

# BRING TRANSPARENCY TO OFF-BALANCE SHEET ACCOUNTING

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Abusive off-balance sheet accounting was a major cause of the financial crisis. These abuses triggered a daisy chain of dysfunctional decision-making by removing transparency from investors, markets, and regulators. Off-balance sheet accounting facilitated the spread of the bad loans, securitizations, and derivative transactions that brought the financial system to the brink of collapse.

As in the 1920s, the balance sheets of major corporations recently failed to provide a clear picture of the financial health of those entities. Banks in particular have become predisposed to narrow the size of their balance sheets, because investors and regulators use the balance sheet as an anchor in their assessment of risk. Banks use financial engineering to make it appear they are better capitalized and less risky than they really are. Most people and businesses include all of their assets and liabilities on their balance sheets. But large financial institutions do not.

Off-balance sheet problems have recurred throughout history, with a similar progression. Initially, balance sheets are relatively transparent and off-balance sheet liabilities are minimal or zero. Then, market participants argue that certain items should be excluded as off-balance sheet. Complex institutions increase their use of off-shore subsidiaries and swap transactions to avoid disclosing liabilities, as they did during both the 1920s and the 2000s. Over time, the exceptions eat away at the foundations of financial statements, and the perception of the riskiness of large institutions becomes disconnected from reality. Without transparency, investors and regulators can no longer accurately assess risk. Finally, the entire edifice collapses. This is the story of both the 1920s and today.

As in the past, the off-balance sheet complexity and exceptions have gone too far. The basic notion that the balance sheet should reflect all assets and liabilities has been eaten away, like a piece of Swiss cheese with constantly expanding holes. Because off-balance sheet assets and liabilities were not included in financial statements, banks took leveraged positions that were hidden from regulators and investors. Because bank liabilities used to finance assets were not transparent, the financial markets could not effectively discipline banks that used derivatives and complex financial engineering to take excessive risks. Even if there are legitimate exceptions for items that might not belong on the balance sheet, those exceptions should not swallow the rule. Yet that is what has happened.

Congress should harness the power of free, well-functioning markets by requiring that banks include all of their assets and liabilities on their balance sheets. Transparency is one of the central pillars of a well functioning market. Congress recognized the importance of transparency in 1933 and 1934, when it imple-

mented a two-pronged approach to shine sunlight on the markets with (1) a requirement that companies disclose material facts, and (2) an enforcement regime for companies that do not make such disclosures. Now that the markets have once again swung too far away from transparency, Congress should implement a similar regime to require that (1) balance sheets are a clear picture of a corporation's financial health, and (2) there are consequences for companies that hide their debts.

Today, the problems associated with off-balance sheet accounting remain acute, despite efforts in the past decade by standard setters to improve transparency. The rules do not provide for sufficient transparency, and there is no effective enforcement mechanism. There is a lack of information regarding exposures to risks accompanying derivative transactions, and the potential impact on cash inflows and outflows. There is also a lack of information regarding how "interconnected" companies are to one another as a result of such transactions. As a result, even after the recent crisis, no one can get an accurate view of bank assets and liabilities. Too much exposure is buried within swaps and "Variable Interest Entities," known as VIEs. Financial reform proposals should promote the flow of information by requiring that companies report all of their assets and liabilities, including derivatives and VIEs, in a transparent, understandable way.

Here are our main recommendations:

- Companies must include swaps on their balance sheets.
- Companies must record all assets and liabilities of VIEs, in amounts based on the most likely outcome given current information.
- Companies must report asset financings on the balance sheet (not as "sales").
- Congress should adopt a legislative standard requiring such disclosures (mere "guidance" from the accounting industry is not enough).
- Companies that fail to disclose material facts should face civil liability.

## OFF-BALANCE SHEET LIABILITIES

### WERE AT THE CENTER OF THE RECENT FINANCIAL CRISIS

Off-balance sheet liabilities have been at the center of most recent financial crises, including the crisis of 2007-08. For example, in 1994, after the Federal Reserve raised short-term interest rates, losses on swaps and related derivatives shook the financial system, and regulators and investors were stunned to learn of hidden off-balance sheet bets on interest rates at dozens of funds and companies. Similar problems arose in 1997, when financial institutions disclosed off-balance sheet losses triggered by the devaluations of several Asian currencies. And then, of course, there was Enron, with off-balance sheet derivatives exposure that, as one of us testified at the first Senate hearings on Enron's collapse, "made Long-Term Capital Management look like a lemonade stand."

