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Deregulation of Wall Street Fuels Credit Crisis

By Michael Blatchley

The mortgage crisis has tightened its stranglehold on the global economy, decimating some of the most longstanding and venerated financial institutions in the United States within a matter of weeks. In response to this crisis, Congress passed an emergency bill representing one of the most drastic and expensive government bailouts in history. Whatever one's views on the merits of the plan, the commitment of $700 billion in taxpayer funds — representing approximately 6 percent of the current gross national product — is staggering by any measure. (In comparison, the government's bailout of the savings and loan institutions in the 1980s was only 3.7 percent of GDP.)

While it may be true, as the Federal Reserve Chairman noted in urging his colleagues to support the federal bailout, that "[t]here are no atheists in foxholes and no ideologues in financial crises," it is now clear that a particular ideology — and the policies it encouraged — played a significant role in bringing about the current economic crisis. For more than a decade, that philosophy — an unquestioned faith in the virtues of the free market and an unencumbered contempt for governmental regulation and private enforcement of legal rights — has been successfully championed by the engineers of this economic calamity and their allies in government. Even while the events of this past month have exposed the fundamental flaws of this approach, with some of the most ardent advocates of deregulation admitting a need for greater oversight, amazingly, certain proposals now receiving serious consideration by policymakers threaten to reintroduce elements of this now-discredited view.

The Collapse

Over the past several months, several former titans of Wall Street were either gobbled up by the government or allowed to fail under the crushing weight of the illiquid mortgage-related assets held on their balance sheets. The speed and severity of their collapse has been dizzying.

On September 7, 2008, the government took control of Freddie Mac and Fannie Mae, in an attempt to prevent the faltering mortgage market from grinding to a halt. While officials hoped that the federal rescue of Freddie Mac and Fannie Mae would calm a jittery market, mounting losses at financial institutions continued to halt the markets' desperate quest for capital and liquidity.

Less than a week later, on Monday, September 15, 2008, Lehman Brothers Holdings Inc. ("Lehman Brothers") — a bank founded before the Civil War and a survivor of the Great Depression — filed for bankruptcy, the largest in United States history. That same day, Merrill Lynch & Co., Inc. ("Merrill"), the venerated bull of Wall Street, barely escaped the same fate.

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CREDIT CRISIS

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After posting more than $40 billion in write-downs and credit losses over the past year, Merrill was scooped up by Bank of America at a 60 percent discount to its stock price.

The September 15 upheaval at Lehman Brothers and Merrill sent the markets into a tailspin, with the Dow Jones Industrial Average plunging 504 points that day, the largest decline since the terrorist attacks of 2001. By Wednesday, the Federal Reserve was rushing to put out the next fire. Although federal officials had spurned earlier requests by American International Group, Inc. ("AIG") for funding, the government now recognized that the collapse of world's largest insurer would have unknown ripple effects throughout the global economy, and stepped in to provide an $85 billion emergency loan in exchange for an 80 percent stake in the company.

On September 25, the Federal Deposit Insurance Commission ("FDIC") seized control of Washington Mutual ("WaMu") on the bank's 119th anniversary, placing the nation's largest savings and loan association into receivership. On September 29, the FDIC helped avert the collapse of Wachovia Corporation, formerly the nation's sixth-largest bank, by orchestrating the sale of its assets and liabilities, including its retail operations and banking units, to Citigroup, Inc. (By the end of the week, Wells Fargo announced a surprise deal to acquire the entire bank for seven times the amount Citigroup had offered.)

As these major financial firms scrambled for capital, investors remained unwilling to trust the valuations the banks assigned to their mortgage-related holdings, credit problems spread globally — banks hoarded cash and clamped down on lending, threatening to stifle consumer and business spending. This vicious cycle, Federal Reserve Chairman Bernanke warned Congress, is similar to that which triggered the Great Depression.

The Cause of the Crisis

As we now know, the wholesale adoption of unrealistically lax lending standards, an unfounded belief in the supposed miracles of mortgage securitization and an unchecked willingness to excessively leverage risky bets, not only jeopardized the interests of investors, but posed systemic risks to the entire economy.

