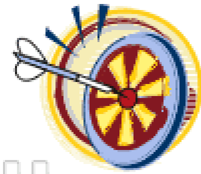
Objectives

after completing this lesson, YOU will be able to



» Understand how **securities fraud violates public trust** and undermines the U.S. economy;

» Discuss the *problems relating to insider trading*; and

» Know something about *other forms of stock manipulation,* and their effects on public trust.

For this lesson, please read:

» Rosoff, Pontell and Tillman, *White-collar Crime*:

- **Chapter 6. Securities Fraud**

» Pontell and Shichor, *Contemporary Issues in Crime and Criminal Justice:*

- **Griffen and Block, "Penny Wise"**

Perhaps no other institution is violated more by fraud and other illicit activities than the economy. Simply defined, **economy** refers to all activities organized around the production and distribution of goods and services, and it functions to satisfy people's basic material requirements.

»

Some feel that the economy in the United States is the most dominant and important of all social institutions. As such, maintaining trust in the economy is vitally important. The honest trading of securities provides the major foundation for a successful capitalist economy.

Paper Entrepreneurism

» Over the years, the United States has moved to a new form of capitalism. The older form, ***industrial capitalism***, was built upon a strong manufacturing and production sector.

» While we are still in the business of production, there has been a major shift in the U.S. economic form to that of *finance capitalism*, also known as ***paper entrepreneurism***. Here, little is "produced" except paper profits based on zero-sum games of dubious value to the overall economy. We have moved from investing to trading, and from industrial production to deal-making as major sources of income.

By the 1980s greed had ***"come out of the closet."*** Its new ***"dignity"*** could be seen clearly on Wall Street. ***A number of major scandals rocked the financial markets, including those involving Technical Equities Corporation, Prudential Securities, and E. F. Hutton.***

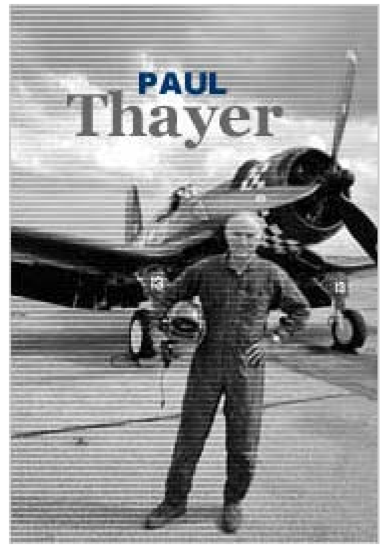
Two major categories of securities fraud became the most prominent in the financial markets: ***insider trading and stock manipulation.***

» Although they are not always clear-cut categories, we can make some distinctions. ***Insider trading*** is traditionally committed by corporate and brokerage insiders. ***Stock manipulation*** is a more inclusive category for general frauds of the "new economy" that involve numerous outsiders.

Insider Trading

Insider trading was made illegal under the Securities Exchange Act of 1934. It prohibited "insider traders" (stockholders, directors, officers, or any recipients of information not publicly available) from taking advantage of limited information for their own benefit.

Before Ivan Boesky and Michael Milken became household names, two other cases surfaced that shocked the business community. One involved Paul Thayer and the LTV Corporation in Dallas. Thayer, a former CEO, was serving as the Deputy Secretary of Defense under Ronald Reagan. Thayer had leaked information on LTV to numerous associates, who were later caught profiting from it. He also shared information on other companies on whose boards he sat.



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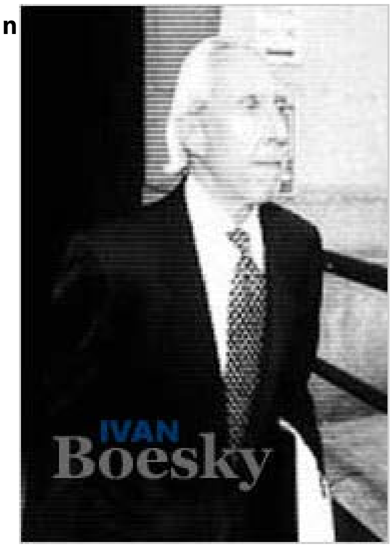
A second major case involved Wall Street Journal reporter R. Foster Williams. Williams entered into a conspiracy with a stockbroker to supply information from his column before it was published, allowing the stockbroker's clients to make trades before the news was public.