The most recent financial crisis was no different. Financial institutions built up hundreds of billions of dollars of exposure to subprime mortgage markets without disclosing these assets and liabilities on their balance sheets. The culprits

included both swaps and VIEs. For example, AIG disclosed only the “notional amount” of its credit default swaps, not the actual or potential liabilities associated with those trades. There was no warning in the AIG disclosures of the potential need for a bailout amounting to hundreds of billions of dollars. Similarly, major banks did not disclose their positions in super-senior tranches of synthetic collateralized debt obligations. Bank disclosures about swap and VIE exposures were incomplete and limited to footnotes. The officers and directors of these institutions have asserted that their disclosures were adequate, based on then-existing rules, though experts dispute those assertions.

In any event, it is now widely understood that these exposures generated the losses that crippled the banks. These swaps and VIEs were the instruments at the core of the crisis. And yet, as regulators and investors learned beginning in summer 2007, financial institutions had not included the money they owed pursuant to swaps and VIEs as liabilities in their financial statements.

Even today, the major banks continue to exclude trillions of dollars of swap and VIE liabilities from their balance sheets. More than a year after the height of the crisis, the balance sheets of financial institutions remain impenetrable. Significant liabilities are missing from their financial statements. Unlike the average person or business, banks continue to be permitted to keep many of their liabilities off-balance sheet.

Consider Citigroup as just one example. In its most recent quarterly financial filing, Citigroup described \$101 billion of “payables” based on credit derivatives. Those “payables” are a debt: Citigroup actually owes counterparties more than \$100 billion on these financial instruments. Yet that amount does not appear as an obligation on Citigroup’s balance sheet. To be sure, Citigroup has assets to offset this liability. And it does disclose its obligations in a footnote. But anyone who looks at Citigroup’s actual liabilities, as recorded in its financial statements, will not see these obligations. Importantly, regulatory risk and net capital formulas are based on financial statements, not footnotes.

Likewise, another footnote in Citigroup’s recent filing reports \$292 billion of “significant” unconsolidated VIEs. These VIEs are the nieces and nephews of Enron’s Special Purpose Entities, or SPEs. The VIEs have debts, but – like Citigroup’s swaps and other derivatives – the VIEs are referenced only in a footnote. They are not part of Citigroup’s actual balance sheet, and Citigroup does not record its interest in or maximum exposure to these entities.

Because banks do not report these assets and liabilities in any comprehensible way, regulators and market participants cannot understand the banks’ exposure to risk. Instead, the banks’ approach to off-balance sheet liabilities has made their financial statements virtually useless.

### **SWAPS PUSHED LIABILITIES OFF-BALANCE SHEET**

The recent history of off-balance sheet accounting begins with swaps. Swaps

are private over-the-counter derivative transactions in which two counterparties agree to exchange cash flows based on some reference amount and index. The story of how banks lobbied to push swaps off their financial statements into the shadow markets should trouble any proponent of free markets.

This story began in the 1980s, when the derivatives market was relatively small and off-balance sheet transactions were largely unknown. The Financial Accounting Standards Board, the group that publishes most accounting guidance, suggested that banks should include swaps on their balance sheets.

The accountants' argument was straightforward. Banks already accounted for loans as assets, because the right to receive payments from a borrower had positive value. Banks already accounted for deposits as liabilities, because the obligation to pay depositors had negative value. A swap, the FASB argued, was no different: it was simply an asset and a liability paired together, like a house plus a mortgage, or a car plus a loan. (The asset part of the swap was the money owed by the counterparty; the liability part of the swap was the money owed to the counterparty.)

The FASB's premise was simple, common sense. When most people and businesses prepare financial statements, they list all of their actual assets and liabilities. The reason is straightforward: the government, creditors, and investors want to see the entire picture. Individuals and small business owners cannot hide some of their debts merely by relabeling them.

