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From the Financial Fraud Law Blog: The Interviews

Steven A. Meyerowitz

Since its inception, the Financial Fraud Law Blog has interviewed a variety of experts on different aspects of financial fraud law. A number of the most significant of those interviews are published below.

Subjects:

Are Credit-Default Swaps Insurance that Should Be Regulated as Insurance?

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How Can Anti-Money Laundering Systems Break Down?

Steven A. Meyerowitz, the editor-in-chief of the *Financial Fraud Law Report*, writes the Financial Fraud Law Blog (http://www.financialfraudlaw.com/lawblog). Mr. Meyerowitz can be reached at smeyerow@optonline.net.

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Are Credit-Default Swaps Insurance that Should Be Regulated as Insurance?[1]

Finance expert Barry Ritholtz recently wrote an interesting article in the *Washington Post* in which he opined on the nature of credit-default swaps ("CDS"), declaring that they "are insurance products" and must be regulated as such. Ritholtz based his opinion on the following main two grounds:

- First, unlike other tradeable assets (options, futures, securities), CDS need to be interpreted to determine whether they can be triggered; put another way, the question as to whether an event of default occurs—within the meaning of the ISDA documentation—which triggers the payment obligation under a CDS, has to be determined by a committee created by the ISDA composed of conflicted interested parties; and
- Second, CDS must be subject to reserve requirements like insurance products to ensure that protection sellers would not default when called on by protection buyers.

Not everyone agrees with this view. Alain Gauvin, an avocat partner at the law firm Lefèvre Pelletier & associés in Paris, recently spoke with us about this issue. Mr. Gauvin told us here at the Financial Fraud Law Blog and the *Financial Fraud Law Report*:

"Our opinion is that Mr. Ritholtz is wrong when declaring that CDS must be construed and regulated as insurance products, which is not to say that CDS must not be regulated.

"On the one hand, re-characterizing CDS as insurance products, on the mere reason that they need a committee to opine on whether they could be triggered, is quite misleading. It is true that this committee, like an insurance expert, determines whether the protection seller has to pay. However, the insurance expert determines whether the insured party has suffered a loss as a result of the occurrence of an event whilst the ISDA committee determines whether an event of default has occurred, irrespective of whether this event of default results in a loss: in the insurance world, one speaks in terms of 'loss,' whereas in the derivative galaxy, one speaks in terms of 'event.'

"On the other hand, asserting that CDS must amount to insurance products because they need to be subject to reserve requirements is both heretical and wrong.

"Heretical, because the nature of a product whatsoever (here, a CDS) depends on intrinsic criteria (intention of parties, loss (or not) driven instruments, etc.): a CDS must be subject to reserve requirements applicable to insurance products if this CDS is an insurance product because parties to this CDS behave like parties to an insurance contract.

"Wrong, because CDS are governed by draconian prudential rules. For instance, a CDS is likely to amount to a reliable credit risk hedging contract, only if it complies with several requirements amongst which are the exclusive categories within which the protection seller must fall and the fact that the protection must be direct and incontrovertible.

"The key-problem with CDS is not that, as Mr. Ritholtz affirms, 'the law created a unique class of financial instruments that was neither fish nor fowl'; the pivotal issue is that CDS, not to say all derivatives, are intrinsically neither fish nor fowl, so that it is quite impossible to regulate them per se.

"Why?

"Merely because one can do everything he wants through a derivative contract: selling whatever assets which will be delivered (physically settled transaction) or not (cash settled transaction), hedging against an event, insuring against a loss, speculating, investing, lending or borrowing money.

"This was illustrated in the '90s when Sumitomo filed suit against Chase Manhattan Bank and UBS A.G. The suit charged the banks for having granted loans to one of Sumitomo's employees disguised as 'copper swap transactions' to enable him to continue his allegedly illicit trading activities.

"This was still illustrated in 2009 by the mortality swap pursuant to which the French re-insurer SCOR sought to hedge its exposure on major pandemics, natural catastrophes and terrorist attacks.

"Now, it is illustrated by total-return swaps, which were originally created to allow parties to exchange assets yields and are now used to 'window-dress' loans with collateral embedded therein.

"The question as to whether CDS are insurance products deserves to be enlightened; but it has to be extended to all derivatives and even to all financial products like cat-bonds, limited recourse deposits or loans, etc. For instance, and to be concrete, should a CLN (credit linked note), under which the issuer receives up-front payment in anticipation of the occurrence of an event of default, be still considered as amounting to a bond (security) rather than an insurance product?

"As a conclusion, Mr. Ritholtz's article is of great help to put the problem on the table; it however fails to capture the entire challenge which is to be found in the following question: how to regulate instruments that are — often properly and legitimately — used by financial players for purposes which such instruments are not initially expected to be dedicated to?"

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The Failure of Public Accounting, and What To Do About It[2]

Richard H. Kravitz is a CPA who is the founding director of the not-for-profit Center for Socially Responsible Accounting and who also is a member of the Board of Editors of the *Financial Fraud Law Report*. He recently wrote an article for the *Financial Fraud Law Report* asking, in essence, where were the auditors and why did they not do what we expected they would have done before the Great Recession. Mr. Kravitz is of the view that the public accounting profession "has totally failed the public in its mission." We spoke with him about that.

Financial Fraud Law Blog: What is the role of public accounting today?

Mr. Kravitz: The core values of the accounting profession are honorable. A CPA's traditional role is to serve, as the head of the New York State Society of CPAs has said, as the moral and ethical compass within our democratic society, to insure that financial disclosure and reporting of government and private enterprises are truthful, honest, fair, accurate, and responsible.

The AICPA, the profession's self-regulatory body, clearly defines its commitment to objectivity, integrity, competence, and excellent performance. That is in the charter of the AICPA and in every annual report. In fact, CPAs have among the highest reputation of any profession in the Western World.