» This clearly illustrates the "problem" with insider trading as it relates to a "free economy." It's like ***"having your own time machine . . . knowing the winning horse in the fifth race at Belmont before post time."*** It is no mere coincidence that insider trading has been termed "the financial equivalent of fixing a race."

» Here's the problem for the economy: If insider trading were left unchecked, there would be little reason for persons to invest. Without ***"inside information,"*** they would certainly lose their funds to those who had access to the information. The economic growth engine would be stifled, if not shut down entirely.

The stories of **Dennis Levine**, **Ivan Boesky**, **Martin Siegal**, and **Michael Milken** are among the most dramatic instances of major insider trading in U.S. history. **The collusion that took place was all the more remarkable in that these individuals didn't have to engage in crime to make money:** ***They were already quite successful.***



"

This brings up the inevitable question: ***Why did they do it?*** *Perhaps the simplest answer is,* ***"Because they could."*** *The arrogance and greed that was evident in these crimes was unparalleled at that time.*

"

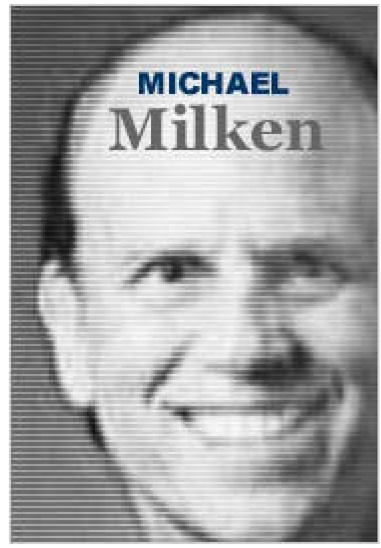
Forum *discussion*

"to post your reply, select OUTLINE from the TOOLS menu and enter the FORUMS area"

After reading about **Levine, Boesky, Siegal,** and **Milken**, *how do you make sense of their crimes?* ***What factors*** (individual, cultural, situational, and so on) *do you think had major effects and why?*

» Write two paragraphs in response.

Perhaps the most controversial figure in the insider trading scandal was **Michael Milken**, who to this day has strong defenders (and his own Institute in Santa Monica, California). ***They claim he found "real money" and put it into "real businesses."***



Others claim, however, that his "product" (junk bonds) was a fraud sustained largely through **Milken's** hype. ***He essentially overfunded his issuers, so that they in turn could buy the funds of other issuers of junk bonds.*** *This greatly expanded the junk bond market before it finally collapsed.*

His business represented a gigantic chain letter, which is a version of a Ponzi scheme (a "get rich quick" fraud where money from new investors is used to pay off old investors). Milken's market manipulation caused major economic turmoil and was associated with the failure of large numbers of S&Ls that had invested in his junk bonds.

Forum *discussion*

"to post your reply, select OUTLINE from the TOOLS menu and enter the FORUMS area"

What do you think of **Warren Buffet's** idea for controlling insider trading (as described in the book) compared to the traditional law enforcement response of increasing the risk (deterrence)?

» Write two paragraphs in response.

Video

» Watch Henry Pontell talking to CNN's Aaron Brown about Martha Stewart.

One of the most interesting cases of the corporate scandals was **Martha Stewart's** recent insider trading case. Most interestingly, perhaps, she was never formally charged with insider trading (although it was suspected), but with lying to federal investigators.

The case also divided the public on the treatment of white-collar offenders, and what many saw as selective enforcement against a powerful and successful woman.

Assignment

"select OUTLINE from the TOOLS menu.
In the OUTLINE, click on the appropriate ASSIGNMENT in this week's lesson"

One of the most interesting cases of the corporate scandals was Martha Stewart's insider trading case. Most interestingly, perhaps, she was never formally charged with insider trading (although it was suspected), but with lying to federal investigators. The case also divided the public on the treatment of white-collar offenders, and what many saw as selective enforcement against a powerful and successful woman.

