



CENTER FOR FINANCIAL STABILITY

Dialog Insight Solutions

Emotion Is No Substitute for Evidence: An Essay on the Lack of Prosecutions of Wall Street Executives Stemming from the Financial Crisis

Bradley J. Bondi and Christopher Jones

March 27, 2014

Introduction

On November 11, 2009, two former Bear Stearns executives stepped out of a federal courthouse in Brooklyn, victorious. Theirs was the biggest trial in the wake of the financial crisis, and a jury of their peers found them not guilty, ending a saga that had begun with the two men paraded in handcuffs for the cameras.

The case was the first major prosecution brought against Wall Street executives, and it provided an opportunity to see how other potential cases might go forward. Now, more than four years later, it is the only prosecution the government has brought against Wall Street executives related to the financial crisis.

Many people have asked why the government has not brought more such cases. And their indignation and demand for accountability is justified. After all, the financial crisis may have wiped away as much as \$14 trillion from the U.S. economy.¹ And previous financial crises resulted in significant convictions. Following the S&L crisis, the government successfully prosecuted more than 1,000 individuals, including hundreds of executives. The highest profile conviction was that of Charles Keating, who ran Lincoln Savings and Loan until it collapsed in 1989. Yet the 2008 financial crisis – the most significant crisis since the Great Depression – has not produced any prosecutions on a level comparable to Keating's.²

Federal judges, former politicians, and big-name journalists have proposed myriad theories to explain the lack of prosecutions. Mostly recently, Judge Jed S. Rakoff of the Southern District of New York wrote that a diversion of prosecutorial resources away from white-collar crime, lax government regulation, and a focus on prosecuting companies rather than individuals has contributed to the void in prosecutions.³ Eliot Spitzer, the self-described “Sheriff of Wall Street,” said the Justice Department

¹ David Luttrell, et al., *Assessing the Costs and Consequences of the 2007–09 Financial Crisis and Its Aftermath*, THE FED. RESERVE BANK OF DALLAS (Sept. 2013), available at <http://www.dallasfed.org/research/eclett/2013/el1307.cfm>

² While Bernie Madoff's Ponzi scheme was not a cause of the financial crisis, the two events are related. Bernie Madoff's notorious Ponzi scheme wiped out nearly \$20 billion from his victims, and the financial crisis helped expose the fraud he began in the early 1990s. Madoff could not keep up with the market turmoil, and as investors sought to redeem their funds, Madoff's Ponzi scheme fell apart. Jordan Maglich, *A Ponzi Pandemic: 500+ Ponzi Schemes Totaling \$50+ Billion in 'Madoff Era'*, *Forbes* (Feb. 12, 2014), available at <http://www.forbes.com/sites/jordanmaglich/2014/02/12/a-ponzi-pandemic-500-ponzi-schemes-totaling-50-billion-in-madoff-era>.

³ Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, THE N.Y. REV. OF BOOKS (Jan. 9, 2014), available at <http://www.nybooks.com/articles/archives/2014/jan/09/financial-crisis-why-no-executive-prosecutions>.



CENTER FOR FINANCIAL STABILITY

Dialog Insight Solutions

never tried to bring together one coherent narrative against major players.⁴ Rolling Stone reporter Matt Taibbi blamed the revolving door between Wall Street and the Federal Government, and suggested that the criminal justice system has evolved into “a highly effective mechanism for protecting financial criminals.”⁵ And United States Senator Ted Kaufman suggested that some people were simply “too big to jail.”⁶ But anyone who has paid attention to U.S. Attorney for the Southern District of New York Preet Bharara’s relentless pursuit of inside trading, including high profile convictions of Raj Rajaratnam or recently former SAC Capital portfolio manager Mathew Martoma, knows that these theories are too simplistic and that prosecutors continue to aggressively pursue high profile financial cases, even if these are unrelated to the financial crisis.

All of these theories stand on a faulty premise. All *assume* that high-level executives engaged in fraudulent conduct. They assume that where there is a financial crisis, there must be a criminal element. So much for innocent until proven guilty. What the lack of high-profile prosecutions shows is that proving the elements of a crime in these circumstances has been more than just difficult, it has been impossible in most cases.

The dearth of prosecutions of Wall Street executives is attributable to three primary factors: first, by and large, Wall Street executives did not commit fraud; second, investigative efforts have yielded few cases; and third, even where suspicion of fraud exists, it is extraordinarily difficult to prove in court.