But the public accounting profession is also a new profession. Unlike medicine, engineering, or law, whose evolution has taken place over thousands of years, the attest function of the public accounting profession is barely more than 100 years old. The first school in America to formally teach accounting and auditing, NYU's school of commerce, began barely more than 100 years ago. My second point here is that it is primarily rules- and principles-based, unlike medicine and law, which are principally case-based. Its newness is demonstrated by the fact that the hierarchy of its rules was not formerly codified until July 2009 — that is less than three years ago — and convergence between U.S. accounting principles and practices and the newly empowered International Financial Reporting Standards Committee is not expected until 2015 to 2016.

Financial Fraud Law Blog: So, in your view, to whom should CPAs ultimately be responsible?

Mr. Kravitz: CPAs today need to have a responsibility far beyond the investors and companies they audit, broader than shareholders. In fact, I define four principle constituencies who depend on a corporation's viability, long term growth, and sustainability. These are the "publics" whose livelihoods, living standards, funding for children, and retirement depend on corporations and the honesty and integrity of their financials:

- Customers, community (jobs, public services to the public),
- Employees,
- Suppliers, and
- Shareholders.

Financial Fraud Law Blog: That concept is not a popular one in the United States.

Mr. Kravitz: Yes, that is true. It is a more common idea for European businesses. The notion of these owners or stakeholders was presented to me by two board chairmen of Wolters Kluwer, the third-largest global information company in the legal, regulatory, and tax markets (we know this company in the U.S. as Aspen and CCH). Their comment was that we are partners for life with our customers, employees, suppliers, and shareholders.

Financial Fraud Law Blog: Isn't that an idealistic notion?

Mr. Kravitz: Certainly, one might dismiss this as idealistic, or even naïve. Consider, however, the measures taken by the U.S. government, even in the absence of this mindset, when it intervened in the Chrysler and General Motors bankruptcies (and I believe the U.S. still is the majority owner of GM):

- Customers — car warranties needed to be guaranteed and franchises needed to be maintained or dropped on Main Street;
- Employees — unions and retirees needed to make concessions; Detroit and surrounding areas dropped in population by one-third, as did housing prices and the property tax base;
- Suppliers — parts and accessories manufacturers received financing guarantees and funding; and
- Shareholder owners — whether it was bondholders or shareholders, their interests were significantly changed.

Financial Fraud Law Blog: What is the bottom line?

Mr. Kravitz: The public accounting profession needs to redefine its accountability to the public.

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Why Do Financial Statements Ignore Critical Financial Activities and Transactions?[3]

All too often, according to Richard H. Kravitz, financial statements ignore critical financial activities and transactions. Mr. Kravitz is a CPA who is the founding director of the not-for-profit Center for Socially Responsible Accounting and a member of the Board of Editors of the *Financial Fraud Law Report*. Mr. Kravitz recently wrote an article for the *Financial Fraud Law Report* asking, in essence, why the auditors did not do what we expected they would have done before the Great Recession.

We recently spoke with Mr. Kravitz about his opinion that the public accounting profession "has totally failed the public in its mission." Now, he discusses why financial statements frequently ignore critical financial activities and transactions.

Financial Fraud Law Blog: Is the problem a common one?

Mr. Kravitz: Unfortunately, there are hundreds of examples where critical financial transactions were not reported in the financial statements or were buried in obscure footnotes. In addition, there is substantial evidence of lack of disclosure of off balance sheet financing, or creating better optics of a company by removing financial risk at the end of quarters. Even worse, many of these non-disclosure and non-reported events are in accordance with generally accepted accounting principles and generally accepted auditing standards.

Financial Fraud Law Blog: Can you give us a few examples?

Mr. Kravitz: Here's one example: If you look at Groupon's 10k that is currently under SEC investigation, Groupon restated its earnings due to an increase in refunds. However, there is no "reserve for refunds" category on the consolidated balance sheet. There is no mention of how these reserves were calculated. The auditors on the Groupon account, Ernst and Young (who gave the company a clean or unqualified opinion), did not provide any independent judgment in this area and did not assess financial risk to revenues or profits in the event refunds would increase. Auditors did not perform any independent verification or "sensitivity analysis" (what impact would a one-percent increase in refunds have on the current and future business?) of enterprise financial risk to identify material misstatement of the financials. We do find "reserve for refunds" buried on pages 72 and 80 in the footnotes in an account called "accrued expenses" lumped in with "payroll and benefits" and "other," even though the refund line item is almost twice the next largest item in "accrued expenses," increased by 500 percent over 2010, and is larger than 10 balance-sheet items that were presented in the consolidated financials.

Moreover, the business has gone foreign (more than 50 percent of 2011 sales are Europe and Asia), on higher ticket-travel items, as reported by the press, which obviously presents significantly greater financial risk for these deals than local advertising coupons. However, Groupon does not categorize these deals, nor does it separately identify their risk.

There are dozens of other examples, but merely look at audit reports of municipal governments. Try to find a risk assessment in the footnotes that describes the enterprise risk in the event the municipal government fails and the bond insurer also fails. Why are public accountants not raising red flags and warning signs — enterprise risk — in the event the municipalities go bankrupt? Note that headlines on the website Profit Confidential noted in March 2012, that municipal bond defaults are doubling and bailout options are diminishing with defaults for the first three months of 2012 at $978 million, now almost double that of all of 2011.

Shouldn't the financials presented by public accounting firms on municipalities address this issue and disclose enterprise risk for the protection of the public they serve?

Financial Fraud Law Blog: We know you also have expressed concern about "uninsured deposits."

Mr. Kravitz: Yes. Financial statements to this day do not at all require disclosure to depositors of the banks that CPAs audit of the potential loss of money and the number of depositors — uninsured depositors — who exceed the FDIC deposit guarantee threshold if an FDIC-insured entity goes into default. Banks do not protect assets over the FDIC limit and people are still waiting years for recovery of their excess savings lost by "safe banks" that defaulted with their money years ago. Nowhere is there a footnote in an auditor's report of a bank or savings institution that identifies/quantifies the potential loss suffered by uninsured depositors. Nowhere.

