Mr. President, last Thursday, the bankruptcy examiner for Lehman Brothers Holdings Inc. released a 2,200 page report about the demise of the firm which included riveting detail on the firm’s accounting practices. That report has put in sharp relief what many of us have expected all along: that fraud and potential criminal conduct were at the heart of the financial crisis. Now that we’re beginning to learn many of the facts, at least with respect to the activities at Lehman Brothers, the country has every right to be outraged. Lehman was cooking its books, hiding $50 billion in toxic assets by temporarily shifting them off its balance sheet in time to produce rosier quarter-end reports. According to the bankruptcy examiner's report, Lehman Brothers’ financial statements were "materially misleading" and its executives had engaged in "actionable balance sheet manipulation." Only further investigation will determine whether the individuals involved can be indicted and convicted of criminal wrongdoing.

According to the examiner’s report, Lehman used accounting tricks to hide billions in debt from its investors and the public. Starting in 2001, that firm began abusing financial transactions called repurchase agreements, or “repos.” Repos are basically short-term loans that exchange collateral for cash in trades that may be unwound as soon as the next day. While investment banks have come to over-rely upon repos to finance their operations, they are neither illegal nor questionable; assuming, of course, they are clearly accounted for.

Lehman structured its repo agreements so that the collateral was worth 105 percent of the cash it received – hence, the name “Repo 105.” As explained by the New York Times' DealBook, “That meant that for a few days – and by the fourth quarter of 2007 that meant end-of-quarter – Lehman could shuffle off tens of billions of dollars in assets to appear more financially healthy than it really was.”
Even worse, Lehman’s management trumpeted how the firm was decreasing its leverage so that investors would not flee from the firm. But inside Lehman, according to the report, someone described the Repo 105 transactions as “window dressing,” a nice way of saying they were designed to mislead the public.

Ernst & Young, Lehman's outside auditor, apparently became “comfortable” with, and never objected to, the Repo 105 transactions. And while Lehman never could find a U.S. law firm to provide an opinion that treating the Repo 105s as a sale for accounting purposes was legal, the British law firm Linklaters provided an opinion letter under British law that they were sales and not mere financing arrangements. And so Lehman ran the transactions through its London subsidiary and used several different foreign bank counterparties.

Mr. President, the SEC and Justice Department should pursue a thorough investigation, both civil and criminal, to identify every last person who had knowledge that Lehman was misleading the public about its troubled balance sheet – and that means everyone from the Lehman executives, to its board of directors, to its accounting firm, Ernst & Young. Moreover, if the foreign bank counterparties who purchased the now infamous "Repo 105s" were complicit in the scheme, they should be held accountable as well.

*Returning the Rule of Law to Wall Street*

Mr. President, it is high time that we return the rule of law to Wall Street, which has been seriously eroded by the deregulatory mindset that captured our regulatory agencies over the past 30 years, a process I described at length in my speech on the floor last Thursday. We became enamored of the view that self-regulation was adequate, that “rational” self-interest would motivate counterparties to undertake stronger and better forms of due diligence than any regulator could perform, and that market fundamentalism would lead to the best outcomes for the most people. Transparency and vigorous oversight by outside accountants were supposed to keep our financial system credible and sound.

The allure of deregulation, instead, led to the biggest financial crisis since 1929. And now we’re learning, not surprisingly, that fraud and lawlessness were key ingredients in the collapse as well. Since the fall of 2008,
Congress, the Federal Reserve and the American taxpayer have had to step into the breach – at a direct cost of more than $2.5 trillion – because, as so many experts have said: "We had to save the system."

But what exactly did we save?

First, a system of overwhelming and concentrated financial power that has become dangerous. It caused the crisis of 2008-2009 and threatens to cause another major crisis if we do not enact fundamental reforms. Only six U.S. banks control assets equal to 63 percent of the nation’s gross domestic product, while oversight is splintered among various regulators who are often overmatched in assessing weaknesses at these firms.

