	12.0
Tax Offenses	16.6	12.0
Money Laundering	46.3	33.0
Environmental/Wildlife	14.5	9.5
Antitrust	12.7	6.5
Food & Drug	23.1	12.0

But this, of course, does not tell the whole story. As we have seen already in connection with incarceration rates, the courts are often constrained by statutory requirements. So too with the length of terms of imprisonment imposed.

As a general rule, the length of a sentence is determined either by statute or, of course, by the operation of the sentencing guidelines. [The guidelines themselves are statutorily mandated, yet substantively developed through regulation; they are, thus, ultimately derived from statute]. It is useful therefore to ask whether the sentences reflected in the data are of the lengths they are because they are required to be that long by the sentencing guidelines or if they are the product of disparate departures from those guidelines by the courts. In other words, do judges for ignore the guidelines and reduce the sentences in white-collar offenses or are the guidelines sentences for white-collar crimes regularly imposed? The answer is that the courts do not appear to depart from the guidelines with any greater frequency in white-collar cases than in street-crime cases. Consider the following data (which exclude departures for substantial assistance to the authorities):

Crime Type	Rate of Departure (%)
Robbery	12.7
Drug Trafficking	4.9
Firearms	10.4
Larceny	6.3
Fraud	9.2
Embezzlement	6.2
Immigration	18.8
Other Miscellaneous	9.8

Once again, immigration offenses are unusual. Beyond that, the rates of departure from the guidelines are roughly consistent for all offenses and there is even some suggestion that serious offenses such as robbery and firearms are more likely to have judges depart from the guidelines than white-collar crimes. Again, the drug trafficking offenses are a possible exception to the general rule.

There are several tentative conclusions that can be drawn from this data. First and foremost, whatever disparities exist are principally the product of the actions of Congress. Median and mean sentences vary by type of crime, but insofar as we can tell, when offered a discretionary choice among offenders the courts do not impose incarceration in a disparate manner. Even drug trafficking offenders are, in the midst of the war on drugs, incarcerated less than 50% of the time when the courts are given the opportunity to choose whether to impose a sentence of imprisonment or not.

Moreover, the lengths of sentences flow almost exclusively and directly from directly either statutory requirements (mandatory minimums, and the like) or indirectly from statutes through the sentencing guidelines adopted by the U.S. Sentencing Commission. With the possible exception of drug trafficking charges there appears to be little difference, generally, in the way judges treat offenders before them. They get sentences less than what the guidelines would call for

with the same approximate frequency.

Finally, insofar as the data are susceptible to analysis, other than serious personal offenses (such as robbery) and offenses relating to drug trafficking (including money laundering) most offenses are treated relatively similarly, with typical sentences falling in a fairly narrow range of from 1-2 years. Even manslaughter sentences do not vary appreciably from this seeming norm. One might almost suspect that we have reached a general consensus on the subject as a society and identified 1-2 years as the appropriate just punishment for most criminal offenses.

This is not terribly surprising. Recall, if you will, how it is that the Sentencing Guidelines were initially developed. The Commission chose to take the tack of historical analysis, looking to past practice around the nation, and attempting to carry that historical practice forward into the guidelines, while evening out disparities between regions and districts. In doing this, the Commission collected data on more than 40,000 cases.

Interestingly, the one area where the Commission chose to depart from this historical base was in the area of economic or regulatory crime. There, the historical data reflected that "economic crime[s] [were punished] less severely than other apparently equivalent behavior." Consequently, the guidelines as initially proposed in 1987 and as in use today make an effort to upgrade the penalties for regulatory and economic, white-collar offenses. I think the success of that effort is reflected in the data presented. With the exception of drug offenses – a *sui generis* topic on which Congress has often legislated – we have reached a fairly consistent point of equilibrium.

The question then is whether that equilibrium is the right place to be.

What To Do?

Our goal in punishing criminals is two-fold. We have the utilitarian goal of deterring criminal conduct. As Horace Mann said, "The object of punishment is the prevention of evil." We also have the equally significant goal of doing justice by imposing punishment on those who have acted wrongfully – the "just deserts" aspect of criminal law.

As to the appropriate quantum of punishment for true white-collar fraud, I have no crystal ball, nor any independent moral authority to advise you. It appears, however, that the sentencing guidelines, as I have noted, reflect equivalence between white-collar fraud, tax evasion, and simple drug possession. Whether this equivalence is appropriate is not an easy question to answer, particularly for an academic happily ensconced in the ivory tower of a think tank.

I can, however, say that with respect to frauds of the nature alleged against Enron – real frauds with real victims – I share the sentiments expressed last week by Treasury Secretary Paul O'Neill, in typically colorful fashion. He said "I think people who abuse our trust, we ought to hang them from the very highest branch." I also agree with him, however, that truly large scale, significant corporate abuses are "relatively infrequent, but [that] even a few cases can poison confidence in our system which depends on entrusting public company managers with investors' capital."

To the extent that we think that justice requires harsher sentences for white-collar frauds, the answer must lie principally in revision of the sentencing guidelines. Presently, they measure the "harm" from a fraud by the dollar amount of the loss caused. Such a measurement does not differentiate between frauds of different sorts. Two frauds of the exact same scale may have vastly different impacts in the number of victims and the effect on their lives. To the guidelines, it does not matter whether the loss is incurred by a single pension fund that may be insured against the loss (thereby distributing the loss broadly throughout the economy), or the loss is incurred by hundreds of small investors whose life savings are wiped out. I cannot say how the law can adequately capture the distinction, but I do know that it exists and is inadequately addressed in the current guidelines structure.

More importantly, when we consider increasing the deterrence of white-collar frauds we need to consider both sides of the deterrence equation. Deterrence is accomplished by increasing the risks perceived by a wrongful actor of being punished. That involves both a consideration of the likely sentence of incarceration and an estimation (for the rational actor) of the chance of being caught.

It is not enough then, merely to look at the punishment side of deterrence. Increasing maximum sentences and revising the sentencing guidelines only go part way towards addressing the problem and are much the less important aspect where change is needed. What really drives the equation is the fraud that goes undetected. By definition we cannot, of course, know how much undetected fraud there is – but we can know that the more a fraudulent actor perceives that he is not likely to get caught the more likely he is to act in a wrongful manner.

In the context of white-collar crime this means that it is imperative to distinguish between the two types of crimes within the general category – the true frauds and the technicalized, regulatory offenses. We live in a world of limited resources – one where, increasingly, federal attention will rightly be devoted to matters of national security. Beyond that important area, all the remaining law enforcement priorities must compete for scarce attention and every technical, regulatory offense to which resources are devoted is one less instance where resources that might be devoted to truly deserving fraud

investigations.

Thus, as the Judicial Conference of the United States put it in its Long Range Plan, criminal activity is appropriately the focus of federal concern only when federal interests are paramount. When federal resources are devoted to non-violent criminal conduct or regulatory offenses that are localized and with only an attenuated impact on interstate commerce those efforts are misdirected and contribute to an under-deterrence of fraud through the diversion of resources to other areas.

The use of law enforcement resources for "technicalized" crime also contributes to disaffection from the legal system. As the reach of the regulatory state increases, we are seeing a broadening of the category of criminal offenses beyond those that one might consider appropriate. Do we really need, for example, to create a white-collar crime enforcing the ban on honeybee importation? And are federal resources really well invested in police extortion cases where the only connection to interstate commerce is that the motorist paid the police officer with cash from an ATM?

Concomitant with the growth in the scope of criminal law we are also seeing a related diminution in the mental state requirements for criminal conviction – again, resulting in a frittering away of scarce time and energy. If deterrence is our goal, there is no reason to make simple negligence the subject of criminal sanction when civil tort laws provide sufficient redress for wrongs done through accident, mistake, or neglect. Yet Congress has seen fit to create negligence crimes (not to mention crimes of strict liability, which ought to be anathema in any civil society) and the Federal government prosecutes them. [

Put most succinctly, government properly imposes criminal liability only on those who commit acts of misconduct with bad intent, and not on those merely accused of negligence or mistake. This is the fundamental moral component of the criminal law – the "just deserts" aspect of punishment – and it is trivialized when the criminal law is used to address conduct that is not intentionally wrongful. The criminal law in a free society must be carefully crafted to target wrongful conduct, and not be used simply to ameliorate adverse consequences attributable to non-criminal conduct. The public interest is vindicated not based on successful prosecutions, but on successful administration of justice. Criminal sentencing should reflect society's collective judgment about the kind of conduct that warrants the most severe condemnation, seizure of property, and loss of liberty and life.

In the technicalization of criminal law, we have gotten away from these principles. The trends I have identified permit an arbitrary use of prosecutorial power in a way that erodes respect for the law and contributes to the misallocation of scarce prosecutorial resources. At the same time that we are under-deterring white-collar fraud, we are over-deterring productive economic

conduct.

Though it is nearly impossible to gather comprehensive data in this area of the misapplication of criminal law to technical offenses, anecdotal evidence suggests that the use of criminal law as a substitute for civil sanctions is growing. And the costs of such criminalization are very real – both for the individuals targeted and for society. Consider, for example, the case of doctors – many of whom are leaving the profession rather than face the specter of criminal prosecution.

There are now over 110,00 pages of Medicare rules, policies, and regulations. Complex federal regulations equate to countless hours of paperwork -- not patient work -- for physicians. And failure of a physician to follow Medicare's needlessly complex rules -- or even just a perception of such failure -- can result in an audit of a physician's billing records, withholding of payments and a complete crippling of a physician's practice. One doctor, oncologist John Kiraly of California, spent over 2 ½ years and $10,000 in legal fees fighting an audit mistakenly assessing more than $58,000 in overpayments.

"The sense of intimidation and fear of HCFA among physicians is widespread and troubling...HCFA regulations are so excessively complicated, voluminous, and changeable that full compliance even among the most motivated is difficult. My office, for instance, receives about 35 pounds by weight of HCFA regulations every year," said Dr. Joe Sam Robinson, a neurosurgeon from Georgia.

Instead of trying to educate physicians about these complex regulations, physicians are treated as criminals that are trying to rip off their patients and the Medicare Trust Funds. To cite but one more of many possible examples:

Dr. Carol Vargo, a family physician in rural Montana, fought federal Medicare charges for over five years. The expert called in to review the criminal case for the government was instead willing to testify on behalf of Dr. Vargo, claiming that the prosecutors didn't have a good grasp of coding and didn't understand what standard physicians were being held to at the time that the billings occurred. The prosecutors soon dismissed the case. The government then pursued a civil suit for the sum of $37 million - - a figure calculated using a provision in the False Claims Act that allows the government to recover $10,000 per false claim, plus triple damages. The entire ordeal cost Dr. Vargo more than $300,000 in legal bills and a pulmonary embolism that doctors attributed to stress.

Nor is health care the only area where arbitrary prosecutions are possible. When a 70-year old owner of a family business is indicted for a technical violation of the Clean Water Act, something is amiss. After it was discovered that EPA agents had altered some of the evidence, the case was dropped. I

yield to no one in my concern for the environment, but this was a case that at least one federal judge found to be "clearly vexatious." Whatever the merits of the matter, one may justly ask whether this form of criminal enforcement produces any results or merely erodes our confidence in law enforcement.

Thus, if there were one recommendation I can make to the Subcommittee for its consideration it would be to bear in mind the distinction between the two types of white-collar offenses. The misallocation of resources reflects a lack of focus on true white-collar fraud – fixing that is at least as important as is the enhancing the length of the penalties imposed.

The analysis presented here is based upon a fairly extensive empirical evidence data set. Nonetheless, our understanding of the issues can be broadened and deepened through more research. Perhaps the most important thing this Subcommittee can do, then, is help answer these questions about the comparative effectiveness of criminal enforcement in the white-collar arena. Remarkably, there is virtually no data on whether or not criminal enforcement programs actually have a deterrent effect, much less assessments of the quantum of that effect. Instead, agencies prosecuting white-collar crime routinely report only the number of cases they have brought, without any attempt to determine the effectiveness of their activity. This "bean counting" mentality is the wrong way to evaluate criminal programs – it would be as if the D.C. Metropolitan Police Department reported only the gross number of murder prosecutions each year without reporting its clearance rates for unsolved murders or changes in the murder rate in the city.

Regulatory agencies report their prosecutions, without ever tying those prosecutions to increased regulatory compliance. But after enactment of measures like the Government Performance and Results Act we ought to be asking questions about the effectiveness of enforcement programs – i.e. the results they achieve. If we knew the answers to those questions we might better know where to direct our law enforcement resources – we could balance the comparative benefits of different enforcement methods and make conscious decisions about what does and does not work. Knowing something about the answer to that question is truly a worthy goal for this Subcommittee.

Thus, in the end, the answer to the question "Are we getting tough enough" on white-collar crime is, "maybe." The answer depends on which white-collar crimes you are talking about and how you define tough. If you define it as greater sentences, we plainly can increase the penalties to an infinite level. If, however, you define "tough" as "effective" then the best answer is a mix – greater penalties for significant frauds and greater law enforcement focus on non-technical, "true" frauds.

Mr. Chairman, thank you for the opportunity to testify before the Subcommittee. I look forward to answering any questions you might have.

NASAA

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
10 G Street N.E., Suite 710
Washington, DC 20002
202/737-0900
Telecopier: 202/783-3571
E-mail: info@nasaa.org
Web Address: http://www.nasaa.org

TESTIMONY OF BRADLEY W. SKOLNIK

Indiana Securities Commissioner
Chairman, Enforcement Section
North American Securities Administrators Association, Inc.

Before the
Crime and Drugs Subcommittee
Senate Judiciary Committee

"Penalties for White Collar Offenses: Are we Really Getting Tough on Crime?"

June 19, 2002

Mr. Chairman and Members of the Subcommittee,

I'm Brad Skolnik, Indiana Securities Commissioner and Chairman of the Enforcement Section for the North American Securities Administrators Association, Inc. (NASAA).[1] I commend you for holding this hearing, and thank you for the opportunity to appear today to present our views on penalties for white collar crime.

The securities administrator in your state is responsible for the licensing of investment professionals and securities offerings, investor education and, most importantly, the enforcement of state and federal securities laws. We have been called the "local cops on the beat," and I believe that is an accurate characterization.

Our country has undergone a historic transformation. In the past generation we have become a nation of stockholders – half of all households are invested in the stock market.

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

State securities regulators have an increased responsibility to make sure that Wall Street is a safe street for Main Street investors. Congress, regulators and the industry must act to restore confidence in the integrity of our markets and to hold those who defraud investors accountable for their crimes.

Investor education is an effective crime prevention tool but the strongest deterrent to crime, I believe, is criminal prosecution and prison time. Prosecutors, juries and the media understand street crime like robbery, assault and murder. Somehow securities fraud seems sanitized, bloodless, technical. Many people, including some in law enforcement, view securities fraud as an essentially victimless crime that involves as much gullibility on the part of the victim as it does culpability on the part of the perpetrator.

But we know white collar crimes aren't victimless crimes. Just like street crime, securities fraud ruins lives, destroys families, steals hopes and kills dreams.

To protect investors, we need to make better use of the laws already on the books. This means bringing more criminal actions against white collar crooks. States securities regulators obtain an average of 300 convictions a year, but we need to obtain more, many more. The truth is, most investment scams are nothing other than sophisticated criminal enterprises. They need to be treated as such.

One problem is, securities cases are complex, costly and time-consuming – deterrents to law enforcement agencies with limited personnel and budgets. The truth is some prosecutors shy away from them because the subject is complicated and difficult to understand. But from my perspective as a state securities regulator, white collar criminals who commit securities fraud deserve prison time just like thieves, muggers and murderers.

There are other reasons why so many cases end up being handled administratively or civilly. A prosecutor's willingness to undertake a complicated and technical securities case depends on other cases competing for attention. Murders, terrorism, and drug-related crimes are sometimes easier to argue to a jury and don't require the vast amount of staffing often required for a criminal prosecution of a securities case.

There are some ways where my colleagues can help. State securities regulators can, and do, provide resources to prosecutors to assist with the investigation and prosecution of these cases. We can develop cases fully and hand them over to prosecutors, reducing this burden substantially.

We all need to make the extra effort to bring criminal cases to right wrongs and ensure justice is done, but also to send a message. Too many crooks think they can get away with securities fraud and frankly, too many get off easy.

Moreover, even when criminal convictions are obtained in white collar cases, the sentences imposed are often insufficiently severe, considering the amount of harm inflicted.

Think about it. Someone steals your car, they go to prison; some con artist steals the money your parents needed for retirement, they get fined. That's just not right.

NASAA believes educating juries is another key to getting convictions in securities fraud cases. We have distributed updated model jury instructions to our membership and have posted them on our web site at www.nasaa.org.

In addition, we have sent these model jury instructions to prosecuting attorneys across the country as well as other law enforcement organizations.

There is another way we are bringing this issue to the attention of our membership. Every year NASAA hosts an enforcement conference where state and federal securities regulators and other law enforcement officials meet and brainstorm ways to work together to fight securities fraud and bring more criminal prosecutions. This is an effective way to share ideas on bringing securities fraud cases to trial.

Also, we have to stop using euphemisms when we talk about white collar crime. White collar criminals are cold, calculating, and vicious. Many are serial violators, career criminals. It's time, it's past time, we called a crook a crook and put more of them in jail.

We need plain talk and tough action if we're going to protect our families, our friends, our neighbors and our fellow citizens who now look to financial products to secure their futures.

On the legislative front, NASAA supports the provisions in S. 2010, the Corporate and Criminal Fraud Accountability Act of 2002, and believe it sends a powerful message that wrongdoers in the securities markets will be punished.

As an aside, NASAA supports the provision in S. 2010 that would make debts from securities law violations non-dischargeable in bankruptcy. At the present time, the bankruptcy code enables defendants who are guilty of fraud and other securities violations to thwart enforcement of the judgments and other awards that are issued in these cases. Section three of the bill would protect fraud victims by amending the Bankruptcy Code to make judgments and settlements based upon securities law violations non-dischargeable.

Unfortunately white collar crime is not as high on our national agenda as it needs to be. However, the problems in this area can be successfully addressed if law enforcement officials, regulators, Congress and others work together on solutions. I thank you for holding this hearing and would be pleased to provide any additional information you may need.

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From the Regulators

The Profitability of White Collar Crime

by Joseph Borg

In 1995, Joseph Borg became the Director of the Alabama Securities Commission and continues to serve in this position. Mr. Borg is currently the president of the North American Securities Administrators Association (NASAA). Mr. Borg has also served as Chair of the Enforcement Section, as a member of the Board of Directors, and as the Treasurer for NASAA. He has testified before various committees of Congress in the areas of micro-cap securities fraud, criminal elements in the markets, and most recently in support of law enforcement data-base information sharing among state and federal regulators.

Stock market and investor fraud has hit TV and the big screen, first, there was "Wall Street" the movie, then "The Sopranos" showing stock swindles on prime time television and more recently, it was the movie "Boiler Room" detailing high-pressure stock sales. Also, major news magazines have detailed stock scams that have shaken Wall Street with articles such as: "The Mob Goes Downtown", *U.S. New and World Report*; "The Dark Side of the Brokerage Business"; *Research Magazine*; "Don't Get Suckered By The Latest Stock Scams", *Money Magazine*; and of course the latest market fraud soap opera – ENRON.

With the onset of the bull market in the '90s, Main Street America discovered the securities markets. From a mere 10% of Americans investing in the markets, over 52% of households now hold IRAs, Keoghs, 401ks, retirement accounts, mutual funds, and equities. But as with any new "opportunity", there are always those who seek to profit at the expense of others. The securities markets certainly are no different and the bull market created an unexpected and unwanted element: the bad broker, the fraudulent promoter, and the international financial scam.

State securities regulators have always been the national "early warning radar system", looking into investor complaints against promoters, brokers, and unlicensed personnel. These same state securities regulators have seen old scams dusted off and repackaged with new hype and new "once in a lifetime opportunities" often created by ripping headlines right out of the newspaper.

As one of my esteemed colleagues, Bill McDonald, the former Chief of Enforcement for the California Department of Corporations, stated, "These people have no respect for their victims. They think the world is divided into wolves and sheep and the sheep are meant to be sheared." "It's all just a big game and it's all about salesmanship." Whether its the personal pitch, radio and late-night TV, boiler rooms with high-pressure cold calling, or infomercials and now the Internet, these are all venues that are used in a new generation of investment fraud. The internet is especially favored by fraudsters. For just a few hundred dollars, they can be on the 'net'—and the credibility is enormous. I've heard it said that "... any con artist who doesn't use the internet ought to be sued for malpractice". ---and in jest we find truth.

Historically, white-collar crime has been treated differently than street crime. Where a mugger could get 5, 10 or even 15 years for stealing a handbag containing $25.00, white collar criminals steal millions and get fined and have their license revoked. Let's face it; criminal prosecution is the only real deterrent when it comes to controlling criminal activity- the 'street' or the 'paper' kind. Criminal cases are time intensive, paper intensive and expensive. But either criminals go unchecked because it is a hard case to try or regulators must invest the resources to make a difference. Here is a scenario that could have come out of "Boiler Room".

> The impeccably dressed principal of the firm walked into the "Boardroom". There were almost 200 crowded desks and every phone was being worked. He jumped up on the center desk and called for everyone's attention. " ... After a year and a half, we have settled with the regulators and it is costing us a million dollars." Silence and some hushed "Oh no's." As the principal walked to his office,

one of the newer cold callers approached. "A million dollars" he said with awe and disbelief. "That's OK", said the principal. "In the year and a half that it took, we took in over $40 million. It's just the cost of doing business."

This did not come from a TV or movie script, this was an actual event as related to state securities regulators.

As long as society, prosecutors, courts and judges think white collar crime is different than street crime, then these attitudes are not only continuing, but also encouraging white-collar criminal activity. Steal my car, snatch a purse and no one questions that prison time is deserved. But a con man who steals money with a pen...who ruins your dreams of buying a home...who steals from your retirement fund ... who wrecks your dream of a secure future ... these white collar criminals will get a fine and they will be barred from the industry, and they will laugh all the way to the bank.

Not too long ago, during the micro cap fraud epidemic, we came across a script taken from a trashcan at a brokerage house in New York. The script begins with a stage instruction to "speak slowly and nonchalantly". Then it goes on,

"Two or three times year, we get our preferred clients involved with a niche area of the market where we can turn a 6 – 7 figure profit within the course of a few trading hours ...". And after more hype about a particular stock, the script goes on to say, "In other words, a return of $100 in 20 minutes perhaps sounds a bit unrealistic ... but that's exactly how our trades work. We did these deals last year ... yielding 34 points within the first 10 days of trading ... that's a fact."

But Wall Street is not cresting in 2002. The IPO hubbub has subsided, and yet, investment scams are continuing to rise. It's not micro cap and IPOs anymore, now it's prime bank programs, corporate "safe as a CD" promissory notes, defense technology stock, offshore foreign currency exchange, and a myriad of others. Whether it's a rogue broker or a con artist who steals your money or just someone who would sell you anything by any means, let's call it what it is ... lying, cheating and stealing. And the resulting devastation and emotional scars that white-collar crime leaves is no different than street crime and should be treated no differently. Whether its churning accounts, selling unrealistic investments, promising high no-risk returns, manipulating a stock or selling investments in non-existent technology, the effect is the same. Billions of dollars lost, hard working citizen's retirement funds, college money, or savings for a home are stolen and lost forever.

We had a case not too long ago in the northern part of Alabama. One victim made the point very clear when she said, "I'm over 70 years old and I don't have 30 more years to again save all the money that I will need for the rest of my life. I would rather have been robbed and beaten up on the street than to have lost all my retirement savings."

Unless regulators are given the necessary enforcement tools and resources to strike back with criminal sanctions, the "cost of doing business" factor will remain just that. Federal, state, SRO and local regulators and authorities must discourage "investment fraud entrepreneurs" by bringing criminal cases and let it be known that the "cost of doing business" just went up. Rogue firms, brokers and other scamsters will easily agree to pay a civil fine of $100,000 or even millions as a cost of doing business as long as they can continue to bilk investors of hundreds of millions of dollars. *Securities Week* recently quoted veteran prosecutor and New York's Chief Deputy District Attorney, John Moscow as saying "I do not see how we can deter highly profitable misconduct by having people sign pieces of paper." Moscow is right on point – the answer is – we can't.

More than ever before, regulators must pool resources, share information and act jointly. Too often the punishment dished out just isn't tough enough to deter future frauds. Boundaries, whether state, national, or continental have little, if any, meaning in today's Internet-technology driven society and international cooperation is now of greater importance.

America cannot take white-collar crime lightly. The damage that it inflicts emotionally and financially can be more harmful and devastating than street crime. There will always be those who seek to take advantage of others. As the infamous bank robber Willie Sutton once stated when asked why he kept robbing banks – "That's where the money is" – now the money is in the investment field, in securities and through the Internet. We are no longer a nation of savers, we are now a nation of investors – and we must be ever vigilant. The old "street crime" saying: "if you do the crime – you do the time" must increasingly become applicable to investment fraud – it's the only real deterrent.

PENALTIES FOR WHITE COLLAR OFFENSES: ARE WE REALLY GETTING TOUGH ON CRIME?

WEDNESDAY, JULY 10, 2002

UNITED STATES SENATE,
SUBCOMMITTEE ON CRIME AND DRUGS,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:34 p.m., in room SD–226, Dirksen Senate Office Building, Hon. Joseph R. Biden, Jr., Chairman of the Subcommittee, presiding.

Present: Senators Biden, Durbin, Grassley, and Sessions.

OPENING STATEMENT OF HON. JOSEPH R. BIDEN, JR., A U.S. SENATOR FROM THE STATE OF DELAWARE

Chairman BIDEN. The hearing will come to order. We thank our witnesses for being here, and those in the audience. Senator Grassley and I are each going to make relatively brief opening statements and then turn it over to our witnesses.

We are now in a period of, I guess it would not be an exaggeration to say, if not a major, a minor reevaluation on how we do business in America. The thing that I would like to point out before I begin this hearing is this is not merely about stockholders who have been defrauded. This is not merely about employees who have lost their jobs. This is not merely about the wrongdoing of individuals. Quite frankly, and it is not hyperbole, this is about the capitalist system. It all rests on the notion of transparency, period.

If, when you go to purchase a stock, you do not have any reliable public information that gives you an ability to make an educated guess as to what the prospects of that company are based on its assets, its liability, its product, the market, the time, the environment, then you might as well go play the lottery instead of buying stock. Go play the lottery.

It is not an accident that Europeans are for the moment disinvesting in this country. It is not an accident that the American Business Roundtable, the sort of bogeyman—not in my State, the corporate State of America, but the bogeyman of sort of the conspiratorial theories, the trilateralist opponents kind of thing—it is not a mistake that the Business Roundtable sent a letter to me.

"Dear Senator Biden, I am writing on behalf of the Business Roundtable to urge you to vote for Senate bill S. 2673, the Public Company Accounting Reform and Investors Act of 2002."

This didn't come from the Consumers Union of America. This didn't come from a group of new world, new order types. This is the establishment of the established business interests in the

world, and they have it right because guess what? There have been an awful lot of driveby shootings.

You have companies as old, as honorable, and as sound as the DuPont Company opening up their 200th stockholders meeting and an honorable guy, chairman of the board, starting off by saying "By the way, I want to make it clear to you we aren't one of those guys. Think of that, think of that."

So we need to look at how this economy is run. The problems we confront range across the width and breadth of business activities. We have Enron, WorldCom, Martha Stewart, Xerox, Rite Aid, all in varying degrees of collapse or difficulty, and the list goes on and on of people and corporations admitting cooking the books or being accused of inside deals.

We need to ask, as someone else said, are the capitalists killing capitalism? I expect the dialogue to last beyond this session of Congress. Everyday, people come up to me in my State and say, "Joe, you have to do something."

If I ever thought, Senator Grassley, that I would be going to Fourth of July parades in my State—this is the God's truth, and you probably experienced the same thing—whether it is in Hockessin, Delaware, or down in Laurel, Delaware, and people saying to me, "You know, I own stock in my 401(k)." These are blue-collar workers, not just white-collar workers. "I lost this, that, or the other thing. What are you going to do about those guys?"

I haven't had this much spontaneous concern expressed to me and calls for penalties for wrongdoers, as the President might say—I haven't had this much since the beginning of the drug epidemic in this country.

Everyday, as I said, people want to know what we are going to do. They are concerned about a climate of corporate greed and overreaching and what appears to be the loss of an ethical framework in some American corporate board rooms. They are concerned about corporate stock options, the vast amount of money executives make, and the way incentives are structured for CEOs to walk away from failing companies.

I support Senator Levin's legislation, which requires stock options to be clearly listed as a corporate expense, a position already endorsed by Alan Greenspan and Warren Buffet.

Delawareans are concerned about how our tax treaties are written to give inappropriate encouragement to companies to move overseas to avoid taxes. I listened to a Wall Street analyst as I was shaving, leaving my house this morning, on CNN, who was asked about the President's speech. The response he gave was, you know, we have created—how do you phrase it—a climate for corporate greed. This was a Wall Street analyst.

As my mother would say, and the nuns that taught me, Joe, you have to avoid the occasions of sin. They usually meant girls back then, the nuns, but the truth of the matter is we present a lot of occasions of sin for corporate executives. The incentive that we place before them is one that the vast majority resist, but it is to take actions that are counterintuitive to the interests of their stockholders.

Delawareans are concerned about providing more transparency and accountability so when you want to buy a stock that is a good,

safe investment, you know the books aren't cooked. That is why I support Senator Sarbanes' bill, as the Business Roundtable suggests that we should, that is on the floor today.

If you are an employee, you need to know that your pension is safe, and if there are real hard criminal penalties if it is not, then you have got a better fighting chance that it stays safe. That is why I joined Senator Leahy in offering an amendment to strengthen the criminal penalties for what are now white collar crime misdemeanors. So if you steal a pension, you go to jail, no different than if you steal a car.

I live about 2 miles from the State line and if you steal a car out of my driveway and you drive it across into Pennsylvania, 10 years, Federal guidelines. If you take a pension by violating ERISA, the Federal system to safeguard pensions, misdemeanor, maximum one year. The pension may be worth $1,800,000. My car may be worth $2,000, and if you saw the car I drive, you would know why I say that.

Today, we are voting on the floor of the Senate to address a lot of these concerns, specifically honesty and trustworthiness of the reports that are provided by accounting firms about what is going on inside corporate America.

I will offer an amendment today to restore the power of stockholders to bring lawsuits against executives who distort and inflate the value of their company, misleading investors and setting them up to fail. That is why it is so important here today that we hear from witnesses who will help us examine many of the issues in terms of criminal and civil enforcement of the laws governing how we do business, and we do have a very, very distinguished panel for that purpose.

Before I introduce them, I will yield to my colleague from Iowa, Senator Grassley, for any comments he wishes to make, and then we will go with the witnesses.

STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM THE STATE OF IOWA

Senator GRASSLEY. Mr. Chairman, I wasn't in any parades over the holiday week recess, but I did have town meetings in 14 counties of northwest Iowa and this issue did come up at many of those meetings, if not all of those meetings, because it was on people's minds.

First of all, I want to make very clear that I appreciated the President's speech yesterday. For those who have been somewhat critical of it, I want to suggest that the President did not say that there were any ideas before Congress that he would oppose. Now, he might oppose some. I don't know, but he didn't that there were any before Congress he would oppose.

Obviously, he suggested a lot of legislative responses himself, and I think the President is going to feel comfortable signing legislation that we pass. I have never seen the President not willing to listen to Congress and work with Congress on this issue. So I applaud the President for speaking out and setting a very, very good tone.

We have listened about this issue in a previous hearing and we have had the issue raised about white collar crime, whether or not

criminals are punished less severely if they are white collar criminals than other criminals. Many legal scholars and others believe that white collar offenders are rarely prosecuted. We need to get to the bottom of this and ask why and what we can do about it.

I think a message needs to be sent that white collar crime, especially as it relates to fraud, is serious and carries significant penalties. This is an area where we need to be even tougher on criminals. I am very happy that the President is taking the lead in setting up the Financial Crime Swat Team, because this means that the President is not going to wait for Congress to act before he can do what he can under his own authority and what the Justice Department can do.

I also want to emphasize that we need to look into the problems of accounting standards and business ethics systems. There needs to be a revival of business ethics in today's corporate world, and legislation that we pass will not guarantee that. It will guarantee punishment when things that are criminal happen.

But we need to have, as evidenced by the letter the chairman has referred to, as well as ads that were in yesterday's Post, as an example, business leaders themselves see that there is a real need for people at the top of the business world to set good standards, and a promise from those people that are involved with those ads, at least, that there will be that leadership to do that.

Now, I want to concentrate on one last point more in depth than the three or four things that I have mentioned, because this is something the chairman knows I really believe in.

Most of the time when I talk about whistleblowers, it is in regard to government service and people that are in public service blowing the whistle on wrongdoing. But I think one important way to protect investors is to ensure that corporate whistleblowers will be protected from retaliation when they go public with knowledge of fraud.

For nearly two decades, I have come to appreciate and honor whistleblowers, not meaning that everybody that comes before Congress or before me has a legitimate position. But I think that we need to be open to at least listening to what those positions are because there is an awful lot to learn. Only whistleblowers can explain why something is wrong and provide evidence to prove it. Then we can fix the problem and hold miscreants responsible.

Only whistleblowers can help us understand the culture that produces wrongful behavior. Understanding the culture is the key to fixing the problem and realizing meaningful institutional reform. In that regard, I consider whistleblowers national assets.

In the context of corporate wrongdoing, whistleblowers can provide the evidence that prosecutors need to build a case against corporate criminals. Without these brave men and women, prosecutors would lack an important tool in their efforts to curb corporate fraud.

It is for these reasons that I have worked to provide protections for corporate whistleblowers, as well as Federal Government whistleblowers, who are retaliated against for exposing fraud, waste and abuse. Because whistleblowers are so important to cracking down on corporate fraud, I asked Mr. Tom Devine, from the Gov-

ernment Accountability Project, to come and testify, and I will wait for him to summarize what he has to say.

Mr. Chairman, I didn't read my entire statement. I would like to have it all put in the record.

Chairman BIDEN. It will be pleased in the record.

[The prepared statement of Senator Grassley appears as a submission for the record.]

Chairman BIDEN. Let me introduce our first panel and welcome back Mr. Chertoff, who is the Assistant Attorney General in charge of the Criminal Division of the Department of Justice.

He has served as U.S. Attorney for New Jersey from 1990 to 1994, and before being nominated to his current position he was a partner in Latham and Watkins. Mr. Chertoff is a graduate of Harvard University undergraduate, as well as the law school, a man who knows of what he speaks.

I kidded him before we began by saying it is a good time to have this job. What is that old curse? May you live in interesting times. You are in interesting times. We thank you for being here and we appreciate the balance you always bring to this committee.

Mr. William W. Mercer is the United States Attorney for the District of Montana and head of the Department of Justice's White Collar Crime Working Group. Mr. Mercer had seven years of experience as Assistant U.S. Attorney before he became the U.S. Attorney. He has an undergraduate degree from Harvard, and also a law degree, and we welcome him here as well.

Gentlemen, the floor is yours, if you will proceed in any order you would like to. Michael, you fire away.

STATEMENT OF MICHAEL CHERTOFF, ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION, DEPARTMENT OF JUSTICE, WASHINGTON, D.C.

Mr. CHERTOFF. Thank you, Mr. Chairman, Senator Grassley. I would like to thank you for inviting Bill Mercer and myself to appear here. Bill is also the chairman of the Subcommittee on Sentencing of the Attorney General's Advisory Committee of U.S. Attorneys. Both of us welcome the opportunity to appear today to continue the discussion about what this administration has done, is doing, and intends to do to detect, punish, and deter white collar crime.

Yesterday, the President travelled to New York and called for a new ethic of corporate responsibility. Although most business people do play by the rules, some do not, and we are reminded again recently of the serious damage to people's trust and confidence in our economy that this type of wrongdoing fosters. The President's proposals would give prosecutors important new weapons in the fight against this kind of white collar crime.

As I know you are aware, we have not hesitated at the Department of Justice to proceed with criminal cases against corporate executives, accountants, and others who have abused their positions of trust and authority for personal gain or for other improper purposes by breaking the law.

Indeed, until recently some people were calling us too aggressive in pursuing these criminal cases. Not surprisingly, those voices of

criticism seem to be growing more faint as evermore egregious business practices are exposed to public scrutiny.

I am proud of the work we have done and continue to do both here in Washington and at the many U.S. Attorneys' offices around the country, where Justice Department prosecutors and FBI agents are going after corporate crooks everyday. We have made a lot of progress, but we have a lot left to do.

In the meantime, this administration is sending a very clear message: fraud, obstruction of justice, and other types of criminal activity in the business world will not go unpunished or receive merely a slap on the wrist. To the contrary, robust enforcement of the law gives people both on Wall Street and Main Street confidence that the financial marketplace and our economy in general will continue to operate under principles of honesty, integrity, and trust. That is a message that most honest, hard-working people in the business community have welcomed and one that will give the American people renewed faith in our economic system and our criminal justice system.

The President's proposals would both increase the ability of agents and prosecutors to catch white collar criminals and stiffen the penalties for offenders when they are convicted. Let me take a moment to highlight some very specific proposals as they relate to criminal law enforcement.

First, the President has ordered the formation of a corporate fraud task force within the Department of Justice which will be chaired by the Deputy Attorney General and of which I will also be a member. The task force will provide direction for the investigation and prosecution of white collar crimes, including significant cases of securities fraud, accounting fraud, and other financial misbehavior. The task force will also actively work to improve cooperation with other Federal agencies and State authorities, and will recommend policy and legislative changes as appropriate.

Second, the President has called for increased white collar penalties, including measures to ensure that prison sentences, substantial ones, will be the rule rather than the exception in significant criminal cases. Swift and certain punishment of financial crimes is vital to the prosperity of the U.S. and to people's faith in the system.

We recommend increasing the available penalties for mail and wire fraud, the two the statutes that govern most basic forms of white collar crime. Too often, the public believes that business criminals receive relatively lenient treatment in court, and unfortunately I think there is some truth to that. Not only are the maximum statutory penalties for fraud and other white collar-type offenses significantly less overall than those for violent offenses or drug cases, but it appears that judges in some jurisdictions are sometimes too willing to depart downward from the mandated Federal sentencing guideline range to sentence white collar offenders to minimal, if any, jail time or home detention, or even probation.

We strongly oppose lenient treatment for white collar criminals. The bottom line is that white collar criminals are just as much criminals as those who steal with a gun or a knife. They do real harm to people, they ruin lives. Jail time performs two functions. It holds these white collar criminals accountable for their past mis-

deeds and it prevents future misbehavior by those executives who might toy with the idea of beating the system.

Third, the administration's proposal would provide regulators, investigators, and prosecutors with enhanced investigative tools. As you know, investigating white collar fraud cases is very challenging and resource-intensive. Often, the critical evidence is to be found among e-mails or accounting memoranda of the corporation and its advisers. Without that documentary or electronic evidence, uncovering the footprints of fraud becomes a virtually impossible task.

Accordingly, the President's proposal would both simplify and toughen the law against obstruction of justice, particularly document shredding and destruction. Under the current statute, some courts have ruled that the Government can only charge someone for persuading others to engage in obstruction of an anticipated official proceeding. If a person acts alone, no matter how egregiously, he or she cannot be prosecuted unless a proceeding is actually begun. The President has asked Congress to clarify this law so that it unambiguously punishes all individuals who seek to interfere with law enforcement by removing or destroying evidence.

Although we look forward to being able to use the new tools the President has proposed, we are proud of this administration's record of vigorous enforcement of the laws against white collar criminals. I am sure the committee understands I am prevented from discussing pending cases in detail. And, of course, I can't reveal information about non-public investigations. But I can make reference to several major corporate investigations which have become public.

WorldCom: The Department of Justice is currently reviewing the facts behind WorldCom's recent disclosure that it had improperly accounted for $3.9 billion in expenses.

