Responses by the Federal Communications Commission to WorldCom’s Accounting Fraud

Warren G. Lavey*

I. INTRODUCTION............................................................................. 615
II. HOW DID THE FCC RESPOND IN THE DAYS AND WEEKS FOLLOWING WORLDCOM’S DISCLOSURE? .................................. 619
   A. WorldCom’s Disclosure of Accounting Fraud...................... 619
   B. FCC’s Public Statements Responding to WorldCom’s Disclosures............................................................................ 624
   C. Analysis of the FCC’s Immediate Response ......................... 628
III. WHAT REGULATIONS DID THE FCC APPLY OR NOT APPLY TO WORLDCOM DURING THE ACCOUNTING FRAUD? ............... 631
   A. Findings of Financial and Character Qualifications for WorldCom’s Licenses ............................................................... 631
      1. Legal Framework for the FCC’s Analysis of WorldCom’s Qualifications ................................................................. 631
      2. Application of Financial and Character Qualifications Tests to WorldCom During the Fraud................................. 634
   B. Assessment of WorldCom as a Financially Strong Competitor in Authorizing Other Carriers ................................. 635
   C. Audit of and Reports by WorldCom........................................... 637

*Partner, Skadden, Arps, Slate, Meagher & Flom LLP. J.D., Harvard Law School; former Adjunct Professor, Washington University Law School and Kellogg School of Management, Northwestern University; former Assistant to the Chief, Common Carrier Bureau, Federal Communications Commission. I am grateful for the assistance of Anthony Oettinger, David Prohofsky, Joseph Hanley, James Harper, Blair Levin, Holly Rosencranz, Ruth Milkman, and Joan Summers. Errors are mine alone.
D. Statistical Reports Reflecting WorldCom’s Financials .......... 640
E. Enforcement Action .......................................................... 641
F. Regulations of Prices, Terms, and Conditions for Services
   Offered by Local Exchange Carriers ..................................... 645
G. Analysis of the FCC’s Relevant Regulations During the
   WorldCom Accounting Fraud ............................................. 646

IV. AFTER SEVERAL YEARS, HOW DID THE FCC CHANGE OR NOT
    CHANGE ITS REGULATIONS RELATED TO WORLDCOM’S
    DISCLOSURE? ..................................................................... 649
A. FCC Proceedings Triggered by WorldCom’s Disclosure .... 649
   1. Discontinuance of Some Noncore Services ................. 650
   2. WorldCom’s Licenses .................................................. 651
   3. Local Exchange Carriers’ Protection Against
      Uncollectibles .................................................................. 654
B. Continuation of Other FCC Regulations Related to
   WorldCom’s Disclosure ....................................................... 655
   1. Information Filing and Accounting Requirements for
      Nondominant Carriers .................................................. 656
   2. License Applications .................................................... 657
   3. Audits ........................................................................... 659
   4. Enforcement Actions ..................................................... 660
C. Analysis of the FCC’s Maintenance of its Regulations and
   Practices Following its Public Statements on WorldCom’s
   Disclosure ............................................................................. 662

V. WHAT EXPLAINS THE FCC’S RESPONSE TO WORLDCOM’S
   DISCLOSURE? ................................................................. 663
A. Protecting Consumers and Rooting Out Corporate Fraud .... 663
B. Partial Explanations for the FCC’s Stance on Financial
   Fraud .................................................................................... 668
   1. Changes in Securities Laws, SEC Regulations, and
      Other SEC and Justice Department Actions .................. 668
   2. Telecommunications Industry Downturn ....................... 672
   3. Deregulation and Market Forces ................................... 674
   4. Political Accountability .................................................. 677

VI. CONCLUSION ........................................................................ 679
I. INTRODUCTION

The disclosure of massive financial accounting fraud at WorldCom, Incorporated (“WorldCom”) on June 25, 2002,¹ was a major shock to the Federal Communications Commission (“FCC”). The FCC is the principal federal agency responsible for fostering reliable, universally available telecommunications services, as well as competition and growth in the communications and related Internet services industries.² A wide range of FCC policies, proceedings, and capabilities were implicated by the accounting fraud and resulting bankruptcy of WorldCom. At that time, WorldCom was the second largest long-distance carrier, one of the largest competitive local exchange carriers, and the largest provider of Internet backbone services.³ WorldCom held numerous FCC licenses for landline and wireless services. During the quarter century prior to the disclosure of fraud, advocacy by WorldCom and MCI Communications Corp. (“MCI”)⁴


⁴. WorldCom acquired MCI in 1998. See Application of WorldCom, Inc. and MCI Communications Corp. for Transfer of Control of MCI Communications Corp. to WorldCom, Inc., Memorandum Opinion and Order, 13 F.C.C.R. 18025, para. 1 (1998). At times between 1998 and 2002, the company was named “MCI WorldCom, Inc.” and was renamed “WorldCom, Inc.” To avoid confusion, this Article refers to the post-acquisition company as “WorldCom.”
reshaped telecommunications regulations.\(^5\)

The FCC’s regulations did not cause, prevent, detect, or remedy the criminal conduct at WorldCom. However, the FCC’s rules required WorldCom to file accurate financial information and to show that it had the financial and character qualifications necessary to hold radio and other FCC licenses.\(^6\) With broad statutory authority to require information filings and perform investigations of telecommunications carriers, the agency with telecommunications industry expertise might have done more to detect and protect the public against harms from financial fraud at major telecommunications carriers such as WorldCom, Qwest Communications International, Inc. (“Qwest”),\(^7\) and Global Crossing Ltd.\(^8\)

The securities laws and regulations and the competence of the Securities and Exchange Commission (“SEC”) were the focus of the public debate following WorldCom’s disclosure. There was relatively slight attention to the FCC’s enabling statute, regulations, and performance. The spotlight was instead directed at public companies’ audited financial

\(^5\) See, e.g., MCI Telecomm. Corp. v. FCC, 561 F.2d 365, 380 (D.C. Cir. 1977) (stating that the FCC does not have the general authority to insist carriers get prior approval for tariffs proposing new services or rates); MCI Telecomm. Corp. v. FCC, 580 F.2d 590, 591–92 (D.C. Cir. 1978) (stating that AT&T must provide interconnections for MCI’s competing intercity services); MCI v. AT&T, 708 F.2d 1081, 1092–93, 1174 (7th Cir. 1983) (affirming, in part, an antitrust jury verdict against AT&T and remanding for further damages proceedings); MCI Telecomm. Corp. v. FCC, 765 F.2d 1186, 1187–88 (D.C. Cir. 1985) (finding the FCC lacked authority to remove tariffs from MCI’s service offerings); MCI Telecomm. Corp. v. FCC, 842 F.2d 1296, 1297–98, 1307 (D.C. Cir. 1988) (reversing FCC determination that special access tariffs were reasonable); MCI Telecomm. Corp. v. FCC, 917 F.2d 30, 33–35, 39–40 (D.C. Cir. 1988) (reversing in part and remanding an FCC decision approving aspects of AT&T contract tariffs); MCI Telecomm. Corp. v. FCC, 59 F.3d 1407, 1409, 1417, 1420 (D.C. Cir. 1995) (affirming damages assessed by the FCC against local exchange companies and denying FCC-allowed offsets for those damages); MCI Telecomm. Corp. v. FCC, 143 F.3d 606, 607–09 (D.C. Cir. 1998) (remanding FCC decision setting payphone compensation rates).

\(^6\) See infra Part III.A.1.


statements filed with the SEC. Perhaps this occurred because WorldCom’s
disclosure was preceded by disclosures of accounting fraud at Enron Corp.⁹
and many other companies,¹⁰ as well as the criminal prosecution of Arthur
Andersen LLP.¹¹ The failures within the communications industries were
largely treated as further examples of problems with the securities laws,
accounting standards, and the SEC. The FCC’s public response to
WorldCom’s disclosure focused primarily on continuity of
telecommunications services to the public, with secondary concerns about
punishing and preventing fraud.¹²

WorldCom’s disclosure provides an opportunity to examine certain
areas of the FCC’s regulations in both their direction and effectiveness.
This Article analyzes WorldCom’s disclosure of accounting fraud as a
shock to the FCC in four parts: (1) How did the FCC respond in the days
and weeks after the disclosure?; (2) What regulations did the FCC apply or
not apply to WorldCom during the accounting fraud?; (3) After several
years, how did the FCC change or not change its regulations related to
WorldCom’s disclosure?; and (4) What explains the FCC’s response to
WorldCom’s disclosure?

The picture that emerges shows an agency that had responsibilities
and made findings related to WorldCom’s financial accounts but which
was unaware and unsuspecting of the criminal conduct until WorldCom’s
public disclosure. Following the disclosure, the FCC gave certain
assurances to the American public and Congress and completed some

---

⁹ See, e.g., Press Release, Enron, Enron Provides Additional Information About
Related Party and Off-Balance Sheet Transactions; Company to Restate Earnings for 1997–
2001 (Nov. 8, 2001), http://www.enron.com/corp/pressroom/releases/2001/ene/docs/78-
SECReleaseLtr.pdf; Testimony Concerning Recent Events Relating to Enron Corporation:
Before the Subcomm. on Capital Markets, Insurance and Government Sponsored
Enterprises and the Subcomm. on Oversight and Investigation, H. Comm. on Financial
Services, 107th Cong. (2001) (Robert K. Herdman, Chief Accountant, SEC),
http://www.sec.gov/news/testimony/121201tsrkh.htm; Written Testimony Concerning
Accounting and Investor Protection Issues Raised by Enron and Other Public Companies:
Before the S. Comm. on Banking, Housing and Urban Affairs, 107th Cong. (2002) (Harvey
(demonstrating the significance placed on and the attention given to the Enron scandal by
the SEC).

¹⁰ U.S. GEN. ACCOUNTING OFFICE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS,
MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES 121–235 (2002),

¹¹ See, e.g., Arthur Andersen LLP v. United States, 125 S. Ct. 2129, 2131 (2005);
Press Release, SEC, SEC Announces Reporting Requirements for Companies Audited by
SEC, SEC Statement Regarding Andersen Case Conviction (June 15, 2002),

¹² See infra Part II.B.
proceedings addressing WorldCom’s fraud and bankruptcy. It appears that the FCC did not reform its analysis or regulations with the goal of protecting against future occurrences of similar harmful conduct. On the contrary, as part of its efforts to decrease unnecessary regulatory burdens and promote market forces, the FCC applied streamlined requirements related to financial qualifications and accounting after WorldCom’s disclosure.\textsuperscript{13} Although WorldCom’s fraud and bankruptcy was a major development for the industries regulated by the FCC and helped spur reforms in securities laws and regulations, it does not appear to be a turning point in FCC regulations.

If indeed the FCC did not substantially reform its efforts to protect against accounting fraud and financially unstable carriers, and given that the FCC treated WorldCom’s conduct as more than ordinary aggressive accounting, at least four partial explanations may apply. On the level of substantive regulation, the post-WorldCom tightening of the securities laws—the Sarbanes-Oxley Act\textsuperscript{14}—along with changes in SEC regulations and other actions by the SEC and Justice Department may have obviated the need for changes in the FCC’s analysis, regulations, and enforcement practices. In terms of the structure of the communications and Internet services industries, the downturn of the industries and other rule changes weighed against the FCC imposing penalties on or blocking opportunities for financially weak firms that were often innovators and emerging competitors. Regarding long-range regulatory philosophy, the FCC was oriented toward deregulation, competitive entry, and market forces and was reluctant to intervene in the market once the immediate threat of service disruption and financial meltdown passed. Finally, on the political level, high-profile investigations and rule changes at the FCC would have put the agency more in the spotlight of what it, rather than the SEC, could have done to prevent accounting fraud by major telecommunications carriers; the FCC needed its political credibility as an effective regulator and industry analyst to push forward deregulation.

The Article concludes that the FCC’s inactivity regarding financial qualifications and financial fraud resolved inconsistencies in the FCC’s deregulation of nondominant carriers. Regulatory inactivity in these areas likely promoted the public interest, and the FCC correctly resisted various pressures to throw additional accounting, audit, and enforcement resources at determining financial qualifications and deterring financial fraud.

\textsuperscript{13} See infra Parts IV.B.1 and IV.B.2.

II. HOW DID THE FCC RESPOND IN THE DAYS AND WEEKS FOLLOWING WORLDCOM’S DISCLOSURE?

WorldCom's financial scandal directly affected investors in, creditors of, and employees of WorldCom. It posed the possibility of also affecting users of WorldCom's services (both consumers and interconnecting carriers) and the telecommunications carriers that supplied services to or competed against WorldCom. The FCC was, on the one hand, the federal agency with the greatest responsibility for licensing and regulating WorldCom's service offerings, as well as making reliable, efficient telecommunications services available to all Americans. On the other hand, the FCC had been pursuing deregulation and reliance on market forces for over three decades, and a majority of the commissioners in 2002 were Republicans. Various issues and forces formed an interesting mix of options for both WorldCom and the FCC in how the accounting scandal was disclosed and its aftermath. This Part describes (A) WorldCom's disclosure of its financial fraud, and (B) the FCC's responses to such disclosure during the following five weeks.

A. WorldCom's Disclosure of Accounting Fraud

On June 25, 2002, WorldCom announced that it intended to restate its financial statements for 2001 and the first quarter of 2002. An internal audit together with subsequent review by external auditors determined that transfers of over $3.8 billion from “line cost” expenses to capital accounts during this period were not made in accordance with generally accepted accounting procedures (“GAAP”). Line costs were the payments

15. WorldCom Press Release, supra note 1.

16. See id. The financial fraud and restatement were with regard to GAAP rules developed and administered by the SEC and Financial Accounting Standards Board (“FASB”). See The Roles of the SEC and the FASB in Establishing GAAP: Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises, H. Comm. on Financial Servs., 107th Cong. 1–6 (2002) (testimony of Robert K. Herdman, Chief Accountant, SEC), http://financialservices.house.gov/media/pdf/051402rh.pdf [hereinafter Roles of the SEC]. Regulatory accounting rules were not involved in this matter because WorldCom was in the category of nondominant carriers, which were not subject to federal or state regulatory accounting rules and were generally not required to file regulatory reports showing allocations of expenses, investments, revenues, and earnings by service. Regulatory accounting and reporting rules were viewed as unnecessary burdens on nondominant carriers that could interfere with new offerings, increase costs (and thus, prices), impede discounting, and facilitate collusion. Nondominant carriers were allowed to charge market-based prices and not required to file cost justification for their tariffs. See Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, First Report and Order, 85 F.C.C.2d 1, paras. 15–16 (1980) [hereinafter First Competitive Carrier]. For dominant carriers, regulators have long struggled with accounting categories, cost allocations, and the relationships between regulated rates and costs. See generally Policy and Rules Concerning Rates for Dominant
WorldCom made to other carriers for transmitting portions of WorldCom’s calls, such as payments to local exchange carriers for originating and terminating calls transmitted on WorldCom’s intercity network (called “access charges”). Access charges are regulated by the FCC and the state public utility commissions. WorldCom’s press release noted that WorldCom notified the SEC and retained a former chief of the SEC’s Enforcement Division to conduct an independent investigation. The press release did not mention any notification to the FCC, potential violation of the FCC’s rules, or steps taken to comply with the FCC’s policies. WorldCom did state in this initial press release that its services and customers would be unaffected.

According to the bankruptcy court examiner, “given the magnitude of the WorldCom accounting fraud and the relative simplicity of the execution of some of its aspects, it is disappointing that the Company’s gatekeepers failed to detect the fraud for so long.” The bankruptcy court examiner’s report found that the fraud was primarily executed through two processes. First,

by at least 1999, WorldCom was relieving some of the pressure of its spiraling line costs on its bottom line by releasing line cost reserves into income, which resulted in a corresponding reduction in line cost expenses reported on the Company’s income statement. The manipulation of line cost reserves was achieved through a number of means, including: (i) the failure to release reserves in accordance with [generally accepted accounting procedures], at the point when they were no longer necessary; (ii) the release of some reserves without any analysis to support that they were excess and should be released; and (iii) the use of reserves recorded for other purposes to offset line cost expenses.


18. WorldCom Press Release, supra note 1. WorldCom had numerous applications pending at the FCC for new or modified radio licenses. The FCC’s rules require applicants to provide “additional or corrected information” whenever information in pending applications is either “no longer substantially accurate and complete” or “whenever there has been a substantial change as to any other matter which may be of decisional significance” in FCC proceedings involving such applications. 47 C.F.R. §1.65(a) (2005).


