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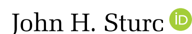
ARTICLE

The Financial Crisis on Trial: What Went Wrong


John H. Sturc

Americans demanded retribution from the mortgage lenders whose subprime loans defaulted and from investment bankers whose mortgage-backed securities sharply declined in value in 2007, leading to financial panic and the Great Recession. From 2008 to 2019, the federal government extracted hundreds of billions in fines from dozens of corporations, but few individual business executives were held accountable, and no senior banker was convicted of a crime. I use the trial court record of five government enforcement cases against individuals to explain this apparently anomalous result. I conclude that, in addition to a lack of funding, the prosecution effort was hindered by the government's erroneous selection of cases to pursue. Further, the diffused nature of decision making in the mortgage finance market made it difficult to prove that any one senior-level participant had the criminal intent necessary for a conviction or a Securities and Exchange Commission civil fine or injunction. The trial results also support the argument that the growth and consolidation of investment banks from 1990 to 2008 created incentives for misconduct within the firms.

Keywords: Financial Crisis, government enforcement, financial regulation, business crime

Introduction

On November 13, 2019, the United States Department of Justice (DOJ) reached a civil settlement with former Deutsche Bank investment banker Paul Mangione, bringing to an end more than ten years of criminal and civil enforcement actions against individuals alleging misconduct prior to the financial crisis of 2007–2009.[1] Because the crisis wreaked such economic havoc and caused personal hardship for millions of people, there were widespread calls for retribution against firms and individuals who were presumed to be responsible for the debacle. In the wake of the crisis, regulators and prosecutors leveled an unprecedented wave of enforcement cases against financial institutions.[2] Ultimately, however few individuals were

1. Agreement for Compromise Settlement and Release, *United States v. Paul Mangione,* ECF No. 47. (ECF is Electronic Calendar Fling.)
2. Garrett, "Rise of Bank Prosecutions."

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held accountable for misconduct, and no one employed by a major financial institution served a prison sentence for a crime arising out of the financial crisis. The widespread belief that the wealthy escaped the crisis without suffering consequences has doubtless contributed to the populist backlash that continues to dominate public political discourse.

In this article, I discuss five cases that went to trial, and I compare their results. Why did the government succeed in only two cases? Why did juries absolve financial crisis actors in the remaining three? I argue that when asked to assess personal responsibility, jurors were reluctant to censure actions made under stress or by relatively minor figures in a larger scheme. I also argue that the unsatisfying result of the government's enforcement program was in part due to its failure to focus its efforts on those actors whose businesses systematically sought to profit through deception in the origination and securitization of home loans. I also compare the financial crisis prosecutions to other white-collar prosecution efforts and suggest that the nature of the violations themselves and the absence of cases against senior executives of investment banks reflect the growth and complexity of twenty-first-century financial institutions. This made it more difficult to situate accountability and may also have encouraged organic misconduct at lower levels of the firm.

Many economists, inspired by the work of Hyman Minsky, view the US financial crisis and its antecedent, the subprime mortgage crisis, as a typical cycle of boom, bubble, and bust driven by the overexpansion and then overcontraction of credit. Robert Aliber argues that the housing boom was a typical credit bubble that began with an expansion of credit leading to an episode of "Ponzi finance" in which borrowers depended on the continued escalation of housing prices to pay interest and recover principal.[3] In 2008, Robert Shiller wrote that it was a mistake to entirely blame factors such as dishonesty among home mortgage lenders and increasing greed among securitizers, hedge funds, and ratings agencies.[4] Instead, he found that "the most important single element to be reckoned with. . . is the *social contagion* of rapidly rising prices" that gave credence to the belief that the boom would continue.[5] Shiller saw this contagion as rooted in psychology and epidemiology as well as economics. It rested on the myth that real estate prices must inevitably trend upward. The collective lowering of credit standards and unreadiness to deal with its consequences was to him the normal process of a speculative bubble as described by Minsky.[6]

A substantial group, however, posits that the financial crisis was the result of greedy, reckless, and often criminal behaviors of mortgage brokers, lenders, investment bankers, rating agencies, and other financial intermediaries and institutions. Financial journalists have portrayed the crisis as a consequence of complacent government officials bent on deregulation that gave unscrupulous lenders the freedom to harm borrowers and amoral bankers a license to create exotic and highly leveraged instruments to finance the boom.[7] Journalists chronicling the demise of major investment banks place the blame on Wall Street executives who ignored

3. Kindleberger and Aliber, *Manias, Panics and Crashes*, 11, 70.
4. Shiller, *Subprime Solution*, 4.
5. Shiller, *Subprime Solution*, 41.
6. Shiller, *Subprime Solution*, 43, 47, 54.
7. Morgenson and Rosner, *Reckless Endangerment*; McLean and Nocera, *All the Devils are Here*; Gasparino, *The Sellout*.

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risk in favor of escalating profit, often skirting, if not crossing, the line into illegal behavior.[8] Several sociologists and criminologists support this view, contending that the financial crisis was the product of a "crimogenic environment" in which "control fraud" permitted bankers to profit from illegal behavior.[9] Similarly, US District Judge Jed. S. Rakoff wrote, "Subprime mortgages, i.e., mortgages of dubious creditworthiness, increasingly provided the chief collateral for highly leveraged securities that were marketed as AAA, i.e., securities of very low risk." He asked, "How could this transformation of a sow's ear into a silk purse be accomplished unless someone dissembled along the way?"[10] The Financial Crisis Inquiry Commission majority found that "to pin this crisis on mortal flaws like greed and hubris would be simplistic," yet the majority of the commission also found that there had been "a systemic breakdown in accountability and ethics.[11] More recently, Neil Fligstein and Alexander F. Roehrkasse concluded that "market competition and firms' vertical integration across markets shaped motivations and opportunities for malfeasance through 'crimogenic tiers.'"[12]

At the same time that journalists denounced financiers, government officials announced that they would hold "bad actors" to account. On February 5, 2009, several senators introduced the Fraud Enforcement and Recovery Act of 2009. It was signed on May 20, 2009.[13] The Senate Judiciary Committee explained that the legislation was to "increase accountability for the corporate and mortgage frauds that have contributed to the recent collapse."[14] The legislation authorized (but did not appropriate) $165 million to hire more fraud investigators and prosecutors at the DOJ in 2010 and 2011 and another $100 million for other agencies that were also investigating aspects of the financial crisis. In November 2009, the government organized the interagency Financial Fraud Enforcement Task Force to prosecute significant crimes related to the crisis.[15]

The DOJ vowed to bring accountability. Lanny Breuer, then the assistant attorney general for the Criminal Division of the Department of Justice, told a congressional committee, "[W]e are fully committed to rooting out and prosecuting financial fraud, whether perpetrated on Main Street or Wall Street."[16] For its part, the Securities and Exchange Commission (SEC), chastened by the crisis and its failure to detect the massive Ponzi scheme perpetrated by

8. For a chronicle of the demise of Bear, Stearns, see Cohan, *House of Cards*; for the "fire sale" of Merrill Lynch to Bank of America, see Farrell, *Crash of the Titan.*

9. Black's 2012 article, "Department of Justice Chases Mice," is representative. Similar arguments may be found in Rosoff, Pontell, and Tillman, *Profit Without Honor*; Taub, *Big Dirty Money.*

10. Rakoff, "Financial Crisis."

11. Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Report,* xxiii.

12. Fligstein and Roehrkasse, "Causes of Fraud," 619.

13. U.S. Senate, Report No. 111-10, "Fraud Enforcement and Recovery Act of 2009," March 23, 2009, 1; Barack H. Obama, "Remarks on Signing the Fraud Enforcement and Recovery Act of 2009 and Legislation to Prevent Mortgage Foreclosures and Enhance Mortgage Credit Availability," May 20, 2009, Statements of the President, https://www.govinfo.gov/content/pkg/PPP-2009-book1/pdf/PPP-2009-book1-doc-pg687.pdf.

14. Senate Report No. 111-10, "Fraud Enforcement and Recovery Act of 2009," 3.

15. Executive Order 13519, "Establishment of the Financial Fraud Enforcement Task Force," 74 F.R. 60122, November 17, 2009.

16. U.S. Department of Justice, Statement of Lanny A. Breuer, Assistant Attorney General, Before the Subcommittee on Crime and Drugs, Committee on the Judiciary, United States Senate, May 4, 2010, www.usdoj.gov/archives/2010-5-04-crm-breuer-wall-street-fraud.pdf.

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Bernard L. Madoff, brought in a former federal prosecutor, Robert Khuzami, to be the director of its Division of Enforcement. He labeled the credit crisis as his highest priority and vowed that "where there was fraud and wrongdoing and investors suffered, we will take action."[17]

Results were mixed. The DOJ pursued only one criminal case against Wall Street executives and met defeat. The SEC commenced dozens of civil enforcement cases against banks, asset managers, mortgage lenders, and others. Some individuals were charged with violations, but none were chief executive officers or senior operating executives of investment banks. (The SEC settled enforcement claims against a former chief financial officer of Citigroup for causing Citigroup to understate its exposure to subprime mortgages in a call with investors in 2007. It also settled enforcement cases against senior executives of several large mortgage lenders, including Countrywide Financial and New Century Financial.)[18] In late 2010, the DOJ shifted course and began to pursue civil claims with significant monetary penalties (but no term of imprisonment) against mortgage lenders, investment banks, and ratings agencies. These were often based on the civil fraud provisions of the Financial Institutions Recovery, Reform, and Enforcement Act (FIRREA) of 1989, a rarely used remedy that had the advantage of a ten-year statute of limitations, far longer than the five-year term that applied to criminal mail fraud or securities fraud allegations. The DOJ argued that the FIRREA civil remedies could "provide a more efficient use of resources than traditional criminal prosecutions and may be just as effective."[19] From 2010 to 2018, the DOJ and SEC filed many lawsuits but only a few had one or more mid-level executives as defendants. Most of the SEC cases settled without a trial and all but one of the DOJ cases also settled.

Even though the two agencies recovered nearly $200 billion in damages and fines, few people were satisfied. Journalist Jesse Eisenberg asserts that the government's failure to charge top bankers from the top financial firms with violations of law arising out of the financial crisis was inexcusable in light of what he concluded was the widespread malfeasance that led to the 2008 financial crisis.[20] Former Senate staff member Jeff Connaughton also concluded that the government had failed, which he attributed to regulatory capture and cooptation.[21] Others asserted that the government was afraid that a criminal case against a bank could lead to its collapse, making the banks "too big to jail."[22] Recently, John Coffee concluded that the prosecutors were underfunded and unable to meet the challenge of subtle, intensive investigations, giving them an incentive to accept early large dollar settlements rather than go after prosecutions of executives.[23] In a 2013 interview, Breuer said that criminal investigators had in fact pursued every lead. He said, "With respect to Wall Street cases, we looked at those as

17. Robert Khuzami, "Remarks Before the New York City Bar: My First 100 Days as Director of the Division of Enforcement," August 5, 2009, www.sec.gov/news/speech/2009/spch080509rk.htm.