» What aspects of white-collar crime/deviance come into play in the case of Martha Stewart, in terms of the crime, public reaction and sanctioning?

Write three pages describing the relationship of the Stewart case to white-collar crime and deviance theory and research.

Stock Manipulation

Insider trading is an insidious form of illegal stock manipulation. There are other forms as well, that not only manipulate markets, but countless investors as well.

Boiler rooms *mushroomed during the stock market bubble of the 1990s, as investors threw money at seemingly legitimate stocks in an ever rising market. Inexperienced investors were taken by those who saw an incredible opportunity to reap illegal gains on bogus stocks.*

»

As the chairman of the SEC lamented in 1998,

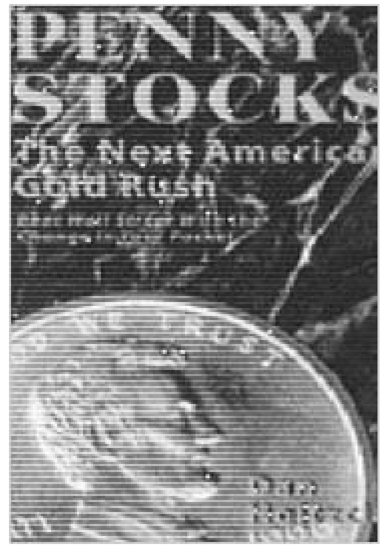
"The best markets bring out the worst elements."

Security fraud has also moved to the Internet, making it a form of computer crime as well. **Mass numbers of targets, low costs, and the anonymity of cyberspace make this an attractive environment for fraudsters.**

» *In fact, authorities have seen evidence that those formerly running boiler room operations have moved onto the Internet to continue defrauding, in scams dealing with everything from wireless cable television to ostrich farming.*

The variety and forms of such scams are seemingly endless. Microcap frauds are particularly popular and involve ***penny stocks***. Unlike major corporations, these are highly unregulated, with little information-reporting requirements. *Swindlers post bogus messages about such stocks, which allow prices to rise and then fall dramatically.*

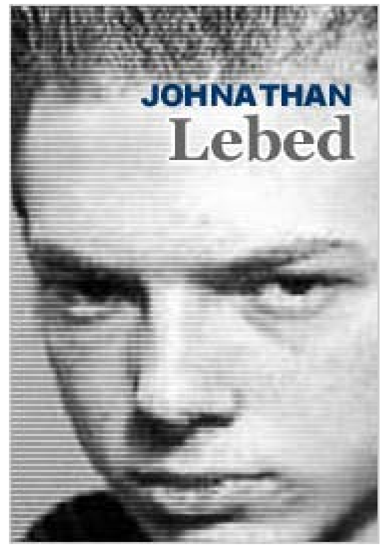
The persons behind the fabricated messages usually ***"dump"*** their shares when the value is ***"pumped"*** up high enough through their hype, and can receive considerable profits through the scheme. *Hence the term for this fraud:* ***"pump and dump."***



Organized crime has found that pump and dumps can easily raise their profit margins as an illicit organization, and have taken to the business in earnest. ***In doing so, they've brought a new level of violence to Wall Street.***

An early episode of the popular HBO series The Sopranos shows the organization involved in a traditional boiler room pump and dump scheme that turns vicious when an employee's personal ethics gets the better of him and he forgets to hype the penny stock of the moment.

Lebed had bought cheap microcap stocks and then posted fictitious messages about them on the Internet, pumping up their value. He then sold his shares. He even put in advance orders to sell stocks as they spiked, so that he would not have to miss school the following day.



*He reached a settlement with the SEC in which he returned **$285,000.** Further investigation showed that he had made over **$800,000.***

»

Lebed's case exemplifies a new breed of delinquent in society. Juveniles who commit massive economic crimes might be termed **"white-collar delinquents."**

Forum *discussion*

"to post your reply, select OUTLINE from the TOOLS menu and enter the FORUMS area"

Now that you have read **"I was a Teenage Wheeler Dealer"**, *what aspects of this case do you feel are most relevant to white-collar crime, and why? What do you think needs to be done to curb the growing threat of white-collar delinquency?*

» Write two paragraphs on this topic.