But banks foresaw that the burgeoning business of swaps would inflate the size of their balance sheets if they were reported as assets and liabilities. Banks wanted to profit from trading swaps, but they did not want to include swaps in their financial statements. Instead, they argued to the FASB that swaps should be treated as off-balance sheet transactions. In 1985, the banks formed a lobbying organization called the International Swap Dealers Association. That group, now widely known as ISDA, pressed the FASB to exempt swaps from the standard approach to assets and liabilities. The banks argued that swaps were different, because the payments were based on a reference amount that the swap counterparties did not actually exchange. ISDA was a forceful advocate, and the banks persuaded the FASB to abandon its argument.

ISDA and the banks have continued their lobbying efforts to keep swaps and other derivatives off-balance sheet, as they argued more generally for deregulation of these markets. As a result, banks and corporations that trade swaps do not play by the same rules as other individuals and businesses. Banks are permitted to exclude their full exposure to swaps from their financial statements, and instead report only the "fair value" changes in those swaps over time. Such reporting is like an individual reporting only the change in their debt balances, instead of the debts themselves.

## THE “ALPHABET SOUP” OF SPEs AND VIEs

### PUSHED LIABILITIES OFF BALANCE SHEET

The banks also lobbied for off-balance sheet treatment of deals using “Special Purpose Entities,” or SPEs. An SPE is a corporation or partnership formed for the purpose of borrowing money to buy financial assets.

Historically, under accounting rules adopted by the American Institute of CPAs, corporations were required to consolidate any SPEs they used to finance assets. During the 1970s, if a transaction was a financing, both the assets being financed as well as the financing had to be reported on the balance sheet. During the following two decades, the finance industry lobbied for changes that would permit them to avoid consolidating SPEs for many transactions. In general, the revised approach required that a corporation include the assets and liabilities of another entity in its financial statements only if it had a “controlling interest” in that entity. Importantly, the banks and Wall Street quickly sidestepped these rules by engineering transactions in which the sponsor did not have legal control, but still had economic control and would suffer losses from a decline in the assets’ value. The rationale was that if a bank did not have a legally controlling interest in an SPE, the liabilities of the SPE could remain off-balance sheet. The key question was: what was “control”?

That vexing question led many companies, most notoriously Enron, to create SPEs in which they held just a sliver of ownership, and – therefore, they argued – did not have control. Enron’s infamous Jedi and Raptor transactions were designed to take advantage of the so-called “three percent rule,” an accounting pronouncement that essentially permitted companies with less than three percent ownership of an SPE to keep the SPE’s assets and liabilities off-balance sheet. Enron arguably violated the “three percent rule” in many of its deals, but even the “rule” itself reflected the power of the banks over the regulators. The SEC’s chief accountant previously had expressed concerns about the abuses of SPEs and off-balance sheet transactions, but when the FASB delegated responsibility for addressing these concerns to its Emerging Issues Task Force, the result – after much lobbying – was a consensus among the major accounting firms in which they concluded that if outside parties put up just a mere three percent of the equity in the transaction, they could avoid treating the original sponsor as being in control.

Enron became the poster child of off-balance sheet liabilities, and the FASB responded to public outrage about Enron’s hidden liabilities by adopting FIN 46 and later a watered-down version called FIN 46(R), a new rule with a new acronym. FIN 46(R) recast the guidance on SPEs by creating a new definition of “Variable Interest Entity,” or VIE. The new guidance ostensibly was designed to limit the kinds of accounting shenanigans that had permitted Enron to hide so many liabilities. But FIN 46(R), like the earlier rules, continued to focus on “control.” In simple terms, if a bank did not have control of a VIE, it could keep that VIE’s liabilities off-balance sheet.

In the aftermath of Enron, banks responded to this new guidance cautiously at first. During the early 2000s, there was a lull in off-balance sheet deals. But by 2004-05, banks were using new forms of financial engineering to create VIEs that, like Enron's SPEs, remained off-balance sheet. The FASB was aware of these problems, but decided not to rewrite FIN 46(R). By 2008, VIEs were even more common than SPEs had been a decade earlier.

## CONGRESS SHOULD REQUIRE

### COMPANIES TO RECORD ALL OF THEIR LIABILITIES

Congress should address the problems associated with the accounting treatment of swaps and VIEs by adopting a general requirement that companies record all of their liabilities in their financial statements. This provision should include all liabilities for which a company will use its assets to pay or liquidate those liabilities. It should include all liabilities that are, in substance, a financing of assets, regardless of legal form. Most crucially, Congress should require that balance sheets include assets and liabilities associated with swaps and VIEs. Without such transparency, regulators and investors who look at the reported assets and liabilities of financial institutions are looking at a mirage. It should not be a radical request to ask that financial statements of banks reflect reality.