18. For a listing of SEC financial crisis-related enforcement actions, see, "SEC Enforcement Actions: Addressing Misconduct That Led To or Arose From the Financial Crisis," www.sec.gov/spotlight/enf-actions-fc-shtml (page is archived as of October 2016).

19. Weidman, "Civil Remedies for Mortgage Fraud," 22–27.

20. Eisinger, *Chickenshit Club*, xvii.

21. Connaughton, *The Payoff.*

22. See, for example, Gretchen Morgenson, "A Bank Too Big to Jail," *The New York Times,* July 17, 2016, 1BU; William Cohan, "How Wall Street's Bankers Stayed Out of Jail," *The Atlantic,* September 2015, https://www.theatlantic.com/magazine/archive/2015/09/how-wall-streets-bankers-stayed-out-of-jail/399368/

23. Coffee, *Corporate Crime and Punishment*, ix, 3, 8–12.

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hard as we looked at any others, and when a case could be brought, we did. But when we cannot prove beyond a reasonable doubt that there was criminal intent, then we have a constitutional duty not to bring those cases."[24] When asked what the record of the mortgage crisis would show, Breuer answered:

> You know what I think it's going to show, unfortunately? It's going to show that people in Wall Street and throughout thought that there was no going down in the market. Everybody was going to get rich. And so, they bundled these mortgages, and they made representations with their sophisticated lawyers, and another sophisticated entity, another financial institution, purchased those securitizations. And they knew what they were purchasing, or they knew enough about what they were purchasing.[25]

There were many reasons why so few individuals were held accountable for misconduct in the financial crisis. The government litigation effort did not start in earnest until mid-2009, years after most of the events themselves occurred. Congress promised to provide resources but then failed to appropriate the needed money. Although, as noted, Congress had authorized $165 million for mortgage fraud investigations and prosecutions in fiscal years 2010 and 2011, only $54 million was appropriated.[26] So too, SEC funding increased but not to the level necessary to investigate the vast number of potential cases. There were many distractions. No sooner had the dust of the financial crisis begun to settle when new, and more current, incidents arose, such as price fixing in the LIBOR market, institutionalized insider trading by hedge funds, and new allegations of scandal concerning mortgage foreclosure and modification practices. Investigations of the financial crisis also competed for resources with foreign bribery cases.

I argue, however, that a central problem was the government's misplaced narrative. Between 2009 and 2013, five enforcement cases against individual defendants enmeshed in the world of mortgage finance were tried before juries. The government prevailed in two instances, but in three cases the juries either found for the defendant on all charges or returned a verdict that was well below the government's expectations (Table 1). The government's early cases concerned central actors whose spectacular business failures attracted great public attention. One might expect that juries would be eager to find investment bankers and mortgage traders liable, but the jurors' decisions were more nuanced. When the proof showed that the defendants were reacting to the unprecedent stress and unknowns presented by the panic, sympathetic juries acquitted. In other cases, juries wanted to see proof that a defendant had personal responsibility for deliberate false statements made to induce a financial transaction; they did not like scapegoating. On the other hand, the government succeeded in cases against businesspeople who systematically engaged in creating toxic financial instruments and misled others about those instruments.

24. Breslow, "Lanny Breuer."

25. Breslow, "Lanny Breuer."

26. U.S. Department of Justice, Office of the Inspector General, *Audit of the Department of Justice's Efforts to Address Mortgage Fraud*, 3–4.

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Table 1. Five Jury Trials

Case and Financial Institution	Government Claims	Verdict and Winning Narrative
United States v. Ralph Cioffi and Matthew Tannin. Bear Stearns employees who managed two hedge funds investing in securitized debt.	False statements to investors regarding fund performance and withdrawals and own personal investments in the funds.	Not liable. Defendants did their best to save investment funds during a crisis; jury thought their decisions were reasonable under the circumstances.
SEC v. Bruce Bent, Jr., Bruce Bent II, and Reserve Capital Management Fund (RCMI). Bent Jr. was the chairman of RCMI and the Reserve Funds; Bent II was president. RCMI was the investment advisor to the Reserve Prime Money Market Fund.	False statements to investors, Moody's, and the Reserve Fund board of directors regarding RCMI's intention to pay redemptions of money market fund shares.	Bent Jr. not liable; Bent II liable for negligence. RCMI liable for fraud. The jury largely excused bad decisions made in haste by Bent II while under the unprecedented stress of the sudden failure of failure of Lehman Brothers.
SEC v. Brian H. Stoker. Stoker, a director of Citigroup, was a "structurer" of a collateralized debt obligation (CDO) created by Citigroup called Class V III.	False statements to investors regarding Citigroup's role in selecting assets for the portfolio and failure to disclose Citigroup's short position against the CDO.	Not liable. Defendant seen as a minor player and a scapegoat for a scheme devised by others who were not charged.
SEC v. Fabrice Tourre. Tourre was a vice president of Goldman Sachs who managed the creation and offering of a CDO called ABACUS AC-1. The portfolio was largely selected by Paulson & Co., a hedge fund that took a short position against the assets of the CDO.	False statements to an investor regarding Paulson's role in the transaction and failure to disclose Paulson's intention to take a short position against the CDO.	Liable. Defendant shown to be the one person at Goldman Sachs who knew that investors thought Paulson was a long investor and chose to remain silent to sell the offering.
U.S. v. Countrywide Financial and Rebecca Mairone. Mairone was chief operating officer of the "Full Service Loan" home mortgage division.	False statements about bad loans sold to Fannie Mae and Freddie Mac.	Liable. Defendant implemented a new mortgage lending system to raise cash even though she knew bad loans would increase, and permitted them to be sold.

To assess the competing perspectives about why few individuals were held accountable for misconduct in the financial crisis, I rely on the trial records and verdicts of these five government enforcement cases.[27] The prior debate regarding the reasons for the government's prosecution decisions and perceived shortcomings does not account for results in the courtroom. As one court noted, "Trials are primarily about the truth."[28] Through the presentation of live testimony and documents, the arguments of counsel, and instructions regarding the law from the presiding judge, jurors are asked to render a verdict that is based on "cold, hard, solid

27. The author was previously employed by a law firm that represented Goldman Sachs & Co. in a congressional hearing on the ABACUS transaction that is discussed in this article. The author did not participate in that representation. The author and other law firm personnel also once met with Brian Stoker, the defendant in *Securities and Exchange Commission v. Brian Stoker*, also discussed in this article. The author and his firm did not represent Mr. Stoker, who hired a different law firm. This article is based solely on the court record of the five trials, other public judicial records, and newspaper and scholarly articles listed in the bibliography.

28. *Securities & Exchange Commission v. Citigroup Global Markets, Inc.*, 752 F.3d 285, 295 (2d Cir. 2014).

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facts. . . as to the truth of the allegations in the complaint."[29] Each of the five cases was widely followed by the national media, and reporters spoke to jurors about the reasons for their decisions in four of the cases. The juries were, in effect, focus groups who gave contemporaneous reactions to the evidence presented. I do not rely on consent judgments and settled cases because "[a] settlement is by definition a compromise" that may be based not only on the parties' differing perceptions of the merit of their cases but also on other undisclosed factors that may not be relevant to "where the real truth lies."[30] These can include the costs of litigation and trial and too few resources. For the government, there is also that the risk that an adverse judgment could hurt its ability to pursue other, similar cases. For the defendants, there was the imminent risk that a loss in a trial against the government would leave it liable to pay many hundreds of millions in private civil damage actions based on the same facts. Businesses often want to put the past behind them without the drag of an ongoing case, and individual defendants are often unwilling to undertake the personal stress of extended litigation. Thus, while the government seeks to file a complaint or statement of facts it believes reflects the results of its investigation, it may need to compromise by modifying the facts alleged or narrowing its claims as a part of the settlement. Judge Rakoff, himself an experienced former prosecutor and defense lawyer, has criticized such settlements in part because he believed that settlements and fines are perceived by business community as "a cost of doing business."[31]

I have excluded two jury trials from the analysis because they are either irrelevant or inconclusive. The DOJ obtained a conviction of Lee Farkas, chairman and owner of Taylor, Bean & Whitaker. This case was a financial fraud scheme involving misappropriation of company funds and the sale of nonexistent mortgage loans to raise capital. It does not bear on the mortgage lending and securitization that are the subject of article.[32] I also do not discuss in detail an SEC civil enforcement action (*Securities and Exchange Commission v. Larry Goldstone, et al.*) because the jury was unable to reach a verdict on the key claims of fraud made by the SEC.[33] The SEC later voluntarily dismissed the case.[34] I also do not rely on two nonjury trials in which an SEC administrative law judge, rather than a jury, was the initial finder of fact. In one such case, the SEC found that the manager of a collateralized debt obligation was liable, but the decision was reversed on appeal because of procedural issues unrelated to the merits of the claim. The case was later settled for modest sanctions.[35] In the second administrative case, the SEC said that two State Street Global Advisors managers misled investors about the mix of securities in a mortgage security-based fund and understated

29. *Id.*

30. *Id.*; *Securities & Exchange Commission v. Citigroup Global Markets, Inc.*, 827 F. Supp. 2d 328, 333 (S.D. N.Y. 2011) (opinion of Judge Jed. S. Rakoff).

31. *Securities & Exchange Commission v. Citigroup Global Markets, Inc.* (opinion of Judge Jed. S. Rakoff).

32. U.S. Dept. of Justice, Office of Public Affairs, press release, "Former Chairman of Taylor, Bean & Whitaker Convicted for $2.9 Billion Fraud Scheme That Contributed to the Failure of Colonial Bank," April 19, 2011, www.justice.gov/opa/pr.former-chairman-taylor-bean-whitaker-convicted-2.9-billion-fraud-sceme-contributed-failure.

33. *S.E.C. v. Goldstone, et al.,* 233 F. Supp. 3d 1169, 1184-1187 (D.N.M. 2017).

34. *SEC v. Larry A. Goldstone,* Docket No. 655, February 28, 2017.

35. *In the Matter of Harding Advisory LLC and Wing F. Chau*, https://www.sec.gov/litigation/admin/2019/33-10705.pdf.

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the fund's risk. A US court of appeals held that the SEC had failed to provide substantial evidence to support its claim and dismissed the case.[36] This result is consistent with the jury findings in the *Cioffi/Tannin* and *Reserve Management* cases discussed in this article.

