William Black: Wealth for Fraudsters and Economic Ruin for Households

The SEC Flacks Paint Lehman's Looters as the Victims of a "Political" SEC

by William K. Black, New Economic Perspectives

Black observes that a recent New York Times article ends with this morality play about the SEC's anti-enforcement "team":

"The S.E.C. team also concluded that Repo 105 would not have been 'material' to investors because the firm's leverage ratio was trending downward regardless of Repo 105.

That conclusion set off a wave of dissent inside the S.E.C. Senior accountants and the head of the S.E.C. unit that oversaw corporate disclosures questioned the findings. Ms. Schapiro urged Mr. Canellos to keep digging.

But Mr. Canellos, a former federal prosecutor who is now the co-head of the S.E.C.'s enforcement unit, did not budge. Despite the political pressure, he told colleagues at one of the meetings, they could not bring a case if the evidence was lacking.

'Our job is to seek justice,' he said."

It gets better, the reporters claim that Cannelos and his teams' "careers likely would have benefited from bringing such a prominent case." So, they are not only uniquely ethical, they are selfless.

Cannelos failed to investigate Lehman's largest frauds and concluded he would lose the case if he brought it. That would have harmed his career. But the article unintentionally allows us to see how the SEC leakers spun their heroic morality tale and how the reporters swallowed it whole. I am a former enforcement director and head of litigation for a federal financial regulatory agency that conducted real investigations.

To understand this example of non-enforcers pretending to virtue requires a bit of context. The Department of Justice (DOJ) and the SEC focused their "investigations" solely on Lehman's quarter-end "Repo 105" transactions that were entered into for the sole purpose of deceiving investors and the SEC about Lehman's liquidity, earnings, and leverage crises - crises that would soon cause it to collapse. A "repurchase obligation" (REPO) is a short-term borrowing that is nominally structured as a "sale" with a "repurchase obligation." Lehman improperly treated these short-term borrowings as if

they were a true sale with no repurchase obligation, which caused Lehman to report lower debt levels.

Note that the journalists report that the SEC's experts on whether such deceit was "material" to investors ("senior accountants and the head of the S.E.C. unit that oversaw corporate disclosures") concluded that it was material. The fact that Lehman was so desperate to deceive its investors about the crises that would soon cause it to collapse that it sought out a legal opinion in the City of London (which "won" the ethical race to the bottom) to bless the deceit and proceeded to recurrently make large transactions near the end of quarters for the sole purpose of deceiving its investors and the SEC demonstrates that Lehman knew its deceit was material to its investors. That is a central reason why publicly traded firms engage in accounting fraud.

It is not (remotely) normal for a U.S. investment bank to go to a UK firm to obtain a legal opinion on U.S. law. Nevertheless, the cynical act by Lehman's leaders of legal dumpster diving to obtain a legal opinion blessing an obvious fraud was not treated by the Department of Justice (DOJ) as it should have been as an aggravating factor, but rather as a "get out of jail free card." Consider the implications of that DOJ policy briefly so that you can, unlike the NYT reporters, test the depth of the rot at DOJ and why they embraced "too big to jail" as their mantra. Under the DOJ position reported by the journalists, a large publicly traded company can search all over the world for the least ethical law firms and buy an opinion from them that will immunize the company and its officers from liability for any act of fraud because they "relied" on the legal opinion. Let's extend that doctrine to street gangs. I'm sure they could get legal opinions on justifiable homicide in advance of their next murders.

Cannelos' reported basis for denying that investors would have considered Lehman's REPO 105 fraud scheme to be "material" is that "the firm's leverage ratio was trending downward regardless of Repo 105." It is difficult to respond to a claim that is a non sequitur because it has no logical relationship to the conclusion. As best one can guess, Cannelos is claiming that investors would have considered it irrelevant what Lehman's true leverage ratio (debt:equity) was and would have only been interested in the direction of the trend in that ratio. Because Cannelos believes that Lehman's leverage ratio was falling as it approached collapse he asserts that investors would have considered the actual leverage ratio irrelevant. That assertion assumes that investors are incompetent. A rational investor would care about the actual ratio, not simply the direction of the trend in the ratio. Lehman collapsed due to the interaction of its severe credit losses and a liquidity crisis. As its credit losses surged its liquidity needs became far more acute because of collateral demands by its creditors and, eventually, the unwillingness of creditors to roll their loans to Lehman. Lehman's true leverage ratio, therefore, would have provided critical information to its investors, which is precisely why it used the REPO 105 scam to deceive its investors about its debt exposure.