As Wall Street and others saw that fees could be generated by pooling mortgages and repackaging them into mortgage-backed securities, banks began to relax their lending standards and make mortgage loans primarily to sell them on to other financial institutions. These securities could then be pooled again, new instruments would be created, and the same process would be replicated over and over. Emboldened by the rationale that the sale of these loans transferred risk off their balance sheets, banks then

Inside Look

The past few months have seen some of America's most esteemed financial institutions fail, become forcibly acquired or accept governmental regulation in exchange for their survival. Governments and central banks around the world are throwing well over one trillion dollars of taxpayer-derived capital into the international banking system, while the end of this financial crisis remains out of sight. This quarter, all eyes are on the financial sector and the *Advocate* sheds light on the causes of the largest credit crisis since 1929.

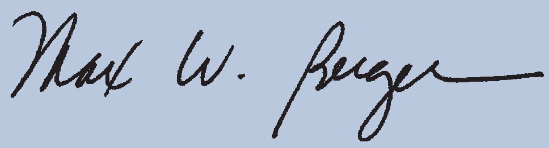
In "Deregulation on Wall Street Fuels Credit Crisis" (our cover story), firm associate Michael Blatchley provides a comprehensive look at how the behavior of an unchecked investment banking sector essentially triggered the collapse of the entire banking system.

The *Advocate* has continually highlighted the problems caused when government fails to protect investors. Equally important and entirely related — as we saw in the financial scandals earlier in the decade — is the need for government to protect whistleblowers in the public and private sectors. Firm associate Sean O'Dowd takes an insightful look at the increasing disregard the Department of Labor has exhibited towards whistleblowers in general, and how it directly relates to the financial crisis at hand.

Max Berger

I also direct your attention to the regular "Eye on the Issues" column. Firm associate Takeo Kellar provides a perceptive compilation of the most significant recent developments in securities litigation, regulation and corporate governance.

We trust that you will find this issue of the *Advocate* both informative and insightful. As always, we welcome your comments, questions and input.



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relaxed their underwriting standards in an effort to originate more loans to meet the Wall Street demand for securitized instruments — a process that created spillover effects and systemic risks that were woefully neglected by regulators.

While the ultimate fallout from this crisis is still unknown, the motive for such reckless risk-taking is clear: the securitization of the real estate bubble not only inflated asset prices, it also inflated profits and executive compensation. The Wall Street firms that presided over the lax lending standards and repackaging of toxic mortgage-related assets were beneficiaries of an enormous transfer of wealth, with the five major investment banks paying more than $3 billion in the last five years to their top executives.

Merrill Lynch paid its chief executive, Stanley O'Neal, who was ousted in November 2007 following the firm's announcement of $7.9 billion in write-downs, $172 million in executive compensation from 2003 to 2007. Before the Bank of America buyout, O'Neal's successor, John Thain, pocketed $86 million, having just begun work last December. Kerry Killinger, who acted as CEO of WaMu up until several weeks before its collapse, received $54 million over the past five years and is now entitled to a golden parachute valued at approximately $44 million. Killinger's successor, Alan Fishman, is slated to receive almost $20 million for the 17 days he spent on the job. Former Bear Stearns CEO James "Jimmy" Cayne made off with $161 million before his company was "sold" (with guarantees from the federal government) to JPMorgan Chase & Co. in June. Lehman Brothers, AIG, Fannie Mae and Freddie Mac — all reportedly under FBI investigation because of the mortgage crisis — paid their top executives a total of $1.4 billion in salaries, bonuses and stock-related pay from 2003 to 2007.

A Belated Acknowledgement

Seeing that the subsequent collapse of other major Wall Street institutions was further cutting off the flow of capital through the economy, Congress enacted a $700 billion taxpayer-funded proposal to buy distressed mortgage-related assets from these financial institutions — a plan intended to stem the cascade of financial institution failures and avert a slide into a severe recession. The law's supporters hope that removing these risky assets from the market and providing an injection of much needed capital will instill certainty and confidence into the markets and prompt banks to begin lending again.

While many disagree on the merits of the bailout law — whether the plan will achieve its purpose or what the ultimate cost to taxpayers might be — a consensus has emerged that a lack of regulation and government oversight laid the groundwork for the current crisis, enabling a powerful few on Wall Street to wreak havoc on the global economy.