The results in these five jury trials also shed light on two larger issues: the history of prosecution of white-collar crime in America and the growth and bureaucratization of financial services firms. Cases from earlier decades concerned decisions made in executive suites. The financial crisis cases often occurred in the trenches of trading floors and mortgage origination centers. The increased size and decentralized locus of financial services firms made it more difficult for the government to prove the culpability of the most senior executive managers and may have weakened senior management's ability to control their own firms.

The Fog of War

Bear Stearns: The Government's Cioffi and Tannin Debacle

The July 2007 collapse of two hedge funds—managed by Ralph Cioffi, a Bear Stearns & Co. senior employee who was assisted by Matthew Tannin and Ray McGarrigal—was a seminal event in the deterioration of the subprime housing finance market that led to the financial crisis of 2008.[37] The High-Grade Structured Credit Strategies Master Fund was opened to investors in March 2003. In August 2006, Bear Stearns opened a parallel fund, the High-Grade Structured Strategies Enhanced Master Fund, which made similar investments but with a significantly higher leverage ratio of 27.5:1. That is, the fund borrowed $27.50 for each dollar invested into the fund. The first fund had a leverage ratio of 10:1. The equity investors for both funds were limited to institutions and wealthy individuals. The funds purchased portfolios that emphasized AAA- and AA-rated collateralized debt obligations (CDOs). These were relatively illiquid fixed income securities issued by investment pools themselves that owned securities issued by other investment pools whose assets were residential mortgage-backed securities. Ultimately, the assets of the CDOs were low-quality subprime residential mortgages. The funds pledged the CDOs as collateral for loans called "repos" from money-center banks and financial institutions. The funds made money on a positive "carry" when the interest received from the CDOs in the portfolio was greater than the interest paid to the repo lenders. Because the funds were leveraged, equity investors made a multiple of the interest differential. As of March 31, 2007, the High-Grade Fund had $925 million in equity investor money and a portfolio of $13.7 billion, comprising $9.7 billion of "long" ownership investments and $4 billion in "short" investments in credit default swaps and other derivatives. As of March 31, 2007, the Enhanced Fund had $638 million in investor equity capital, $6 billion in debt, and owned $11.5 billion long and $4.5 billion short positions.[38] The funds were sold to investors on the premise that they offered a stable, safe annual

36. *Flannery v. S.E.C.,* 810 F.3d 1, 4 (1st Cir., 2015).

37. Bernanke, *Courage to Act*, 140.

38. Indictment, *United States v. Ralph Cioffi and Matthew Tannin*, 1:08 CR 00415 (2008); Kate Kelly, Serena Ng, and David Reilly, "Two Big Funds at Bear Stearns Face Shutdown," *The Wall Street Journal,* June 20, 2007.

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return of approximately 10 percent to 12 percent per annum.[39] Until February 2007, the funds earned a consistent positive return.

The funds also carried risks. The income was dependent on continued payment of interest and principal by less creditworthy borrowers on subprime mortgages. If a significant number of homeowners defaulted, then the credit ratings agencies could downgrade the CDOs, leading to a significant loss in their value. If investment losses occurred, the funds' investors took the first hit. The repos upon which the funds depended were very short term, payable in weeks and sometimes overnight. Losses could lead repo lenders to refuse to continue to extend credit to the funds, which could then force the funds to sell securities at "fire-sale" prices, magnifying the losses and sending the funds into a death spiral. Alternatively, the lenders could seize the CDOs, sell them, and seek reimbursement for any losses from the funds' investors.

In March 2007, Bear Stearns reported to investors that for February the Enhanced Fund had a negative 0.08 percent annual rate of return and the High-Grade a modest positive 1.5 percent rate of return. In May 2007, Bear Stearns reported that the value of the Enhanced Fund had fallen by 6.75 percent and two weeks later said that the loss had grown to 18 percent.[40] On June 7, investors were told they could not get their money out of the funds and repo creditors seized $2 billion in securities owned by the funds. Bear Stearns committed to lend $3.2 billion to the High-Grade Fund, but the rescue proved inadequate, leading the funds to file for bankruptcy protection on July 3l.[41] Investors in the funds were wiped out.[42]

On June 18, 2008, Cioffi and Tannin were arrested, endured the ritual "perp walk" and denunciation by the US Attorney as people who "chose to breach that trust [owed to investors], and they will now be held to account."[43] Relying on excerpts from emails authored by the defendants, the indictment alleged that during March 2007, Cioffi and Tannin falsely and repeatedly told investors that the markets presented "great opportunities" and urged investors to add to their investment. Tannin told one investor, "We are seeing opportunities now and are excited about what is possible. I am adding capital to the Fund. If you guys are in a position to do the same, I think this is a good opportunity." He made similar written comments to others. However, Tannin never added to his personal investment in the funds. Meanwhile, on March 23, 2007, Cioffi redeemed $2 million from the $6 million he had invested in the Enhanced Fund and transferred it to a better-performing fund managed by other Bear Stearns employees working under his supervision.[44] The government claimed that investors perceived personal investments by managers as significant in their investment decision making because it showed that the managers "had skin in the game" and their interests aligned with the investors.

39. Indictment, *Cioffi and Tannin*, 6.

40. Indictment, *Cioffi and Tannin*, 8; Kelly, Ng, and Reilly, "Two Big Funds at Bear Stearns."

41. Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Commission Report,* 241.

42. Indictment, *Cioffi and Tannin*, 18–19.

43. Heidi N. Moore, "Body Language: Analyzing the Bear Stearns Perp Walks," *The Wall Street Journal*, June 19, 2008, blogs.wsj.com/deals/2008/06/19/body-language-analyzing-the-bear-stearns-perp-walk/; U.S. Department of Justice, United States Attorney's Office for the Eastern District of New York, press release, "Two Senior Managers of Failed Bear Stearns Hedge Funds Indicted on Conspiracy and Fraud Charges," June 19, 2008.

44. Indictment, *Cioffi and Tannin*, 10–12.

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The government charged that Tannin never intended to add to his investment and that Cioffi traded on inside information regarding the funds when he exchanged his $2 million share for another fund.

The government also alleged that Cioffi and Tannin withheld information regarding withdrawals of capital from the funds by investors. Investment results for March were worse than those for February. On April 19, 2007, a portfolio manager for Concord Management, an investment firm that chose hedge fund investments for others, told Cioffi and Tannin that Concord intended to withdraw its entire investment with part to be paid out on June 30 and the balance on July 31. (Under the funds' terms of investment, investors were required to give the funds no less than thirty days' notice before they could withdraw funds and sixty days' notice for withdrawal without payment of a penalty.)[45] That same day, Cioffi and Tannin received a report with an initial analysis that indicated the funds' AAA- and AA-rated CDOs could be downgraded. On Sunday, April 22 at 8:30 a.m., Tannin used his personal email account to send a lengthy message intended for Cioffi but sent via the personal account of Cioffi's wife. Tannin wrote:

> Question one: what should we do now? . . . I think we have two basic options: close the two High Grade funds now or get very, very, aggressive. . . . There are now a few reasons to close the funds now. The subprime market looks pretty damn ugly. CPR CDR [a new report] tells us we are looking at major write-downs across the board. If we believe the runs Steve [Van Solkema] has been doing are anywhere close to accurate, I think we should close the funds now. The reason for this is that if CPR CDR is correct, then the entire subprime market is toast. It is toast in the way the high CDO market is toast. If AAA bonds are systematically downgraded then there is simply no way for us to make money ever.[46]

On April 24, three days later, Cioffi and Tannin held a quarterly conference call with investors. During the call, they expressed optimism that the funds could withstand the current market turmoil. Cioffi said only a few million dollars were scheduled for withdrawal on the next redemption date—June 30—and did not mention the Concord withdrawal notification, even though Concord was one of the largest investors in the funds.[47] Withdrawals too, the government charged, were material facts to investors because it would show what third parties thought about the future of the funds.

The government presented a simple, straightforward case. In its closing summation, the prosecutor argued: "This trial really isn't about hedge fund strategy, and it's not about the hows and whys of what happened in the market in 2007. It's not about second-guessing investment strategies in a difficult market environment. What this trial is about is the two defendants lying to their investors."[48] The defendants, the government contended, knew that the funds were in trouble and lied about their personal investments and about pending redemptions to give

45. *Cioffi and Tannin*, Transcripts of Proceedings, October 27, 2009, 1708–1710; October 29, 2009, 2223.

46. *Cioffi and Tannin*, Transcript of Proceedings, October 21, 2009, 1037.

47. Indictment, *Cioffi and Tannin*, 6.

48. The US government's closing argument is in *Cioffi and Tannin*, Transcript of Proceedings, November 5, 2009, 2604.

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investors a false sense confidence so that they would keep their existing positions in the funds or even add to them.

But the evidence was neither simple nor straightforward. Rather, emails by Cioffi, Tannin, and other hedge fund employees and their managers at Bear Stearns showed that while all recognized that the asset-backed securities market was stressed and volatile in February 2007, they also believed that the funds had done well under difficult conditions and were optimistic that it could continue to do reasonably well by engaging in "relative value trading." Their plan was to continue to hold highly rated securities and to hedge or sell short lower-rated securities they believed would fall in value, enabling the funds to make money even if the market as a whole declined.[49] On April 19, Steven Van Solkema, a credit analyst assigned to work on the hedge fund management team, distributed the first iteration of a massive analysis of ninety-two CDOs in the funds' portfolios as well as the funds' short positions, and it ranked the securities owned and the funds sold short by the likelihood of write-down. It was this report that caused Tannin to write his April 22 email to Cioffi via Cioffi's wife. But Van Solkema testified that while the model could accurately rank the likely future performance of different securities, it was not sufficiently precise to evaluate the absolute value of any given security. Van Solkema said that he had did not see the model results as indicating that it was time to suspend redemptions from the fund. He saw the model as a "secret weapon" that would enable the funds to sell securities that were likely to lose value, terminate hedge positions that were likely to lose money, and make other adjustments. Later on April 22, Cioffi and others managers evaluated the portfolios. Early the following week, the portfolios' team met and became optimistic that the market had overreacted, giving the funds an opportunity to make money. After an April 24 meeting between lower-level and senior managers, Bear Stearns itself decided to invest an additional $25 million into the funds.[50] Thus, the defense argued, the cautious optimism expressed by Cioffi and Tannin to investors on the April 25 conference call was sincere and not a fraudulent sales pitch.

With regard to the allegedly concealed redemption request by Concord Management, the defense showed reports generated by the Bear Stearns Asset Management accountants and distributed to Cioffi. These did not show the Concord redemption on the day of the April 25 call.[51] Cioffi's silence was, they said, understandable in light of testimony by others from Bear Stearns who had expressed a belief that Concord would not go through with the redemption.[52] The significance of Tannin's unfulfilled statement of intent to add to his existing investment and of Cioffi's transfer of part of his investment to a different hedge fund was also muddied. Several of the government witnesses were investment managers who testified that they submitted redemption notices even after being told that Tannin would add more of his own money into the funds and that the two managers had large investments in the funds.[53]

49. See, for example, the testimony of Steven Van Solkema in *Cioffi and Tannin*, Transcript of Proceedings, October 16, 2009, 385–385; 401,412, 424, 444.