Second, a system in which the rule of law has broken yet again. Big banks can get away with extraordinarily bad behavior – conduct that would not be tolerated in the rest of society, such as the blatant gimmicks used by Lehman, despite the massive cost to the rest of us.

The Lessons of Lehman Brothers and Other Examples

Mr. President, what lessons should we take from the bankruptcy examiner’s report on Lehman, and from other recent examples of misleading conduct on Wall Street? I see three.

First, we must undo the damage done by decades of deregulation. That damage includes financial institutions that are “too big to manage and too big to regulate” (as former FDIC Chairman Bill Isaac has called them), a “wild west” attitude on Wall Street, and colossal failures by accountants and lawyers who misunderstand or disregard their role as gatekeepers. The rule of law depends in part on manageably-sized institutions, participants interested in following the law, and gatekeepers motivated by more than a paycheck from their clients.

Second, we must concentrate law enforcement and regulatory resources on restoring the rule of law to Wall Street. We must treat financial crimes with the same gravity as other crimes, because the price of inaction and a failure to deter future misconduct is enormous.

Third, we must help regulators and other gatekeepers not only by demanding transparency but also by providing clear, enforceable “rules of the road”
wherever possible. That includes studying conduct that may not be illegal now, but that we should nonetheless consider banning or curtailing because it provides too ready a cover for financial wrongdoing.

The bottom line is that we need financial regulatory reform that is tough, far-reaching, and untainted by discredited claims about the efficacy of self-regulation.

*The Fraud Enforcement and Recovery Act*

When Senators Leahy, Grassley and I introduced the Fraud Enforcement and Recovery Act (FERA) last year, our central objective was restoring the rule of law to Wall Street. We wanted to make certain that the Department of Justice and other law enforcement authorities had the resources necessary to investigate and prosecute precisely the sort of fraudulent behavior allegedly engaged in by Lehman Brothers.

We all understood that to restore the public's faith in our financial markets and the rule of law, we must identify, prosecute, and send to prison the participants in those markets who broke the law. Their fraudulent conduct has severely damaged our economy, caused devastating and sustained harm to countless hard-working Americans, and contributed to the widespread view that Wall Street does not play by the same rules as Main Street.

FERA, signed into law in May, ensures that additional tools and resources will be provided to those charged with enforcement of our nation's laws against financial fraud. Since its passage, progress has been made, including the President’s creation of an interagency Financial Fraud Enforcement Task Force, but much more needs to be done.

Many have said we should not seek to "punish" anyone, as all of Wall Street was in a delirium of profit-making and almost no one foresaw the sub-prime crisis caused by the dramatic decline in housing values. But this is not about retribution. This is about addressing the continuum of behavior that took place – some of it fraudulent and illegal -- and in the process addressing what Wall Street and the legal and regulatory system underlying its behavior have become.
As part of that effort, we must ensure that the legal system tackles financial crimes with the same gravity as other crimes. When crimes happened in the past (as in the case of Enron, when aided and abetted by, among others, Merrill Lynch, and not prevented by the supposed gatekeepers at Arthur Andersen), there were criminal convictions. If individuals and entities broke the law in the lead up to the 2008 financial crisis (such as at Lehman Brothers, which allegedly deceived everyone, including the New York Fed and the SEC), there should be civil and criminal cases that hold them accountable.

If we uncover bad behavior that was nonetheless lawful, or that we cannot prove to be unlawful (as may be exemplified by the recent reports of actions by Goldman Sachs with respect to the debt of Greece), then we should review our legal rules in the US and perhaps change them so that certain misleading behavior cannot go unpunished again. This will not be easy. As the Wall Street Journal’s “Heard on the Street” noted last week, “Give Wall Street a rule and it will find a loophole.”

Systemic issues in Uncovering and Prosecuting Fraud

This confirms what I heard on December 9 of last year, when I convened an oversight hearing on FERA. As that hearing made clear, unraveling sophisticated financial fraud is an enormously complicated and resource-intensive undertaking, because of the nature of both the conduct and the perpetrators.