Not surprisingly, because Congress has not required that financial statements reflect reality, they do not reflect reality. Off-balance sheet transactions can have legitimate purposes, but too often one of those purposes is to avoid any impact on the balance sheet. As a result, off-balance sheet transactions can swallow up what remains on balance sheet.

Again, consider Citigroup as just one example. In its balance sheet for December 31, 2006, Citigroup recorded \$1.88 trillion of assets and \$1.76 trillion of liabilities, leaving stockholders' equity of \$120 billion. Most of those assets and liabilities were straightforward: assets included loans, trading account assets, federal funds sold and repurchase agreements, and investments; liabilities included deposits, federal funds purchased and repurchase agreements, and short-term and long-term debt. A year later, Citigroup reported some additional items on its balance sheet (it consolidated some of its Structured Investment Vehicles, revalued some swaps, and included various mortgage-related instruments), but the reported value of its equity was down just \$7 billion. By the end of 2008, Citigroup's assets and liabilities on the balance sheet were smaller, but its equity was up to \$142 billion.

Anyone looking only at Citigroup's balance sheet would assume that the bank had experienced a period of relative calm during the financial crisis. Of course, Citigroup's income and cash flow statements revealed a different story, as the bank recorded massive losses from off-balance sheet transactions. Ultimately, the federal government had to execute its own off-balance sheet deal, effectively guaranteeing a portfolio of \$306 billion against losses. Citigroup's losses on off-balance sheet transactions swallowed up the rest of its balance sheet. Citigroup is an illustrative example, and the same analysis holds for other major

financial institutions. Bank officers and directors have argued that the recent financial crisis was a perfect storm, and that no one could have anticipated the downturn in the subprime mortgage markets, or the increase in the correlation of mortgage defaults. But here is the crucial point: the banks, by hiding their off-balance sheet exposures to these markets, including exposures to non-performing subprime loans, did not give investors and analysts a chance. Because bank balance sheets were not transparent, even regulators could only guess at the extent of the banks' exposure to these risks. The hedge funds and other investors who made money speculating on the banks' downfall were not doing so based on analysis of transparent disclosures in the banks' financial statements. That was impossible. Instead, they were speculating on the inaccuracies of those disclosures. When the value of bank stocks depends, not on transparent information the banks have disclosed, but rather on guesses about what the banks have not disclosed, the basic principles of free markets are no longer working, and major reform is necessary.

Many sophisticated analysts and traders understand that bank balance sheets are inaccurate, and they may largely ignore them, instead opting to model their own numbers. However, bank balance sheets are supposed to serve an important function in the financial markets, both for regulators who look to balance sheet measures to assess risk, and for average investors who lack the capacity to parse the "shadow balance sheet" to spot the hints about risks contained in footnoted off-balance sheet disclosures. Balance sheets and shadow balance sheets are at cross purposes. Because the risks of off-balance sheet transactions have grown so large, they have rendered the remaining balance sheet disclosures useless, as was seen in the case of AIG. Congress must act to restore the proper role of the balance sheet in a well-functioning market.

Specifically, Congress should remedy the problems arising from shadow balance sheets by requesting the SEC, or a standard setter designated by it, to require that all liabilities appear on the balance sheet. Then, companies, if they want, can explain the extent of those liabilities in a footnote. Today, the default rule is reversed, with the footnotes – instead of the balance sheet – as the repository of material information.

In other words, Congress should switch the disclosure mandate. It should clarify that financial statements have primacy over footnotes, not the other way around. Regulators and investors should not have to scour hundreds of pages of impenetrable footnote disclosure to get a reliable estimate of liabilities. Instead, banks should determine that number, and report it upfront. If a bank is concerned about the appearance of this number, perhaps because some liabilities are contingent on events they believe are unlikely, they can explain that in a footnote.