50. *Cioffi & Tannin*, Transcript of Proceedings, November 2, 2009, 2423–2430.

51. *Cioffi and Tannin*, Transcript of Proceedings, October 27, 2009, 1731, 1734.

52. *Cioffi and Tannin*, Transcript of Proceedings, October 16, 2009, 385–386, 412, 424; October 27, 2009, 1586; October 27, 2009, 1760, 1771, 1773–1775, 1780, 1786; November 2, 2009, 2451.

53. *Cioffi and Tannin*, Transcript of Proceedings, October 21, 2009, 1140, 1154; October 22, 2009, 1365, 1369.

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Another witness, the manager of the Bear Stearns hedge fund to which Cioffi transferred the $2 million, acknowledged that he had told his investors that management had invested in his fund—although neither he nor his co-manager had ever invested in it themselves.[54] Jurors were reminded that Cioffi lost $4.2 million and Tannin lost about $650,000 when the funds failed.

The defense presented an expert: economist R. Glenn Hubbard, dean of the Columbia Business School and a former chair of the President's Council of Economic Advisers. He testified that he had reviewed the funds' portfolios and concluded that "the funds were structured and managed so that it would be reasonable from an economic perspective, profitable to operate them on an ongoing forward basis, as of month end January, February, March and April of 2007," adding that it was also reasonable for them to seek additional capital for investors.[55] Hubbard testified that his review of the hedging or short positions in the funds' portfolios indicated they would have returned about $1.4 billion in profits had the repo lenders not decided to refuse to extend further credit.[56] Continuing to operate the funds in spring 2007 was "the right decision."[57]

After a three-week trial, the jury deliberated for six hours and returned a verdict of not guilty as to both defendants on all counts.[58] After the verdict, one juror told *The New York Times*, "There was a reasonable doubt. . . . We just didn't feel that the case had been proven."[59] A second juror was more expansive. He saw the April 22 email as a debate between two reasonable options. "They decided, 'We need to make a decision now. And we need to be aggressive whichever way we go.' The entire market crashed. You can't blame that on two people."[60] The foreperson added, "We made a point of saying, 'We're not going to look at the fact that we're in a recession, or that the markets are down. Because that wasn't relevant to the case.'"[61] In short, the government's narrative of personal greed and deception was not persuasive. Rather, the defendants were seen as people who did their best to play the hand that they were dealt.

In hindsight, the prosecutors' failure was predictable. The government had no "storyteller"; that is, it had no witness from inside the company who could say what had happened from beginning to end and who could attest that the defendants' statements to investors were false. Rather, the case was largely predicated on emails read into the record by a Federal Bureau of Investigation agent. There were no sympathetic victims. Most investor witnesses were well-heeled professional managers who made investments in hedge funds on behalf of wealthy individuals and institutions. The individual investor witnesses were affluent and knew the

54. *Cioffi and Tannin*, Transcript of Proceedings, October 22, 2009, 1264, 1298–1299.

55. *Cioffi and Tannin*, Transcript of Proceedings, November 3, 2009, 2563.

56. *Id.*, 2565–2566, 2585–2586.

57. *Id.*, 2583.

58. *Cioffi and Tannin*, Transcript of Proceedings, November 10, 2009, 3272–3275.

59. Zachary Kouwe and Dan Slater, "2 Bear Stearns Fund Leaders Are Acquitted," *The New York Times,* November 11, 2009; A1; Amir Efrati and Peter Lattman, "U.S. Loses Bear Fraud Case," *The Wall Street Journal*, November 11, 2019, A1.

60. Kouwe and Slater, "2 Bear Stearns Fund Leaders Are Acquitted"; Efrati and Lattman, "U.S. Loses Bear Fraud Case."

61. Kouwe and Slater, "2 Bear Stearns Fund Leaders Are Acquitted"; Efrati and Lattman, "U.S. Loses Bear Fraud Case."

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risks of their investment in the funds. None seemed to have suffered as a result of the recession, and certainly no more than Cioffi and Tannin, who not only lost some of their investments but also their jobs. The other government witnesses were former colleagues of the defendants, many of whom offered exculpatory evidence when questioned by the defendants' lawyers. More than that, the government's decision not to challenge the bona fides of the defendants' investment activities proved fatal. To establish that the defendants had lied to investors to induce them to stay in the funds or had engaged in insider trading, the government had to prove that Cioffi and Tannin did not believe what they were saying. But the documentary evidence was ambiguous, and Hubbard was adamant that the investment strategy was reasonable given what was known at the time and it would have succeeded but for panic by the repo lenders.

The loss of the *Cioffi/Tannin* case had an outsized effect. It had been widely followed, and the government's failure made it far more cautious moving forward.[62] The DOJ did not indict another Wall Street executive for alleged crimes pertaining to the financial crisis.

The Reserve Fund

On Sunday, September 14, 2008, Lehman Brothers Holdings Inc. announced that it would file for bankruptcy when the courts opened the following morning. At the time, the Reserve Primary Fund, the nation's initial money market fund, held $785 million in debt securities issued by Lehman (out of total managed assets of $62.5 billion). Like all money market funds, the Reserve Primary Fund, managed by Reserve Management Company, promised to redeem shares on demand at a net asset value equal to par −$1.00 per share—even though the assets of the fund were invested in debt securities that would take time to liquidate. Before the markets opened on Monday, September 15, the fund had received $5 billion in requests for redemptions. By noon, its custodial bank stopped making payment on redemption requests fearing that the fund could not make good in the midst of a run.[63] That day, Bruce Bent II, the president of Reserve Management Company, and his father, Bruce Bent Jr., the chairman, told the fund's board of trustees that Reserve Management would seek SEC approval for it to provide financial support to the fund to satisfy redemption requests. Bent II then issued public statements announcing an unqualified proposed credit support agreement and that the Lehman failure would not have a material impact on the fund. Hours later, the fund's chief investment officer, falsely told Moody's that redemptions had stopped and that Reserve Management had sufficient assets to pay redemption requests.[64] But redemptions continued to escalate, forcing the Bents to tell the trustees on Tuesday, September 16, that redemption requests had reached $24.6 billion, of which only $10.7 billion had been paid and that no support agreement would be forthcoming. After the market closed, the fund announced that the net asset value was only

62. Kouwe and Slater, "2 Bear Stearns Fund Leaders Are Acquitted"; Eisinger, *Chickenshit Club*, 181.

63. Memorandum Opinion and Order, *Securities & Exchange Commission v. Reserve Management Company, Inc., et al.,* 09 Civ. 4346 (PGG), September 30, 2013, 1.

64. *Id.*, 4–6; Complaint, *Securities & Exchange Commission v. Reserve Management Company, Inc., et al.*, May 5, 2009, paragraphs 312–336.

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$0.97 per share and redemptions were suspended indefinitely. The fund proceeded to adopt a plan of liquidation.[65]

The announcement that the Reserve Primary Fund was "breaking the buck" (meaning the net value asset had fallen below $1.00 per share, which was not required but which was expected by investors) was highly consequential. Coming on the heels of Lehman's failure, the nearly simultaneous sale of Merrill Lynch & Co. to Bank of America and mounting evidence that AIG too was about to fail, the Reserve Primary Fund's crisis "spread to other money market funds, threatening the stability of the entire industry and endangering the cash holdings of households, corporations and nonprofit organizations."[66] Alarmed by a new threat to the economy, later that week the Department of the Treasury used its Emergency Stabilization Fund to backstop uninsured money market funds.[67]

On May 5, 2009, the SEC charged the Bents and Reserve Management with fraud. It contended that the Bents knew that they could not provide sufficient support for the fund while hoping that something would turn up to save their business. The defense argued that the Bents were only stating their intent and that neither they nor the SEC (citing a contemporaneous and upbeat broadcast remarks by then Chairman Christopher Cox) foresaw how the crisis would unfold. After a two-week trial, a jury concluded that Bruce Bent Jr. was not liable and Bruce Bent II had been negligent, but it found that Reserve Management Company alone had engaged in knowing or reckless misconduct. After the surprise verdict largely favorable to the defendants, one juror said that the jury had been divided and the decision was difficult: "There wasn't quite enough evidence for recklessness. However, we felt it was clear there was a lot of negligence."[68] This thinking was reflected by the trial judge, who imposed a fine of $100,000 on Bent II, though saying, "His wrongful conduct took place over a period of less than 36 hours and under extremely stressful and unprecedented economic conditions."[69]

The CDO Cases: Who Was Responsible?

"Where's Waldo?": The *Stoker* Case

Starting in 2010, the SEC filed several civil enforcement cases alleging fraud by investment banks and collateral managers in the creation and sale of "squared" CDOs, "synthetic" CDOs, and "hybrid" CDOs. Unlike the CDOs owned by the Bear Stearns hedge funds, these instruments were derivatives. Squared CDOs owned selected tranches of other CDOs and were themselves segmented into tranches that were evaluated by credit ratings agencies. Investors received payments from the CDO tranches into the portfolio.

65. Memorandum Opinion and Order, *Securities & Exchange Commission v. Reserve Management Company*, 7; Complaint, *Securities & Exchange Commission v. Reserve Management Company,* paragraphs 35–36.

66. Bernanke, *Courage to Act*, 279–280.

67. Bernanke, *Courage to Act*, 301–302.

68. Kirsten Grind and Julie Steinberg, "Reserve Primary Managers Cleared in SEC Fraud Case," *The Wall Street Journal*, November 12, 2008, C1.

69. Memorandum Opinion and Order, *Securities & Exchange Commission v. Reserve Management Company*, 38. The court also imposed a fine of $650,000 on the management company entities that were wholly owned by the Bent family.

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To create a residential mortgage-backed securities (RMBS), the offering parties purchased home loans from the banks that lent money to homeowners, pooled them together, and then sold interests in the pool to investors. CDOs owned tranches of previously issued RMBS and received a pass-through payment on the homeowners' mortgages from the RMBS. Both RMBS and CDOs received credit ratings from one of the three major credit ratings agencies. Synthetic CDOs "referenced," but did not own, tranches of existing residential mortgage-backed securities (RMBS) or other previously issued CDOs. Investors in synthetic CDOs received payments proportional to those paid by homeowners to owners of the referenced RMBS or CDOs. These too were rated. But instead of receiving money actually paid by homeowners, purchasers of notes issued by synthetic CDOs received payment from other investors who had purchased "credit protection" on the referenced assets through financial contracts called credit default swaps (CDS). Thus, if residential mortgages did well, synthetic CDO buyers profited. If, on the other hand, the mortgages went into default and the referenced securities declined in value, then the "short" investors (purchasers) of CDS would profit and the "long" investors (sellers) would lose. Synthetic CDOs were a zero-sum game. For one party to profit from continued payment by the referenced mortgage-backed securities or CDOs, the counterparty had to suffer losses.

