**RESTORING CRIMINAL LIABILITY FOR FINANCIAL FRAUD**

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The 2008 financial crisis was brought about by bank managers who finagled various transactions, primarily in the mortgage markets or the market for their securitizations, and obfuscated with accounting cover-ups and opaque disclosures. Our governments have prosecuted very few of the criminals and have meted out fines at a fraction of the amounts that managers fraudulently. Furthermore, as Jonathan Weil recently pointed out in his article titled [“When Will the SEC Finally Go After Auditors?”](http://mobile.bloomberg.com/news/2012-09-27/when-will-the-sec-finally-go-after-the-auditors-.html), our governments have not brought a single action against an auditor for their involvement in the financial crisis. What has happened to our institutions? Is justice dead in America? Does the current administration care, or is it just incompetent?

An interesting paper came our way recently that addresses these topics. “Restoring Criminal Liability for Financial Fraud in the United States: A Moral and Legal Imperative” written by Catharyn Baird, CEO of EthicsGame; Don Mayer, University of Denver; and Anita Cava, University of Miami. They presented the paper at the 2012 Academy of Legal Studies in Business conference and won the “Virginia Maurer Best Ethics Paper” award. One may obtain a copy of the paper by emailing Kathi Quinn at [*kquinn@ethicsgame.com*](mailto:kquinn@ethicsgame.com)*.*

“Too big to fail” has become a mantra for our times, but frankly the phrase does not capture the essence of this story. Matt Taibbi has referred to the era as “too crooked to fail,” and this seems more apropos. Even better in our minds is the slogan “too in bed with government to fail.” That, at least, provides an explanation for the impotence of our so-called watchdogs. As Baird, Mayer, and Cava suggest, “Government may have gradually become the chief enabler of ‘too big to fail’ as well as ‘too big to jail.’”

This injustice has to end. “Some high-level criminal prosecutions for fraud are essential to restore balance in the financial system, a balance that would come from a healthy fear of individual indictment rather than fines paid by the firm [i.e., shareholders].”

The authors of this paper explore the deficiency of various assumptions and theories, such as that of self-interest. They point to Alan Greenspan’s confession that he relied on the self-interests of corporations to protect themselves and their shareholders. We disagree with this point. The real errors by Greenspan are his reification of the firm, thinking it can maximize utility, and that maximization of shareholder wealth is an application of the self-interest principle. The truth is that CEOs and CFOs are maximizing their own utility and they care about shareholder wealth only to the extent that it coincides with their interests. Greenspan should have known that managers do not maximize the wealth of shareholders.

We do however appreciate the authors’ discussion about ethical “blind spots,” applying a concept of bounded ethicality. Business decision-making often must be quick, preventing a deeper analysis of ethical issues. Individuals often put their ethical principles aside, complying with superiors or trying to win promotions or bonuses based on successful business transactions. And individuals seldom pay attention to the conflicts of interest that frequently intersect their lives. The authors illustrate these blind spots in their analysis of the crimes at Ameriquest, Countrywide, Lehman Brothers, Goldman Sachs, and Wells Fargo.

[Sam Antar, former CFO at Crazy Eddie](http://www.whitecollarfraud.com/), would add the blind spots of auditors. He says that many young accountants tell him about reprimands received from their superiors for actually “auditing”—even when they are just reading questions from a firm checklist. They are not allowed to demonstrate any skepticism of their “client.”

Baird, Mayer, and Cava mention that too much faith has been put into self-regulation. They point to reliance on the efficient market hypothesis instead of government oversight, the repeal of the Glass-Steagall Act, and the inertia that impedes the regulation of derivatives. We would add that in our experience self-regulation always drifts into no regulation. We need look no further than the accounting and auditing profession for a current example.

The best part of the paper is the analysis of “why current laws [and regulations] are either inadequate or under-enforced.” Baird, Mayer, and Cava posit nine possible reasons for this state of affairs:

* “Some deception is accepted as part of marketplace behavior. Caveat emptor is still a practical ‘default’ position.…the duty to favor the firm becomes almost automatic.”
* “Juries are mystified by the complexities of financial transactions.”
* The hurdle of the reasonable doubt standard is too high as “jurors are generally likely to find ‘reasonable doubt’” which masquerades for their ignorance.
* “Financial wrong-doing at the highest levels often has the protection of corporate attorneys representing the alleged wrong-doers.” Ironically, these fees are paid by the shareholders who have been injured by the fraud.
* “The FBI’s resources are limited, and the Department of Justice can only prosecute the files that the FBI prepares; in addition, agents are promoted within the ranks based on successful convictions…” The number of employees at the FBI and the SEC is simply too small to confront these demons.
* “There is the appearance that major civil lawsuits and government-sponsored settlements create sufficient accountability, but individuals are not held accountable as criminal laws would, and the firms themselves often pay just a portion of the monies they ‘earned’ as a result of deceptive practices.”
* “Neither political party has the nerve to alienate the major banks as potential funders of their political campaigns.”
* “Financial fraud detection requires a whole different type of training. Creating these types of specialized agents takes significant time and money.”
* “It is possible that new criminal statutes need to be crafted that will meet the due process and vagueness concerns of” recent court cases.

While the authors do discuss some legal “fixes” for financial fraud, we found their suggestions amorphous and inchoate, so we do not repeat them here. Indeed, the inability to address adequately the accounting and corporate scandals during the last several decades indicates something is wrong in our cultural fabric. We do think Baird, Mayer, and Cava are correct when they state “the crisis is not just financial, but legal and ethical as well.”

We do not pretend to have the answers, but hope that these observations will serve as a wake-up call. As trust is a requirement for economic actors to transact business deals, and since regulators and courts seem unwilling or unable to supply justice to capital providers, the capital markets will be in danger unless some fundamental changes are made.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*