Financial Fraud Law Blog: Should auditors have disclosed the increased risk and potential dangers from shifts in bank lending strategies, policies, and aggressive underwriting standards?

Mr. Kravitz: Accountants have 100 years of bank audit experience. CPAs audited the S&L portfolios in the '80s when 3,000 banks and thrifts failed. How could public accountants ignore the same patterns? Why did auditors ignore them? And why did our federal government and the EU regulators need to independently "stress test" their financial institutions? Did the governmental entities also conclude that public audits were insufficient?

Consider "option ARMs." Auditors could have uncovered the risk here. CPAs could have observed that no major commercial bank that was regulated by the Office of the Controller of Currency wrote option ARMs. The largest audit firms have specialized practice areas. Could auditors not compare notes and audit work papers within the firm and identify exceptional differences in risk between similar clients within the same sector?

Financial Fraud Law Blog: Give us some of the worst "off balance sheet" offenders.

Mr. Kravitz: If a financial instrument or financial commitment does not appear on the balance sheet, does the risk not exist? Off balance sheet activities — repurchase agreements that sunk Lehman Brothers and MF Global, arbitrage and structured investment vehicles, leveraged puts — have huge effects on the stability of institutions. Why are these financial instruments not adequately disclosed, or buried in hundred page documents in footnotes?

One of the most troublesome is the qualified special purpose entity, or QSPE. One hundred thirty banks responded to a FASB draft and fought against disclosure of QSPEs, including Citibank, whose liability now is expected to be over $150 billion. Citibank will now book them. But "booking" does not mean consolidating or even putting them on the balance sheet. Booking means disclosing them either in the financials or burying them in a footnote disclosure. The expectation by the Federal Reserve is that almost three-quarters of a trillion dollars will need to be disclosed among the top 19 banks.

There also is something called "credit default SWOPS." Auditors continue to ignore $60 trillion in non-balance sheet credit default swops, which equals four times our gross domestic product, even though Lehman's few billion of losses almost seized the market.

And then there are off balance sheet land deals. Accounting rules say that a less than 50-percent ownership of land rights or an obligation to purchase land at a future date need not be disclosed. The lack of transparency results in the serious potential for materially misleading investors because investors cannot assess the level of risk that the company is taking. In 2008, Florida homebuilder Tousa filed for bankruptcy protection after defaulting on $500 million of loans for land — not disclosed on its balance sheet.

Financial Fraud Law Blog: What's the bottom line?

Mr. Kravitz: The fact is that generally accepted accounting principles and generally accepted auditing standards that served society well in the past may no longer be relevant today. What may be called for is development of a framework of financial reporting and disclosure principles, as well as auditing standards and practices that better serve society and protect the public trust. Financial information that is relevant, accurate, honest, fair and truthful is not beyond our asking. As Somerset Maugham once remarked, "If you accept nothing less than the best, you often get it."

Financial Fraud Law Blog: Thank you, again, Mr. Kravitz.

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Detecting Financial Fraud — and What To Do When It's Discovered[4]

Joseph P. Dooley is Managing Director in the Business Intelligence & Investigations Division of Stroz Friedberg, a global digital risk management and investigations firm, where he leads the firm's forensic accounting practice. We recently spoke with Mr. Dooley about the extent of financial fraud today and what steps companies should take to lower their risks.

Financial Fraud Law Blog: Why are we seeing so much financial fraud nowadays?

Mr. Dooley: We are seeing so much financial fraud because companies have cut back on staff as a result of the economic situation, and are trying to do more with less resources. The rule about "separation of duties" has been contracted — and that presents many risks to organizations.

Employees are concerned about their jobs, wondering if the next wave of cutbacks is going to affect them. To protect themselves, they may steer some money, to have a cushion to rely on when and if they lose their jobs.

Financial Fraud Law Blog: So, it's the economy?

Mr. Dooley: To some extent, yes. Organizations are trying to make their numbers and make their latest quarterly earnings forecast, so there are pressures in the area of revenue and costs. Managers are afraid if they don't hit the forecast they will be out on the street.

Financial Fraud Law Blog: What are the steps that companies should take as part of a fraud program?

Mr. Dooley: The first thing in any type of fraud program is to conduct a risk assessment. Companies should have an objective fraud risk assessment performed, focusing on the areas where they can be hurt the worst. This will provide a roadmap of where to spend limited fraud prevention resources.

Companies also need good policies and procedures, controls over third parties, and communication from the top of the organization. It is important to have senior management involved with this program.

Companies also must know their vendors — who are they? With respect to the Foreign Corrupt Practices Act, they should know what third parties they use. Third parties need to be held to the same ethical standards as companies themselves.

Financial Fraud Law Blog: Can an investigation be handled internally?

Mr. Dooley: Yes, one person can perform a fraud investigation for a small company. But all companies should think about how to leverage outside resources.

Financial Fraud Law Blog: What should an internal audit focus on?

Mr. Dooley: It can be cycle-based or risk-based. A cycle-based audit reviews certain areas every two or three years and certain areas every year. The risk-based audit is a more sensible approach, where companies focus on the areas that present the biggest risks.

Financial Fraud Law Blog: What else is key to cutting fraud risks?

Mr. Dooley: As part of any fraud program, an organization must have a response mechanism in place. How can a problem be investigated? Who handles it? A low-level employee? What if a senior person is involved in the fraud? You may need to go outside and get third-party resources.

Financial Fraud Law Blog: And how can risks be mitigated?

Mr. Dooley: Following an investigation, an organization needs to put new controls in place. They need to put in new protocols based on what they see or what's happening in their industry.

Financial Fraud Law Blog: Thank you, Mr. Dooley.