Hybrid CDOs were comprised of both cash assets and CDS assets. Thus, here too some investors went long by selling CDS that referenced underlying CDO assets as an investment while others went short by purchasing CDS that referenced those same CDO assets.

Two of CDO cases went to trial before juries.[70] The first was *SEC v. Brian H. Stoker.*[71] The case arose out of Citigroup's creation and sale of a hybrid CDO squared called Class V Funding III (hereafter, Class V III), which closed on February 28, 2007. Most of its assets were synthetic; that is, the CDO sold protection CDS that referenced designated single A-rated ("mezzanine") CDO securities. The Class V III pool of assets was also broken into tranches. "Super Senior" securities had first priority of payment, lower-rated mezzanine securities were second, and "equity" securities received residual or remaining money payments from the pool. In the event of a default by one of the referenced securities, equity investors bore the first loss, mezzanine the second, and super senior only if the payments to the lower two tranches were also unpaid. Citigroup's CDO desk developed the concept for the Class V III, selected Credit Suisse Alternative Capital LLC (hereafter, CSAC) to act as the manager of the Class V III; obtained the collateral and assets for the new CDO; prepared a term sheet, a "flipbook" (a slide presentation describing the offering), and the official offering circular; and then sold interests to investors.

70. The other cases were against Credit Suisse, J.P. Morgan, Merrill Lynch, and Mizhuo Securities, acting as arranging banks, and against several firms that served as collateral managers for the newly created CDOs. These included Harding Advisors, GSC Capital Corporation, ICP Asset Management, NIR Capital, and Delaware Asset Advisors. Several employees of the arranging banks and collateral managers were also defendants. Most of these cases settled at the time they were commenced. See "SEC Enforcement Actions: Addressing Misconduct That Led To or Arose From the Financial Crisis," Key Statistics (through October 7, 2016), https://www.sec.gov/spotlight/enf-actions-fc.shtml (page is archived). The case against Harding Advisors settled after extensive litigation. The SEC's case against Edwin Steffelin, a managing director of GSC Capital, which was the collateral manager in the J.P. Morgan case, was litigated and ultimately voluntarily dismissed by the SEC on November 16, 2012. Stipulation of dismissal with prejudice, *Securities & Exchange Commission v. Steffelin,* Docket No. 43.

71. *Securities & Exchange Commission v. Brian H. Stoker*, Civil Action No. 11-cv-7388 (JSR) (S.D.N.Y. October 19, 2011) (hereafter *Stoker*).

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The largest investor was an affiliate of the monoline insurer Ambac Assurance Corporation, which purchased $500 million of the super senior tranche by selling $500 million in CDS protection to the Class V III CDO. As was customary, Citigroup was the initial swap counterparty, buying CDS protection from the CDO. However, rather than serving as a market making intermediary, the SEC alleged Citigroup secretly retained $490 million in the protection CDS, mimicking a strategy used by the hedge fund Magnetar Capital. It also alleged that Citigroup selected highly risky securities for the Class V IIII portfolio to better ensure its failure. The Class V III CDO launched on February 28, 2007. By November 19, 2007, 83 percent of the assts referenced in the Class V III portfolio had been downgraded and the CDO declared default. Long investors, including Ambac, lost hundreds of millions of dollars while Citigroup realized net trading profits of over $160 million.[72]

Brian Stoker was a subordinate within the group's structuring desk. Generally, new CDOs offered by Citigroup were developed based on ideas from the firm's secondary traders, who obtained information on current secondary market prices and trends from its institutional sales group, which learned what new securities were of interest to the firm's customers. Using mathematical models, the structuring group analyzed the proposed portfolio to assess whether it could generate the desired return and cash flow for investors, meet the standards of the ratings agencies, and generate the desired transaction fee for Citigroup. Stoker ran these models for the Class V III CDO and worked on the deal documentation (such as the term sheet, flipbook, and offering circular) in coordination with other members of the team and outside professionals. Thus, he was dubbed the "deal manager."[73] A separate unit, the syndicate desk marketed the new issues of CDOs to investors through Citigroup's institutional sales force.[74] The SEC contended that Stoker was responsible for Citigroup's fraud because he helped model a weak portfolio likely to fail, he reviewed and approved the flipbook and offering documents that omitted that Citigroup had helped select the portfolio, and he was aware that Citigroup had taken a proprietary trading position adverse to the interests of the CDO investors.[75]

To present its case, the SEC fought through a parade of hostile current or former Citigroup employees who attempted to explain away email evidence suggesting interest in a proprietary trade. Donald Quinn, a managing director who headed the CDO secondary trading desk, said he had not recommended assets for inclusion in Class V III, but then ultimately admitted that in October and November 2006 he had directed his subordinates to compile a list of twenty-five possible reference securities, mostly mezzanine tranche securities in cash CDOs that were sponsored by hedge fund Magnetar Capital. He then directed Stoker to "please be sure that these names are included in the CSAC list."[76] Quinn acknowledged that he knew that Magnetar's strategy was to simultaneously purchase the equity tranche of these CDOs and CDS protection against the mezzanine tranches, a position that could offer handsome profits if the CDO declined in value.[77] Quinn also said that, at his behest, Stoker created a model of a CDO in

72. *Id.*

73. *Stoker*, Transcript of Proceedings, July 19, 2012, 773–774; July 23, 2012, 874–877; July 26, 2012, 1562, 1578.

74. *Stoker,* Transcript of Proceedings, July 19, 2012, 626.

75. *Stoker*, Complaint, 2–3.

76. *Stoker*, Transcript of Proceedings, July 17, 2012, 256.

77. *Id.*, 245–248.

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which Citigroup retained a large short position in CDS against assets held by the CDO. Quinn also discussed it with other personnel on the CDO desk. Quinn and his colleagues testified that these discussions were simply preliminary general talk that had nothing to do with the ultimate creation of Class V III. Quinn's desk was supposed to function only as a market maker and not take proprietary risk positions for Citigroup, and Quinn denied that he purchased the $500 million CDS protection to make a profit. Instead, he said, the trading desk had no role in deciding what collateral would be included in the CDO and only intended that Citigroup obtain fee banking revenue. The list of twenty-five securities was sent to CSAC for possible inclusion in the CDO. Sixteen of those securities were included in the portfolio and were the ones against which Citigroup bought CDS protection.[78] Stoker's superior, who was the head of the structuring desk, another trader, and the Citigroup institutional salesperson who serviced both CSAC and Ambac created or received emails referring to the CDO as "DQ's prop trade." Nevertheless, they testified that CSAC—and not Citigroup—had selected the assets for inclusion in the new CDO and denied that it was a vehicle for Citigroup trading profits. The SEC established that Stoker was involved in discussions about the DQ prop trade and the desirability of including certain Magnetar-linked securities in the proposed portfolio. He was also responsible for modeling the portfolio, had reviewed and approved the flipbook and offering memorandum, and helped distribute those documents. The offering memorandum said that CSAC had selected the assets for the portfolio, that Citigroup was the initial counterparty for the purchase of CDS protection from Class V III, and that Citigroup might or might not continue to hold the protection. However, neither the offering memorandum nor the flipbook disclosed Citigroup's role in the asset selection process or its actual intention to hold its CDS position for an indefinite period.

The SEC's case featured an investor and an expert. The investor-witness was David Salz, an Ambac managing director. Salz testified that he relied heavily on CSAC's independence and knowledge of the CDO market. He said that both CSAC and his Citigroup salesperson told him that the trade was advantageous to Ambac because hedge funds managers who thought that the housing market would decline had indiscriminately shorted mortgage-backed securities without any fundamental analysis of the underlying collateral, thereby driving down prices of many below fair value. Believing that CSAC had indeed done a thorough analysis of these securities and that Citigroup was simply seeking investment banking fees, he recommended a long investment to Ambac. He testified that he would never have recommended the investment had he known that Citigroup had influenced the portfolio section and intended to keep a large short position.[79] Ambac lost $305 million. The expert was an economist who testified that of the 125 securities included in the Class V III CDO, 25 had been suggested by Citigroup and had far riskier collateral than the remaining 100. In addition, 15 of the securities suggested by Citigroup and included in the referenced portfolio were from CDOs organized by Magnetar. They had the highest risk and weakest collateral of the securities in the portfolio and thus defaulted at a higher and faster rate than other CDOs. He found the default variance between those securities suggested to CSAC by Citigroup and the remainder to be statistically significant, and he opined that Citigroup's selections were deliberate and not the product of a

78. *Id.*, 319–320.
79. *Stoker*, Transcript of Proceedings, July 24, 2012, 1184, 1191–1194, 1207.

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random selection. By adversely selecting the collateral for the Class VIII CDO and then taking a short position against it, Citigroup's market exposure was adverse to the long investors.[80]

The defense counterattacked the SEC's case through cross examination of its witnesses and also testimony from several CSAC employees. The Citigroup (and CSAC) witnesses testified that arranging banks and collateral managers often exchanged ideas about collateral and portfolio, and all said that it was CSAC, not Citigroup, that selected the portfolio. Each disclaimed an intent to create a portfolio that was designed to fail and none foresaw the coming market collapse. All participants in this market were sophisticated, competing "big boys." Ambac was also a "big boy" that made a leveraged bet that its adviser, CSAC, was smarter and more knowledgeable than hedge fund managers. Yes, the Citigroup employees had discussed purchasing CDS protection from Class V III, but that was a hypothetical and done separately from the ultimate offering. Moreover, Ambac and other investors knew that someone was purchasing CDS protection from the Class V III CDO, and the offering documents had included that Citigroup might "provide CDS assets alone without any offsetting position" and "had no duty to act on behalf of noteholders and may act in ways adverse to them."[81] Customarily, underwriters never disclose trading positions in CDO offerings. Though the large and extended short position was unusual for the CDO trading desk, Citigroup witnesses denied any investment intent. Stoker's counsel called Samir Bhatt, the CSAC manager for Class V III, and two of his colleagues as witnesses. Bhatt testified that it was "our group at CSAC, myself and others" who selected the assets, that they had done their own analysis of the collateral, and they liked it. While he did not know that Citigroup intended to maintain a short position, he said that information would have been irrelevant to his analysis.[82] It appeared, however, that he agreed to the portfolio suggested by Citigroup in under two hours.[83]

Stoker himself testified that his job, while well-paid, was relatively low on the corporate ladder and was largely ministerial. Although he and others tried to structure deals that investors would like, his principal tasks were to run portfolio models based on securities and derivatives suggested by others to ensure that they could generate sufficient cash to cover payments to CDO investors and to meet agency rating requirements for the various tranches. He also coordinated the preparation of and reviewed the content of sales and transactional documents that were shared with investors, and he also coordinated the offering with trustees, accountants, ratings agencies, and managers.[84] Stoker said that the CDO that became Class V III was Quinn's idea that was shared with many others, most of them more senior than himself. Although he was involved in email discussions of "prop trades," Stoker said that these trades occurred a few months before the Class V III offering, and that he was not personally involved in discussions with CSAC about which assets it would select, did not know if Citigroup would keep some or all of its initial short position, and had no role in or knowledge of its trading

80. *Stoker*, Transcript of Proceedings, July 25, 2012, 1355–1383.

