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EXPERT ANALYSIS

Corporate Governance in The Trump Era: A Note of Caution

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The past decade or so has been a challenging time for publicly held companies, particularly those in the financial sector. Since 2008, banks and financial services firms have been the subject of an aggressive effort by the U.S. government to crack down on those seen as associated with the market crash of 2008 and the subprime mortgage crisis.

Public reports suggest that, as of this time last year, America's largest banks had paid fines totaling upward of \$110 billion in connection with the mortgage crisis.¹ That staggering total includes settlements between nine of the largest global banks and the Justice Department's Residential Mortgage-Backed Securities Working Group totaling more than \$43 billion in cash penalties and consumer relief.²

Further, the number of investigations and civil and criminal prosecutions for violations of the Foreign Corrupt Practices Act, and the penalties associated with those prosecutions, seem to have spiked in the wake of 2008.

CHANGING 'A HORRIBLE LAW'?

Following the election last November, one could almost hear the collective sighs of relief coming from Wall Street and boardrooms across America. That sense of relief was, in certain respects, predictable.

It is unlikely that the Justice Department or the Securities and Exchange Commission will continue to demand the record-setting penalties and disgorgement figures characteristic of the past few years.

And we may well see a significant shift in the prosecutorial priorities of law enforcement, which could lead to a decline in FCPA investigations. Indeed, in a 2012 interview, future President Donald Trump stated that the U.S. approach to FCPA enforcement was "absolutely crazy" and that it is a "horrible law and it should be changed."³

For his part, Jay Clayton, Trump's nominee for chairman of the SEC, had previously signed on to a paper, while in private practice, opining on the costs that the U.S. government's approach to FCPA enforcement places on companies.

More recently, however, he forcefully stated his position that "[b]ribery and corruption have no place in society [and] combating corruption is an important governmental mission."⁴ Likewise, a closure may well be at hand to the extended effort to punish institutions that the government deemed contributors to the 2008 financial catastrophes.



Following the election last November, one could almost hear the collective sighs of relief coming from Wall Street and boardrooms across America.

However, caution is warranted in both the C-suite and the boardroom. The expectation that the regulatory and law enforcement climate will loosen and the sense of relief in corporate America must be tempered.

While enforcement efforts may decline somewhat, the governance and oversight duties of board members — along with the board's overarching responsibility for the "tone at the top" — remain unchanged.

And history teaches us that the cyclical swings in market oversight and law enforcement priorities that are often associated with elections (and with the ensuing market exuberance) can set the stage for corporate behavior that crosses the line into corporate misconduct.

Such misconduct could add to the escalating distrust of corporate America that has typified the past decade. We then might expect an aggressive law enforcement and regulatory reaction to follow.

THE 1980S

Perhaps the best historical analogy is the insider trading and savings and loan scandals that rocked our markets in the 1980s. After the election of President Ronald Reagan, John S.R. Shad was appointed as chairman of the SEC.

Shad, the former vice chair of E.F. Hutton, had a decidedly deregulatory philosophy. His appointment came amidst the historically most active merger and acquisition period in the U.S. markets. It also coincided with the tail end of the SEC's foreign payments program, which led to the passage in 1977 of the Foreign Corrupt Practices Act.

Under Shad, and as a result of Reagan's budget cuts, the staff ranks at the SEC shrank considerably as the chairman proudly proclaimed that the agency could do "more with less."⁵

Meanwhile, in the merger and acquisition frenzy, small fortunes were made by those trading in advance of the public announcement of proposed corporate deals, both friendly and hostile. The deregulatory climate soon took an unanticipated turn.

INSIDER TRADING

The SEC staff, which labored with the rudimentary investigative tools of the time, began investigating increasingly more cases of suspicious trading. Staffers examined the flow of information, the identities of those privy to the deals, and the question of any "duty" that may have been breached by inappropriate "tips."

It is safe to say, in hindsight, that the traders under scrutiny mistakenly assumed that the gumshoes were inept or the trail was too obscure — or both — for the SEC to catch them.

That was until Dennis Levine, a young investment banker at Drexel Burnham Lambert, was undone by a handful of dogged SEC lawyers who counted on, in addition to their hard work, a few lucky breaks to make their case.