Summary

a brief overview of what you learned

» The honest trading of securities provides the major foundation for a successful capitalist economy: **all activities organized around the production and distribution of goods and services.** Unfortunately, this institution is repeatedly violated more by fraud and other illicit activities.

» The US economy, built on industrial capitalism, has shifted to paper entrepreneurism, where little is produced except paper profits. **The greed this engendered led to several types of securities fraud, notably insider trading (committed by corporate or brokerage insiders) and stock manipulation (frauds involving outsiders).**

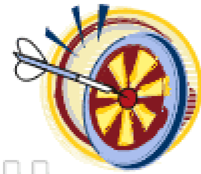
» Insider trading must be controlled. Otherwise, there would be little reason for people without inside information to invest. **This might eventually shut down economic growth entirely.**

» Other forms of illegal stock manipulation include boiler rooms (notable during the stock market bubble of the 1990s), Internet security fraud, and microcap frauds, which involve penny stocks (called "pump and dump"). **Organized crime has recently become involved in these scams**.

» The Internet has also made it possible for scams to be conducted by young people. These new **"white-collar delinquents"** can commit massive economic crimes.

Objectives

after completing this lesson, YOU will be able to



» Gain insight into the **hows and whys of corporate fraud;**

» Discuss *Enron's "business model"* and subsequent collapse; and

» Discuss other *frauds and Sarbanes-Oxley*

For this lesson, please read:

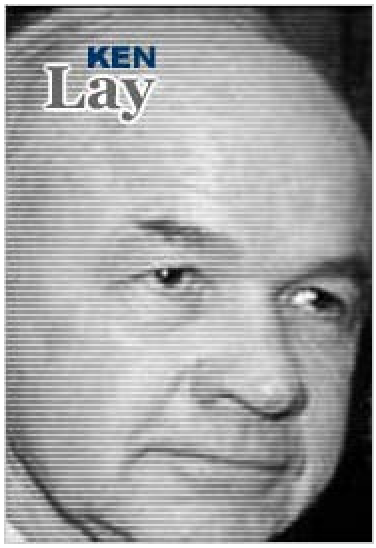
» Rosoff, Pontell and Tillman, *White-collar Crime*:

- **Chapter 7. Corporate Fraud**

» Fortune Magazine piece (handout).

»

In late 2001, a new wave of corporate and accounting scandals hit Wall Street, beginning with the meltdown of Enron. ***Enron's complicated business model turned out to be nothing but a house of cards, as major losses were hidden through accounting schemes and insider fraud.***



Ken Lay (who had very close ties to the **Bush Administration**) was publicly touting the company, bolstering its stock price, and selling his own shares as the company continued to lose money and get closer to bankruptcy.

The first major officer of the company, Andrew ("Fast Andy") Fastow, cut a deal with prosecutors and will be serving prison time. Former CEO **Jeffrey Skilling,** who testified before Congress that he didn't really know what was going on within the company, has been indicted. He faces more than 300 years in prison if convicted on all counts brought against him.

The Enron debacle has resulted in the loss of thousands of jobs and retirement savings of its employees. Because Enron was one of the world's largest companies, its crash caused major shockwaves and the acknowledgment that similar accounting abuses and frauds were occurring in other major companies at that time.

» The effects of these disclosures battered the world's economies, and investor confidence fell to the lowest levels since the Great Depression.

The story of Enron, retold and explained in the reading, is somewhat complicated. We can make three major points about the case.

"

First, it is hard to imagine a company as large as Enron, and with so much legal and political clout (it virtually designed the laws and regulations in its own business environment) not being able to turn a legal profit — unless it was incredibly mismanaged or was simply engaging in fraud.

"

That is, what other business has ever created its own environment and not been able to succeed?

A second issue involves **Wall Street** and the financial media.