Secretary Paulson recently stated that the past several weeks have demonstrated "in vivid terms that our financial regulatory structure is suboptimal, duplicative and out-dated" — quite a reversal from his statement in March of this year that he did not believe "it is fair or accurate to blame our regulatory structure on the current turmoil." Securities and Exchange Chairman ("SEC") Christopher Cox, reacting to a damning report by the SEC's inspector general detailing the agency's missteps in handling the Bear Stearns collapse, just last week admitted that the SEC's policy of ''voluntary regulation" of investment banks was a failure that contributed to the current crisis.

Ironically, many of those now calling for increased regulation are the same officials who only recently urged that such regulation was a source of weakness that threatened America's capital markets.

Just one year ago, Treasury Secretary Paulson sought a severe curtailment of investor rights, arguing that excessive litigation and regulation was threatening American "competitiveness." Secretary Paulson encouraged the Committee on Capital Markets Regulation, also known as the "Paulson Committee," which advocated relaxing numerous regulatory protections and weakening shareholder rights, an agenda premised on the notion that the threat of litigation decreased the competitiveness of the United States capital markets. While the Paulson Committee's assertions were dubious when made (at the time the Committee issued its Interim Report, the number of initial public offerings on U.S. exchanges had actually reached its highest level since 2000), the unfolding of the credit crisis reveals the extent to which they were flat-out dangerous.

The Paulson Committee report was but one of many efforts over the past decade by those opposed to strong protections for shareholders. Other successful initiatives, including Congress' enactment of the Private Securities Litigation Reform Act in 1995, which restricted the ability of investors to sue companies for misstatements and unrealistic projections, not only paved the way for the corporate misconduct exemplified in the Enron and WorldCom scandals, but also

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Eye on the Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Takeo Kellar

Regulators Ease Rules On Fair Value Accounting. The banking industry has taken advantage of the current financial crisis to push for a revision of certain critical accounting rules. Under pressure from the banking industry, trade groups and the Bush Administration, the Securities and Exchange Commission ("SEC") and the Financial Accounting Standards Board ("FASB") issued new accounting guidance that will allow banks and other companies to use more flexibility when valuing illiquid securities, such as subprime mortgage-backed securities. Specifically, the SEC and FASB issued "clarifications" to the existing accounting rules that require companies to value securities at the price for which they can be sold in the market, known as mark-to-market, or fair value accounting. Although the regulators did not completely suspend the fair value rules altogether, as bank lobbyists, trade groups and the Bush Administration have been calling for, the new guidance allows executives to use their own financial models and judgment if no market exists or if assets are being sold only at "fire-sale" prices. The new guidance, with its heavy reliance on executives' "judgment," is consistent with recent efforts to weaken U.S. accounting rules by shifting from more precise rules to more "principle-based" standards found in international accounting standards. The SEC, FASB, Federal Reserve Chairman Ben Bernanke and, notably, accounting firms, have objected to completely abolishing fair value accounting because it would make a company's position more difficult for investors to interpret and would likely postpone banks from taking their losses. *The Wall Street Journal, October 1, 2008; http://www.sec.gov/news/press/2008/2008-234.htm*

House Passes Bill Enhancing SEC Enforcement Powers. Prompted by the current turmoil in the U.S. capital markets, the U.S. House of Representatives passed a bill on September 11, 2008 aimed at increasing the SEC's enforcement powers and requiring increased attention to accounting and auditing matters. The Securities Act of 2008 (H.R. 6513), which has bipartisan support including that of House Financial Services Committee Chairman Barney Frank, incorporates recommendations made by the SEC to Congress. Key provisions include: (i) authorizing the SEC to assess and impose civil penalties in a cease and desist proceeding; (ii) creating three tiers of increasing civil penalties for acts or omissions of increasing gravity; and (iii) allowing nationwide service of subpoenas, without application to the court or a showing of cause, in any action instituted by the SEC. The bill requires the SEC, the Financial Accounting Standards Board and the Public Accounting Oversight Board to annually provide oral testimony to certain Congressional committees "to provide more accurate and clear financial information to investors." The testimony must include, among other topics, the reassessment of "complex and outdated accounting standards" and discussions promoting financial disclosures in "plain English." Following House approval, the bill was sent to the Senate and referred to the Committee on Banking, Housing, and Urban Affairs pending approval. *http://thomas.loc.gov/cgi-bin/bdquery/z?d110:HR6513:/*