21. Id. at 273.
After the line cost reserves were substantially drawn down, WorldCom implemented a second type of accounting manipulation:

beginning in the first quarter of 2001, [WorldCom’s chief financial officer] directed that hundreds of millions of line cost expenses be capitalized, subtracting them from what otherwise would have been expenses against the Company’s earnings for the successive quarters, and disguising most of those reductions by transferring them as additions to the Company’s fixed assets.\(^{22}\)

The Special Investigative Committee of WorldCom’s Board of Directors concluded that the accounting fraud had a substantial effect on WorldCom’s reported ratio of line-cost expenses to revenues. This ratio was reported at about forty-two percent each quarter in 2001\(^{23}\) and was a key measure of performance in WorldCom’s communications with the public (including its annual financial statements filed with the SEC and the FCC).\(^{24}\) According to the Special Investigative Committee, if WorldCom had not capitalized a portion of its line costs, this ratio would have been much higher, typically exceeding fifty percent.\(^{25}\)

For purposes of this Article, the “truth” about this ratio for WorldCom and comparable companies is neither assumed nor critical to the analysis. Rather, the important point for this Article is that, after WorldCom’s disclosure and the resulting allegations of a “red flag” in this ratio, the FCC did not investigate such allegations nor propose any change in its accounting rules, data collections, or analysis to increase its ability to detect and deter such financial fraud. However, any significance of comparisons of this ratio to other companies’ financial ratios, and the interpretation of any disparity, were questionable. Telecommunications carriers differed in their revenue and expense accounting treatment of access charges and other operations expenses, and one carrier reported a change in such accounting in 2001.\(^{26}\) Additionally, WorldCom had a significantly differentiated mix

---

22. Id. at 278.
23. INVESTIGATION REPORT, supra note 1, at 92.
24. Id. at 10.
25. Id. at 17, 92. See also KRISHNA PALEPU ET AL., BUSINESS ANALYSIS & VALUATION: USING FINANCIAL STATEMENTS, at 13–15 (3d ed. 2004), which stated:

[F]inancial ratio analysis of WorldCom’s financial performance should have revealed a significant decline in the company’s cost structure that was not matched by any of its competitors. Such analysis should have been a red flag for the auditor that prompted a detailed examination of WorldCom’s costs and capitalization policies, and might have led the auditor to detect the massive fraudulent change in capitalization of network costs at WorldCom.

26. This ratio could be changed by several percentage points by moving the financial reporting of some intercarrier payments for reciprocal compensation (termination of calls performed on behalf of other carriers’ customers) and access charges from (A) a component of both revenues and expenses, to (B) a reimbursement not reflected as a component of revenues or expenses—that is, a net flow-through to local exchange carriers. GAAP allowed
of services and products compared to other telecommunications carriers, and the FCC ordered many changes in regulatory accounting and intercarrier compensation rules, which materially affected access charges and cost-to-revenue ratios.

WorldCom's initial disclosure of accounting fraud was preceded by several months of negative public information regarding the company's financial condition and financial reports. In the days following Global for the choice of either approach, and carriers differed in their accounting treatment of reciprocal compensation payments and access charges. Some accounting changes were driven by the FCC's changes in the rules for collecting and billing portions of access charges. In particular, WorldCom reported a reclassification and showed the new and old presentations in the third quarter of 2000. See MCI WorldCom Inc., Annual Report (Form 10-Q), at 8 (Nov. 14, 2000); MCI WorldCom Inc., Annual Report (Form 10-K 405/A), at 37 (April 26, 2001). Carriers also changed the financial accounting for various types of costs that would affect certain expense-to-revenue ratios. See XO Communications, Quarterly Report (Form 10-Q), at 13 (Aug. 13, 2001) (changing its expense categories to report engineering and operations expenses in the category of selling, operating and general expenses, whereas it previously reported engineering and operations expenses in the category of cost of services).

It is possible that the FCC was skeptical of any assertions that reported financial ratios for WorldCom, AT&T, and Sprint could be meaningfully compared in light of the differences in these carriers' mix of services and products and related differences in cost-to-revenue ratios. For example, in the first half of 2001, WorldCom was the largest Internet backbone services provider and had substantial international services revenues, including from its interest in a Brazilian carrier; AT&T was the largest provider of residential voice long-distance services and had major cable television and wireless services operators; and Sprint owned incumbent local exchange carriers, a wireless carrier, and Yellow Pages businesses. See WorldCom, Inc., Annual Report (Form 10-K 405), at 5–12 (Mar. 13, 2002); AT&T Corp., Annual Report (Form 10-K), at 1–6 (Apr. 1, 2002); Sprint Corp., Annual Report (Form 10-K), at 1–4 (Mar. 4, 2002). Apparently, AT&T and Sprint (WorldCom's largest competitors) did not treat WorldCom's reported financial ratios as indicative of fraud until WorldCom's disclosure on June 25, 2002. See Dionne Searcey, Tracking the Numbers/Outside the Audit: On Judgment Day, Assessing Ebbers's Impact, WALL ST. J., July 13, 2005, at C3; DICK MARTIN, TOUGH CALLS: AT&T AND THE HARD LESSONS LEARNED FROM THE TELECOM WARS 25, 83, 207, 253 (AMACOM 2005). In private securities litigation, various defendants and experts disputed the existence and significance of any disparity in a relevant financial ratio between WorldCom and comparable companies. See In re WorldCom, Inc. Securities Litigation, 02 Civ. 3288 (DLC) (S.D.N.Y. Dec. 15, 2004).


Crossing’s bankruptcy filing on January 28, 2002, the values of WorldCom’s stock and bonds declined sharply.\(^{30}\) On March 11, 2002, WorldCom announced that it received a request for documents and information from the SEC related to, among other areas, its accounting treatment for goodwill, loans to officers and directors, revenue recognition procedures, accounts receivable-related reserves, and certain write-offs.\(^{31}\) The company stated that it believed all its policies, practices, and procedures complied with all applicable accounting standards and laws. WorldCom’s credit ratings for its debt securities were downgraded several times in the first half of 2002, including on April 22–23,\(^{32}\) again on May 9–10,\(^{33}\) and again on June 17–20; the downgrades reduced WorldCom’s credit ratings from investment grade to “junk” status.\(^{34}\)

Among the numerous developments from WorldCom’s initial disclosure on June 25, 2002 until WorldCom (renamed as MCI) emerged from bankruptcy with restated financials on April 20, 2004,\(^{35}\) WorldCom filed for bankruptcy on July 21, 2002.\(^{36}\) On August 8, 2002, WorldCom announced it discovered an additional $3.3 billion in improperly reported earnings, intended also to restate its financials for 2000, and expected further write-offs of assets.\(^{37}\) WorldCom entered into a settlement investigation).


\(^{34}\) First Report, supra note 31, at 24 (noting that on or about June 17, 2002 WorldCom’s credit rating was downgraded).


agreement with the SEC on November 26, 2002. On March 12, 2004, MCI released restated financials for 2000 and 2001, as well as a financial statement for 2002, including impairment charges totaling $59.8 billion and $4.8 billion of charges to pretax income to correct line costs that had been reduced either by improper capitalization or inappropriate reductions to reserves.

B. FCC’s Public Statements Responding to WorldCom’s Disclosures

WorldCom’s press releases regarding its financial fraud identified its notice to and developments with the SEC but did not mention the FCC. Yet, the FCC did not treat WorldCom’s disclosure as outside the FCC’s concerns. Rather, the FCC immediately made public statements and took other actions demonstrating its responsibilities, capabilities, and roles in these developments. This Part highlights several FCC responses during the five weeks following WorldCom’s initial disclosure.

On June 26, 2002 (the day after WorldCom’s initial disclosure), FCC Chairman Michael Powell released the following public statement tying the Agency to continuity of telecommunications services, financing the telecommunications industry and public trust in the telecommunications sector:

I am deeply concerned by the WorldCom developments, and the impact it could have on consumers and other providers in the industry. We are closely monitoring the situation and are doing everything possible to ensure and protect both the stability of the telecommunications network and the quality of service to consumers.

To better assess the continuing troubles in the telecommunications industry, I will travel to New York on Friday to meet with a variety of telephone industry officials, analysts and debt-rating agencies to gain a first-hand understanding of the recent developments that continue to challenge the telecom industry. Through this exchange, I hope to assure the financial markets that the FCC is committed to doing whatever it can to assist in the recovery of the sector and strengthen the public trust in this vital segment of our economy.

Powell separately stated that within days he met with WorldCom’s


chief executive officer, John Sidgmore, to hear about WorldCom’s ability to maintain service quality, followed by “regular communications” between them.\textsuperscript{41}

Powell was appointed to serve on the interagency Corporate Fraud Task Force created by President Bush on July 9, 2002. The FCC Chairman stated a broad readiness by the FCC to assist on this matter. He stated that the FCC’s commitment to and role in restoring investor confidence in the telecommunications sector was inherent in the goals of the Telecommunications Act of 1996 (“1996 Act”):

> [T]he Commission stands ready to offer its expertise to assist in the effort to investigate and prosecute significant financial crimes and restore credibility to the market . . . . My colleagues and I deeply appreciate that the goals of the Telecommunications Act cannot be achieved without a concerted effort by government and corporate leadership to restore investor confidence. We are committed to doing our part.\textsuperscript{42}

The next day, in a publicly-released response to a letter from Congressman Edward Markey, Powell gave assurances that he and “the entire FCC” had undertaken “hard work . . . to minimize the threat of a WorldCom bankruptcy to continuity of service.”\textsuperscript{43} Powell described the FCC’s rules pursuant to Section 214 of the Communications Act of 1934 (“Communications Act”), as amended, which provide consumers with advance notice and an opportunity to migrate carriers in response to a request by a carrier to discontinue services.\textsuperscript{44}

In a press briefing on July 16, 2002, Powell pointed to the FCC’s ongoing attention to policy issues related to the industry’s financial crisis as well as the FCC’s surprise by WorldCom’s disclosure:

> The Commission will also additionally continue to consider the deep and continuing problems that the financial crisis presents for the telecommunications sector more broadly. I don’t need to remind any of you that the day before any [of] us learned about these seemingly heinous acts, that this stock was trading near a $1 anyway. There were problems in the telecom sector that were continuing to present stresses, and there was no sector who needed less to be kicked in the gut than the telecom sector at this moment in time.


\textsuperscript{43} Markey Letter, \textit{supra} note 41, at 2.

\textsuperscript{44} Communications Act of 1934, ch. 652, § 214, 48 Stat. 1064.
So we continue to be focused on what policy can do and regulatory authorities can do to continue to try to ensure the economic viability of competitors and the competitive visions that were imagined by Congress in the 1996 [A]ct. 45

The phrase “the day before any of us learned about these seemingly heinous acts” indicates that nothing about WorldCom’s reporting of line costs, other aspects of its financial reports, or other filings with or analysis by the FCC caused the FCC to suspect that WorldCom was engaged in a massive accounting fraud. 46 Similarly, eight days before WorldCom’s disclosure, Powell spoke about accounting scandals without any reference to WorldCom’s financial viability or line costs; referring to Enron’s disclosure of its financial fraud and the conviction of Arthur Andersen, he observed that accounting scandals create short-term pressures on both corporate boards and government agencies. 47

On the day that WorldCom announced its bankruptcy filing, Powell released a statement including this commitment: “Th[e] Commission will act vigilantly, and to the full extent of its statutory authority, to protect the integrity of the telecommunications network and protect consumers against any abrupt termination of service.” 48 Additionally, the FCC released a letter from Powell to Sidgmore dated July 22, 2002 describing the requirements for FCC approval prior to a restructuring or acquisition through bankruptcy proceedings, as well as notice to the FCC and customers prior to discontinuing services. 49 Powell referred to the importance of WorldCom’s bankruptcy proceedings “to millions of consumers and to the integrity of the nation’s communications network.” 50 The FCC issued a Consumer Bulletin highlighting the rights and protections consumers have in light of WorldCom’s bankruptcy filing, and the FCC sent a representative to the first bankruptcy hearing. 51


46. Id. See infra Part II, which reviews some of the FCC proceedings and actions during the accounting fraud.


50. Id.

51. Press Release, FCC, Federal Communications Commission Assures WorldCom Customers Concerning Continuation of Phone Services (July 26, 2002),
Finally, on July 30, 2002, Powell testified before the Senate Committee on Commerce, Science, and Transportation in hearings on “Financial Turmoil in the Telecommunications Marketplace: Maintaining the Operations of Essential Communications.” Addressing the immediate challenges posed by WorldCom’s bankruptcy, he stated the view that “[p]rotecting consumers from service disruption is our first and highest priority.” In describing six critical elements to managing the current turmoil and stabilizing the industry over time, Powell first discussed the work of the FCC and state regulators in ensuring continuity of telecommunications services and maintaining the integrity and reliability of the nation’s telecommunications network. In contrast, he next emphasized the importance of government actions aimed at rooting out corporate fraud, without any mention of the responsibilities, authority, or actions of the FCC.

Nevertheless, Powell’s testimony went on to request increased enforcement powers and penalties for the FCC. Powell asked Congress to provide the FCC with more tools to protect and promote the public interest in light of the financial challenges to the telecommunications industry. First, he asked for legislation clarifying the FCC’s authority over service discontinuance, including Internet backbone services. Second, he renewed his request made to Congress fifteen months earlier to increase the maximum fines allowable under the Communications Act, such as from $120,000 to $1 million for a single violation. While acknowledging the FCC’s existing rules, enforcement powers, and penalties, he stated: “It has remained my strong view that these increased penalties along with the stepped up enforcement of our rules will have a solid, deterrent effect

53. Id. at 1 (scroll down to page 4 of the pdf document).
54. Id. at 10 (scroll down to page 14 of the pdf document).
55. Id. at 10–11 (scroll down to pages 14–15 of the pdf document).
56. Id. at 16–17 (scroll down to pages 20–21 of the pdf document).
57. Id. at 16 (scroll down to page 20 of the pdf document).
against illegal activities.\textsuperscript{59} Third, he asked Congress to produce the right regulatory environment for broadband services, a key for the long-term recovery of the telecommunications industry and the nation’s economic growth.\textsuperscript{60}

Clearly, WorldCom’s disclosure and bankruptcy were front and center on the FCC’s radar screen from June 25 to July 30, 2002. However, the FCC did not initiate any formal investigations or enforcement actions against WorldCom during this period. The FCC began issuing public notices requesting comments on petitions filed by WorldCom and other persons on matters related to WorldCom’s disclosure and bankruptcy on July 31, 2002.\textsuperscript{61} As described in Part III, infra, the FCC did not address the imposition of any penalties or other sanctions against WorldCom until it adopted an order on December 15, 2003, in response to WorldCom’s application to reorganize and emerge from bankruptcy.\textsuperscript{62}

In contrast to the lack of formal enforcement action at the FCC in the days and weeks following WorldCom’s disclosure, the SEC commenced a formal investigation of WorldCom on June 26, 2002, requiring the company to file, under oath, a detailed report on its financial statements and disclosures by July 1st.\textsuperscript{63} On June 27th, the SEC filed a civil action charging WorldCom with accounting fraud totaling more than $3.8 billion and seeking appointment of a corporate monitor, an injunction prohibiting the destruction of documents, and other relief.\textsuperscript{64} The next day, the court agreed to appoint a corporate monitor and order WorldCom to preserve documents and assets.\textsuperscript{65}

\textbf{C. Analysis of the FCC’s Immediate Response}

WorldCom’s disclosure of massive financial fraud forced the FCC to

\textsuperscript{59} Powell Testimony, supra note 52, at 16 (scroll down to page 20 of the pdf document).

\textsuperscript{60} Id. at 17 (scroll down to page 21 of the pdf document).


\textsuperscript{62} WorldCom, Inc. and MCI, Inc., App. for Consent to Transfer and/or Assign Section 214 Authorizations, Memorandum Opinion and Order, 18 F.C.C.R. 26484, para. 25 (2003) [hereinafter WorldCom Emergence].


\textsuperscript{64} Litigation Release, SEC, SEC Charges WorldCom with $3.8 Billion Fraud, No. 17,588 (June 27, 2002), http://www.sec.gov/litigation/litreleases/lr17588.htm.

make several public commitments and take a range of actions. In the days and weeks following WorldCom’s initial disclosure, the FCC responded in three important ways.