Why No Wall Street Convictions?

Fraud Did Not Cause or Substantially Contribute to the Crisis

Many theories have been proposed about the causes of the crisis, but fraud by Wall Street executives is not one of them. Investigative bodies such as the Financial Crisis Inquiry Commission (“FCIC”) and the Permanent Subcommittee on Investigations of the United States Senate (“PSI”) spent years conducting interviews, reviewing documents, and analyzing evidence in search of the causes of the crisis. But there are no allegations that Wall Street executives engaged in fraudulent conduct. And while the FCIC issued three different reports reaching three different conclusions on the causes of the crisis, they all agreed as to one point – fraud by Wall Street executives was not one of them.

The majority report, issued by six Democrats, focused on three key causes: (1) lack of mortgage-lending standards; (2) over-the-counter derivatives, which fueled the housing bubble; and (3) failures of the credit rating agencies.⁷ The report catalogued other factors such as mortgage fraud, lax lending standards, deregulation in Washington, and Wall Street greed. But the FCIC report does not accuse Wall Street executives with criminal conduct that contributed to the crisis.

Three dissenting Republicans issued a report and also discussed mortgage fraud. They acknowledged that it did tremendous harm, facilitated by lax lending standards that allowed lenders to create a huge

⁴ *Frontline: The Untouchables* (PBS television broadcast Jan. 22, 2013).

⁵ Matt Taibbi, *Why Isn't Wall Street in Jail?*, ROLLING STONE (Feb. 16, 2011), available at <http://www.rollingstone.com/politics/news/why-isnt-wall-street-in-jail-20110216>.

⁶ Ted Kaufman, *Why DOJ Deemed Bank Execs Too Big To Jail*, FORBES (July 29, 2013), available at <http://www.forbes.com/sites/tedkaufman/2013/07/29/why-doj-deemed-bank-execs-too-big-to-jail>.

⁷ Financial Crisis Inquiry Commission, THE FINANCIAL CRISIS INQUIRY REPORT xv–xxviii (2011).



CENTER FOR FINANCIAL STABILITY

Dialog Insight Solutions

volume of bad mortgages without breaking the law. But they did not impute the mortgage fraud by borrowers and lenders to Wall Street executives.

Finally, Republican Commissioner Peter Wallison, the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute, wrote a dissent explaining how the failure of the sub-prime mortgage industry weakened financial institutions. According to Wallison, U.S. housing policies led to a significant growth of these mortgages.⁸ He did not blame Wall Street executives for the cause. As he explained, \$4.5 trillion of high-risk mortgages was like an exploding gasoline truck in a tinder-dry forest.⁹

A two-year investigation by the PSI identified four primary causes: (1) high-risk lending; (2) regulatory failures; (3) inflated credit ratings; and (4) high-risk, poor quality financial products. The Subcommittee did not identify fraud as a central cause of the crisis. Like the FCIC report, the PSI documented the risk of mortgage fraud. The PSI quoted then SEC Chairman Christopher Cox, who testified in a Senate Committee hearing that the credit default swap market was “ripe for fraud and manipulation.”¹⁰ Yet the Subcommittee report did not allege that fraudulent practices occurred at the highest ranks on Wall Street.

Investigative Efforts Have Yielded Few Possible Cases

So far, federal agencies have had little success in finding evidence of fraud in their investigative efforts, and it is not for want of trying. Virtually every federal agency with jurisdiction – from the Department of Justice, the FBI, and the SEC to Congressional subcommittees and the Financial Crisis Inquiry Commission (“FCIC”) – has investigated potential fraudulent conduct during the financial crisis. And despite millions of dollars expended and thousands hours searching, few cases against any individuals at any level have been pursued, and no cases against executives.

Two central figures in the financial crisis – AIG’s Joseph Cassano and Countrywide’s Angelo Mozilo – were not criminally prosecuted. They were both named as two of the 25 people to blame for the crisis by Time Magazine.¹¹ By the fall of 2008, AIG suffered a severe liquidity crisis, prompting the federal government to step in and rescue the troubled insurer. Cassano, the chief executive of AIG’s insured mortgage-related securities unit, came under scrutiny for his role in the company’s collapse because he said that AIG’s obligations on mortgage securities were unlikely to produce losses. Yet other evidence uncovered showed that Cassano made key disclosures about the value of its swaps. The federal prosecutors who investigated the collapse of AIG determined not to bring charges against Cassano.