Enron: In January, we set up an unprecedented national task force to investigate the collapse of Enron. The investigation has so far led to the jury conviction of the accounting firm Arthur Andersen for obstructing justice in connection with an SEC investigation of its client, Enron. Furthermore, the global managing partner in charge of the Enron engagement team, David Duncan, has been convicted by plea of guilty to obstruction of justice in April. He will be facing sentencing in the near future. More recently, three bankers were recently indicted based on allegations of a multi-million-dollar fraud scheme arising out of one of the Enron-related partnerships. This Enron investigation is active and ongoing.

AllFirst: The United States Attorney in Maryland recently obtained a seven-count indictment against a former AllFirst Bank currency trader, alleging among other things, bank fraud which resulted in the loss of more than $691 million.

ImClone: The U.S. Attorney in Manhattan is currently investigating allegations of insider trading with regard to ImClone Systems, Inc. You will recall that the former CEO, Samuel Waksal, was arrested last month and charged with insider trading.

Rite Aid: On June 21, the U.S. Attorney for the Middle District of Pennsylvania announced criminal charges, including mail and wire fraud, against five former and current officers of Rite Aid Corporation, the drug chain, including the former CEO. Those charges involved an accounting scheme that led to a $1.6 billion restate-

ment of income. I think at the time it was the largest. It has since unfortunately been superseded. It has become one of the largest in U.S. history. One defendant has pled guilty.

In closing, I want to thank you, Mr. Chairman, and the committee for your leadership and the spirit of bipartisan cooperation you have brought in addressing the challenges of rooting out, punishing, and preventing white collar crime. The President's proposals in this area will greatly enhance the Department's ability to enforce the laws and ensure that criminals who violate their trust in operating businesses face stiff penalties, including jail time. We look forward to working with you and the committee as we encourage a new ethic of corporate responsibility in this country.

Mr. Chairman, that concludes our prepared remarks. I ask that the full text of my remarks be entered into the record of the hearing, and both Mr. Mercer and I would be happy to answer any questions the subcommittee has.

Chairman BIDEN. It will be placed in the record, and again I thank you both for being here. We will do ten-minute rounds. There are only three of us here at this moment.

Let me begin by saying that one of the things I want to explore with you, Michael—and I just want you to know I am not picking on you or anybody, but I think you at the Justice Department Criminal Division, as well as the FBI, are really strapped. I mean, you are really in a bind, unrelated to what new laws or any amendments to sentencing we propose or you propose, and that is the administration's increasingly understandable use of the Justice Department to fight terror, the FBI's decision understandably to take 518 folks out of the criminal justice area dealing with violent crime and white collar crime, the fact that since 1993, in the Clinton as well as in the first year of the Bush administration—in 1993, according to the transactional records access clearinghouse at Syracuse University, the FBI referred 20,893 white collar crime cases. In the year 2001, the number of referrals was down to 12,000.

That doesn't mean you don't still have a heck of a handful here, but the idea of focusing on white collar crime has been diminishing for some time. Now, we come along and we tell you you have fewer resources and more responsibilities. So I am going to be asking you all back here at some point and telling you you need more money, you need more staff.

Now, you are going to tell me, because you are a good Republican, and as my friend here will say, you can do more with less and you just have to order it better. That is so much malarkey, I am tired of hearing it, and I eventually will convince you that you need more help because, as Barry Goldwater used to say, in your heart you know you do. But having said this, you have a real full plate here.

By the way, I ask unanimous consent that I be able to submit to the record Mr. John T. Dillon, the Chairman of the Business Roundtable, his letter to me calling for tougher laws and supporting the Sarbanes legislation.

I might add, Michael, and to my friend, Senator Grassley, one of the reasons why people in the business community on "Moneyline," not on "Geraldo," were criticizing the President yesterday is they

fully expected he was going to embrace this and he was at least going to go as far as the Business Roundtable would go.

It is true he didn't say he wouldn't, but there is an old expression, people vote with their feet as to what they like and don't like. Well, investors vote with their money. The Dow is down another 167 points today. As the President was speaking, the ticker was going click, click, click, down 173 points.

The language was tough. For example, he called for increasing the budget for the SEC by 29 percent. There is bipartisan support here to do it by 77 percent. He called for making it illegal to shred documents. We all agree with that, but nothing on insider loans, nothing on the accounting industry in terms of specifics, nothing on separating analysts and underwriting in the investment banks. But I think and I hope that he will support some of the things that we are proposing.

On the floor as we speak—and I may have to leave to go offer my amendment—is a bill that many of us have cosponsored, Democrat and Republican. I think Senator Durbin is a cosponsor as well—correct me if I am wrong, Senator—of the Leahy amendment.

We call for stiffer penalties—and I won't go through all of that—including a number of things. I have the White Collar Crime Penalty Enhancement Act of 2002 and I would like to just question you in my remaining moments on if the Department has a view on it.

This legislation which I am going to amend—well, if I have the votes, going to amend the Leahy–Biden, et al, and everybody else who cosponsored it, bill—calls for a couple of things. One, it amends the general conspiracy provisions of Title 18. Under current law, the maximum penalty, as you know, for general conspiracies to commit a crime against the United States is five years' imprisonment, while the penalty for the predicate offense for conspiracy is substantially higher.

So what I do in here—and you may not be prepared to respond, but what I do in this legislation is I make the conspiracy, if it sticks, the sentence has high as the underlying predicate for the crime of conspiracy.

The second thing we do is it amends Title 18, Sections 1341 and 1343, to raise maximum penalties for mail fraud and wire fraud from 5 years to 10 years. Now, as you all know, if you take the Enron example, assuming that the corporate leadership sent out a letter to its stockholders saying the stock is going to go up $100, like they did verbally say that, they would be guilty of mail fraud, if you could prove it, and it increases that penalty.

The third thing we do is it amends ERISA, the Employment Retirement Security Act of 1974, to increase the criminal penalties. As I said, right now the maximum, if you, in fact, violate that law, is a misdemeanor punishable by up to one year. What I do here is amend it to raise the penalty from 1 to 10 years, leaving the Commission the judgment as to what that would be.

I assume—and Mr. Mercer knows this well—I assume they would do it based on the law, like you do on theft and like you do on other things. So if your criminal behavior causes people to lose $10 million, you are going to go to jail longer than if the pension loss is $1,000. Also, it directs the Sentencing Commission to review

and amend the Sentencing Guidelines to provide increased penalties provided under this bill.

Lastly, it creates a new section in Title 18 requiring a certification to be signed by top corporate executives that those financial reports they are putting out reflect the financial condition of the company.

Some will say, well, Biden, that is too tough, but there is a fiduciary responsibility that exists. In all cases it requires scienter, and if they could prove that they were defrauded and they didn't know, then they are not guilty. But they have to sign it, and if they sign it and it turns out it is not accurate, they could receive severe penalties.

Have you had a chance to look at any of those, and if not, will you?

Mr. CHERTOFF. Mr. Chairman, I received it this morning and I am very eager to review it. I know from just having scanned it briefly and from your summary that certain aspects of the proposal are consistent with what the President said yesterday in his speech. In particular, the elevation of the penalties for mail and wire fraud, the directive to the Sentencing Commission to look at adjusting the Guidelines to take account of the dangers posed by white collar corporate fraud, and also the certification requirment are all part of the President's accountability proposal.

So I certainly look forward to reading this and getting into the details, and I am sure that we will have comments in short order from the administration to this proposal.

Chairman BIDEN. Well, that would be useful. Even though I am going to try to introduce it today and amend it, I say, speaking for myself only, even if it is adopted today—if the administration looks at it and if they agree in substance about it, but they have a view that it should be altered on the margins or a tactical difference, I am fully prepared to work with you, even though it will have passed, in conference to determine whether or not it should be altered.

So I mean this sincerely. I am looking for your expertise and this is not something we shouldn't be doing together. But as you know, things have had a way of getting ahead of us here and we are moving along fairly quickly. I hope we don't move in a way that is counterproductive, although what Senator Sarbanes has in the bill has been well thought-out, a lot of hearings, a lot of movement.

I have more questions, but let me yield to my colleague from Illinois and then I will go back to a second round.

Senator DURBIN. Thank you very much, Mr. Chairman. I just have a few questions.

Mr. Chertoff, I looked through your list of prosecutions. How many officers of Enron have been indicted by the Department of Justice?

Mr. CHERTOFF. No officers of Enron to date have been indicted.

Senator DURBIN. None?

Mr. CHERTOFF. Correct.

Senator DURBIN. The decision was made by the Department of Justice to indict a corporation, Andersen.

Mr. CHERTOFF. Well, it was a decision by the grand jury, actually.

Senator DURBIN. Certainly, there was some guidance from the Government.

Mr. CHERTOFF. I would say that it is normally the case that when matters are presented to the grand jury, it is with the guidance of the Government.

Senator DURBIN. The question I have is when the Government considered the indictment of the corporation rather than the wrongdoers, did the Government envision that a successful prosecution would close the corporation and cost 20,000 to 25,000 people their jobs?

Mr. CHERTOFF. Well, let me try to clarify this a little bit, bearing in my mind, as I know you know, Senator, that I am limited in what I can discuss about a pending matter.

First, let me dispel a misconception that I think is embedded in the question. There has actually been a person who has been charged and convicted, Mr. Duncan. He was convicted of obstruction of justice.

Secondly, the penalty for the single-count indictment in the Andersen case is not going out of business. The penalty is a fine of $500,000 and possibly probation, and that is the penalty which Congress has prescribed.

The offense of which this company was convicted is a very serious offense. I can tell you that we can pass all the laws in creation. If we cannot find the evidence to enforce the laws, because people destroy it or tamper with it, we are never going to make any cases.

So it is very important at the beginning of a campaign against white collar crime to lay down a simple proposition: You cannot play with the evidence, you cannot tamper with the witnesses, and you cannot destroy the evidence. And if you do those things, no matter how powerful you are or how much lobbying you do or how many ads you take out in a newspaper, we will proceed with the full vigor of the law.

Senator DURBIN. Of course, that is something that we would all agree with. Any person in any company guilty of that wrongdoing should be held accountable under the law. I don't think anyone would disagree.

The question I asked you was you must have envisioned that a successful prosecution of Andersen would destroy the credibility of the company and virtually destroy the jobs and livelihoods of thousands of people who were not guilty of any wrongdoing, didn't shred a document, weren't even close to the scene of the crime.

Mr. CHERTOFF. Senator, let me take you back to something that the U.S. Supreme Court said 100 years ago, in I think it was the Standard Oil case, which is one of the first cases that deals with corporate liability for criminal law—as you know, we have been indicting and prosecuting corporations for at least the last 100 years.

The principle is this: When people band together and form a corporation and they set up a leadership for that company, a management, and they throw their stake in with that, they have to take the bitter with the sweet. If the company conducts itself properly, then the profits are rightly distributed among the employees and the shareholders and everybody else who benefits. But if the leadership of the company allows the company or directs the company to commit criminal offenses, then the company has to suffer that.

I think what was envisioned by the Department of Justice in pursuing this case against the corporation is what was envisioned in other cases in which corporations have been indicted: that we would enforce the law vigorously, seek the penalties which Congress has mandated, and that we would not be deterred by arguments that appeal to factors that are extraneous or outside the law, or by publicity campaigns or by television advertisements or things of that sort.

Senator DURBIN. I happened to meet about 20,000 of those extraneous factors in Chicago, people who went to work everyday, paid their taxes, obeyed the law, and were just as upset as you and I are about the wrongdoing of some people in their company.

Mr. CHERTOFF. Senator, let me——

Senator DURBIN. Excuse me. Most of those people are out of work today. Those are extraneous factors.

Mr. CHERTOFF. Let me suggest, Senator, that the people who bear responsibility for the consequences of the criminal offense committed by the corporation or the partnership are those who led it and those who had the responsibility to make sure that the law was followed.

When you have a senior partner in a company convicted of committing a criminal offense and when you have evidence at trial that indicates the involvement of others, I think the law has to operate in the way that Congress intended it.

Senator DURBIN. To indict the corporation.

There is an old saw that the law in its infinite wisdom makes it a crime for both the rich man and the poor man to sleep under the bridge. I would like to ask you on the issue of mandatory minimum sentences—we have made it clear in Congress, with the support of this administration, that we are going to establish mandatory minimum sentences for the sale of small amounts of narcotics, a thimble full of cocaine.

Do you believe that when we are talking about wrongdoing by corporate officers, whether it is the destruction of documents, misleading the public, defrauding the public, that we should establish mandatory minimum sentences as well?

Mr. CHERTOFF. I think what the President has said is that in formulating the Sentencing Guidelines which direct the judges as to how to sentence that the Sentencing Commission ought to impose as sentencing guidelines that would require jail time very serious penalties for corporate officials who violate their public trust.

Senator DURBIN. Mandatory minimum sentences?

Mr. CHERTOFF. Well, I think the way the Guidelines operate, if one is observing the rules about departures, federal sentencing is, in effect, mandatory: the required sentences for people who commit serious white collar offenses, unless very narrowly tailored downward departures are appropriate would be prison time. I think if we have that kind of a regime which the President has called for, we will have, in effect, required jail time for big corporate criminals.

Senator DURBIN. Do you feel that Congress was mistaken in 1995 when it changed the securities legislation so that the law no longer allowed suits to be brought by individuals against corporations for

securities fraud? Some have suggested this has helped to create the climate that has led to this corporate corruption today?

Mr. CHERTOFF. Well, I have to say, Senator, first of all that my area of expertise and responsibility does not extend to private civil lawsuits against corporations for securities fraud. I am not sure that I would say that they prevented those lawsuits.

What I would say, though, is I think our focus, certainly the focus of the Department, is on enforcement of the criminal law. Obviously, the SEC has its own powers, regulatory powers and civil enforcement powers, which it then deploys. So I have to, I guess, suggest that the issue of private lawsuits is one that really goes outside of my area of expertise and jurisdiction.

Senator DURBIN. Well, I would just like to suggest to the committee I think it had a lot to do with it. Those people at Enron who are now being sued are using as a defense that they could not be found guilty of aiding and abetting because of the congressional action on security litigation reform. We are going to consider that issue in the bill that is presently before Congress. I just sincerely hope that when this is over that we will look back and say that the wrongdoers will pay a price.

Do you have any idea when the first person at Enron may be indicted for wrongdoing?

Mr. CHERTOFF. Again, as I think you know, Senator, it would be a violation of any number of rules and laws for me to start to predict who might be indicted or when they might be indicted.

What I can tell you is we have a dedicated, large group of prosecutors and agents who are making this investigation their full-time business, and there is a very deep and profound determination on the part of the Department, including on my part personally, to see to it that anybody who has violated the law is going to be punished, whether it be in the case of Enron or any other white collar offender.

Senator DURBIN. Well, I just think it is odd that a shoplifting actress in Hollywood is facing more time in jail than any officer in Enron as we speak today, and I hope that that changes in the near future.

Thank you, Mr. Chairman.

Chairman BIDEN. Thank you.

I would ask unanimous consent that a statement that I made in 1995 on the so-called Private Securities Litigation Reform Act be put in the record at this point. There being no objection, it is so ordered.

I agree with the Senator from Illinois. I think it has a gigantic influence. If I am not mistaken, there were only about eight of us who voted against that at that time.

Senator DURBIN. And 99 in the House.

Chairman BIDEN. And 99 in the House.

Part of what I am about to introduce as an amendment on the floor is to undo three pieces of the seven major changes we made in that law. It is out of the jurisdiction of our friend from the Criminal Division, but I can assure you we will hear more about it.

The Senator and former U.S. Attorney and a man who, were I white collar criminal, I would not want to have gone before, having

worked with him for these years, the Senator from Alabama, Senator Sessions.

STATEMENT OF HON. JEFF SESSIONS, A U.S. SENATOR FROM THE STATE OF ALABAMA

Senator SESSIONS. Thank you, Mr. Chairman. I fundamentally agree with the purpose of your hearings, as I understand it, and that is we have too light sentences for serious white collar crime.

I know Mr. Chertoff remembers the arguments 8, 10, 15 years ago. It was we have got too many people in jail; jails need to be reserved for dangerous criminals, not for non-violent white collar criminals. We heard those arguments.

But in the course of that I think we went too far, because when a person defrauds thousands of people, many of them losing their life's savings, deliberately and with clear criminal intent, then that is a serious crime.

Harsh sentencing does deter. I was a United States Attorney during the Savings and Loan fraud cases. I prosecuted Federal land bank fraud cases. My office prosecuted those cases that I supervised, and I am going to tell you there is a lot better behavior in banking today because people went to jail over those cases in the past. They lost everything they had, their families were embarrassed, and a lot of people started checking to make sure they were doing their banking correctly.

So I kind of have a sense that it is deja vu all over again, as Yogi says. The CEOs of America somehow felt nobody was watching. We have gone through a period of unprecedented growth.

The way these banks got in trouble, Mr. Chairman, if you will remember, is nobody found them to be cheating and defrauding until the price of real estate collapsed. While it was going up, it never revealed itself. It is sort of what is happening in the corporations today. While everything was going so great these problems could be covered up, and now they are coming home to roost.

I do believe in the justice system, which means that every person is presumed innocent and he is entitled to his day in court, but I do hope you are working on your team to move forward rapidly.

Let me just ask you, Mr. Chertoff, in your role as a prosecutor, as a Former United States Attorney, you have seen some of these bank fraud cases. Do you see a similarity between the misbehavior now of corporate America as compared to what we were seeing in the late 1970s and early 1980s with the Savings and Loan community?

Mr. CHERTOFF. There is a similarity, Senator, because we went through a wave back, I guess, 10 or 15 years ago where there were a minority, but nevertheless a troubling minority of bank officials who were violating the law. And I completely agree with you. I think the aggressive use of law enforcement made a real difference in terms of cleaning up banking and savings and loan activity.

I think we are facing a similar situation here. There is a minority, but still a troubling minority of people who are abusing and violating the rules in order to achieve a short-term economic gain for themselves and their companies. I think by having swift and tough penalties, we are going to change the way these corporate officials think and operate.

Senator SESSIONS. To follow up on that precise point, it seems to me that many have argued that white collar criminals are deterred just by the bankruptcies, by the short time in jail, and all of those things. But to me, there is a moral question here. If a person embezzles $50 million, or maybe more, as some of these cases might suggest, their sentencing range should not be a lot different than somebody who robs a bank, in my view, if it is intentional fraud.

So I guess my question is are you in accord that we need to enhance the penalties on these kinds of cases?

Mr. CHERTOFF. I don't think there is any doubt we do. The amount of destruction that is caused by a person who commits a white collar crime, like a fraud, can be every bit as serious as the destruction caused by a burglar or somebody who commits what we would normally consider not to be a white collar crime.

That is one of the reasons I think the President has called for not only an enhancement of the penalties according to the statute, but also for the Sentencing Commission to make sure that we are adequately aggravating sentences to take account of those who betray their corporate trust.

Senator SESSIONS. The way the Sentencing Guidelines are focused, I believe, is a bit off center. Their focus is on the extent of the loss, or in a drug crime almost exclusively on the amount of the drugs, the weight of the drugs. But I have always felt that the true measure of criminality and the punishment is the degree of criminality, the degree of malicious intent, the degree of conscious fraud that has occurred.

Do you think we can do a better job of considering that factor in the sentence that is imposed?

Mr. CHERTOFF. Well, the Guidelines do contemplate that one can look to factors other than just the amount of the loss or the amount of——

Senator SESSIONS. It is fairly limited.

Mr. CHERTOFF. There is no question the Commission could consider the possibility of adding more weight to other factors, such as the degree of violation of trust, irrespective of the dollar loss. So I think there is a wide range of choices that can be made by the Commission in terms of how to implement a broader vision of what kind of penalties are appropriate in white collar cases.

Mr. MERCER. I would like to add something to the Assistant Attorney General's comments on that. I think one of the things that we really face as U.S. Attorneys in trying to deal with this is the fact that we have an increasing number of non-substantial assistance downward departures.

Senator SESSIONS. By the court?

Mr. MERCER. By the court, upon a defendant's motion. In a white collar case——

Senator SESSIONS. Do you consider those rulings in violation of the Guidelines?

Mr. MERCER. The courts clearly have authority to do so either as factors that are considered and have been specifically incorporated within the Guidelines by the Commission and/or by the Supreme Court's decision in 1996, in Koon, where the Court said if a factor wasn't specifically prohibited, then a court can consider that in terms of crafting a sentence.

So it is rare for white collar sentencing to occur without a defense lawyer saying there are extraordinary circumstances based upon the community ties or the community service that the defendant rendered prior to sentencing. Or maybe there has been extraordinary post-offense rehabilitation, or maybe there are family ties or circumstances.

We hear about these all the time when we are sentencing criminal cases, and I think it really goes to Senator Durbin's question. If you have a range that the Commission has established that, in their view, appropriately deals with a crime for courts then to enter downward departures—and we had 600 non-substantial assistance downward departures in the fraud guideline in 2000 is troubling. There are a substantial number of districts that have substantial numbers of non-substantial assistance downward departures in fraud cases.

Senator SESSIONS. Were those on the recommendation of the prosecutor or all on the judge's own decision?

Mr. MERCER. Well, that is based upon the judge's authority. It is not a substantial assistance departure where——

Senator SESSIONS. No, but you could still agree to it. Do you know if those have been over the objection of the prosecutor, or do your numbers disclose that?

Mr. MERCER. The data set that I am looking at doesn't disclose that. I can tell you that in U.S. Attorney Comey's testimony before this committee, in his prepared remarks, we summarized a number of court decisions where the Government had taken affirmative appeals to object to non-substantial assistance downward departures made by courts.

I think the committee can get a flavor of the Government's concern in those cases. But as we said in that testimony, there are a number of times based upon the Koon decision or based upon where a factor isn't prohibited that we simply aren't really able to pursue an appeal because it wouldn't be one that would be reversed by the court of appeals.

Senator SESSIONS. I remember, Mr. Chairman, when I first became United States Attorney before the Guidelines were passed, which was the most significant change in the history of law enforcement since the founding of this country.

Chairman BIDEN. Thank you very much.

Senator SESSIONS. And you deserve much credit for that. I remember telling a Federal judge, in exasperation, when a defendant had smuggled 15,000 pounds of marijuana, and the Judge was thinking about giving a 5-year sentence, I said, "Sir, we just had a presidential election. The President of the United States put me here and the American people have spoken on this." But the judge could give zero to 15 years, totally unlimited, whatever he wanted to do.

I think the judges began to sense from the American people that the judges cared more deeply about large drug smugglers and sentences went up, and then the guidelines kept them up. And I believe we are at this point now.

Chairman BIDEN. I agree.

Senator SESSIONS. I think it is perfectly appropriate for Congress to affirm that we need to do a better job of that.

My time is up. Mr. Chertoff, I know you can use some additional prosecutors, but there are a whole bunch of them out there from the Savings and Loan days. I don't know what they are doing. I don't know how many more new ones you need, actually. It is just an emphasis. If it is clear that you expect your team to give it high priority, I think you may have enough people already, or close to it.

Chairman BIDEN. Thank you very much.

As we break for this vote, because we only have a few minutes left, I would just like to point out the losses weren't just the people at WorldCom who had pensions. It cost the State of California retirement system over half a billion dollars; $300 million, the State of New York pension fund; Michigan pension fund, $116 million; Florida, between $85 and $100 million; Kentucky, $8 million; Wisconsin, $36.3 million; Iowa, $33 million.

Senator SESSIONS. Alabama took a hit, too.

Chairman BIDEN. I assume my staff just picked the biggest ones.

Do either of my colleagues have more questions for this panel?

I do, but I am not going to ask you to wait because we are going to be about 15 minutes, my guess is, and there may be another vote immediately after this. So what we will do is I am going to submit about six questions in writing for you, if I could, General.

I would suggest to the next panel that if you have time, you can go down and get a cup of coffee. I apologize. We don't control the floor and it is going to take us somewhere between 10 and 25 minutes, depending on whether there is a second vote, to get back here.

I thank the Justice Department for its cooperation and look forward to your input specifically on the legislation, and I also look forward to the questions you have.

[The prepared statement of Mr. Chertoff and Mr. Mercer appears as a submission for the record.]

Chairman BIDEN. We will now recess until the call of the Chair, which I expect to be about 15 to 20 minutes.

[The subcommittee stood in recess from 3:31 p.m. to 5:29 p.m.]

Chairman BIDEN. The hearing will come back to order, please. We owe this incredible panel that we are so looking forward to hearing a sincere apology and a debt of gratitude for waiting. This is above and beyond the call.

You guys remember when you were in school the old joke was you only had to wait 20 minutes for a full professor. You only have to wait two minutes for a Senator, and you guys have exceeded that by a couple of hours. Senator Sessions and I were tied up. The irony of all ironies—and I won't take much more time explaining—is that the very thing that we are talking about on this panel literally got called up on the floor of the Senate as we were waiting here. So I am truly sorry.

The next panel that we have, and our last panel, has some very distinguished members. John Coffee is Professor of Law at Columbia Law School, one of the great law schools in the country. Before going to Columbia, Professor Coffee was a lawyer at Cravath, Swain and Moore, where my more successful colleagues at Syracuse went to work. He was a reporter for the American Law Institute's Principles of Corporate Governance. Professor Coffee is an

expert on corporations, security regulation, and white collar crime, and has published numerous books and articles on these topics. We thank him for being here today.

Second, we have Thomas Donaldson. He is Professor of Legal Studies at the Wharton School at the University of Pennsylvania. He was previously Professor of Business Ethics at Georgetown University. He attended school at the University of Kansas, where he majored in business, and got his Ph.D. in philosophy also from the University of Kansas. The professor has written four books on business ethics and more than 70 academic articles and book chapters. I welcome him as well.

Charles Elson is Professor of Corporate Governance and Director of the Center for Corporate Governance at the University of Delaware. Before that, he was Professor of Law at Stetson University, a university my colleague and I know well, and an attorney at Sullivan and Cromwell.

Professor Elson is an expert on corporations, security regulation, and corporate governance. He has written on these issues extensively and is the Vice President of the American Bar Association's Business Law Section Center on Corporate Governance. I want to thank him for making the trip down, and maybe we will be on the same trip home. Columbia and Penn, where my son went to school, are good, but Delaware is better. That is my alma mater.

George Terwilliger is a partner at the law firm of White and Case, where he leads their corporate defense and special litigation group. Before that, he served as a Federal prosecutor for over 10 years, and later as the Deputy Attorney General in the first Bush administration. Mr. Terwilliger earned his B.A. from Seton Hall University and his J.D. from the Antioch School of Law. I want to thank him for coming as well.

Tom Devine is the Legal Director of the Government Accountability Project, a non-partisan, non-profit interest group that works to protect the rights of whistleblowers. Mr. Devine has been working at the Government Accountability Project for more than 20 years and has been a resource for this committee on more than one occasion. He has also taught and written about whistleblower protection issues. Mr. Devine is a graduate of Georgetown University and Antioch Law School, and I want to thank him as well for joining us.

Gentlemen, I will not take any further time, and unless you all have worked out something different, if you could deliver your testimony in the order in which you were called. Usually, we have a rule on time. There is no rule. You all take as much time as you want. Again, I thank you very, very much for waiting for me.

STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY SCHOOL OF LAW, NEW YORK, NEW YORK

Mr. COFFEE. Senator, thank you for having me here, and let me start out with the statement that I really have two areas of specialization—securities law and corporate governance, on one hand, and white collar crime and sentencing on the other. For the last year, these two fields have merged.

Now, we are talking about a series of scandals and issues that have broad macroeconomic impact. Absolutely every topic is relevant, but I am going to be very narrow. I am going to talk about the criminal law because I am someone who teaches the criminal law regularly and I want to explore with you the various levers that I think could be better used to maximize deterrence in the area of white collar crime.

My initial message has already been stolen by Senator Sessions, because he said he had some problems earlier with the way in which the Sentencing Guidelines manual looks at fraud, embezzlement, and similar types of offenses. I think that particular guideline is a little out of date. It has got at its core a kind of a concept that says securities fraud—we know what that is; that is the Ponzi scheme in which the promoter sells stock to the investors, and we will just look at the amount of sales he made to those investors.

That is not what is going on in an Enron or WorldCom or anything like that. We are dealing with cases in which the books have been cooked. There are serious accounting irregularities and the loss is not simply the loss to the individual investors, because frankly the company may be selling no stock during this period. The loss is really the broader social loss of investor confidence in the system being eroded.

When that happens, it is not just that stocks everywhere decline, not only at Enron but a perfectly legitimate company like General Electric will have a transparency discount, but the broader loss is that when investor skepticism grows and they lose confidence in the reported financial numbers, the cost of capital for American corporations rises. And when the cost of capital rises, that means interest rates go up, economic growth is retarded, and layoffs become inevitable.

In that light, I think we should recognize that senior corporate management involved in and convicted of securities fraud, particularly securities fraud involving the credibility of financial statements, is creating a social loss far greater than the loss borne by individual investors, however computed.

Now, having said all that, I wrote this before I saw today's Biden bill, which does instruct the Sentencing Commission to develop a new guideline, and I would certainly endorse that. I read the Leahy bill, but I had not read your amendment to it, and I think that is something that should be done.

I think that it should focus on criteria such as was there an earnings statement, how many quarters were affected by this, what level of management was affected, et cetera. I think there should be an express recognition that when there is a person with a very high-ranking fiduciary duty—the chief executive officer—it is a more serious offense by that person than by someone two levels down the totem pole who may be under pressure from the top.

All of that, though, is something I think the Sentencing Commission can address. I once served as the American Bar Association's reporter on sentencing alternatives.

Chairman BIDEN. I remember that.

Mr. COFFEE. I would urge you to go the Sentencing Commission guideline route rather than adopting mandatory minimums. There is always some over-breadth in mandatory minimums.

Now, what else can be done under the Sentencing Guideline route? We have heard a great deal of interest expressed, including by the President yesterday, in recapturing, let's call it the unjust profits that a chief executive receives when he got stock options, bonus compensation, during a period in which the company's stock price was inflated. The board of directors may have believed that he was doing a great job. Only later do you learn that all those numbers were fabricated.

There is a concept in sentencing that I think needs to be given greater attention. It is not just the area of fines, it is the area of forfeiture and disgorgement. American sentencing law says that if you catch a person with ill-gotten gains, he forfeits that. In other words, if I am a bank robber and I am caught robbing a bank with $1 million in my hand, I am not fined $1 million. I just forfeit it because it wasn't properly mine.

I think when we look at the area of executives who have received stock options or seen those stock options inflate during the period in which corporate financial statements were seriously and materially false, it is possible to deem that a form of unjust ill-gotten gain that could be captured underneath the disgorgement sanction.

Now, I am not saying that Congress should say this itself. I think the Congress should rather instruct the Sentencing Commission to develop the concept of forfeiture and disgorgement, as it might be used as an additional sentencing sanction, in addition to criminal sentences and fines, as a way of having one expedited proceeding in which they would forfeit, if convicted of a crime, the ill-gotten gains, which could include bonus compensation, stock option appreciation, or the award of stock options.

Again, there is a need for detailed and nuanced guidelines, but I think that is an additional area which we would have one proceeding that would efficiently take away all the gain, rather than talking about having the SEC or a private plaintiff sue them.

Chairman BIDEN. Professor, can I ask for a clarification on that?

Mr. COFFEE. Certainly.

Chairman BIDEN. I am the guy that drafted the forfeiture legislation relating to drug cases. So when we use the word "forfeiture"—I understand it in a literal sense, but it is used up here and anyone reading your testimony will assume that we mean that if you can prove that the ill-gotten gains were $5 million and you could not find the cash, you can go take his house. You can take his car, you can take his yacht, et cetera.

Is that what you mean when you use the word "forfeiture?"

Mr. COFFEE. That is one way of doing it. It is also possible to use simply the common law approach which the Guidelines could codify that if you had the proceeds of a crime in front of you in a court, that gets automatically forfeited.

Chairman BIDEN. But if you don't have the proceeds of the crime in front of you in court—in other words, he has cashed out the stock options.

Mr. COFFEE. Money is fungible. I think you could trace the money.

Chairman BIDEN. Yes, okay. I just want to make sure we are talking about the same principle.

Mr. COFFEE. Well, I think you give some authority saying we want to have the concept of forfeiture apply to these ill-gotten gains, and instruct the Commission to come up with a more——

Chairman BIDEN. As opposed to drafting legislation?

Mr. COFFEE. As opposed to simply either writing a one-sentence statute that won't deal with all the problems, or as opposed to instead telling the SEC to sue or telling private plaintiffs that they can sue, all of which will take five more years and involve two or three more judges.

Chairman BIDEN. I am with you. I just wanted to make sure I understood it. Thank you very much.

Mr. COFFEE. Now, additional things I think you should focus on: There will also be occasions in which the corporation will be prosecuted. That may or may not happen in Enron because it is bankrupt, but securities fraud is an offense——

Chairman BIDEN. It happened at Andersen.

Mr. COFFEE. Okay. It certainly is a case in which we would like to see corporations occasionally prosecuted. I won't get into the nuances of when yes and when no. When we do that—and I was one of the draftsmen of these provisions back in 1991—we have very elaborate organizational guidelines which put very significant weight on whether or not the corporation has an effective compliance plan.

There are seven elaborate criteria set forth in the Sentencing Guidelines manual to determine when you do have an effective guideline compliance plan which can reduce the sentence by 50 percent or more. We have had those guidelines for a decade now and I don't think anyone has a clear idea of whether or not those guidelines have any deterrent value, whether they are producing compliance plans that do reduce the risk of corporate crime, that do create greater internal monitoring.

I think there is some possibility that those compliance plans were all adopted by one or two law firms coming up with a standard form compliance plan that is used by 500 corporations, with very little attention.

I think two things. There should be a study about whether those compliance plans do create enough value to justify the enormous sentencing credit that they create. There is lots of theory here, but very little observation.

Secondly, I think we can easily redesign these guideline compliance plans so as to create a number of desirable consequences, including much greater protection for whistleblowers. I certainly understand that the Leahy bill gives protection to whistleblowers against retaliation, but that comes when we are talking about the criminal law at the later stages.

If a company wants to have an effective compliance plan, it would be possible to address in it and require as a minimum condition that these compliance plans had to establish a variety of techniques, whether they are anonymous hotlines, whether they are direct connections to the audit committee.

I don't want to get into the details of specifying what should be the adequate procedures to invite anonymous and confidential comments from employees who feel that this conduct is occurring, and

I don't want to get into the details of who they should report to, whether it goes to the audit committee directly or someone else.

But I think we can take best practices as they now exist and incorporate them into our standard of what a compliance plan should look like, because a compliance plan is ultimately an invitation to the company to do something in advance to get an enormous credit in the event that you are ever convicted. I think that is an area where you can take best practices, not make them mandatory, but say if you want enormous sentencing credit, you should be complying with the best practices in the area of both compliance plans and treatment of the potential whistleblower.

A last point, because I realize I am running long on time. We have another sanction that is available but little used. It is corporate probation. Now, it can be used in addition to a sentence when we convict the corporation. When we have that kind of world in which the corporation appears to have been somewhat dysfunctional and there were corporate governance failures, we will often find that there are corporate officers, past or present, who may have deceived the company, received ill-gotten gains, elaborate loans in some recent examples, and we have a problem.

The corporation may have great difficulty asserting claims against those individuals because the corporation has its own internal conflicts. There may be a controlling shareholder, there may be other problems on the board of directors.

One way to resolve that is to authorize as a condition of probation that the court appoint a court-appointed monitor, which monitor would have the corporation's power to assert claims against past and present officers and directors who may have engaged in improper self-dealing.

What I am suggesting is that as part of the sentencing process, the court could appoint a basic equivalent to the special counsel that we all know about from the public sector. The public sector has special counsels occasionally investigating Cabinet members and the like. If we have pathology in a corporation and the corporation has been convicted of a crime and there is some evidence that individuals may have wronged the corporation, appointing such a court-appointed monitor, with authority in the name of the corporation to sue for a recovery to the corporation, creates an efficient and fairer and more independent procedure than either relying on a board of directors that might be compromised in some cases or relying on the tender mercies of the plaintiff's bar, which often gets a larger fee than they get a recovery in the world of derivative actions.

So I suggest there are ways that the concept of corporate probation could be utilized to try to rectify corporate governance problems that emerge in these corporate accounting irregularity cases, and in particular that they can be used as a way to ensure that individuals don't escape with their unjust gains.

Thank you.

[The prepared statement of Mr. Coffee appears as a submission for the record.]

Chairman BIDEN. Thank you very much, Professor.

Professor Donaldson, thank you for being here today.

STATEMENT OF THOMAS DONALDSON, MARK O. WINKELMAN PROFESSOR, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PENNSYLVANIA

Mr. DONALDSON. I speak not as an expert in law, but in business ethics, and I am reminded of the fact that over 200 years ago Adam Smith, the father of capitalist, himself a professor of ethical philosophy, said something that agrees well with what Amartya Sen, the recent Nobel Prize Winner in Economics, said, namely this remarkable system of capitalism—even this remarkable system doesn't function well unless it can rely on the integrity of its participants.

There are a number of economic duties of citizenship that are required in order for capitalism to function well. Some of these are engaging in fair competition, not abusing government relationships, providing non-deceptive information to the market. Recent scandals have turned heavily on this last issue. When companies fail to provide investors with accurate information, investors make worse decisions, and in turn efficiency lowers.

However, one characteristic winds its way throughout all of these duties of economic citizenship, and it is that for markets to function well, at least a critical mass of people, and in particular executives and managers, must behave much of the time for reasons that assign intrinsic worth to certain values; that is to say, we have to have a threshold mass of people who are willing to do something because it is the right thing to do and not because they will avoid legal penalties, and not even because they will avoid financial losses.

The limits of the law and regulation to cope with corporate ethics became obvious in the last century as we learned, for example, that information inside an industry often races ahead of the knowledge outside of it, including the knowledge of regulators. Industries like asbestos became very difficult for regulators and the government to regulate effectively because knowledge inside the industry typically led knowledge outside the industry. In recent scandals, it was often a new, clever scheme, a financial arrangement such as the raptors at Enron that bedazzled and cheated investors. By the time the law and the investor had caught up, it was too late.

None of this is to say that we don't need new and tougher laws. In fact, we do, and I support very much what I have seen coming out of this committee and indeed what is being proposed today in the Senate, but it is to clarify the contours of a broad solution to our current mess.

Unfortunately, many of the most popular attempts to improve corporate ethics have been either lukewarm successes or failures. My colleague, Professor Coffee, alluded to one of them, namely the compliance systems that have arisen in the wake of the corporate criminal sentencing guidelines.

Ethics and compliance programs abound now; they are hot. In 1991, I don't have to tell you the U.S. Sentencing Guidelines offered companies a dramatic incentive to develop formal programs. The Guidelines promised reduced penalties in exchange for bona fide ethics and compliance programs.

Unfortunately, no persuasive data exists suggesting a correlation between having such a compliance program or an ethics code and lessened pressure on executives to commit unethical acts. In fact,

some of what was being suggested here has already been attempted.

My colleague, Bill Laufer, at Wharton has done a study of the efficacy of the corporate criminal sentencing guidelines and the results have not been encouraging. Now, I don't think this is because codes and compliance——

Chairman BIDEN. Has that study been done and published?

Mr. DONALDSON. Yes, Bill's study has been published and I will be happy to make it available to you.

Chairman BIDEN. Great. I would like to see it. I am just unaware of it and I would like to see it.

Mr. DONALDSON. By the way, let me hasten to add I am not suggesting that codes and compliance programs are worthless. In fact, I think, when well designed, they are very important. That is not my point. In fact, discovering whether they are effective or not, I think, is an almost insurmountable technical research task.

But one thing is clear from this. Codes and compliance programs are, at best, only the first steps in successfully managing corporate ethics. We would do well to remember the dazzling creativity of corporate slime. In the recent spate of Enron and WorldCom tragedies, every time it has been a new scam.

Enron, for example, had all the bells and whistles of a modern compliance program. Employees had wallet cards. Almost all of them could repeat the word, RICE, Respect, Integrity, Communication, Excellence. And they had the usual thick list of rules that was passed around and signed every year. None of this came close to preventing the Enron implosion, nor are such mechanisms relevant for virtually any of the recent scandals.