First, the FCC took the leading role in attempting to limit the harms to the telecommunications marketplace from WorldCom’s financial problems, especially with regard to the continuity of telecommunications services to the public. Without trivializing the importance to the public of the FCC’s message, in effect, the FCC proclaimed that the company that committed billions of dollars worth of criminal fraud and caused shareholders to lose as much as $200 billion would not be allowed to disrupt telephone service to a single residential or business subscriber in any village or city in America. The FCC recognized that the WorldCom disclosure threatened what Powell called the regulators’ “first and highest priority.” Put differently, far from being a matter solely implicating the securities laws and the SEC, the FCC immediately connected WorldCom’s conduct and financial problems to key telecommunications policies and rules, including the universal availability of services, competition, and deployment of broadband services.

Second, the FCC accepted roles with regard to deterring and punishing corporate fraud at telecommunications carriers. Powell did not publicly allege that WorldCom violated FCC rules or was potentially liable for FCC monetary penalties; nor did the FCC initiate a public enforcement or formal investigation proceeding against WorldCom. However, Powell asked Congress for authority to impose increased penalties to strengthen the FCC’s ability to deter some harmful conduct in the post-WorldCom era. Even with the lower level of existing penalties, Powell acknowledged to Congress the FCC’s ability, pursuant to its existing authority, to increase its enforcement of rules against certain conduct related to WorldCom’s fraud. Moreover, the FCC joined the interagency Corporate Fraud Task Force and offered its assistance.

Third, the FCC acknowledged that it had no suspicion of WorldCom’s improper accounting for line costs prior to WorldCom’s disclosure. Despite the threat by WorldCom’s conduct and financial difficulties to important FCC policies as well as the FCC’s industry expertise, the FCC had not identified any deficiencies in WorldCom’s

---

67. See supra notes 48–49 and accompanying text.
68. Powell Testimony, supra note 52, at 1 (scroll down to page 5 of pdf document); see also supra note 53 and accompanying text.
69. Id. at 16–17 (scroll down to pages 20–21 of pdf document).
70. Id.; see also supra note 56 and accompanying text.
financial reports, reported line-cost expense to revenue ratio, or financial viability. Instead, the FCC recognized the industry’s financial turmoil starting before and worsened by WorldCom’s disclosure. Powell used the attention following WorldCom’s disclosure to focus Congress and the public on the need to establish a regulatory framework for the industry to generate new revenues and profits from broadband services. The FCC failed to initiate a formal investigation of WorldCom during this period.

It is also important to recognize some of the FCC’s policies and concerns which were not addressed as WorldCom fallout in Powell’s statements. Even though the FCC treated WorldCom as a nondominant carrier, lacking market power and not subject to rate regulation, accurate financial reports by WorldCom would have promoted several FCC policies regarding competitive markets. First, the FCC adopted rules to promote the availability of adequate information for consumers to choose among carriers in competitive, deregulated markets. Some customers—including the largest, the U.S. federal government—considered the financial strength of carriers in making selections. WorldCom’s illusory financial strength misled consumers and harmed competitors. Second, WorldCom’s reported profits led consumers and competitors to believe that its aggressive pricing was sustainable. While the FCC adopted price deregulation in the belief that markets would yield competitive, efficient pricing, WorldCom’s fraud undermined this policy. Third, the FCC chose to have market forces, rather than regulatory judgments, determine how

71. See Powell Press Briefing, supra note 45 and accompanying text; Powell Testimony, supra note 52, at 17 (scroll down to page 21 of pdf document).


capital would be deployed in the industry. WorldCom’s falsely reported profits channeled capital toward some carriers and business plans and away from others.  

Part III, infra, analyzes some of the FCC’s proceedings and other actions during the period of WorldCom’s fraudulent financial reports leading up to the responses to WorldCom’s disclosure. Part IV, infra, then considers what the FCC did to change its rules and analysis following its public commitments during the immediate post-disclosure period.

III. WHAT REGULATIONS DID THE FCC APPLY OR NOT APPLY TO WORLDCOM DURING THE ACCOUNTING FRAUD?

While WorldCom was engaged in massive accounting fraud, the FCC reviewed WorldCom’s financial reports and made determinations about its financial qualifications, character, and conduct in a wide range of proceedings. This Part describes the FCC’s proceedings and analysis in six categories: (A) findings of financial qualification and character for WorldCom’s licenses; (B) assessment of WorldCom as a financially strong competitor in authorizing other carriers; (C) audit of and reports by WorldCom; (D) industry statistical reports reflecting WorldCom’s financials; (E) enforcement actions; and (F) regulation of prices, terms, and conditions for services offered by local exchange carriers.

A. Findings of Financial and Character Qualifications for WorldCom’s Licenses

The FCC repeatedly found that WorldCom had the financial and character qualifications to hold licenses to use radio spectrum and other FCC authorizations, including in a multibillion dollar acquisition in January 2001, and grants of licenses in June 2002.

1. Legal Framework for the FCC’s Analysis of WorldCom’s Qualifications

The Communications Act addresses the financial and character qualifications of an applicant both directly and as part of the broader determination of the public interest. Section 308(b) addresses applications for radio licenses, including various types of microwave, paging, and satellite earth station licenses granted to WorldCom:

All applications for station licenses, or modifications or renewals thereof, shall set forth such facts as the Commission by regulation may

---

76. See Rebecca Blumenstein & Peter Grant, On the Hook: Former Chief Tries to Redeem The Calls He Made at AT&T—As He Retires, WALL ST. J., May 26, 2004, at A1; Sidak, supra note 3, at 228.
prescribe as to the citizenship, character, and financial, technical, and other qualifications of the applicant to operate the station . . . .77

Two other provisions dealing with granting and transferring licenses, Sections 214(a)78 and 310(d),79 require the FCC to determine that the “present or future public convenience and necessity” or “public interest, convenience, and necessity” will be served thereby. The FCC has interpreted these provisions as requiring a determination of financial and character qualifications, with the applicants bearing the burden of proof.80 In particular, radio spectrum is scarce and the FCC seeks to avoid situations where a licensee warehouses or otherwise fails to use a radio license because of a lack of financial capability.81

The FCC made such determinations regarding WorldCom and MCI


80. Schoenbaum v. FCC, 204 F.3d 243, 247 (D.C. Cir. 2000) (denying renewal of amateur radio license following felony conviction for fraudulent conduct. The court stated, “[I]t is well recognized that the Commission may disqualify an applicant who deliberately makes misrepresentations or lacks candor in dealing with the agency.”). The FCC has stated that it “would treat any violation of any provision of the [Communications] Act, or of the Commission’s rules or policies, as predictive of an applicant’s future truthfulness and reliability and, thus, as having a bearing on an applicant’s character qualifications.” GTE Corp., and Bell Atlantic Corp.; For Consent to Transfer Control of Domestic and International Sections 214 and 310 Authorizations, Memorandum Opinion and Order, 15 F.C.C.R. 14032, para. 429 (2000). See also Craig O. McCaw and American Tel. and Tel. Co. For Consent to the Transfer of Control of McCaw Cellular Comms., Inc., 9 F.C.C.R. 5836, para. 8 (1994) (requiring review of citizenship, character, financial, technical, and other qualifications of applicant); NYNEX Corp. and Bell Atlantic Corp. For Consent to Transfer Control of NYNEX Corp., Memorandum and Order, 12 F.C.C.R. 19985, para. 245 (1997) (finding necessary qualifications were satisfied by the company’s long history and broad experience); Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorization from[ ] S. New England Telecomm. Corp., to SBC Comm., Inc., Memorandum Opinion and Order, 13 F.C.C.R. 21292, para. 13 (1998) (asserting that public interest concerns are paramount when considering transfer applications).

many times prior to the period of fraudulent accounting. Two leading cases in this area involved these parties. First, in approving WorldCom’s acquisition of MCI in 1998, the FCC analyzed oppositions to the merger based on financial analysis by the Communications Workers of America (“CWA”) and others. CWA submitted what the FCC described as “extensive financial analysis,” contending that the debt taken on for this transaction would leave the merged entity financially weak; with the claimed “synergy” savings, the company would be forced to reduce network expansion and service to residential subscribers. The FCC rejected this claim as speculative. Relying on letters from the chief executive officers of WorldCom and MCI, the FCC accepted the applicants’ contentions that the merger would allow them to expand into residential markets more efficiently by avoiding duplicative capital and operating expenditures.

Second, in an earlier enforcement action, the FCC denied a petition to suspend or revoke licenses issued to MCI. Along with allegations of several specific rule violations, the petitioner alleged that MCI engaged in misrepresentation and lack of candor. The FCC applied a standard of “deceptive intent,” not merely the existence of a mistake in an application. Noting no evidence of intent to deceive as well as MCI’s expeditious resolution of disputes after notice of the error, the FCC held: “[W]hile we admonish MCI to exercise more care in its dealings with the Commission, we conclude that there has been no misrepresentation or lack of candor by MCI.”

In March 2002, the FCC adopted rules streamlining the applications and review for domestic Section 214 authorizations for both new authorizations and transfers. The streamlining was based on the FCC’s conclusion that a substantial number of transactions do not raise public

83. WorldCom-MCI Application, supra note 82.
84. Id. paras. 187–92.
85. See id.
86. Id. paras. 191–97.
88. Id. paras 35–43.
89. Id. para. 36.
90. Id. para. 43.
interest concerns and should be granted on an expedited basis.  

For applicants in the presumptively streamlined categories, which do not involve a financial-means test, the FCC’s rules do not require a showing of financial qualifications; rather, the streamlining gives the applicant flexibility in the issues it addresses in a statement showing how a grant of the application will serve the public interest, convenience, and necessity. 

2. Application of Financial and Character Qualifications Tests to WorldCom During the Fraud

The FCC granted a large number of WorldCom’s applications during the fraud period. In each case, the FCC determined that WorldCom satisfied its burden of proof as to its financial and character qualifications.

The most detailed order on WorldCom’s qualifications for licenses during the fraud period was adopted on January 17, 2001. The FCC approved the application pursuant to Sections 214 and 310(d) to transfer control to WorldCom of radio licenses and other authorizations held by Intermedia Communications, Inc. The financial information in the application was limited to statements that WorldCom’s revenues in 1999 were $37 billion and that the transaction would give the acquired company access to WorldCom’s capital. Without addressing WorldCom’s showing of its financial and character qualifications, the FCC found that the transaction was likely to serve the public interest by providing WorldCom with additional web-hosting assets, making it a stronger competitor in next-generation communications services to business customers. In opposing the application, AT&T Corp.—the sole party filing an opposition—alleged anticompetitive effects but did not challenge WorldCom’s financial and character qualifications. Apparently, the FCC and AT&T believed at that time that WorldCom clearly had the requisite financial and character qualifications. Similarly, the FCC did not request further information on WorldCom’s financial qualifications in connection with WorldCom’s

---

92. Id. para. 6.
93. Id.; 47 C.F.R. §§ 63.03–.04 (2002).
95. Intermedia Comm’ns. Inc., & WorldCom, Inc., Application for Consent to Transfer Control, CC Dkt. 00-206, at 4, 6 (2000), available at http://www.fcc.gov/transaction/worldcom-intermedia/wc-intermediaappli102300.pdf (scroll down to page 8 of pdf document) [hereinafter Intermedia Comm’ns. Inc.]. The application explained WorldCom’s intent to retain Intermedia’s controlling interest in Digex, Inc. (a web-hosting provider) and divest other Intermedia assets.
97. Id. paras. 7, 9.
application to acquire Sprint Corp., which was withdrawn in July 2000.98

Other WorldCom license applications were processed routinely during the fraud period. For example, the FCC’s files show grants of new earth station authorizations—radio station licenses allowing exclusive use of certain frequencies at a location for fifteen years—by the FCC’s International Bureau on June 18, 2002, only one week before WorldCom’s disclosure, for operation in Andover, Maine, and on June 6, 2002, for operation in Quicksburg, Virginia.99 The FCC’s application forms did not require WorldCom to file any financial information, but WorldCom did file with the FCC a verified copy of its 2001 Form 10-K annual report pursuant to the requirements of another FCC rule.100

B. Assessment of WorldCom as a Financially Strong Competitor in Authorizing Other Carriers

In reviewing applications by other carriers for various types of licenses or authorizations, the FCC made findings that these carriers faced strong actual or potential competition. Several orders from April 2001 through June 2002 identified WorldCom as having the technical, financial, and managerial qualifications to be a strong competitor in local and long-distance telecommunications services. These findings are in sharp contrast to the FCC’s fears expressed in the weeks following WorldCom’s disclosure as to “the immanency of possible collapse.”101

In an order on August 14, 1997, regarding the proposed merger of Bell Atlantic Corp. and NYNEX Corp., the FCC concluded that MCI along with AT&T Corp. and Sprint Corp. each had the “capabilities and incentives to acquire a critical mass of customers in the relevant [local and long-distance] markets and to do so relatively rapidly.”102 Citing MCI’s Annual Report, the order stated that “MCI serves approximately 15% of

98. See generally FCC, MCI WorldCom & Sprint, http://www.fcc.gov/transaction/mcwc-sprint.html (providing documents pertaining to the proposed merger of WorldCom and Sprint, including the application, correspondence with the FCC, and the official withdrawal).


102. NYNEX Corp. & Bell Atlantic Corp., Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries, Memorandum Opinion and Order, 12 F.C.C.R. 19985, para. 82 (1997).
long distance customers nationwide and had operating revenues of $18.5 billion in 1996, with net income of $1.2 billion."^{103}

The FCC repeated its findings as to WorldCom’s capability, incentive, and stated intention to serve the mass market for local exchange services in orders dated October 6, 1999,^{104} and June 16, 2000.^{105} Neither of these later orders reflected any analysis of WorldCom’s financials.

During the fraud period, the FCC continued to view WorldCom as a significant competitor in international long-distance and local services markets. In approving Deutsche Telekom AG’s acquisition of VoiceStream Wireless Corp. on April 24, 2001, the FCC referred to WorldCom as a significant competitor in the U.S. international services market and cited an FCC report showing WorldCom’s 1999 revenues from U.S. facilities-based and facilities-resale services at $5.45 billion.^{106} Similarly, the FCC pointed to WorldCom’s fiber-optic network for local services in Rochester, New York, in approving a transaction between Global Crossing Ltd. and Citizens Communications Co. on April 16, 2001.^{107}

Also during the fraud period, the FCC adopted a series of orders concluding that the Bell Operating Companies had sufficiently opened their local services markets to competition, and that the public interest would be served by authorizing them to provide in-region long-distance services.^{108} In each proceeding, WorldCom extensively contested the adequacy of the interconnections and support services provided to it by the relevant Bell Operating Company, the pricing of the Bell Operating Company’s wholesale offerings, and the extent to which WorldCom was an actual

---

103. Id.
105. GTE Corp. & Bell Atlantic Corp., Consent to Transfer Control of Domestic and International Sections, Memorandum Opinion and Order, 15 F.C.C.R. 14032, para. 118 (2000) (approving the merger of Bell Atlantic Corp. and GTE Corp).
competitive alternative for local services. The FCC found that WorldCom was one of the largest competing carriers that provided services to residential and business customers almost exclusively over its own facilities, an approach requiring high capital and operating expenses.\(^{109}\) The FCC closely addressed the challenges raised by WorldCom to the Bell Operating Companies’ conduct, examining whether such allegations should be treated as foreclosing entry and expansion by a competitor. In none of these orders, including one adopted one week before WorldCom’s disclosure, did the FCC analyze any aspect of WorldCom’s financial statements or question WorldCom’s financial capability to expand its local services.\(^{110}\)

C. Audit of and Reports by WorldCom

The FCC required WorldCom to file verified copies of its Form 10-K annual financial reports from 2000 and 2001, which were later substantially restated, as well as other financial reports.\(^{111}\) Moreover, the FCC conducted an audit of certain financial reports filed by WorldCom from mid-2000 through mid-2001.

The FCC adopted accounting standards and reporting requirements for telecommunications carriers and required independent audits or performed audits using its own staff for various purposes.\(^{112}\) Some standards, reports, and audits were applicable only to carriers that the FCC subjected to rate regulations based on their market power to charge supracompetitive prices.\(^{113}\) Since 1983, the FCC treated carriers like WorldCom as nondominant and not subject to rate regulations.\(^{114}\) Conversely, certain FCC accounting standards and reporting requirements were applicable to carriers like WorldCom, and the FCC staff audited nondominant carriers for certain purposes.