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Whistleblower Chiefs Discuss Reporting Of Corporate Fraud[5]

There has been much debate and discussion of the controversial whistleblower provision in the Dodd-Frank Wall Street Reform Act, Section 922 *et seq*., and the impact the expanded whistleblower rules and protections implemented since then would have on corporate compliance programs and the internal reporting and resolution of allegations of corporate wrongdoing.

The SEC and CFTC now both have official Whistleblower Offices up and running, and their chiefs, Sean McKessy of the SEC and Vincente Martinez of the CFTC, recently provided some insight into their offices' inner workings and what they are seeing in the early days of their respective whistleblower programs.

We spoke about what they said with William J. Kelleher III, a partner in the Stamford, Connecticut, office of the law firm Robinson & Cole LLP and a member of the Board of Editors of the *Financial Fraud Law Report*.

Financial Fraud Law Blog: Are people submitting complaints to the SEC and the CFTC? What happens to the complaints when the government gets them?

Mr. Kelleher: McKessy reported that the SEC has seen "more than a few" anonymous complaints, although he did not say how many, but more are filed through counsel for an unidentified client or counsel with a named client. He said that the SEC does not notify companies that it has received a complaint (even an anonymous one) and, as such, there is presently no process for them to respond to the complaint.

Confidentiality is a key issue and it must be maintained for the whistleblower program to be effective. The SEC has seen a greater volume of complaints, about seven per day on average, than the CFTC. Both McKessy and Martinez agreed that the quality of the tips has been high and they have not been inundated with a large number of low quality tips. The SEC has a centralized "TCR" system (for Tips, Complaints and Referrals) and some tips have been so strong and timely that they were immediately assigned to a specific group or office for enforcement action, such that they did not pass through the usual screening process. The CFTC has less volume of complaints than the SEC and has a two-tier review process for complaints. At both agencies, the tips and referrals have run the gamut of the types of complaints and alleged wrongdoing.

Financial Fraud Law Blog: Did they talk about whether employees should talk to their companies first, before filing a whistleblower complaint?

Mr. Kelleher: Yes. One of the main issues that was discussed when the SEC whistleblower rules were issued was whether a company employee should be required to report the wrongdoing internally first before filing a whistleblower complaint with the SEC. In terms of the impact there, McKessy said the 120-day period for an employee to report internally and go to the SEC and get the benefit of reporting internally comes into play. But it does not mean that a company has only 120 days to investigate because as a practical matter some matters cannot be thoroughly investigated and wrapped up in 120 days. The SEC does not have an expectation that every complaint can be reviewed and resolved within 120 days. He said, anecdotally, the SEC has not seen a push to subvert internal company reporting policies and compliance programs. A "significant majority" of whistleblowers have said that they also reported their complaint internally.

Financial Fraud Law Blog: Are we looking at occasional employee whistleblowers, or is there something potentially larger here?

Mr. Kelleher: The whistleblower chiefs were asked whether their programs allow for "professional whistleblowers," such as Harry Markoplos, who tried to raise the Madoff Ponzi scheme with the SEC. McKessy said the statute and rules allow for non-employees to submit tips based on their own independent research and analysis of public information. He said the SEC wants to encourage people to do so and that it would aid the efforts of the SEC's Enforcement division. Martinez agreed and said that he hoped that type of whistleblower will become an important part of the CFTC's whistleblower program.

Financial Fraud Law Blog: Have there been any bounties paid to whistleblowers yet?

Mr. Kelleher: Since it is still early in the agencies' whistleblower programs, neither agency has paid an award under their program as yet. But each has several matters in the pipeline that are covered actions in which awards may be paid.

Financial Fraud Law Blog: What's the bottom line so far on the whistleblower program?

Mr. Kelleher: It's still early. Time will tell as the whistleblower programs progress whether they are effective at ferreting out and addressing corporate wrongdoing in the way that was intended by Congress and the SEC and CFTC.

Financial Fraud Law Blog: Thank you, Mr. Kelleher.

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More Whistleblowers — Not Working Groups — Needed for Housing Crisis, Ex-Assistant U.S. Attorney Says[6]

In his State of the Union address, President Obama announced that the Attorney General would form a "special unit" of federal and state prosecutors to investigate "abusive lending and packaging of risky mortgages that led to the housing crisis." The announcement garnered great applause and received continued praise. But Brian M. Feldman, counsel at the law firm of Harter Secrest & Emery LLP in Rochester, New York, wonders why, if this unit is a silver bullet in investigating the housing crisis, it has been so long in coming. Feldman is a particularly interesting voice on this subject: As an Assistant U.S. Attorney in the Southern District of New York until September 2011, he served in that Office's Civil Frauds Unit as Senior Litigation Counsel and as the lead attorney on the government's case against Deutsche Bank and its mortgage lending subsidiary, MortgageIT. His thoughts follow:

"In truth, federal and state prosecutors have been salivating over and diligently searching for possible new leads and big breaks in their multifold investigations into the roots of the housing crisis since that crisis exploded in 2008. They were not waiting for a magic unit to bring their investigations to life. Indeed, the public would have legitimate grievances against this Attorney General if he had puttered around for three years before forming the right team to kick off those efforts. No doubt aware of that fact, Attorney General Holder was on the defensive in announcing the special unit trumpeted a few days earlier in the President's speech. It turns out that, in the Attorney General's telling, the special unit is not particularly special. Rather than being a new team created from whole cloth, the unit is merely a working group formed from a pre-existing task force, which has already been pursuing these investigations. Even the name of the new unit — the Residential Mortgage-Backed Securities Working Group — sounds familiar, like a quick re-scrambling of the Mortgage Fraud and Securities and Commodities Fraud working groups already on the task force's masthead. As Mr. Holder took pains to emphasize, the new working group isn't 'starting from scratch' because the task force has been busily investigating these matters for the last three years.

"Of course it has. Although conspiracy theories abound positing that the Justice Department and SEC are looking the other way (allegedly based on ties between government lawyers and the industry players in the mortgage crisis), those theories make little sense. As SEC Enforcement Chief Robert Khuzami told Charlie Rose, 'Ask yourself candidly, what law enforcement authority, what SEC staffer wouldn't like to bring the case against the high-profile executive?'