The most important determinants of ethical behavior in a corporation are the way managers are rewarded, the culture of the corporation, the leadership example that is set, and the institutional systems surrounding the corporation, including legal and regulatory systems.

Hence, it is a mistake to think that our current problems are simply the product of a few bad apples. Corporate Watergates typically involve scores, and sometimes hundreds of people inside the corporation, and often many people outside the corporation in institutions such as accounting firms, investment banks, and law firms.

I believe the single most important change fueling the recent corporate scandals is the transformation of the compensation system for upper-level executives. We have moved from a cash-based system to a stock-based one. Good reasons exist for the change, but we must now see that the game of executive motivation has forever changed.

Over the past two decades, I have talked with hundreds of executives about issues they have confronted in ethics behind closed doors. During the last six years, the tone of those conversations has shifted markedly. Increasingly, short-term stock price has assumed significance as the salient goal, and increasingly these executives' ethical pressures center on either the demands they must make or the demands they must fulfill to bolster short-term stock price. That is one of the reasons I very much agree with Senator Biden's suggestion that we need to get at the incentive system that surrounds executives in the corporate suite.

What should we do? We need more laws of the kind that are being considered today. We need better enforcement and more resources, and we need to arrange the incentives in the executive suite. But we also need to educate Americans, and especially current and future executives, about the importance of ethics.

Part of this duty falls on you, elected representatives, but a lot of it falls on me and my colleagues, especially at business schools. These schools, the training grounds for tomorrow's executives, have the unavoidable duty of taking ethics seriously wherever it arises, in accounting, in marketing, in management, and in finance.

Thank you.

[The prepared statement of Mr. Donaldson appears as a submission for the record.]

Chairman BIDEN. Thank you very much, Professor.

Professor Elson?

STATEMENT OF CHARLES M. ELSON, EDGAR S. WOOLARD, JR. PROFESSOR OF CORPORATE GOVERNANCE, AND DIRECTOR, CENTER FOR CORPORATE GOVERNANCE, UNIVERSITY OF DELAWARE, NEWARK, DELAWARE

Mr. ELSON. I come to you all as a professor of corporate governance, but I used to be a law professor in my old life, so a little law will leach its way into my testimony.

Chairman BIDEN. That is okay.

Mr. ELSON. Good for the soul.

When I taught law, the fundamental point to law students vis-a-vis civil and criminal sanctions was that criminal sanctions were designed to punish and deter. That was the whole point. White collar criminal prosecution has the exact same goal, to punish wrongdoers and deter bad conduct going forward. How does this apply in the corporate context?

I believe very strongly in criminal prosecution and punishment for those who intentionally act in a self-enriching fraudulent manner, in violation of the securities and other financial regulatory law. I think it is good deterrent policy. Criminally prosecuting folks who break the law intentionally deters bad conduct going forward.

I think an example of this is in the area of insider trading regulation. Initially, insider trading was prosecuted civilly. It didn't work, and by the mid–1980s we engaged in a number of criminal insider trading prosecutions, very high-profile, and I think they achieved the proper deterrent impact.

Obviously, in the corporate fraud area the same thing applies. I think that the solution is to enforce the laws on the books and commit more funds to enforcement. It is good deterrence. If someone aggressively, actively, knowingly violates the law, they should be punished.

Now, I think it is important to create a distinction, though. It is fine to punish self-dealing, or, in the vernacular, sleazy conduct and those who conduct that sleazy conduct criminally, perfectly okay. The problem, though, is when you begin to change the standard a little bit and prosecute what is, in essence, slothy or sloppy conduct in the corporate context criminally.

I think what then happens, unfortunately, is it creates the wrong incentives, in that it will result—and this comes out of what was

referred to earlier, the Federal sentencing guideline corporate compliance code, or as we say in the State law context the Caremark codes, which results, I think, in numerous procedures that are adopted by companies to prevent legal liability that end up elevating form over substance, and in the end I think create activity that is harmful to shareholder interests because people are more interested in meeting the legal requirements than actually thinking through what was the intent of those legal requirements—form over substance, if you will.

I think when you prosecute someone criminally for slothy or sloppy conduct, it creates a desire on the part of those slothy individuals to avoid potential liability and it creates systems within the corporate organization that, in fact, are form over substance. I think that is what happened, unfortunately, in the Sentencing Guidelines and the Caremark case.

The solution to slothy conduct is internal. It is creating vigilant, independent, equity-compensated, equity-holding boards of directors. I think that that in the end creates the greatest incentive within the organization to act carefully.

On the other hand, self-dealing conduct can't be dealt with in that manner and it has got to be dealt with through the criminal process, because I think as we saw in the insider trading area, it was the only effective method, in my view, of deterring future bad conduct.

Chairman BIDEN. Thank you very much, Professor.

Mr. Terwilliger?

STATEMENT OF GEORGE J. TERWILLIGER, III, WHITE AND CASE, LLP, WASHINGTON, D.C.

Mr. TERWILLIGER. Thank you, Mr. Chairman, Senator Sessions. As you noted, I was a Federal prosecutor for 15 years. Today, I am in private practice at an international firm and I regularly represent corporations and other institutions involved in Government investigations, enforcement proceedings, and sometimes prosecutions.

Senator SESSIONS. Do you think he has gone soft now that he has been representing those big corporations?

Chairman BIDEN. No, no.

Senator SESSIONS. Maybe we will get an objective analysis, having been on both sides.

Mr. TERWILLIGER. I hope so, Senator.

I do have the privilege of helping clients today understand and navigate the business enforcement issues, but I also cherished my role as an Assistant U.S. Attorney, as a colleague of yours, Senator Sessions, as a United States Attorney, and as Deputy Attorney General.

I vigorously prosecuted white collar crime cases, including the BCCI matter which involved the prosecution of a corporation. While I was U.S. Attorney in Vermont, I tried a case against two local bank presidents, one of whom was very popular. They abused positions of trust and went to jail.

I accepted your kind invitation to be here today and stuck around, Senator Biden, because——

Chairman BIDEN. I do appreciate it, I really do.

Mr. TERWILLIGER. Well, I am happy to be here because I believe it is essential that this loss of faith that we are talking about in business be remedied, but I also fear that we are in danger of overreacting in how we respond.

The crisis we have is to one of the most fundamental prerequisites to our economic well-being—investor confidence in the capital markets. Without that kind of confidence, our economic engine is starved for fuel. But because the matter of confidence in financial reporting is so fundamental and sensitive, steps taken to address it, in my judgment, should be carefully considered and measured.

Most business leaders today are, in fact, honest, law-abiding, and faithful to their duties to secure the interests of stockholders. Many may indeed be aggressive, and in most cases rightly so. A few are crooks. Now, however, the many bear the burdens created by those few.

Financial accounting and reporting is not an exact science. Experts can, and do, disagree about how accounting items should be treated. These disagreements and uncertainties, though, are different than the intentional exploitation of fuzzy lines to perpetrate a fraud.

In the context of financial reporting, a fraud means that investors and regulators are intentionally deceived about a company's performance, not simply that experts disagree about how that performance should be accounted for and reported.

Truly corrupt business practices, of course, deserve sanctions, but I believe we need to be very careful about whom, and more importantly what we sanction. Corporations and other business entities provide the jobs that give Americans an unparalleled standard of living and fuel the crucial consumer sector of our economy.

Individuals who engage in intentionally corrupt financial practices or reporting betray their duty to the entity that employs them, their responsibilities to shareholders, and their obligations under the law. But unlike these real persons, corporations and other business entities cannot think or act for themselves.

Thus, while individuals can, and do, form the corrupt intent that defines criminal behavior, to ascribe criminal intent to a corporation is a judicially-created legal fiction endorsed by the Supreme Court in 1909. Even though legally permissible, sanctioning a corporation for a crime may be less effective than some alternatives in influencing positive corporate behavior.

I honestly believe, and candidly say so, that neither new crimes nor increased penalties alone are going to solve our problems. In fact, we might remember that in the real world excessive exposure to draconian sanctions in economic crime cases has the potential to discourage meaningful corporate critical self-examination, as well as disclosure, cooperation, and guilty pleas by individuals and companies. In addition, as initiatives are considered, reviewing relevant and fundamental precepts of our constitutional system can provide some invaluable guidance.

It is, for example, helpful to recall that a core function of the Federal establishment is to promote and secure the benefits of commerce to the people. In harmony with this purpose, for over 200 years the Federal criminal law applicable to commercial activity

was aimed at protecting the means and instrumentalities of commerce.

Surely, capital and credit markets are obviously key means and instrumentalities of commerce, and protecting them from corrupt practices is consistent with this core Federal role. The question, though, is how best to do that, and it seems to me that the answer is not to reflexively create new offenses or simply impose greater sanctions. Rather, it may be more efficacious to seek a balance, including incentives for good corporate practices, correction and reform of questionable practices, and reserving effective sanctions, and severe ones, for truly corrupt practices.

There are alternatives to corporate criminal prosecutions that can help restore confidence in our companies and our financial systems. First and foremost, as the President recognized yesterday, corporations themselves need to do more to promote confidence in their own performance and in their financial reporting.

Steps include more active internal oversight, including through board audit committees. Internal auditors and audit committees can be highly effective inside watchdogs. It is better to have financial reporting that gets it right the first time.

Likewise, corporate legal officers and auditors should not merely empowered, but encouraged and provided the resources to proactively investigate internal malfeasance. This is not only good public policy, but has significant value in protecting corporations.

The Government can do much to encourage critical self-examination by corporations and other business entities. Real incentives rather than just rhetorical ones should attach to voluntary correction and disclosure of wrongdoing. I must report to you that most attorneys advising companies today are forced to conclude that the benefits of voluntary disclosure are insufficient to outweigh the risks attendant to them.

As an example, even a limited waiver of attorney-client privilege requested by prosecutors can result in a complete loss of privilege in related civil proceedings by private parties. Congress could consider a statute making limited waiver agreements with enforcement authorities enforceable against third parties. Although this may sound radical, particularly at this point in time, as a matter of prosecutorial policy business entities that make timely disclosure of wrongdoing might enjoy a presumption, not a bar, but a presumption against criminal prosecution.

I do not advocate going lightly on real cheats and crooks. A dishonest market is not a free one. But we must also work to discriminate between conduct that merits the harshest sanctions and that which can be addressed more effectively through alternate means.

Because facilitating commerce is a core Federal responsibility, we should police the marketplace, in my judgment, judiciously, utilizing good judgment and discretion in establishing and assessing sanctions for commercial misconduct.

Mr. Chairman, I would ask to submit the balance of my statement for the record, if I may, and thank you very much for having me.

Chairman BIDEN. Without objection, it will be. Thank you for being here.

[The prepared statement of Mr. Terwilliger appears as a submission for the record.]

Chairman BIDEN. Mr. Devine?

STATEMENT OF TOM DEVINE, LEGAL DIRECTOR, GOVERNMENT ACCOUNTABILITY PROJECT, WASHINGTON, D.C.

Mr. DEVINE. Thank you for inviting my testimony.

It is rare for the Government Accountability Project, but my primary goal this evening is to offer credit where it is due. Through the provisions creating state-of-the-art whistleblower protection that were unanimously approved by this committee and on the Senate floor this afternoon, the Judiciary Committee exercised bipartisan leadership for a genuine breakthrough in corporate accountability.

The Corporate Fraud and Accountability Act of 2002 is outstanding, good-government legislation. It complements your leadership in today's hearing. The Act's centerpiece is legal rights for whistleblowers at publicly-traded corporations. Future Sherron Watkinses could not be fired at will for warning corporate leaders or shareholders of consequences from cheating, such as bankruptcy liability or other risks that could sabotage investments.

The strategy is creating a safe channel for shareholders' and management's right to know, as well as for testimony in law enforcement investigations. The goal is to frustrate cover-ups by giving reprisal victims access to district court jury trials if they cannot receive a timely decision from what all too frequently has been the black hole of the Department of Labor's administrative law system. For example, our organization has represented a client with a case pending there for 14 years. The cases would be governed by the modern legal burdens of proof that Senator Grassley helped create in the Whistleblower Protection Act of 1989 for Government workers.

Disclosure has been the trans-ideological, bipartisan cornerstone of all post–Enron reform proposals. The common-sense logic is unassailable. Two long-accepted truths are, first, that secrecy is the breeding ground for bureaucratic corruption, and, second, that sunlight is the best disinfectant. Otherwise, even the best corporate leaders are ignorant of misdeeds until they are being blamed for the consequences. Similarly, shareholders are blind-sided by risks being taken behind their backs. The ultimate fate of the Judiciary Committee's whistleblower legislation will confirm whether political leaders are serious about disclosure.

Whistleblowers are the Achilles heel of bureaucratic corruption. As the eyewitnesses to the birth of scandals, they are indispensable to bridge the secrecy gap. Their free speech right is more than just the freedom to protest misconduct. It also includes the freedom to warn.

In the Netherlands, for example, these individuals are called bell-ringers, after folks who climbed the church tower to warn the community of danger. In other nations, they are called lighthouse-keepers, after those who shine the light on rocks which could sink ships arriving in their harbors or ports.

The common theme is warning about threats to the public's well-being before avoidable crimes or disasters occur and before we are

limited to damage control. Over and over, their dormant potential has been proven anecdotally since the 1980s. The common theme in the disclosures of whistleblowers represented by the Government Accountability Project has been warning of liability or Government sanctions for cheating.

Sherron Watkins acted as a corporate Paul Revere by warning that devastating liability was coming. Enron chief Ken Lay ignored her at his own peril and sealed his doom. These people are the lifeblood of anti-corruption campaigns, which are lifeless, empty symbols doomed to failure without testimony from those who bear witness. It is just a truism to share with some of the folks I am talking within this audience that it can be very difficult to win criminal convictions without leads and testimony.

Whistleblowing disclosures to the SEC doubled during the Enron hearings, and the SEC enforcement chief commented, "Because of this phenomenon, we are learning of potential securities law violations earlier than ever before. Keep those cards and letters, not to mention e-mails, coming."

But unless rights are locked in, things will soon be back to normal and would-be whistleblowers will decide instead to stay silent observers. Ironically, except for Senator Grassley's work on the False Claims Act, the norm is that whistleblowers proceed at their own risk when sounding the alarm.

Corporate law is a crazy quilt of hit, or usually miss, protections for everything except the False Claims Act. With scattered exceptions, the lucky ones who have coverage are prisoners of the Department of Labor's administrative law system, and the norm there is well over two years to get a decision, with no chance for interim relief. That is professionally akin to patients who die while they are waiting for the operation to occur, while they are waiting for an organ donor or something like that. Ms. Watkins only survived because Enron collapsed before retaliation could be carried out, and then she became a celebrity. For whistleblowers, the sad truth is that if you are not a celebrity, you are cooked.

As Professor Fred Alford of the University of Maryland observed, for every Sherron Watkins there are several hundred whistleblowers who lack the protection of visibility. These people are openly fired for disloyalty to company managers who themselves often were breaching their fiduciary duty to the shareholders. It really raises the question, loyalty to whom?

Initially, this reform appeared trapped by a partisan deadlock, but thanks to work beyond the call of duty by Senators Leahy and Grassley's staff, we achieved a composite model that sparked a consensus. The Judiciary Committee's compromise is a win-win for everyone, except corporate crooks.

Honest managers, boards, shareholders, whistleblowers, and Federal law enforcement agencies will be empowered with an early-warning system to prevent new Enron disasters by nipping scandals in the bud. It would place the United States in compliance with the whistleblower requirement in international anti-corruption treaties.

The unanimous committee approval in today's vote suggests the Senate may be ready to prove it is serious about making a difference, and that is a welcome development. Legislators of both

parties have rhetorically lionized whistleblowers and chastised those who violated their duty by remaining silent, but it is time to add genuine rights to this rhetoric. The rhetoric rings hollow to someone who is fired and facing bankruptcy for warning a corporation of that same risk.

The legislation adopted by this committee should be a beachhead for other stalled pending legislation, especially S. 995, amendments to revive the Federal Whistleblower Protection Act, which was the strongest free speech law in history when unanimously approved by Congress in 1989 and strengthened in 1994.

But after brazenly hostile activism by a court with a monopoly on judicial review, it is a trap that creates more victims than it helps, and our organization, which worked to pass that law, has to warn people against using it. There is also legislation to provide whistleblower rights for FBI employees, also approved by this committee, and Federal baggage screeners, introduced by Senators Grassley and Levin, which would close inexcusable loopholes. These bills badly need bipartisan sponsors, and I hope there will be an opportunity to work with your staffs on this legislation.

The Judiciary Committee bill is only a first step, but it is a giant step forward. It means that future Sherron Watkinses will have rights when they risk their personal financial future to defend that of the shareholders. It is unrealistic to expect that whistleblowers will defend shareholders or the public if they can't defend themselves. Like current corporate whistleblower law, profiles in courage are the exception, not the rule.

Thank you.

[The prepared statement of Mr. Devine appears as a submission for the record.]

Chairman BIDEN. Thank you very much, all of you. The Senator and I are used to working together, and since there is the two of us, we are just going to sort of have a conversation with you, okay?

Mr. COFFEE. Senator, I have to leave in about ten minutes to make my airplane, which is the last plane of the night going back to Newark.

Chairman BIDEN. We will have a conversation with you first, if we can.

Let me say sort of as a context for the few questions I have that I want to make it clear that I, for one, do not believe that merely changing criminal penalties and sanctions is going to solve this problem. I do agree with you, Mr. Terwilliger, that the loss of faith we are experiencing now may produce overreaction.

I have been involved either directly or indirectly or literally writing every major criminal law, for good or bad—I made some big mistakes, like the crack cocaine question—since 1984.

Mr. TERWILLIGER. Mr. Chairman, if I may, I don't mean to interrupt you, but I know you have, having worked directly with you when I was Deputy Attorney General. You have been a member of this body that has certainly put no partisan interest in the way of very truly substantive work for the benefit of the criminal law.

Chairman BIDEN. Well, I thank you.

Let me tell you I am worried in this moment that we find ourselves, and the extent of the anger that is palpable. As you all

know better than I do, more people are, quote, "in the market" now, average people. It is amazing.

I commute everyday. The conductors come up to me. These guys are blue-collar workers, my buddies, and they are in the market. I mean, their 401(k)s are in the market, but they personally are dealing on their computers; they are day- trading. I don't know the number, but I think——

Mr. COFFEE. I know the number. Eighty-eight million Americans directly own stocks or mutual funds.

Chairman BIDEN. Is that a higher percentage than in the 1920s?

Mr. COFFEE. About 50 percent of American households have a stock investment. In Europe, it would range between 15 percent and 12 percent, so we are three times more invested than any maximum in a European country.

Senator SESSIONS. Mr. Chairman, Professor Coffee has to go in just a minute. I had one question.

Chairman BIDEN. Go ahead, if you have a question for him directly.

Senator SESSIONS. My question was when you talk about a special counsel, would that be something like what happens in bankruptcy where a trustee comes in, but this company may not be in bankruptcy?

Mr. COFFEE. It could be very similar to that because the trustee takes over the board's powers

Senator SESSIONS. They would sue the officers to recover assets for the company?

Mr. COFFEE. I don't want to supplant the board of directors generally. They should still be the decisionmaking organ. But with regard to the decision, do we sue the former chief executive who was our friend and colleague, do we sue the controlling shareholder who has a lot of friends on the board—that is the world where in the appropriate case the probation condition could be one under which the court appoints an officer who will make a disinterested decision and who will not be motivated, as plaintiffs' attorneys sometimes are, by the prospect of a one-third recovery. It will be more of a fair, independent decision.

Chairman BIDEN. Well, let me speak to that for a second. What is the problem with motivating an attorney? I mean, I find this kind of interesting. Part of our English jurisprudential system for 800 years has been, before Adam Smith and since Adam Smith, that if, in fact, you do not want government to grow and government to—and I will put this in the most base terms I can—and if you cannot have or do not successfully have self-effectuating mechanisms that the industry places upon itself or individuals do, then we basically have said as a part of our capitalist system that what we will do is we will incentivize people to allow stockholders and allow investors to, in fact, stop bad behavior that occurs, whether or not they can recover everything that they want to recover.

To put it in its most naked terms, thank God for vultures; they clean up the roadkill. Let's assume that every plaintiff's attorney, which seems to be what is the view in this town the last ten years, is a vulture. I disagree fundamentally with that, but let's assume they are.

Mr. COFFEE. I am not disagreeing with that, Senator. In fact, I was the special counsel to the White House general counsel office during the passage of the PSLRA, and I do agree that there is a role.

The special problem about derivative actions is that unlike the class action, where it tends to be a kind of joint venture in which the legal entrepreneur gets 25 to 30 percent if the recovery, in a derivative action very often the plaintiff's attorney is able to settle on a cosmetic basis and, in effect, preempt the entire recovery. You get a settlement for cosmetic relief and you get a several-million-dollar award in attorney's fees, and I think that does not serve well the shareholders.

Chairman BIDEN. Now, let me speak to that one way and then let you go, because I am told you must leave very soon. If the issue is that that action, the derivative action, overcompensates the attorney and under-refunds, if you will, the stockholder, that wouldn't even matter to me if, in fact, it affected corporate behavior.

Are you suggesting that it doesn't affect corporate behavior?

Mr. COFFEE. I really have two points here.

Chairman BIDEN. I am not disagreeing. I am trying to understand you.

Mr. COFFEE. I served for 13 years as the reporter to the American Law Institute for its Litigation Remedies Section as part of the restatement of corporate governance.

Chairman BIDEN. Right.

Mr. COFFEE. The problems with the derivative action are that it is almost impossible to bring one because of what is called the demand rule, which is probably the best known body of law among Delaware lawyers. They all know the demand rule and the exceptions to the demand rule, and I am good friends with many of those judges.

Because the derivative action is subject to that very high burden, the appointment of a special monitor who could sue in the name of the corporation avoids the derivative suit problems. It allows you to bring an action as the corporation suing in its own name, as opposed to a small shareholder going through a court of equity and seeking to get permission to commence a derivative action.

It is both a more effective remedy and I think it is one in which there won't be quite the same compensation problems in which you may get a cosmetic and meaningless relief in return for a high award of attorney's fees.

Chairman BIDEN. I know you have to go, so you should go. I am not suggesting that your suggestion is not better. I am just trying to understand whether or not the reason why the derivative actions are not as useful is because the burden that has to be met is so high.

Mr. COFFEE. It is a very high burden.

Chairman BIDEN. If that is the reason, or because, even if the burden is met, it does not result in affecting corporate behavior.

Mr. COFFEE. I think both of those diagnoses apply to some cases.

Chairman BIDEN. Thank you for being here. I appreciate it. With your permission, on your way out, we may submit to you a couple of questions in writing, and I know you are busy.

Mr. COFFEE. I really apologize.

Chairman BIDEN. No. You hung around here for two hours.

Now, let me continue to pursue that for a minute and ask any of you to chime in here. Professor Elson, as well as Professor Donaldson, if you can put on the portion of your professorial hats that has a historical perspective here, what is the history of the role of government enforcing these ethical standards on corporate behavior, building in mechanisms that are designed as part of the capitalist system to be sort of self-cleaning, like allowing and incentivizing stockholders and/or aggrieved parties and/or entrepreneurial lawyers to enforce proper behavior?

Talk to me about that just a little bit. I am not getting into any specific actor. Just tell me about what the role has historically been of those two functions, because my understanding has generally been the last thing you want is you want a large government enforcement regulatory role that does have, I think, the potential to have a deflating sort of impact upon corporate ingenuity, corporate growth, corporate innovation.

So talk to me about that, if you will. That is not a very well articulated question, but I hope you know what I am trying to get at.

Mr. ELSON. I think that the key is how you create compliance with law within the organization. That is a fundamental issue. We have attempted lately to create bureaucratic mechanisms within the organization, compliance committees and what not, and this comes out of the Federal Sentencing Guidelines and out of the *Caremark* case, to do it. They were, as I think Professor Donaldson pointed out, ineffective.

The real key is creating within the organization an ethical culture. That comes from the top, that comes from top management. And who is responsible for top management? It is not the government or even those who bring litigation under the securities laws. It is really the board of directors when you get down to it. They are the shareholders' representatives who are there to oversee the organization.

Unfortunately, boards have fallen very short lately, for the reason that they were typically managers. They were insiders on the boards or those who were friendly with management or had relationships to management, which made it impossible to monitor. That is why modern corporate guidance—and I am wearing my governance hat now—calls for independent, long-term, equity-holding directors as the real solution here. I think those of us in the governance community have been arguing this for a long time.

Chairman BIDEN. How do you get there, social disapprobation?

Mr. ELSON. You get there through institutional investors and the stock exchanges, which they are proposing now, to call for substantial majorities of the board to be independent, no financial connection at all to the company other than equity ownership. Independence gives you objectivity in reviewing what management is up to. Equity gives you the incentive to exercise that objectivity.

I think when you have that kind of board, the whistleblower, who I think is a very important party, has a group to go to. At this point they don't, where they are captured by management. If the

board is dominated by management, there is no point in the whistleblower going forward.

On the other hand, if the board is independent or the audit committee is independent, obviously there is an incentive there for someone who disagrees with what management is doing to come to that body, who are acting in the company's interest as shareholders. I think that that is really the key, at least in my view, to a solution.

Otherwise, you are going to have a regime which is fabulous for the lawyers. And as a member of that profession, I am not too unhappy about that. On the other hand, it will be form over substance, and I think that is what we have gotten and that is why we find ourselves in the pickle we are in.

Every company that has had these ethical issues the last couple of years all had codes of ethics, compliance programs, toll-free hotlines, and none of it made a difference.

Senator SESSIONS. To interrupt there, isn't the board relying to a large degree on the accounting firm?

Mr. ELSON. Yes, absolutely.

Senator SESSIONS. So the accounting firm is the one that is supposed to be the paid whistleblower, isn't it?

Mr. ELSON. Well, the internal audit and external audit, yes, they were. Unfortunately, there was a linkage or relationship between the accounting firms and the managers, which made it more difficult. And I could go into a lot of explanation for this as to why they didn't come forward or didn't look hard enough.

I think one of the problems was they believed that the audit committee itself was dominated by the management and there was no point in going to them where there were disagreements, because you were effectively going back to the same party. That is why independence on the part of the audit committee is so critical so that the independent auditors feel some sort of comfort in going to that group, and having the auditors report to the audit committee, be engaged by the audit committee.

Senator SESSIONS. Just one more little question. So you are calling for a new kind of board? I mean, the boards that are presently constituted today, many of them do not have the time nor the expertise to challenge an auditor or a financial accounting plan established by management, right? Aren't we asking a lot of them?

Mr. ELSON. No. I am calling for the same kinds of boards; I think different composition, though. The job of the board is to monitor, not to run the business, but to monitor.

Senator SESSIONS. Monitor?

Mr. ELSON. Right, and monitor means ask good questions, or if someone comes to you with a problem, listen to them. But if you are perceived of as part of management, then no one is ever going to bother to come to you. Or if you are too linked to management, you are never going to bother to make an issue, for fear of being replaced on the board.

That is why independence vis-a-vis nominating committees, vis-a-vis the audit committees, and vis-a-vis compensation committees is really the solution. That is what institutional investors have been arguing for for the last five, six years. We are moving in that direction. That is the ultimate solution, at least in my view.

How do you stimulate this monitoring mechanism, known as the board, to do its job effectively? I think it has to do with independence and long-term equity ownership on their part. I am not saying that the board should run the company. That is silly. They don't have the time, expertise, the will, or the patience. On the other hand, their job is to hire good management, monitor good management and, when necessary, fire bad management.

Chairman BIDEN. Professor Donaldson, can you give me a little history lesson here?

Mr. DONALDSON. Well, I sense in your question a concern that I think has been reflected by smart people throughout history for something other than a command and control model of managing large-scale entities. It is at least as old as Montesquieu. It probably goes back to Aristotle.

With the exception of corporate governance changes, I think the corporate criminal sentencing guidelines are one of the first and most innovative attempts to try to build in, rather than impose on, certain kinds of corporate virtues. For that reason, I found the idea very attractive, and I still do.

In practice, however, with limited resources, what has happened is that the Federal people have not been inclined to bring suits against large corporations, have often cut deals with this phenomenon that one of my colleagues calls reverse whistleblowing; that is to say the entity will provide information about usually lower-level white collar criminals and as a result a few people may go to jail or may be fined. But the compliance programs themselves are rather ineffective when it comes to the kind of Enron/WorldCom scandal.

I still believe in that. I wrote about that in a book I published in 1982; that is, building it in instead of imposing it from the outside. For this reason, expensing options, restricting the time in which executives sell shares that have come from options, requiring shareholder approval of options plans, all of which have been discussed, I think are critical adjustments to the mechanism that will realign incentives and make things different.

In terms of compliance programs themselves, I don't want to do away with them. But, for example, most of them have these whistleblowing provisos already built in, but they tend to go to the legal department. They aren't connecting to auditing. They need to be changed.

Chairman BIDEN. Let me say it a slightly different way, then. Again, I am not trying to make a case for this. I am just trying to understand. Let me just tell you a little story and then have you react to it.

I come from the corporate State in a literal sense in terms of the culture of the State. I was attending a meeting in the Hotel DuPont and I came out of one of the conference rooms where they have meetings and a group of high-level executives from other States were meeting. One individual said I knew said they wanted to introduce me to these people. There were two meeting rooms and we just literally met in the hallway.

Most of these people are of a different party than I am, but this guy supported me and he said, "I want to introduce you to my friends," and these were major CEOs of major companies. He intro-

duced me to one and this guy said you know, I like you very much, Senator, but I don't understand why you are always with the trial lawyers on this tort reform stuff.

I looked at him and I said, because I am trying to save your soul. And he looked at me and he said, well, what do you mean by that? And I said, well, you know, all the incentives are built in in a way that make it very difficult, with your fiduciary responsibility to your stockholders, to make some very difficult decisions. I went through this little thing and I said, so if you are faced with the following problem I outlined, which I won't bore you all with, it is a very tough decision you have.

I said, but if you know that all that can be collected is the out-of-pocket expenses, the personal injury if your widget blows up and hurts everybody, you are going to have to ask a logical question. You are going to bring in your quality engineer and say how many of these are likely to blow up? And he is going to say 1,000, or 10,000. And you are going to bring in your legal counsel and say what is my outside liability if I do this?

I said maybe you are different. Maybe you will say it is just wrong and I am going to do the right thing, and get fired by the board. Then you are going to add it and it is going to be $20 million to recall this and your total exposure is $3 million.

I said I don't want you to have to make that tough decision, because let me tell you guys, as Ralph Waldo Emerson said, society is like a wave; the wave moves on, but the particles remain the same. We haven't made a new brand of man in a millennium. Corporate executives are just as good, just as bad, just as venal, just as noble as everybody else.

For example, I always get the Chamber of Commerce guys telling me about the coupon case, where one of the airlines overcharged everybody an average of, I don't know, two dollars. I forget what the number is. No one customer lost more than $200 or $500, and yet the lawyer got a $20 million fee. Do you know what my answer is? So what, so what?

What happens if we found out—and we don't know this, but let's assume one of the major oil companies just owns their gas stations and clicks back—for every 100 gallons sold on that machine, they really only sold 99.7. Nobody, no matter how much gas they guy, is going to have lost more than $100, $200, $300, $1,000. It is going to cost them $25,000 or $30,000 to go hire you or me.

I was relatively good at what I did and I get job offers that are astounding in the amount of money the law firms want to pay me to come back, literally astounding to me, anyway, for a guy of my salary.

It is going to cost a lot of money to sue xyz corporation, so guess what? It doesn't bother me a bit that some lawyer goes out and puts together a fund of $6 or $8 or $10 million to go after the oil company and sue them. The class that is suing, each person only gets back $175 of what they lost and the lawyer makes $20 million. What incentive is there other than pure honesty, pure desire to do the right thing, social disapprobation? No government is going to come and do anything about it. The Government didn't go after the tobacco companies, nor would they. Thank God for Dickie Scruggs. He made obscene amounts of money. So what?

Now, you guys in the corporations always tell me don't do criminal penalties and, by the way, raise the bar on the area where we can get sued because of frivolous lawsuits. And you are coming along, Professor Elson, and saying, you know, just do the right thing.

What do we do about this balance?

Mr. DONALDSON. If I could add, I spent three days on the witness stand testifying against the tobacco industry in the trial that was terminated as a result of a $300 billion-plus settlement. I think there is a very important role for people making a lot of money when they create an enormous contribution in the way that that happened. So I very much agree.

Now, that is not to say that they haven't been used excessively, class action suits, in some instances.

Chairman BIDEN. They have. I don't have any doubt about that.

Mr. TERWILLIGER. Mr. Chairman, if I may, I just want to go back to a point that you made before that I think is an excellent one and deserves emphasis. You really asked what I think is the right question: How do we most effectively influence positive corporate behavior?

Chairman BIDEN. Right.

Mr. TERWILLIGER. A lot of what we talk about doing of necessity is dealing with that behavior after it has occurred and imposing some kind of sanction which may be as the result of a tort lawsuit. It may be a criminal sanction, it may be a civil enforcement action.

But there are other issues, I think, that are worth looking at about how on the front end of that process can we affect it, and some of what——

Chairman BIDEN. Can I stop you there?

Mr. TERWILLIGER. Yes, sir.

Chairman BIDEN. Don't lose your train of thought.

I am assuming, as I have as a lawyer and as a Senator, that this does affect the front end. What is the rationale for punishment? It is not retribution. It is to incentivize someone to do the right thing. What is the incentive for these civil lawsuits brought by individual stockholders? It is if they know it can be brought, they are more inclined not to do it.

So I wouldn't make an artificial distinction here that this is only after the horse is out of the barn. I assume criminal statutes we are talking about are to be a disincentive to do bad things.

Mr. TERWILLIGER. Of course, yes, and I agree with that and I don't mean to suggest that they are not.

Chairman BIDEN. I am not sure how good they are.

Mr. TERWILLIGER. Well, that is the point. The point is that if we exclusively focus on those after-the-fact solutions, then I think we lose the opportunity, and particularly the opportunity for the Government to be part of the package to incentivize other kinds of behavior.

The first responsibility is in the corporations themselves. Then the question becomes what can the Government do? Some of the things that it can do is remove some of the incentives to bad behavior and reward incentives for good behavior.

Right now, our whole system of reviewing public accounting is geared toward singling out those companies who don't do it right.

Why can't the Government and the accounting industry and business get together and identify what are the best accounting practices and recognize those companies that engage in them? That has as very beneficial effect for investors, in that they know that this company is not playing fast and loose, and I think there are other things of that nature.

My concern is that if we try to simply deter through sanctions that we will not really take advantage of this opportunity to do some other things that can be very positive.

Chairman BIDEN. That is my whole point. I am not stating it well. I would like to figure what are those things that aren't Government regulations or Government sanctions criminally that can incentivize.

Let me give you an example. I guess it has been six, eight months, maybe longer, but I was meeting with a personal friend, a good acquaintance at home, a CEO of a major corporate company. It was in a social setting.

He said, do you know what galls me? He said, I go up and I sit down with a bunch of guys on Wall Street who summoned me to Wall Street. I sit down with three or four or five people—I forget the number he said, but a small number—average age, probably 30, and they are looking at me and saying, okay, what is the next quarter going to be? What are you doing next quarter?

And he said, well, we are going to continue to build this and we will maintain the same return on investment next quarter. No, no, no, that is not good enough. We are going to have to essentially downgrade your outfit unless you can show us you are going to have a growth of 1 percent or a profit of whatever.

And he said I have three options. My first option is I can tell them to go to hell, and the value of my stock falls, the value of my company falls, even though I am doing just fine, but I am not meeting their expectations.

The second thing I can do is I can go home and say, okay, I can cut expenses. So I go home and fire people, because now what I have done is my profit margin is slightly higher.

Or, three, I can have a new product in my pocket that I can put out there, but I don't always have that. So what do I do?

Then they say to me, okay, now part of my compensation, a gigantic part of my compensation in some cases is the stock option, and I have "x" amount of time to exercise that option. I am not stupid, Joe. I know if I don't meet these projections expected of me by these guys on Wall Street, who don't know squat about my business, the value of that stock is going to fall.

Now, is he wrong about that? Is that not how it works?

Senator SESSIONS. Life in the big leagues.

Chairman BIDEN. That is right.

Senator SESSIONS. You either have to perform or you get downgraded, but he has got to have integrity.

Mr. DONALDSON. You are running the company for the an analysts and not for the company.

Senator SESSIONS. Analysts represent investors, and the investors have a right to ask questions. But we shouldn't be whining around here about the poor CEO who therefore cheats to satisfy some demanding investor.

Chairman BIDEN. I am not whining about anything. I am just trying to understand.

Senator SESSIONS. He has to have the integrity to do the right thing or else his fanny goes to the slammer.

Mr. ELSON. The CEO is wrong to answer you that way.

Chairman BIDEN. Say again.

Mr. ELSON. The CEO is wrong to answer you that way.

Senator SESSIONS. I didn't like that answer.

Mr. ELSON. I don't think it is the appropriate answer. The answer is most of the institutional investors who are with you in your stock are indexed, which means they are locked in with you for the long term. They can't buy or sell. They have got too much in you and they go on everyone. That is number one, so they are with you.

If you can convince the world that you have long-term prospects for your company and you are locked into the stock long term and you can't take your options, exercise them and move on—that has been the problem lately. People take the stock, they sell it, and they leave. The idea is you have got to be locked in for the long haul.

At that point, I think your decisionmaking as an executive or as a board reviewing an executive's decision is appropriate. You can't run a company on a quarter. You have to run a company over the long term. What happened was I think our incentive systems went out of whack, not that equity compensation was wrong, but it was equity compensation that you could sell.

In fact, everyone who has been advocating equity comp for directors for years has said it has got to be restricted for your service term on the board. If you allow someone to sell it short term, you take advantage of informational advantage or short-termism that in the end is devastating to the company.

Chairman BIDEN. What is the primary practice right now in, say, the Fortune 100 companies in America? In the compensation that they get in stock, are they able to sell it short term or are they required to hold it long term?

Mr. ELSON. Well, you have insider trading regulations that make it tougher to sell the stock. But as we saw in Enron and these other companies, people were dumping massive amounts of stock. That was the problem. And, frankly, I blame their boards on it, too, because why didn't the board say why are you selling all this stock? It is a terrible sign to our investors that you are leaving. If you are selling it, you have obviously found a better place to put the money.

Chairman BIDEN. Excuse me. I got that. I understand what happened. What I am asking you is in most of the compensation plans—I don't know if there any such study out there, but if you took the Fortune 100 companies and you looked at compensation and you looked at the portion of compensation related to stock, not direct salary, can you generalize for me or are there any studies done saying that 75 out of 100 of the top 100 require you to hold it for four years?

I mean, is there any pattern, and has it changed? Something has happened, fellows; something has happened in the last 15 years. As they used to say when I was a kid, something is rotten in Denmark.

Mr. DONALDSON. That is right, and I don't know of the studies. I suspect we could find some. Certainly, it is the minority of business leaders today who are standing up, but there are few courageous ones, and saying we have all got to play the game this way; we have got to have limits on when we can sell the stock and they have got to be significant.

Mr. TERWILLIGER. I think that is an important point in terms of the equality of treatment. I mean, let's face it, the competitors of some of these companies were put at a great disadvantage in the stock market if these companies were cheating on what their companies were really worth through false financial reporting. That gives all of business an incentive to play it right.

I think one of the things we keep hearing over and over in this discussion from Professor Elson is the role of the boards. I really think that illustrates a point that a lot of this has to do with holding businesses accountable for how they run their businesses.

Going back to your point of how you incentivize this, there is no one answer. There are a number of ways in which they are held accountable, but in our system at least the principal responsibility is that of the board to the stockholders to make sure that that business is being run in their best interest, not in some cadre or group of conspirators among senior management who are self-dealing.

Mr. DEVINE. Senator, one suggestion would involve an expanded model of whistleblower rights. Protecting whistleblowers is one way to maximize accountability, while minimizing the size of Government intervention that is a necessity, but it is only one side of the coin.

The other side is making a difference with their disclosures. The point of whistleblower protection is to make a difference, not to make noise, and one thing that I would suggest for you folks to start considering is a way for them to have more impact through their disclosures than just putting something on the record.