---

110. See supra note 108.
111. 47 C.F.R. § 1.785(b) (1993), § 43.21(b)–(c) (2002).
112. 47 U.S.C. § 218 authorizes the FCC to “obtain from [] carriers . . . full and complete information necessary to enable the Commission to perform the duties and carry out the objects for which it was created.”
113. These “dominant” carriers were limited to incumbent local exchange carriers from 2000 through 2002. See, e.g., 47 C.F.R. §§ 32.11(a) (uniform system of accounts), 64.903 (cost allocation manuals), 64.904 (independent audits); Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services, 16 F.C.C.R. 22745, Notice of Proposed Rulemaking, para. 41 (2001); Fourth Competitive Carrier, supra note 72, paras. 1–2, 6–7, 38.
114. Fourth Competitive Carrier, supra note 72, para. 38. See also supra note 16.
Historically, the FCC’s telecommunications accounting standards and audits were directed primarily at verifying carriers’ costs for purposes of determining whether carriers’ rates were just, reasonable, and nondiscriminatory. In 2000, the FCC revised its accounting requirements for dominant, incumbent local exchange carriers. The FCC sought to eliminate unnecessary reporting requirements and burdens while retaining sufficient information for the FCC and state commissions to meet their responsibilities. The FCC further reformed certain accounting and reporting requirements for these carriers in October 2001.

Aside from the reform of accounting and audit requirements for rate-regulated, dominant local exchange carriers, the FCC implemented new accounting and audit rules in several areas. The 1996 Act required the FCC to establish explicit support mechanisms for telephone service in high-cost areas and other programs through a federal universal service fund. In conjunction with contributions to and disbursements from the federal universal service fund, the FCC promulgated quarterly and annual filing requirements based on a system of revenue accounting for nondominant as well as dominant carriers. The FCC’s accounting forms required

115. 47 U.S.C. § 220 (2000); see also Qwest Communications, Inc. v. FCC, 229 F.3d 1172, 1178 (D.C. Cir. 2000) (describing the authority granted to the FCC with respect to financial audits and accounting when carrying out its mandate of ensuring the just and reasonable rates and practices of carriers). For example, in December 1997, the FCC, joined by a team of auditors from five state regulatory commissions, released a report looking at the basic property records of GTE Corp.’s telephone operating companies (local exchange carriers). The audit encompassed verification of physical assets, evaluation of procedures, and verification of plant additions, retirements, and transfers. GTE Tel. Operating Cos., Release of Information Obtained During Joint Audit, Memorandum Opinion and Order, 13 F.C.C.R. 9179 (1998); Joint Audit Report on the Basic Property Records of GTE Corporation’s Telephone Operating Companies, Executive Summary (Dec. 1997), http://www.fcc.gov/Bureaus/Common_Carrier/Reports/gteaudit.html.


120. See Federal-State Joint Board on Universal Service, Petition for Reconsideration
substantial detailed breakdown of the revenues of nondominant carriers such as WorldCom as well as the wholesale revenues from access charges for local exchange carriers. However, the accounting requirements were directed at the universal service fund contributions which were calculated based on certain categories of revenues. Carriers’ invested capital and expenses did not enter into the calculation of their regulatory payments, and thus, were not covered by this accounting and reporting system.

Other emerging areas for FCC reporting standards and audits around 2000 included numbering resource optimization with random and “for cause” audits by the FCC’s staff,121 and accounting and audits for the Bell Operating Companies’ compliance with conditions for their mergers or authorizations to provide long-distance services, including separation between the Bell Operating Companies’ subsidiaries providing long-distance services and their local exchange carriers.122 WorldCom and other nondominant carriers were also subject to detailed reporting requirements for their international services revenues, traffic, and facilities.123

The FCC’s accounting and audits staff conducted an audit of WorldCom’s charges to its customers for the federal universal service fee and related reporting of its revenues. The FCC’s audit included several requests for information from April 20, 2000 through June 5, 2001, as well as an on-site audit that was scheduled to begin on October 10, 2000.124 Among the issues addressed by the FCC’s investigation was a


124. Letter from Kenneth P. Moran, Chief, FCC, Accounting Safeguards Division, to Robert Lopardo, Agency Relations, MCI WorldCom (June 5, 2001) [hereinafter Moran Letter]; e-mail from Mark Gerner, FCC, to Lori Wright, MCI WorldCom (Apr. 20, 2001); e-mail from Chuck Needy, FCC, to Bradley Stillman, MCI WorldCom (Nov. 8, 2000); Letter from Hugh L. Boyle, Chief, FCC, Audits Branch, to Bradley Stillman, Agency Relations, MCI WorldCom (Sept. 21, 2000) [hereinafter Boyle Letter] (documents on file with the FCLJ).
reconciliation of revenue figures in WorldCom’s annual Form 10-K reports with revenue figures reported on the FCC’s forms for the universal service fund. The FCC did not issue a final audit report or notice of apparent liability related to its investigation of WorldCom’s accounting for universal service fund purposes or WorldCom’s charges to its customers. The FCC’s audit was for a limited purpose and did not examine WorldCom’s accounting for other regulatory charges, including access charges paid by WorldCom to local exchange carriers pursuant to tariffs filed with and reviewed by the FCC. Nevertheless, the FCC’s audit of WorldCom’s universal service fund accounting in 2000 and 2001 demonstrated the FCC’s ability to conduct an audit of aspects of WorldCom’s accounts related to important FCC policies and decisions.

D. Statistical Reports Reflecting WorldCom’s Financials

The FCC analyzed some aspects of WorldCom’s reported financials as well as related information from WorldCom’s competitors. The FCC published several reports reflecting WorldCom’s reported financials and such analysis. At least one FCC statistical report involved the agency in analyzing or at least presenting WorldCom’s fraudulent financials as filed with the FCC. During the fraud period, at least one other FCC statistical report involved the Agency in calculating and presenting cost-to-revenue benchmarks for the industry closely related to WorldCom’s fraudulently-manipulated ratio of line costs to revenues.

The FCC prepared and released a variety of quarterly and annual statistical reports on the telecommunications industry. These reports were intended to assist the FCC in satisfying its responsibilities by identifying industry developments which could cause the FCC to revise its rules or adjust its enforcement practices and by providing the factual basis for setting rates and other findings by the FCC in its proceedings. In addition to filing verified copies of their Form 10-K reports with the FCC, WorldCom and many other carriers had to report annually the value of their total communications plant and operating revenues.

125. Moran Letter, supra note 124.
127. See id.; Moran Letter, supra note 124.
129. 47 C.F.R. § 1.785(b) (1993), § 43.21(b)–(c) (2002).
In Statistics of Communications Common Carriers, 2000/2001 Edition, the FCC reported certain financial indicators for WorldCom. The FCC staff explained in the introduction to the report: “This statistical summary is produced after the data has been checked, inquiries on suspect items sent to the carriers, corrected submissions received, and the industry tables compiled.”

The first table presented selected data of twelve holding companies, including WorldCom as well as the other two largest long-distance carriers, AT&T and Sprint. The data was from the companies’ annual reports to shareholders and annual Form 10-K filings with the SEC. The 2000 financials shown for the companies included (a) revenues; (b) costs and expenses, which were reduced by WorldCom’s fraudulent transfer of line costs to capital expenditures; (c) net income, which was increased by this improper accounting; and (d) total assets and property, plant, and equipment, both categories which were increased by this improper accounting.

In Telecommunications Industry Revenues 2000, the FCC used data filed by all telecommunications carriers, including WorldCom, on FCC Form 499-A. The staff calculated the annual industry-wide ratio of access and universal service costs as a percentage of revenue per minute, for U.S. interstate domestic conversation minutes and for international conversation minutes. A table shows the trends for these ratios from 1992 through 2000. WorldCom’s line costs and revenues included components not captured by the FCC’s calculation of these ratios, such as intrastate and foreign services as well as nontelecommunications services. Nevertheless, these ratios reflected industry-wide benchmarks related to large components of WorldCom’s line costs and revenues. The FCC reports did not point to any noteworthy difference in this area.

E. Enforcement Action

The FCC pursued various types of enforcement actions before and
during the WorldCom fraud period. Some enforcement actions were
directed at WorldCom but not at its fraudulent accounting and financial
reports. Other enforcement actions were directed at several carriers’
misrepresentations and lack of candor but not at WorldCom’s financial
fraud and misrepresentations.

The FCC conducted investigations into and imposed fines on
WorldCom for a range of violations of the FCC’s consumer-protection
rules. Among the largest enforcement actions against WorldCom in 2000
were one consent decree for slamming violations—a changing of a
consumer’s preferred long-distance carrier without proper authority134—
another for misleading long-distance advertising,135 and a third for
violating rules on operator service provider consumer disclosures.136
Similarly, in March 2002, the FCC issued a declaratory ruling finding that
WorldCom’s and AT&T’s failure to provide consumers with a second
listing during directory assistance calls in accordance with their tariffs was
unjust and unreasonable in violation of the Communications Act.137

The FCC’s Enforcement Bureau also addressed intercarrier disputes
involving WorldCom during this period. For example, Verizon filed a
complaint against WorldCom claiming that WorldCom failed to pay per-
call compensation to payphone service providers for certain service
arrangements. In 2001, the FCC issued an order interpreting its rules for
payphone compensation and finding that WorldCom and one other carrier
owed Verizon damages.138

As for WorldCom’s submission to the FCC of verified Form 10-K
reports reflecting its fraudulent accounting, the FCC’s rule regarding
misrepresentations and candor stated in 1990–2002: “No applicant,
permittee or licensee shall in any response to Commission correspondence
or inquiry or in any application, pleading, report or any other written
statement submitted to the Commission, make any misrepresentation or
willful material omission bearing on any matter within the jurisdiction of

suggesting a voluntary contribution to the U.S. Treasury of $3.5 million and strengthening
WorldCom’s slamming compliance and monitoring policies).

135. MCI WorldCom, Inc., Order, 15 F.C.C.R. 4545, para. 1 (2000) (requiring $100,000
payment); Id. app., para. 4 (discussing WorldCom’s commitment against the use of
misleading advertisements).

136. WorldCom, Inc.; Operator Service Consumer Information Requirements, Order, 15
F.C.C.R. 21478, paras. 2, 5 (2000) (requiring $56,000 payment and implementing program
to ensure future compliance).

137. Curt Himmelman v. MCI Comm. Corp., Declaratory Order, 17 F.C.C.R. 5504,
para. 1 (2002).

138. Bell Atlantic-Delaware v. Frontier Comm. Servs., Memorandum Opinion and
the Commission.”

The FCC explained this standard as “absolute” and “fundamental.” Along with its standard of complete and accurate information, the FCC announced its dedication to strong, swift enforcement of its rules. This announcement was included in a speech by a commissioner only a few weeks before WorldCom filed its fraudulent Form 10-K in 2002.

There are several examples of FCC enforcement actions, before or during the WorldCom fraud period, against carriers based on false and misleading filings or lack of candor. After finding that a licensee filed incomplete and misleading information and failed to promptly and accurately report its unauthorized operations, the FCC denied fifteen applications for private operational fixed microwave service and imposed a forfeiture of $1,425,000. Similarly, the FCC revoked some of a licensee’s mobile services licenses and assessed a $10,000 forfeiture for failure to respond to FCC inquiries and filing a pleading that lacked candor. Also, in 2000, the FCC issued a public notice on proceedings to...

---

140. SBC Communications, Inc., Notice of Apparent Liability for Forfeiture and Order, 16 F.C.C.R. 19091, para. 42 (2001), where the FCC stated:
   The duty of absolute truth and candor is a fundamental requirement for those appearing before the Commission. Our decisions rely heavily on the completeness and accuracy of applicants’ submissions because we do not have the resources to verify independently each and every representation made in the thousands of pages submitted to us each day. . . . Moreover . . . our rules require companies promptly to correct inaccurate or incomplete information submitted to the Commission . . . .
   See also The Commission’s Forfeiture Policy Statement and Amendment of Section 1.80 of the Rules to Incorporate the Forfeiture Guidelines, Report and Order, 12 F.C.C.R. 17087, para. 21 (1997) (“Regardless of the factual circumstances of each case, misrepresentation to the Commission always is an egregious violation.”).
141. See David H. Solomon, Chief, FCC Enforcement Bureau, Doing Things Differently: The Enforcement Bureau’s First Year, Presented at The New Enforcement Bureau: Nuts, Bolts & Strategies (Sept. 27, 2000) (“I think the message is getting out to regulated companies that if you engage in a serious violation of the Communications Act or the FCC’s rules, there will now be serious enforcement consequences.”) (on file with the FCLJ).
determine whether an entity’s licenses and applications in the private local mobile service should be revoked or denied for misrepresentations or lack of candor as to real parties-in-interest, leading to revocation decisions in 2003 and 2004.145

Two forfeiture orders in 2001–02 addressed SBC’s failure to comply with these FCC requirements. In October 2001, the FCC issued a notice of apparent liability proposing a forfeiture of $100,000 for SBC’s failure to provide sworn verification of the truth and accuracy of answers to a letter of inquiry issued by the FCC.146 The FCC adopted a forfeiture order for this amount in April 2002.147 In another proceeding, the FCC investigated SBC’s submission of inaccurate factual information in affidavits supporting an application for authority to provide long-distance services. The FCC entered an order in May 2002 by which SBC paid $3.6 million to the U.S. Treasury and agreed to a compliance plan, including an independent audit.148

Three more illustrations of such enforcement actions deserve mention. In May 2002, the FCC found AT&T Wireless Services, Inc. apparently liable for a forfeiture of $2.2 million for making inaccurate statements in its request for a waiver.149 In October 2001, the FCC referred a matter to the Enforcement Bureau for further investigation involving potential rule violations when applicants for a transfer of control failed fully to disclose information on foreign shareholders.150 Finally, about one week before WorldCom’s disclosure, the FCC released an order based on its investigation showing an apparent pervasive pattern of misrepresentation in FCC filings by the Publix Companies in order to obtain payments from the telecommunications relay services fund.151


148. SBC Communications, Inc., Order, 17 F.C.C.R. 10780, app., paras. 4, 11 (2002). See id. at app. (incorporating the consent decree and compliance plan as part of this order in an appendix).


151. Publix Network Corp., Order to Show Cause and Notice of Opportunity for
F. Regulations of Prices, Terms, and Conditions for Services Offered by Local Exchange Carriers

As the second largest long-distance carrier and one of the largest competitive local exchange carriers, WorldCom was a major customer of the Bell Operating Companies and other local exchange carriers for access and other services. Information on WorldCom’s use of these services and the collection of revenues from WorldCom were important factors in developing rates which would cover the local exchange carriers’ costs.

The FCC regulated the prices, terms, and conditions for the local exchange carriers’ interstate access services; those services provided originations and terminations for interstate long-distance calls transmitted on interexchange carriers’ intercity networks. The FCC also promulgated rules addressing prices, terms, and conditions for the local exchange carriers’ wholesale local services, including resold local services, unbundled network elements, and unbundled network element-platforms.

WorldCom aggressively contested the rules, tariff filings, and other service proposals for these offerings, including many appeals to the courts. Generally, the FCC’s orders carefully addressed WorldCom’s factual assertions and other arguments.

The FCC’s review of these matters prior to and during the WorldCom fraud period considered the possibilities that the local exchange carriers would be asked to supply services to financially weak wholesale customers and would be left with uncollectibles from bankrupt wholesale customers. Generally, services provided to wholesale customers with

---

Hearing, 17 F.C.C.R. 11487, paras. 36–37 (2002). The FCC directed the companies to show cause as to why their authority to provide interstate common carrier services should not be revoked and referred specified issues for a hearing by an administrative law judge to determine whether the companies violated certain FCC rules. Among the issues was whether the companies violated the FCC’s rule requiring that they file true and accurate information on their expenses and investment. See id. para. 1.


154. See, e.g., WorldCom, Inc. v. FCC, 308 F.3d 1 (D.C. Cir. 2002); WorldCom, Inc. v. FCC, 246 F.3d 690 (D.C. Cir. 2001); WorldCom, Inc. v. FCC, 238 F.3d 449 (D.C. Cir. 2001).