New DOJ Guidelines On White-Collar Crime. In an effort to stave off legislation that would further restrain the Department of Justice's ("DOJ's") power in prosecuting corporate fraud, the DOJ voluntarily revised its internal charging guidelines for prosecuting white collar crime in August. The new guidelines, which took effect immediately, are intended to counter criticism from some judges and members of Congress that prosecutors have unfairly threatened criminal charges against companies to pressure them during investigations of company employees. Critics say the DOJ's tactics included pushing companies to disclose information normally protected by attorney-client privilege or to cut off legal fees for employees under federal investigation. Legislation to restrain the Department's use of attorney-client privileged information in prosecuting white-collar crime passed the House last year and is currently pending in the Senate. The DOJ opposes such legislation which would tie its hands as it works to fight corporate malfeasance and to protect the integrity of the markets. The changes were made after review within the DOJ and meeting with, among others, members of Congress and representatives of the criminal defense bar and civil liberties community, according to the DOJ. Among the new guidelines are restrictions preventing prosecutors from requesting disclosure of certain attorney-client privileged communications. Further, in evaluating a company's cooperation in the investigation, prosecutors are no longer permitted to consider whether a company is paying legal fees of the employee under investigation, or whether a company has entered into joint defense agreements with employees. *http://www.usdoj.gov/opa/pr/2008/August/08-odag-757.html*

SEC Sets Timeline For Pulling The Plug On U.S. Accounting Standards. The SEC announced in August a proposed roadmap that could lead to the use of International Financial Reporting Standards ("IFRS") by multinational American companies by 2014, at the expense of long established U.S. Generally Accepted Accounting Principles ("GAAP"). The SEC estimates at least 110 U.S. companies would qualify based on their market capitalization, among other factors. The SEC says the change will help the U.S. to compete globally because more than 100 countries — including all European Union nations — currently require or permit IFRS reporting. The current U.S. accounting system is based on detailed rules, while the international system expects companies to follow broad principles. Critics of the switch worry that the international standards offer too much "wiggle room" for companies, compared with the more precise U.S. accounting rules. The international standards are set by the International Accounting Standards Board ("IASB"), based in London, which is currently funded by companies and auditing firms. Finding an independent source of funding for the IASB is one of the conditions the SEC has set for the switch. The proposals will be open for public comment and could be finalized later this year. *http://www.sec.gov/news/press/2008/2008-184.htm*

FBI Official Predicted Threat Of Mortgage Crisis. Long before the current subprime mortgage meltdown, a top FBI official reportedly warned of widening loan fraud in 2004 due to the booming mortgage business fueled by low interest rates and soaring home values. The FBI official in charge of criminal investigations told reporters in September 2004 that "It has the potential to be an epidemic." But, he reassuringly added, "We [the FBI] think we can prevent a problem that could have as much impact as the S&L crisis." Few would disagree that the current global financial crisis has more than exceeded that of the savings-and-loan bailouts of the 1980s and early 1990s. It has been reported that, according to sources in the FBI, despite requests by FBI criminal investigators for more resources to take on the mortgage fraud, the investigators ended up with fewer resources. In 2007, the number of agents pursuing mortgage fraud reportedly shrank to around 100. By comparison, the FBI reportedly had about 1,000 agents deployed on banking fraud during the S&L crash. The FBI says it now has about 200 agents working on mortgage fraud, but some say the agency might have averted much of the problem had it heeded its own warning. *Los Angeles Times, August 25, 2008*

SEC Charges Brokers In Billion Dollar Subprime Auction Rate Securities Fraud. The SEC charged two Wall Street brokers, who were employed at Credit Suisse Securities (USA) LLC, with defrauding their customers when making more than $1 billion in unauthorized purchases of subprime-related auction rate securities. The SEC alleges the brokers misled customers into believing that auction rate securities being purchased in their accounts were backed by federally guaranteed student loans, and were a safe and liquid alternative to bank deposits or money market funds. Instead, the securities that the brokers purchased for their customers were backed by subprime mortgages, collateralized debt obligations and other non-student loan collateral. The complaint alleges that customers were stuck holding more than $800 million in illiquid securities after auction rate securities began to fail in August 2007. The Commission seeks permanent injunctive relief, disgorgement of ill-gotten gains, if any, plus prejudgment interest on a joint and several basis, and civil money penalties. *http://www.sec.gov/news/press/2008/2008-187.htm*