81. *Stoker*, Transcript of Proceedings, July 17, 2012, 1265.

82. *Stoker*, Transcript of Proceedings, July 26, 2012, 1480, 1495–1496, 1512–1514.

83. *Id.*, 1471, 1496. Unbeknownst to the jury, Bhatt and CSAC separately settled SEC charges that they had negligently defrauded Class V III investors, but the parties agreed that this settlement was not admissible as evidence in Stoker's trial. *In the Matter of Credit Suisse Alternative Capital LLC, Credit Suisse Asset Management, LLC, and Samir H. Bhatt,* Oct. 19, 2011, Administrative Proceeding File No. 3-14594.

84. *Stoker*, Transcript of Proceedings, July 26, 2012, 1562, 1578.

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decisions.[85] Although he knew that lists of assets for the portfolio were exchanged with CSAC and that some of the assets were tranches of Magnetar-sponsored CDOs, he thought that CSAC selected the assets, and he understood from an email from Bhatt that the assets were chosen by Bhatt because he liked them.[86]

The SEC's theory stressed that Stoker, as the person responsible for the accuracy of the flipbook and offering circular, was in a position to demand more disclosure of Citigroup's role and interest. Displaying a page from a children's book, Stoker's lawyer stressed his client's minimal role and knowledge and emphasized that he did not make any final decisions:

> I hope you noticed that most of this trial has nothing to do with Brian Stoker. It reminds me of a children's book that I used to read to my children and then eventually my grandchildren. *Where's Waldo?* Do you remember *Where's Waldo?* Those things where the kids, you open it, and you look and try to find Waldo in there?. . . . And, I mean, look at how many people didn't raise this question about, shouldn't we put in the secondary trading desk position? Here is—this is another sort of Where's Waldo sort of thing. This is his sending around the draft offering circular to—I think there's like 60 people there, including Brian Stoker and Mr. Salz and some others. There's 60 people there, all of whom are reading this. Nobody is saying, let's go find out—let's go find out what the secondary trading desk has done.[87]

The jury returned a verdict within a few hours of deliberation finding that Stoker was not liable, but it appended a note: "This verdict should not deter the SEC from continuing to investigate the financial industry, to review current regulations and modify existing regulations."[88] Explaining the verdict to the press, the foreman said:

> The SEC tried to focus on a relatively low-level executive who had several layers of managers above him. He did not act in some kind of vacuum where his behavior was not tolerated or encouraged by his bosses. . . . To try to hang all this on Stoker didn't work. . . . I would like to see the CEOs of some of these banks in jail or given enormous fines, not a lower-level employee.[89]

Another juror added: "Where I'm from, you hear Wall Street is an evil place, but you have nothing to base that on. But after sitting on the jury, I thought, 'Wow, greedy, reckless behavior really does happen there.' . . . . [W]hy didn't they go after the higher-ups rather than a fall guy?"[90]

"The Fabulous Fab"

The second SEC CDO case, and the better-known one, was *SEC v. Goldman, Sachs & Co. and Fabrice Tourre,* which went to trial in 2013.[91] It concerned the creation and sale of ABACUS

85. *Id.*, 1614–1615.
86. *Stoker*, Transcripts of Proceedings, July 18, 2012, 584; July 26, 2012, 1612.
87. *Stoker*, Transcript of Proceedings, July 30, 2012, 1945, 1985.
88. *Stoker*, Transcript of Proceedings, July 31, 2012, 2037.
89. Peter Lattman, "A Jury's Message for Wall Street, S.E.C. Gets Encouragement in Rare Note with Verdict," *The New York Times,* August 4, 2012, B1.
90. Lattman, "S.E.C. Gets Encouragement from Jury That Ruled Against It."
91. Complaint, *Securities & Exchange Commission v. Fabrice Tourre*, Civil Action No. 1:10-cv-3229 (KBF) (S.D.N.Y. 2010), filed April 15, 2010.

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2007-AC1, a synthetic CDO. The transaction began in late December 2006 when Paolo Pellegrini, a portfolio manager for the hedge fund Paulson & Co., approached Goldman asking that it help create and market a synthetic CDO referencing low-rated RMBS that Paulson believed were likely to default and against which it wished to purchase credit default swaps. Goldman agreed, and it suggested that to market the new securities, it would need the assistance of an independent firm. This firm would act as the portfolio selection agent and would have authority over the identity of the RMBS to be used as the reference portfolio. The SEC contended that Goldman believed such an independent agent was necessary to assure prospective investors that the portfolio had been fairly selected and was not biased in favor of short sellers.

Fabrice Tourre managed the transaction for Goldman. Tourre at that time was a 28-year-old junior vice president who worked on a trading desk within Goldman's mortgage securities business. In January 2007, Tourre identified ACA Management LLC, a unit of the financial insurance and management firm ACA Financial Holdings, as a potential portfolio selection agent for the proposed CDO. He arranged a meeting between Pellegrini and Laura Schwartz, a senior managing director of ACA and the head of its CDO management business. Over the course of the next several weeks, Pellegrini and Schwartz met and, through Tourre and Goldman, negotiated the terms of the transaction. Paulson & Co. made the initial selection of RMBS for the reference portfolio. Half of the 123 securities it identified were also on ACA's list of securities that were acceptable for investment by entities under its management. Over time, with input from Goldman, the two sides agreed on 90 reference securities. In February 2007, Goldman began selling the ABACUS notes to its customers using marketing materials that identified ACA as the party that selected the portfolio and emphasized the value of ACA's service. The documents did not mention Paulson's interest in the transaction or its role in the securities selection process.

In April 2007, a Goldman customer, IKB Deutsche Industriebank AG, purchased $150 million of ABACUS mezzanine notes for clients IKB advised. The notes were rated AAA by Standard & Poor's and Aaa by Moody's. ACA also purchased ABACUS mezzanine notes for a CDO it managed as well as for ACA Financial Guarantee, one of its affiliates. ACA also purchased $909 million of the super senior tranche of ABACUS through CDS protection. Goldman received a $20 million fee for its role, including the sale of ACA's CDS protection on the ABACUS securities to Paulson. Within a few months, Standard & Poor's and Moody's significantly revised their opinions of mortgage-backed securities in general and severely downgraded many subprime RMBS that were in the ABACUS reference portfolio. Within a year, the reference portfolio was nearly worthless. IKB lost its entire investment. ACA and its intermediary bank, ABN AMRO, were required to pay on the CDS protection they had sold, sending ACA's parent company, ACA Capital Holdings, Inc., into liquidation. ABN AMRO was forced to merge with Royal Bank of Scotland. Paulson & Co. made about $1.2 billion in profits.[92]

The SEC contended that Tourre defrauded ACA, IKB, and ABN AMRO. Laura Schwartz of ACA was the SEC's key witness. She testified that she had believed that Paulson was a long

92. Complaint, *Securities & Exchange Commission v. Tourre,* 19 (hereafter *Tourre*); *Tourre,* Transcript of Proceedings, July 17, 2013, 610-611.

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investor in the ABACUS CDO and had purchased the entire equity tranche of the CDO structure that would absorb the first losses on the portfolio up to 10 percent of the principal value of the entire $1.2 billion deal should losses be incurred. Thus, she thought that when Paulson suggested securities for the referenced portfolio, it was predicting that they would do well, not poorly. Schwartz testified that she based this belief on a January 2007 email from Tourre that identified Paulson as the "transaction sponsor," a term that connoted a long investor. Other emails stated that the equity, or first loss, portion of the contemplated capital structure was "pre-committed," which Schwartz took to mean that it had been sold to Paulson. In an email to her salesperson at Goldman, which had been forwarded to Tourre, Schwartz referred to Paulson's "equity perspective," a misimpression that Tourre did not correct.[93] Schwartz and her superior at ACA were adamant that if they had known that Paulson was only taking a short position in ABACUS, ACA would never have agreed to be the portfolio selection agent.[94] Critically, the SEC offered into evidence several email messages by Tourre sent to his then girlfriend, a Goldman salesperson in London. On February 20, 2007, he sent a message to her with the link to www.mortgageimplode.com and said, "I love this website."[95] On January 13, as he was working on the ABACUS transaction, he wrote to his girlfriend:

> [M]ore and more leverage in the system. The entire building is at the risk of collapse at any moment. Only potential survivor, the Fabulous Fab (as Mitch would kindly call me, even though there is nothing fabulous about me, just kindness, altruism, and deep love for some gorgeous and super smart French girl in London), standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all the implications of those monstrosities. Anyway, not feeling too guilty about this, the real purpose of my job is to make capital markets more efficient and ultimately provide the U.S. consumer with more efficient ways to leverage and finance himself (so there is a humble, noble and ethical reason for my job, amazing how good I am in convincing myself).[96]

After a hard-fought two-week trial, the jury found Tourre liable. How did the SEC win the case? It was in many respects similar to the *Stoker* case. Schwartz acknowledged that she never asked Pellegrini or Tourre whether Paulson was short and never noticed that no equity had been issued when the ABACUS offering closed. More important, the evidence showed that ACA had the same information as Paulson about the RMBS referenced in the ABACUS transaction, including the source and quality of the underlying mortgages. All were sophisticated investors with extensive experience with subprime loans and asset-backed securities. Like CSAC, ACA used its own proprietary tools to screen the assets, and the ABACUS notes were also rated by Moody's and Standard & Poor's. Schwartz and her superior acknowledged that ACA's evaluation of the reference portfolio was objectively based on the underlying assets and would not have been influenced by the identity of the transaction sponsor, whether long or short.[97] Indeed, ACA had recently served as the portfolio selection agent in other synthetic

93. *Tourre,* Transcript of Proceedings, July 23, 2013, 1501, 1513, 1515, 1519, 1525–1526, 1542, 1556.
94. *Tourre,* Transcript of Proceedings, July 22, 2013, 1381.
95. *Tourre,* Transcript of Proceedings, July 25, 20132139.
96. *Id.*, 2065.
97. *Tourre,* Transcript of Proceedings, July 23, 2013, 1593–1596, 1594, 1624–1626, 1676.