155. WorldCom’s financial weakness and bankruptcy greatly changed the magnitude of these risks faced by local exchange carriers. To illustrate, SBC reported total interstate access uncollectibles from all carriers of $47.7 million in 2001. Verizon Petition for Emergency Declaratory and Other Relief, Policy Statement, 17 F.C.C.R. 26,884, app. B (2002) [hereinafter Verizon Petition]. On August 15, 2002, SBC told the FCC that it could lose as much as $300 million in WorldCom’s bankruptcy. Id. para. 17. Uncollectibles as a percentage of interstate access revenue generally rose from 1996 to 2001 for the Bell
usage-based pricing were billed in arrears, exposing local exchange carriers to potential uncollectibles. In 1984, the FCC limited proposed protections for uncollectibles in the access tariffs of incumbent local exchange carriers. These local exchange carriers were allowed to require deposits only from those customers with a proven history of late payment or without established credit. In 1986, BellSouth pointed to increasing telecommunications industry bankruptcies and sought additional protections. The FCC did not allow the requested deposit increase and allowed a reduction in the notice period to refuse orders or terminate service for nonpayment from thirty days to fifteen days only if the customer received its bill within three days after the billing date.

As for rate regulation, rates for interstate access services were developed annually with factors reflecting the carriers’ historic experience with uncollectibles. If a local exchange carrier experienced a rise in its uncollectibles resulting in an interstate rate of return below an authorized level, it could file for higher rates the following year or possibly a mid-term correction. Rates were required to be nondiscriminatory, with no difference based on the customer’s credit rating or other indicator of financial risks of nonpayment.

During the period of WorldCom’s fraud, there were no changes in the local exchange carriers’ access tariffs or local network offerings or in the related FCC rules reflecting the increased risk of uncollectibles from billings to WorldCom.

G. Analysis of the FCC’s Relevant Regulations During the WorldCom Accounting Fraud

The preceding description of six areas of FCC regulation during the WorldCom accounting fraud supports the following three observations.

Companies: BellSouth, 0.85% in 1996 to 1.43% in 2001; SBC, 0.39% in 1996 to 0.53% in 2001; Verizon, 0.53% in 1996 to 1.28% in 2001; but Qwest showed a decrease, 0.60% in 1996 to 0.49% in 2001. See also Statement of SBC Communications, Inc., Request for Initiation of Proceeding into Character of WorldCom, RM-10613 (Jan. 31, 2003), http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6513407629, at 6–8 [hereinafter SBC Statement] (describing the impacts of WorldCom’s fraud, SBC states that it is owed more than $600 million).


157. Investigation of Access and Divestiture Related Tariffs, Memorandum Opinion and Order, 97 F.C.C.2d 1082, app. D at 1169 (1984) (the FCC “recognize[d] that it is prudent for the telephone company to seek to avoid non-recoverable costs imposed by bad credit risks.”).


159. Verizon Petition, supra note 155, para. 9.
First, WorldCom was an active participant in FCC proceedings and a significant element of the FCC’s analysis and policies. Although the FCC did not conduct extensive financial analysis of WorldCom, the FCC believed WorldCom’s strong financials based on market capitalization, investments, and absence of challenges regarding WorldCom’s financial qualifications for large acquisitions. While WorldCom was regulated as a nondominant carrier, it was the focus of or a highly prominent party in a wide range of proceedings at the FCC. These included a multibillion dollar corporate acquisition by WorldCom; WorldCom’s applications for new or modified licenses; a noting of its competitive strength in other carriers’ corporate acquisitions and applications for authorizations; an audit of and reports by WorldCom; industry statistical reports; enforcement actions; and regulation of prices, terms, and conditions for services offered by local exchange carriers. In addition to being the second largest long-distance carrier and network operator, WorldCom was a leader in two industry directions actively promoted by the FCC, local exchange competition, and high-speed Internet services. Moreover, WorldCom was a leader in shaping and challenging the FCC’s regulation of the Bell Operating Companies.

Second, the FCC’s acceptance of WorldCom’s financials came despite performing a variety of related information collections and analysis as well as having some relevant staff capabilities. The Communications Act gave the FCC the authority to obtain from carriers full and complete

---

160. Fourth Competitive Carrier, supra note 72, paras. 35–37.
162. See supra note 99 and accompanying text.
163. See supra notes 107–09 and accompanying text.
164. See supra note 124.
165. See supra note 134–37 and accompanying text.
166. See supra note 132.
167. See supra note 3 and accompanying text.
170. See supra note 108 and accompanying text.
information necessary to perform its duties. The FCC required WorldCom to file verified annual financial reports, quarterly universal service fund reports with detailed revenue categories, and information in response to an audit and various investigations. The FCC imposed detailed cost and revenue accounting and reporting requirements on incumbent local exchange carriers, including their access charges which were a large part of WorldCom’s line costs. The FCC’s staff included auditors, accountants, economists, and industry analysts. The FCC imposed a strict standard of accuracy and candor in filings, and its enforcement actions included substantial penalties for misrepresentations by several carriers. Also, the FCC’s staff calculated and published industry-wide indices closely related to WorldCom’s ratio of line costs to revenues.

Third, the FCC embraced competitive market forces and deregulation during this period. By the time of WorldCom’s disclosure, the FCC had over two decades of experience with treating WorldCom and similar carriers as nondominant—not subject to rate regulation or authorizations prior to providing services or constructing or operating new lines. The FCC found that competitive market forces would provide consumers services at reasonable prices and on reasonable terms, with sufficient information for them to maximize their welfare in choosing among carriers and service offerings. Although the uncollectibles suffered by incumbent local exchange carriers rose in the period from 1996 through 2001 because of the bankruptcies of some nondominant carriers, the FCC viewed such bankruptcies as part of the competitive market forces which ultimately benefited consumers. In the period of WorldCom’s accounting fraud, the FCC was intently focused on increasing the competitive opportunities and challenges for nondominant carriers by opening local exchange services to competition and allowing the Bell Operating Companies to provide long-distance services. While the FCC viewed WorldCom as financially strong, the FCC did not view itself as responsible for requiring any

173. See discussion supra Part III.C.
174. See Biennial Review, supra note 118, paras. 1, 4–5.
178. See Verizon Petition, supra note 155; SBC Statement, supra note 155.
179. See infra Part IV.A.3.
180. See supra note 108 and accompanying text.
nondominant carrier to earn profits sufficient to cover its cost of capital or prudently invest its capital. The FCC did not consider the potentially destabilizing effect of the financial weakness of a large nondominant carrier on consumers, interconnected carriers, pricing, competitors, and investment.  

IV. AFTER SEVERAL YEARS, HOW DID THE FCC CHANGE OR NOT CHANGE ITS REGULATIONS RELATED TO WORLDCOM’S DISCLOSURE?

WorldCom’s disclosure threatened the FCC’s policy of universal, reliable telecommunications services as well as other FCC policies, including competition in long-distance and local services, expansion of high-speed Internet services, and reasonable revenues for incumbent local exchange carriers. This disclosure also implicated the quality and effectiveness of the FCC’s findings, analysis, and actions in a wide range of proceedings involving WorldCom’s financial qualifications, character, and conduct.

As described in Part II.B, supra, five weeks post-disclosure, Chairman Powell asked Congress to provide the FCC with more tools to protect and promote the public interest in the face of the financial challenges to the telecommunications industry. As of the date of this publication, approximately four years later, no such legislation has passed.

Within its existing statutory authority, the FCC had the ability to adjust its rules and take other actions related to WorldCom’s disclosure. Subpart A of this Part describes three FCC proceedings triggered by WorldCom’s disclosure. Subpart B considers several other aspects of the FCC’s post-disclosure regulations implicated by the disclosure—information filing and accounting requirements, license applications, audits, and enforcement actions. This analysis shows that while the management and corporate governance of WorldCom changed before the FCC approved the company’s post-bankruptcy licenses, the FCC did not substantially adjust its ongoing regulations or practices related to WorldCom’s disclosure.

A. FCC Proceedings Triggered by WorldCom’s Disclosure

Three sets of proceedings were triggered by WorldCom’s disclosure: (1) authorization for WorldCom to discontinue some noncore services, (2) requests to investigate WorldCom’s qualifications to hold licenses and to

181. See supra Part II.C.
182. See supra Parts II.B., III.
approve license transfers, and (3) requests by local exchange carriers to revise their tariffs to protect against uncollectibles. None of the FCC’s actions in these proceedings were significantly adverse to WorldCom or substantially changed the FCC’s rules or practices.

1. Discontinuance of Some Noncore Services

The FCC’s public commitment post-disclosure was to protect consumers against large-scale abandonment of service by WorldCom. The FCC rules required a carrier to give notice to the FCC and customers at least thirty days prior to discontinuing a service. The FCC could issue an order requiring the carrier to continue its service to some customers who would not be able to transition to such service or a reasonable substitute from another carrier. The FCC could also issue an order if the FCC determined that the public convenience and necessity would be otherwise adversely affected.

The FCC’s fears about massive service disruption caused by WorldCom’s financial weakness and subsequent bankruptcy did not materialize. WorldCom filed with the FCC for discontinuance of its resold wireless services but not for its mass-marketed landline or other core services. WorldCom continued to provide most of its services to end-users and interconnected carriers following its disclosure and throughout its bankruptcy.

The FCC issued five public notices from August 1 through August 21, 2002, inviting comments on WorldCom’s applications to partially discontinue the provision of wireless communications services.

183. Chairman Powell wrote to WorldCom’s CEO Sidgmore and Congressman Markey stating the FCC’s commitment to vigilant enforcement of its rules on service discontinuance, and the FCC issued a Consumer Bulletin. See supra notes 41, 49.


WorldCom provided these wireless services via resale of the services of five wireless network operators. These applications explained that WorldCom intended to transfer approximately 820,000 customers to the applicable network operators and had sent notice of its intent to discontinue service to another approximately 534,000 customers. At that time, there were six wireless carriers with radio licenses and network facilities to serve most of the nation, in addition to regional carriers operating their own networks and other resellers. The FCC did not block or delay WorldCom’s proposed discontinuance of service to any of these customers.

In addition, on August 15, 2003, WorldCom applied to transfer to a subsidiary of Nextel Communications, Inc. licenses it used to provide fixed wireless broadband data services to approximately 1,400 customers in 13 markets. No discontinuance of service was involved. The FCC approved the transfer on April 2, 2004.

2. WorldCom’s Licenses

The FCC did not revoke any WorldCom license, disqualify WorldCom from applying for additional licenses, or impose a monetary penalty on WorldCom for its fraudulent filings. The FCC approved transfers of WorldCom’s licenses to and from the bankruptcy debtor in possession.

The issue of possible revocation arose in connection with a petition filed by the Office of Communication of the United Church of Christ, Inc. (“UCC”). UCC’s petition filed on October 15, 2002, requested that the FCC “establish new standards of conduct that w[ould] be required of all telecommunications providers . . . .” The petitioner explained that the WorldCom fraud merely served as an example of the Commission’s need to act, and that the petition was forward-looking, not seeking any punitive or adjudicative action against WorldCom. Seven weeks later, the FCC issued a public notice establishing dates for filing comments on this petition.
SBC and Verizon filed comments on this petition urging the FCC to initiate such an investigation and revoke WorldCom’s licenses. These companies argued that WorldCom’s accounting fraud and filing of false financial reports with the FCC demonstrated insufficient character qualifications and harmed the telecommunications industry.

In contrast, WorldCom opposed the initiation of such an investigation, pointing to the SEC’s actions and the FCC’s reliance on market forces:

[The FCC] has in place those accounting rules it believes are needed to fulfill its core regulatory functions.

At bottom then, petitioner is requesting that the Commission establish rules designed to prevent accounting fraud more generally. But it cannot explain why the Commission should duplicate the efforts of Congress and the SEC in setting such rules, or the SEC and the Department of Justice (“DOJ”) in enforcing those rules. . . .

Common carriers should be allowed to compete. If they break the law, they should be subject to enforcement action by the appropriate regulatory body [SEC], as WorldCom has been. But denying carriers licenses in advance based on the Commission’s assessment of their character would vastly reduce the competition that is the best hope for eliminating the current financial woes in the telecommunications industry. Indeed, the Commission has repeatedly concluded as much over the past twenty-five years, determining that initiation and expansion of service by common carriers generally requires no scrutiny at all. The Commission has emphasized that the market, rather than regulators, will best discipline competitors. That remains the case today.

As for WorldCom’s qualifications to hold FCC licenses, WorldCom claimed that it had fulfilled its responsibilities as a telecommunications carrier. Moreover, WorldCom argued that revoking its licenses would “cause vast harm to the mill [sic] ions of consumers who have chosen to

---


193. See id. at i (providing WorldCom’s argument that petitioner could not demonstrate how it had failed to fulfill its responsibilities as a telecommunications carrier).
continue their service with WorldCom and would pose a huge blow to the telecommunications infrastructure . . . .”

Qwest, which was the subject of an SEC investigation and in the process of restating some of the financial reports it had filed with the FCC, also opposed UCC’s petition, asserting that an FCC investigation would be duplicative and unnecessary in light of the SEC’s actions to address concerns regarding corporate governance and accounting. The FCC did not make any determination on the merits of this petition, initiate such a general rulemaking proceeding, or initiate a WorldCom-specific investigation or revocation proceeding.

On December 5, 2002, more than four months after WorldCom’s bankruptcy filing, the FCC denied the objection of UCC to the pro forma assignment of licenses to WorldCom and its subsidiaries as debtors in possession. That order observed: “as the licensee is receiving no compensation as a result of the assignment, no deterrence interest would be served by denying the application. Also, the public will not be prejudiced by the change in the status of the licensee.” This rationale appears disingenuous in that WorldCom’s creditors benefited from the assignment, and any FCC condition or the commencement of an FCC investigation in this high-profile bankruptcy may have sent a strong signal to the marketplace to deter future fraud.

Anticipating its emergence from bankruptcy, on June 13, 2003, WorldCom applied to transfer its licenses from the debtors in possession to the newly formed MCI. UCC and one other party alleged that the character of the transferor and transferee raised public interest concerns. The FCC’s order referred to the extraordinary reviews of WorldCom’s governance structure, accounting policies, and internal ethics that had occurred as a result of the SEC’s actions. The FCC also noted that the officers and employees involved in the accounting fraud had left the company, and there was a new board of directors with a radically reformed governance structure.  

---

194. Id. at 3.
196. See WorldCom Emergence, supra note 62, paras. 8, 27.
198. Id.
199. WorldCom Emergence, supra note 62, para. 1 n.l.
200. Id. para. 13.
201. Id. para. 16.
governance structure. Consequently, the FCC found that the new MCI satisfied the character qualifications for a licensee and approved the license transfers. The order went on to describe how the FCC’s approval of the license transfers promoted the policies and procedures of the bankruptcy laws and was consistent with FCC precedent dealing with licensees emerging from bankruptcy.

3. Local Exchange Carriers’ Protection Against Uncollectibles

On July 24, 2002, Verizon filed a Petition for Emergency Declaratory and Other Relief based on the potential impact of WorldCom’s bankruptcy filing three days earlier as well as other telecommunications bankruptcies. Verizon claimed that to achieve the “vital goal” of “ensuring continuity of services by limiting the financial fallout from the difficulties facing WorldCom and other firms in the industry . . . it is essential that surviving carriers be able to protect their ability to obtain payment for services that they are required to provide to financially troubled companies.” Verizon asked the FCC to permit carriers to revise their tariffs to require advance payments, security deposits, and shorter notice periods for discontinuing service following a failure to make payment. Several local exchange carriers, including Verizon and SBC, filed tariff revisions to increase their interstate access rates and universal service charges to cover the claimed increased cost of rising uncollectibles. WorldCom filed an opposition to the petition, claiming that incumbent local exchange carriers did not require additional protections that would harm their customers.