Senator SESSIONS. Getting more what, impact?

Mr. DEVINE. Getting more impact. There are two precedents that could be considered. One is the disclosure mechanism in civil service law in the Whistleblower Protection Act. Whistleblowers don't just defend themselves under that law; they can challenge betrayals of the public trust by making formal disclosures to the Office of Special Counsel, a Government agency.

If the Special Counsel finds a substantial likelihood they are correct, they order the agency head to investigate and report back what they are going to do about it. The Special Counsel, with the whistleblower's comments, evaluates whether that was a good-faith resolution of the alleged problems and places it all in the public record.

Something like that could be developed for the Securities and Exchange Commission, where whistleblowers could make disclosures of significant misconduct to SEC, and if the agency found a substantial likelihood that the charges were well taken, to order, akin to what Mr. Sporkin did after the political payments scandals in the early 1970s, a board investigation and report back on how they were resolving the problems.

Chairman BIDEN. Well, you know, there is an old expression: you have to know how to know. Whistleblowers don't always know. I

mean, we are fortunate if there is a whistleblower in a position where there is an intersection of information that they are aware is, in fact, inappropriate.

For example, the report released on Sunday by the Senate Permanent Subcommittee on Investigations concluded that members of Enron's board of directors contributed to the firm's collapse by, among other things, failing to curb the company's risky accounting tactics and by approving conflicts of interest.

The report cites several red flags since February 1999 that arguably should have triggered concern among the board members, including notice by auditors that Enron was using questionable accounting methods and requests to waive the company's conflict of interest policy.

To what extent are directors now held liable for misdeeds of company executives, and to what extent should they be sanctioned?

Mr. ELSON. I testified before that committee and some of the red flags that they talked about were some of the things I talked about in the report. I think the problem on that board was independence. The red flags were there. I mean, waiving the code of ethics was an incredible red flag that was missed. That was extraordinary.

Chairman BIDEN. Waiving the conflict of interest?

Mr. ELSON. They voted to waive the company's Caremark conflict of interest policy, which is sort of like saying let's say no speed limits for an hour and see what happens, which obviously doesn't make a lot of sense.

The point was why did they do it, and I believe that it had to do with an independence issue. I think that there were independence problems on that board which caused them, I think, to view what management was telling them vis-a-vis those flags not in the same light that others who were independent would view those flags.

Chairman BIDEN. How do we get independent boards, then? Do we just count on this public disclosure generating that?

Mr. ELSON. The latest New York Stock Exchange and Nasdaq reports on corporate governance have called for listing standards that require majorities of corporate boards to be independent, and by independent they mean no financial connection to the company or management other than long-term equity ownership. I think that that is the key.

Chairman BIDEN. Didn't they discourage that? Was that not proposed earlier, as well?

Mr. ELSON. Well, no, it has never been proposed. The institutional investors and the Business Roundtable that five, six years ago and it never went anywhere.

Chairman BIDEN. Why?

Mr. ELSON. Well, I think that there were a lot of management who didn't want to have an independent board, for obvious reasons.

Chairman BIDEN. Bingo.

Mr. ELSON. Yes.

Chairman BIDEN. So it didn't get adopted.

Mr. ELSON. Well, it began to be adopted. You have seen many, many companies over the last four or five years that have moved to substantial majority independent boards based on investor pressure. Large institutions—Calpers, TIAA–CREF, the New York

State and City funds—put pressure on boards to reform and you began to see changes.

Chairman BIDEN. In the meantime, though, a lot of people are dead. I mean, it is a little bit like saying we need more cops in a crime-ridden area and the public is going to put pressure on the local councilmen to vote to do that, but it is going to take a while here and my neighborhood is still—I mean, I don't get your guys.

Mr. DONALDSON. There are always clever things that can be done. In the Enron case, for example, the audit committee, sort of the focus on the problems—half of the people lived outside the country. Everybody on that six-member board had something big in their pocket from Enron, and the head of the audit committee had been there for 13 or 14 years. This is very bad practice. So some of the reforms that are working on board and audit committee relationships to the corporations and other systems are important. I like, for example, the idea of having the audit committee pick the outside auditing firm instead of having that picking being done by the CEO.

Mr. ELSON. They should have done that to begin with. You are absolutely right. To begin with, the reporting line should have been to the audit committee. But these changes have been taking place over the last couple of years. I think what you have seen are outliers. Listen, I believe strongly in substantial majority of independent boards. I would go beyond simply majority.

Chairman BIDEN. Let me tell you what worries me. In a sense, this whole subject is above my pay grade. This is not something I claim any expertise in. I am going to say something outrageous.

Regarding the criminal justice system and criminal behavior that is violent criminal behavior, I believe I know as much about that as anybody who has served in the United States and almost any criminologist in the country, not because I am so smart, but for 30 years I have listened to every single expert we could find, and I hope I am not stupid.

This is above my pay grade, in a sense. But do you know the people I listen to? I listen to the people who, in fact, are deeply invested in this capitalist system, and they have concluded, in my view, that this is a systemic problem. This isn't a few bad apples; this is systemic.

You have the Nasdaq at a five-year low after the President's speech. You have the Dow down to 8,813 at the close of business today. You have almost every major business leader I know and not because I am important—I think I am probably the only guy in the United States Senate, and I am not proud of this, that does not own one stock, one bond, one debenture, and never has.

I had a stupid idea when I was 29 saying that was an inherent conflict, and I am inherently poor. It was dumb, so I am not suggesting that I know much about this, about how the system works. But I will tell you what. When the guys and women who rest upon making it off of this believe, whether it is true or not, that they haven't seen the bottom of this yet and they believe it is systemic—and I hope I am proven to be wrong, but let me tell you something. They are voting with their dollars right now, and I will be dumbfounded and overjoyed if six months from now we gather for a reunion and there have been no more Enrons, there have been no

more WorldComs, there has been no more significant readjustment of major corporate assets.

Senator SESSIONS. Mr. Chairman, one reason we will probably see some more is because when things are going well, it is not apparent.

Chairman BIDEN. Exactly.

Senator SESSIONS. It is when things go bad and the prices drop 20 percent and all of a sudden you can't pay dividends. So I suspect we may find some more, but I don't know that it means the entire financial structure is compromised.

Mr. DONALDSON. If I could add, I think, too, everybody is stripping down to their underwear at this point to prove they have nothing to hide.

Chairman BIDEN. I agree with that.

Mr. DONALDSON. So we are going to see a little of that for a while.

Senator SESSIONS. It is healthy.

Mr. DONALDSON. It is systemic, but we will pull out of it.

Chairman BIDEN. I think we will pull out of it.

Mr. DONALDSON. I think the question it will be interesting to ask is two years from now, will we be able to say the reforms that we put in place—I don't know how we got along without them all these years. That is the way I want that question to be answered.

Senator SESSIONS. Mr. Chairman, I wanted to pursue Mr. Devine's whistleblower idea. And, George, maybe you can comment on this.

We have the qui tam provisions in Federal contracting law, where a person can reveal a fraud that hurts the Government in a Government contract, and then a lawsuit can be filed and they are paid 15 percent of the recovery. You have to have, a person to report to though.

I had a person come to me when I was in private practice, and you call the Department of Justice and try to get them to file it. If they don't, you can file it yourself.

Should there be within the corporate structure of major corporations a committee that the employees all know that they can take a complaint and a concern to?

Mr. DEVINE. I think there does need to be—and as the other witnesses have pointed out, there has been a lot of these committees created. The Achilles heel has been conflict of interest.

Senator SESSIONS. George, you have been a prosecutor. If a person comes into this committee, and at least if they write down the complaint and everybody on the committee sees this complaint and says there is nothing to it, and George comes along about two years later and starts investigating them for criminal fraud and you are looking to prove knowledge, that puts them in a big hurt, doesn't it?

Mr. TERWILLIGER. Yes, it does, and I think in terms of the internal whistleblowing and reporting process, part of what we hear here from the two ends of the table alongside me are two different considerations.

One is the concept of whistleblowing and having a place to take these complaints. Frankly, when companies ask me about that, I say that is a great idea. Who would you rather have them report

some alleged fraud or malfeasance to, you or some outside lawyer who is going to file a lawsuit?

Senator SESSIONS. The FBI.

Mr. TERWILLIGER. Or the FBI, that is right. Giving the company a chance to deal with it proactively to begin with is a good idea.

What we hear from the other side is whether or not it works the way it is set up. Is there a compliance process that this goes into, and does that work well or not? I dare say that every corporation in America is probably asking itself that very question about its own internal processes now, which is a good thing to come out of this.

I would like to just react further for just one second to what the chairman mentioned before about not seeing the bottom of this yet and what not. It is far too late in the day to pick a fight with the chairman, if there is ever a time to do it, and I am not intending to do that.

But I do think it is important that if there are systemic deficiencies that allow this to happen, that is one thing. That is different than saying that this kind of cheating and this level of dishonesty and disloyalty to corporate duty is systemic in and of itself, because I don't think that is true.

I don't think that most corporations are like those outliers that we have seen now, and we do a disservice to ourselves and to our economy and to investors if the perception is that we are generally vilifying corporations, which I don't think the chairman intended to do and I don't think that is what he was saying.

I do agree that we are in a horrible crisis now, and stock prices are very low, Mr. Chairman, and maybe if you were ever tempted to buy, this would be a good time to do it.

Chairman BIDEN. I don't have enough money to buy now.

Mr. DEVINE. I have a little more to offer in answer to your question, Senator. We have been involved in an experiment for those types of committees that seek to break through the conflict of interest. It is a form of alternative dispute resolution, a committee sponsored by the company that the whistleblower can go to.

We tried it with the Westinghouse Corporation out at the Hanford nuclear weapons site, a Government contract facility, and the committee they bring their concerns to has a balanced representation from the board of the company, Government representatives to observe, and citizens organizations. Something like that could be adapted to the shareholder institutions, the institutions of a corporation.

If someone raises their issues to that committee, there is a general pledge and consensus that they cannot be retaliated against for working through that option. It has had a healthy impact; it has been a real change. It is not a panacea, but it has had very visible results.

The other suggestion would be going right to the example that you used to illustrate, the False Claims Act. I think that it is worth considering adopting that model to a fraud against the shareholders. Right now, it is just fraud against the Government in contracts. This would be a way to slice through the conflict of interest if whistleblowers had standing to sue on behalf of the shareholders when there was fraud that threatened their investments.

Senator SESSIONS. The people here that are victimized are the shareholders ultimately, and they are trusting to corporate leadership and they are willing to accept bad judgment. The company tries a new product line and it fails and everyone loses their shirt. People can accept that, but they are not willing to accept being cheated, and they shouldn't.

I do think usually there is somebody in the system who knows about the problem and should bring it forward if they have a convenient place, and perhaps the qui tam might be a way to do it.

Mr. DONALDSON. Could I just insert one thing?

Senator SESSIONS. Yes.

Mr. DONALDSON. The kinds of deep, almost catastrophic shenanigans that have been revealed recently would be very difficult for any of the sort of compliance model, information line, hotline, open-door policies to handle. I just want to make that point.

Senator SESSIONS. But you could have had a——

Mr. DONALDSON. I am not saying we shouldn't have them and we shouldn't try to improve them.

Senator SESSIONS. But do you think there is somebody at, say, Enron that saw the accounting problems here at an earlier stage and could have expressed concern to somebody?

Mr. DONALDSON. Absolutely.

Senator SESSIONS. One more thing. Judge Griffin Bell, a former Attorney General of the United States, discussed a problem with me when I was Attorney General of Alabama. He was dealing with a company that may have acted improperly regarding some commercial contracts, retail-type contracts, and they were concerned about doing the right thing.

You can be sued in any State in America for fraud, and they want to come forward and they wanted to pay everybody, but they were terrified they were going to get sued in a big class action and the whole company would be in danger. I think they eventually came up with some way to do it, but there is not a real mechanism in America today for a board to say, wait a minute, we have been doing this kind of procedure for many years. We have cheated our customers or they have lost $100 a piece and we are willing to pay them. But if each one of those people are going to then sue them for $100 million in every State in America, the whole thing gets awfully scary.

Should we have some mechanism by which a company can self-report and pay just compensation, maybe even some penalty in addition, but it wouldn't turn into a massive litigation frenzy?

Mr. TERWILLIGER. Well, I will respond to that in part, Senator Sessions, that at least in the first instance on criminal sanctions, the fact of the matter is that voluntary disclosure programs generally do not work because the incentives for doing so are outweighed by the risks, including the risks of lawsuits, the risks of being prosecuted.

Senator SESSIONS. Don't you think the risk of civil litigation is probably worse than being prosecuted?

Mr. TERWILLIGER. It is at least as bad.

Chairman BIDEN. Not for any corporate executive I know. Give me a break, give me a break.

Mr. TERWILLIGER. No, no. I think, Senator, we are talking about the corporation itself.

Chairman BIDEN. I got that. I have found, though, at the end of the day they don't sit there and think, oh, my God, the corporation. They are sitting there saying, oh, my God, me.

Mr. TERWILLIGER. That is a good point. Again, I think that is why some other types of alternatives to affect the corporate behavior of managers is important. God help me if I wind up representing one of these people on this kind of an issue, but I think the idea of expanding the sanction of banning someone from serving in a position of corporate responsibility in a publicly-held company is a very good incentive because a lot of people think that the risk of engaging in dishonest behavior is worth it. Even if they wind up paying some kind of a price for that act, they believe they will get back in the game. If what they are talking about doing is giving up a career completely, I think that helps to change the equation.

Senator SESSIONS. The example I am giving is if self-reporting an action that might be marginally criminal, the person might feel like they are really not going to be prosecuted if they go to the prosecutor, the U.S. Attorney, and lay it all out and say they have got a plan for correction. Maybe it is a regional manager for the western United States that has been doing a contract in a satellite dish deal and they found out the way they are doing it is wrong.

Mr. TERWILLIGER. It would probably be procedurally difficult to insulate them from civil liability, but it certainly might be a way to avoid punitive damages, mitigate damages in a case.

Senator SESSIONS. Judge Bell feels very strongly about it and probably would write us his opinion on it.

Chairman BIDEN. Let me proceed along these lines just a little while, and we realize we are really trespassing on your time, but it is seldom we have this much fire power here to help us out.

If you take a look at WorldCom, they now say that 40 percent of its investment last year was really operating expense. Now, I understand that cooking of the books is fairly simple trickery, but the company just simply stated that routine operating expenses were capital investments, which had the effect of inflating the profits extraordinarily.

Now, I am no accountant and I am no expert, but that little math gimmick strikes me as the kind of basic accounting that students in 101 at the University of Delaware would understand was inappropriate. Yet, WorldCom's auditors didn't catch it. Arthur Andersen, which reportedly was paid $4.4 million to certify its books, didn't detect this seemingly simple trick. The board of directors didn't seem to know it.

How could WorldCom fake nearly $4 billion in expenses? How could the regulators, the auditors, the analysts, the banks have missed this possibility of corporate fraud? What am I missing here?

Mr. DONALDSON. Classic cases, long Harvard Business Review type cases, and business ethics for decades have had accounting fudging, pushing the envelope in accounting, as an issue. But what we have seen in the last five years is brazen pushing of the envelope, of the WorldCom type.

I think you have just got to face the fact that the climate has changed. With all the emphasis on short-term stock value, driven

by some of the Internet shenanigans earlier, and with stocks constantly rising, corporate officers have been willing to make amazing accommodations with accounting tricks.

Chairman BIDEN. You sound like you are from the State Department.

Mr. TERWILLIGER. Mr. Chairman, I think that the fact of the matter is—and I am not an accountant and I can't speak to specific treatments in specific circumstances. One of the oldest tricks in the book in accounting and financial reporting fraud is to, in fact, capitalize what should be annualized expenses.

There are rules that govern this. These rules are not necessarily ironclad principles that reduce proper accounting treatments to black and white. I have been involved in cases where there have been great arguments about when inventory can remain valued as inventory and when it is no longer of any value or not of the same——

Chairman BIDEN. I got that. I was on the other side of you guys. I was a public defender, and I still got elected. When someone recklessly endangers another person's life, they can get convicted of manslaughter and they can go to jail for a long time. And they didn't have to intend to kill anybody. They had to know that this reckless behavior might result in that happening.

Yet, on the white collar side of the equation, right now the WorldCom situation—and you guys are former prosecutors—under current law, the prosecutor has to prove that the defendant actually knew and took part in the fraud, not just was incredibly and willfully or recklessly negligent.

When I can be convicted of manslaughter for recklessly behaving if I cost the economy—and I mean talk about driveby shootings. This has been a driveby shooting. There are a whole heck of a lot of people who are in real trouble who were no part of WorldCom, didn't own any stock in WorldCom, didn't have anything to do with WorldCom.

Look, there is a Brazilian company at WorldCom. You know, talk about this being internationalized, for example, WorldCom's largest international subsidiary was a Brazilian long-distance company. Their stock dropped even after it was absolutely clear that it was operationally and financially independent of WorldCom. Talk about a driveby shooting in a country that is already in deep trouble, whose economic system is in dire straits, and boom.

Should we have a standard in the law that says if you are recklessly negligent?

Mr. TERWILLIGER. Well, we do to a certain extent in the criminal law of fraud on the Federal level have that standard in the sense that the legal term is "conscience avoidance." As a practical matter, what it means is turning a blind eye, and prosecutors can substitute evidence of turning a blind eye for actual knowledge and obtain convictions of individuals on that basis. So you can't simply say "I don't see."

The concept of recklessness, I think—and again I am not a law professor, but the concept of recklessness is inconsistent with the notion of fraud, which is an intentional misrepresentation or concealment.

Chairman BIDEN. Well, I would argue it is no more inconsistent than the notion of murder or manslaughter.

Mr. TERWILLIGER. Well, that may be a legislative judgment, frankly, Mr. Chairman, to make to make that a crime, but I don't think that is fraud as we have known it to date.

Senator SESSIONS. Mr. Chairman, I am kind of interested in that because you are raising a good point. My observation is when you talk to the business community and the prosecutorial and law enforcement community, it is like they have entirely different visions of that animal we are dealing with.

The business community is just terrified. They sign all these documents everyday, the regulations that come in. People around them are signing documents, just like we do. People sign our names to things we don't even read and they are going out all over the place and they think they are going to be put in jail for it. So they don't want to strengthen the power of the Government's hand. It terrifies them because they are honest and they think they might be dragged before the bar.

Chairman BIDEN. A legitimate concern.

Senator SESSIONS. But the truth is we need to focus some way on criminality here. We talked about it earlier. Maybe the punishments could be less for these kinds of reckless matters.

What do you think, Professor Elson? It is making you nervous, I can tell.

Mr. ELSON. Well, yes. If the goal here is shareholder protection, which is the whole point—I have got my retirement monies in TIAA–CREF, the teacher's retirement fund. So, you know, I am in the equity markets as a potential retiree, too.

Chairman BIDEN. If you were in California, you just lost $580 million.

Mr. ELSON. In TIAA–CREF, I just got my statement and I have lost quite a bit, too.

The bottom line is protecting investors' money, because if we don't in the long run what happens is nobody invests and our whole system stops. The key to investor protection is confidence in the markets so people will invest. The question is how do you get to the goal of preserving company assets and shareholder assets.

What I fear in changing the standard to recklessness is that you will create avoidance procedures on the part of management, who will develop all kinds of legal regimes, compliance procedures and what not, to avoid that kind of prosecution, which in the end I fear will take the focus off of preventing wrongdoing and instead simply avoiding liability. That is terrifying to me as an investor and I think that is the bottom line.

I want management and the board working for the investor, period, and when their goal is taken off of that and focused instead on avoiding some sort of a liability, then I think you have got a real problem in the system.

Senator SESSIONS. As a prosecutor, I prosecuted several cases that I personally tried that dealt with fraud charges that pivoted around values of properties. And I am telling you it is a difficult deed to convict somebody on anything when you are dealing with value. It is like pornography; I know it when I see it. I know this

property is not worth this much. He loaned two times its value, but somebody somewhere said it was worth "x."

Oil prospects in Texas was one case we tried. So what is it worth? It wasn't worth what they said it was, but it is difficult indeed to prove beyond a reasonable doubt when you have got some witness to say, well, it could have been worth that much. So my prosecutorial instinct here is that we have got a lot of people getting off the hook on some things that are difficult to prove.

Chairman BIDEN. I would note that most of the U.S. Attorneys I have had the privilege of suggesting should be appointed by the President of the United States over the last three decades and most of the Attorneys General that I know are not crazy about picking up these suits. And it is not because they are not good guys. It is because they are incredibly time-consuming, they are incredibly difficult to prove, they are incredibly complex. And if they have an ambition to demonstrate that they, in fact, can protect society, they can pick up three or four murderers in the time they get one of these major cases through.

Senator SESSIONS. And if it blows up and their case falls apart, then they are ridden out of town on a rail.

Chairman BIDEN. And most who are appointed and want the jobs don't come from the civil side of the equation. They are not the lead corporate counsel in a large law firm who wants to be a U.S. Attorney. They are usually somebody else.

I won't keep you much longer, but if the Lord Almighty came down and sat in the well there and said, okay, you get to have one reform, one thing that would change in order to sort of reconstruct the appropriate corporate culture, reconstruct the notion that there is transparency, reconstruct or elevate competence in the system—if you only got one, what would you pick, what one thing, Professor Elson?

Mr. ELSON. Very simply, truly independent, long-term, equity-holding boards, period.

Mr. TERWILLIGER. I agree with that.

Mr. DONALDSON. That actually combines a number of items. I was going to say limitations on the sale of stock acquired by options, but that is part of the issue here.

Mr. DEVINE. Predictably, my dream would be around whistleblower rights, and since you passed the reprisal protection in the Senate today, I get to switch to helping them make a difference. My suggestion would be to apply the False Claims Act model to whistleblowers who are suing on behalf of the shareholders of the corporation.

I would point you to the track record with Government contracts. In 1985, the last year before the False Claims Act was modernized, the Civil Division of the Justice Department collected $26 million in civil fraud recoveries. That increased exponentially the first decade after the False Claims Act was passed to average about $200 million a year. Last year, in one suit alone, the Justice Department collected over $850 million. This is a highly effective remedy if the internal reforms of more reliable boards aren't sufficient.

Chairman BIDEN. Did we do the right thing, and does it matter, in the elimination of joint and several liability in security fraud cases?

You get a dispensation, Mr. Terwilliger. You need not answer that.

Mr. TERWILLIGER. Thank you, sir.

Chairman BIDEN. What do you think? Did we do the right thing?

Mr. ELSON. I believe so. I supported the reform.

Chairman BIDEN. I am just taking that one provision. I am not talking about the whole thing. You have outside accounting firms saying the inside accounting operation should have known it. The company goes bankrupt. The thing that is left is the accounting firm, although that is not the case now. Well, think about that one.

From my perspective—and I will end with this and anybody who wants to comment on it, you are welcome to. What we will do is rather than keep you longer, I have several questions to ask each of you in writing, if I may. I have kept you here until 7:30 almost.

From my perspective—and I have a lot more to learn here and I would rather make no law than bad law right now—it seems to me there are multiple pieces to what has evolved in a culture that is not merely a corporate culture, but a culture that we have seen sort of the aberrations in the dot.com—I mean, this notion that we are global, we are interconnected, everything is in a moment, everything requires immediate gratification and impact for your stockholders, for your investors.

It seems to me we have to address four or five things, and I don't know the answer to each of them, but I am going to ask you to think about this. If you want to comment now, fine. If not, I would appreciate it for the record.

One is we have spurned the OECD initiative regarding the tax shelters offshore. It seems that we have incentivized people to do things that don't make any sense. We have to do something relative to the notion of how we deal with stock options. You folks have spoken about that.

Thirdly, we have to have what the Sarbanes legislation primarily focuses on. We have to deal with the whole notion of transparency, accountability, responsibility of accounting firms, separating accounting and consulting, and disincentivizing people from doing things on hard decisions they have to make.

We have to deal with the criminal penalties side, which this committee is focusing on, and we have to at least go back and look at the private sector, the legal community, the stockholders' availability to initiate on their own civil suits that have nothing to do with government involvement at all; at least go back and examine whether what we have done was, in fact—did we go too far, or did it have no impact on part of what is happening now? Lastly, unrelated in a direct sense, we have to figure out federally how to deal with the whole notion of pension protection in ways we haven't addressed yet.

So I want to make it clear to you I don't think there is any one answer, and I want to make it clear to you how much I appreciate the fact you have just been sort of brainstorming with us here. If I had all the answers, I would be the first to tell you I thought I did, but I don't.

Mr. DONALDSON. Senator Biden, can I interrupt and add just one item to your list?

Chairman BIDEN. Please.

Mr. DONALDSON. I am resistant to legislation in this area, if there is any other way of handling it, but I do think the issue of the relationship between investment banks and analysts is part of this whole cultural issue.

I will never forget being in front of dot.com presidents about a year-and-a-half ago, about 300 of them, asking them if a person came to you from a large investment bank and said, sotto voce, you know, we can ensure that your stock will be valued high, but we do want you to do your investment banking with us, how many of you would do it? Ninety percent of the people in the room raised their hands. Then, of course, they turned and said but it is their responsibility in the investment banks, not ours.

Chairman BIDEN. I agree, and I mentioned that at the beginning of this hearing because there is such a symbiotic relationship there. A 60-second digression here. When every foreign, newly-emerging democracy comes to me and to the Senator and others and says, help us with our constitution, talk to us about it, what is the most significant thing that your Founding Fathers had—they are looking for little nuggets, and I say the most significant thing about our Founding Fathers was they took human nature as it was, not as they wished it to be, and they wrote it in; they wrote it that way.

I realize they should step up and they should do the right thing, but the idea that if I go to xyz investment banking company and they get a piece of the action and they are the ones who are going to rate me and they are the ones who are going to sell me—and the ability of the human mind to rationalize should never be underestimated.

At any rate, I would like to put into the record Senator Leahy and Senator Hatch's statement. So I ask unanimous consent to do that.

Chairman BIDEN. I will leave, as is appropriate, the closing questions or comments to my friend from Alabama, and if he has none, invite any of you to make any closing comment at all on anything at all.

Senator SESSIONS. I would just say, Mr. Chairman, that I won't go into it now, but I think Mr. Terwilliger understands that the SEC really is where a lot of this stuff is first identified, and the relationship between the SEC and the Department of Justice and the prosecutors and/or the FBI sometimes is really important to enhancing the identification of actual fraud.

I truly believe that if a whistleblower comes forward with a complaint today, every board in America is going to pay a lot more attention than they would have six months ago. So it is a painful catharsis we are going through here, but I believe the net result is going to be more integrity in our financial markets and more integrity in corporate leadership.

The American people are angry and they are losing money. The best thing about the American democracy is there is nothing better.

Chairman BIDEN. Well, I wouldn't agree with you more. One of the reasons you have got folks like McCain and others calling for Mr. Pitts' resignation is because he has the SEC, Securities and Exchange Commission, and he was one of the main arguers against the stock exchanges changing some of the regulations you call for here.

You know, the President called for a corporate fraud task force. The thing I want you to think about is what about basically a shareholders fraud task force and people leading that?

Again, I can't tell you how much I appreciate it. If any of you have a closing comment, I would be happy to hear it.

Mr. TERWILLIGER. Mr. Chairman, I just want to say thank you for the opportunity to be here with you and Senator Sessions and your colleagues to talk about these very important issues. I am honored to be here.

Chairman BIDEN. Well, I thank you all. We are truly honored to have such a distinguished panel. I will warn you, we may call on your later. I like to think we are out of the woods and we know what we are doing, but I am not sure we do yet, and so we may need some additional help.

I will have some questions, and I will leave the record open for other Senators to submit questions. I don't want to overburden you. I know you are all busy, but we would like to ask some questions that we didn't ask tonight.

With that, I again thank you for your indulgence.

Thank you for being here. We are adjourned. [Whereupon, at 7:33 p.m., the subcommittee was adjourned.]

[Submissions for the record follow.]

[Additional material is being retained in the Committee files.]

pointments. For those who voted for the Senate version earlier, let me indicate that this piece of legislation emerging from the conference is far worse. It eliminates the provisions Senator SPECTER offered with respect to RICO. It heavily imbalances the sanctions that are imposed against lawyers who file frivolous lawsuits by making the burden whole and entire on plaintiffs but not so with defendants. It enhances the pleading requirements, which makes it much more difficult to bring. It fails to address the statute of limitations issue. It fails to correct the deficiency in the law which allows aiders and abettors to go home free. It reverses hundreds of years of judicial precedent in common law in limiting the right of recovery balance between an innocent investor and those whose conduct was reckless. It says under the proportionate liability that only the proportionate responsibility shall be made payable to that innocent investor, when the actual perpetrator is judgment proof or without money to respond.

Finally, let me say that the conference report even diminishes that ability to recover even further. I thank the Chair.

Mr. President, I am just informed that the distinguished Senator from Illinois wants to speak as in morning business for 2 minutes. I do not have any objection.

I ask unanimous consent that she may speak for 2 minutes as in morning business.

The PRESIDING OFFICER. Without objection, it is so ordered.

CONGRATULATIONS TO THE NORTHWESTERN UNIVERSITY FOOTBALL TEAM

Ms. MOSELEY-BRAUN. Mr. President, I wanted to take a moment to congratulate Northwestern University's football team, the Wildcats, who, in Senate resolution 197, offered by Senator SIMON and me, are being honored and congratulated for one of the greatest underdog-to-champion stories in the history of sports. The Northwestern team is now being called "the miracle on Central Street." What they have done here is to celebrate their first conference championship in some 60 years.

Coach Barnett has taken this team from really a very low profile in the conference to being a top contender, now in the Rose Bowl. They are going to go to Pasadena. He fulfilled his pledge to take the Purple to Pasadena. That rallying cry has taken this team to a 10-1 season, a No. 3 national ranking, and with defeats over Notre Dame, Penn State, and Michigan, a feat which has, frankly, not been accomplished by any one team in over 30 years.

Northwestern really proved that it is possible to produce a football champion as well as Nobel Prize winners and Pulitzer Prize winners and academicians throughout the world. They have captured, by their actions, the hearts of fans all over the country. They have made all of us from Illinois very proud of them. If nothing else, the football team, in their perseverance, hard work, and dedication, have proved once again in this Christmas season that miracles do happen.

I thank my colleagues for their time.

Mr. BRYAN. Mr. President, I join in congratulating Northwestern. I was 11 the last time they went to Pasadena. So it is time for the Purple not only to go to Pasadena but to win in Pasadena.

PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995—CONFERENCE REPORT

The Senate continued with the consideration of the conference report.

The PRESIDING OFFICER. The Senator from Delaware.

Mr. BIDEN. Mr. President, I rise today to oppose, in the strongest terms possible, H.R. 1058—inappropriately titled the "Private Securities Litigation Reform Act of 1995." This bill has nothing to do with reform in the normal sense of the term. Rather, the bill is about protection from liability for fraud—pure and simple. The bill is the worst kind of special interest legislation that the American public is sick and tired of.

It will give corporations a license to lie to investors and will severely restrict the ability of defrauded investors to recover their hard-earned dollars from the unscrupulous and reckless individuals and corporations who swindled them.

Six months ago, I stood on the Senate floor and urged my colleagues to oppose this bill in its earlier incarnation because—put simply—it was a bad bill. Because it was a bad bill, every major consumer group, State attorneys general, State and county treasurers, mayors, finance officers, labor unions, the American Association of Retired Persons, the National League of Cities, educators, and hundreds of other nations, State, and local organizations, opposed the bill.

It is easy to understand why when you consider that a city like San Francisco has over $8 billion in pension funds and other investments and when more than 60 State and local governments nationwide have lost more than $3.5 billion in securities markets, partly due to derivative investments.

Despite the tremendous opposition to H.R. 1058, which was a bad bill in June, it is a worse bill now. Therefore, I strongly urge my colleagues to oppose it.

What is most disturbing about this bill is the impact that it will have on what are often the forgotten Americans—that is, average middle-class Americans.

At a time when job and wage insecurity are to all-time highs, and corporate profits are skyrocketing to new records, middle-class Americans have begun investing their hard-earned dollars in stocks in record numbers. In fact, as the Washington Post reported just a few days ago, securities have supplanted real estate as the No. 1 source of family nest eggs.

Middle-class Americans believe they must invest because there may not be a decent pension when they retire—whether they will be let go too soon because of corporate down-sizing or their company, to which they have been loyal, will not be there 20 or 30, or even 10 years from now.

Middle-class Americans also want to invest for the future because they aren't sure that Social Security or Medicare will be there for them in their later years when they are most vulnerable.

Last, middle-class Americans believe they must invest to ensure that their children are able to receive an education that provides them with the essential skills to enable them to become productive and integral participants in what will be an extremely competitive and global work force in the 21st century.

Because middle-class Americans recognize the need to secure and protect their financial futures, they have entered to stock market directly—or through mutual funds—to such a degree that the most significant asset held by American families today is not their home, but their 401(k) plan. Today, assets in 401(k) plans total more than $500 billion. Assets in investment retirement accounts total more than $1 trillion. The majority of these funds are in stocks.

Under these circumstances, this Nation's two primary securities laws—the Securities Act of 1933 and the Securities and Exchange Act of 1934—have become even more, not less, important.

The principal philosophy governing these two laws—enacted more than 60 years ago after the stock market crash of 1929, caused largely by a crisis of confidence due to unregulated fraudulent stock promotion—is that investors and prospective investors should have access to all material information about corporations that offer securities so that the public can make informed investment decisions and that honest markets should be maintained by strong antifraud enforcement.

At a time when middle-class Americans are investing in record numbers because they believe they must, the U.S. Congress should be strengthening the most fundamental protections for investors in our securities laws, not gutting them. Yet, gutting these laws is exactly what this bill does.

This bill strikes a severe blow to the heart of the middle class. Let me tell you about just a few of the devastating provisions in this bill.

One of the most outrageous provisions in this bill is the safe harbor provision. This provision, by providing broad immunity from liability for fraudulent corporate predictions and projections, essentially gives corporations a license to lie. This provision is much worse than the safe harbor provision in the Senate bill.

The Senate bill language that made knowingly fraudulent defendants ineligible for the safe harbor was eliminated. Now, under this bill, deliberately fraudulent statements, written or oral, as long as they are accompanied by cautionary language, will be immunized from private liability. Let me repeat—this bill protects deliberately fraudulent statements.

Let me give you a frightening but likely scenario that could occur under the safe harbor provision in this bill: In an effort to entice unsuspecting consumers to purchase stock, company X makes a bunch of optimistic and fraudulent predictions about how great a new product will perform and how the company's profits will increase because of the manufacture of this new product. The company gets its lawyers and accountants to vouch for the representations.

Based on these rosy predictions, your uncle, your grandmother, your sister's teacher's union, your church, and the State of California decide to purchase the stock. All of them wind up losing their money when the fraud is exposed. Your grandmother believes the company should not be able to get away with lying to her. The company's lawyers argue, however, that even though there were fraudulent statements, there was a paragraph of cautionary language in some filing at the Securities and Exchange Commission. Under this bill, grandma loses, all the swindled investors lose, and the fraudulent company and its lawyers and accountants win.

This is absolutely outrageous. And it's just one example of the many anti-investor provisions in this bill.

To add insult to injury, this bill also fails to restore traditional aiding and abetting liability for securities fraud in private actions. Thus, lawyers, accountants, and others who turn a blind eye to the fraudulent activity of their clients, or who recklessly aid and abet their clients, will be let off scott free.

The bill also dramatically erodes the doctrine of joint and several liability and moves to a system of proportionate liability. The bottom line for an investor is that under this bill, if a corporate defendant is found guilty of fraud and goes bankrupt, the victim will not be able to recover all of his losses. In essence, what this bill does is determine, as policy matter, that it is more important to protect adjudged wrongdoers from having to pay more than their strict proportion of the harm than it is to protect the innocent victims of fraud.

Another of the troubling provisions in this bill is the one which adopts a higher pleading standard than was in the Senate bill—higher in fact than the standard adopted by the second circuit—which is currently the highest standard in the land.

As my colleague Senator SPECTER discussed earlier, it was Senator SPECTER who offered an amendment that clarified that the heightened pleading standard in the Senate bill could be satisfied by evidence of a defendant's motive and opportunity to commit securities fraud. The current version of this bill, however, eliminates the language in the Specter amendment.

This bill is also worse than the Senate bill because it imposes a mandatory loser-pays fee shifting penalty under rule 11 of the Federal Rules of Civil Procedure that is harsher on plaintiffs than on defendants.

Under current law, rule 11 gives courts the discretion to impose sanctions for pleadings and motions that are unwarranted, without evidentiary support, or otherwise abusive.

The Senate bill required courts to determine whether any party violated rule 11 and to presume that the appropriate penalty for violating rule 11 is fee shifting. Under the Senate bill, the party who violated rule 11 would have to pay the opposing party's legal fees incurred as a direct result of the violation.

The bill on the floor today is worse than the Senate bill because it unfairly increased the penalty imposed against plaintiffs who are found to have violated rule 11 while not doing so for defendants who are found to have violated rule 11. The presumptive penalty for plaintiffs is have to pay all of the defendant's legal fees and costs incurred in the entire action.

Proponents of this bill claim that the bill is balanced and fair. Is this provision balanced or fair? Not by any stretch of the imagination.

This bill, unlike the Senate bill, also adopts a provision, modeled on the House bill, that may require plaintiffs to post a bond to cover a possible fee-shifting penalty. Moreover, there is no limitation on the amount of the bond. This could be a major obstacle for individual victims or their attorneys in bringing a meritorious action against a large corporation defendant. The bill also fails to restore an adequate statute of limitations for private securities fraud actions, and gives the greatest control in cases to the wealthiest plaintiffs.

Lastly, as someone who has long sought to do what he could to combat crimes of all kind, I also find it incredible that language in the Senate bill concerning the application of our RICO laws in securities fraud cases has been almost eliminated entirely.

Under an amendment I offered, the Senate bill allowed the RICO statute to be used in a securities fraud civil case if at least one person in the civil case has been criminally convicted. Under this bill, RICO could only be used in the civil case against the person who was actually criminally convicted.

The safe harbor, proportionate liability, pleading, aiding and abetting, fee-shifting, and RICO provisions, are bad enough alone, but together, they will actually encourage the kind of conduct our securities laws were designed to eliminate.

I am sure that there is not one Member in this body who does not want to bring an end to all frivolous lawsuits, not just shareholder lawsuits. Yet, the legislation before us today is not the answer—it is far from it.

Indeed, the managing editor of Money magazine, the largest financial publication in the United States, with over 10 million, largely middle-class readers, said it well when he stated, and I quote:

At a time when massive securities fraud has become one of this country's growth industries, this law would cheat victims out of whatever chance they may have of getting their money back . . . in the final analysis, this legislation . . . would actually be a grand slam for the sleaziest element of the financial industry, at the expense of ordinary citizens.

The president of the Fraternal Order of Police said it best, however, when, in his letter to the President urging him to veto the bill, he stated:

Mr. President, our 270,000 members stand with you in your commitment to a war on crime, the men and women of the Fraternal Order of Police are the foot soldiers in the war. On their behalf, I urge you to reject a bill which would make it less risky for white collar criminals to steal from police pension funds while the police are risking their lives against violent criminals!

I urge my colleagues to heed these words.

Mr. BRYAN. Mr. President, I thank the distinguished senior Senator for his statement and for his insight.

Mr. COHEN. Mr. President, I am well aware of the hazards of abusive class action lawsuits and unethical attorney conduct.

Just before Thanksgiving there was an article on the front page of the New York Times about a constituent of mine who received a benefit of $2.91 from a class action suit concerning overcharges in mortgage escrow accounts, but had $91.00 removed from his account to pay the attorney's fees of class counsel. I will soon be introducing legislation to protect consumers from these types of abuses.

There are undoubtedly abusive securities class actions as well. But the key to reforming this area of the law, like all litigation reform, is to devise remedies that will weed out the frivolous lawsuits while allowing the meritorious ones to go forward.