Rob Khuzami, head of the SEC’s enforcement division, put it this way during the hearing:

“White-collar area cases, I think, are distinguishable from terrorism or drug crimes, for the primary reason that, often, people are plotting their defense at the same time they’re committing their crime. They are smart people who understand that they are crossing the line, and so they are papering the record or having veiled or coded conversations that make it difficult to establish a wrongdoing.”

In other words, Wall Street criminals not only possess enormous resources but also are sophisticated enough to cover their tracks as they go along, often with the help, perhaps unwitting, of their lawyers and accountants.
Assistant Attorney General Lanny Breuer and Khuzami, along with Assistant FBI Director Kevin Perkins, all emphasized at the hearing the difficulty of proving these cases from the historical record alone. The strongest cases come with the help of insiders, those who have first-hand knowledge of not only conduct but also motive and intent. That’s why I’ve applauded the efforts of the SEC and DOJ to use both carrots and sticks to encourage those with knowledge to come forward.

At the conclusion of that hearing in December, I was confident that our law enforcement agencies were intensely focused on bringing to justice those wrongdoers who brought our economy to the brink of collapse.

Going forward, we need to make sure that those agencies have the resources and tools they need to complete the job. But we are fooling ourselves if we believe that our law enforcement efforts, no matter how vigorous or well funded, are enough by themselves to prevent the types of destructive behavior perpetrated by today’s too-big, too-powerful financial institutions on Wall Street.

Is Lehman Brothers an Isolated Example?

Mr. President, I’m concerned that the revelations about Lehman Brothers are just the tip of the iceberg. We have no reason to believe that the conduct detailed last week is somehow isolated or unique. Indeed, this sort of behavior is hardly novel. Enron engaged in similar deceit with some of its assets. And while we don’t have the benefit of an examiner’s report for other firms with a business model like Lehman’s, law enforcement authorities should be well on their way in conducting investigations of whether others used similar “accounting gimmicks” to hide dangerous risk from investors and the public.

The Case of Greece

At the same time, there are reports that raise questions about whether Goldman Sachs and other firms may have failed to disclose material information about swaps with Greece that allowed the country to effectively mask the full extent of its debt just as it was joining the European Monetary Union (EMU). We simply do not know whether fraud was involved, but
these actions have kicked off a continent-wide controversy, with ramifications for U.S. investors as well.

In Greece, the main transactions in question were called cross-currency swaps that exchange cash flows denominated in one currency for cash flows denominated in another. In Greece’s case, these swaps were priced “off-market,” meaning that they didn’t use prevailing market exchange rates. Instead, these highly unorthodox transactions provided Greece with a large upfront payment (and an apparent reduction in debt), which they then paid off through periodic interest payments and finally a large “balloon” payment at the contract’s maturity. In other words, Goldman Sachs allegedly provided Greece with a loan by another name.

The story, however, does not end there. Following these transactions, Goldman Sachs and other investment banks underwrote billions of Euros in bonds for Greece. The questions being raised include whether some of these bond offering documents disclosed the true nature of these swaps to investors, and, if not, whether the failure to do so was material.

These bonds were issued under Greek law, and there is nothing necessarily illegal about not disclosing this information to bond investors in Europe. At least some of these bonds, however, were likely sold to American investors, so they may therefore still be subject to applicable U.S. securities law. While “qualified institutional buyers” (QIBs) in the U.S. are able to purchase bonds (like the ones issued by Greece) and other securities not registered with the SEC under Securities Act of 1933, the sale of these bonds would still be governed by other requirements of U.S. law. Specifically, they presumably would be subject to the prohibition against the sale of securities to U.S. investors while deliberately withholding material adverse information.

The point may be not so much what happened in Greece, but yet again the broader point that financial transactions must be transparent to the investing public and verified as such by outside auditors. AIG fell in large part due to its credit default swap exposure, but no one knew until it was too late how much risk AIG had taken upon itself. Why do some on Wall Street resist transparency so? Lehman shows the answer: everyone will flee a listing
ship, so the less investors know, the better off are the firms which find themselves in a downward spiral. At least until the final reckoning.