Five months after Verizon filed this petition, the FCC adopted a policy statement providing general guidance to local exchange carriers on these issues. The FCC acknowledged the problem of millions of dollars of accrued but unpaid pre-bankruptcy-petition interstate access charges at stake for local exchange carriers created by the WorldCom and other telecommunications industry bankruptcies. On the other hand, the FCC expressed concerns about the possible application of the requested

202. Id. paras. 15–16.
203. Id. paras. 13, 32.
204. Id. paras. 15–21.
205. See Verizon Petition, supra note 155, para. 2.
206. Id. (citation omitted).
207. Id. para. 4 n.12.
209. Verizon Petition, supra note 155, para. 15.
protections in a discriminatory manner as well as the potential burdens on long-distance carriers.\textsuperscript{210} Also, the FCC pointed to evidence that bankruptcy courts gave priority to the claims of local exchange carriers so that the bankrupt carriers could continue serving their customers.\textsuperscript{211}

The FCC found that the proposed additional deposit requirements were not warranted but recommended other tariff provisions to address the risk of nonpayment, including a tighter definition of “proven history of late payments” in existing tariffs, accelerated billing cycles, shortened intervals for discontinuance of service following a failure to make payment, and billing in advance for usage-based services based on average usage over a sample period.\textsuperscript{212} As for rate increases to offset uncollectibles, the FCC investigated the proposed increases and allowed some to take effect.\textsuperscript{213}

Along the same lines, in August 2002, the National Exchange Carrier Association, on behalf of various small local exchange carriers, filed a proposed tariff to increase the circumstances under which the carriers could require security deposits and to revise provisions for discontinuance of service.\textsuperscript{214} WorldCom and Sprint filed petitions to reject or, alternatively, to suspend and investigate this tariff. The FCC found substantial questions regarding whether the tariff was unjust and unreasonable, unreasonably discriminatory, or impermissibly vague. The FCC suspended the tariff for five months and instituted an investigation. The tariff filing was withdrawn in January 2003 after the FCC released its policy statement responding to Verizon’s petition.\textsuperscript{215}

In short, the FCC recognized that the WorldCom and other carrier bankruptcies created financial losses for local exchange carriers but balanced this problem against concerns about deterring competitive services by, or increasing the costs of, some small or financially weak long-distance carriers. The FCC allowed some targeted tariff revisions and cost-justified rate increases.

\textbf{B. Continuation of Other FCC Regulations Related to WorldCom’s Disclosure}

Following the FCC’s expressions of interest in July 2002 in deterring fraud by telecommunications carriers, the FCC did not tighten its rules or

\begin{itemize}
\item \textsuperscript{210} Id. paras. 21–29.
\item \textsuperscript{211} Id. para. 19.
\item \textsuperscript{212} Id. para. 26.
\item \textsuperscript{213} See Verizon Petition, \textit{supra} note 155, para 2.
\end{itemize}
practices in four areas: (1) information filing and accounting requirement for nondominant carriers, (2) license applications, (3) audits, and (4) enforcement actions.

1. Information Filing and Accounting Requirements for Nondominant Carriers

It is not apparent that the FCC adopted any new forms or other requirements for nondominant carriers to report financial information in the wake of WorldCom’s disclosure. Nor did the FCC develop and publish new industry benchmark analysis of the financial data it collected that might be useful to private-sector industry analysts in identifying outliers and potential corporate fraud.

On September 5, 2002, the FCC issued an order convening a Federal-State Joint Conference on Accounting Issues (“Joint Conference”) “to ensure that regulatory accounting data and related information filed by carriers are adequate, truthful, and thorough.”216 In November 2002, the FCC placed several accounting changes on hold for incumbent local exchange carriers that would have eliminated some accounts, in light of the accounting scandals.217 The next month, the Joint Conference sought comments on some specific accounting issues as well as a series of broader issues on possible greater roles for regulatory accounting and audits in deterring fraud.218 That order noted: “Recently there has been increased public concern over the adequacy of financial accounting.”219 There was no further analysis of the restatements by major carriers, the Sarbanes-Oxley Act, or the investigations of telecommunications carriers by the SEC.

Neither the Joint Conference nor the FCC addressed the broader issues on which comments were invited.220 The Joint Conference noted that the regulatory accounting rules were intended to provide an accurate financial picture of carriers:

After the FCC finished its review and issued its order in 2001, the financial and accounting scandals that rocked the telecommunications industry began to surface. The economic impact on individual carriers as well as on the country as a whole has not been fully quantified but is

219. Id. at 24903.
220. See Accounting Order, supra note 217, 11772–73 (Statement of Comm’r Michael J. Copps, approving in part, dissenting in part); see also id. at 11775 (Statement of Comm’r Jonathan S. Adelstein, approving in part, dissenting in part).
known to be significant. . . . [T]he broader purpose of section 220 [of the Communications Act is] to ensure that investors and regulators are presented with an accurate picture of the financial health of the carriers.221

However, the Joint Conference’s recommendations and the rules adopted by the FCC only addressed the financial picture of the incumbent local exchange carriers.222 The FCC reinstated some of the accounts for the incumbent local exchange carriers that were subject to the suspended rule changes.223 There was no action imposing, and not even a discussion of, regulatory accounting requirements for or audits of nondominant carriers like WorldCom. This result was consistent with the policy stated in an earlier order that certain “specific accounting rules and reports were no longer necessary or were outdated in the ‘pro-competitive, deregulatory’ national policy framework for the telecommunications industry.”224

2. License Applications

The FCC’s streamlined rules for transfer of control of many telecommunications carriers do not require a showing of financial qualifications.225 Also, the FCC’s Form 601 used by applicants for radio station licenses does not require any filing of financial information or certification of financial qualifications, except in connection with bidding preferences for small entities in auctions.226

Many applications involved transfers of control over small nondominant carriers, such as providers of domestic interstate and international services which resell other carriers’ lines.227 The potential for financial fraud by and bankruptcy of such transferees would not raise the concerns about substantial service disruptions that the FCC voiced

222. See id. at 27033.
223. Accounting Order, supra note 217, paras. 15–18.
224. Joint Conference Recommendations, supra note 221, app. A at 27021.
225. Streamlining Order, supra note 91, paras. 2–3, 37; 47 C.F.R. §§ 63.03–.04.
following WorldCom’s disclosure. However, even in cases of acquisitions of dominant local exchange carriers by entities that were not publicly held—and in at least one case by a newly-formed entity with no prior FCC license or authorization—and in acquisitions of scarce radio licenses, the FCC has approved transfers without analysis of the transferee’s financials.228

In two long orders approving multibillion dollar consolidations of wireless carriers in July and August 2005, the FCC found no need to re-evaluate the qualifications of the transferor and transferee.229 The FCC noted that the applicants were previously found qualified to hold licenses, and no party raised issues with respect to the applicants’ qualifications. Moreover, the FCC’s market analysis of competition referred to various carriers (e.g., national, regional, and local, including privately-held companies) as competitors with the ability to add capacity, without considering their financial strength.230

The FCC continued to be concerned about the financial qualifications of radio licenses. These concerns were generally manifested not in the FCC screening applicants’ financial statements,231 but rather in establishing

---


230. See ALLTEL, supra note 229, paras. 70–71, app. C; Sprint, supra note 229, paras. 2–3, app. C.


3. Audits

The FCC continued to utilize audits in several areas. However, since WorldCom’s disclosure, apparently there has been no public notice of an audit of a carrier conducted or ordered by the FCC investigating whether there was fraudulent reporting of access charges paid, earnings, or property, plant, and equipment investments.

As before WorldCom’s disclosures, one application of audits related to compliance by the Bell Operating Companies with certain structural, nondiscrimination, and accounting safeguards related to their offerings of long-distance services.\footnote{See Verizon Telephone Companies, Inc., Order, 19 F.C.C.R. 14409, para. 4 (2004) (providing the independent auditor’s biennial report that identified certain issues, leading to investigation by FCC staff); Enforcement Bureau Seeks Comment on Verizon Communications, Inc., Public Notice, 20 F.C.C.R. 11880, 11880 (2005).} Similarly, the FCC decided in 2005 to continue requiring independent audits by Verizon and SBC to evaluate compliance with conditions imposed in orders approving prior mergers.\footnote{See GTE Corp., Order, 20 F.C.C.R. 791, paras. 2, 4, 6, 10, 67 (2005); Ameritech Corp., Order, 20 F.C.C.R. 796,800, paras. 8–9 (2005).}

contribute to the universal service fund. Other FCC audit and enforcement activities were focused on compliance with the FCC’s equal employment opportunity rules.

4. Enforcement Actions

After WorldCom’s disclosure, it does not appear that the FCC imposed any penalties on a licensee or other party for misrepresenting or lacking candor in connection with its financial condition. More generally, it does not appear that the FCC significantly increased its enforcement activities for any misrepresentation or lack of candor.

In March 2003, the FCC adopted an order amending its rules concerning truthful statements. This amendment was pursuant to a notice of proposed rulemaking adopted in February 2002, before WorldCom’s disclosure. The new Section 1.17 rule was intended to be more precise in defining the standard of care required, thereby enhancing the effectiveness of the FCC’s enforcement efforts. The new rule prohibits written and oral statements of fact that are intentionally incorrect or misleading, as well as written statements made without a reasonable basis for believing that the statement is correct. The FCC’s order did not mention WorldCom or false filings of financial information.

As for enforcement activity generally involving Section 1.17, the FCC completed several investigations begun prior to WorldCom’s disclosure, resulting in license revocations. These orders cited violations of Section 1.17 and other sections of the FCC’s rules. Another investigation of a manufacturer of ultrasonic cleaning devices, initiated after June 2003, resulted in a consent decree. The FCC’s order required a $75,000 contribution to the U.S. Treasury and implementation of an FCC regulatory


243. See Brasher Decision, supra note 145; Ralph H. Tyler, Order, 18 F.C.C.R. 16241, para. 1 (2003) [hereinafter Tyler Order].

compliance plan. The manufacturer had to train its employees regarding compliance with the FCC’s rules to ensure and maintain the accuracy and completeness of any materials or information provided to the FCC, appoint a compliance officer, and take appropriate disciplinary action against any employee that intentionally made any misrepresentation or engaged in any lack of candor in any submission to the FCC.

Aside from not imposing a monetary fine or license revocation on WorldCom, the FCC did not even require WorldCom to implement a regulatory compliance plan. MCI announced another restatement in January 2006, involving FCC-regulated expenses, again without action by the FCC. Moreover, the FCC did not take enforcement actions against other carriers based on inaccurate or incomplete financial filings. For example, Qwest Communications International, Inc., in 2003, and Global Crossing Ltd., in 2004, announced substantial restatements of financial reports that had been filed with the FCC. Neither company was in bankruptcy at the time of such restatement. The FCC did not initiate an investigation or enforcement action against either company related to its misrepresentation through filing false financial reports. The FCC did not require employee training on providing accurate financial information to the FCC, the installment of a compliance officer, or disciplinary actions.

245. Id. paras. 10–11, 17 of Consent Decree.
246. Id. para. 3 of Compliance Plan.
247. Id. para. 11 of Consent Decree.
248. Id. para. 4 of Compliance Plan. See also Virgin Islands Tel. Corp. d/b/a Innovative Tel., Order, 19 F.C.C.R. 18535, para. 8 (2004) (requiring compliance manual and training program with regard to universal service fund payments in Virgin Islands Telephone Corp).
C. Analysis of the FCC’s Maintenance of its Regulations and Practices Following its Public Statements on WorldCom’s Disclosure

Two general observations flow from the preceding description of the FCC’s actions after its public statements and other responses during the initial weeks following WorldCom’s disclosure.

First, the FCC did not have to deal with any significant loss of service related to WorldCom’s financial weakness and bankruptcy. Service continuity was the centerpiece of the FCC’s public commitments in the days and weeks following WorldCom’s disclosure. From one perspective, the FCC’s rules pursuant to Section 214 of the Communications Act—together with the FCC’s statements notifying WorldCom and consumers of such regulatory obligations and intervention in WorldCom’s bankruptcy proceeding—effectively protected the interests of consumers and interconnected carriers in reliable telecommunications services. WorldCom gave advanced notice to consumers and the FCC of its plans to discontinue its wireless resale services, and the FCC decided not to block the discontinuance or extend the notice period to accommodate any consumers who would lack a reasonable alternative service provider. It appears that the consumers experiencing discontinuance of WorldCom’s wireless services readily transitioned to alternative service providers during the thirty-day notice period.

From another perspective, the FCC was fortunate not to confront plans by WorldCom to discontinue any of its mass-marketed landline or other core services. In particular, if WorldCom had discontinued some of its Internet services, the FCC would have lacked the statutory authority to protect consumers and interconnected Internet services providers from the service disruption.252

Second, WorldCom’s disclosure did not lead the FCC to substantially change its regulations or practices. The FCC did not impose any penalties or a regulatory compliance plan on WorldCom. Nor did it impose accounting requirements on nondominant carriers; generally require more financial information from applicants; scrutinize the financial qualifications of applicants or their competitors; audit reported expenses related to access charges or reported investments in property, plant, and equipment; or pursue enforcement actions based on misrepresentations of financial information.

Powell broadly proclaimed in his July 2002 Congressional testimony

---

252. See Markey Letter, supra note 41, at 2; Powell Testimony, supra note 52, at 16 (scroll down to page 20 of pdf document).
that rooting out corporate fraud was a critical step for government to take to manage the financial turmoil in the telecommunications marketplace. Yet, far from tightening its regulations and enforcement activity regarding possible financial fraud of WorldCom’s ilk, the FCC was largely on the sidelines as a supporter for actions by Congress, the SEC, and the Justice Department against corporate fraud in the telecommunications marketplace.

V. WHAT EXPLAINS THE FCC’S RESPONSE TO WORLDCOM’S DISCLOSURE?

This Part considers several explanations for various aspects of the FCC’s response to WorldCom’s disclosure in terms of (A) protecting consumers and rooting out corporate fraud and (B) partial explanations for the FCC’s stance on financial fraud.

A. Protecting Consumers and Rooting Out Corporate Fraud

It is easy to understand the FCC’s high profile role on consumer protection following WorldCom’s disclosure.

Neither the SEC nor the Justice Department was in a position to address the consumer fallout of WorldCom’s fraud. WorldCom had millions of customers for long-distance and local telephone services and was the largest provider of Internet backbone services. What if WorldCom’s financial fraud meant that it would shortly choose or be forced to shut down its lines and switches? The Internet services provider Excite@Home did that in December 2001.254 The FCC stepped into a vacuum not occupied by other governmental authorities. These steps did not require promulgating new rules through emergency actions or mobilizing teams of government engineers and accountants. Rather, the FCC merely publicized its existing rules and asserted its readiness to enforce them.

Six months earlier, the Federal Energy Regulatory Commission (“FERC”) provided precedent for a regulatory stance involving close

---

253. “The degree of deception and malefeasance that has been uncovered in recent weeks is deplorable. There is no hope for any sector of the economy if corporate leadership and government do not root out and stomp out such deception and breach of public trust.” Powell Testimony, supra note 52, at 10 (scroll down to page 14 of pdf document).

market monitoring by regulators without rules or intervention to protect against potential disruptions to customers. Following Enron’s disclosure of fraud and bankruptcy filing, the FERC reported that it engaged in more vigorous monitoring of wholesale electric and gas markets, but that the competitive markets produced by deregulation showed price stability and no disruption in deliveries.255

Along these lines, Powell’s statement on June 26, 2002, indicated the FCC was “closely monitoring the situation” without describing the FCC’s rule on service discontinuance.256 Instead of later pointing aggressively to its regulatory controls over service discontinuance, the FCC perhaps could have assured Congress and the public that WorldCom was merely a nondominant carrier in markets with financially strong alternative service providers. The FCC could have released industry data on competitors and their capacity to serve all of WorldCom’s customers and interconnected carriers. Also, the FCC could have encouraged other providers to publicize their readiness and procedures to serve any WorldCom customers.257

Such a nonregulatory response by the FCC to WorldCom’s disclosure would have been inadequate. There were well-founded concerns that, despite the abundance of industry transmission capacity, there would have been substantial service disruptions in transitioning millions of customers and complex networks to other providers. Powell had bemoaned the FCC’s lack of statutory authority to apply its service discontinuance rules to protect Excite@Home’s Internet service subscribers;258 he could hardly waive such protections for the many more WorldCom customers for basic telephone services. Moreover, as Powell observed eight days before WorldCom’s disclosure, there was widespread support for big government to step in to address the occurrences of corporate fraud and their fallout.259

The more difficult question involves the FCC’s stance on deterring, detecting, and punishing financial fraud by telecommunications carriers. Other federal government agencies, especially the SEC and Justice Department, moved quickly to address Enron’s misconduct disclosed in


258. See Markey Letter, supra note 41, at 1–2; Powell Testimony, supra note 52, at 16 (scroll down to page 20 of pdf document).

259. See Powell Remarks, supra note 47, at 4.
November 2001 and Arthur Andersen’s relation to it. The SEC was already investigating WorldCom’s accounting practices. Congress and the public could look to the same agencies to address many aspects of WorldCom’s fraud. In fact, WorldCom’s initial press release stated that WorldCom had notified the SEC, and the SEC announced the next day that it commenced a formal investigation.