"Until last September, I served as an Assistant United States Attorney in Manhattan, in the Civil Frauds Unit of the Southern District of New York, and I can assure you that no sane government attorney would turn these cases away. That's especially true of my former boss, the United States Attorney in Manhattan, Preet Bharara, who now appears on the cover of *Time* with the words 'This Man Is Busting Wall St.' scrawled across his face, and who brings to his job a keen intellect, boundless energy, and a devoted following of some of the nation's most hard-driving lawyers. Mr. Bharara and his peers at the Justice Department and SEC would, presumably, love nothing more than to bring to justice those responsible for any crimes or frauds committed during the housing crisis.

"Indeed, Mr. Bharara and his colleagues have made great efforts and scored laudable successes in this field. And yet, most of the lenders and investment banks — and their executives — likely implicated in the run-up to the crisis have managed to survive without finding themselves defendants in government prosecutions or penalty suits. There were shoddy mortgages everywhere, along with people who blessed them and people who packaged them up to look like great deals and sold them off. Despite the government's tremendous efforts, enforcers appear to have hit a wall when it comes to the evidence, which is not especially surprising with efforts scattered over such an extensive set of actors. A new working group will not change that.

"There is another approach that might: whistleblower actions. The sheer magnitude of the housing crisis means that, throughout the various industries involved (e.g., mortgage lenders, investment banks), hundreds or even thousands of individuals had hands-on exposure to the root problems. They were in the trenches, churning out mortgages, selling them to eager buyers, pooling them into securities, and figuring out how to market junk as gold. There was top-to-bottom exposure at these firms to information that could unlock these cases: from the mortgage underwriters who knew not to look too hard to the corporate executives who understood their standards were meaningless. Any of these individuals could have blown the whistle.

"They still can, and the potential rewards are enormous. Under one law, the False Claims Act, a whistleblower is generally entitled to 15 percent to 25 percent of the government's recovery. Under another, the SEC's new whistleblower law, rewards are in the range of 10 percent to 30 percent of any monetary sanctions the SEC collects. These laws generally provide for rewards regardless of how the government collects the money — whether through criminal prosecutions, civil judgments, administrative sanctions, or settlements. With potential recoveries in the hundreds of millions or even billions, the proportional rewards for whistleblowers — tens or hundreds of millions of dollars — are simply staggering.

"With such immense rewards looming, where are these whistleblowers, and why haven't they stepped forward? Some of them (e.g., the mortgage underwriters) are out of work and struggling, and would seem to have much to gain and little to lose from spilling the beans. They may simply not realize that these opportunities exist. Indeed, there have been no well-publicized rewards for whistleblowers who helped launch cases relating to the housing crisis. As for many of the well heeled and best placed insiders (e.g., the corporate executives and managers), they landed on their feet and may well fear the repercussions of speaking out against their friends and colleagues. These industries are powerful, and for individuals, careers — often lucrative ones — are at stake.

"The good news is that the laws are set up to protect whistleblowers. The FCA, for instance, protects whistleblowers' identities through a court sealing order, usually until the point where, following substantial government investigation, the whistleblower knows whether the case is likely to haul in a massive recovery or wither on the vine. The law gives the whistleblower the choice, at that point, to withdraw its action and remain anonymous in perpetuity. Likewise, SEC provisions allow whistleblowers to provide their tips anonymously, through their lawyers, until the whistleblower is ready to claim his or her award. To get the full benefit of these laws, whistleblowers really should contact lawyers who work in this field; fortunately, most of those lawyers will not charge anything unless and until the whistleblower collects at the end of the case.

"The President's State of the Union address reflects the growing consensus that it is time to find a new approach to try and hold accountable those companies and individuals that engaged in the reckless and criminal practices at the root of the housing crisis. Yet, it takes a certain naivety to believe that the Justice Department was holding off for three years on building the right team for tackling these cases, and that a new working group will suddenly shake everything up. Something drastically different is required. Perhaps that something is a call to insiders to come forward. The financial incentives are there; but the word still needs to get out. These insiders not only witnessed the events that caused the historic housing crisis; they're also holding lottery tickets for huge jackpots with devastatingly good odds."

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Chaitman Responds: Nocera's Column 'Full of Errors'[7]

When *New York Times* columnist Joe Nocera wrote about the $162 million settlement between Madoff trustee Irving Picard and N.Y. Mets owners Fred Wilpon and Saul Katz, we here at the Financial Fraud Law Blog and the *Financial Fraud Law Report* took notice. Madoff's Ponzi scheme, of course, is a topic of interest for us. In addition, though, we saw that Mr. Nocera's column, The Mets Switch Teams, contained a scathing attack on attorney Helen Davis Chaitman, a partner in the Commercial Litigation Practice Group of Becker & Poliakoff P.A.

Ms. Chaitman, a litigator with a diverse trial practice in the areas of lender liability, bankruptcy, bank fraud, RICO, professional malpractice, trusts and estates, and white collar defense, has been advocating for Madoff's victims for the past three years. We spoke with her about Mr. Nocera's column, which she says is "full of errors."

Financial Fraud Law Blog: Mr. Nocera talks about New York law and "clawbacks." Can you comment on his view?

Ms. Chaitman: It is not New York law for *creditors* of a Ponzi schemer to have to disgorge funds they received from a dishonest debtor. Mr. Nocera is confusing cases where people made *equity* investments in a Ponzi schemer's business and received dividends based on fictitious profits with numerous cases where courts have recognized that a creditor of a Ponzi schemer is entitled to repayment of his debt. The confusion, I believe, stems from the word "investor." People entrusted their life savings to Bernard L. Madoff to be invested by Madoff in Fortune 100 company stocks for the customers' accounts. They did not buy an equity interest in Bernard L. Madoff Investment Securities LLC. Thus, under New York law, there is no authority for requiring them to disgorge money they received from Madoff in reduction of Madoff's debt to them.