The conference report under consideration contains a number of necessary

STATEMENT OF MICHAEL CHERTOFF,
ASSISTANT ATTORNEY GENERAL
CRIMINAL DIVISION

AND

WILLIAM W. MERCER
UNITED STATES ATTORNEY,
DISTRICT OF MONTANA
AND
CHAIRMAN, ATTORNEY GENERAL'S ADVISORY COMMITTEE
SUBCOMMITTEE ON SENTENCING

BEFORE THE SUBCOMMITTEE ON CRIME AND DRUGS
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

July 10, 2002

INTRODUCTION

Chairman Biden, Senator Grassley, and Members of the Subcommittee:

We thank you for the invitation and very much welcome the opportunity to appear before this Subcommittee today to discuss what this Administration has done, is doing, and intends to do to detect, punish and ultimately deter white collar crime.

Just yesterday, President Bush called for a new ethic of corporate responsibility. Although most businesspeople play by the rules, some do not, and we are now seeing the serious damage to people's trust and confidence in our economy that this type of wrongdoing fosters. The President's initiative gives prosecutors important new weapons in the fight against white-collar crime and, as noted below, establishes a new Corporate Fraud Task Force within the Department of Justice. As you know, we have not hesitated

to proceed with criminal cases against corporate executives, accountants, and others who have abused their positions of trust and authority for personal gain or for other improper purposes by breaking the existing laws. Some have called us too aggressive, but those voices seem to be growing more faint as ever more egregious business practices are exposed to public scrutiny. We are proud of the work we have done, and continue to do, both here in Washington and at the many United States Attorney's offices around the country where Justice Department prosecutors are going after corporate criminals every day. We have made considerable progress, but we have much yet to do.

In the meantime, this Administration has sent a very clear message: that fraud, obstruction of justice, and other types of criminal activity in the business world will not go unpunished or receive merely a slap on the wrist, a nominal fine, and an admonition to "go forth and sin no more." To the contrary, robust enforcement of the law gives people both on Wall Street and Main Street confidence that the financial marketplace, and our economy in general, will continue to operate under principles of honesty, integrity, and trust. This message is one that most honest, hardworking people in the business community have welcomed, and it is one that we hope will give the American people a renewed faith in both our economic system and in our criminal justice system.

Strong enforcement of our laws against white collar crime, and tough penalties for those who commit such crimes, has been this Administration's policy, and these principles form the cornerstones of the President's proposal. We believe that strong

enforcement and tough penalties are especially important in the context of white collar crimes, because business criminals act with calculation rather than in a fit of anger or compulsion. Because white collar criminals act more rationally than most other criminals, they can more easily be deterred. In our experience, one thing is crystal clear: businessmen and women want to avoid jail at any cost. If their calculus includes a reasonable likelihood that they will be caught, and if caught, a reasonable likelihood that they will go to jail rather than get probation, home detention, or some other "alternative to incarceration," they will be much less willing to roll the dice and commit a fraud. Of course, white collar criminals also count on their misdeeds being difficult both to detect in the first instance and ultimately to prove in court beyond a reasonable doubt. Indeed, white collar cases are generally very complex, and take considerable time and resources to investigate and litigate. For that reason, it is all the more important that corporate criminals realize that meaningful punishment lies at the end of the road to conviction.

The President's Proposal: A New Ethic of Corporate Responsibility

The President's proposals would both increase the ability of federal agents and prosecutors to catch these types of criminals, and would stiffen the penalties for white collar offenders when they are convicted. Let me highlight some specific reforms, focusing on those most pertinent to federal criminal enforcement:

The Corporate Fraud Task Force

As noted previously, the President has ordered the Attorney General to form a Corporate Fraud Task Force within the Justice Department in order to strengthen the efforts of the federal government in its investigation and prosecution of financial crimes. The Task Force will provide direction for the investigation and prosecution of white collar crimes, including significant cases of securities fraud, accounting fraud, and other financial and white-collar crimes. The Task Force will actively work to improve cooperation among other federal agencies and state authorities, and recommend policy and legislative changes as appropriate. We believe that this Task Force will significantly enhance the Department's existing ability to tackle those increasingly common cases that involve large, complex businesses where questionable practices, transactions or other activities are nationwide or even international in scope. The Deputy Attorney General will chair this Task Force. The Assistant Attorneys General for the Criminal and Tax Divisions will be members. The other members will include the FBI Director and U.S. Attorneys from major financial centers, including New York, Chicago, San Francisco, Los Angeles, and Houston.

Increased White Collar Penalties, Including Prison Sentences

As U.S. Attorney James Comey of the Southern District of New York told this Subcommittee last month, this Administration recognizes that the swift and certain punishment of financial crimes is vital, both to the prosperity of the United States and to

people's faith in the criminal justice system. We have attached a copy of Mr. Comey's statement for your reference. For this reason, another cornerstone of the President's proposal is an increase in the available penalties for mail fraud and wire fraud -- two statutes that govern basic forms of white collar crime. Too often the public perception has been that people who commit business-related crimes receive punishment not based on the gravity of their offense, but according to their social or economic stature. In some cases we think that those concerns have been warranted. Not only are the maximum statutory penalties for fraud and other white collar-type offenses substantially less overall than those for violent offenders or drug cases, but it appears that judges in some jurisdictions are overly willing to depart downward from the mandated federal sentencing guideline range to sentence such offenders to minimal (if any) jail time, home detention, or even probation.

We strongly disagree with this kind of lenient treatment for white collar criminals. The bottom line is that white collar criminals are just as much criminals as those who steal with a gun or knife. They do real harm to real people. They ruin lives. Jail time performs two functions: it holds white collar criminals accountable for their past misdeeds, and it prevents future misbehavior by those executives who might toy with the idea of beating the system. Greed will ultimately overcome reason in some cases – after all, no criminal ever starts out with the intention of getting caught -- but deterrence always works best at the margins of criminal behavior. The President believes in making

the penalties for white collar crime tougher and especially in making real jail time more meaningful in business cases.

Enhanced Investigative Tools

The Administration's proposal also recognizes the considerable challenges that regulators, investigators and prosecutors face in detecting white collar crimes and preparing these cases for trial. Many, if not most, white collar crimes initially appear to be normal business transactions. Indeed, most of the names in the headlines in recent months have been those of legitimate, well-regarded corporations. The smart corporate criminal will conduct his affairs in a manner that seems perfectly above-board and legitimate. Like termites infesting a house, everything appears fine until the first shingle is pried loose. Then the task becomes even more difficult – assessing the extent of the activity, determining who was responsible, and preparing a case for indictment and trial. Here, too, the nature of the beast works against us – the very essence of these crimes is deception, conspiracy, and coverup.

Thus, the President's proposal would give us an important new tool to fight obstruction of justice, particularly document shredding. As some courts have interpreted one of the current statutes, the government can only charge someone for persuading *others* to engage in obstruction of an anticipated official proceeding; if a person acts alone, no matter how egregiously, he or she cannot be prosecuted unless a proceeding has actually begun. The President has asked Congress to amend a different obstruction

of justice statute – not subject these court-imposed limitations – to clarify unambiguously the government's ability to prosecute all individuals involved in obstructing justice in these circumstances.

White Collar Enforcement

As we mentioned before, this Administration is rightly proud of its record of vigorous enforcement of the laws against white collar criminals. We are sure the Subcommittee will understand that we are precluded from discussing pending cases in detail, and of course we cannot reveal information about any investigations which have not been publicly acknowledged by the Department. However, we are currently pursuing several investigations involving major corporations, as well as indictments and trials. We would like briefly to describe a few:

- WorldCom: The Department is reviewing the facts behind WorldCom's June 25 disclosure that it had improperly accounted for $3.9 billion in expenses. The SEC has formally charged WorldCom with defrauding investors.
- Enron: In January, the Department set up a Task Force to investigate the circumstances behind the collapse of Enron Corp. The Task Force is led by Leslie Caldwell, an experienced federal prosecutor from the San Francisco U.S. Attorney's Office. The investigation has so far led to the conviction of Arthur Andersen in June, and the filing of wire fraud charges on June 27 against three

British bankers who engaged in transactions with Enron officials. The Enron Task Force's investigation is active and ongoing.

- Arthur Andersen: On June 15, a federal jury in Houston convicted the accounting firm Arthur Andersen LLP of obstruction of justice, in a case arising out of the Enron investigation. The indictment charged, and the jury found, that Andersen obstructed an SEC investigation into the Enron collapse. David Duncan, the Global Managing Partner at Andersen in charge of the Enron Engagement Team, pled guilty to obstruction of justice in April.
- AllFirst: On June 5, the U.S. Attorney for Maryland announced a seven-count indictment against a former AllFirst Bank currency trader, alleging bank fraud and making a false entry in bank records which resulted in the bank's losing more than $691 million.
- ImClone: The U.S. Attorney in Manhattan is investigating allegations of insider trading with regard to ImClone Systems, Inc. Former ImClone Chief Executive Samuel Waksal was charged in June with insider trading for allegedly tipping off other investors about the FDA's pending rejection of the company's application for approval of a cancer drug.
- Rite Aid: On June 21, the U.S. Attorney for the Middle District of Pennsylvania announced criminal charges including mail and wire fraud against five former and current officers of Rite Aid Corporation, the drug chain. One defendant has pled

guilty. The charges involve an accounting scheme that led to a $1.6 billion restatement of income, one of the largest in U.S. history.

- Republic Securities Corp.: In December 2001, Republic entered a guilty plea in the Southern District of New York to securities fraud and conspiracy, and agreed to pay $606 million in restitution to victims of the fraud. A Republic trader, Martin Armstrong, was indicted in 1999, and those charges are still pending.

Conclusion

In closing, we thank you, Mr. Chairman, Senator Grassley, and the Subcommittee, for your leadership and the spirit of bipartisan cooperation that you have brought to addressing the challenges of rooting out, punishing, and preventing white collar crime. The President's proposals in this area will greatly enhance the Department's ability to enforce fraud, obstruction, and other important statutes, and ensure that criminals who operate in the business community face stiff penalties which include jail time. We look forward to working with you as we enforce the laws and encourage a new ethic of corporate responsibility in this country.

Mr. Chairman, that concludes our prepared remarks. We would be glad to answer any questions the Subcommittee may have.

Testimony of Professor John C. Coffee, Jr.
Adolf A. Berle Professor of Law,
Columbia University School of Law
before the

Subcommittee on Crime and Drugs
of the
Committee on the Judiciary
United States Senate
on
July 10, 2002
relating to
"Sentencing Standards for Securities Fraud"

Introduction

A consensus appears to exist that greater use should be made of the criminal law in combating securities fraud and accounting irregularities. Not only has the President and the Chairman of the SEC announced their views that the perpetrators of fraud must be brought to justice, but Senator Leahy and the Senate Judiciary Committee have drafted a bill that in my judgment would usefully simplify the prosecution of securities fraud and obstruction of justice cases.[1] In this light, I will not replow ground that has already been covered and will focus today only on issues of implementation: How do we appropriately adjust the criminal law to deter "cooking the books"? No time will be spent defending the propositions that securities fraud and accounting irregularities are morally wrong or constitute major societal problems, because I sense that on this topic I would be preaching to the choir in appearing before you today.

My focus will be on the sentencing stage because the Senate Judiciary Committee has already addressed the substantive criminal law in adopting the Leahy Bill (S. 2673, Title VII). As a brief word of background, I should indicate that my areas of legal specialization include (1) securities regulation and corporate governance, and (2) white collar crime and sentencing. Increasingly, these two areas of law appear to be merging. With regard to the former area, I have served as a Reporter to the American Law Institute for its Restatement-like project, PRINCIPLES OF CORPORATE GOVERNANCE: Principles and Recommendations (1992), am a co-author of the most widely used casebook on Securities Regulation (Jennings, Marsh, Coffee & Seligman, SECURITIES REGULATION: Cases and Materials (8th ed. 1998)) and of several

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[1] See S. 2673, Title VII (the "Corporate and Criminal Fraud Accountability Act of 2002").

other books on corporate law, have served as a member of the Legal Advisory Boards to both the New York Stock Exchange and Nasdaq, and was a member of the SEC's Advisory Committee on Capital Formation and the Regulatory Process. With regard to the sentencing and white collar crime fields, I served as a Reporter to the American Bar Association for its Standards on Sentencing Alternatives and Procedures in connection with its Minimum Standards for Criminal Justice Project, have been a member of a National Academy of Sciences Panel that reviewed the empirical research on sentencing, and have served as a consultant for, and as a member of an Advisory Committee to, the United States Sentencing Commission with regard to its organizational sentencing guidelines and its proposed environmental sentencing guidelines. I have also written extensively on white collar crime and taught a course on this subject with United States District Judge Jed Rakoff for the last decade.

II. Recommendations for Individual Defendants

How do we best deter economic crime? The consensus of criminologists is that likelihood of apprehension is far more important than the severity of punishment. For example, Professor Daniel Nagin, a criminologist at Carnegie Mellon University, told a symposium hosted by the United States Sentencing Commission in 2000 that research on tax compliance indicated that:

> "[C]ompliance is nearly perfect when detection risk is very certain, and compliance is nearly zero when detection risk is negligible."[2]

He added:

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[2] See Proceedings of the Third Symposium on Crime and Punishment in the United States, SYMPOSIUM ON FEDERAL SENTENCING POLICY FOR ECONOMIC CRIMES AND NEW TECHNOLOGY OFFENSES, (October 12-13 2000) at p. 23.

> "The flip side of this conclusion... is that draconian penalties are unlikely to be an effective substitute for a more-difficult-to-achieve alternative of effective detection and prosecution. For example, a penalty of 25 years of imprisonment with a probability of .01 is unlikely to be as effective a deterrent as a 2.5 year of punishment but with a probability of .1"[3]

Criminologists have consistently held this view at least since the days of Cesare Beccaria in the 18th Century, and modern empirical research has confirmed it.

From a policy perspective, this means that the passage of tough mandatory sentences that impose exemplary sentences on white collar offenders will do less to achieve deterrence than investment in enforcement and detection. On this basis, my first recommendation would be the following, which is, I believe, fully consistent with the American Bar Association's Minimum Standards for Criminal Justice:

> RECOMMENDATION ONE: Avoid Mandatory Minimum Sentences. They Are An Election-year Solution to Crime. Fair, but Certain, Punishment Works Far Better.

The United States Sentencing Commission was, of course, created by Congress to reduce sentencing disparities and ensure fair and certain punishment. The Sentencing Commission has long promulgated sentencing guidelines for economic crimes, including Guideline §2B1.1 which applies to offenses involving "fraud and deceit." This will be the guideline that typically applies to securities fraud cases, but, as next discussed, it needs revision to deal adequately with accounting fraud cases. Essentially, this guideline starts at Base Offense Level 6 and then further increases the "Base Offense Level" in direct proportion to the loss caused by the crime, starting at the $5,000 level and enhancing the offense level by up to 26 levels (if the loss exceeds

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[3] Id.

$100,000,000). In addition, Guideline §2B 1.1 also increases the Base Offense Level by two levels if more than ten (but less than 50) victims are involved and by four levels if more than 50 victims were involved. A variety of other offense level enhancements are also authorized if specific additional factors are present; for example, if the defendant derived more than $1,000,000 in gross proceeds from a financial institution or if the defendant "substantially jeopardized the safety and soundness of a financial institution," the base offense level rises by two and four levels, respectively.

While I have long believed that the Commission's guidelines tend to take an overly mechanical approach to the determination of offense severity, the foregoing guideline illustrates the limitations inherent in this approach in a particularly revealing way. First, let's begin with the definition of the "loss" in a case where corporate executives are convicted of securities fraud for "cooking the books." Assume that no defendant engaged in insider trading and that the company did not sell securities to the market during this period. Yet, when the earnings overstatement is revealed, the company's stock price drops *50%* over the next two days for a total loss (in terms of market capitalization) of $2 billion dollars.[4] Does this count as a "loss" for purposes of §2B 1.1? The definition of "loss" in Application Note 2 to §2B 1.1 looks to the "reasonably foreseeable pecuniary harm" that the defendant "reasonably should have known was a potential result of the offense." The problem here is that a chief financial officer who overstates earnings by even two cents a share can trigger a vehement reduction in the firm's stock price by an angry market when an earnings restatement is later announced. But this stock price reduction could sometimes be

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[4] In Enron, the total loss in terms of market capitalization was roughly $80 billion, and it has been even larger in some other cases.

small and sometimes large; it is seldom predictable. Moreover, in civil litigation, courts do not necessarily assume that the full stock price reduction was attributable to the earnings restatement; rather, they require the plaintiff to prove "loss causation." For example, a court might often find that much of the stock price decline on a given date was attributable to new macro-economic news reaching the market or to industry conditions that also affected the firm's competitors. Accordingly, the sheer stock market decline is not necessarily an accurate proxy for the "reasonably foreseeable pecuniary harm." In this light, it seems apparent that this guideline was really drafted to deal with the very different case in which the fraudulent stock promoter obtains funds from deceived investors. But this does not happen in many (and probably most) "accounting irregularities" cases where the loss falls on shareholders who purchased in the secondary market, not from the defendant promoters.

My point then is simply that the existing guidelines for fraud offenses (i.e., §2B 1.1) does not mesh well with "accounting irregularity" cases. This point is reinforced when we consider the enhancement for the number of "victims" in such a case. Who are the victims? If all shareholders are the victims, the earlier noted *"50* or more" victim enhancement will be triggered in every case. But some shareholders bought at a very low price at the outset of the corporation's history and have thus experienced no real economic loss. One cannot easily determine the number of shareholders who have suffered a net economic loss (although I admit that it will usually be well in excess of 50). If the corporation is instead seen as the victim, then there is only one victim, and the "number of victims" test is nullified.

Similarly, the special enhancement for deriving funds from a financial institution seems to produce an indefensible result in such a case, because it does apply when the corporation sells

its bonds to a bank, but not when it sells equity to proverbial widows and orphans. All this leads to my second recommendation:

> RECOMMENDATION TWO. Congress Should Instruct the Sentencing Commission to Develop a Special Guideline for Securities Fraud Cases Involving Accounting Irregularities.

Such a new guideline needs to take a broader perspective on the social harm involved in corporate overstatements of earnings and understatement of liabilities. The premise of §2B 1.1 is that the loss is visited exclusively on the specific victims of the defendants who give them cash or property for overvalued stock. That rationale may fit the classic Ponzi scheme well enough (which was the type of case that used to be criminally prosecuted), but not an Enron or a Worldcom. In these cases, the broader social injury needs to be recognized; that is, the victims are not just the shareholders of Enron, but shareholders in all other public corporations whose share prices have also been discounted because investors no longer trust the credibility of reported financial results. Indeed, viewed more generally, the victims include not only investors, but employees, creditors, other stakeholders, and citizens generally – all of who suffer a loss when securities fraud erodes investor confidence and thereby produces an increase in the cost of capital.

This last point cannot be overemphasized: securities fraud has macro-economic consequences. It injures not only investors, but the public generally by raising the cost of capital for all corporations and thereby retarding economic growth, increasing interest rates, and producing inevitable layoffs.

So what should be done? Although Congress itself should not write sentencing guidelines, Congress could instruct the Sentencing Commission to consider these broader public

injuries and report back, within say one year, with a revised guideline for this special context. For example, such a guideline could sensibly look to the amount of the earnings restatement and also the number of quarterly reports that were misstated in considering the impact on public confidence.

In addition to fines, a federal court can also order disgorgement of profits obtained from the crime. In "accounting fraud" cases, the real motive underlying the crime may be the desire to receive stock options or other bonuses based on presumed superior performance. Or, the motive could be the desire to maximize the value of stock options that were earlier awarded by inflating the stock price. Either way, the Sentencing Commission needs to consider when the disgorgement sanction should include executive compensation that was received or that earned an enhanced valued during the period of the fraud. Admittedly, this will involve some subtle distinctions.

> Recommendation Three: Instruct the Sentencing Commission to Determine and Report When and to What Extent Executive Compensation Awarded During a Period in Which Earnings Were Overstated Should Be Deemed Subject to Disgorgement.

III. Corporate Defendants

In some securities fraud cases, the corporation itself may be prosecuted, and the Sentencing Commission has special organizational sentencing guidelines applicable to corporate defendants.[5] These organizational guidelines contain a special sentencing credit against any fine if the corporation has established and maintained an effective compliance program to detect and

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[5] See U.S. Sentencing Guideline Manual, Chapter 8 (2001). For an overview, see Richard Gruner, CORPORATE CRIME AND SENTENCING (1994).

prevent violations of law.[6] The actual content of such an effective compliance program has long been the suspect of reasonable debate and disagreement (and this author was among those who participated in their initial drafting). Yet, this topic seriously needs re-examination in light of the Enron debacle. For example, Enron shows the importance and social value of whistle-blowers (as Worldcom may also). A model corporate compliance plan might well include procedures by which potential whistle-blowers were alerted as to how to report suspected violations of law to the broad - - and on an anonymous basis. Indeed, procedures could be mandated in these guidelines under which at least certain serious violations of law (including securities fraud) could be reported directly to the Audit Committee on a confidential basis. Again, all the elements in a model compliance plan need not be established by Congress at this stage, but this is a timely topic that has received little recent attention, and needs re-examination. Accordingly, I recommend:

> RECOMMENDATION FOUR: Require the United States Sentencing Commission to Review and Determine If Compliance Plans Are an Effective Deterrent to Organizational Crime and If They Justify the Sentencing Credits That Are Currently Awarded. Also, Specific Attention Should Be Given to the Possible Need for Greater Protection in Them for Whistle-blowers.

The President and others have suggested the need to restrict improper loans or payments to corporate executives. In addition, following a corporate conviction, it may become apparent that the corporation has strong legal claims against present or former officers or directors. Sometimes, the corporation may be reluctant to assert these claims. One means by which to

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[6] See U.S. Sentencing Guidelines Manual, §8A1.2, comment 3(k). For an overview, see Jed Rakoff, et al., CORPORATE SENTENCING GUIDELINES: Compliance and Mitigation (1993).

address this problem is through the use of corporate probation. Corporate probation is already an authorized sanction (in addition to fines and other penalties), but it could be expanded by making the appointment of a corporate monitor an authorized probation condition. Such a monitor could be authorized in an appropriate case to sue in the corporation's right and place for a corporate recovery from the former officers or directors. Essentially, this proposal assures a more objective and independent evaluation of the legal strength of the corporation's claims, and it is a parallel to the independent counsel statute in the public sector.

> RECOMMENDATION FIVE: Instruct the Sentencing Commission to Evaluate and Report on the Potential Utility of Corporate Probation as a Means by Which to (a) Correct Failures in Corporate Governance at the Defendant Organization, and (b) Recover Amounts or Damages Due to the Defendant.

MISTER CHAIRMAN:

Thank you for inviting my testimony. My name is Tom Devine, and I serve as legal director of the Government Accountability Project, a nonprofit, nonpartisan, public interest law firm dedicated to helping whistleblowers -- those employees who exercise free speech rights to challenge illegality or other abuses of power that betray the public trust. GAP has led outside campaigns that led to passage of numerous government, military and corporate whistleblower protection laws. We represent whistleblowers in test cases of those statutes, and to investigate their dissent against alleged misconduct threatening the public. We steadily monitor implementation of whistleblower statutes and share our results through books, law review and popular articles, as well as congressional testimony. See, e.g., The Whistleblower's Survival Guide: Courage Without Martyrdom, and "The Whistleblower Protection Act of 1989: Foundation for the Modern Law of Dissent," 51 Administrative Law Review 531 (1999). We teamed up with American University Law School to draft a model whistleblower protection law implementing the Inter-American Convention Against Corruption.

It is rare for the Government Accountability Project, but my primary goal in this testimony is to offer credit where it is due. Through unanimously approved provisions creating state of the art whistleblower protection, this Committee exercised bipartisan leadership for a genuine breakthrough in corporate accountability. The Corporate Fraud and Accountability Act of 2002 is outstanding good government legislation. The Act lengthens the statute of limitations and empowers state Attorney Generals to prosecute corporate criminals under existing federal racketeering law. Its centerpiece, however, is legal rights for whistleblowers at publicly-traded corporations. Future Sherron Watkins

could not be fired at will when warning corporate leaders or shareholders of consequences from cheating such as bankruptcy, liability or other risks that could sabotage investments.

The bill's strategy is whistleblower protection to create a safe channel for shareholders and management's right to know, as well as for testimony in law enforcement investigations. Its goal is to frustrate coverups: employees are protected from reprisal for releasing information the shareholders are legally entitled to under Securities and Exchange Commission disclosure rules. Witnesses in criminal investigations also are shielded. It gives reprisal victims access to district court jury trials if they cannot receive a timely decision from what all too frequently has been the black hole of the Department of Labor administrative law system. Their cases would be governed by the modern legal burdens of proof from the Whistleblower Protection Act of 1989 for government workers.

Disclosure has been the trans-ideological, bipartisan cornerstone of all post-Enron reform proposals, from Democrats to President Bush. The common sense logic is unassailable. Two long-accepted truths are that secrecy is the breeding ground for corruption, and sunlight is the best disinfectant. Otherwise even the best corporate leaders are ignorant of misdeeds until they are blamed for the consequences. Similarly, shareholders and their investments are blindsided by risks taken behind heir backs. Political leaders' support on the Senate Judiciary Committee's whistleblower protection bill will be a test whether they are serious, or their posturing about full disclosure is as cheap talk as Enron and WorldCom's SEC filings.

Whistleblowers are the Achilles heel of bureaucratic corruption. As eyewitnesses to the birth of scandals, they are indispensable to bridge the secrecy gap. Their free speech right goes beyond the freedom to protest misconduct. It also includes the freedom to warn. In the Netherlands, these same individuals are called "bell ringers," after those who warn their communities of danger. Other nations refer to whistleblowers as "lighthouse keepers," after those who save ships from sinking by shining the light on areas where rocks are both invisible and deadly. The common theme is that they warn about threats to the public's well-being, before avoidable crimes or disasters occur and we are limited to damage control. They are the living disclosure statements who refuse to be falsified.

Their dormant potential already has been proved anecdotally since the 1980's, when investors believed whistleblowers over Nuclear Regulatory Commission rubber-stamps and pulled the plug on plants that were accidents waiting to happen. The common theme in the disclosures of GAP clients has been warning of liability or government sanctions for cheating. Sherron Watkins acted as a corporate Paul Revere by warning that devastating liability was coming. Enron chief Ken Lay ignored her at his own peril and sealed his doom.

They are the lifeblood of anti-corruption campaigns, which are lifeless, empty symbols doomed to failure without testimony from those who bear witness. It is difficult to win criminal convictions without leads and testimony. Whistleblowing disclosures to the SEC doubled normal rates during congressional Enron hearings. As SEC enforcement chief Stephen Cutler commented, "Because of this phenomenon, among other reasons,

we are learning of potential securities law violations earlier than ever before. Keep those cards and letters, not to mention emails, coming."

Unless rights are locked in, things will soon be back to normal as would-be whistleblowers decide instead to stay silent observers. Ironically, the norm is that whistleblowers proceed at their own risk when sounding the alarm, except when shielded by the False Claims Act for challenging fraud in government contracts. Corporate law is a crazy-quilt of hit or (usually) miss protections generally tucked into specific environmental or public safety laws. With scattered exceptions, the lucky ones with rights generally are unemployed prisoners of an administrative law system that commonly takes well over two years for decisions, with no chance for interim relief – professionally akin to patients who die while waiting for an operation or organ donor.

Ms. Watkins only survived because Enron collapsed before retaliation could be carried out, and then she became a celebrity. For whistleblowers the sad truth is that if you're not a celebrity, you're cooked. As University of Maryland Professor Fred Alford, author of Whistleblowers: Broken Lives and Organizational Power, observed, "[F]or every Sherron Watkins, there are several hundred whistleblowers that lack the protection of visibility." Those at Paine Webber, Global Crossings, World Com and similar firms will confirm his insight. In some instances they were openly fired for disloyalty – to company managers who themselves were breaching their fiduciary duty of loyalty to shareholders.

Initially reform appeared trapped by a partisan deadlock. Then the staffs of longtime whistleblower champions Senators Leahy and Grassley worked beyond the call of duty to craft a composite model that sparked a consensus. They agreed to drop

punitive damages, and to restrict court access unless administrative proceedings are bogged down over 180 days.

The Leahy-Grassley compromise is a win-win for everyone except corporate crooks. Honest managers, Boards, shareholders, whistleblowers and federal law enforcement agencies will be empowered with an early warning system to prevent new Enron disasters by nipping scandals in the bud. It would place the U.S. in compliance with the whistleblower requirement in the OAS Inter-American Convention Against Corruption, ratified last year after leadership by Senator Chafee. Comprehensive corporate whistleblower protection also has been recommended internationally in Organization for Economic Cooperation and Development Guidelines.

Unanimous Judiciary Committee approval suggests the Senate may be ready to prove it is serious about making a difference. Then it will be the House and the President's turn. Throughout the Enron hearings, legislators of both parties rhetorically lionized whistleblowers and chastised those who violated their "duty" by remaining silent. It is time to add genuine free speech rights to the rhetoric, which rings cynically hollow to someone fired and facing bankruptcy for warning a corporation of that same risk.

The Leahy-Grassley bill should be a beachhead for other stalled, pending legislation. Amendments to revive the Whistleblower Protection Act for federal employees are stalled. That law was the strongest free speech law in history when unanimously approved by Congress in 1989 and strengthened in 1994. But after brazenly hostile activism by a court with a monopoly on judicial review, it is a trap that creates more victims than it helps. The rules have been rigged so that whistleblowers are

guaranteed legal endorsement of reprisals they challenge, unless they present "irrefragable" proof of government misconduct. That means undeniable, uncontestable proof, although the law as written only calls for evidence of a reasonable belief. In the absence of a confession there is no such thing as a whistleblower. Amazingly, the House has not even scheduled hearings on the bill. . A bipartisan Paul Revere Freedom to Warn Act in the House would secure Congress' right to know through similar protection for anyone who blows the whistle to Congress. Legislation to provide whistleblower rights for FBI employees, also approved by this Committee, and federal baggage screeners, introduced by Senators Grassley and Levin, also would close inexcusable loopholes.

The Judiciary Committee bill is only a first step. Employees of private corporations are not covered, and tools to help whistleblowers make a difference should be seriously considered. The inspirational track record of the False Claims Act in exposing government contract fraud should be an expanding beachhead for corporate accountability, not an island. Those future challenges should be put in perspective, however. This committee's corporate whistleblower bill is a giant step forward. It means future Coleen Rowleys will have rights when they risk their personal financial future to defend the shareholders.' It is unrealistic to expect whistleblowers to defend shareholders or the public if they can't defend themselves. Like current corporate whistleblower laws, Profiles in Courage are the exception, not the rule.

Remarks prepared for the hearing, "Penalties For White Collar Crime: Are We Really Getting Tough on Crime? " of the Senate Judiciary Committee Subcommittee on Crime and Drugs, July 10, 2002,ROOM: SD-226

Prepared by:
Thomas Donaldson
Mark O. Winkelman Professor
2203 Steinberg Hall-Dietrich Hall
The Wharton School
University of Pennsylvania
3620 Locust Walk
Philadelphia, PA 19104.6369

What about Business Ethics?

Outline:

1. Why markets need ethics
2. Where the law ends
3. The failure of current approaches
4. Recent changes that have challenged corporate integrity
5. What government and business should be doing.

1. Why markets need ethics:

More than 200 years ago, Adam Smith, the father of capitalism and himself a professor of moral philosophy, made a point echoed recently by the Nobel Prize winner in Economics, Amartya Sen: namely, markets won't succeed unless they are supported by the ethical cooperation of their participants. Even capitalism, the best of all economic systems, remarkable for its capacity to direct the inevitable self interest of people towards the common good (the "invisible hand"), will fail unless it operates against a critical backdrop of moral integrity. In the United States, this very integrity today stands in the

balance.

In ethics and economics, not all nations are created equal. A nation can hold key competitive advantages stemming simply from elements of its ethical behavior in the market. Some nations build "competitive advantages" not only by dint of hard work and abundant resources, but by attention to trust, fairness, and integrity. These are part of a nation's "social capital." For decades, US stocks have been a haven to foreign investors because of our business community's reputation for transparency and integrity. That valuable reputation, too, today stands in the balance.

Many analyses of past global events help show why ethical attributes or their absence impact economic success. The broad and continuing failure of markets in former Soviet Union over the last decade has been linked to patterns of widespread bribery and corruption. Crony capitalism and the lack of transparency were rightly implicated in the Asian melt down of 1997-1998. Without transparency and reliable numbers about the economic health of Asian companies, investors were stymied from responding rationally to the crisis. They were unable to dump their investments in poorer companies and hold their investments in better companies—because they simply couldn't trust the numbers. In the ensuing crisis, they dumped everything—with pernicious consequences. Today, we appear to be experiencing a "transparency discount" in the American equity markets. Investors pay less because they believe that they know less.

Nations have held the integrity of US financial markets in awe—until recently. Our accounting standards, our principles of corporate governance, and our corporate ethics programs, were blueprints for the reform of institutions abroad. But the recent exposures of greed, dishonesty, and sophisticated theft in the US have damaged our national reputation. That reputation took decades to build. It *can* be rebuilt, but clearly not overnight.

Nowadays one hears often about the staggering cost of corporate crime, and about

transparency failures in corporate bookkeeping and how such failures raise the cost of capital, thus harming society. But these are only two of the symptoms of ethical issues that flow in the lifeblood of business and society. Our problem is bigger than the cost of raising capital.

Consider the basic issue of fairness. When people perceive that a game is fundamentally unfair, they won't play as hard. As the economist, Amartya Sen, has noted, *how* a cake is to be divided can influence the *size* of the cake. An employee's incentive is less if she believes that the reward system at her corporation is rigged and unfair. The ordinary employees of Enron, who lost the bulk of their savings watching the elite executives at the top walk away rich, are today dispirited and unmotivated. Throughout our country, millions of employees are beginning to doubt the very fairness of their corporate system, and are beginning to distrust the ethics of their corporate leaders. Countless Americans are asking this hard question, "even if I strain every nerve and muscle, working the hardest I can for my corporation, can I receive my fair share?"

Economic efficiency also demands that we accept the duties of economic citizenship. A list of the duties of economic citizenship important for a market system include:

1. Respect for intellectual property
2. Engaging in fair competition and avoiding monopolies
3. Avoiding nepotism and "crony capitalism."
4. Not abusing government relationships
5. Providing non-deceptive information to the market (including transparency of relevant information)
6. Avoiding bribery
7. Respecting environmental integrity
8. Duties to honor contracts, promises, and other commitments

Recent scandals have turned heavily on #5, i.e., providing non-deceptive information to the market. The importance of accurate information in fueling efficient economic activity is well substantiated. Rational choice demands accurate information. When

companies fail to provide investors with accurate information, investors make worse decisions and markets, in turn, become less efficient. Indeed, one of the three "principal objectives" asserted at the end of 1998 by the head of World Bank, James Wolfensohn, in the wake of the financial turmoil at Asia was "improving the quality and transparency of key government institutions, including addressing issues of corruption and accountability." The IMF, too, has emphasized financial accountability as a key financial pillar for recipient nations.

2. Where the law ends:

One characteristic winds its way throughout these success criteria, and it has implications for how Congress should address the currently boiling problems of corporate misbehavior. For markets to function well, the values discussed above must be accorded "intrinsic worth" by market participants. Put simply, we need at least a threshold number of executives and employees who often will act simply because "it is the right thing to do," and not because they believe they will make more money or help them escape legal penalties.

We ought not to be surprised by the key role played by intrinsic values in economic activity. In daily life we rightly prefer doing business with people who show independent concern for values. Think of integrity. If we believe that our lawyer or banker is constantly lying in wait, looking for the moment he can abandon integrity, and that he is routinely seeking the hidden moment when acting unscrupulously will fatten his advantage and decrease ours—while escaping legal penalties--then we suppose it is time to hire a new lawyer or banker. Most of us prefer doing business with a lawyer or banker who places intrinsic value on integrity.

The need for placing a value on integrity itself and for "doing the right thing *because* it's the right thing" has implications for the limits of law in correcting abuses. For example, the limits of law and regulation to cope with corporate ethics became obvious in

the twentieth century when consumers saw that regulation inevitably lags behind knowledge inside an industry. Governments were powerless to regulate successfully the use of asbestos because knowledge about its carcinogenic effects was known not by regulators, but by employees *inside* the industry. By the time the law caught up, it was too late. In the recent scandals, it was often a clever and complex financial arrangement, such as the "Raptor" entities of Enron, that bedazzled and cheated investors. MBAs and financial experts are trained to develop clever ways to make money. Some are ethical, some are not. But the law alone cannot be expected to anticipate each new creative financial design. Rather, society must rely, at least to some extent, on companies to use their creativity in a responsible way, and to act right because it is the right thing to do.

None of this is to say that we do not need new and tougher laws. As I will explain later, I think we do. But it is to clarify the contours of a broad solution to our current problems..

This brings us to the issue of how best to insure corporate integrity

3. The failure of current approaches:

. Unfortunately, many of the most popular recent corporate approaches to ethics are either failures or lukewarm successes. Corporate ethics programs were like hummingbirds in the 1950s. You didn't see one often and when you did it seemed too delicate to survive. Now, these curiosities have proved their sturdiness, flourishing and migrating steadily from their historical home in Europe and the US to Asia, Africa and Latin America. Most of the 500 largest corporations in the US now boast a code of ethics, and the proportion among a broader collection of US companies has risen to 80 per cent. Similarly, a recent study of FTSE 350 companies and non-quoted companies of equivalent size showed that 78 per cent of the responding companies had a code of conduct, compared with 57 per cent three years ago.

In 1991, US Federal Sentencing Guidelines offered companies a dramatic

incentive to develop formal schemes in the US. The guidelines promise reduced penalties for companies found guilty of criminal conduct as long as they meet requirements for compliance and ethics programs. In turn, compliance-oriented ethics programs, usually with designated ethics officers, have boomed. Both the Ethics Officers Association and the Defense Industry Ethics Initiative have hundreds of members and share best practice for establishing ethics offices, hot lines, code design, web pages and training programs. Most of the largest 200 companies in the US belong to one or both of these groups.

Unfortunately, no persuasive data exist establishing a correlation between having an ethics code, or even an ethics program, and lessoned pressure on executives to commit unethical acts or better ethical behavior. In fact, some studies show an upside-down correlation: that is, companies with codes and programs do worse, not better![1] I do not think this is because codes and ethics/compliance programs are worthless. In fact, when designed well, they play a critical role. The absence of a correlation, or the presence of even an upside-down correlation, is probably like the phenomenon of "where you have more doctors, you have more disease." Doctors do not *cause* the disease, rather they *follow* the disease. Similarly, when corporations have ethical troubles, their first response is usually to call in their lawyers and develop codes and compliance mechanisms. But their underlying habits of bad ethics may well persist.

Yet, this makes one thing clear. Codes and compliance programs are at best only first steps in successfully managing corporate ethics. We do well to remember the dazzling creativity of corporate slime. In the recent spate of Enron and WorldCom tragedies, every time it has been a new scam. If sleaze were less flexible; if corporate offenders tried the same scam again and again, then we could better design internal rules and external laws to cope with the problem. But smart people are too often smart enough to invent new ways to evade old rules.

[1] One exception, however, appears to be in the instance where a corporation has recently gone through a major restructuring or acquisition. In these instances, codes and programs appear to have a positive effect.

Enron, for example, has all the bells and whistles of a modern corporate ethics and compliance program. Employees could repeat the phrase, "RICE," (Respect, Integrity, Communication, and Excellence). They had wallet cards listing the company's published values and received a thick list of ethics rules (which managers signed each year.) I have a copy of a letter signed by Kenneth Lay in November of 2001 sent to the head of a large New York life insurance company. It says, in effect, we stand for the highest of ethical principles, and if you happen to see any unethical behavior, please contact our designated compliance officer. None of these ethics and compliance mechanisms came close to preventing the Enron implosion. Nor are such mechanisms relevant for most of the recent scandals.