In the weeks following WorldCom’s disclosure, Powell issued a statement on his appointment to the interagency Corporate Fraud Task Force and asked Congress to increase the amounts of penalties that the FCC could impose in order to deter corporate fraud more effectively. Given the actions of the SEC and Justice Department as well as pending legislation in Congress to strengthen the securities laws applicable across industries, why did the FCC step forward in these areas? Moreover, these steps were not as strong as if the FCC undertook a formal investigation of WorldCom’s fraudulent filings at the FCC, their effects, and penalties. Why did the FCC not take more aggressive actions against financial fraud?

During the five months prior to WorldCom’s disclosure, the SEC conducted formal investigations of WorldCom, Global Crossing, and Qwest. The FCC took no public role in assisting the SEC in these investigations, such as by providing access to its files and industry expertise. The FCC did not testify in Congressional hearings related to these SEC investigations of telecommunications carriers. Nor did the FCC launch its own formal investigations of any of these companies’ financial frauds or initiate proceedings on possible rule changes in light of such market conduct.

It appears that WorldCom’s disclosure was so shocking and massive that it changed the game for the FCC. The public record does not indicate whether (a) Powell volunteered for an FCC role on the interagency Corporate Fraud Task Force in light of the financial turmoil in the telecommunications industry, (b) the SEC or Justice Department requested participation of the FCC with its industry expertise, or (c) the White House initiated a role for the FCC to show that it was marshalling all of the relevant Executive Branch and administrative agency resources to address the issue of corporate fraud in the wake of WorldCom’s disclosure. The Corporate Fraud Task Force’s First Year Report and Second Year Report

260. See Powell Appointment, supra note 42; Powell Testimony, supra note 52, at 16–17 (scroll down to pages 20–21 of pdf document).
261. See SEC Charges Qwest, supra note 7; Global Crossing Press Release, supra note 8; First Report, supra note 31.
pointed to minimal contributions from the FCC.263

When Powell testified to the Senate committee on July 30, 2002, his legislative wish list included increased authority to impose penalties. Did he intend to impose penalties on WorldCom and other filers of fraudulent financial statements to the full extent of the FCC’s authority? Did he believe that larger potential FCC monetary fines would have a significant deterrent effect in light of the FCC’s existing authority to revoke licenses as well as the enforcement powers and practices of the SEC and Justice Department? Probably not. This request was at the end of his testimony after he discussed the importance of governmental actions to root out corporate fraud in the telecommunications industry without any mention of FCC investigations or potential penalties.264

In the post-Enron world, the FERC also asked Congress to expand the FERC’s penalty authority to create stronger deterrents to anticompetitive behavior, market manipulation, and other violations of the Federal Power Act and Natural Gas Act.265 Before Enron disclosed its financial fraud, the SEC initiated its own investigation of Enron separately from any FERC action.266 After Enron’s disclosure, the FERC jumped in with several extensive investigations and rulemaking proceedings.267 The matters before the FERC ranged from whether Enron submitted false information to obtain a FERC certification, to proposed changes in FERC’s accounting and disclosure requirements, and to whether Enron illegally manipulated markets for power in California and other Western states.268 The FERC


264. See Powell Testimony, supra note 52, at 10–11, 16.


268. Of course, there are many differences between the issues raised by WorldCom’s disclosure and those raised by Enron’s disclosure. The disclosure revealed that WorldCom adjusted its book entries at or after the end of a fiscal quarter; it did not appear that WorldCom earned high profits by failing to pay access charges to local exchange carriers,
noted its coordination in these investigations with the SEC, Justice Department, and Commodities Future Trading Commission. Among these actions, the FERC revoked the marketing authorization for Enron affiliates.

As for the FCC’s follow through in the years after WorldCom’s disclosure, the FCC did not tighten its rules or practices to deter financial fraud by nondominant telecommunications carriers. It is possible that the FCC viewed WorldCom’s financial reporting as more or less in line with ordinary aggressive business practices. After all, the FCC implemented a series of orders over the twenty years prior to WorldCom’s disclosure that changed, by billions of dollars annually, the charges made by local exchange carriers. These were reflected in access charges, including in WorldCom’s line costs. The FCC may also have been aware that different carriers had reported different ways of accounting for access charges, reciprocal compensation, and operating expenses, which were apparently consistent with GAAP. The FCC understood that every day carriers made decisions for connecting customers between expanding their networks (i.e., costs accounted for as capital expenditure) and obtaining services from other carriers (i.e., costs that WorldCom accounted for as line costs prior to its fraudulent shift of some of these expenses to capital expenditure accounts). More generally, the FCC had extensive experience in shifting cost allocations and accounting practices and may have been reluctant to treat a violation of GAAP as a serious misrepresentation to the FCC.

failing to collect or remit universal service fund contributions, obtaining universal service fund support where not qualified, inaccurately billing customers, etc. There were allegations of general distortions to competition, pricing, and investment flowing from WorldCom’s fraudulent financial reports. See supra Part III.C. Allegations of specific fraudulent conduct by WorldCom in the marketplace did not arise until over thirteen months after WorldCom’s disclosure. See Press Release, AT&T, AT&T Files Federal Civil-Racketeering Lawsuit Against MCI/WorldCom And ONVOY, Inc., (Sept. 2, 2003) (alleging scheme to defraud AT&T into paying high termination fees related to traffic routing), http://www.att.com/news/2003/09/02-12137. In contrast, Enron’s disclosure of accounting fraud through the use of various affiliates quickly led to allegations that Enron unlawfully manipulated prices in certain markets through transactions with affiliates. See Wood Testimony, supra note 265, at 136 (scroll down to page 148 of pdf document).

269. See Wood Testimony, supra note 265, at 142 (scroll down to page 154 of pdf document).


271. See supra note 28.

272. See supra note 26.


274. See supra notes 16, 28.
While this context is relevant to understanding the FCC’s responses to WorldCom’s disclosure, it is too easy to dismiss the relevance of financial accounting to the FCC. The FCC recognized that achieving many of its policy priorities—including expanding the availability of broadband services and competition in local exchange services—required capital investments that would not occur if the financial reports of telecommunications carriers were unreliable.\(^\text{275}\) Also, the FCC sought to conform its regulatory accounting rules with GAAP in several areas.\(^\text{276}\)

B. Partial Explanations for the FCC’s Stance on Financial Fraud

The remainder of this Part explores four partial explanations for the FCC’s responses on financial fraud: (1) changes in the securities laws, SEC regulations, and other SEC and Justice Department actions; (2) downturn in the telecommunications industry; (3) the FCC’s long-term commitment to deregulation and market forces; and (4) the political accountability borne by the SEC.

1. Changes in Securities Laws, SEC Regulations, and Other SEC and Justice Department Actions

In the months before and after WorldCom’s disclosure, there was a whirl of legislative, regulatory, and litigation activity addressing fraud in financial statements across industries. This activity was focused on the SEC and the Justice Department.

On July 30, 2002—the day that Powell testified to the Senate Commerce Committee on the challenges posed by WorldCom’s bankruptcy and the need to root out corporate fraud in the telecommunications industry—President George W. Bush signed into law the Sarbanes-Oxley Act.\(^\text{277}\) In order to strengthen investor confidence in the U.S. financial markets, the legislation mandated sweeping corporate disclosure and financial reporting reform. Among other provisions, the legislation established the Public Company Accounting Oversight Board, restricted the services that an auditor may provide to an issuer that is its client, required chief executive officers and chief financial officers to certify financial reports submitted to the SEC, and enhanced the SEC’s power and ability to enforce the federal

\(\text{275. See Powell Testimony, supra note 52, at 15 (scroll down to page 19 of the pdf document).}\)

\(\text{276. Biennial Review, supra note 118, paras. 83, 103, 114–15.}\)

As disclosures and suspicions of corporate fraud grew in late 2001 and early 2002, the SEC undertook several investigations across a range of industries and proposed rule changes. In particular, starting within twenty-four hours of WorldCom’s disclosure, the SEC filed actions against WorldCom and certain former officers and employees. With the enactment of the Sarbanes-Oxley Act, the SEC was required to adopt rules on several reporting matters. The legislation also spurred the SEC’s enforcement actions against corporate fraud. Additionally, the Financial Accounting Standards Board (“FASB”) undertook many projects to address some of the issues with accounting standards highlighted in the financial restatements. The FASB also addressed SEC enforcement actions in the years leading up to WorldCom’s disclosure and soon thereafter.

These developments took some of the pressures off industry-specific regulators to enact rules or take enforcement actions in response to corporate fraud in the industries subject to their jurisdiction. For example, after Enron’s disclosure and collapse, the FERC proposed rules to update its accounting and reporting requirements and invited comments on whether entities such as power marketers should be subject to these proposed regulations. After the SEC’s subsequent proposal to require additional accounting-related disclosures, FERC Chairman Wood testified to a Senate Committee that the SEC’s proposal, applicable to “a broad universe of companies[,] . . . could eliminate the need for the FERC to alter its reporting requirements in this regard.”

The Corporate Fraud Task Force, created by Executive Order on July 9, 2002, also became a focus of the federal government’s activities against fraudulent financial statements across multiple industries. From July 2002 through August 2005, the Corporate Fraud Task Force secured over

---


282. SEC REPORT, supra note 278, at 43 n.106 (scroll down to page 47 of pdf document); see Roles of the SEC, supra note 16, at 6–8.


284. Id. at 16 (scroll down to page 19 of pdf document).

285. FIRST CORPORATE REPORT, supra note 263, at 1.2.
700 corporate fraud convictions. Without much assistance from the FCC, the Justice Department and other agencies in the Corporate Fraud Task Force moved forward with the goal of rooting out corporate fraud in the telecommunications industry. The group’s First Year Report includes descriptions of the SEC’s actions against WorldCom and actions by the Federal Bureau of Investigation, U.S. Attorney’s Office for the District of Colorado, and SEC against Qwest. The U.S. Attorney General issued statements in July and August 2002 on the Justice Department’s request for an independent examiner in the WorldCom bankruptcy case and the indictments of two former WorldCom executives.

Turning now to the FCC’s lack of action against financial fraud by telecommunications carriers, part of the explanation may be the enactment of the Sarbanes-Oxley Act and actions by the SEC, Justice Department, FASB, and other entities. Yet, this explanation is not completely satisfactory.

First, many telecommunications carriers are not publicly-held companies or otherwise subject to SEC accounting and reporting requirements. The provisions of the Sarbanes-Oxley Act and the SEC’s rules do not reach such companies. The FCC and Joint Conference backed away from addressing how the FCC’s accounting and reporting requirements together with regulatory audits could address gaps in the

---

287. See FIRST CORPORATE REPORT, supra note 263, at 3.36.
288. Id. at 3.7, 3.26, 3.28.
SEC’s rules.291 Similarly, the FCC did not discuss the reach of the Sarbanes-Oxley Act in any order, such as in connection with the FCC’s findings of financial qualifications or revisions to the FCC’s rule on candor.

Second, the securities laws, including the Sarbanes-Oxley Act, did not preempt actions by the FCC against corporate fraud. There are several examples of overlaps between FCC regulations and those of other federal agencies. Both the FCC and the Federal Trade Commission (“FTC”) regulate telemarketing with coordination between the agencies.292 In mergers and acquisitions, the FCC performs its own review and makes its own findings of competitive impact, separate from those of the Justice Department or FTC.293

Third, the FCC adopts rules and takes enforcement actions to promote competition in ways that may overlap or go beyond the antitrust laws applicable across industries.294

Finally, in other instances, the FCC has taken the enforcement actions of other government agencies as the starting point for its own investigations and rulemaking proceedings. For example, in August 2005, after the New York State Attorney General entered into a settlement agreement with a recording company, the FCC opened its own formal investigation into payola allegations in the radio industry.295 The FCC’s staff reviewed the

291. See supra Part III.B.
documents from the New York State Attorney General’s investigation. The FCC’s probe could lead to changes in the FCC’s rules and proceedings to revoke licenses. 296

2. Telecommunications Industry Downturn

Another partial explanation of the FCC’s passivity on financial fraud involves the timing of WorldCom’s disclosure relative to both the telecommunications industry’s health and restatements by other major carriers.

WorldCom’s disclosure occurred when the telecommunications industry was, in Powell’s phrase, “riding on very stormy seas.” 297 He stated that during the preceding two years in the industry, nearly 500,000 people in the U.S. lost their jobs and about $2 trillion of market value was lost. 298 He also cited estimates that the sector was struggling under nearly $1 trillion in debt. 299

As a part of his formulation for a lasting recovery, Powell proclaimed the need to ruthlessly root out corporate fraud by uncovering and punishing the “deplorable and despicable actions by those select few in the industry . . . ” 300 Long term, the industry required accurate financial statements in order to attract capital and for the efficient functioning of markets for telecommunications services. An FCC that deterred corporate fraud could promote this piece of the long-term foundation for the industry.

On the other hand, a “tough cop” FCC perhaps could, in the short term, worsen the downturn that the industry was suffering. If WorldCom had some FCC licenses revoked or applications denied, investors in other telecommunications carriers would fear instability in their operations. Even opening an investigation or the rulemaking proceeding requested by UCC 301 could have sent shock waves through the industry and investor community. Such regulatory stance could have pushed more financially weak firms into bankruptcy. In addition to deterring corporate fraud, a tough cop FCC might have deterred the capital flows necessary for competitive entry, expansion of broadband (i.e., high-speed Internet) facilities, and innovative services.

297. Powell Testimony, supra note 52, at i; see also Salkever, supra note 30.
298. Powell Testimony, supra note 52, at 1 (scroll down to page 5 of pdf document).
299. Id. at 1–2 (scroll down to pages 5–6 of pdf document).
301. UCC Petition, supra note 189.
The FCC might have reacted differently if WorldCom was a unique case of financial fraud in the telecommunications industry. Instead, there were well-publicized SEC investigations into Global Crossing and Qwest, and these carriers announced restatements of their financial reports.

Other FCC licensees subject to SEC investigations for financial reporting fraud included AOL Time Warner Inc. and Adelphia Communications.

Qwest in particular should have been of concern to the FCC. It was the incumbent local exchange carrier in fourteen states and in the process of opening its local networks to competition. Qwest also had financially-troubled intercity and international networks. Some analysts pointed to Qwest as teetering on the brink of bankruptcy. Additionally, the FCC was pursuing enforcement actions and penalties against Qwest for several matters related to local services competition. A tough stance by the FCC against financial misrepresentations could have scared Qwest’s lenders, investors, suppliers, and customers.

A different perspective on the industry conditions around the time of WorldCom’s disclosure appears in a speech by Powell at a Wall Street conference on October 2, 2002. WorldCom was the poster child for new entrants in long distance, local, and Internet services. Powell’s description of the FCC’s policy principles flowing from the 1996 Act portrayed the FCC as a cheerleader for new entrants, not as their disciplinarian. As Chairman Powell stated:

Government policy was to create a competitive industry to compete in

---


304. See Application by Qwest Communications Int’l Inc. for Authorization to Provide In-Region, InterLATA Services, Memorandum Opinion and Order, 17 F.C.C.R. 26303, paras. 1, 4 (2002); See Application by Qwest Communications Int’l Inc. for Authorization to Provide In-Region, InterLATA Services in Minnesota, Memorandum Opinion and Order, 18 F.C.C.R. 13323, paras. 1, 3 (2003).


the local telecommunications market. And it did. Government policy was to provide extraordinary advantages to competitive entrants in order to bring competition into being rapidly. And it did.

Government policy also explicitly and implicitly signaled that it would protect these new entrants from failure. No matter how weak or shoddy the fundamentals or poor business models were, and no matter how irresponsible the debt levels or exaggerated the growth expectations were, policy promised that all competitors could be salvaged and sustained in the name of competition.

It is here where the government’s pro-competitor industrial policy cracked. It could not possibly protect against these shortcomings. The reason is simple—money flows in the free market. While the terms and conditions of access to the market could reside and be controlled by the government, capital could not.\(^\text{307}\)

As the FCC sought to develop rules for long-term competition, growth, and investment in the telecommunications industry, it was sensitive to short-term disruptions. Many of the FCC’s rule changes built in substantial transition periods.\(^\text{308}\) In this context of rule changes adverse to financially-weak new entrants, the FCC would have been wary to pile on enforcement actions and tougher rules against financial fraud.

Of course, a tougher stance against financial fraud would have generated benefits to some players in the telecommunications industry. Verizon and SBC argued to the FCC in response to UCC’s petition that WorldCom should be disassembled and sold off to carriers satisfying reasonable financial and character qualifications.\(^\text{309}\) However, the FCC was wary of the fallout for other financially weak carriers, potential new entrants, and competition.