Financial Fraud Law Blog: The Picower settlement proposes to return $7 billion to Madoff's estate, for distribution to those who were victimized by Madoff's Ponzi scheme. Why would you be challenging that?

Ms. Chaitman: Jeffry Picower was, according to Irving Picard's own complaint against his widow, the primary co-conspirator of Madoff and the principal beneficiary of his crimes. Over a period of 25 years, Picower invested $650 million into his accounts with Madoff and he withdrew $7.8 billion. If he had taken that money and simply invested it in US Treasury notes, it probably would have tripled in value. Despite the fact that Picower was a criminal, Picard settled with his widow for a mere repayment of the money he took out in excess of what he put in. No accounting for profits, interest, or the fact that he was a massive criminal. Yet, Picard has sued my clients — who he acknowledges are totally innocent of any wrongdoing — for the money they took out in excess of what they put in, plus nine percent interest!

Financial Fraud Law Blog: OK, so what are the specific legal grounds for your objection?

Ms. Chaitman: If Mr. Nocera had read the court papers I have filed, he would know that my appeal of the Picower settlement was solely on the ground that Picard gratuitously obtained for Picower's benefit an injunction against any victim of Picower's crimes suing his estate. This injunction was not a condition of the settlement; it was something that Picard felt he wanted to do for Barbara Picower. To me, the hundreds of people that I represent who are the victims of Picower's thievery are entitled to sue Picower's estate to recover the damages they are entitled to under state law. Why would Picard (and Nocera, for that matter) want to protect a thief's family from the victims of his crimes?

Financial Fraud Law Blog: What are you trying to accomplish in the Madoff case?

Ms. Chaitman: My motive is solely to protect the victims of the crimes of Madoff and Picower. As Mr. Nocera knows, because I gave him more than an hour of my time over a year ago, I was a "net loser" in that I never took any money out of my Madoff account. Thus, I had an allowed claim and, in fact, would have been the beneficiary of Picard's clawback suits against innocent investors because the recoveries would have increased my distribution from the fund of customer property. However, I am deeply convinced that the clawback suits against innocent investors are illegal and immoral. At my own expense and against my own economic interests, I have lobbied on a *pro bono* basis in Congress against the clawback suits and I have testified twice in Congress against them.

Financial Fraud Law Blog: Finally, what do you think about Picard's settlement with Wilpon and Katz?

Ms. Chaitman: As to the settlement with Fred Wilpon and Saul Katz, I confess that I have never met either of them, I am not a Mets fan, and I don't care about baseball. But I do care about people who abuse their power and Irving Picard is such a man. His campaign, conducted largely in the *New York Times*, against the Mets and Messrs. Wilpon and Katz, was vicious and unjustified. Picard settled on the eve of trial because he had no case against them and he didn't want to subject himself to the public humiliation of allowing the world to see that he was all bluster and no substance. The settlement costs the defendants, at most, $29 million three years from now. Quite a discount off the $1 billion that Picard bragged he could recover. Picard's firm has been paid almost $300 million in legal fees and probably well more than $29 million just for the work in the Wilpon case.

Mr. Nocera's attack on me is difficult to comprehend unless he is expressing the emotions of Irving Picard and his legal team.

Financial Fraud Law Blog: Thank you, Ms. Chaitman.

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MF Global's Proposed Bonuses: A Criminal Law Perspective[8]

Attorney James M. Keneally is a partner in the white collar crime and investigations practice of the law firm Kelley Drye & Warren LLP in New York, and a member of the Board of Editors of the *Financial Fraud Law*

Report. Mr. Keneally frequently defends individuals, corporations, partnerships and professional associations before the Securities and Exchange Commission and FINRA, and in federal and state court. We spoke with Mr. Keneally about the proposal to pay bonuses to MF Global executives.

Financial Fraud Law Blog: From your perspective as a white collar defense and investigations lawyer, does the proposal to pay bonuses to MF Global executives pose any challenges — ethical or criminal?

Mr. Keneally: I suspect Louis Freeh and his team made certain they were on sound legal footing before they floated it. No one has been found guilty, or even accused, of any wrongdoing at this stage. And, strictly speaking, it likely makes economic sense for the estate, since, as Mr. Freeh and his colleagues have pointed out, it would be more cost efficient to rely on employees to try to track down the funds, rather than pay outside consultants. What has stuck me is the public backlash against the proposal. There is a public perception, as reflected in the letters from U.S. Senators Jon Tester from Montana and Amy Klobuchar of Minnesota, that the executives who were responsible for the $1.6 billion in customer funds that went missing are now going to be paid for helping to find those same missing funds. Couched in that way, it makes the bonus proposal sound like a ransom demand of the MF Global executives. So, there are really two vantage points from which to look at this. First, if you represent the estate and you're trying to figure out what happened, relying on the executives and employees and compensating them based on the level of assistance they give the estate makes sense. On the other hand, if you represent one of the individuals involved, this could raise some interesting issues down the road.

Financial Fraud Law Blog: How so?

Mr. Keneally: First, let me say that I'm not assuming that these executives, or anyone else at MF Global, is liable, be it civil, criminal or otherwise, for what happened at MF Global. But it's clear that, at least theoretically, some individuals have exposure. Let's assume for a moment that an individual from MF Global is accused of knowingly taking part in the improper transfer of part or all of those customer funds. If that same individual collected a bonus for assisting in recovering those funds, that could be interpreted as an effort to be enriched by one's own knowingly improper conduct. Even if the individual isn't charged with *knowingly* engaging in such conduct, a trier of fact, especially a jury, might just perceive it as greedy. This, in turn, could have an impact on the sentence one receives in a criminal proceeding, or in the penalty a person must pay in a civil or regulatory action

Financial Fraud Law Blog: It has been noted that it could cost more not to keep the MF Global executives on salaries. To pursue investigations with an "objective, third party" trying to untangle and trace the financial documentation could drive up the expense of the investigation. Who stands to lose money, picking up the tab in this case, the estate or the investors? What do you think would be the most cost-efficient, legal way to investigate where the money went?