Government Accountability Office Warns Of Need For Improved Oversight At Pension Guarantor. The U.S. Government Accountability Office ("GAO"), known as "the investigative arm of Congress," recently released a report on the financial and management challenges facing the Pension Benefit Guaranty Corporation ("PBGC"), a federal corporation that insures the pension benefits of 44 million private sector workers and retirees. It is governed by a three-member board made up of the Secretaries of Treasury, Labor and Commerce. A seven-member, presidentially appointed advisory committee represents the interests of pension holders and the general public. In July 2007, the GAO reported to Congress that the PBGC's governance structure and corporate bylaws needed improvements and made recommendations to improve oversight. In the recent report following up on those recommendations, the GAO found that although the PBGC's board has strengthened its governing bylaws, it is still limited in its ability to provide policy direction and oversight to the PBGC. Because of the board's small size, the board has not been able to develop procedures and mechanisms to monitor PBGC's operations. While improvement still is needed, the GAO did commend the PBGC for revising its bylaws to define the roles and responsibilities of its board members more clearly. *CFO.com, September 12, 2008; http://www.gao.gov*

PCAOB Inspections Reveal Flaws In Audits. The Public Company Accounting Oversight Board ("PCAOB") recently released its annual evaluations of two of the "Big Four" auditing firms, PricewaterhouseCoopers ("PwC") and KPMG. The PCAOB is required to conduct an annual inspection of each registered public accounting firm that regularly provides audit reports for more than 100 clients. The PCAOB criticized PwC for various "deficiencies" that included failing to get enough information to support its opinions about the financial statements of some of its clients. The PCAOB found that PwC sometimes failed to identify or appropriately address errors in the client's application of GAAP and failed to perform, or to perform sufficiently, certain necessary audit procedures. The PCAOB also found that PwC sometimes failed to properly document its work in violation of Auditing Standards. As for KPMG, the PCAOB found that the auditors failed to do the proper evaluations and testing procedures to back up its assessments of 10 clients. For example, the PCAOB reports that KPMG failed to test the accuracy of the loan delinquency data and borrower credit score ranges that a client had used to estimate its allowance for loan losses; failed to sufficiently test its client's valuation of "hard to price" securities; and failed to gather sufficient evidence that revenue involving licensing agreements was not recognized prematurely. *http://www.pcaobus.org/Inspections/Public_Reports/2008/KPMG_LLP.pdf;http://www.pcaobus.org/Inspections/Public_Reports/2008/PricewaterhouseCoopers-0627.pdf*

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Whistleblowers Under Seige

By Sean O'Dowd

In 2002, in the wake of the Enron and WorldCom scandals and the intelligence failures of September 11, 2001, *Time* Magazine selected as "Persons of the Year" three women who had blown the whistle on misconduct at Enron, WorldCom, and the FBI. That same year, Congress acknowledged the critical role whistleblowers play in preventing corporate fraud by including whistleblower protections for insiders who reported corporate fraud in the Sarbanes-Oxley Corporate Reform Act of 2002 ("SOX"). Unfortunately, the administration and some courts have recently taken steps to weaken SOX and other protections for citizens who expose corruption and fraud.