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deals with other hedge funds, including Magnetar Capital. Magnetar's role in those deals was also undisclosed to long investors. All parties to the synthetic ABACUS deal understood that for each investor who took a long position seeking to profit if real estate mortgages paid off, another investor had made an equal prediction that subprime mortgages would default. Thus, Pellegrini testified:

> WITNESSS: We essentially—we express the view that the sub-prime market was flawed, and people who believed that the sub-prime market was sound could take the other side of that bet. . . . Obviously, everybody had different views about the adjustable-rate mortgages, like Greenspan said at the time, said, you know—
> THE COURT: Yes. Sustained. Only because you can't say whatever you said unless we're going to take it for the truth.
> THE WITNESS: Greenspan is the truth.[98]

Learning from the *Stoker* trial, the SEC emphasized that only Tourre was "primarily responsible for the AC1 transaction. He was the deal captain." The SEC described Tourre as young, but he had six years' experience and was "not some entry-level rookie."[99] As the principal conduit between ACA and Paulson, he knew of ACA's mistaken belief that Paulson was a long investor and nevertheless described Paulson as a "transaction sponsor." He kept silent after reading an email in which Schwartz told her Goldman salesperson of her belief that Paulson had an equity perspective.[100] Thus, while not absolving Goldman, the SEC made its case as one that concerned Tourre's individual responsibility for false statements to induce a transaction. And the jury concurred.

Mortgage Loan Origination and Sale: The Countrywide "Hustle" Case

Unlike the Bear Stearns trial, the DOJ's civil case against Countrywide and one of its former employees, Rebecca Mairone, concerned the making of bad home mortgage loans and their sale to others—a case that directly charged that risky, substandard loans were made and were then falsely passed off as good investments (hereafter, Countrywide Hustle case).

Countrywide was a colossus in the mortgage lending market. Founded in 1968, it was the nation's second-largest residential housing lender in 2005.[101] In 2006, Countrywide issued $450 billion in mortgage loans.[102] Countrywide had been the largest source of mortgages for Fannie Mae and Freddie Mac, the two government sponsored enterprises (GSEs) that purchased mortgages from home lenders and then either held them for investment on their own books or packaged them into RMBS securities that they sold to investors. Because Fannie Mae and Freddie Mac guaranteed investors in their RMBS that they would pay the principal value

98. *Tourre,* Transcript of Proceedings, July 16, 2013, 437.
99. *Tourre,* Transcript of Proceedings, July 30, 2013, 2569.
100. *Id.*, 2569, 2576–2578, 2581, 2586–2587.
101. Countrywide Financial Corporation, *Annual Report on Form l0-K for 2005*, 4, www.sec.gov/Archives/edgar/data/25191/00010465907015136/a07-4926_110.htm.
102. Countrywide Financial Corporation, *Annual Report on Form l0-K for 2005*, 7–8.

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even if the borrowers were to default, their securities were perceived to be almost as safe as US Treasury bonds. To protect themselves against loss, they demanded that their correspondent lenders only make loans to persons who were deemed to have good credit and that were underwritten in compliance with criteria set by the GSEs. They also limited the size of each single-family home loan to $419,000 (and $625,000 in high-cost areas). Loans eligible for sale to Fannie Mae and Freddie Mac were termed "conforming" loans in the industry.

As the housing bubble formed in the early 2000s, conforming loans became less popular. Newly established nonbank lenders with aggressive lending policies became willing to make loans with more exotic features that did not meet the GSE criteria, such as "teaser rates" and "pay option adjustable-rate mortgages" to borrowers with little documentary evidence of ability to pay (such as persons with "stated income" rather than provable W-2 income statements or tax returns). Securities backed by these "subprime" loans carried a higher rate of interest, but because the pools of mortgages backing the securities were large and seemed diverse, investors and ratings agencies thought they were safe, even though the interest rate they carried exceeded those on Fannie Mae and Freddie Mac securities. Following the industry crowd, Countrywide's lending shifted substantially. Prime conforming loans eligible for sale to Fannie Mae and Freddie Mac dropped from 54.2 percent of Countrywide's business in 2003 to 31.9 percent in 2006.[103]

In 2006, housing prices stalled and then began to fall. In 2007, the secondary market for subprime loans largely evaporated because borrowers with poor credit were beginning to default on their loans. In mid-2007, Countrywide shifted its business away from subprime lending and back to prime loans that could be sold to the two GSEs.[104] Faced with increasing defaults on the subprime loans it had issued in earlier years—for which investors were now demanding repayment—Countrywide needed cash.

The Countrywide Hustle case arose out of the company's response to changing conditions in the mortgage market.[105] The Countrywide Full Service Loan (FSL) division, which had previously made subprime loans, moved into origination of prime loans.[106] To shorten the time between a loan application and the sale of a loan to Fannie Mae or Freddie Mac, Countrywide implemented a new "streamlined" mortgage origination program dubbed the "High-Speed Swim Lane," or "Hustle" for short.[107] The government contended that the heart of the scheme was a decision by defendant Rebecca Mairone, then the chief operating officer of the FSL division, and her superior, FSL division president Greg Lumsden, to replace trained loan underwriters—who closely reviewed loan files to ensure that borrowers could repay—with entry-level personnel known as "loan specialists" and to remove other quality control checks in the loan process. Penalties for producing low-quality loans were suspended, more aggressive funding targets were set, employee compensation was made more dependent on the

103. Complaint, *Securities and Exchange Commission v. Angelo Mozilo, et al.,* CV-09-03994 (JFW) (C.D.Cal. 2009, June 4, 2009), 7–8.

104. Complaint, *United States ex rel. Edward O'Donnell v. Countrywide Financial Corporation, et al.*, Case No. 1:12 CV 01422 (JSR) (S.D.N.Y 2012), paragraph 47.

105. *Id.*

106. *Id.*

107. *United States ex rel. O'Donnell v. Countrywide Financial Corp., et al.*, 33 F. Supp. 3d 494, 497 (S.D.N.Y. 2014) (hereafter, *Countrywide* Penalty Opinion).

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volume of loan production, previously rejected loans were aggressively re-reviewed to see if they could be eligible for sale to the GSEs.[108]

The Hustle program began as a pilot. Early quality control reports showed that up to 41 percent of the loans approved by the new loan specialists were at a high risk of not meeting the criteria necessary for sale to Fannie Mae and Freddie Mac. Two mid-level managers, Edward O'Donnell and Michael Thomas, testified that they complained to Mairone and Lumsden about the elimination of quality control measures and the degradation of loan quality, arguing that the Hustle program should be abandoned. But they testified that Mairone was more interested in the reduction in time between loan origination to funding, an acceleration that, when applied to thousands of loans, would increase profits and cash flow. Rather than heed the warnings, they testified that the quality control reports that had alarmed O'Donnell and Thomas were denigrated and presentation of those results to more senior managers at Countrywide was suppressed. Contemporaneous documentation and later analysis confirmed the testimony of O'Donnell and Thomas, showing that 41 percent of the loans originated during the pilot program were high risk—which increased to 80 percent by the time the program was fully implemented.[109]

The government's evidence also showed that Fannie Mae and Freddie Mac were victims. Both GSEs bought conforming loans in bulk pursuant to contracts with Countrywide in which Countrywide, like other lenders, made promises—commonly referred to as "representations and warranties"—that the loans were eligible for sale and met the GSEs' criteria for creditworthiness. Witnesses from Fannie Mae and Freddie Mac testified that they relied on the veracity of Countrywide's promises because they had limited capacity to inspect the loans themselves and would not have purchased loans that Countrywide's own quality control tests showed were defective. The government's evidence showed that Countrywide made $165 million from 28,800 Hustle loans sold to the GSEs, 45 percent of which defaulted. The Hustle trial lasted four weeks, but the jury needed only six hours to return a verdict of liability as to Countrywide, its successor (Bank of America), and Mairone.

Why did the government succeed in the Countrywide Hustle case when it had failed to convince a jury regarding Cioffi and Tannin? Unlike the Bear Stearns case, the lead government witnesses were insiders who told the story of the origin and operation of the Hustle program. Their testimony explained why Mairone and her colleagues were anxious to increase loan production without regard to quality, how objections were ignored, and how false representations were made to Fannie Mae and Freddie Mac. Nor were the false statements made in the midst of crisis as in the *Reserve Management* case; instead, the Hustle loan program was developed over several months, was tested in a pilot program, and was debated in multiple meetings. The government contended that the defendants knew the risks of the program and that the risks were becoming reality. The government also presented testimony

108. *United States ex rel. O'Donnell v. Countrywide Financial Corp., et al.,* 83 F. Supp. 3d 528, 534–535 (S.D. N.Y. 2015) (hereafter *Countrywide* New Trial Opinion).

109. *Countrywide* Penalty Opinion, 502–503, 499; *Countrywide* New Trial Opinion, 531–536. In 2016, the district court's judgment was overturned on appeal because, while the government had proven an intentional breach of Countrywide's contract with the GSEs, it had not proven that Countrywide had an intent to defraud the GSEs at the time it originally entered into the contract. *United States ex. rel O'Donnell v. Countrywide Home Loans, Inc.,* 822 F.3d 650, 652-653, 662, 665-666 (2d Cir. 2016).

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from sympathetic witnesses—ordinary Fannie Mae and Freddie Mac employees—who said that their companies were not engaged in speculation and would not have purchased the loans had Countrywide been truthful about their credit quality. Critically, the government could identify Mairone's specific personal responsibility, unlike with the diffused decision making that plagued the government's case in *Stoker.* Mairone's defense that she was simply doing her job in good faith fell flat.

Conclusion: What Went Wrong?

The last of the financial crisis enforcement actions concluded in 2017. Notwithstanding nine years of investigations and litigation, the public has not been satisfied that justice was done. Why did this happen? What do the verdicts suggest regarding the history of prosecution of financial crimes generally, and the structure of Wall Street in the early twenty-first century specifically?

Some reasons for disappointment originated with bureaucratic hurdles. To deal with the savings and loan scandal of the 1980s, Congress appropriated funds to hire an additional 450 lawyers and investigators, and the Department of Justice created a separate office with the specific mission to find and prosecute malefactors.[110] In the early 2000s, the DOJ recruited a task force of elite prosecutors from around the country to prosecute Enron executives, the leading case of the next business scandal: financial statement fraud by industrial companies. But with respect to the financial crisis, there was no special congressional appropriation and there was not a centralized approach until late 2009. As a result, funding was lacking and responsibilities for the prosecution were not clearly defined. A second reason was tactical. In the financial crisis cases, the government focused much of its initial effort on spectacular collapses, such as the Bear Stearns hedge funds and the Reserve Fund. Though these failures had significant effects on financial markets, juries did not find that the defendants had an intent to defraud. They concluded that mistakes had been made in the midst of unprecedented market uncertainty and enormous pressure. Both the Bear Stearns funds and the Reserve Fund were, directly or indirectly, buyers of toxic securities and not creators or sellers of those assets. The misplaced focus on people whose alleged misconduct occurred as the crisis peaked was costly. Each case that went to a jury required years of DOJ and SEC effort to investigate and litigate. The losses were demoralizing to the government and may have encouraged other prospective defendants to refuse to cooperate in the government's investigations.