Mr. Keneally: If I were conducting the investigation on behalf of the estate, I'd want as many executives and employees to be available to assist as practicable. They are essentially fact witnesses and, thus, they are the best source for information. They were at MF Global while this was happening. Information from those individuals, supplemented with assistance by lawyers, forensic accountants, and other consultants, will get you the best, most complete answers. Without the executives and employees, your investigative costs go up, and you lose valuable time because of a substantially greater learning curve. The problem, of course, is that when a firm goes under, uncompensated ex-employees are simply not as accessible. So using a form of incentivized compensation that meets with the court's approval makes some sense, even if it is going to subject you to a certain level of criticism.

Financial Fraud Law Blog: If you were representing a director, officer or executive in that situation, what would you do?

Mr. Keneally: Obviously, every situation is different. And certainly the client's financial situation has to play a role. But depending on what the attorney believes to be the client's level of exposure, one might want to consider advising the client to turn down a bonus, especially if there is a chance it would be viewed as exorbitant. That would remove an arrow from the opposition's quiver at trial. Or, if the client decided to seek a resolution, whether through a plea agreement in a criminal setting or consent decree with a regulator, it would be evidence of the client's having done the right thing, and having gone an extra length to cooperate with the trustee regulators, and/or prosecutors. But again, that would all depend on the specific circumstances.

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Longer Prison Sentences Coming for Financial Fraud?[9]

Bill Kelleher, a partner in the Stamford, Connecticut, office of Robinson & Cole LLP and a member of the Board of Editors of the *Financial Fraud Law Report*, recently spoke with us about the likelihood of insider trading and financial fraud cases coming to Connecticut. Kelleher also has some interesting thoughts on the increased federal sentences that are being proposed for securities fraud, insider trading and financial institution fraud — and the implications for officers, directors and investment advisers:

"That Dodd-Frank law again. Buried deep in the Dodd-Frank Wall Street Reform Act enacted in 2010, Section 1079A required the U.S. Sentencing Commission, the agency that recommends penalties and adopts policy for federal criminal sentences, to review its Guidelines to reflect Congressional intent that securities fraud and financial institution fraud sentences 'appropriately account for' the severity of the offense, and the potential and actual harm to the public and the financial markets. In other words, under Dodd-Frank, Congress wanted tougher sentences for securities fraud, similar offenses including insider trading, mortgage fraud and frauds relating to financial institutions.

"On January 19, 2012, the Sentencing Commission proposed changes to (and requested comment on related issues in) the U.S. Sentencing Guidelines for financial fraud, insider trading and securities fraud. In line with Congress' encouragement, the changes ratchet up the stakes in these cases. Under the proposed Sentencing Guidelines, applicable to criminal charges brought in federal court by the Department of Justice around the country, the starting point for computing criminal sentences is the 'base offense level.' The proposals would impose an 'enhancement' or increase of: two points to the base offense level if the conduct involved 'sophisticated insider trading' and four points if the defendant was in one of several positions of trust. Sophisticated insider trading would be determined by factors such as the number of transactions, dollar amount involved, duration of the offense, whether fictitious entities were used, and importantly for companies and organizations, whether internal monitoring and auditing systems were circumvented to avoid detection. Positions of trust would include a defendant who was an officer or director of a publicly traded company, a registered broker-dealer or an investment adviser.

"In general, the higher a defendant's total 'offense level' on the sentencing table, the longer the sentence imposed, subject to a judge's decision and any downward departures. Although the Sentencing Guidelines are advisory, and are no longer mandatory on federal courts, sentences that are within the Guidelines are generally presumed to be reasonable and most judges still usually follow them or do not depart from them significantly.

"In combination with Dodd-Frank's requirement that most hedge funds, private equity and investment firms register with the SEC as investment advisers, offenses originating from the financial services sector and the C-level suite and Boardroom will be subject to the enhanced sentences. If adopted, these changes may dramatically increase sentences for the specific defendants to which they apply and continue the recent trend of stiff sentences in significant cases of securities fraud, insider trading and financial institution fraud. The changes will also likely give federal prosecutors more leverage to obtain guilty pleas and to foster cooperation from other defendants, which assistance is often key in making these types of charges stick due to the nature of the conduct. They reflect the current regulatory climate. There is one piece of potential good news for defendants to come out of the proposed sentencing changes. In response to concern about sentencing disparities and long sentences which may overstate the culpability of a defendant due to the Guidelines' calculation of the amount of loss, the Sentencing Commission is seeking comment on how best to determine the amount of the loss in securities fraud and similar cases.

"Public comments on the proposed Guidelines are due by March 19, 2012 (coincidentally, just before the SEC's March 30, 2012 deadline for registration as an investment adviser). If approved by the Sentencing Commission, they would likely go into effect later in 2012 at the earliest."

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How Can Anti-Money Laundering Systems Break Down?[10]

HSBC Holdings apparently is under investigation by a Senate panel in a money-laundering inquiry. Although the specifics regarding the inquiry have not yet been released, there have been reports of a "breakdown" in HSBC's anti-money laundering systems.

We recently spoke about this with Frances McLeod, one of the three co-founders of Forensic Risk Alliance and the firm's managing partner. FRA is located in the UK, France, the US, and Switzerland and has worked on many major international corruption and fraud investigations over the past decade. McLeod advises clients on anti-corruption-related issues both in terms of response to internal and external investigations, in a compliance context, and in related civil and criminal litigation in a variety of jurisdictions.

Financial Fraud Law Blog: What risk and compliance procedures might HSBC have had in place to protect against money laundering?