The Corporate Criminal Sentencing Guidelines have backfired in many respects. They have resulted in a lessoned tendency to impose substantial fines on the corporate entity, and have lessoned the willingness of the government even to embark on litigation. My colleague, William Laufer at the Wharton School often talks of the phenomenon of "reverse whistle blowing." In the context of the Corporate Criminal Sentencing Guidelines, the government has often arranged to spare the corporate entity litigation in return for information that will implicate white collar criminals inside the organization. Hence, during the past six year the government has convicted more, not fewer, white collar criminals.[2] But notably, these white collar offenders have usually been "middle-class" managers, not managers at the top of the hierarchy who often deserve punishment even more. So the systems we have now, both inside corporations and in the government, aim *down* the corporate hierarchy, not *up*. Yet the current scandals have their locus far *up* that hierarchy. In corporate America, it's often more toxically joyful at the top.

This reflects what I call the "teflon top." As we have seen in the recent scandals, executives at the top can insulate themselves from blame by delegating responsibility to

[2] At the same time, mandatory drug sentencing resulted in more criminal convictions, with the result that the percentage of white collar criminals actually declined.

others and hence adopting a deniability posture, even as they put enormous pressure on executives to "hit the numbers" or "manage the numbers" in a way that encourages corporate crime.

The more important determinates of ethical behavior in a corporation are:

1. Reward systems,
2. Corporate culture,
3. Leadership example,
4. Institutional systems outside the corporation (including legal and regulatory systems).

It is a mistake to think our current problems are simply the product of a "few bad apples." Corporate Watergates typically involve scores and sometimes hundreds of people *inside* the corporation, and all too often, scores of people *outside* the corporation, i.e., in institutions such as accounting firms, investment banks, and law firms. The plain truth is that many of these thousands of people are not slime balls or bad apples but ordinary people under extraordinary pressures.

4. Recent changes that have challenged corporate integrity:

I believe the single most important change fueling the recent corporate scandals is the transformation of the compensation system for upper level executives that occurred during the last decade. We have moved quickly from a cash-based compensation system to a stock-based one. Good reasons exist for the change and for aligning executive pay better with corporate performance; but we must now pause and recognize that the game of executive motivation has forever changed. The temptations at the top are fixtures in a new and different world.

Over the past two decades I have talked with hundreds of corporate executives behind closed doors listening as they described their ethical challenges. During the past six years the tone of those conversations has shifted sharply. Increasingly, short-term

stock price pressures have assumed significance as the salient goal, and increasingly these executives' ethical pressures center on either the demands they must make, or the demands they must fulfill, to bolster short-term stock price. Studies reveal that the number one pressure on the ethics of corporate managers is the demand to hit numbers, and more broadly, to, make their company look good to the investment community. As we have seen recently, this pressure has overloaded many—with catastrophic consequences.

Once again, it is not a matter of a few bad apples or even a few bad companies. To be sure, the Enrons and WorldComs are gross exceptions, companies that lie on the outer periphery of ethical behavior. But commentators who say that 99% of corporations are honest and only 1% dishonest make a fundamental mistake. Their picture is too simple. Virtually all large, publicly traded corporations in the US today are confronted with temptations that are unprecedented in American corporate history. And many have made at least modest accommodations in the direction those temptations.

5. What government and business should be doing.

Without question, we should change the cost-benefit equation that fuels temptations in the executive suite. For this reason I support the Corporate and Criminal Fraud Accountability Act Ethics passed by this committee, which would create a new federal securities-fraud felony and give prosecutors better tools to pursue corporate executives. I also support measures being discussed elsewhere to place limits on the exercise of stock options that would align executive benefits more with long-term rather than short term equity values. And I support measures to strengthen the role and integrity of audit committees of corporate boards, especially ones that would tighten the connection between the CFO and the audit committee and, in turn, loosen it between the CFO and the CEO.

But when it comes to laws, even more important than new laws is doing a better job of enforcing ones we already have. This means giving more resources to the Justice Department, the FBI, the SEC, and other institutions charged with the duty of legal enforcement. We must also look once again at the prospect of holding entire corporations, and not merely individuals, accountable and financially liable.

Lastly, we must educate Americans, and especially current and future executives, about the importance of ethics. Part of this duty falls to elected representatives such as you. But much of it falls upon me and my colleagues, that is, professors in our nation's schools of business. These schools, the training grounds for tomorrow's executives, have the unavoidable duty of taking ethics seriously wherever it arises: in accounting, in marketing, in management, and in finance. Ethics is now nominally required as a part of the curriculum in accredited US schools of business, but too many schools take their responsibility lightly, relegating it to a "mention" or "add-on" and refusing to support the serious research without which business ethics simply becomes pleasant discussion.

Chuck Grassley

SENATOR GRASSLEY'S STATEMENT
SUBCOMMITTEE ON CRIME AND DRUGS
"PENALTIES FOR WHITE COLLAR OFFENDERS: ARE WE GETTING TOUGH ENOUGH"
JULY 10, 2002

Mr. Chairman, thank you for holding this second hearing on penalties for white collar offenders. The newspapers are full of stories of business executives violating the public's trust, falsifying records, obstructing justice, and taking multi-million dollar bonuses while the shareholders are left holding the bag. With the recent scandals at Rite-Aid, Worldcom, Global Crossing, and Enron, its entirely appropriate that we continue to focus our attention on this growing problem.

I appreciate the President's speech yesterday, introducing his Administration's new enforcement initiatives for corporate reform. I agree that we need to increase strict enforcement of criminal and securities laws and renew our commitment to higher business ethics

standards. President Bush said it well, "It is time to reaffirm the basic principles and rules that make capitalism work: truthful books and honest people, and well enforced laws against fraud and corruption."

Mr. Chairman, our prior hearing on this subject answered many questions and presented some new ones, so it's good that we are having this hearing today to get even more information. In the last hearing, we looked into how we punish white collar offenders, many of whom defraud pension and investment funds. Since strong criminal penalties serve to deter future crime, we asked the question, "Are white collar criminals punished less severely than other criminals?"

Many legal scholars and others believe that white collar offenders are rarely prosecuted. According to one professor, it is even rare that these offenders are charged with a crime. If that's true, we need to discuss why that is and what we can do about it.

In those cases where white collar offenders are prosecuted and convicted, many argue that they receive lighter penalties for their crimes. And when incarcerated, they do less time in prison than other criminals.

A message needs to be sent that white collar crime, especially as it relates to fraud, is serious and carries significant penalties. This is an area where we need to be even tougher on criminals.

President Bush has created a new Corporate Fraud Task Force at the Department of Justice. I'm not sure how this "financial crimes SWAT team" will function, but I'm interested in learning more about the role it will play in enforcing federal white collar crimes. I hope the Justice Department witnesses will speak about this in their testimony.

I'm glad that Mr. George Terwilliger could be with us today. During fifteen years of public service, Mr. Terwilliger developed a significant expertise in the area of

white collar crime prosecution. He served as the Deputy Attorney General of the United States (the second highest ranking official in the Department of Justice), where he was in a position to craft policy on white collar crime enforcement during the first Bush Administration. He also gained tremendous experience as a United States Attorney and Assistant US Attorney prosecuting white collar criminals. I'm sure Mr. Terwilliger will have a great deal to add to today's discussion on the enforcement of white collar crimes.

In addition to enhancing criminal penalties for white collar crime, we also need to look at problems in accounting standards and business ethics systems. President Bush proposed a "10-point Accountability Plan for American Business" that I look forward to reviewing. Business executives should not benefit from the lies they tell on their accounting forms and any fraudulent gain they realize should be taken from them. There needs to be a revival of business ethics in today's corporate world.

We also need to investigate what other mechanisms exist to protect investors from fraud. Some have advocated investor education as a method to protect investors. The Securities Exchange Commission has created a program just for that purpose.

One important way to protect investors is to ensure corporate whistleblowers that they will be protected from retaliation when they go public with knowledge of fraud in the corporate world.

For nearly two decades, I've learned from, appreciated and honored whistleblowers. Throughout all my oversight investigations over the years, whistleblowers have been the key, whether it was uncovering $700 toilet seats at the Defense Department, bad science at the FBI crime lab or the failure to prosecute millions of dollars in contract fraud. Documents alone will not give you sufficient information about a dysfunctional bureaucracy. Only whistleblowers can explain *why* something is wrong and provide the best

evidence to prove it. Then we can fix the problem and hold the miscreants responsible. Only whistleblowers can help us understand the *culture* that produces wrongful behavior. Understanding the *culture* is the key to fixing the problem and realizing meaningful institutional reform. In that regard, whistleblowers are national assets.

In the context of corporate wrongdoing, whistleblowers provide the evidence that prosecutors need to build a case against corporate criminals. Without these brave men and women, prosecutors would lack an important tool in their efforts to curb corporate fraud.

It is for these reasons that I have worked to provide protections for corporate whistleblowers as well as federal whistleblowers who are retaliated against for exposing fraud, waste, and abuse.

Because whistleblowers are so important to cracking down on corporate fraud, I asked Mr. Tom Devine from the

Government Accountability Project (GAP) to testify today about the contributions of corporate whistleblowers and how they can be protected. Through his work with GAP, Mr. Devine has directly represented, diagnosed, or supervised over 1,500 cases of government or corporate whistleblowers. He has served as a key advisor to members of the Congress, including myself, on a majority of the whistleblower legislation considered in the last twenty years. He worked on the critical 1989 and 1994 Whistleblower Protection Act amendments, and most recently, he assisted Senator Leahy and me on the whistleblower amendment to the Corporate and Criminal Fraud Act of 2002 (S.2010). Mr. Devine's testimony today will describe a very important weapon in the fight against corporate fraud.

I look forward to hearing all of today's testimony. Mr. Chairman, thank you again for holding this timely hearing.

Statement of Senator Orrin G. Hatch
Ranking Republican Member
Before the Senate Committee on the Judiciary
Subcommittee on Crime and Drugs
Hearing on "Penalties for White Collar Crime: Are We Really Getting Tough on Crime"
July 10, 2002

Mr. Chairman, thank you for scheduling another hearing to review the adequacy of current penalties for white-collar criminal offenses. All of us well know that the past few months have been painful ones for our nation's financial markets. At least some of the blame can be laid at the doors of some multi-billion dollar corporations, their highly paid top executives, and the accounting firms who were supposed to assure the public's trust. We learn – each week, it seems – of more and more accounting and corporate irregularities that have caused billions in losses to innocent investors. I am personally outraged by these scandals. It is time for us to take a hard look at the penalties associated with all types of white collar offenses, from accounting violations to bankruptcy and securities fraud.

President Bush yesterday outlined a number of proposals to toughen our corporate fraud laws. Many of his proposals make a great deal of sense; I am considering all of them very carefully. Earlier this year, I sponsored legislation with Senator Leahy that directs the United States Sentencing Commission to review whether the criminal penalties for a number of fraud, obstruction of justice, and corporate misconduct should be increased. But I am committed to doing even more on this subject. A person who steals, defrauds or otherwise deprives unsuspecting Americans of their life savings – no less than any other criminal – should be held accountable under our system of justice for the full weight of the harm that he has caused. The so-called "white collar" criminal should find no soft spots in our laws or in their ultimate sentences.

I am thankful to the Chairman for scheduling this hearing, and look forward to hearing from the highly knowledgeable witnesses who we are fortunate to have here today.

U.S. SENATOR PATRICK LEAHY

CONTACT: David Carle, 202-224-3693 VERMONT

Statement of Senator Patrick J. Leahy
Chairman of the Committee on the Judiciary
For Hearing of Crime Subcommittee
"Penalties for White Collar Crime: Are We Really Getting Tough on Crime?"
July 10, 2002: 2:30 p.m.: SD-226

I want to commend Senator Biden for holding this important hearing. As the Chairman of the Crime and Drugs Subcommittee of the Judiciary Committee he has played a leading role in examining many important criminal law issues. The inadequacy of current statutes and sentences available in white collar cases is one of the most important issues facing our country now. Americans must know that criminals – even those in fancy collars -- will be held accountable for their misconduct.

We cannot have a system where a pickpocket who steals $50 dollars faces more jail time than a CEO who steals $50 million. The integrity of our judicial system depends on accountability. In addition, the mounting scandals and declining stock market have demonstrated, the integrity of our public markets depends on the same accountability.

Indeed, as Senator Biden holds this hearing, the Senate is debating import reform legislation designed to increase the transparency and accountability of our public markets. The Sarbanes bill represents a major reform effort designed to restore the confidence of the American public in the honesty and integrity of our financial system.

As part of that debate, I have been joined by a bipartisan group of Senators including Senator McCain, the Majority Leader, and Members of the Judiciary Committee from both parties, including Senator Brownback, Senator Durbin, Senator Kennedy, Senator Schumer and Senator Edwards, in introducing the provisions of S. 2010, the Corporate and Criminal Fraud Accountability Act, as it was *unanimously* reported out of the Judiciary Committee in April as an amendment to the Sarbanes bill. Senator Biden is a cosponsor of both the underlying bill and the Leahy floor amendment, and these hearings are an important part of his continued attention to white collar crime enforcement. We need to examine all of our laws to ensure they are equal to the new challenges facing law enforcement and our markets.

Enron has become a symbol for the torrent of corporate fraud scandals that have hit the front pages and battered our financial markets. Tyco, Xerox, WorldCom, Adelphia, Global Crossings – the list goes on. But for those who think we are talking about only a few bad apples, its worth reminding about what actually happened at Enron.

senator_leahy@leahy.senate.gov
http://leahy.senate.gov/

The things that happened at Enron did not happen by mistake. They were not the result of one or two "bad apples." *Senior* management at Enron, assisted by an army of accountants and lawyers spun an intricate web of deceit. Setting up partnerships with names like "Chewco" and "Jedi" and "Rawhide" they engaged in a *systematic fraud* that allowed them to secretly take hundreds of millions of dollars out of the company.

This kind of fraud is not the work of a lone fraud artist. Rather it is symptomatic of a corporate culture where greed has been inflated and honesty devalued.

Unfortunately, as I have said and as the experts warned at our February 6 hearing, Enron does not appear to have been alone. Each week we read of another corporation that has engaged in misconduct – and these are not small or marginal corporations. These are major mainstays of corporate America. The web of deceit woven by such publicly traded companies ensnares and victimizes the entire investing public who depend on the transparency and integrity of our markets for everything from their retirement nest eggs to their children's college. That is why comprehensive and systemic reform is urgently needed to restore accountability in our markets.

The Leahy-McCain amendment pending on the Senate floor, which is identical to S.2010 as unanimously reported out of the Judiciary Committee in April, provides just such accountability. The Corporate and Criminal Fraud Accountability Act provides tough new criminal penalties to restore accountability and transparency in our markets. It accomplishes this in three ways:

1. Punishing criminals who commit fraud,
2. Preserving evidence to prove fraud, and
3. Protecting victims of fraud.

Here are some of its major provisions:

- It establishes a new crime of securities fraud, with a tough ten year jail sentence.
- It breaks the "corporate code of silence" by providing, for the first time, federal protection for corporate whistleblowers who report fraud to the authorities or testify at trial.
- It closes loopholes and toughens penalties for shredding documents as we saw at Arthur Andersen.
- It requires audit documents to be preserved for 5 years and provides tough criminal penalties for their destruction.
- It protects victims' rights to recoup their losses by preventing fraud artists from hiding in bankruptcy or concealing their crime and using an unfair statute of limitations to hide.

This bill is going to send wrongdoers to jail and save documents from the shredder, and that sends a powerful and clear message to potential wrongdoers – "don't do it." As a former prosecutor, I have discovered that nothing focuses attention to morality like the prospect of a long prison sentence.

In the Senate, as we have been debating and shaping specific and comprehensive reform

proposals, we had been trying for months -- unsuccessfully -- to get the President's support and input. We have been holding hearings, like this one, and shaping bipartisan and comprehensive reform proposals. The Administration had stayed on the sidelines during this important debate. In fact, last week the Majority Leader and I wrote to the President asking him to support the bipartisan Sarbanes and Leahy bills that had received bipartisan support in Committee and were actually about to be debated on the Senate floor.

For whatever reason -- perhaps the mounting scandals or the declining market – the President decided yesterday to speak out against corporate fraud. I *welcome* his participation and hope that he will follow up his speech by supporting real reform.

As the President was speaking, we were acting by considering the Sarbanes bill and the Leahy bill – two measures which provide a comprehensive reform effort designed to restore confidence in our markets. Although I now understand that a White House official reportedly said that they agreed with the "goals" of these reform bills, I was disappointed that the President has not yet taken the opportunity to support these bipartisan measures pending before the Senate.

Supporting the "goals" is a good first step – but it is a baby step. For those of us in the Senate, like myself, Senator Sarbanes, Senator McCain, the Majority Leader, Senator Biden and others who have worked hard to come up with specific and bipartisan reform proposals, the "goals" have been clear for a long time. It is now time for comprehensive action. I am quite sure that we could accomplish comprehensive reform without further delay, if only the White House would be willing to provide a clear statement of support for the pending, bipartisan Sarbanes and Leahy proposals and communicate to their Republican colleagues in the Senate and the House of Representatives.

While the President's speech was short on details, some of it did sound familiar to those of us on the Judiciary Committee, which unanimously reported my bill, the Corporate and Criminal fraud Accountability Act.

Three of the President's proposals are found in S. 2010 and the Leahy-McCain amendment.

1. The President advocates for strengthening the laws punishing document shredding and obstruction of justice. That is in our bill.
2. The President wants the Sentencing Commission to raise penalties for corporate misconduct. That is in our bill.
3. The President wants the Sentencing Commission to raise the penalties for the existing fraud laws. That is in our bill as well.

I am glad the President has adopted three proposals from our bill, even if he will only say that he supports the "goals." Unfortunately, the President's proposal fails to include many of the important provisions in the bipartisan Leahy amendment.

- It fails to create a new crime to punish securities fraud to directly punish people like Ken Lay.

- It fails to provide whistleblowers with protection that will break the corporate code of silence. Remember, you can put whatever criminal laws you want on the books – but unless there are witnesses who are not scared to help prosecutors prove what happened no one will be held accountable.

- It fails to protect victims of fraud recover their losses from a fraud artist who declares bankruptcy.

- It fails to establish a realistic statute of limitations to allow victims to recoup their losses when a fraud artist can manage to conceal his crimes for long enough. A change that has received strong bipartisan support dating back to the SEC under *former* President Bush.

As I said, I was glad to hear the President finally join this reform debate. But now is not the time for half measures. We need *comprehensive* action. If the Administration has specific legislative proposals, I am sure we would be glad to consider them, but we need to get them first.

I hope that the President will support such comprehensive reform as is fund in the Sarbanes and Leahy bills. I hope that his rhetoric is backed by action and that his generalities are backed with specifics. As he once noted, reform is worth little without "results." The Leahy-McCain amendment provides such "results," as does the Sarbanes bill.

I hope that the President will support the bill's provisions as it moves forward to conference and will appeal to the Republican House not to water it down. That will be the true test of his resolve to restore accountability to our markets.

It is time for action – decisive and comprehensive action that will restore confidence and accountability in our public markets and for the millions of small investors whose economic security, retirement security and investment security have been threatened and who have lost so much to the corporate accounting and mismanagement scandals that dominate today's headlines. We need comprehensive action. The Leahy-McCain amendment on Corporate and Criminal Fraud Accountability Act, which was reported *unanimously* by the Judiciary Committee on April 25 provides such action.

Let's give Americans their markets back.

Statement of

GEORGE J. TERWILLIGER III

Before

Committee on the Judiciary

Subcommittee on Crime and Drugs

United States Senate

Washington, D.C.
July 10, 2002

Mr. Chairman, Senator Grassley, members of the Subcommittee. I was a federal prosecutor for 15 years. Today, I am in the private practice of law at an international firm, regularly representing corporations and other institutions involved in government investigations, enforcement proceedings and, sometimes, prosecutions. While today I have the privilege of helping clients understand and address business enforcement issues, I also cherished my role as an Assistant U.S. Attorney, as a United States Attorney and finally as Deputy Attorney General, the number two official at the Department of Justice. I vigorously prosecuted white-collar criminals, including leading the team that secured the guilty plea and record forfeiture in the BCCI case. While U.S. Attorney in Vermont I tried a case against two local bank presidents, one very popular. They abused positions of trust and went to jail. I accepted your invitation to be here today because I believe it essential that the loss of faith in business be remedied, but I fear that we are in danger of overreacting in response.

A crisis is emerging in connection with one of the most fundamental prerequisites to our economic well-being: investor confidence in the capital markets. Extensive securities laws, regulations and a well-respected government agency all are dedicated to securing investor confidence, and for good reason. Without such confidence, our economic engine will be starved for fuel. Because the matter of confidence in financial reporting is so fundamental and sensitive, steps taken to address it should be carefully considered and measured. In considering new laws, procedures and increased penalties, we should seek, first, to do no harm. Also, with all due respect for the value of public discussion, I do not think it helpful for the discourse to generally vilify corporations and their leadership because some of their number have not observed sound financial and legal compliance practices. This may apply to more companies than any of us would wish, but we should bear in mind that they remain a minority whose impact can be dangerously overblown. Most business leaders are honest, law abiding and faithful to their duties to secure the interests of their stockholders. Many are aggressive, and rightly so. A few are crooks. Now, however, the many bear the burdens created by those few.

Financial accounting and reporting is not always an exact science. Experts can and do disagree about how items should be treated. These disagreements and uncertainties, though, are different than the intentional exploitation of fuzzy lines to perpetrate a fraud. In the context of financial reporting, a fraud means that investors and regulators are intentionally deceived about a company's financial performance, not simply that experts disagree about how that performance should be reported. Truly corrupt business practices deserve sanctions. But I believe that

we need to be very careful about whom, and more importantly what, we sanction. Corporations and other business entities provide the jobs that give Americans an unparalleled standard of living and that fuel the crucial consumer sector of our economy.

Individuals who engage in intentionally corrupt financial practices or reporting betray their duty to the entity that employs them, their responsibilities to shareholders and their obligations under the law. Unlike these real persons, corporations and other business entities can neither think nor act for themselves. Thus, while individuals can and do form the corrupt intent that defines criminal behavior, to ascribe criminal intent to a corporation is a judicially created legal fiction endorsed by the Supreme Court in 1909. Even though legally permissible, sanctioning a corporation for a crime may be less effective than some alternatives in influencing positive corporate behavior.

As to defining new crimes or providing greater sanctions, I would simply observe that just four offenses, the crimes of False Statement to a government agency (18 U.S.C. 1001), Conspiracy to Defraud the United States (18 U.S.C. 371), Fraud by Mail and Wire (18 U.S.C. 1341, 1343) and Money Laundering (18 U.S.C. 1956) provide by themselves ample tools with which prosecutors can address commercial crime. Under the Sentencing Guidelines, the penalties for these offenses can be quite severe where the economic impact of the criminal activity is substantial. I really do not believe that either new crimes or increased penalties will solve our problems. In fact, in the real world, excessive exposure to draconian sanctions in economic crime cases has the potential to discourage meaningful corporate critical self-examination, as well as disclosure, cooperation and guilty pleas by individuals and companies.

As initiatives are considered, reviewing relevant and fundamental precepts of our constitutional system can provide invaluable guidance. It is, for example, helpful to recall that a core function of the federal establishment is to promote and secure the benefits of commerce to the people. In harmony with this purpose, for over two hundred years the federal criminal law applicable to commercial activity was aimed at protecting the means and instrumentalities of commerce. These instrumentalities evolved over time and the law evolved with them. Federal criminal law has traditionally protected the means of commerce, such as the mails, wires and today, the Internet, and the instrumentalities of commerce, such as financial institutions and transportation.

Capital and credit markets are obviously key means and instrumentalities of commerce and protecting them from corrupt practices is consistent with this core

federal role. The question is how best to do that. It seems to me that the answer is not to reflexively create new offenses or impose greater sanctions. Rather, it may be more efficacious to seek a balance, including incentives for good corporate practices, correction and reform of questionable practices and effective sanctions for truly corrupt practices.

There are alternatives to corporate criminal prosecutions that can help to restore and maintain confidence in our companies and our financial systems.

First, corporations themselves need to do more to promote confidence in their performance and their financial reporting. Steps include more active internal oversight, including through board audit committees. Internal auditors and audit committees can be highly effective inside watchdogs that spot issues or concerns and see to it that they are resolved. It is better to have financial reporting that gets it right the first time. Likewise, corporate legal officers and auditors should be not merely empowered, but encouraged and provided the resources, to proactively investigate internal malfeasance. This is not only good public policy, but also has significant value in protecting a corporation from the considerable risks attendant to unaddressed and ongoing internal wrongdoing.

The government can do much to encourage critical self-examination by corporations and other business entities. Real incentives, rather than just rhetorical ones, should attach to voluntary correction and disclosure of wrongdoing. Most attorneys advising companies today are forced to conclude that the benefits of such disclosures are insufficient to outweigh the risks attendant to them. For example, even a limited waiver of attorney client privilege requested by prosecutors can result in a complete loss of privilege in related civil proceedings. Congress could consider a statute making limited waiver agreements enforceable against third parties. As a matter of prosecutorial policy, business entities that make timely disclosure of wrongdoing might enjoy a presumption against criminal prosecution.

In regard to financial accounting and reporting, business, the accounting profession and government might work together to identify "best practices" and companies could be recognized and rewarded for using them. Such a program has the potential to identify companies that utilize sound and reliable financial reporting practices, in contrast to only singling out those who do otherwise.

There are also alternative sanctions for individuals that seem to me worth considering. For example, expanding the availability of discretionary debarment of individuals from serving in positions of trust, including high level corporate responsibility, may both serve as a powerful deterrent to individual wrongdoing

and an assurance to investors and regulators that those who have abused a position of trust will be incapacitated from doing so again. Taking the profit out of white-collar offenses by disgorgement of all ill-gotten gains is also a worthwhile goal. Measures such as these can change the economic calculus for those tempted by opportunities for fraud or other conduct inconsistent with probity in business affairs.

I do not advocate going lightly on real cheats and crooks. A dishonest market is not a free market. But we also must work to discriminate between conduct that merits the harshest sanctions and that which can be addressed more effectively through alternate means. Because facilitating commerce is a core federal responsibility, we should police the marketplace judiciously, utilizing good judgment and discretion in establishing and assessing sanctions for commercial misconduct.

Thank you.

GEORGE J. TERWILLIGER III

George Terwilliger is a partner in the Washington, D.C. office of White & Case LLP, an international law firm. Mr. Terwilliger primarily represents institutional clients in dealings with the United States government. These include government investigations and enforcement proceedings, as well as trial and appellate litigation. He is a veteran litigator with over fifty jury trials and many appearances and arguments in appellate cases.

During fifteen years of public service, Mr. Terwilliger was the Deputy Attorney General of the United States (1991-92), the second ranking official in the Department of Justice. He also served as United States Attorney in Vermont (1986-91) and as Assistant United States Attorney in Washington, D.C. and Vermont (1978-86).

In private practice, Mr. Terwilliger has represented many international and other large companies facing government inquiries and in other public policy matters. He has also represented prominent individuals, including public officials and media personalities. He was a leader on the legal team that represented President Bush and Vice President Cheney in the Florida recount of the 2000 Presidential election.

RESUME

GEORGE J. TERWILLIGER III

LEGAL EXPERIENCE

Private Practice

Partner, White & Case LLP *(May 2000 – Present)*

Partner, McGuire, Woods, Battle & Boothe LLP *(February 1993 – May 2000)*

Public Service

Deputy Attorney General of the United States *(September 1991 – January 1993)*

Principal Associate Deputy Attorney General *(June 1990 – September 1991)*

United States Attorney for the District of Vermont *(October 1986 – September 1991)*

Assistant United States Attorney, Vermont *(1981 – 1986)*

Assistant United States Attorney, District of Columbia *(1978 – 1981)*

EDUCATION

B.A. Seton Hall University *(1973)*
J.D. Antioch Law School *(1978)*

BAR MEMBERSHIPS

District of Columbia; Vermont; U.S. District Courts for the District of Columbia, Vermont, Maryland, Eastern District of Virginia and Southern District of Florida; U.S. Courts of Appeals for the Second, Fourth and District of Columbia Circuits; U.S. Tax Court; U.S. Supreme Court.

ENSURING CORPORATE RESPONSIBILITY: USING CRIMINAL SANCTIONS TO DETER WRONGDOING

WEDNESDAY, JULY 24, 2002

UNITED STATES SENATE,
SUBCOMMITTEE ON CRIME AND DRUGS,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:39 p.m., in room SD–226, Dirksen Senate Office Building, Hon. Joseph R. Biden, Jr., Chairman of the Subcommittee, presiding.

Present: Senator Biden.

OPENING STATEMENT OF HON. JOSEPH R. BIDEN, JR., A U.S. SENATOR FROM THE STATE OF DELAWARE

Chairman BIDEN. I want to thank you for being here, number one. Number two, I apologize for being a few minutes late. We just got finished voting on an issue and some of my colleagues will be coming in late. I have a relatively brief opening statement, after which I will turn to our witnesses.

I would like to welcome you all to the third in a series of hearings I am holding on white collar crime and the adequacy, or shall I say the inadequacy of penalties for white collar offenses.

Way before the truly mind-boggling events of WorldCom, we were exploring this question of corporate responsibility and the extent to which so called white collar crime offenders should be held accountable in the criminal justice system. Embarrassingly, it is a question that has for years evaded this body, the courts, and the overall criminal justice system.

I say embarrassingly because the answer to the question strikes me as painfully obvious. Of course, white collar criminals should be treated as harshly under the law as petty thieves or drug dealers. Yet, our policy prescriptions have been muddled. Indeed, the institutions that oversee crime policy, including the U.S. Congress, have been a bit schizophrenic on this issue.

I have been deeply troubled, as all of us have been, by recent events in corporate America. Even more disturbing has been the impact these scandals have had on investor confidence and this country's economic well-being, at least for the moment.

In concert with an already sagging economy, allegations of corporate malfeasance have resulted in plummeting stock prices, a drop in consumer confidence and consumer spending, and rising unemployment in an otherwise stable economy. With about 60 per-

cent of all American households invested in the stock market, we have become a nation of investors, and if we are unable to preserve investors' confidence, the markets will continue to plunge, and with them the health of our economy.

Today, we will address these questions in light of Congress' ongoing effort to pass accounting reform legislation and the real-world spiral we are now witnessing. There are three things I think we have to do immediately: first, toughen in a rational way criminal penalties. As I mentioned, Senator Hatch and I secured passage of a bipartisan amendment that passed without a dissenting vote in the Sarbanes accounting bill that would enhance the underlying criminal penalties for fraud, for conspiracies to commit certain white collar crimes, and for violations of pension protection measures.

Most significantly, our amendment also includes a provision that imposes criminal penalties on top corporate officials who lie about their company's financial health. Should we expect anything less than accurate financial statements from corporate officials?

Let me be clear. The legislation we passed and is being mulled around in conference now would not hold any corporate executive or chairman of the board liable for negligence. It would only hold them liable if it were proven beyond a reasonable doubt in a court of law that they knowingly and/or willfully misled the SEC.

That is why Federal Reserve Board Chairman Alan Greenspan last week testified before the Senate Banking Committee that imposing criminal sanctions on CEOs who knowingly misrepresent the financial health of their companies is the key to real reform in corporate wrongdoing.

The second thing we must do is insist on more transparency. I won't belabor the point, given our recent and extensive debate on accounting reform, but suffice it to say that we need truth in auditing and truth in accounting. Top executives must be compelled to provide investors with clear, accurate financial information. If they don't, they should be held accountable. And if they don't and they are not confident of it, investors might as well go play the lottery as invest in stock.

The third and final thing we need to do is enable citizen suits. I may be in the minority on this view. I was one of a handful of Senators to vote against the so-called Private Securities Litigation Reform Act of 1995, which was ultimately enacted over President Clinton's veto. I opposed this anti-investor bill because it severely restricts the ability of defrauded investors to recover their hard-earned dollars.

What we are seeing today in the form of corporate abuse, in my view, is the quintessential chicken coming home to roost. I know I won't win many friends by saying this, but we are beginning to see the true consequences of this anti-investor provision included in the 1996 legislation. And if we are serious about ensuring corporate responsibility, we need to make sure that defrauded investors are able to bring legitimate suits to hold corporate wrongdoers accountable and to recover their losses.

Finally, I believe that in the accounting reform legislation, which is in the House–Senate conference this week as we speak and includes the bipartisan Biden–Hatch amendment, it is important to

step up to these problems. I hope we will soon get a bill that preserves fundamental reform initiatives and invites the President's signature.

We have assembled here today a truly blue ribbon panel of witnesses. I am not suggesting by my opening statement that they agree with anything that I had to say, but they will have their own opening statements and I am eager to hear our witnesses.

G. William Miller is the chairman of the merchant banking firm of G. William Miller and Company. He has a wealth of experience both in government and in business. Mr. Miller was Chairman of the Federal Reserve Board from 1978 to 1979.

That is when I first met you, Mr. Chairman.

He served as Treasury Secretary under President Carter from 1979 to 1981. Secretary Miller is also a businessman who rose through the ranks of Textron to become the Chairman and CEO, and now runs his own company. We look very much forward to his statement.

I would also like to welcome Roderick M. Hills, another distinguished member of our panel. He was Counsel to the President and Chairman of the Securities and Exchange Commission under President Ford, who, by the way, is one of the finest guys I ever served with. He currently serves on the board of directors of three corporations. In addition, Mr. Hills has served on the boards of 16 corporations. In 13 of those positions, he was a member of the audit committee, responsible for ensuring that no one was cooking the books. We look forward to hearing his comments.

Mr. JAMES R. Doty is a partner in the law firm of Baker Botts, LLP, and is head of the corporate and securities practice there. He was a former General Counsel of the Securities and Exchange Commission between May of 1990 and December of 1992. He is a graduate of Yale School Law, which is the only thing I hold against him, and has written a number of articles regarding securities legislation. We are glad to have him here.

My son is a graduate of Yale Law School and I point out to him, having graduated from Syracuse Law School, that he really didn't attend a law school. It happens to be the number one rated law school in America, but we refuse to acknowledge that in my household.

Mr. DOTY. Many people agree with you, Senator.

Chairman BIDEN. His brother went to Syracuse, as well, but my son responds that it takes two Syracuse law degrees to equal one Yale law degree. So I don't know what the story is here.

I thank you all for being here, gentlemen, and I can't tell you how much I am looking forward to your testimony because of the wealth of experience you all bring to the table.

Maybe, Mr. Secretary, if we could begin in the order that you were called, I would welcome your comments and then maybe we can have a discussion.

Secretary Miller?

STATEMENT OF G. WILLIAM MILLER, FORMER SECRETARY OF THE TREASURY, FORMER CHAIRMAN OF THE FEDERAL RESERVE BOARD, AND CHAIRMAN, G. WILLIAM MILLER AND COMPANY, WASHINGTON, D.C.

Mr. MILLER. Mr. Chairman, thank you very much. It is a pleasure to be here and I appreciate the opportunity to comment because the subject that you are addressing is obviously enormously important to our economy and to the well-being of the American people.

Momentous events have occurred in the last year. 9/11 certainly exposed us to a foreign threat of unprecedented magnitude and unknown sources of danger to our country. But the parallel threat from what is happening through the breakdown in corporate accountability and responsibility is equally a threat, a domestic threat to our well-being.

There have been corporate and business crises before. This, of course, is of unusual magnitude, not in just the number of companies that have been in trouble, but also the amount of values that have been destroyed. Not only have the savings and hopes of the employees and families of these companies been impacted, but the loss of capital values since Enron announced bankruptcy has exceeded the gross national product of any country in the world other than the United States.

Chairman BIDEN. I never thought of it in those terms. That is kind of staggering when you think of it in those terms.

Mr. MILLER. It is an amazing destruction of values that has occurred. And while, yes, we have had difficulties in the past, that is certainly something that brings the issue home and focuses our minds, all of us, on the importance of seeing why this has happened and how we can assure that it will never happens again.

It is not possible to legislate honesty, but any civilized society will want to have rules of law that deter criminal activity and protect society against dishonesty that can have even minor impacts, not to mention the huge impacts that we have seen recently.

I just want to note, however, that my testimony is not based on my experience in criminal law, in which I have little experience. My testimony is based upon my corporate management experience and my Government experience, and it is in that context that I would like to give you my thoughts.

The Federal Government's response to this crisis has been remarkably swift and comprehensive. Even a few months ago it was very much doubted that the Congress could act so quickly to bring into control a situation that seemed to demand action. The fact that the House and the Senate could pass comprehensive legislation so quickly is quite impressive.

I understand that the conference committee on the two bills was able to reach agreement today, so we will soon see what the structure of the final proposals will look like. We not only have the congressional action, but, of course, the SEC has responded with its own proposals and the President has put forth his plan.

Your subcommittee has had a good deal of testimony about the nature and the characteristics of white collar crime. So I don't want to dwell too much on it, but it is an area that has its own degree of difficulties.

Quite often, white collar crimes are committed by people of above-average education and above-average intelligence who stand in legitimate roles in society and have the capacity to use deception and stealth to carry out their plans with remarkable effectiveness. It is hard to ferret them out, and it is hard often to prosecute them because they can obscure the facts so easily.

As a consequence, this inherent charactristic makes it very difficult to know how to apply the deterrent effect that you are seeking through your amendment to be sure that corporate responsibility is assured.

Financial accounting, which has been the root of much of this problem, is a field that involves many estimates and judgment. As a result, it offers an opportunity to disguise misrepresentation because there are so many elements that can be hard to understand or to comprehend.

Corporate structures also are becoming very complex. Most companies now are not confined to a single-product line. They have multi-product lines. They have operations in many areas. They have global facilities. They have transactions in foreign currencies. They operate under different business ethics in different parts of the world. So it is very easy, if there is a desire to misrepresent, to obscure and hide. So it is a very difficult task to identify and assess blame.

So it makes sense that your subcommittee and the Congress and the Government should be focusing on how to have maximum emphasis on deterring the crime before it is committed rather than trying to penetrate this very difficult system.

The question is how can you use criminal sanctions to deter the wrongdoing. How do you establish a system of punishment and a belief not only that a crime will be detected, but also that there will be swift and effective punishment? How do you make the punishment fit the crime?

In the white collar area, and certainly in the corporate area, there probably has been a sense that detection was not likely and that if detection were made that the threat of punishment was limited and might even be nominal.

So there is going to be success in creating deterrence through criminal sanctions only if there is a belief by potential white collar criminals that there is a high likelihood of detection and a high probability that, if detected, there will be serious punishment.

The most powerful deterrent in this field, as in many, is jail time. That is a threat that people understand. For business criminals, money is also important, but there is nothing that is more effective than the expectation of spending time in prison.

There has been some progress recently in strengthening the criminal sanctions for white collar crimes, and the Biden–Hatch amendment that you have proposed goes further in trying to accomplish that to strengthen and to introduce an element of accountability through requiring the certification of corporate reports.

With respect to the criminal penalties that have been proposed in the amendment, I find them to be rather rational and appropriate. They seem to be harmonizing, and as you have pointed out, they are trying to make the criminal sanctions for white collar

crimes comparable to the sanctions that would apply to other kinds of crime. In that respect, I think the amendment is right on target.

The other element of the amendment, the concept of requiring certification by the senior officers of the financial statements, is one that is being widely discussed. It is clear from what has happened that there may have been a breakdown in accountability for corporate misrepresentation and wrongdoing.

While I would have thought that deliberately misrepresenting financial statements would already be a criminal offense, the amendment makes it explicitly so, and therefore strengthens and focuses clearly on this element of white collar crime. The number of meltdowns makes it clear that accountability needs to be in place, and the idea of getting these certificates is one way to get the hook on for accountability and to assign specific responsibility with a serious sanction for violation.

The proposal is logical in that sense, but as I understand it, it recognizes that senior officers—CEOs, CFOs, chairmen—cannot personally audit the books of a complex company. There is no way they can do that. Thousands and thousands of hours are spent auditing a complex company.

So one would expect that the intent of this particular requirement would be that these officers exercise due diligence, that they make proper investigation, they hire honest people, they supervise them properly, and they involve themselves in making sure that procedures are in place to assure that the statements are correct. And I assume that is the context in which this is presented. In that sense, I believe that the proposal will be a positive contribution to increasing the deterrent effect of the criminal justice system on these misbehaviors.