Similarly, although the SEC pursued civil charges, criminal prosecutors never brought charges against Mozilo. Mozilo was the CEO of Countrywide Financial, one of the nation’s largest mortgage lenders. The SEC accused him of failing to disclose risks in Countrywide’s operations to investors and of generating profits from trading on inside information while he allegedly was aware of Countrywide’s

⁸ Financial Crisis Inquiry Commission, *THE FINANCIAL CRISIS INQUIRY REPORT* (Wallison Dissent) 457 (2011).

⁹ *Id.* at 469.

¹⁰ Statement of SEC Chairman Christopher Cox, “Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions,” before the U.S. Senate Committee on Banking, Housing and Urban Affairs, S.Hrg. 110-1012 (9/23/2008).

¹¹ Time, *25 People to Blame for the Financial Crisis*, Time (Feb. 12, 2009), available at http://content.time.com/time/specials/packages/article/0,28804,1877351_1877350_1877339,00.html.



CENTER FOR FINANCIAL STABILITY

Dialog Insight Solutions

precarious financial position. Mozilo and the SEC settled the case, with Mozilo agreeing to pay \$67.5 million to settle the case. Yet here as well, federal prosecutors did not bring a criminal case. These two investigations brought significant media exposure, and many commentators criticized the government for failing to bring criminal cases. Yet they also illustrate that investigations do not always lead to prosecutions. As FBI Associate Deputy Director Kevin Perkins said in a January 2013 interview about the lack of high-level prosecutions, “We were not able to show criminal intent sufficiently enough to obtain what we believe – to obtain a conviction of a criminal.”¹²

The closest examples of executive-level prosecutions came from a \$2.9 billion fraud scheme involving Colonial Bank and the mortgage-lending firm Taylor Bean & Whitaker (“TBW”). According to court documents and evidence, executives at TBW, including former Chairman Lee Farkas, conspired to misappropriate more than \$1.4 billion from Colonial Bank’s mortgage-lending division. The money then was allegedly used in part to cover TBW’s operating expenses. Farkas was sentenced to 30 years in prison and was required to forfeit \$38.5 million. Six other individuals also were sentenced to serve time for their roles in the scheme. U.S. Attorney Neil MacBride, of the Eastern District of Virginia, said Farkas pulled off one of the largest bank frauds in history and that it affected those at the heart of the financial crisis.

Although prosecutors touted these as prosecutions stemming from the financial crisis, they bore little resemblance to conduct on Wall Street. Farkas’ fraud coincidentally occurred near the time of the collapse of the financial markets, yet TBW’s problems began in 2002 because of an overdraft on its account with Colonial.¹³ Ultimately, the overdrafts grew, leading Farkas and others to sell fraudulent mortgages to Colonial. This scheme was tangential to the sub-prime housing market and the mortgage-backed securities involved in the financial crisis.

Bear Stearns & the Difficulty In Obtaining Convictions

Even where suspicions of fraud exist, obtaining a conviction is difficult. The Bear Stearns case illustrates this challenge for prosecutors. Ralph Cioffi and Matthew Tannin managed two hedge funds that collapsed in June 2007 as the sub-prime mortgage market fell apart. Investors lost \$1.6 billion. The prosecution focused on email exchanges between the two men, which prosecutors believed showed that the men knew the investments were bad while still assuring investors that the funds were sound. In one email discussing the sub-prime market, Tannin wrote, “Looks pretty damn ugly. . . . If [the runs] are correct then the entire sub-prime market is toast.”¹⁴ A few days later, Tannin told investors “we’re very comfortable with exactly where we are.”¹⁵

The defense countered these excerpts, showing that the entire email exchange demonstrated that the two men made aggressive bets rather than closing the funds. One juror likened Cioffi to the captain of a sinking ship, “working hard, 24/7 . . . to stop the boat from sinking.”¹⁶ Ultimately, the jury thought that

¹² *Frontline: The Untouchables*, *supra*, note 4.

¹³ Press Release, Department of Justice, *Former Chairman of Taylor, Bean & Whitaker Convicted for \$2.9 Billion Fraud Scheme That Contributed to the Failure of Colonial Bank* (Apr. 19, 2011), available at <http://www.justice.gov/opa/pr/2011/April/11-crm-490.html>.