A third reason is that the violations on trial in four of the five cases discussed in this article concerned people who worked in middle management. The *Stoker* case showed that juries sympathized with line employees who thought they were carrying out orders from superiors, especially when other—and apparently more—complicit people were not charged. Thus, the government offered evidence in several cases to prove the opposite: that the defendants kept management in the dark. In the *Countrywide* trial, a whistleblower testified that Mairone

110. United States General Accounting Office, testimony, "Savings and Loan Crisis: Federal Response to Fraud in Financial Institutions," August 1, 1990, GAO/T-GGD-90-61, https://www.gao.gov/products/t-ggd-90-61.

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edited his communications to senior management to conceal adverse results of the Hustle program, and the government argued that the Hustle program only ended when senior executives intervened. In the *Cioffi/Tannin* trial, the government argued that Cioffi hid his redemption from the funds from others at Bear Stearns, that both he and Tannin misled senior managers about their true concerns regarding the viability of the funds, and that they also misled Bear Stearns salespeople so that they would encourage customers to stay in the funds. The SEC argued that Tourre was the Goldman employee who clearly knew of ACA's erroneous belief that Paulson was a long investor and that he deliberately chose not to dispel that impression, and even from the Goldman salesperson who covered the ACA account. When juries sympathized with the defendants' position, the government lost the case. On the other hand, when they concluded that the defendant intentionally misled a customer, as in *Tourre*, or directed business programs to mislead buyers of loans, as in *Countrywide*, they found for the government.

Finally, in the cases examined here, only *Countrywide* featured an insider as a central witness—a storyteller—who could lay out how the violation had begun and progressed. One might argue that the government should have gone to greater lengths to get insiders to be cooperating government witnesses. "Cooperators" were key, for example, in the government's earlier prosecution of Enron, and one can only speculate whether the government had the leverage needed to induce key, but also personally culpable, witnesses to testify. Had the government chosen to concentrate its cases on persons who made and sold subprime residential loans or who hid the defects in asset-backed securities, it might well have had greater success. At the end of 2016 and in early 2017, the Justice Department finally commenced civil cases against managing directors of investment banks who were in charge of mortgage securities banking and trading, alleging that they personally directed or knew of and disseminated false statements to sell toxic securities.[111] Econometric studies of mortgage lending and securitization published in 2013 and after found that "conflicts of interest, misreporting and outright were not sideshows, but central features of the [financial] crisis."[112] However, by 2016 and 2017, many statutes of limitations had run out, precluding most new enforcement actions.

On a broader level, the verdicts show that the government's historical efforts to punish predatory business conduct created undue expectations of success. Beginning in the 1980s, the government successfully pursued Wall Street and corporate actors alleged to be responsible for financial and corporate scandals. In 1988, the firm Drexel Burnham Lambert and its high-yield bond trading chief, Michael Milken, were convicted of crimes and the firm's chief executive officer was found liable for failing to supervise Milken.[113] Three years later, Paul Mozer, the head of the government bond trading desk at Salomon Brothers Inc., pled guilty to charges of submitting false bids in auctions of US Treasury securities. His superiors, including

111. Government civil complaints were made against two managing directors in *United States v. Barclay's Capital, Inc., et al.,* Civil Action 1:16-cv-7057 (E.D.N.Y. 2016), on December 22, 2016; and on September 11, 2017, against a managing director who was the head of subprime loan trading at Deutsche Bank. Complaint, *United States v. Paul Mangione.*

112. Griffin, "Ten Years of Evidence," 2.

113. *United States v. Michael R. Milken*, Criminal Action 89 cr 41 (S.D.N.Y. 1990); *In the Matter of Frederick H. Joseph*, 51 S.E.C. 431 (1993).

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the firm's CEO, president, and vice chair in charge of all fixed income trading, were sanctioned by the SEC because they knew of some of his violations and failed to stop him before he committed more of them.[114] The federal response to the fraud at savings and loan and banking institutions in the late 1980s yielded 5,506 convictions, including 411 chief executive officers, board chairs, and company presidents.[115] Prosecutions for accounting fraud following the dot-com failure of 2001 led to convictions of or sanctions against many senior executives of industrial firms. The government's success in these cases set expectations for similar results after 2008.

But the financial crisis cases on trial were not comparable. Apart from *Reserve Management*, the trials concerned conduct on trading floors and within middle management. In *Cioffi/Tannin*, *Stoker*, and *Tourre*, the government stressed the personal interest of the middle management defendants. In later years, middle management defendants settled DOJ civil complaints related to Barclay's and Deutschebank. There, the government's charges emphasized that the bulk of middle managers' compensation was tied to the short-term profit of their own business units and highlighted the practice of large producers jumping from one firm to another.[116] The government's arguments in the trials discussed in this article and the facts alleged in the Barclay's and Deutschebank related complaints suggest that the interests of middle management and more senior executives were not aligned. Twenty years earlier, firm structures were different. Though nominally a senior vice president, Milken was the most important person at his firm. Drexel Burnham Lambert CEO Frederick Joseph discussed transactions with Milken and then personally cleared several illegal ones that Milken sought for the account of the firm or investment partnerships controlled by Milken, his family, Drexel employees, and favored customers.[117] In 1991, Salomon CEO John Gutfreund was close to activity on the trading floor. After being apprised of irregular bids by the firm's head trader for government securities, the SEC concluded that he did little to prevent the trader from future violations.[118] Although compensation in financial enterprises has long been based on personal and business unit profitability, the increased proportion of income derived from bonuses and the diminished importance of ownership interests in firms weakened the incentive to avoid illegal conduct so as to protect the firm's longer-term franchise value.[119] The cases of the early 2000s concerned corporate accounting and disclosure decisions made in conspiracies of senior executives. In Enron, Andrew Fastow, the company's former chief financial officer, and Ben Glisan, its one-time treasurer, testified that they acted in concert with Enron chairman Ken Lay and CEO Jeffrey Skilling.[120] In the WorldCom case of

114. Margaret A. Jacobs and Michael Siconofli, "Mozer Sentenced to Four-Month Term for Role in Salomon Bidding Scandal," *The Wall Street Journal,* December 15, 1993, B2; *In the Matter of John H. Gutfreund, et al.*, 51 S.E.C. 93 (1992).

115. US Department of Justice, Special Counsel for Financial Institution Fraud, *Special Report*, 18–20.

116. Complaint, *United States v. Barclay's Capital, Inc., et. al.,* 95–98; Complaint, *United States v. Paul Mangione*, 15.

117. *In the Matter of Frederick H. Joseph,* 51 S.E.C. 431 (1993).

118. See *In Re Joseph.* For a vivid description of Gutfreund's personal management of the firm's trading, see Lewis, *Liar's Poker*,13–14.

119. Skinner, "Misconduct Risk," 1580–1581.

120. McLean and Elkind, *Smartest Guys in the Room*, 9831–9912; *United States v. Skilling,* 554 F.3d 529 (5th Cir. 2009).

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2002, the government's key witness was Scott Sullivan, the company's chief financial officer, who testified that he falsified records of the company's telephone line cost expenses to meet projected rates of revenue growth, and did so at the direction of CEO Bernard Ebbers.[121]

The savings and loan collapse bears many similarities to the financial crisis as both arose out of lending amid real estate bubbles. In the savings and loan prosecutions, however, the government did obtain convictions of senior executives. A Justice Department report summarizing its effort shows that its prosecutions against senior executives in what the government identified as its most important savings and loan cases—Charles H. Keating (Lincoln Savings), Donald Dixon (Vernon Savings and Loan), and David Paul (Centrust) —involved looting, self-dealing, and sham loans made by the defendants to enrich themselves.[122]

The differing organizational locus of the financial crisis cases made prosecutions of senior executives more difficult. As a part of his *Where's Waldo* defense, Stoker's lawyer emphasized that Stoker was seven reporting levels below Citigroup's CEO, an argument made not only to absolve Stoker but also suggesting that "senior executives do not even get involved in the design of potentially risky financial products, such as collateralized CDOs."[123] The top ten bank holding companies in the United States held inflation-adjusted assets that were thirteen times larger in 2020 than in 1970.[124] The distance between the CEO and the head of government bond trading at Salomon or between the CEO and the high-yield bond department at Drexel was relatively short, and although large, those enterprises were dwarfed in size by Citigroup and its peers. The changing organizational structures, responsibilities, incentives, and cultures are consistent with observations made by Morrison and Wilhelm and by Kaufman regarding the loss of institutional loyalty and cohesion within investment banks following their conversion from partnerships to public corporations and the subsequent consolidation of investment banks into larger and more complex businesses after the repeal of the Glass-Steagall Act.[125]

The *Stoker*, *Tourre*, and *Countrywide* cases also suggest that middle managers were financially incentivized to "phish," often learning from peers at other firms, such as hedge funds.[126] Except for the *Reserve Management* case, the financial crisis trials did not show management mandates from above. To be sure, senior managers should have been more skeptical about how

121. *United States v. Ebbers*, 458 F. 3d 110 (2d Cir. 2006). For a detailed discussion of the differences between the accounting fraud and the financial crisis cases, see Buell, *Capital Offenses.* See also US Department of Justice, Special Counsel for Financial Institution Fraud, *Special Report*, 29, 31–32, 34; Schwarcz, "Excessive Corporate Risk-taking," 544; Akerlof and Shiller, *Phishing for Phools.*

122. Department of Justice, Special Counsel for Financial Institution, *Special Report*, 29, 31–32, 34. I have relied on the *Special Report* because trial records for cases preceding 2000 are not online and are difficult to access. In addition, the few judicial decisions regarding these cases concern procedural issues and do not discuss the evidence presented at trial.

123. Schwarcz, "Excessive Corporate Risk-taking," 534.

124. Pollock, Hamandi, and Leung, "Banking Credit System, 1970–2020."

125. Morrison and Wilhelm, *Investment Banking*, 269–275, 281–284; Kaufman, *On Money and Markets,* 97-98.

126. Akerlof and Shiller, *Phishing for Phools.*

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and why the mortgage finance market generated such large profits, especially as housing prices approached unsustainable levels, but "there is no crime in American law of managing a corporation badly, no matter how serious the harm that results."[127] The financial crisis trials thus suggest that the consolidation of financial institutions into global megabanks with less institutional loyalty and many different lines of business came with a cost. Not only was it more difficult to locate responsibility but it also became more difficult to prosecute and thereby deter criminal economic behaviors.

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