In May 1986, the SEC accused Levine, who by the age of 33 had worked for a series of investment houses, of making \$12.6 million through illegal trading on inside information since 1980.⁶

The agency charged Levine with making the trades based on his knowledge of the pending corporate deals and depositing the profits into a Bahamian account of a Swiss bank.⁷

Just a month later, Levine pleaded guilty to tax evasion, perjury and securities fraud, and settled with the SEC in what was then the largest insider trading case in history by agreeing to disgorge more than \$11.5 million in illicit profits.⁸ More importantly, Levine agreed to cooperate.⁹

TIP OF THE ICEBERG

Levine, as it turned out, was just the tip of the iceberg. He had exchanged confidential information with former investment bankers, and he further implicated Ivan F. Boesky, a prominent market speculator with his own arbitrage firm.¹⁰

In turn, Boesky settled civil insider trading charges, paying \$100 million, and pleaded guilty to conspiring to file false stock trading records.¹¹ Like Levine, Boesky cooperated and implicated numerous others.¹²

In the end, the Levine scandal revealed a sprawling web of individual and institutional misdeeds, resulting in multiple criminal charges, guilty pleas and record-setting fines.¹³

It's no surprise that amid this turmoil Congress' attention turned toward bolstering the SEC's enforcement weapons by passing legislation designed to curb insider trading.

Among other things, the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264, provided the commission with the authority to seek civil penalties up to three times the profit gained or loss avoided in insider trading cases.

Four years later, Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, which validated the misappropriation theory of insider trading, clarified the civil penalty authority, and expanded fines to cover control persons of regulated securities firms who fail to take adequate steps to prevent insider trading.

This legislation also heightened criminal penalties for violation of the Securities Exchange Act of 1934.

THE SAVINGS AND LOAN SCANDAL

The other deregulatory debacle of the 1980s involved the thrift industry. When rising interest rates and increased competition threatened the solvency of the savings and loan industry, the perceived solution was in the deregulation push of the time.

As recounted in the governmental report on the events, the industry's authority to expand its investment portfolio and take on more and riskier liabilities was expanded.¹⁴

The report recounted that there were "[s]ubstantial reductions in supervision and examination [which] occurred at the federal level, and regulation and examination were virtually eliminated in several states," "[n]et worth requirements were effectively eliminated," and "[a]ccounting procedures permitted by regulators made it difficult to detect misuses of resources."

These policies, the report noted, "created powerful incentives and opportunities for insolvent and weakly capitalized S&Ls to use insured deposits to grow rapidly and engage in speculative, imprudent, and sometimes fraudulent activities."

Indeed, the report found that "[i]n the typical large failure, every accounting trick available was used to make the institution look profitable, safe, and solvent," and "[e]vidence of fraud was invariably present as was the ability of the operators to 'milk' the organization through high dividends and salaries, bonuses, perks, and other means."

All told, while estimates vary, the savings and loan crisis shuttered more than 1,000 institutions and resulted in more than 1,000 criminal convictions of individuals.¹⁵

And, like clockwork, in 1989, a heightened focus on oversight and enforcement followed with the passage of the Financial Institutions Reform, Recovery and Enforcement Act, Pub. L. No. 101-73, 103 Stat. 183, which transferred regulatory authority from the Federal Home Loan Bank Board to the Office of Thrift Supervision.

Shortly thereafter, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act, Pub. L. No. 101-429, 104 Stat. 931, the first legislation empowering the SEC to levy financial penalties for any and all violations of the federal securities laws.

LESSONS LEARNED

To be sure, there is currently a sense in the C-suites across America that it's a new day and a new climate, and that may well be the case. Many executives may believe that the aggressive enforcement agendas of the SEC and DOJ over the past decade have been bad for business.

Perhaps the best historical analogy is the insider trading and savings and loan scandals that rocked our markets in the 1980s.

“Do nothing you would not be happy to have an unfriendly but intelligent reporter write about on the front page of a newspaper,” Warren Buffett said.

Regardless of where one comes down on that assessment, however, any sense that a change in the regulatory climate means that the rules do not apply or that enforcement of accounting, disclosure and other fiduciary-like obligations is a relic is dangerous.

It is worth keeping in mind not only the fallout from the market abuses of the 1980s, but also the perceived excesses we saw during the Tyco, Adelphia, Enron and WorldCom era. These accounting scandals, the excessive corporate perks and the governance lapses that were characteristic of this time period were followed in 2002 by the passage of Sarbanes Oxley.

‘WITHIN THE WHITE LINES’

In short, sound corporate governance remains essential and directors should keep their antennas sensitive to ensuring that corporate behavior stays well “within the white lines.”

Warren Buffett applies what he calls the “New York Times Test” to the behavior of corporate employees: “Do nothing you would not be happy to have an unfriendly but intelligent reporter write about on the front page of a newspaper.”¹⁶

While this is a simplified articulation of a standard to apply to a myriad of complicated businesses and human interactions, it is also a straightforward and valuable maxim for corporate oversight.