A couple of comments I would make, however. One is that the amendment specifically calls out three officers or their equivalent. There are many companies that have chairmen who are non-executive. My personal experience is that non-executive chairmen do not have the time or the responsibility to have the intimate knowledge of a company that a full-time executive would have.

It would seem to me you might want to limit this to people who are really full-time executives—the CEO, obviously; the CFO, obviously. If the chairman is, in fact, a full-time officer, yes, but that element might be reconsidered.

Also, I would imagine, as you pointed out, that in the criminal system what is needed is to be sure that we do not make it criminal to have inadvertent error, so that it would be a case where criminality here would relate to deliberate or intentional or knowing misrepresentation, which I believe should already be a crime. But it is better if this is spelled out very specifically.

When it comes to sanctions, I believe that no amount of potential criminal punishment will be effective as a deterrent if the perpetrator believes that punishment will never be applied. Therefore, one might conclude has to say that having sanctions is not enough. One must have the will, the commitment, and the resources to prosecute and to convict. Without that, the deterrent effect is not there.

I want to point out a lesson from history that I think demonstrates this. It seemed to me that early in my business career that there was somewhat a loose attitude toward enforcement of

the antitrust laws, until some senior executives of a major company were sent to jail. As soon as they were sent to jail, the whole attitude about enforcing antitrust laws changed.

In other words, it wasn't the law that changed. What changed was the enforcement, and when the enforcement changed so that executives understood that they could end up in prison, suddenly all corporations adopted antitrust compliance into their ethics standards. They started holding seminars. Their attorneys were required to educate their people.

So it is important here not only to see that we have sanctions, but to see that the law enforcement agencies, the SEC and the Department of Justice, have the resources to follow up and enforce. The impression has been that the SEC has been underfunded in this, and it is encouraging to see that Congress is addressing this and is beginning to increase the human and financial resources that are needed to follow up and to create a real belief that the sanctions are not simply passive, but they are ones that will be enforced and will create a threat to the personal well-being of the perpetrator.

Let me conclude just briefly by saying that in this particular kind of crisis we should not forget that, as bad as the situation is, the great majority of American businesses are managed responsibly and they contribute enormously to the economic system that has created in the United States the most prosperous society in the history of the world.

As we look to increase sanctions and increase enforcement, we must not also add to the discouragement of the business community to attract talent and to attract the skills they need to continue this process. We must not create a situation in which being a business executive is so onerous that only people who are incompetent or inclined to criminality are the ones who are interested.

We must continue to create a system that has flexibility and resilience. There must be responsible accounting, obviously. The safeguards, the supervision, and everything must be in place to create deterrents and to enforce them. But we should also continue to encourage the enormous innovation and creativity of our system.

Even the number of meltdowns we have had in this particular series of events has not been able to stop the dynamics of our economy. Isn't that remarkable? With all of these things that we read about, the billions of dollars involved, the economy is performing well. The economy is growing. Profits will rise. The stock market will recover. We have amazing resilience and we shouldn't talk ourselves into bad times because a few people have upset the apple cart.

We must remember that when the market was rising, there was the view that the wealth effect helped the economy. I hope we don't talk ourselves into a situation where a declining stock market, because of reasons unrelated to the real economy, has a poverty effect which depresses the economy. That would be unfortunate, because this country is really a remarkable example of what can happen with the right standards and the right atmosphere to release human talent.

This country is not broken. So as amendments, are enacted it will be prudent to make sure that the amendments where they are

needed and where will be effective to deter and sanction the criminal actions of a relative few people. While the actions of those few people may have been severe, the great majority continue to be responsible and positive.

[The prepared statement of Mr. Miller appears as a submission for the record.]

Chairman BIDEN. Thank you very much, Mr. Secretary.

Mr. Hills?

STATEMENT OF RODERICK M. HILLS, FORMER CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, AND CHAIRMAN, HILLS ENTERPRISES LIMITED, WASHINGTON, D.C.

Mr. HILLS. Mr. Chairman, in this turmoil that we have surrounding misbehavior by corporations, I hope we won't lose sight of the fact that in the past 26 years enormous progress has been made in corporate governance.

In 1976, because some 400 American companies had been found to have bribed foreign officials, the SEC persuaded the New York Stock Exchange to create independent audit committees, required the accountants to have higher auditing standards, and required corporations to have effective internal controls. Since that time, directors' colleges, conferences, and commissions have been trying to beat the principles of corporate governance into the heads of directors, accountants, and lawyers, but we have some fundamental weaknesses.

First, the system is 70 years old. It is creaky. It needs a major overhaul. Experience tells me that everything 70 years old gets a little creaky. Audit partners have not been able, and probably will not be able under this system to resist management pressures. And, third, the audit committees just have not been exercising the authority that was given them in 1976.

The system: The external audit has become a commodity. Chief executive officers see no intrinsic value in it. Accountants compete for the work on cost, not on quality. The system has too many rules. This maze of rules is an incentive to innovative minds to create these complex systems that wind their way through the maze, satisfying the rules but frustrating the purposes of our securities laws.

The auditors are becoming rule-checkers. If the rules seem satisfied to them, they will approve the financial statement even though common-sense judgment would have directed them to do otherwise. The quality and the number of people entering the accounting profession has deteriorated substantially in the past 25 years.

The audit committees were created to protect the independence of the audit and of the auditors, but they are not doing that. They are not asking the auditors if there is a better way to present the financial statements. They are not participating meaningfully in the selection of auditors or in the fee negotiations, and they are not making any effort for an intensive, independently-assisted evaluation of the work of the auditors. The auditors understand that. As a result, they don't expect the audit committees to protect them from management.

The remedies: There is no secret about where we want to go. Professor Weil of Chicago said, I want accountants to use fundamental

concepts in choosing accounting methods. That is the European–English system. Why aren't we there? It is because the auditors are afraid of having their broad judgment tested in juries across the country and so they ask for specific rules to protect them from that type of litigation.

The SEC could provide a veneer of protection for them, but I must say that it would be unwise for them to do so until there is an oversight body capable of monitoring the profession. The oversight body in the Senate bill is on the right track. Its efficacy is going to depend upon its ability to work harmoniously with the SEC. I trust and hope that the conference report today will have clarified the ability to establish that relationship in a workable fashion.

The body could be given further authority. It could be empowered to do more preventative work to find the bad accounting before it hurts the shareholders. A model could very well be the work of the bank examiners for the Federal Reserve Board, for the Comptroller of the Currency, or even the work the SEC does with broker-dealers.

The prescriptions of the Senate bill, I think, also deserve support. I hope, again, in the conference committee the audit committees, with effective findings of fact, will be able to give a little more flexibility to some consulting work and a little more flexibility to do some internal audit work from the external auditors.

The audit committees can fix themselves. They may need a push from the SEC or from Congress to do so, but they can and must take charge of the audit. They must, and can, confer the independence that is needed for the auditors. The audit partners are not going to yield to management pressure if they feel they can be protected, and the point I am trying to make is they don't feel that way today.

I do believe that the strengthening of the laws, represented by the White Collar Penalty Enforcement Act, is positive. It will have a salutary effect, and as Secretary Miller has said, the real problem is the difficulty of seeking convictions in financial fraud cases.

The task force created between the Justice Department and the SEC can be effective. Joint units working with the SEC at U.S. Attorneys' offices, particularly here in Washington, D.C., can enforce each other's ability for their own enforcement responsibilities. The Justice Department can also at this particular time provide assistance to the SEC because it is going to take the Commission a long time to train the people they need for the responsibilities they should exercise.

The biggest hope, Mr. Chairman, for more effective enforcement of crime will be the budget increases of the SEC and the oversight body that will come out of this. Working with the Justice Department, they can move faster to deal with bad accounting. And by moving faster, they can preserve evidence that is otherwise lost, evidence that can be used later in enforcement proceedings where it is appropriate.

Finally, as we acknowledge the deficiencies in the system and begin to correct them with legislation and by practice, it seems to me we must also acknowledge the importance of the accounting profession to the global economy and to our society. The profession

is in trouble not just because of carelessness. It does not have the quality of people and the responsibility it needs, and so I suggest that it is important to not needlessly harm the profession as we go forward in the task of remedying this system.

I appreciate the opportunity to present those views.

[The prepared statement of Mr. Hills appears as a submission for the record.]

Chairman BIDEN. Thank you very much.

Mr. Doty?

STATEMENT OF JAMES R. DOTY, FORMER GENERAL COUNSEL, SECURITIES AND EXCHANGE COMMISSION, AND PARTNER, BAKER BOTTS, LLP, WASHINGTON, D.C.

Mr. DOTY. Mr. Chairman, I appreciate the opportunity to appear in this historic series of hearings on white collar crime and the relationship to the current economic and corporate crisis we face.

Sitting here thinking about your remarks on the Yale Law School, I have to tell you that when I was there one of the professors who was highly regarded said the trouble with this place is that you, meaning the students, are all young fogies, and we, meaning the faculty, are all old turks, aging turks. So I hope I can give you some testimony today that will at least not be either an old fogy or a young turk.

Your deterrence issue is timely. The current crisis has been cast against this backdrop of September 11, the end of an historic bull market, the pressures on management to meet short-term targets that are intensified by stock option and stock bonus incentives, and the techniques that consultants have developed to try to boost short-term values. Those are all circumstances that are getting properly the attention of lawmakers and regulators.

But what puts the deterrence issue in the forefront is not just the magnitude of the market loss, but the apparent fact that in a few of the most conspicuous cases top management acted either with the belief that they had the informed approval of their boards and their audit committees or without any serious concern that they would be called to account.

I think that in common with the themes of my fellow panelists, deterrence here depends upon two factors. One is increasing the risk of detection of fraud; second, enhancing the governance mechanisms that act as a guard rail and keep management well clear of fraud.

In corporate America, as I think my colleagues have said, we don't want to have management that is close to the border of fraud. We don't want the perception that our people operate close to or in fear of criminal prosecution, but well short of that guard rail.

As a practicing securities lawyer who advises boards and committees, and as a former General Counsel of the SEC, I share your concern that corporate America not only act responsibly, but clearly be seen to act responsibly, and that involves changes, I think, in our system of corporate governance that are now underway.

I would like to touch on some of the aspects of the criminal side and then some of the governance areas that I think relate to what you are doing in this committee.

First, the hearing, as I understand it, is concerned in part, among other things, with the question of whether the U.S. Securities and Exchange Commission should have criminal enforcement powers. That is a real issue, whether Congress should enlarge the SEC's statutory mandate to include the responsibility of seeking indictments and prosecuting criminal cases.

We know that violations of the Federal securities laws which are committed with the requisite intent are now criminal, and indeed the arrest of the Rigas family in the Adelphia scandal today is evidence of that. the SEC now refers criminal conduct to the Department of Justice, and I just say we have observed no reluctance on the part of U.S. Attorneys to pursue those referrals.

In those cases, the SEC staff officers who have investigated a civil fraud case are designated as special assistant U.S. attorneys by judicial order to assist in the preparation and trial of the criminal case. So that perhaps leads to the fair question, why not just take the next step and give the SEC criminal authority? I would like to respectfully warn against that and suggest reasons why I think the SEC's authority should stick with the civil and the structure of civil and criminal demarkation be as it is now.

First, civil trial lawyers really are generally not competent to try criminal cases, and I think they recognize that and I think the SEC civil enforcement staff would say it is true. That means you have to create a separate criminal trial unit within the SEC, and that would be done at a time when the agency is experiencing resource constraints. Once created, that unit may actually impair, I think, the close cooperation that now exists between the U.S. Attorney and the SEC, and which Chairman Hills has referred to.

Second, the SEC has functioned well in the past because of its limited mission. It has been often said that they have a limited mandate; that is, to assure transparency in the markets and preserve market integrity through rulemaking, disclosure, and civil enforcement. If criminal enforcement is added, Mr. Chairman, I think there is a danger of mission creep. I think the question then arises as to whether or not violations of the CFTC and the FTC are also part of that mission.

Finally—and this is, I think, of great concern to the bar that is on the good side of this exercise of trying to obtain compliance—I think the civil enforcement process encourages settlement and, with that, administrative and judicial economy. I think that facility of settlement is something which past general counsels other than myself have noted, and would be impaired if the agency had criminal enforcement powers.

So it seems to me the choice for us is to increase the risk of detection of fraud by those committing it by giving greater resources to the agency for its detection function. I think given the choice between having adequate staff to properly review filings, review accounting policies and practices, investigate initiatives to cover fraud, all in the early stages which leads to early detection, or, on the other hand, launching a criminal division within the agency, I think the agency would prefer to have those resources and, as Chairman Hills' comments indicate, go after fraud in the early stages and be ahead of the wave, ahead of the curve, on where fraudulent practices are beginning to creep into accounting.

Now, does the threshold for criminal liability need to be lowered? I think you have heard persuasive arguments as to why the penalties need to be real. I believe that is true, but I would not tinker with the threshold for criminal liability because we have to remember it is an economy that we are regulating.

This conduct that we are regulating is often not *malum in se*. It is conduct which, if it strays far enough from the complex rules that we expect to be obeyed, can become criminal. The complexity of the rules can be part of the problem, but we need to stick with specific intent. And you, I think, reflected this in your introductory remarks to us. The object is to keep corporate managers careful, not render them paralytic.

The standards of criminal liability, I think, also are fairly well hard-wired into our culture. I think judges, lawyers, and regulators understand what specific intent is, and I think we understand what separates it from negligence or even from recklessness that should involve civil liability.

But none of that implies that we have to rely on just the moral imperative in the mind of the executive, and I would like to touch with you briefly on what I think the three changes are that are occurring in our corporate life that relate to the work of the committee, relate to what you have heard today, and I think are going to transform governance.

First, there is a recognition that corporate accountability and responsibility starts with individual accountability. Just as tone from the top communicates corporate values and creates corporate culture, accountability starts as an individual matter from the top. We are already seeing the effects on accountability of the SEC's June 27 order requiring written statements under oath certifying by chief executive officers as to the material completeness of financial statements. I would say, Mr. Chairman, from where I sit there are few expressions of outrage or surprise. You don't have people saying why are they doing this. I think corporate America understands why this must be done.

There are some questions about authority issues, whether the Commission has authority to continue this as a practice. And that is in your lap and I think you and your colleagues are attending to that. But to pick up with where Mr. Miller was leading, I think processes are in effect. Processes to comply with these certification requirements and to assure accuracy are well along.

Elaborate processes are communicated down from the top. Companies are getting ready on the 15th of August to make the first round of certifications, and I can assure you that it has not gone unnoticed by CFOs and CEOs that these statements, as sworn, are subject to penalties of perjury.

Chairman BIDEN. Mr. Johnson in 18th century England said there is nothing to focus one's attention like a hanging.

And you remember, Mr. Hills, when we went through that. I was here at the time we dealt with the issue of bribery of foreign governments, and I remember how Irv Shapiro of the DuPont Company got positively involved, and it really did change the focus a little bit.

I didn't mean to interrupt you.

Mr. DOTY. You are right on, and I think corporate America is ready to do this. It is getting ready to do it and to show that they have done it right, because they have the overriding interest that Mr. Miller referred to in having this confidence restored.

The second point is I think the SEC is going to get the administrative authority to bar offenders from serving as officers and directors. I would say this is as great a threat to the reputations, the careers, and the livelihoods of professional managers as the threat of criminal prosecution.

Incarceration carries a different threat which Mr. Miller has pointed to, but I do believe that because this bar will be enforced administratively and without the independent determination of an Article III judge, as has heretofore been the case, this is being taken very seriously. I think it may be the greatest single deterrent weapon in the SEC's arsenal going forward.

Third, just to pick up on what Chairman Hills is saying, I think independence from professional management in the form of independent boards, independent audit committees, and independent oversight of the accounting profession is essential.

There are some good things going on that I would point out. The New York Stock Exchange and the NASDAQ rules are going in the right direction. The New York Stock Exchange is going to give the audit committee sole responsibility for hiring and firing the independent auditor and the right to approve the rendering of any non-audit services. These rules will have an effect on the way audit committees function.

Audit committees read the paper. They are like the Supreme Court, and I think the current climate has invigorated audit committees. The passivity and the cozy relationship that Mr. Hills and others have spoken out against over the years, I think, is coming to an end. Along with the real powers they are getting as an audit committee, I think you can look to see compensation committees exhibit more activism and more real oversight of boards of directors.

The accounting profession, with the adoption of the legislation that has been agreed on today, is going to have either a public accountability board or a public company accounting oversight board, however you all decide to style it, but it will change the relationship of the auditing community to regulation. Public accountancy will be a regulated profession, with the auditing practices, the independence, and the standards of each firm subject to annual review by a body with the independent authority to sanction. The result of all of that is the recognition of the responsibilities they have is going to make a big difference.

My testimony is not, Mr. Chairman, that all is well with corporate America, or that criminal sanctions don't have a part to play in ensuring responsibility. On the other hand, I do agree with Chairman Greenspan that we are going to be using this corporate model that we have for some time. I don't see us going to a European model. It would not be good for America.

It would be a good exit from this current crisis if our corporate model and regulatory regime, which have underpinned the most transparent markets in the world, were once again seen abroad and at home in that favorable light. I think with the retrospective

of, say, a couple of quarters in an annual report period, let's say mid–May of 2003, the markets may well have concluded that we once again have the most reliable periodic reports and financial statements in the world.

[The prepared statement of Mr. Doty appears as a submission for the record.]

Chairman BIDEN. I thank you all for your statements. With your permission, I have some questions.

Let me begin by reiterating what most people but the editorial board of the Wall Street Journal seem to fail to understand. As chairman of the full committee and chairman of this subcommittee, I do not believe the answer to our problems lies in criminal sanctions, but I am going to make a relatively broad statement and ask you each to comment on it, if you would.

If you want to know what a society values and what price and value they place upon a transgression against what they value, you have to look at their criminal code. Some societies do not, for example, have penalties that are particularly strong for crimes against females. Some do. Some do not hold crimes against property much higher than crimes against persons.

In our society, we have made some very basic judgments based on our English jurisprudential systems that have been relatively consistent. Having been the guy who has been the author—and it is not hyperbole; I mean it literally—of every major piece of crime legislation that has come out of this Congress since 1982, I believe that we have operated in part up to now on the premise that the threat of embarrassment and the threat of exposure in and of itself was such a deterrent to most business men and women because of the economic and social strata from which they come that it acted as a greater deterrent than it might in other sectors of society. So there was less need to have penalties that resulted in criminal time being done in a Federal or a State prison.

The second thing that operates—and I know you all know this—is it is much harder to make a complex white collar crime case as a prosecutor than it is to make a criminal case, even if the criminal case is murder or something of consequence, not some petty-ante crime. For the reasons that Secretary Miller talked about, it is just harder to do. It is easier to hide, and so on.

So there has been, I would say to Mr. Hills, in the testimony we had in our first two hearings evidence that there are many fewer referrals from the SEC to the Justice Department over the last decade or more. And this is not a Democrat/Republic thing; I am not getting into any of that.

In speaking to members of the Criminal Division of the Justice Department and U.S. Attorneys, there is not a reluctance to take the case that is clear, but you would much rather take cases that are more celebrated and less tortuous to make. It is human nature, I think.

So for all those reasons, all I am attempting to do is try to bring our criminal justice system and the penalties related to white collar crime in line with a slightly different measure, and the measure is what we do in other crimes: what is the degree of damage which they do to society and to individuals?

If a corporate executive knowingly and criminally violates the laws that protect Americans' pensions, ERISA, under the law it is only a misdemeanor. You could cause someone to lose their pension that was $1, $2, $3 million, or 50 people where the pensions added up to $500 million, or 1,000 people, and you could only go to jail for up to one year.

If you steal my car in my driveway in Delaware, which is only a couple miles from the Pennsylvania border, and drive it across the Pennsylvania line, 10 years from the Sentencing Commission guidelines. So there is a real disparity here in terms of the value of the thing taken and the punishment that results.

Also—and I will end my little exposition here and the rationale behind our criminal law—it undercuts respect for the law when average Americans see and know the penalties people pay for crimes that have much less consequence in their neighborhood, their society, the well-being of their friends and neighbors.

As you pointed out, Mr. Secretary, assuming that even a significant portion of it was a consequence of criminal fraud, you are talking about the loss of value, as you point out, if you add it all up, exceeds the GDP of any other country. It is kind of hard for any criminal, including going into Fort Knox, to have that kind of impact.

So I want to make it clear that I am not on a populist crusade here. I might say that I think the Congress has acted pretty responsibly so far, in light of, by the way, what our constituents want us to do. Our constituents want a dead dog delivered to somebody's doorstep. I am serious.

I guess you do have an idea. Our constituents out there—and it doesn't matter whether they are upper- or lower-income, middle-income; they want somebody to pay because they are angry. In some cases, many of my constituents, from their perspective, and they may be literally correct, have had their lives stolen from them in the sense that if you are 56 years old and your 401(k) loses 70 percent of its value or is wiped out, you don't have a whole lot of time to make that up.

So, anyway, that is the context in which I am going to ask you some of these questions. So I really am not looking for draconian measures and I understand the limitations. Chairman Greenspan was pretty straightforward about the notion that personal accountability focuses attention. Now, as the old joke goes, you have handled things way above my pay grade. You have been significant businessmen and CEOs. You have had significant positions in the Government.

Is there a correlation, in your view, between the amount of responsibility and accountability to which a corporate official and/or board member is held and the due diligence that they are likely to exercise in the performance of their duties?

I am not saying that I believe business men and women per se are bad guys. I am not saying that at all, but is there a correlation, and at what point do we impose a potential sanction where it begins to dissuade people from either being innovative or dissuades them from participation on a board?

Let me conclude my little thing by saying this. When you go to school and you are not a business major and you are a lawyer who

is not focusing on corporate questions, or you are an undergraduate who is not a business major, you learn the basic sort of block structure of corporate America, corporations, and the notion of fiduciary responsibility, who reports to whom, who has what responsibility, where the stockholders stand, where the hired hands, including the CEO, are, what the relationship of the board is to the operating officers. Technically, the board hires and fires those folks.

So in the context of responsibility, can you talk to me a little bit about how, as you were saying, Mr. Hills, things have sort of changed in the last 10, 15 years? I mean, I think most Americans thought that if you had an audit committee on the board, they did something other than, when the audit was presented by whomever, just stamp it, that they were supposed to have some function other than merely saying this is okay It is has been submitted a good auditing outfit, a good accounting firm, and it is all right.

What is the function of an audit committee? What was it envisioned to be? What has it become? What should it be?

Mr. HILLS. If I may, having been present at the creation, the notion was that the failure to have an independent audit committee was a material weakness in the controls of the company.

Chairman BIDEN. I know what you mean, but for the record define what you mean by independent audit committee.

Mr. HILLS. Traditionally, I must say we have gotten into the habit of using only one standard, objective independence. To be a little colloquial about it, it means how many times did you play golf with the chief executive officer. You know, are you a cousin, do you get paid, do you have consulting fees?

Objective independence is very easy to find, although many boards haven't done it. But objective independence simply means you have no other business relationships or social relationships that would interfere with independent judgment.

It is way not near enough to have objective independence. I would say it is a three-dimensional form. The second dimension is you have to independently decide what you need to know. You can't just sit there and take what is handed to you. You need to know, for example, that you need a management letter every year, the management letter, not one that is concocted for the audit committee.

It is now public that in Waste Management for five years the audit committee did not get a management letter and didn't ask for it. Yet, the management letter that went to the company had 12 items that the company absolutely had to change to have good accounts and they didn't change it for five years. Nobody asked for that because they did not objectively decide what they should see.

The third dimension of independence which is, in my judgment, as important as the other two, maybe more so, is you will not have an independent auditor unless you confer independence on them. You have got to grab them by the neck and say you work for us, you don't work for the company, you are going to get fired the first time we hear that you have given something to the company that you haven't told us about; we want the letters you have sent management, not the ones you frame for us. So independence has those three dimensions. If you get those three dimensions, you have a good audit committee.

Chairman BIDEN. Now, gentlemen, what is the responsibility of the board in this regard? In other words, is the board's responsibility to insist that it be independent?

One of the arguments being debated right now in the conference—and you raised it, Secretary Miller, and I understand the argument and I disagree with it. One of the differences, as Mr. Doty knows, being the lawyer who advises clients on these issues, is if the law changes as Hatch and I wrote it, it is going to require not just a signature, but a certification to the SEC once every quarter that what we are submitting to you is accurate. If you knowingly or willfully violate that and say you knowingly supply false information or you are involved in concocting that false information, then you are criminally liable.

Now, no one seems to argue with me that a CEO and a CFO should be held accountable because they do the day-to-day management. But people have made the argument to me that about 10 or 20 percent of the chairmen of the board are neither CEO or CFO or hold any other operating position within the corporation. They are doing it part-time, not full-time, and therefore they shouldn't be held accountable to the same standard, even though it is "knowing," which I find interesting, even though it is a criminal standard.

If we don't hold the boards responsible for what on paper you learn in Business 101 is their function, which is to oversee the management of the company, then what are we doing here?

And I don't think this is so black and white. I am prepared to be shown that I am wrong on this, but I don't know what you teach them in Business 101. If, in fact, you say this board here has this responsibility, but if everybody knows they don't take it seriously and it is not a full-time job and you can't expect them to really do the job, then why the hell do we have a board, or why don't we say really what it is?

Yet, we go around and we talk about the board like it has this function that many of the Fortune 20, 25 CEOs whom I know and have spoken to—not every one of them by any stretch of the imagination, but they all basically say to me, well, Joe, you can't expect these guys to be responsible. That is not their phrase. They can't be held to the same accountability as we can.

So how can you have an outfit that oversees and hold it to a lesser standard than the outfit that operates, when one of the reasons you have the outfit that oversees is allegedly to protect the stockholders and the public from malfeasance or maintain good business practices on the part of the operating officers?

Talk with me about that a minute.

Mr. MILLER. Well, Mr. Chairman, I would like to clarify a little bit. I don't believe there should be a lesser standard. Under corporate law, as I understand it, the board of directors is responsible for the management and affairs of the corporation, period. The officers get their authority by delegation from the board; so it is the board that is responsible. I don't disagree.

My point about a chairman who is part-time was not that there should have a lower standard of accountability fo him. In fact, if such a chairman falsely signs a statement, he should go to jail. The question is: does he know enough to sign that statement, as distin-

guished from what else he knows? It was not a question of his being allowed to sign something false. That would be unacceptable.

I want to go back to your point—and perhaps we can elucidate on that. I don't know that it would be popular, but it might be more logical for the chairman of the audit committee to be signing, who should have spent a lot more time on reviewing the financial statements than a part-time chairman. Not every member of the board can be on the audit committee, and it certainly is true some directors will be disqualified if only independent directors can be on the audit committee. So members of the audit committee will have a degree of knowledge about the financial statements that some other director won't have.

I think your comments about the purpose of your legislation and your approach are valuable comments and I just don't want to pass up an opportunity to say that if we had an ideal world, the only criminal law we would need is the Golden Rule.

Chairman BIDEN. Yes, that is true.

Mr. MILLER. That is all we need. We know if we are acting inproperly. We know when we are wrong. We know right and wrong, but unfortunately we have found that not everyone wants to adhere to what is right. So the problem in corporate management has come in waves over the centuries.

Don't forget there was the era of the robber barons, and don't forget there had to be huge reforms in securities law which now are basically founded on disclosure, on the theory that if everybody has the some information, they can act rational and there will be an efficient market.

There was the time when monopolies arose and damaged the economy. The response was to enact various antitrust, laws, including not only anti-monopoly laws, but also anti-price-fixing laws, and so forth.

In the case that we are talking about now, if, in fact, all corporate managers treasured their reputation and their social standing, you wouldn't need these sanctions. Unfortunately, not all those in corporate managment or in business treasure their reputations. Criminal syndicates do gain influence over various activities. Criminal syndicates or equivalents may find their way into the executive suite.

So you need sanctions not because most corporate manager don't so care about their families, their reputations, their standing in the community that they would never will falsify or misrepresent. Sanctions are needed for the others, the minority, who will falsify and misrepresent. I am appalled at the list of those who fall in the latter category.

Chairman BIDEN. Mr. Doty, you advise a lot of serious people and one of the things that seems to have—and, again, I have no pride of authorship in this amendment. If it doesn't make sense, I am not trying to make the case for the amendment, really and truly.

I am trying to figure out what the devil happened. There seems to have been—"meltdown" may be too pejorative a word, but there seems to have been a diminution of the sense of responsibility that board members had over the last decade or more, not because they are bad. Maybe it is because they thought everything is so com-

plicated and things run so well and things are going so fine, all I have to do is show up and get paid my $50 for the meeting, or my $500,000. It is not because they were engaging in anything that was wrong.

Mr. DOTY. Not bad people. They didn't want bad things to happen.

Chairman BIDEN. Yes, but there seems to have been sort of a morphing of the way in which the board related to management. Now, I understand it is very popular now, this phrase about the imperial CEO/chairman of the board doing both, one person controlling everything, et cetera.

Am I wrong, or has there been a diminution of the sense of responsibility when someone is asked to be on a board? When you guys were asked to serve on boards as prominent businessmen 35 years ago, did you have a different sense of responsibility than if you were asked at the same age, but you were the same age in 1995 being asked for the first time to serve on a board?

Mr. MILLER. I certainly have no different sense today than I had 40 years ago.

Chairman BIDEN. I don't mean you personally. Do you understand what I am trying to get at it? What happened?

Mr. HILLS. There is a big difference. Thirty-five years ago—I want on my first board 34 years ago. You were asked to go on the board for your resume, not your advice. You got four crisp $100 bills under your luncheon plate that you didn't have to show your wife and you went home after a good lunch and you played golf with the CEO on weekends and retreats. Yes, you were honest and able, but there was not much expected. The responsibility has evolved over these years.

I come to the same conclusion as to where we are today, Mr. Chairman, but I don't think there has been a diminution.

Chairman BIDEN. I see.

Mr. HILLS. I think the fundamental weaknesses have been there and they show up when you have this burst of a bull market.

Chairman BIDEN. I see. That makes sense to me.

Mr. HILLS. I think that the responsibility of boards, to which they can be held accountable more and more every year, is evolving.

Mr. MILLER. My experience is slightly different. Thirty years ago, I did not serve on a board because of my resume. The directors I served with took their responsibilities very seriously. I remember a board I served on where an environmental issue came up before environmental issues were as important as now, and the board stepped in with great vigor to make sure the the company got ahead of the curve and that its facilities met environmental standards higher than were then required.

The board of that company initiated the first environmental audit. Now, this was 35 years ago. The directors were not just sitting there waiting for their checks and their lunch.

Mr. HILLS. I think you are right, but Peter Drucker wrote a book about General Motors back in the 1930s. General Motors had the perfect board in the 1930s. It had an independent audit committee, but, boy, was that the exception.

Mr. DOTY. Mr. Chairman, I have got to say the two men on my right have done a great deal to cast the improvements that we have seen in board governance over 30 years. I can't speak for 30 years. I can speak for 25 or 20 or so, and I would say I think it has gotten better.

I see directors who are hard-working people. I see directors who have a heightened sense of what they have to do. I see directors who are concerned and embarrassed by what they see going in on some of these front-page stories. I see directors resigning from boards because they think they belong to too many boards.

This is one of the things that happened. People began to collect boards, and the man on my right has never made that mistake. He has moved in and made a real contribution to the boards he has sat on and seen it as his duty to change something for the better. That is an attitude which I think is becoming more common among directors.

One other point I would make is it has become more complicated. The financial instruments have become more complicated. The accounting became more complicated. The SEC's chief accountant, with great freshness of candor, says, look, the rules are too complicated and at times they tempt auditors into creating complex tax schemes.

So I think there is a combination of factors, plus the fact that I do think when times are good, people tend to get a little lax, and that is what Mr. Hills, I think, is referring to.

Chairman BIDEN. Let me ask you one other question. The strongest argument for any heightened accountability for a board member, let alone the chairman, is the world is a lot more complicated, number one, and I don't disagree with that.

Mr. DOTY. And you have seen specialization, Mr. Chairman; as a result of that, specialization within the board.

Chairman BIDEN. The second reason offered is if there is a potential criminal sanction, because things have become so complicated it will have such a chilling effect on good women and good men being willing to serve on boards that what we will do is we will have the reverse impact we are seeking.

We are going to get people who, for either the prestige or the $100 bill under the plate, figuratively speaking, will take the job. You are not going to get serious people who have other enterprises that they have to deal with and take care of participating.

Now, I have great respect for all three of you. What do you think, both from your professional and your personal observation, would be the chilling effect of a criminal standard? Is that enough to keep an otherwise competent person from being willing to become a chairman of a board? That is my question.

Mr. DOTY. Well, the SEC has long recognized that the way in which you evaluate management directors' conduct and the way in which you evaluate independent directors' conduct, outside directors, is quite different. The standard on the securities laws is the same. Scienter, recklessness—all of those standards apply to you, whether you are an independent director, a lawyer, an accountant, or a management member.

But the test is in whether Congress makes it clear in adopting this legislation that it intends not to have a chilling effect, that it

seeks to have the best people join boards, and that it really is not looking for targets in the board room, but instead it wants to ensure that directors do what Justice Douglas said they should do, that they direct, that they work hard, that they not have too many boards, that they take their duties seriously, and that they not be willing to simply rely without good reasons for reliance.

Chairman BIDEN. My problem here is I don't know how, in a principled sense, I introduce legislation, which I did, requiring certification from a CEO and certification from a chief financial officer and the liability incurred as a consequence of that legislation only if there is a knowing or willful conduct to lie, to misstate—how you do that and then not hold the chairman of the board responsible to the same standard which requires a high burden of proof beyond a reasonable doubt that you actually knowingly signed something you knew to be false, not that you should have known.

Mr. DOTY. Well, I think anyone who knowingly signs something they know to be false risks criminal prosecution now. But you do have to recognize, I think, the difference between management which controls the process whereby they can determine the accuracy of the financial information and the board of directors which traditionally has not. They don't have the human resources at their beck and call that management has. That has been a fairly bright line.

If, as the panel is saying, audit committees are more active in hiring and firing the auditors and they are more involved in the actual preparation of the financial statements, you will see heightened responsibility and accountability among audit committee members and it will be a difficult question as to whether one serves on an audit committee. But responsibility and accountability and sanctions should follow actual capacity, ability, to affect the results and control of the resources. It shouldn't just go with status.

Mr. MILLER. Mr. Chairman, put yourself in the position of being a non-executive chairman of a company for a moment and realize what Jim has just said about not controlling the process, not controlling the people. You are asked to sign a statement which reads like an opinion of an auditing firm, reads that the statement fairly presents the financial condition.

I think if you were required to do sign, and you did, and you knew of nothing wrong, that would be fine. Your hesitancy might be, "I don't like to sign something when I have not been able to go through a due diligence process on my own to ascertain that seven layers down they aren't doing something I don't know about because I can't see that at the level of supervision of the board". If any officer signs falsely, he should be accountable. Is it fair to ask non-employee to sign? If it is perceived to be unfair, the office of non-executive chairman will disappear.

Chairman BIDEN. As Tip O'Neill said, all politics is local. All of this gets personal in terms of how we view ourselves in that situation. I am a United States Senator. I am required every year to sign off on rules that I vote for that hold me criminally liable if I make a mistake.

I am required to sign off on documentation of how much money this committee spends. I don't have any idea. I don't follow it. And the budgets aren't like the budgets of a corporation, but they are

several million dollars. I am required to sign off on every expense. If I, as chairman of the Foreign Relations Committee, send someone to Afghanistan, I am required to sign off on that.

It is a higher standard than criminal, than "knowing," and I find myself not easy sometimes about signing those things because I wonder if I don't have the right guy doing this, I haven't spent the 40, 50, 60, 70 hours compiling this for the year. The public expects me to be held responsible as a Senator who is one of 535 people who can affect their lives, and if I screw up on that it may cost the taxpayers a little bit of money—in terms of a $2 trillion budget, a minuscule amount of money.

Yet, if a chairman of a board or a CEO of a major corporation, where when they screw it up it may cause people tens of billions of dollars—I don't know. I guess part of what is at stake—and I will end with this—part of what is at stake is the first guys that want to hold everybody responsible are the business community. They want to hold every car thief responsible and hang them by their heels. They want to make sure that every welfare mother cheat gets nailed. They want to make sure that every politician who does anything wrong—and I agree with them—should be held accountable.

And all of a sudden it comes to a place that affects the well-being and security of may children and my family as much as anything that anybody does, other than the President of the United States, and people are saying, wait a minute, you have got to understand this is a complicated job.

You are not saying that, I know, but I am saying that is the dilemma I am grappling with, without trying to turn this into, as I said, any sort of a semi-populist initiative to go out and hold people accountable when they shouldn't be.

Mr. HILLS. What you can do and what the SEC can do is define more sharply the responsibilities of these people who should be held responsible. After 26 years, the duties of the audit committee are just beginning to evolve.

Chairman BIDEN. I see.

Mr. HILLS. The Enron case won't happen again. The Waste Management case won't happen again. The audit committees won't let that happen. The compensation committee chairman will sooner or later understand that if he doesn't get independent advice on compensation, he is going to be responsible. If he takes advice only from the consultant hired by the management, he is going to be responsible.

If the company continues to hire the auditors and if the auditors continue to work for the company, the board will never be well-informed. If the audit committee asserts its responsibility—it is not easy; you have got to sort of take them by the neck and shake them a little bit—then you have all the eyes and ears you need to be responsible for the company.

If you have got 2 or 300 auditors looking at the operations and they come to you and say, wow, you know, that depreciation schedule they have on that garbage collection down in Florida, it doesn't look to me like those trucks last that long, and you ignore that—if you get a letter from a whistleblower and you pass it back to

management and aren't interested in the result, responsibility is evolving. It is there, it will come.

Chairman BIDEN. With your permission—and I have trespassed on your time a lot already—I have about four or five questions I would like to submit to each of you rather than keep you here for another hour-and-a-half. Maybe you would be willing to, in due course, respond for the record. I will not overburden you, I promise you. It is not a tome, it is not a deposition. It is relatively small.

I would also ask unanimous consent that the statement of Senator Hatch be submitted for the record, and Senator Grassley, at the beginning of the hearing after my opening statement.

As I said, with your permission, I would like to be able to submit to you some questions in writing, mainly to save you the time, but let me conclude with one generic question.

You know that old expression, the wish is the father of the thought, or whatever it is. I am mildly optimistic, and I don't quite know why, that this—maybe I do know why, because I have watched my friends in the business community and how outraged they are about what is happening, how many driveby shootings there are. They are getting clipped and killed for having done nothing wrong, but just being part of a corporate establishment where some bad actors have been engaged in serious, serious malfeasance.

What do you think is going to happen on August 15? Do you think we are going to find, of the 17,000, I guess it is, American corporations that you are going to have 15,000 of them coming forward fly-specking their statements and all of a sudden we are going to find we are further in the hole than we were relative to values? Do you think these scandals are going to be enough to have self-effectuating house-cleaning? What do you think is going to happen, guys?

Mr. MILLER. I think you have good reason to be optimistic because while the impact has been great, the number of companies that are responsible and want to be responsible is overwhelming. You can rest assured that in executive suites today, regardless of what legislation comes out, they are already hard at work figuring out how to protect their company from any kinds of shortcomings that have shown up in these other cases. So there is already a prophylactic effect taking place that will be pervasive.

Also, you have seen a change in attitude about some things that were sacred cows. I think Warren Buffet is being very effective in convincing a number of major companies to begin to account for stock options in a different way. These are reforms that are now being voluntarily moved along, I think, in reaction to this in the sense that we have got to get ourselves in a position where we have the trust and confidence of the American people. It is in our self-interest.

After all, that Adam Smith viewpoint that the self-interest will drive is a very, very powerful force in society. I think the self-interest will drive businessmen to make internal reforms, with or without legislation, that will improve the system. I think you have a good reason to be optimistic. You shouldn't stop the legislation because that reinforces against those who don't want to play by the rules. We do have the invasion of toxic interests into even a perfect enterprise system. But the enterprise system is resilient, it is flexi-

ble, it is self-healing, and it does not like this and it will change it.