During the company's heyday, it was touted by analysts and the media as a ***"model company."*** *Given its complicated and seemingly successful business model (largely built on phony accounting), the financial press and others were completely taken in, failed to adequately examine exactly what the company was actually doing, and ended up essentially reprinting Enron's press releases.*

This leads to our third and final point: ***Exactly how was Enron making money, other than by hyping the value of its own stock?*** This question has not been adequately addressed outside the white-collar crime literature, and certainly not by economists and business types.

The answer seems to be that it wasn't making any real profits.

In fact, ***Enron was hiding its losses in a scheme that involved "limited partnerships."*** In this sense it resembled a giant Ponzi scheme run by controlling insiders with the help of a major accounting firm, Arthur Andersen.

As the *New York Times* later put it: "Enron was not much of a company, but it was one hell of a stock."

Forum *discussion*

"to post your reply, select OUTLINE from the TOOLS menu and enter the FORUMS area"

What are your thoughts regarding the **Enron** case (based on the reading)? *How does this case relate to some of the major points we have discussed regarding white-collar crime?*

» Write two paragraphs on these topics.

Enron's record as the world's largest corporate bankruptcy was soon eclipsed by the fall of Worldcom, which had cooked its books by classifying ordinary expenses as capital expenditures.

While Worldcom was experiencing huge losses, ***it made it appear as a $1.4 billion profit. Worldcom executives earned $104 million in salaries and bonuses based on theses phony earnings***. As in the Enron case, the CEO pointed the finger at the CFO, and claimed that he didn't know this was going on.

If nothing else, the fall of Worldcom demonstrated that Enron was no anomaly.

A number of other major corporations collapsed in scandal in the early years of this century. The roster includes:

- Global Crossing, a voice and data carrier, and the fourth largest bankruptcy in history;
- Qwest Communications, the fourth largest long-distance carrier;
- Xerox, the photocopy giant;
- Adelphia Communications, of Rigas family "fame" and the sixth largest cable company in the United States;
- Tyco, whose former CEO Dennis Koslowski reportedly spent $135 million of his company's money to finance his ultra-lavish lifestyle;
- Rite Aid, one of the largest pharmaceutical chains; and
- Halliburton, whose accounting abuses occurred mostly during the watch of former CEO Dick Cheney, the current vice president of the United States.

Sarbanes-Oxley and the Future of Corporate Fraud

In response to the unprecedented scale of fraud in America's corporations during this time period, **Congress passed the Sarbanes-Oxley Act of 2002.**

» This law represents the toughest piece of corporate governance legislation ever enacted, and imposes new duties on public corporations and executives, directors, auditors, attorneys, and securities analysts. Among the major provisions of the Act is the requirement that CEOs assume responsibility for the validity of their company's financial statements.

Given this start to the new millennium, it appears that corporate morality still has a long way to go in the United States. **A healthy economy was pushed to the brink of a major crash**. Executives looted their companies and became astonishingly wealthy, while employees lost their jobs and retirement savings and shareholders lost their investments.

> » ***Investor confidence fell to lows not seen since the Great Depression. "Infectious greed," as Alan Greenspan termed it, had threatened our very way of life.***

If nothing else, this unfortunate chapter in American history proves that white-collar crime cannot simply be dismissed as the "other" crime problem. As a US Attorney investigating allegations of corporate crime put it, **"Corporate fraud has emerged as one of our top priorities, second only to fighting terrorism."**

Summary

a brief overview of what you learned

» In late 2001, a new wave of corporate and accounting scandals hit Wall Street, beginning with the meltdown of Enron. **Enron's complicated business model turned out to be nothing but a house of cards, as major losses were hidden through accounting schemes and insider fraud.**

» Enron's record as the world's largest corporate bankruptcy was soon eclipsed by the fall of Worldcom, **followed by the collapse of a number of other major corporations .**

» In response to the unprecedented scale of fraud in America's corporations during this time period, **Congress passed the Sarbanes-Oxley Act of 2002,** which imposes new duties on public corporations and executives, directors, auditors, attorneys, and securities analysts. **Among the major provisions of the Act is the requirement that CEOs assume responsibility for the validity of their company's financial statements.**

» **Corporate greed pushed a healthy economy to the brink of a major crash.** This unfortunate chapter in American history proves that white-collar crime cannot simply be dismissed as the "other" crime problem.