Now, perhaps more than ever, when the trend indeed may be toward a more deregulatory climate, board members and senior executives bear a heightened responsibility to set the appropriate tone at the top, to set the right example, and to enforce sound standards for employee behavior.

Any significant or widespread departure from good corporate governance will most surely lead to a scandal or to a series of corporate missteps that will create the climate for an even more aggressive regulatory and law enforcement response.

Directors and those in the C-suites of corporate America should take extra care to ensure that the optimism over what is expected to be a more lenient regulatory climate does not erode the discipline required for sound corporate governance.

NOTES

¹ See Christina Rexrode & Emily Glazer, *Big Banks Paid \$110 Billion in Mortgage-Related Fines. Where did the Money Go?*, WALL ST. J., Mar. 9, 2016, <http://on.wsj.com/2oR9NgH>.

² To date, the Justice Department has entered into RMBS-related settlements with JPMorgan (2013), Citigroup (2014), Bank of America (2014), Morgan Stanley (2016), Goldman Sachs (2016), Ally Financial (2016), Deutsche Bank (2017), Credit Suisse (2017) and Societe Generale (2017).

³ See *Trump: Dimon’s Woes & Zuckerberg’s Prenuptial*, CNBC, May 15, 2012, Minutes 14-15:40, <http://cnb.cx/2nU1mwj>.

⁴ See Comm. on Int’l Bus. Transactions, Ass’n of the Bar of the City of New York, *The FCPA and its Impact on International Business Transactions — Should Anything Be Done to Minimize the Consequences of the U.S.’s Unique Position on Combating Offshore Corruption?* (December 2011), <http://bit.ly/2iNzjQM>; Jay Clayton, Responses to Questions for the Nomination of Mr. Jay Clayton to be a Member of the Securities and Exchange Commission, from Ranking Member Sherrod Brown, 9 (Mar. 23, 2017) (emphasizing the need for a similar commitment to anti-corruption enforcement from “non-U.S. authorities” and coordination among U.S. and foreign authorities).

⁵ See Nancy L. Ross, *Shad: SEC is Doing More, With Less*, WASH. POST, Feb. 8, 1983, <http://wapo.st/2nxvfau>.

⁶ See Steve Coll, *The Puzzling Wall Street Saga of Dennis Levine*, WASH. POST, May 22, 1986, <http://wapo.st/2nZYlpD>.

⁷ See *id.*

⁸ See Michael A. Hiltzik, *Levine Guilty of Fraud, Perjury and Tax Evasion: Investment Banker Agrees to Give Up \$11.5 Million of Illicit Insider Profits*, L.A. TIMES, June 6, 1986, <http://lat.ms/2oXliBl>.

⁹ See *id.*

¹⁰ See James Sterngold, *Boesky Sentenced to 3 Years in Jail in Insider Scandal*, N.Y. TIMES, Dec. 19, 1987, <http://nyti.ms/2hIEmyY>; *Highlights of the Wall Street Scandal; From Levine Arrest to Drexel Settlement*, N.Y. TIMES, Dec. 22, 1988, <http://nyti.ms/2nU5Nr0>.

¹¹ See Sterngold, *supra* note 10.

¹² See *Highlights of the Wall Street Scandal*, *supra* note 10.

¹³ See *id.*

¹⁴ Nat'l Comm'n on Fin. Inst. Reform, Recovery and Enforcement, *Origins and Causes of the S&L Debacle: A Blueprint for Reform: A Report to the President and Congress of the United States*, 1-2 (July 1993).

¹⁵ See Jean Eaglesham, *U.S. Sets 50 Bank Probes*, WALL ST. J., Nov. 17, 2010, <http://on.wsj.com/2opNBjG> (estimating that the S&L crisis closed more than 1,800 institutions and resulted in over 1,000 individuals going to prison); see also Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13(2) FDIC BANKING REVIEW 26, 33 (Fall 2000) (reporting that 1,043 institutions failed from 1986-1995), <http://bit.ly/1PROlyK>; *Two Financial Crises Compared: The Savings and Loan Debacle and the Mortgage Mess*, N.Y. TIMES, Apr. 13, 2011, <http://nyti.ms/2eSPCG2> (reporting 1,100 criminal prosecutions of individuals and 747 failed institutions by 1992).

¹⁶ See Lawrence A. Cunningham, *The Philosophy of Warren E. Buffet*, N.Y. TIMES, May 1, 2015, <http://nyti.ms/2oYjYNm>.



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