Who’s Responsible? The Role of Congress, Regulators, Accountants and Lawyers

Who’s to blame for this state of affairs, where major Wall Street firms conclude that hiding the truth is okay? Well, there’s plenty of blame to go around. As I said previously, both Congress and the regulators came to believe that self-interest was regulation enough. In the now-immortal words of Alan Greenspan, “Those of us who have looked to the self-interest of lending institutions to protect shareholder's equity -- myself especially -- are in a state of shocked disbelief.” The time has come to get over the shock and get on with the work.

What about the professions? Accountants and lawyers are supposed to help insure that their clients obey the law. Indeed, they often claim that simply by giving good advice to their clients, they’re responsible for far more compliance with the law than are government investigators. That claim rings hollow, however, when these professionals now seem too often focused on helping their clients get around the law.

Experts like Professor Peter Henning of Wayne State University Law School, looking at the Lehman examiner’s report on the Repo 105 transactions, are stunned that the accountant Ernst & Young never seemed to be troubled in the least about it. Of course, the fact that a Lehman executive was blowing a whistle on the practice in May 2008 did not change anything, other than to cause some discomfort in the ranks. While saying he was confident he could clear up the whistleblower’s concerns, the lead partner for Lehman at Ernst & Young wrote that the letter and off-balance sheet accounting issues were "adding stress to everyone."

As Professor Henning notes, one of the supposed major effects of the Sarbanes-Oxley Act was to empower the accountants to challenge management and ensure that transactions were accounted for properly. Indeed, it was my predecessor, then-Senator Biden, who was the lead author of the provision requiring the CEO and CFO to attest to the accuracy of financial statements, under penalty of criminal sanction if they knowingly or
willfully certified materially false statements. I don't believe this is a failure of Sarbanes-Oxley. A law is not a failure simply because some people subsequently violate it.

I am deeply disturbed at the apparent failure of some in the accounting profession to change their ways and truly undertake the profession's role as the first line of defense (the gatekeeper) against accounting fraud. In just a few years time since the Enron-related death of the accounting firm Arthur Andersen, one might have hoped that "technically correct" was no longer a defensible standard if the cumulative impression left by the action is grossly misleading. But apparently that standard as a singular defense is creeping back into the profession.

The accountants and lawyers weren't the only gatekeepers. If Lehman was hiding balance sheet risks from investors, it was also hiding them from rating agencies and regulators, thereby allowing it to delay possible ratings downgrades that would increase its capital requirements. The Repo 105 transactions allowed Lehman to lower its reported net leverage ratio from 17.3 to 15.4 for the first quarter of 2008, according to the examiner's report. It was bad enough that the SEC focused on a misguided metric like net leverage when Lehman's gross leverage ratio was much higher and more indicative of its risks. The SEC's failure to uncover such aggressive and possibly fraudulent accounting, as was employed on the Repo 105 transactions, provides a clear indication of the lack of rigor of its supervision of Lehman and other investment banks.

The SEC in years past allowed the investment banks to increase their leverage ratios by permitting them to determine their own risk level. When that approach was taken, it should have been coupled with absolute transparency on the level of risk. What the Lehman example shows is that increased leverage without the accountants and regulators and credit rating agencies insisting on transparency is yet another recipe for disaster.

**Conclusion**

Mr. President, last week’s revelations about Lehman Brothers reinforce what I’ve been saying for some time. The folly of radical deregulation has given us financial institutions that are too big to fail, too big to manage, and too
big to regulate. If we have any hope of returning the rule of law to Wall Street, we need regulatory reform that addresses this central reality.

As I said more than a year ago: "At the end of the day, this is a test of whether we have one justice system in this country or two. If we don’t treat a Wall Street firm that defrauded investors of millions of dollars the same way we treat someone who stole 500 dollars from a cash register, then how can we expect our citizens to have faith in the rule of law? For our economy to work for all Americans, investors must have confidence in the honest and open functioning of our financial markets. Our markets can only flourish when Americans again trust that they are fair, transparent, and accountable to the laws."

The American people deserve no less.