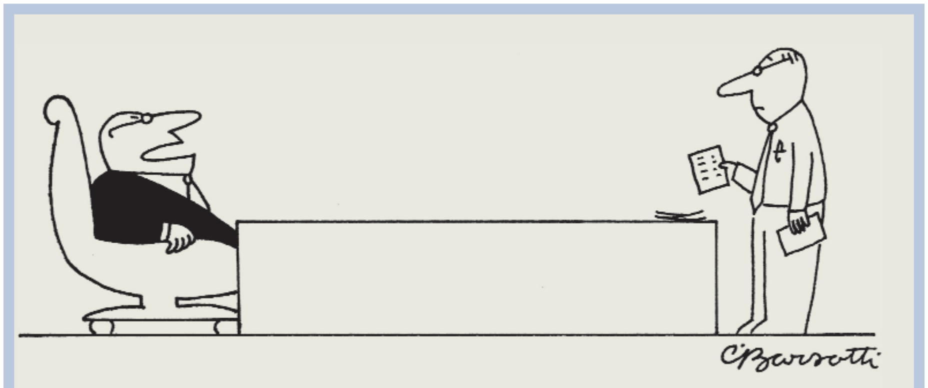
SOX includes a clear and comprehensive provision designed to protect all employees of publicly traded companies who report fraud at their employers. Specifically, SOX creates civil and criminal penalties for public companies and any officers, employees, contractors, subcontractors, or agents who "discharge, demote, suspend, threaten, harass or in any other manner discriminate against" whistleblowers. Under the law, employees who suffer illegal retaliation are empowered to seek relief from administrative law judges operating under the Department of Labor.

The Labor Department has interpreted the Sarbanes-Oxley whistleblower provision so narrowly as to render it toothless. The agency has only ruled in favor of whistleblowers 17 times out of 1,273 complaints filed with the Labor Department. The Department dismissed a staggering 841 of the filed cases with the remainder withdrawn, settled, or awaiting resolution.

Whistleblower protections under attack

Despite the intent behind SOX, a September 4, 2008 report in *The Wall Street Journal* shows that the Labor Department has interpreted the SOX whistleblower provision so narrowly as to render it toothless. The current administration has been using a distorted reading of the statute and limited the protection to employees of parent corporations while leaving employees at subsidiaries unprotected. The agency has only ruled in favor of whistleblowers 17 times out of 1,273 complaints filed with the Labor Department. The Department dismissed a staggering 841 of the filed cases with the remainder withdrawn, settled, or awaiting resolution.

This is not what was intended by SOX. The bipartisan authors of the whistleblower provision, Senators Charles E. Grassley and Patrick Leahy, immediately expressed their "dismay" at the Labor Department's tortured reading of the law, and noted that the agency's interpretation violates the "spirit and goals" of SOX. As Senator Leahy pointed out to the *Journal*, the provision was clearly intended to apply to corporate subsidiaries because, "[o]therwise, a company that wants to do something shady could just do it in their subsidiary." Indeed, the Enron scandal was based on a series of frauds occurring in corporate subsidiaries and sham sub-entities. Speaking to the *Journal*, the legal director of the Government Accountability Project, a nonprofit group that promotes whistleblower rights, called the department's stance "dysfunctional," saying: "This one is a no-brainer. There is nothing in the law that allows for that type of loophole." So far, despite the outcry from the Act's authors and others, the Labor Department has stood behind its narrow interpretation.



"Well, get some new numbers or I'm getting a new numbers guy."

The gutting of the SOX whistleblower provision comes on the heels of a challenging two years for whistleblowers generally. In the public sector, individuals reporting fraud against the government have been blocked from pursuing their cases by the U.S. Department of Justice

("DOJ"). For example, in September 2008, news emerged that senior Justice Department officials had prevented the United States Attorney for Colorado from supporting a whistleblower's action against oil company Kerr-McGee Corporation. This case, which would have been brought by the whistleblower as a *qui tam* action on behalf of the United States, could have recovered as much as $40 million for the federal government.

Public sector employees also have an abysmal record in proceedings before the administrative board that hears their cases under the Whistleblower Protection Act of 1989, with a 2-53 win-loss record on final decisions under the current Chair. And, in 2006, the U.S. Supreme Court issued a major setback to government employees who expose misconduct in *Garcetti v. Ceballos*. That case held that the Whistleblower Protection Act does not protect public officials who make statements in their capacity as public employees, rather than as public citizens.