An example of language Congress could consider is as follows:

*The Securities and Exchange Commission, or a standard setter designated by and under the oversight of the Commission, shall, within one year from the enactment of this bill, enact a standard requiring that all reporting companies record all of their assets and liabilities on their balance sheets. The recorded amount of assets and liabilities shall reflect a company's reasonable assessment of the most likely outcomes given currently available information. Companies shall record all financings of assets for which the company has more than minimal economic risks or rewards.*

*If the company cannot determine the amount of a particular liability, it may exclude that liability from its balance sheet only if it discloses an explanation of (1) the nature of the liability and purpose for incurring it, (2) the most likely and maximum loss the company could incur from the liability, (3) whether there is any recourse to the company by another party and, if so, under what conditions such recourse can occur, and (4) whether or not the company has any continuing involvement with an asset financed by the liability or any beneficial interest in it. The Commission shall promulgate rules to ensure compliance with this provision, including both enforcement by the Commission and civil liability under the Securities Act of 1933 and the Securities Exchange Act of 1934.*

It is crucial that a requirement to disclose all assets and liabilities come in the form of a legislative mandate from Congress. Just as Congress required audits of public companies in the early 1930s, it should require that companies record all assets and liabilities in their financial statements. Guidance from the FASB and interpretation from regulators will be helpful only if they are made pursuant to a broad and clear legislative mandate that companies record all liabilities. As recent experience shows, guidance and interpretation alone – without an umbrella Congressional requirement – will not significantly improve transparency. Disclosures to date from companies, including major financial institutions, indicate that hundreds of billions of dollars of VIEs will escape consolidation. As a result, substantial questions have arisen as to whether the FASB's June 2009 guidance, FASB Statement No. 161, regarding off-balance sheet accounting and securitizations, will result in companies being required to record all of their assets and liabilities. And while this standard is the FASB's most rigorous and robust standard to date, it is also exceedingly complex and will require substantial technical expertise if it is to be implemented properly. (Even the FASB's own Investor Technical Advisory Committee raised numerous concerns with the FASB's proposal.)

The FASB's guidance suffers from two fatal flaws. First, without a clear congressional mandate, the new guidance is subject to the same kinds of interpretations that have encouraged financial engineering and “regulatory arbitrage” transactions designed to move debts off-balance sheet. Specifically, a company is now required to consolidate a VIE only if it has “control” over the VIE's “most signifi-

cant activities” and has the “right to receive benefits or [an] obligation to absorb losses.” By design, this guidance is highly qualitative. It requires judgment and assumptions. Companies can exclude liabilities from their financial statements, as long as they describe their judgments and assumptions in a footnote. That approach is unlikely to generate transparent financial reporting.

Moreover, it remains unclear when banks will be required to adopt the new guidelines for capital purposes. And even among companies that do follow the new approach, significant liabilities will remain off-balance sheet. The savviest regulators understand these limitations, and some have expressed support for a broad off-balance sheet disclosure mandate. As Sheila Bair, head of the FDIC, told the Financial Crisis Inquiry Commission, “Off-balance-sheet assets and conduits, which turned out to be not-so-remote from their parent organizations in the crisis, should be counted and capitalized on the balance sheet.” Congress should follow Ms. Bair’s advice.

Congress should mandate that companies base disclosure decisions on the substance of their VIE transactions. If a company is financing assets, those assets and the related liabilities should remain on the balance sheet, regardless of the form the company uses to construct these financings. If a company continues to manage and service assets, as is commonly the case, or if it continues to receive cash flows from the assets, the assets and liabilities should be reported on the balance sheet. If a company can be required to use its assets to pay for an obligation, that obligation must be reported as a liability on its balance sheet. If a company’s disclosures are based on the most likely outcome given available information, not only will balance sheets be more accurate, but company employees will be more likely to consider the risks associated with transactions. (For example, major financial institutions would have been required to record significant liabilities for subprime related swaps and VIEs.)

Second, even if the new FASB guidance were sufficient, there is no independent enforcement mechanism to ensure that banks accurately report all of their liabilities. Most importantly, although companies generally remain liable for material misstatements, there is no clear and independent provision for civil liability if a corporation omits assets and liabilities from its balance sheet. Indeed, under the current approach, if a company describes the assumptions and judgments supporting its rationale for excluding material liabilities from its financial statements, it can argue that it is not liable for securities fraud, particularly given the complexities of interpreting the existing rules and the widespread custom and practice related to the use of off-balance sheet liabilities. Put another way, companies can argue that, even if they are later found to have violated GAAP by excluding items from their balance sheets, they, and their officers and directors, did not have the requisite mental state required for a finding of securities fraud.