The reporters try to picture the scam as trivial, with this unsourced claim about the DOJ and the FBI's alleged findings about Lehman's Repo 105 scam.

"They discovered that Repo 105 had nothing to do with Lehman's failure and was technically allowed under an obscure accounting rule. Noting that London lawyers had approved Repo 105, prosecutors in Manhattan also worried they could not prove that executives intended to mislead investors."

First, an accounting scam does not have to "cause" a "failure" to be a crime or a violation of rules. Accounting frauds are frequently undertaken to cover up the failing firm's problems. That is why Lehman engaged in the REPO 105 scam. So the first sentence was fed to the NYT reporters for the purpose of deceiving the reader. REPO 105 is an obscure accounting rule - that does not mean that Lehman was allowed to use it to deceive investors. I've explained why the desperate search by Lehman's officers for an attorney willing to give them the opinion they were shopping to obtain. The attorney shopping actually confirms that Lehman's officers intent to deceive investors.

Canellos, an SEC enforcement attorney, overruled the SEC's experts on interpreting "materiality" and insisted on employing his own idiosyncratic view that investors would not have considered it important to know the truth that Lehman's officers intended to hide through deceit. The journalists do not understand the implications of an enforcement attorney arrogating onto himself the ability to determine the agency's interpretation of the agency's rules. Instead, they mischaracterize Cannelos' actions as evidence of his brave devotion to justice in the face of improper pressures from the head of his agency. Under the version of the facts presented by the journalists, however, this interpretation is untenable.

Cannelos is an attorney representing a client, the SEC. The SEC has experts in what "material" means. Cannelos' ethical duty is to represent his client's position unless that position cannot be argued in good faith. Cannelos is wrong - terribly wrong - about materiality for the reasons I have explained, but that does not begin to capture how wrong his refusal to act against Lehman's senior officers' recurrent frauds was. Cannelos' refusal to enforce the law as his clients interpret the law could only be justified if there was no good faith basis for arguing that Lehman's frauds were "material" to investors. The reality is that the SEC's experts were correct about materiality, but Cannelos could not have believed that the SEC's position that Lehman's frauds were material was an interpretation of the agency's rules that was so unreasonable that he could not ethically represent his client's views. Even then, his proper course of action was to step aside and let another enforcement attorney present the agency's position. Only if he believed that Lehman's senior officers were the victim of some deliberate form of abuse prompted by illegal considerations (e.g., discrimination or a politically-driven effort at retaliation) should he have sought to block the agency from bringing the action against Lehman's senior officers by blowing the whistle to the SEC's Inspector General.

It is disgraceful that the SEC enforcement team has been leaking to the NYT reporters the false claim (under their own account of the facts) that they bravely resisted "SEC Chair Mary Schapiro['s] 'political pressure [to] bring a case [where] the evidence was lacking.'" Cannelos and his teams were not brave martyrs for "justice" and Schapiro was not

exerting "political pressure" to force them to bring an abusive suit motivated by the Obama administration's (non-existent) desire to punish Lehman's looters for their politics. Under the facts found by Cannelos, the SEC's experts on materiality and fraud concluded that Lehman's officers had engaged in a very large fraud that was material to investors. Schapiro and the SEC's experts on materiality believed that Cannelos was wrong about materiality and that it was improper for him to override the client's interpretation of "material." Schapiro's and the SEC's experts' positions were not "political." They were substantive, and they were correct. Cannelos was in the wrong and he compounded his failure by making false claims that those who disagreed with him were "political" and "unethical."

Let me be clear that the ultimate responsibility for the SEC fiasco lies with Schapiro. She was appointed to head the SEC by Obama for his traditional reason - she was an abject failure as the leader of securities industry's self-regulatory body that took no effective action against the epidemics of accounting control fraud that devastated that industry and our Nation. Ultimately, Schapiro deferred to "Canellos's team, which was closest to the evidence" rather than appoint a competent team and team leader to investigate Lehman's looters. The issue as to "materiality," however was not "close[ness] to the evidence" but the analysis of whether only the direction of the (dishonestly) reported trend in the leverage ratio (v. the actual leverage ratio) was "material" to investors. The experts on that issue were the "senior accountants and the head of the S.E.C. unit that oversaw corporate disclosures" and they understood correctly that the actual leverage ratio was material to investors.