Some courts have also expressed hostility to whistleblowers in the context of securities class action litigation. Many securities fraud cases are supported by statements of confidential witnesses, who are generally former employees of the defendant corporation. Until recently, keeping the identities of insider witnesses confidential until discovery had been a time-honored practice that allowed plaintiffs to draft complaints with the high degree of specificity required by courts. However, several recent decisions cast doubt on the willingness of courts to consider confidential witness testimony — even at the pleading stage. In his July 2007 opinion in *Higginbotham v. Baxter International, Inc.*, Judge Frank Easterbrook of the United States Court of Appeals for the Seventh Circuit held that the exacting pleading requirements in securities fraud cases require courts to "discount" the testimony of confidential witnesses. The court emphasized that "[u]sually that discount will be steep." Fortunately, Judge Richard Posner moderated his colleague's holding in a January 2008 decision, *Makor Issues & Rights, Ltd. v. Tellabs Inc.* Judge Posner explained that "the absence of proper names does not invalidate the drawing of a strong inference from informants' assertions." Nevertheless, these decisions and others suggest that corporate fraud cases that depend on confidential witnesses may also face challenges ahead.

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Quarterly Quote...

Most of the mistakes for which we are paying now were made "by four entities that under conservative economic theory should have exercised effective market discipline — the appraisers, the originators of the mortgages, the rating agencies, and the investment banking firms that packaged the subprime mortgage-backed securities." Instead of "disciplining" the markets, these private actors "served as the four horsemen of the financial apocalypse, aiding the accounting fraud and inflating the housing bubble." It is they who "turned a crisis into a catastrophe."

Professor William Black, a professor of economics and law at the University of Missouri-Kansas City, as quoted in *The Wall Street Journal,* October 1, 2008

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Bad timing

The erosion of whistleblower protections is always troubling, but the timing of these developments could not be worse. In recent months, a flood of reports has demonstrated the critical importance of citizen informants. Many of these reports involved government and corporate insiders exposing serious fraud, resulting in huge savings for the public. For example, a recent review by the DOJ showed that whistleblowers have helped the government reclaim at least $9.3 billion lost to health-care fraud since 1995. In fact, *The Wall Street Journal* reported that 90% of DOJ's health-care fraud lawsuits are now initiated by private citizen whistleblowers. Insider complaints also led to a Department of the Interior report that uncovered a wide-ranging "culture of ethical failure." That investigation revealed industry contacts who exercised improper influence over lucrative contracts and a "culture of substance abuse and promiscuity" that undermined arm's length negotiations. Finally, many of the most significant active corporate fraud cases, including the securities class action litigation against Washington Mutual, are supported by allegations from confidential witnesses.

And, of course, September 2008 also saw an enormous financial crisis in which insider testimony might have prevented huge losses to the public. In the days and weeks since Bear Stearns, Lehman Brothers, and, most recently, Washington Mutual collapsed, the country has already witnessed a profound reshaping of the United States financial system, and there is little doubt that working class Americans will face substantial economic pain. At the root of the crisis are mortgages sold with faulty lending criteria and then repeatedly bundled and resold by leading financial institutions. It is now indisputable that many of these complex mortgage-backed instruments were packaged fraudulently or were subject to inadequate risk disclosures. Even before the crisis broke, the companies at the center of the turmoil were the target of active fraud investigations and prosecutions. One cannot help but wonder if more robust protections for employees could have inspired corporate insiders to expose the bad practices earlier, staving off or mitigating the crisis. Perhaps the attacks on SOX and other whistleblower protections help explain why more insiders did not emerge.

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helped foster the excessive risk-taking that led to the current crisis. Having gained political power, like-minded deregulatory advocates were entrusted with overseeing the very institutions they believed were standing in the way of America's competitiveness, leading to complacency, disinterest and an unwillingness to enforce the regulatory protections that a healthy economic system depends on.

The last several weeks have made one thing painfully clear: Shareholder litigation and governmental regulation do not harm American competitiveness and did not cause the current crisis — they are the means by which we ensure the honesty, transparency and accountability that are integral to properly functioning capital markets.

As explained by Nobel Prize-winning economist Edmund Phelps in a recent editorial: "What has occurred is not just an old-fashioned banking crisis but also a banking scandal. Most of the big banks were shot through with short-termism, deceptive practices and self-dealing. We must institute basic changes in corporate governance and in management practice to restore responsibility and honesty for the sake of the economy and for the self-respect of the country."

In order to restore such honesty and responsibility, we need the tools to hold those who would betray these ideals accountable, and the willingness to use them.

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