3. Deregulation and Market Forces

The FCC’s long-term commitment to deregulation and market forces provides a third partial explanation for the FCC’s responses to financial fraud. For over twenty years leading up to WorldCom’s disclosure, the FCC’s orders pointed to the benefits from relying on market forces rather than regulatory controls.\(^\text{310}\) The FCC concluded that easing barriers to

\(^\text{307}\) Powell Speech, supra note 300, at 3–4.


\(^\text{309}\) See SBC Statement, supra note 155, at 4–5.

\(^\text{310}\) See First Competitive Carrier, supra note 16, paras. 3–7; Public Notice, FCC,
entry and exit would promote competition and consumer benefits.\textsuperscript{311} Regulatory controls, such as scrutinizing financial qualifications for a license or investigations into the accuracy of earnings reports, were viewed as costly, time consuming, unnecessary impediments to the workings of competitive markets.\textsuperscript{312}

From the FCC’s perspective, aside from the enforcement actions of the SEC and Justice Department, market forces would operate to deter financial fraud. Lenders, investors, suppliers, and customers had strong incentives to identify financial fraud. These market players had large, established agents to do this work, such as debt and credit rating firms and financial analysts. The marketplace would discipline bad actors by taking away business, assets, investment value, and future opportunities. FCC enforcement actions against financial fraud were unnecessary and, worse, would deter some practices and players that were acceptable to the capital and commercial markets.

Part of this emphasis on market forces was based on the FCC’s recognition of its limited capabilities. Within a wide range, it could not determine which among diverse business and financing plans for telecommunications carriers had value and which did not. The diversity and growing number of carriers also made it unlikely that the FCC could identify financial fraud by benchmarking or audits.

Perhaps there were moments after WorldCom’s disclosure when some in the FCC questioned whether deregulation had gone too far. WorldCom’s financial fraud threatened to disrupt service to consumers and interconnected carriers. What if the threats following WorldCom’s disclosure worsened and this deregulated carrier actually disrupted basic telephone service? Moreover, WorldCom threatened to curtail some of the competition and capital flows into telecommunications infrastructure that the FCC had nurtured.

So the FCC did some saber rattling about seeking authority to impose tougher penalties to deter financial fraud. This not only sent a signal to the marketplace, but it also bought the FCC time politically. As the bankrupt WorldCom proved to be a stable service provider, the FCC could go on to

\textsuperscript{311} See Fourth Competitive Carrier, \textit{supra} note 72, para. 38.

\textsuperscript{312} See Abernathy, \textit{supra} note 142.
minimize the risks associated with deregulation. Yes, WorldCom’s
disclosure was a bump in the road. But, Powell could frame the
developments as the work of a few bad actors and point to the efficiency of
the FCC’s remaining regulatory controls over service discontinuance.\(^{315}\)

Even companies that urged the FCC to revoke WorldCom’s licenses
had bigger potential gains from further deregulation by the FCC. The large
incumbent local exchange carriers wanted termination or further
streamlining of various regulatory accounting requirements.\(^ {314}\) Moreover,
with all of their filings at the FCC, these companies and AT&T did not
want strict rules against misrepresentations to the FCC and tough
enforcement actions against any lack of candor.\(^ {315}\)

Finally, the FCC wanted to proceed with further deregulation and
competition for the telecommunications industry. As illustrations, the FCC
planned to issue more spectrum licenses,\(^ {316}\) support the entry and
expansion of largely unregulated voice over Internet Protocol service
providers,\(^ {317}\) authorize Qwest and the other Bell Operating Companies to
provide deregulated long-distance services,\(^ {318}\) reduce regulatory
obligations for the Bell Operating Companies to offer unbundled network
elements,\(^ {319}\) and determine that the broadband service offerings by cable
television operators and incumbent local exchange carriers are unregulated
information services.\(^ {320}\)

It would have been counter to this long-term direction for the FCC to

\(^{313}.\) Powell Speech, supra note 300, at 2; Powell Remarks, supra note 47, at 4; Powell
Testimony, supra note 52, at 1, 10–11 (scroll down to pages 5, 14–15 of pdf document).

\(^{314}.\) Accounting Order, supra note 217, para. 62.

\(^{315}.\) See Martin, supra note 26, at 255 ("[AT&T’s] public stance was relatively muted as
we took the high road, careful not to look as if we were exploiting another company’s
misfortune. And frankly, some of us worried that people who live in glass houses shouldn’t
throw rocks. Who knew what honest mistakes lurked in the thousands of financial records
we had filed during our serial acquisitions, divestitures, and bond and share offerings?");
Amendment of Section 1.17 of the Commission’s Rules Concerning Truthful Statements to
the Commission, Reply Comments of Verizon, GC Dkt. No. 02-37, at 4 (May 7, 2002)
http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdfandid_document=6513191
104.

\(^{316}.\) See Amendment of Part 2 of the Commission’s Rules to Allocate Spectrum Below 3
GHz for Mobile and Fixed Services, Second Report and Order, 17 F.C.C.R. 23193, para. 1
(2002).

\(^{317}.\) Vonage Holdings Corp. Petition for Declaratory Ruling, Memorandum Opinion and
Order, 19 F.C.C.R. 22404, para. 2 (2004); See IP Enabled Serv., Notice of Proposed

\(^{318}.\) See supra notes 108, 304 and accompanying text.

\(^{319}.\) Triennial Review Order, supra note 308, para. 4.

\(^{320}.\) See Brand X, 125 S. Ct. at 2695–99 (2005); Appropriate Framework for Broadband
facilities-based wireline broadband Internet access service is an information service).
treat WorldCom’s disclosure as a trigger for tighter regulatory controls or a signal of the failure of past deregulation. As Powell said eight days before WorldCom’s disclosure, the call for big government in the face of corporate fraud was, from his perspective, a short-term fad.321

This view of the FCC’s response to financial fraud by telecommunications carriers is consistent with part of the FERC’s response to Enron’s fraud. The FERC chairman testified that the FERC should push forward in opening wholesale power markets to further competition.322 He viewed the deregulated markets as functioning well to minimize disruptions following Enron’s collapse. The FERC’s answer to the challenge of strengthening the reliability of deliveries was more deregulation and competition, not more regulation.

4. Political Accountability

As a fourth partial explanation of the FCC’s response to financial fraud, a more aggressive regulatory stance would have increased the FCC’s political accountability for the malfeasance of certain telecommunications carriers. With the focus of Congressional critics on the SEC, there was no upside for the FCC to become a target in the Washington blame game.

The SEC’s Chairman Harvey Pitt was strongly criticized for being “asleep at the switch” in protecting against corporate fraud.323 After months of criticism from Congressional Republicans and Democrats, he was forced to resign in November 2002.

The FCC played the politically attractive role of savior to millions of subscribers by protecting them from potential service discontinuance because of WorldCom’s fraudulent actions. A higher profile on corporate fraud would likely have led to some embarrassing accusations about the FCC’s performance of its duties in 2001 through mid-2002: How had the FCC repeatedly found WorldCom financially qualified to acquire and hold licenses? What were the FCC’s auditors, accountants, and industry analysts

321. Powell Remarks, supra note 47, at 4 (“I don’t think it will last, but I do think that we sort of slipped into a cycle of that.”).
322. Wood Statement, supra note 255, at 13, 17 (scroll down to pages 14, 20 of pdf document).
doing while WorldCom was hiding billions of dollars in expenses that it had paid to FCC-regulated carriers? How had the expert agency missed what some later reports called obviously suspicious indicators of WorldCom’s performance relative to its closest competitors? What was missing in the FCC’s rules and enforcement practices that condoned or fostered the financial fraud at WorldCom, Global Crossing, and Qwest? Why didn’t the Joint Conference and FCC take any actions after asking for comments on various broader issues on the adequacy of regulatory accounting and audits in December 2002?

In this context, it was politically safer to avoid asserting strongly that the FCC would do more in the future to combat corporate fraud. It was also politically safer to avoid investigations into what representations and information the FCC received from WorldCom that violated the FCC’s rules.

The FCC commissioners needed to survive with sufficient political support to tackle at least two highly controversial, industry-reshaping rulemaking proceedings. These proceedings were ongoing when WorldCom disclosed its financial fraud. Decisions were announced within one year thereafter. Both proceedings were based on extensive analysis by the FCC of the industries under its jurisdiction. Success for the FCC required that Congress and the courts defer to the FCC’s industry analysis and judgments as to the problems created by some regulatory restrictions. One proceeding dealt with the FCC’s rules limiting media ownership. The FCC’s order adopted on June 2, 2003 triggered a political firestorm and the adoption of legislation in January 2004 which reversed part of that order.324 A second proceeding dealt with the rules for competition in local exchange telecommunications services. An order adopted in February 2003 by a sharply split FCC generated numerous legislative proposals.325

In short, Congress had already found in the SEC chairman a scapegoat for government failure in the face of corporate fraud across multiple industries, the FCC could have suffered from inquiries into its past failures to deter and detect financial fraud, and the FCC had larger items on its agenda that required it to be viewed as a competent analyst of the telecommunications and media industries.

325. Triennial Review Order, supra note 308, paras. 3, 6.
VI. CONCLUSION

WorldCom’s disclosure of financial fraud was a shock to consumers, the telecommunications industry, Congress, and several federal agencies—the FCC as well as the SEC and Justice Department. The FCC responded quickly and strongly to assert its consumer-protection rules. This potential fallout did not materialize, as WorldCom continued to provide its landline telecommunications and other core services through its financial collapse and bankruptcy.

The FCC also had rules, enforcement practices, and other actions intended to deter and detect financial fraud by major telecommunications carriers as well as to avoid giving licenses to financially weak carriers. The FCC’s response to WorldCom’s disclosure was more muted on this area of regulation. The FCC’s chairman said that corporate fraud in the telecommunications industry needed to be rooted out and asked for greater statutory authority in order to increase the FCC’s effectiveness in this area. However, in the years following WorldCom’s disclosure, the FCC did not tighten its regulations related to such financial fraud. Four partial explanations for the FCC’s response involve the actions of the SEC and Justice Department, downturn in the telecommunications industry, long-range deregulation by the FCC, and political accountability.

Recognizing that there is little substance behind the FCC’s rules and findings for financial qualifications, as well as the FCC’s rules and enforcement threats for financial fraud, are the FCC’s practices in these areas in the public interest? Suppose that the FCC could apply additional accounting, auditing, and enforcement resources to these financial issues. Would such additional regulatory activity promote consumer welfare and efficient use of radio spectrum and other resources?

I agree with the position developed by the FCC before and after WorldCom’s disclosure: more FCC vigilance in screening out financially-weak applicants and in detecting and penalizing financial fraud would cause more costs than benefits to the public interest.

In essence, the FCC has, by inaction, reasonably extended its deregulatory rule changes. The FCC’s practices regarding financial qualifications and financial fraud are supported by the rationale applied in a series of orders during 1980–84 and by the practices extended in later proceedings to eliminate other regulatory burdens for nondominant carriers.326 As the FCC determined in a 1983 order, “the purposes of the

---

Communications Act are best satisfied by reduced entry, exit, and pricing barriers and burdens for non-dominant carriers.\textsuperscript{327} The FCC predicted that eliminating certain regulations would benefit consumers through increased competition, greater availability of services, and lower prices.\textsuperscript{328}

The deregulation for nondominant carriers provided by the orders covered four types of burdens: (1) carriers did not have to apply for Section 214(a) approval to enter, add lines, or add services, and there was a presumption in favor of allowing them to discontinue services; (2) carriers did not have to file cost justification for rates; (3) carriers did not have to file tariffs specifying the rates, terms, and conditions for their offerings; and (4) certain types of carriers did not have to file consolidated balance sheets and income statements.\textsuperscript{329} However, nondominant carriers still had to file for and bear the burdens of showing their financial and other qualifications to acquire other nondominant carriers under Section 214(a) or to acquire (by issuance or transfer) radio licenses under Section 310(d).\textsuperscript{330} The FCC lifted these burdens and streamlined forms for some applicants in subsequent orders,\textsuperscript{331} but various financial showings for nondominant carriers remained.\textsuperscript{332} Moreover, nondominant carriers were subject to the same rules as dominant carriers on filing their annual reports and fraudulent filings.\textsuperscript{333}

This mix of areas of deregulation and areas of continuing regulation had logical and practical inconsistencies. The FCC’s open-entry policy under Section 214(a) allowed for the possibility that some carriers would

\textsuperscript{327} Fourth Competitive Carrier, \textit{supra} note 72, para. 38 (“Such barriers and burdens impair competition by delaying or deterring carriers in their service and rate offerings and causing them to bear additional costs. Consequently, users pay higher rates and there is limited availability of services satisfying users’ needs.”).

\textsuperscript{328} \textit{Id.} para. 40.

\textsuperscript{329} \textit{See Id.} para. 1, n.1; Proposed Rule, \textit{supra} note 326, para. 8. (“Form P does not provide a reliable data source. The Commission does not audit the figures. The lack of a uniform system of accounts for the reporting carriers gives rise to inconsistencies across companies in the financial figures reported.”).

\textsuperscript{330} \textit{See supra} Part III.A.1.


\textsuperscript{332} \textit{See, e.g.,} 47 C.F.R. §§ 22.7 (outlining financial qualifications of applicants for a new cellular system), 22.107 (stating that applications for authorizations, assignments, or transfers of control of licensees must demonstrate qualifications to hold an authorization in the public mobile services and state how the grant would serve the public interest, convenience, and necessity).

\textsuperscript{333} \textit{See supra} Parts III.D and E.
be financially weak and unstable service providers. Similarly, the FCC did not apply regulatory tools to prevent a carrier from charging rates that were too low to be sustained by its costs and financial resources. The FCC concluded that market forces—the availability of competing carriers and capital markets—checked any harms from the entry, practices, or exit of nondominant carriers. 334 Some consumers might bear the inconvenience of changing carriers, and some competitors might bear short-term losses of market shares. Nevertheless, the FCC determined that additional regulations aimed at screening out financially weak carriers and financially unsustainable prices would have chilled competition and decreased consumer welfare. 335 Accordingly, the FCC found that it promoted the public interest by not scrutinizing the financial qualifications of nondominant carriers like WorldCom and Intermedia to enter, build lines, offer services, or charge any rates.

In contrast, the FCC maintained rules requiring it to determine that carriers like WorldCom were financially qualified to acquire carriers like Intermedia and all types of radio licenses. 336 The same concerns about chilling competition and reliance on market forces logically applied to such transactions and allocations of resources. Moreover, if the public interest did not warrant the FCC screening out financially weak carriers or financially unsupported rates and offerings, there was little reason for the FCC to devote accounting, auditing, and enforcement resources to detecting and punishing fraudulent filings of financial information by nondominant carriers.

The FCC resolved these inconsistencies by making findings of financial qualification without factual support or analysis and by refusing to apply license forfeitures, monetary penalties, or remedial measures in cases of fraudulent filings or financial information. 337 These practices would, according to the FCC precedent in deregulating nondominant carriers, promote the public interest.

Neither these FCC rulemaking decisions nor this analysis of the benefits of the FCC’s practices regarding financial qualifications and financial fraud depends on the roles of the SEC or Justice Department in

334. Fourth Competitive Carrier, supra note 72, paras. 6–7, which stated:
[F]ull regulatory scrutiny under Title II of firms lacking market power can impose costs on these firms and consumers without offsetting benefits. . . . In a competitive market, a firm finds it unprofitable to restrict its output; if it did, some of its potential buyers simply would turn to alternative suppliers which stand ready to sell to them at the competitive price.
335. Id. paras. 36 n.79, 40 (removing costly regulatory burdens promotes the public interest in efficient telecommunications services).
336. See supra Parts III.A.1 and 2.
regulating financial disclosures and fraud. Rather, the FCC’s logic is based on competitive forces in the telecommunications and capital markets. The FCC did not presume that actions by other governmental agencies were effective in this area.

The saga of the FCC’s actions before and after WorldCom’s disclosure may be viewed by some as demonstrating the FCC’s regulatory incompetence and neglect of its statutory obligations. On the contrary, whether carefully planned or the product of various fortuitous developments, the FCC’s practices did more to promote the public interest than if the FCC had thrown lots of resources at determining financial qualifications and deterring financial fraud. The FCC correctly resisted pressure to increase its regulations in these areas after WorldCom’s disclosure.