Schapiro lacked the courage to replace an enforcement attorney who arrogated to himself the clients decision and who would have attacked Schapiro had he been replaced as unethical and political. The reporters claim: "Ms. Schapiro did not override [Cannelos'] judgment after S.E.C. officials cautioned her that it could be unethical for a political appointee like herself to do so." But the relevant question was not overriding Cannelos' judgment - it was Cannelos who was overriding the judgment of the client. That was contrary to the ethical obligations of an attorney, including an enforcement attorney unless the client was pressing a bad faith interpretation of "material." Allowing Cannelos to override his client's (eminently correct) interpretation of "material" was a dereliction of duty on the part of Schapiro and her head of enforcement. The SEC was so weak under Schapiro because she was such a weak leader.

Cannelos was so out of control in his devotion to Lehman's looters' cause that he was insubordinate.

"But at a 2011 meeting of senior S.E.C. officials, Lorin L. Reisner, then the No. 2 enforcement official, suggested preparing a draft of potential charges so the agency could have a concrete document to review. Mr. Canellos's team balked, officials who attended the meeting said.

Mr. Canellos, the officials said, instead proposed that the S.E.C. publish a report that would publicly explain the decision to forgo charges. Ms. Schapiro and other S.E.C.

officials rejected that option, concerned that Mr. Canellos's first draft was too sympathetic to Lehman."

It was a perfectly reasonable and normal "suggest[ion]" by Cannelos' boss that Cannelos' team prepare a draft of potential charges against Lehman's officers. When your boss makes a "suggest[ion]" of this nature you prepare the document. There is no "ethical" issue in providing your superior with the strongest notice of charges you believe is supported by the evidence. Cannelos' real problem was that had he drafted such a notice of charges it would have been obvious that the evidence did support a finding of materiality under the agency's interpretation of materiality. The limited nature of his draft would also reveal how little about Lehman's far larger frauds Cannelos' team had actually investigated.

Instead, Cannelos had already begun drafting the propaganda that has now become the NYT article. He wanted the SEC to publicly endorse his defense of Lehman's officers' fraudulent conduct as immaterial. Note that this would set a terrible precedent that was contrary to the agency's much broader interpretation of "materiality" - a precedent that would allow many frauds to escape sanction and impair deterrence. No enforcement lawyer whose concern was the agency, rather than his personal reputation, would make such a self-serving suggestion. Naturally, after Cannelos caused the SEC to allow Lehman's controlling officers to escape all accountability for growing obscenely wealthy by committing widespread fraud and arrogated to Cannelos the interpretation of an accounting provision where an attorney's duty is to represent the client's position rather than his own he was promoted for his failures and now co-leads the SEC's exceptionally weak enforcement effort.

The SEC leakers and the NYT reporters almost have to be admired for their audacity. Admittedly, the SEC enforcement staff has nothing to be brag about in their entire response to the fraud epidemics that drove the crisis and caused the worst epidemic of securities fraud in history. Not a single elite banker who led a control fraud has had his fraud proceeds removed by the SEC. Not a single elite banker who became immensely wealthy by leading a control fraud has even had to personally pay a non-trivial portion of his fraud proceeds to the SEC. In this long list of failures Lehman stands out as a glaring failure. Lehman was destroyed by widespread looting that made it senior officers exceptionally wealthy. Lehman's failure triggered the global financial crisis. The SEC allowed Lehman's securities frauds to continue for many years when it was not only reviewing Lehman's securities filings but also serving as Lehman's "consolidated supervision" authority. The SEC compounded its total failure as Lehman's supervisor through a total failure as an enforcer of the securities laws and its supervisory rules even after Lehman's control fraud caused its failure. The mortgage fraud crisis represents the worst enforcement failure by the SEC in its history.

Cannelos and the SEC flacks now have the chutzpah to try to spin one of the SEC's worst enforcement failures into a morality play in which Cannelos is the hero precisely because he refused to hold Lehman's looters accountable for their violations and allowed them to walk away wealthy with the proceeds of numerous insider fraud schemes. The villain

becomes Ms. Schapiro who is reimagined as a would-be unethical official who tried to sue the poor, innocent Lehman officers for "political" reasons but was blocked from doing so by Cannelos' selfless valor and dedication to "justice." It is an odd form of "justice" in which the most elite frauds became wealthy by scams that caused a $11 trillion loss to American households and cost over 10 million Americans their jobs and avoid all accountability for their frauds. But that is Cannelos' definition of "justice" and the NYT reporters are so credulous that they have become the propagandists for Cannelos and Lehman's looters.