Chairman BIDEN. Mr. Hills?

Mr. HILLS. I think I have seen over the years an evolving responsibility on boards. I think I am optimistic, but on August 14 or 15, you are going to have some house-cleaning. It is natural. Every time you send an audit team out to see a facility that they haven't seen for six or seven years, they find stuff, and so it is not an unusual thing. By emphasizing the need for the certification, they are cleaning the attics all this year instead of every two or three years. So you will get some. If the media handles it right, I think that will not be a serious problem.

Mr. DOTY. It will be interesting and the 10(q) will be worth reading.

Chairman BIDEN. Well stated. As chairman of the Foreign Relations Committee, it is amazing how many foreign leaders, heads of state—well, that is an exaggeration. I have not seen that many heads of state in the last month, but several heads of state, foreign ministers, defense ministers, and counterpart parliamentarians are absolutely perplexed, some of them with a little bit of glee, a little bit of "I am glad to see your problems," but them immediately realizing it is their problem if it is our problem.

You made the analogy to 9/11, Mr. Secretary. They are making a similar analogy that this is of incredible consequence. In the globalization of the economy, this has ripple effects that 35 years ago would not have had nearly the effects it has—the dollar relative to the euro, the dollar relative to the yen, the dollar and its strength and the failure to invest in the United States temporarily. I mean, this is serious stuff.

Mr. HILLS. The chairman may remember Ambassador Tommy Koh, from Singapore.

Chairman BIDEN. Yes.

Mr. HILLS. A week ago, we were in Singapore convening a session on corporate governance and significant people from eight countries came and spent three days in intense discussions not unlike the one we are having here.

Chairman BIDEN. Did you discern the same thing that this concern is deep? I mean, it is not a concern that is confined to the shores of the United States of America by any stretch of the imagination.

Mr. HILLS. They understand they have a much deeper problem.

Chairman BIDEN. Well, gentlemen, I can't tell you how much I appreciate you having given me this much time. As I said, I promise I will not submit more than four questions to each one of you. And there is not an urgency in a matter of days, but as expeditiously as you could respond, I would appreciate it.

It sounds trite, but thank you for your service. You have rendered great service to this country in the past, and the fact that you are willing to be here at this subcommittee is further evidence that you are still in the game and we appreciate it a bunch. Thank you very much.

We are adjourned.

[Whereupon, at 4:10 p.m., the subcommittee was adjourned.]

[Submissions for the record follow.]

SUBMISSIONS FOR THE RECORD

TESTIMONY OF
JAMES R. DOTY
BAKER BOTTS L.L.P.
INSURING CORPORATE RESPONSIBILITY:
USING CRIMINAL SANCTIONS TO DETER WRONGDOING

Before the Subcommittee on Crime and Drugs of the
Senate Judiciary Committee
U.S. Senate
July 24, 2002

Chairman Biden, Senators:

It is a pleasure and a privilege to join this distinguished panel and to commence a dialogue on an issue of great relevance to the task of restoring confidence in our corporate governance and financial reporting system: that is, insuring corporate responsibility and, in that context, the use of criminal sanctions to deter wrongdoing.

The *deterrence* issue is timely. The current crisis has occurred in a context that may be unique. Contributing (or exacerbating) factors include: (i) the end of an historic bull-market cycle, (ii) the events of September 11, (iii) the pressures on management to meet short-term targets, intensified by stock-option and stock-bonus incentives, leading to exotic tax and accounting techniques -- techniques designed and marketed by consultants to exploit the complexity of accounting rules. These circumstances are getting the attention of lawmakers and regulators. What puts the deterrence issue in the forefront is not just the magnitude of the market losses, but the apparent fact that in a few of the most conspicuous cases, top management acted either with the belief that they had the informed approval of boards, audit committees, outside auditors, or without serious concern that they would be called to account.

Deterrence involves (i) increasing the risk of detection of fraud and (ii) enhancing the governance mechanisms that act as a guardrail, to prevent management from stretching the rules and gaming the system. As a practicing securities lawyer, advising boards, audit committees and management, and as a former General Counsel of the SEC, I share your concern, and that of the

President, that corporate America not only act responsibly, but clearly be seen to act responsibly. That involves changes in our system of corporate governance that are now underway.

A. Should the SEC Have Criminal Enforcement Authority?

This hearing, I understand, concerns (among other issues) the question of whether the U.S. Securities and Exchange Commission should have criminal enforcement powers -- *i.e.* whether Congress should enlarge the SEC's statutory mandate to include the responsibility of seeking indictment and prosecuting criminal cases. Although the current crisis is real, and although the President, the Congress and the SEC are all on the right track in evaluating the range of options to assure accountability, we need to be wise in our selection among remedies. My testimony will focus on the other, and to my mind better, methods of achieving the corporate ethic our nation expects and deserves.

As we know, violations of the federal securities laws which are committed with the requisite intent are now criminal. The SEC refers criminal conduct to the Department of Justice; and we have observed no reluctance on the part of U.S. Attorneys to pursue such referrals. In many such cases, the SEC Staff officers who have investigated a civil case are designated as "Special Assistant U.S. Attorneys" by judicial order, to assist in the preparation and trial of the criminal case. It is, perhaps, fair to ask "Why not just take the next step and give the SEC criminal authority?" I respectfully warn against that next step, for the following reasons:

1. Civil trial lawyers are not generally competent to try criminal cases. A separate criminal trial unit would need to be created within the SEC at a time when the agency is experiencing resource constraints. Once created, that unit may actually impair the close cooperation that now exists between the SEC Enforcement Staff and the Offices of U.S. Attorneys.[1]

2. The SEC has functioned well in the past because of its limited mission. This has been said many times, many ways. The SEC's mission has been to foster disclosure and transparency and preserve market integrity through rulemaking and civil law enforcement. If criminal enforcement is added, there is real danger of "mission creep." Would the new criminal enforcement division be limited to

[1] No independent federal agency currently has power to initiate criminal prosecutions. Only the Department of Justice and the 94 United States Attorneys' Offices have that authority. Only a few federal agencies (including the SEC) have the authority to bring civil lawsuits.

securities law violations? What if wire fraud, mail fraud, consumer protection (FTC) or commodities (CFTC) violations are involved?

3. The civil enforcement process encourages settlement and, with that, administrative and judicial economy. Creating a Janus-like, civil/criminal enforcement agency will make that process less efficient, and may disrupt it altogether. In short the SEC's civil enforcement process is of a piece with its rulemaking and disciplinary process (which applies to lawyers and accountants, incidentally): that process works, notwithstanding what we have seen in corporate America.

And of course, the question should be put to the SEC itself: given the choice, (i) on the one hand, between having adequate resources to properly staff the reviewing, accounting and investigative initiative to discover fraud, in the early stages, or (ii) on the other, launching a fledgling criminal enforcement division, which would the agency prefer? Devoting greater resources to early detection will enhance deterrence for the civil enforcement initiatives and programs of the SEC.

B. Does the Threshold for Criminal Conduct Need to be Lowered?

If, then, we are going to rely on the Department of Justice to invoke criminal sanctions against corporate wrongdoing, should we, as some have suggested, deter by lowering the threshold for criminal liability? I think not, for the following reasons:

1. We must never forget that it is an economy we are regulating: that is, none of the conduct is (as in the case of selling crack cocaine, or extortion) malum in se. Defining economic crime – and in particular criminal financial fraud – involves identifying the gradation of conduct that departs from fairly complicated rules. The complexity of the rules, as we have seen, can become part of the problem. Therefore, we need to stick with specific intent – egregious conduct that involves deliberate evasion of statutes, rules and regulations, or the creation of schemes that could only have deception as their purpose. For all the rest (whether through negligence or recklessness) there's civil liability. The object is to keep corporate managers careful – not paralytic.

2. The standards of criminal liability are "hard-wired": The specific intent standard is part of our culture – it means deliberate disregard of clearly established duties. That is why we regard the conduct as criminal. Negligent conduct can result in truly awful consequences; but it is not criminal just because it caused great injury.

But none of this implies we have to rely on the "moral imperative" of the corporate executive's own conscience to keep them on the civil side of the law.

C. The Changing Governance Model.

In fact, out of the implosion of Waste Management, Enron, Global Crossing and WorldCom, we are witnessing the emergence of a new corporate governance model. This hinges on three broad reform principles that should go a long way to distinguish conscientious management from the appropriate objects of the criminal process.

What, then, are the reforms that will get the job done?

First, corporate responsibility starts with individual accountability. Just as "tone from the top" communicates corporate values and creates corporate culture, accountability starts as an individual matter and starts from the top. For a start, we are already seeing the effects on accountability of the SEC's June 27, 2002 Order (under Section 21(a)(1) of the Exchange Act), requiring written statements under oath from senior officers, certifying the material completeness of filed reports. The SEC's pending rule proposal will make that Order generally applicable. I can testify today that this certification has got the undivided attention of CEOs and CFOs around the country.

Processes to comply with these certification requirements, and to assure the accuracy of those certifications, are being put in place in the largest public companies. Those procedures are being communicated down the line, implemented and the implementation documented, all in a manner that should contribute to the reliability and completeness of our continuous reporting for years to come. It has, of course, not gone unnoticed by the CEO and CFO that these statements are sworn, with the attendant risks of criminal referral by the SEC in the case of knowingly false oaths. The NYSE rules will also require criminal certification of both the procedures to assure accurate, complete information, and the company's compliance with those procedures.

Second, the SEC will likely get the administrative authority to bar securities-law offenders from serving as officers and directors of public companies. This is as great a threat to the reputations, careers and livelihoods of professional managers as the threat of criminal prosecution; and I say that because it will be enforced administratively and without an

independent determination by an Article III Judge (as has heretofore been the case). The threat of the SEC's administrative bar may be the single greatest deterrent weapon in the arsenal.

Third, independence from professional management, in the form of independent boards and independent audit committees, and independent oversight of the accounting profession should be assured. These reforms are now ideas whose time has come. The New York Stock Exchange and NASDAQ reforms, requiring independent boards and independent audit committees, and the SEC's rules which will foster the activism of these independent bodies, have fundamentally changed corporate culture. Professional managers have been brought into a relationship with boards in which the power of the professional managers has been diminished and the oversight of the board strengthened.[2]

The accounting profession will also stand in a different relationship to the regulatory regime upon creation of a new "Public Accountability Board" or "Public Company Accounting Oversight Board": public accountancy will be a regulated profession, with the independence and the auditing practices and standards of each firm subject to annual review by a body with the independent authority to sanction.

Conclusions:

My testimony is not, of course, that all is well with corporate America or that criminal sanctions do not have a part to play in insuring corporate responsibility: without speculation on the specific targets of criminal sanctions, I believe we will (and should) see the criminal process employed in some of the cases we are daily reading about.

On the other hand, Federal Reserve Chairman Greenspan has testified that he believes that the structure of the business corporate model -- boards of directors overseeing a management team and accountable to shareholders -- would be our model for some time to come: *i.e.*, that we

[2] Under the NYSE rule proposals, for example, audit committees, consisting solely of independent directors, would have sole responsibility for hiring and firing the independent auditors and for approving significant non-audit work by auditors.

will not be abandoning the U.S. model for a continental European model.[3] It would be a good exit from the current crisis, if our corporate model and regulatory regime, which have underpinned the most transparent markets in the world, once again were seen in that favorable light. When the three reforms I have mentioned have had time to work (and I am suggesting a "retrospective" from two quarterly and one annual reporting period, or mid-May 2003), the markets may well have concluded that the periodic reports and financial statements of U.S. public companies are again the most reliable in the world.

[3] It is common knowledge that prior to the current crisis, in European companies the management, composition and structure of boards, constituencies represented and powers of shareholders, were being compared critically with the U.S. model, both in terms of transparency and in terms of rights of minority holders. The current corporate governance crisis here has caused many European lawyers to express a preference for the "stability" of their own governance model, and has strengthened the resolve of proponents of International Accounting Standards over U.S. GAAP.

STATEMENT OF CHARLES GRASSLEY
"ENSURING CORPORATE RESPONISIBILITY: USING CRIMINAL SANCTIONS TO DETER WRONGDOING"
HEARING OF THE SUBCOMMITTEE ON CRIME AND DRUGS

JULY 24, 2002

Mr. Chairman, thank you for holding this third hearing on white collar crime. In our last two hearings we explored several measures that can be taken to deter white collar crime.

First, we looked into how we punish white collar offenders, many of whom defraud pension and investment funds. Since strong criminal penalties serve to deter future crime, we asked the question, "Are white collar criminals punished less severely than other criminals?" Because white collar crime, especially as it relates to fraud, is serious crime with devastating effects on individuals and the economy as a whole, it should carry significant penalties. This is an area where we need to be even tougher on criminals.

In our second hearing, we focused on ways to protect investors from being defrauded. We discussed the roles corporate governance, business ethics, investor education play in changing the corporate culture to prevent fraud.

We also heard testimony that another important way to protect investors is to ensure corporate whistleblowers are protected from retaliation when they go public with knowledge of fraud in the corporate world. In the context of corporate wrongdoing, whistleblowers can provide valuable evidence for prosecutors to build a case against corporate criminals. Without these brave men and women, prosecutors would lack an important tool in their efforts to curb corporate fraud. It is for these reasons that I have worked to provide protections for corporate whistleblowers as well as federal whistleblowers who are retaliated against for exposing fraud, waste, and abuse.

Today, in this third hearing, we'll be exploring the criminal sanctions issue from the perspective of securities and accounting, as opposed to the DOJ perspective which we looked into in our first hearing.

I hope that we will be able to discuss several issues that may strengthen the Securities Exchange Commission's ability to enforce the federal securities laws.

We need to talk about the relationship between the Department of Justice and the Securities Exchange Commission in the investigation and prosecution of securities fraud. As I understand it, the SEC has a good working relationship with the Department of Justice and the various U.S. Attorneys, who bring the criminal prosecutions against corporate fraudsters.

Some in both the securities and law enforcement communities have advocated changes in current law that

may help the SEC investigate violations of the federal securities laws.

One such change is allowing the Department of Justice to share grand jury information on corporate fraud cases with the SEC. An exemption like this exists in the banking world. Another change would be to provide nation-wide service of process to the SEC. I don't know if these two changes are good policy that will make a great difference, but I look forward to discussing them with today's witnesses.

I also think we should explore how auditor independence plays a role in preventing securities fraud. We may want to examine whether the Auditor Independence Rule should be strengthened. I understand that the Commission is currently revisiting this rule to determine whether it should be made tougher. It's critical that auditors be free from the influence of corporate

executives, so I think that it's important that we discuss any modifications that are needed to that rule.

Today we'll be hearing from some of the most experienced minds in the securities world. Mr. Miller and Mr. Hills, I look forward to hearing your perspectives on how we can best deter corporate fraud.

I'm also looking forward to hearing from James Doty of Baker Botts. Mr. Doty served as General Counsel to the SEC during the early 1990s and is particularly qualified to discuss SEC enforcement issues. Thank you for testifying today.

Mr. Chairman, I want to thank you for today's hearing and for your efforts to look into ways to deter corporate fraud.

STATEMENT OF SENATOR ORRIN G. HATCH
RANKING REPUBLICAN MEMBER
Before the SENATE JUDICIARY COMMITTEE
Hearing on
"Ensuring Corporate Responsibility: Using Criminal Sanctions to Deter Wrongdoing"
July 24, 2002

Mr. Chairman, thank you for scheduling another hearing – our third in the past two months – to review the adequacy of current penalties for white-collar criminal offenses. As our financial markets roil in the wake of accounting and corporate irregularities that have caused billions in losses to innocent investors, we need to assure the American people that these lapses will not go unchecked. This is a critically important area for us to focus on.

Senator Biden and I have worked together for years now on many important pieces of legislation. Just this month, we jointly sponsored legislation that increased the maximum penalties for conspiracy, mail fraud, wire fraud and ERISA offenses. Our legislation also made corporate officials criminally responsible for the accuracy of their public filings with the Securities and Exchange Commission. Finally, our legislation directed the U.S. Sentencing Commission to review the adequacy of current guidelines for white collar offenders. I was happy to see this important bill pass the Senate by a unanimous vote, and am pleased to see that some of the technical concerns I had about the bill are being addressed. I strongly believe that we should do all we can to curb corporate and accounting abuses, but we must do so in a measured way – carefully protecting the interests of investors and employees without burdening our economy.

Where there is a demonstrated need for tougher laws or for tougher enforcement, I am committed to doing all I can to curb corporate and accounting abuses. For this reason, I am anxious to hear from the experts during this important hearing.

THE TESTIMONY OF

THE HONORABLE RODERICK M. HILLS

BEFORE THE

SUBCOMMITTEE ON CRIME AND DRUGS OF THE

SENATE JUDICIARY COMMITTEE

UNITED STATES SENATE

July 24, 2002

INTRODUCTION

I am pleased to have this opportunity to express my views about the spate of accounting scandals that began, perhaps with Waste Management, in 1998 and have filled our newspapers for well over one year. That these scandals have seriously eroded confidence in corporate America and tainted both Wall Street and the accounting profession cannot be seriously doubted. The questions before this Subcommittee and, indeed, before all of corporate America are:

- Why did it happen;
- Can we reduce the possibility that it will happen again; and
- What can we do to restore investor confidence?"

This Subcommittee is particularly interested in the question whether strengthening of criminal laws and/or penalties can be constructive.

Why did it happen? It is sad to say but history does tell us that near the end of each bull market too many who are desperate to extend the good times break or bend the rules. The "conglomerate craze" of the late 1960's and the Wall Street excesses of the late 1980's are examples.

Our disappointment today is that the great strides that we have made in corporate governance in the past 26 years did not protect us from these extraordinary accounting abuses that show up now almost every week.

The first serious effort to require board supervision of corporate conduct began in 1976, 26 years ago, in reaction to the fact that over 400 U.S. companies had to admit that they had made questionable payments to foreign officials. At that time the SEC:

- Persuaded the New York Stock Exchange to require independent audit committees to monitor corporate books and records;
- Required the auditing profession to adopt tough new auditing standards; and
- Required publicly traded companies to have effective internal controls over its books and records.

Since then the Treadway Commission, the Blue Ribbon Commission, Directors' Colleges at prestigious business and law schools and countless conferences have pounded the principles of good corporate governance into lawyers, accountants and directors. A fair evaluation of corporate America today will conclude that great progress has been made. Still, we cannot avoid the conclusion that notwithstanding that progress and all those well-intended efforts the system failed us.

In my view it failed because of three fundamental weaknesses.

- Our regulatory system, begun in the 1930's needs a major overhaul;
- Second, it is increasingly clear, under the existing system, that there have been, and likely will be, too many audit partners that are not able, in the present system, to resist management pressures to permit incomplete or misleading financial statements; and
- Third, the audit committees of too many boards have not exercised the authority given them in 1976 or the responsibility expected of them as spelled out in so many commission reports.

The Audit System.

The external audit has become a commodity. Companies produce them because they must. Few CEO's see any intrinsic value in them and so the accounting firms compete for the work on price rather on the quality of their people.

The system has too many rules. There are so many of them that it is common for accountants and lawyers to believe that anything not prohibited is, therefore, permitted. This maze of rules is a challenge to innovative minds. Investment bankers are paid

millions, as in the case of Enron, to create corporate structures that wend their way though the maze, satisfying the rules but frustrating to purpose of our securities laws.

The Auditors.

Auditors are becoming rule checkers. They seldom exercise the kind of judgments to which I became accustomed in the 1970's when running a troubled conglomerate. They still put their formula sentences in their audit letters:

> ***"In our opinion the company's financial statements fairly present, in all material respects, the financial position of the company."***

But they do not really mean that. This opinion means only that they have found no material violation of the rules.

Also, the quality of people entering the profession has deteriorated significantly over the past 25 years. Then between 15% and 20% of our MBA graduates from our better business schools entered the profession. Not any more! Then 25% more people took the CPA than take it today yet the big firms hire more people today. So, we have a smaller pool with less talent in it and the big firms are hiring more people out of it.

The Audit Committees.

They were created to protect the independence of the audit and the auditors. Yet most audit committees do not yet understand what that assignment entails. They are not:

- Asking the auditors if there is fairer way to present the company's financial statements;
- Participating, in any meaningful way, in the selection of the audit firm or in the selection of the new partner who is rotated in every seven years;
- Playing a significant role in the setting of fees; or
- Making any real effort to evaluate the performance of the external auditors.

Also, while audit committee members are, for the most part, objectively independent, they are too often selected for the board by the CEO who also decides who will sit on the audit committee and who will chair it.

Auditors understand all this. They are, as a result, fearful of being fired by management and they have little confidence that the audit committee will protect them.

In the case of the former Waste Management, the audit committee had not seen a management letter for five years yet, for those same five years, the auditors had given management a list of serious changes that had to be made in their accounting practices.

REMEDIES

For the System.

There is no secret about what the system should look like. Professor Roman Weil of the Chicago Business School spelled it out:

> ***"I want accountants to use fundamental concepts in choosing accounting methods. I want accountants not to hide behind the absence of a specific rule."***

The Accounting Department of NYU has added:

> ***"It takes the Financial Accounting Standards Board four years to write a rule and an investment banker four minutes to find a way around it."***

In the system envisioned by Professor Weil, the audit partner could have real value to CEO's who would both want and need their judgment. They would pay more attention to the quality of the accountant and less to the cost of the audit.

Such a system would be like that in England and much of Europe. There auditors do reason from broad principles. Why do we not have that system? Simply because the auditors are justifiably afraid that they will be sued and have their judgment questioned by juries. They seek specific and detailed rules to protect themselves from litigation.

The SEC does have the authority to provide a "Safe Harbor" that would to some degree protect the auditors from private challenges to their judgment, but the Commission would be unwise to do so until such time as an effective oversight capacity is established that can monitor the profession.

The SEC is now pushing the profession toward a more judgment-based approach. In December of last year, it told auditors that they have a responsibility to tell the board and the shareholders if there is another way to present the company's financial system that would materially affect debt or earnings. In February of this year, auditors were told that mere satisfaction of all the rules is not sufficient. They must be certain that the statements are "fairly presented".

Congress and the SEC are now considering the kind of new oversight needed for the profession. The Senate's bill is constructive in its proscriptions and in providing for stronger oversight and in providing the added funds so badly needed for the work of the SEC.

With one mild caveat, I support the proscriptions of the bill. Its apparently blanket prohibition of internal audit work is unnecessary and would if strictly enforced be extremely difficult to implement. There is no bright line between the internal and the external audits. In many companies, the two groups work each year to divide the primary basic audit work between them. In some parts of the world, such as Central America, the major accounting firms have very little strength and must, therefore, rely on the internal audit. In other places, the company does not have enough activity to justify regular trips by internal auditors and, as a result, ask the external auditor to fill in.

Also, when the company does the internal audit itself, as opposed to outsourcing the work, the external auditors are often asked to supplement parts of the work. The SEC limitation is that the external auditor may do only 40% of the internal audit. It is a preferable approach but would be enhanced by a requirement that any such work would need the approval of the audit committee.

In the same vein, I am concerned that the prohibitions against consulting may be too stringent. Here too the cause of good corporate governance is well served by requiring the audit committee to establish guidelines for any such work by the external auditor and by approving all work over a strict limit of say 20% of the audit fee.

The Senate Bill would be strengthened if it included a mandate for audit committees that would require regular (say every four years) evaluations of the external auditor. With independent expertise the committees could be required to

change auditors unless they were able to find that renewal of the existing auditor is in the best interest of the shareholders.

I also support the oversight provisions of the Senate Bill. Its efficacy, however, will depend on the ability of this new unit to work harmoniously with the SEC. ***Presumably, the SEC will have the authority to allocate tasks between it and the new body.***

Also, there is a need to do more review work, forensic work, so that bad accounting can be caught before the stockholders feel their brunt. The model for such an effort can be found in the work of the bank examiners employed by the Federal Reserve Board or the Comptroller of the Currency and that of the SEC in its monitoring of broker/dealers.

Today, the major accounting firms all have "watch lists" of those companies that appear to have the greatest audit risk. The SEC could develop software comparable to that used by those firms to create the same lists for the purpose of selecting companies for review. However, a program to examine the current accounting practices of corporations would need to have the authority to protect the confidentiality of the examinations comparable to the authority of the bank regulators.

I suggest to this Subcommittee that funds made available to the SEC to have this kind of monitoring unit would substantially improve the quality of accounting.

For the Audit Committees.

Audit committees can easily fix themselves, but it probably will take significant SEC pressure to cause them to:

- Meaningfully participate in selecting auditors and in fixing their fees;
- Insist on knowing alternative ways of presenting the company's financial position; and
- Conduct at regular intervals, say four years, an evaluation of the auditor's work using independent expertise to decide whether it is in the shareholders' interest to retain the same firm for a future year.

In short, the audit committees must take charge of the audit; they must confer the needed independence on the auditors.

Also, the SEC and the independent directors must insist that nominating or governance committees, not the CEO, choose new directors and decide who shall sit on the audit committee. This point cannot be overstressed. If directors feel obliged to the CEO for their board position, a misplaced sense of old world courtesy will often causes them to resign from the board rather than to criticize their benefactor.

For the Auditors.

Audit partners will not yield to management pressure if the audit committees effectively protect their independence. The aggressive accounting policies too often adopted by companies seldom if ever originate from the auditor. In my experience on 17 boards of directors over the past 32 years, innovative accounting has always come from management and was in almost every instance resisted, sometimes not enough, by the auditors.

Correspondingly, the work of the audit committees will be considerably eased if the auditors firmly believe that the committee will protect them. Committee members can, in such a circumstance, count on the fact that the auditors really will work for them. When the auditors truly become the eyes and ears of the audit committee the entire system will work so very much better.

The point I wish to emphasize is that very few audit partners today believe that they have this kind of relationship with the audit committees.

Use of the Criminal Laws.

I believe the strengthening of the law represented by the "White-Collar Penalty Enhancement Act" will have a salutary effect. The Act, with its increased penalties and

by codifying the duty of the CEO to validate financial statements, will make crystal clear the costs of adventuresome accounting.

The real problem, however, is the difficulty of securing convictions in financial fraud cases. The primary need, therefore, is to supplement the investigative authority and the budgets of the relevant agencies.

The recent task force created between the Justice Department and the SEC to focus on securities fraud may prove effective. I do have some concern about the melding of the SEC's civil authority with the criminal might of the Justice Department. Considerable care must be taken to avoid the temptation to use the threat of criminal prosecution to secure a civil settlement.

With that caveat, joint units of the United States Attorneys' offices and the SEC's enforcement personnel, particularly in Washington D.C., could better prepare both offices for successful enforcement action. Also, until the SEC has the funds and the time to train significant numbers of new trial attorneys the U.S. Attorney in Washington D.C. may be able to provide needed personnel.

In this same vein, it may be sensible for the SEC and the Department of Justice to cooperate in creating the type of monitoring capacity referred to earlier in my testimony.

The opportunities for more successful criminal prosecutions will be significantly enhanced both by the new oversight actions and by increasing the Commission's budget. If the SEC can move faster to protect evidence in serious cases that evidence will be available for any subsequent criminal action that is appropriate.

SUMMARY

As stated in the Introduction, there can be no question about the fact that accounting abuses have eroded confidence in the accounting profession and in both corporate America and Wall Street. As we acknowledge the deficiencies in our system and begin to correct them, we must also acknowledge the importance of the accounting profession to the global economy and to society.

The profession is certainly not blameless but it is just as certain that it does not deserve all the blame. It has been caught in a system that it cannot reform itself. As we adopt the needed reforms, we must not needlessly harm it.

Thank you for this opportunity to present these views.

RODERICK M. HILLS

BOARD OF DIRECTORS (CURRENT)

ICN Pharmaceuticals, Inc., Chairman of Audit Committee 2002-;
Chiquita Brands International, Inc., Chairman of Audit Committee 2002-;
Regional Market Makers, Director, 2000-.

PRIOR BOARDS ACTIVITY

Federal-Mogul Corporation, Chairman Governance Committee and former Chairman, Audit Committee Member, 1977-2002;
Per-Sé Technologies, Chairman, Audit Committee, 1999-2001;
Orbital Sciences Corporation, Audit Committee Member, 2001;
Waste Management, Inc. (merged with USA Waste and renamed Waste Management, Inc. in July, 1998), Chairman, Audit Committee, 1997-2000;
Oak Industries Inc., Vice Chairman and Chairman, Audit Committee, 1985-2000;
Mayflower Group, Inc., Audit Committee Member, 1993-96;
Sunbeam-Oster, Audit Committee Member, 1991-96;
Drexel Burnham Lambert, Inc., Member, Oversight Committee, 1989-90; appointed by U.S. Government.
Alexander & Alexander Services, Inc., Chairman, Audit Committee, 1978-87;
Anheuser-Busch Companies, Inc., Member, Audit Committee, 1977-89;
Santa Fe International, Chairman, Audit Committee, 1977-86;
Republic Corporation, Chairman, Audit Committee Member, 1971-75;
Beck Industries, Audit Committee Member, 1970.

GOVERNMENT

Law Clerk to Justice Stanley F. Reed, Supreme Court of the United States, 1955-57;
Counsel to the President of the United States, 1975;
Chairman, Securities & Exchange Commission, 1975-77.

PRIVATE EMPLOYMENT

Founder and Partner, Munger, Tolles & Hills, 1962-75;
Chairman, Republic Corporation (NYSE) 1971-75, Chief Executive Officer, 1974-75;
Chairman and Chief Executive Officer, Peabody Coal Company, 1977-78;
Partner, Latham, Watkins & Hills, 1978-82, Of Counsel, 1982-84;
Chairman, Hills Enterprises, Ltd. (formerly The Manchester Group, Ltd.), 1984-.
Chairman, Federal-Mogul Corporation, 1996;
Founder and Partner, Hills & Stern, Attorneys at Law 1996-.

ASSOCIATIONS

RAND Institute For Civil Justice, Board of Overseers.
U.S./ASEAN Business Council, Founder, former Chairman, and present Vice Chairman.
Committee for Economic Development, Trustee and Member, Research & Policy Committee.
Vice-Chairman, Trustees of Claremont College, 1970-75.
Chairman, Research Committee, American Bar Foundation, 1965-69.
Member, State Bar of California, District of Columbia, United States Supreme Court, Ninth Circuit and District Courts of Appeal; American Bar Association; American Bar Foundation; Chancery Club.
Chairman Fund for the Study of Crime & Corruption.

ACADEMIC EXPERIENCE

Professor, Harvard University, School of Law & School of Business, 1969-70;
Distinguished Faculty Fellow & Lecturer (International Finance), Yale University, School of Organization & Management, 1985-7;
Lecturer in Law (Visiting), Stanford University School of Law, 1960-70.

EDUCATION

Stanford University, B.A. 1952, LL.B. 1955; Order of the Coif, Comment Editor, Stanford Law Review, 1953-55.

UNITED STATE SENATE

COMMITTEE OF THE JUDICIARY SUBCOMMITTEE ON CRIME AND DRUGS

HEARING ON: ENSURING CORPORATE RESPONSIBILITY: USING CRIMINAL SANCTIONS TO DETER WRONGDOING

STATEMENT OF G. WILLIAM MILLER
July 24, 2002

Chairman Biden, Senator Grassley, and Members of the Subcommittee:

Thank you for affording me the opportunity to comment on the important issues now being considered by your committee. Momentous events have affected our nation over the past year. Certainly the events of 9-11 evidence a powerful and pervasive foreign threat to America's security that is unprecedented in our history. The parallel powerful domestic threat from corporate misbehavior is likewise unprecedented in its magnitude and scope. While this internal threat does not directly endanger lives or destroy physical property, the potential damage to the American financial and economic systems can be enormous, causing widespread hardship and even suffering. The current shattering of confidence not only has destroyed the savings and hopes of many employees caught in the maelstrom but also has wiped out capital values greater than the gross national product of many major countries.

While it is not possible to legislate honesty, any government concerned with the welfare of its citizens must have a structure of laws which protects against criminal and predatory behavior affecting the lives, property and rights of all its people.

Indeed, in a civilized society there must be a rule of law that includes effective sanctions to deter all forms of criminal wrongdoing.

I'm sure the Subcommittee members understand that I appear here not as an expert in criminal law, but as one whose experience in corporate management and governance and in government service may be relevant in your deliberations.

* * * * * *

The federal government's response to the sudden eruption of corporate accounting and disclosure problems has been swift and comprehensive. Each house of the Congress has passed its version of broad reform legislation. The bills are now in conference. The SEC has proposed rules covering much of the same ground. The President has presented the Administration's own plans for reform. So, much is underway.

In the process of considering legislation, your Subcommittee has heard well-informed testimony with respect to the nature and characteristics of white collar crime. Such crime is often committed by persons of above average education or intelligence, operating from legitimate platforms, capable of clever deception and stealth, weaving complex webs which are difficult to unwind, and corrupting associates in order to provide cover.

As a consequence, it is inherently difficult to ferret out most forms of white collar crime. The task is formidable for corporate wrongdoing in the securities area. Financial accounting involves many estimates and judgments, with room for disguising misrepresentations. Corporate structures are becoming more and more complex, with multiple product lines, extensive production and service units, global activities with transactions in many currencies involving varying business practices, complicated financing arrangements, and layers of government regulation. In this maze, criminal wrongdoing may be difficult to discover and difficult to prove beyond a reasonable doubt. So it is makes sense to create a regime with maximum emphasis on deterring the crime before it is committed.

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The question here is how to ensure corporate responsibility by using criminal sanctions to deter wrongdoing.

As has been pointed out, there is a perception that penalties for white collar crimes are not commensurate with the gravity. As a result the deterrent is weak. Certainly the greed that drives the recent rash of alleged corporate wrongdoing is fostered by the criminal's belief that the rewards are great and the possibility of more than nominal punishment is low.

For the corporate wrongdoer the deterrent is only likely to be effective if there is a high likelihood of detection and a high probability of serious punishment. The most powerful deterrent is the threat of jail time. The prospect of substantial monetary penalties can also affect behavior.

In recent times there has been some progress in strengthening criminal sanctions for white collar crimes to bring them more in line with other criminal penalties. Both the Senate and the House have passed bills which increase fines and prison terms for some white collar crimes. The proposed White-Collar Crime Penalty Enhancement Act of 2002 (S. 2717) sponsored by Chairman Biden and Senator Hatch focuses clearly on the issue as well as on the certification of corporate financial reports by corporate officers.

With respect to criminal penalties, the Biden-Hatch bill seems balanced and appropriate. The approach is to harmonize and rationalize rather than to place white collar criminal penalties outside the general pattern of criminal sanctions. As to conspiracy, the proposal is to conform the penalty to the one applicable for the predicate crime, consistent with other criminal statutes. The increased penalties for wire fraud and mail fraud are put in line with those for security fraud under a section of the Securities Exchange Act and with those proposed for a new security fraud offense. The change for criminal violation of ERISA would be consistent with penalties for pension fraud and other criminal fraud laws.

While I have not carefully studied the House bill, my impression is that some of the proposed penalties go beyond what is necessary to make sanctions for white collar crimes more consistent with other criminal penalties. A more effective deterrent for corporate wrongdoing is in order, but it would be prudent not to overshoot the mark.

The concept for corporate officer certification of financial statements is much in discussion. The experience with a number of the recent corporate melt-downs has stimulated a demand for accountability. If the CEO is required to certify the reports he will be hard pressed later to say he thought the CFO had every thing in apple pie shape. So the certificate becomes the hook that establishes accountability.

The proposed certificate in the Biden-Hatch bill reads almost like the opinion of an independent auditing firm. It must be recognized, however, that the chairman, CEO and CFO cannot themselves duplicate the auditor's work. In a large company thousands of work hours are expended in auditing the financial statements. Even then it is not possible for the most competent auditing firm to guarantee that there are no defalcations of any kind at any place. The object is to be as sure as can be that there are no material errors.

As a practical matter, in order to certify the financial statements, any officer will need to rely upon others. The certifying officer should be judged, therefore, upon whether he has been diligent, exercised due care, established procedures for verification, made adequate investigations, and provided appropriate supervision. In a nutshell, a certifying officer should not be in violation if he or she relies in good faith on the representations of those

who have direct knowledge of the accounting and financial entries. I take these comments to be consistent with the intent of the Biden-Hatch bill since under its terms a certifying officer would be liable only if he or she recklessly and knowingly or willfully violates any provision of the section.

Under the proposal, the certification is required by the chairman of the board, the CEO and the CFO or their equivalents. By definition a CEO and a CFO should be employees of the company. Some corporations have non-executive chairmen who are not employees. It might be appropriate to require certification only from such officers as are full-time employees, since it is they who will have intimate knowledge of the operations as well as authority over the organization.

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When it comes to deterrence, the threat of jail time and fines must be real. The most Draconian penalties will not deter wrongdoing if the perpetrators believe that the penalties will not be enforced.

A lesson from the past is worth noting. A change in corporate attitudes toward observance of anti-trust laws came not from a change in the law but from a change in enforcement. The milestone event was the imposition of significant prison sentences on high-ranking officers of a major corporation. A tremor ran through all executive suites.

Today well-managed manage corporations include anti-trust compliance in their code of ethical conduct and run regular seminars to educate and re-educate managers and employees down the line in order to avoid antitrust violations.

It is not unreasonable to have the view that enforcement of present securities laws has not been as vigorous as required in order to deter the risk of widespread damage from wrongdoing. This is being recognized, and it is to be hoped that the Congress and the Administration will allocate sufficient human and financial resources to assure rigorous enforcement.

CONCLUSION

In my view the great preponderance of American corporations are managed responsibly and contribute to a remarkable economic system which has created the most prosperous society in the history of the world. A relative few, even if far too many, corporations have failed in their stewardship. The damage done to employees and shareholders has been tragic. The damage done to public confidence in corporate governance has impacted all Americans and destroyed investment values in the trillions.

Those responsible must be held accountable. Safeguards must be established to prevent a recurrence. The actions being taken by Congress in general and by this Subcommittee in particular are appropriate. Higher standards, better oversight, strong deterrents, more vigorous enforcement, clearer lines of accountability—all will help the healing.

Equally important is to guard against stifling initiative and creativity. To deal with a few bad actors it will not be necessary to hem in with burdensome regulation the talents essential for American economic vitality. It would undermine American economic progress to drive out the most productive managers by forcing them out of innovative activities into bean counting.

As large, previously regarded companies fail and the stock market sinks, anxieties grow. But the remarkable thing, overlooked in our anxiety, is that the aggregate impact of all these failed companies has not shaken the recovery of the U. S. economy. This is an amazingly resilient system. It is absorbing the shock and moving ahead. Economic growth will continue. Corporate earnings will increase. The stock market will turn up again. America is not broke, so legislate with care.

POSTSCRIPT

I cannot pass up this opportunity to point out that white-collar crime is not limited to cooking the books or manipulating stock prices. There is an enormous plague of tax fraud. Tax evasion and fraud does not kill people or demolish skyscrapers. But it involves the equivalent of embezzling money which is owed to the government, often rationalized by a perverse view that the government doesn't deserve the funds in any case. Tax evasion does great harm, not only in the unfairness from the unequal treatment among tax payers but also in eroding the moral base of citizenship.

In the past, the IRS may have engaged in over-aggressive enforcement, but now the IRS has been starved of resources to pursue a vigorous and fair enforcement regime. Today there is inadequate audit of tax returns and abusive tax shelters are alive and well. Tax evasion will be found in the corporate world as well as among individual taxpayers.

As events have rapidly shifted the federal budget from surplus to deficit, tax enforcement could be a timely fiscal reform. I believe that an effective collection of taxes actually owed would bring in sufficient funds to eliminate the present deficit, or at least to greatly reduce it.

Tax evasion is, of course, more rewarding to those who have more income. Such taxpayers have considerable influence on tax policy, and may use that influence to hold down the funds available to the IRS for enforcement. Inadequate funding of SEC enforcement made it easier for corporate wrongdoing to get out of hand. That was counter-productive. Acquiescing in a lax enforcement atmosphere that allows individuals and corporations to fudge on or to cheat on their taxes is not a worthy system. It is not good citizenship; it is not good governance. It too is counterproductive.