Since the 1930s, the twin pillars of the American market-based system of financial regulation have been (1) mandatory disclosure of material facts, and (2)

enforcement of misstatements and omissions through a robust private right of action. Congress does not need to invent a new legislative rubric to resolve the problems associated with off-balance sheet transactions. Transparency coupled with private enforcement is a tried-and-true strategy. The dual approach of required disclosure and anti-fraud remedies served the financial markets well for more than seven decades. Congress could renew this approach by adopting a standard requiring reporting of all assets and liabilities in financial statements with appropriate disclosures, and by providing for a clear and independent private right of action for failure to comply with such a standard.

Civil liability is a particularly important part of the reform needed in this area. During the previous decade or so, Congress and the courts have whittled away at shareholders' litigation rights by imposing new hurdles related to causation, third-party liability, class action certification, and various pleading and evidentiary requirements. The result is particularly stark in the area of off-balance sheet liabilities. Directors and officers are almost never found personally liable for fraud or breach of duty related to complex financial engineering. Unless mandatory disclosure is paired with effective enforcement, it will be toothless.

Congress should enact the same kind of legislative mandate it pursued during the 1930s. Until recently, the private right of action that arose from America's securities laws had helped to support a transparent and well-functioning market. It is no coincidence that off-balance sheet liabilities and inaccurate financial statements have multiplied as the risk of civil liability has declined. This deterioration also parallels the 1920s, as does its remedy. Oliver Wendell Holmes famously described the law as a prediction of what a judge will do. Yet today any bank officer or director considering whether to approve off-balance sheet accounting rationally would predict that a judge would do nothing. Until recently, few lawsuits have even mentioned off-balance sheet liabilities.

The evisceration of the private right of action is ironic given the growth of the regulatory state and the multiplication of legal rules, particularly in the areas of banking and securities. As the system has become more rules-based, officers and directors understandably have focused more on complying with rules than on achieving the objectives of transparency and accuracy in financial statements. By adopting a rigorous private enforcement regime, Congress could help shift the thinking of officers and directors away from simply complying with rules and instead in the direction of acting in a way they believe a judge would find acceptable at some future date. Moving toward standards enforced *ex post* (and away from rules specified *ex ante*) would help develop a culture of ethics in financial statements. This is particularly important given the failure of regulators to spot and remedy problems at major financial institutions. Without a robust private enforcement regime, a rules-based culture of financial innovation will always be one step ahead of the regulators.

## REFORMING OFF-BALANCE SHEET

### ACCOUNTING IS A GOOD POLICY WITH BROAD APPEAL

In sum, Congress should mandate that companies report all of their assets and liabilities. Companies that omit material assets and liabilities from their balance sheets should be subject to civil liability in the same way companies generally have been exposed to private rights of action for material misstatements. This is not a radical proposition: it is precisely what Congress did in 1933 and 1934, in response to that era's financial crisis.

At first blush, the off-balance sheet problem might seem unfathomably complicated, and perhaps that is why some people in government did not include reforms directed at this problem as part of the "Plan A" approach to financial reform. But average people understand what liabilities are, and they know what can happen if people are permitted to lie about their debts. Market capitalism requires transparency, or it will not function properly. That is not a controversial proposition. And it is why requiring disclosure of off-balance sheet transactions is a crucial part of "Plan B."

It only takes a few simple questions for the average person to understand how much trouble off-balance sheet accounting can cause. Here are a few: What if the next time you wanted to borrow money you didn't have to list most of your debts? What if Congress let you keep your credit card bills and mortgage liabilities hidden from view? If you could hide your debts, how much would you borrow? What would you do with that borrowed money? How much risk would you take? The answers do not require knowledge of rocket science. Common sense tells us that if we let people hide their debts, they will borrow more than they should, at the wrong times, for the wrong reasons.

Simply put, our biggest banks have been hiding their debts. Even after the recent crisis, they continue to hide them, now more than ever. Most people and business include all of their liabilities on their financial statements. Banks should, too.

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