¹⁴ Financial Crisis Inquiry Commission, *THE FINANCIAL CRISIS INQUIRY REPORT* 239 (2011).

¹⁵ *Id.*

¹⁶ Amir Efrati and Peter Lattman, *U.S. Loses Bear Fraud Case*, *WALL ST. J.* (Nov. 11, 2009), available at <http://online.wsj.com/news/articles/SB125788421912541971>.



CENTER FOR FINANCIAL STABILITY

Dialog Insight Solutions

the prosecution did not present enough evidence that Cioffi and Tannin acted with criminal intent or that they conspired to mislead investors.

The not guilty verdict in the Bear Stearns case shows how difficult it is to prove a violation of federal Securities laws. Congress has imposed a willful or knowing standard for violations of the Exchange Act, which means the government must prove beyond a reasonable doubt that the individual participated in the scheme to defraud knowingly, willfully, and with intent to defraud.¹⁷

Even with emails and other documents like those used by prosecutors in this case, often none of that evidence is akin to a smoking gun. Often, federal prosecutors do not find a concrete piece of evidence that reveals the requisite level of intent to reach a conviction. As Preet Bharara told the New Yorker, without the evidence “you don’t actually have the criminal intent, and it may look like the person was simply negligent.”¹⁸

Another challenge for prosecutors is finding witnesses willing to cooperate. Often, prosecutors rely on low-level employees or others who are willing to provide information about misconduct by others, most often misconduct by individuals that hold senior positions. For example, the government leaned on former Enron CFO Andrew Fastow in making its case against Ken Lay and Jeffrey Skilling.¹⁹ The inability of prosecutors to make greater use of this tactic in financial crisis prosecutions could suggest that fraudulent conduct was limited to the front-line borrowers and lenders of the sub-prime mortgages.

The lack of criminal prosecutions of Wall Street executives does not mean the government has not had success in civil cases, however. It recently won a civil mortgage fraud case over mortgages sold by Countrywide. Countrywide originated the mortgages and sold them to Fannie Mae and Freddie Mac, which suffered losses of more than \$800 million on the bad loans. The government utilized the Financial Institutions Reform, Recovery, and Enforcement Act (“FIRREA”), a law enacted after the S&L crisis and one not often used by prosecutors, to bring the case. Importantly, FIRREA, like other laws imposing civil liability, has a lower burden of proof. It requires only a preponderance of the evidence, rather than the “beyond a reasonable doubt” standard as in criminal cases. Following the victory, Bharara said his office would “never hesitate to go to trial to expose fraudulent corporate conduct and to hold companies accountable, particularly when it has caused such harm to the public.”²⁰

¹⁷ Samuel W. Buell, *What is Securities Fraud?*, 61 Duke L.J. 511, 557 (2011).

¹⁸ George Packer, *A Dirty Business: New York City’s top prosecutor takes on Wall Street crime*, The New Yorker (June 27, 2011), available at

http://www.newyorker.com/reporting/2011/06/27/110627fa_fact_packer?currentPage=all.

¹⁹ Wade Goodwyn, *Former CFO Testifies Against Enron Executives*, NPR.org (Mar. 7, 2006), available at

<http://www.npr.org/templates/story/story.php?storyId=5250132>.

²⁰ *Id.*



CENTER FOR FINANCIAL STABILITY

Dialog Insight Solutions

Conclusion

The call for executive-level liability for the financial crisis reflects the public outrage from the many individuals who lost their homes or savings when the bubble burst. Yet outrage at Wall Street for participating in a system that ultimately crashed does not lead to prosecutions and convictions. Anger and emotion are not the same as evidence. Poor management or a lack of foresight by Wall Street executives do not mean the individuals willfully engaged in fraudulent conduct. What we know for certain is that the lack of prosecutions of Wall Street executives reflects both the challenge of bringing a fraud case in a complex industry in addition to the challenge of pinning liability on a handful of actors for a systemic problem that was bigger than any one person or institution.

The Center for Financial Stability (CFS) is a private, nonprofit institution focusing on global finance and markets. Its research is nonpartisan. This publication reflects the judgments and recommendations of the author(s). They do not necessarily represent the views of Members of the Advisory Board or Trustees, whose involvement in no way should be interpreted as an endorsement of the report by either themselves or the organizations with which they are affiliated.