

## CHAIRMAN'S CORNER

by James A. Kaplan



### ***Don't Believe Everything You're Told!!***

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"If only I had known, I would never have bought it."

That lament was uttered by a pension fund manager after the Enron collapse. I co-founded Audit Integrity in 2002 immediately following the Enron debacle.

The mission of Audit Integrity was, and remains, to apply forensic analysis to differentiate between risky and trustworthy behavior, and to ferret out corporate malfeasance and fraud. Fraudulent acts are rarely detected by other means, since great pains are taken to mask them.

Major academic studies<sup>1</sup> posted on Audit Integrity's website have shown that the forensic approach has proven very valuable in uncovering both fraud and malfeasance. Our Accounting & Governance Risk rating (AGR<sup>®</sup>) has been available to financial professionals since 2003. This tool is widely used by D&O insurers, government agencies, auditors and institutional investors. Unfortunately, it is only used selectively by very sophisticated pension plans – the very people we formed Audit Integrity to protect.

Of all parties injured in the events of the past year, the most heart-wrenching are employees whose life savings disappeared as they approached retirement, but the vast majority of the 1,000 largest U.S. retirement plans, representing assets of \$6.08 trillion<sup>2</sup>, have elected to be relatively passive with regard to risk management.

Although no fraudulent CEO is going to hand us his "smoking gun," few plans have taken an active role in safeguarding the investors they represent by examining the transparency and governance of companies in which they place their assets. This passivity has been motivated by the fact that the investment expertise required to manage assets is prohibitively costly. Plan administrators believe they can avoid those costs by relying on government agencies and other objective entities to protect their interests in respect to fraud and malfeasance.

While I am in no position to argue the cost side of that equation, overwhelming evidence shows that government agencies have failed to protect investors from corporate fraud. Consider the negligence of the SEC and the primary government-approved rating agencies -- Standard & Poor's and Moody's Investors Service -- in fulfilling their mandate to protect investors' interests by providing objective analysis.

In order to illustrate the problem, I have taken the liberty of focusing on two particularly damaging events. It is alarming to consider that I had many examples to choose from.

The first is the Madoff Ponzi scheme and the SEC investigations that preceded its discovery. I quote literally from the report by the SEC Office of Investigations<sup>3</sup>:

<sup>1</sup> <http://www.auditintegrity.com/publications.html#b302>

<sup>2</sup> "Top 1,000 funds' asset decline slows," Robert Stever, *Pensions & Investments*, March 19, 2010

<sup>3</sup> "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme – Public Version," U.S. Securities and Exchange Commission Report No. OIG-509, August 31, 2009

*“... the SEC conducted two investigations and three examinations related to Madoff’s investment advisory business based upon the detailed and credible complaints that raised the possibility that Madoff was misrepresenting his trading and could have been operating a Ponzi scheme. Yet, at no time did the SEC ever verify Madoff’s trading through an independent third-party, and in fact, never actually conducted a Ponzi scheme examination or investigation of Madoff... the examination teams discovered suspicious information and evidence and caught Madoff in contradictions and inconsistencies. However, they either disregarded these concerns or simply asked Madoff about them. Even when Madoff’s answers were seemingly implausible, the SEC examiners accepted them at face value.”*

Whether the actions of the SEC examiners were tainted by Madoff’s standing in the community is moot. The examiners accepted the criminal’s verification of his own data and sought no corroboration. The best we can say for the SEC as an agency for the protection of investors in this instance is that they are complete bunglers.

Let’s now turn to the government-appointed credit rating agencies. It is generally acknowledged that their fee structure presents a conflict of interest. They are compensated by the very companies they rate. Wouldn’t any reasonable person assume that these ratings should be verified before being acted upon?

Connecticut Attorney General Richard Blumenthal sued Moody’s and Standard & Poor’s “for knowingly assigning tainted credit ratings to risky investments backed by sub-prime loans.” The Attorney General’s press release<sup>4</sup> states:

*“Despite repeated statements emphasizing their independence and objectivity when rating structured finance securities, Moody’s and S&P knowingly failed to live up to their representations. In particular, their ratings on structured finance securities were tainted by their desire to earn lucrative fees*

*“Moody’s and S&P knowingly catered to the demands of investment banks and other large issuers of structured finance securities in order to increase their own revenues. As a result, many structured finance securities that contained a great deal of credit risk undeservedly received Moody’s and S&P’s highest ratings, Blumenthal alleges.*

*“These credit rating agencies gave the best ratings money could buy – catering to their powerful investment bank clients, rather than objectively rating risky bonds,” Blumenthal said. ‘Countless investors and others – including individuals, banks, mutual funds, insurance companies, hedge funds and pension funds – were misled into believing that these credit ratings were independent and objective, and lost money on investments they might have avoided if told the truth.*

*“Moody’s and S&P violated public trust – resulting in many investors purchasing securities that contained far more risk than anticipated and that have ultimately proven to be nearly worthless.”*

Moody’s and Standard&Poor’s lack of independence serves corporate America all too well, contrary to their mandate of providing objective third-party reporting. Corporate management is notorious for spreading false information, and without the cross-check we expect from rating agencies, investors don’t stand a chance. Take a look at the claim filed by the State of New Jersey in its suit against Lehman Brothers for consciously deceiving investors<sup>5</sup>:

*“New Jersey sued top executives and board members at Lehman Brothers... charging that they misled officials into buying company stock that eventually lost the state pension system \$118 million when the financial services firm went bankrupt last year.*

*“Lehman’s executives kept telling investors its financial position was solid when, in fact, the opposite was true,” state Attorney General Anne Milgram said in a statement. ‘The state bought and held Lehman securities at artificially inflated prices and lost millions, which we seek to recover with this suit.’”*

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<sup>4</sup> “Attorney General Sues Credit Agencies for Tainted Ratings That Enabled Financial Meltdown,” Connecticut Attorney General’s Office Press Release, March 10, 2010

<sup>5</sup> “N.J. suing Lehman Brothers for \$118M in lost pensions,” David Giambusso, *The Star-Ledger*, March 17, 2009

Eight years after the collapse of Enron I unfortunately continue to hear the laments of pension plan participants who have suffered from the lack of due diligence by plan managers. How many more hundreds of billions of dollars of pensioners' money is going to be lost before pension fiduciaries wake up to the preponderance of evidence that agencies cannot be relied upon to safeguard the markets, and accept both the authority and the responsibility for protecting the assets entrusted to them?

In 2002 I believed the availability of forensic analytical tools would make the world safe for investors. That has not yet happened, and investors continue to suffer severe losses from unforeseen events. The complicity and/or ineptness of regulatory agencies only compounds the danger.

While I am hopeful, and I believe that government agencies, particularly the SEC, are returning to their charter of protecting investors, this reform may be slow in coming. I challenge our great U.S. pension plan system to verify the trustworthiness of investments they select and not rely on what they are told.

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