Frances McLeod: It is to be expected that HSBC has robust compliance procedures in place, as it is a member of the Wolfsberg Group and a major international bank. Those would include robust Know Your Customer policies and procedures and transactional monitoring which would likely conform to the highest global standards across its offices worldwide.

Financial Fraud Law Blog: How is it possible that an anti-money laundering system can "break down?"

Frances McLeod: The key to effective compliance is taking a risk-based approach. This allows for the allocation of resources (money, people, systems) to the most vulnerable areas. International AML standards, and those proscribed by the Wolfsberg Group, advocate such a risk based approach to two of the fundamental tenets of AML programs: KYC and transaction monitoring.

In our experience, KYC breaks down when such a risk-based approach is not taken either at client adoption or during the life cycle of the account relationship. If it becomes a "box ticking" exercise regardless of the client's risk profile, there are real risks of Politically Exposed Persons ("PEPs"), designated individuals, or groups starting and/or maintaining a relationship with the bank.

Equally, if transactional monitoring is not designed to pick up riskier transactions or transactional patterns which require the bank to report them to the enforcement authorities, systems can break down.

Financial Fraud Law Blog: What are the keys to effective monitoring?

Frances McLeod: Effective monitoring is underpinned by trained compliance staff *and* AML software tools. The tools can help identify patterns or anomalies or matches, for example to OFAC lists, which given the volumes concerned can be impossible to do manually; human analysis can determine whether the transactions are indeed suspicious and recommend a course of action. Systems which are overly automated and compliance departments which are under-resourced or under-trained risk either over-reporting of suspicious transactions, or worse, genuinely suspicious transactions remaining unreported.

Financial Fraud Law Blog: Are there other factors that can lead to these kinds of problems?

Frances McLeod: Yes. Other factors which can lead to break downs in AML compliance systems are lack of effective AML training, under-staffing, and silos of responsibility (i.e., the compliance department is overly divorced from the operational and sales function).

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Insider Trading and Financial Fraud Cases Coming to Connecticut[11]

The U.S. Attorney in Connecticut, David Fein, says he is targeting and about to bring a new round of insider trading charges and similar financial fraud cases. We spoke about that with Bill Kelleher, a partner in the Stamford, Connecticut, office of Robinson & Cole LLP, and a member of the firm's Business Litigation and White-Collar Defense and Corporate Compliance Practice Groups. Kelleher represents clients in SEC, government, and white collar investigations.

Financial Fraud Law Blog: What is the status of insider trading cases in Connecticut?

Mr. Kelleher: Recently, most insider trading cases have been prosecuted in the Southern District of New York even when the individuals and firms charged or involved were based elsewhere, including in Connecticut. The U.S. Attorney for Connecticut, David Fein, took office in 2010 and made an early point of prioritizing financial fraud and white collar criminal offenses. In particular, he reorganized the structure of the Office's Criminal Division, moving away from divisions based on its three Connecticut offices, to program-based units covering categories of criminal offenses. He formed a Financial Fraud and Public Corruption Unit and thereunder a Connecticut Securities, Commodities and Investor Fraud Task Force, which brought together investigators from several federal and state law enforcement agencies. His office has brought some financial fraud cases including as to investment advisers and Ponzi schemes.

Financial Fraud Law Blog: What does Mr. Fein seem to be focusing on now?

Mr. Kelleher: Connecticut, and in particular Fairfield County, is home to several financial services companies and a couple of hundred hedge funds. After New York City and London, Connecticut has the largest concentration of hedge funds in the world and many of the world's largest funds call Connecticut home. When Mr. Fein took office, he promised to step up criminal enforcement of financial crimes including, where appropriate, wielding investigative techniques such as wiretaps that are generally used in non-white-collar criminal cases. In a nationally published interview last week, Mr. Fein said the public should be expecting to see charges soon as a result of matters his Office has been investigating.

Financial Fraud Law Blog: Where do you think all of this is likely to lead?

Mr. Kelleher: The new prosecutorial units in Connecticut will ultimately have to show results and make use of their resources by converting leads into charges and convictions. At the same time, the U.S. Attorney's Office can only go where its case agents find the facts and evidence warranting criminal prosecution.

There were always some white collar criminal prosecutions in Connecticut, most notably for public corruption, but there has been an uptick in investigative activity in this area by several regulators and many of them, such as the U.S. Attorney's Office and SEC, work together and share leads, information and referrals. In many instances, investigations into financial fraud cases spawn or lead to other unknown cases or criminal conduct, some closely related but some not. The cases take time to develop especially when there has not historically been a base of investigative resources from which to work.

Financial Fraud Law Blog: What's the bottom line?

Mr. Kelleher: Where the cases in Connecticut go from here and whether there is a wave of cases remains to be seen. Stay tuned.

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Asian And Middle Eastern Business Ethics Hit Latin America[12]

We recently spoke with Michael Diaz, Jr., the Miami-based managing partner at Diaz, Reus & Targ, LLP, who has spent more than 20 years in private practice defending and investigating Latin American money laundering and public corruption cases. A Cuban-born bilingual international attorney, Diaz is a former U.S. government prosecutor who investigated and prosecuted highly publicized corruption, economic, drug, and other cases. Excerpts from his remarks appear below.

"Beware when doing business in Latin America. Thanks to well financed and growing Chinese and Middle Eastern investment there, fraud and bribery are growing as well. Business practices considered unethical, fraudulent, and illegal in the United States, such as bribery and financial 'favors,' are largely tolerated and thriving in the developing regions of the Western Hemisphere, with little risk to the perpetrators.

"I use the phrase 'opportunity with impunity' to describe these business, trade, and investment relationships, since both parties are often comfortable negotiating with embedded kickback schemes. For example, in Latin America's mining industry, extra compensation remains a frequent factor in negotiating for drilling, cultivation, or exploitation rights.

"However, that impunity faces fresh challenges from America. The U.S. government has recently passed new regulations and stepped up enforcement of the Foreign Corrupt Practices Act ("FCPA"), anti-money laundering ("AML") laws, the USA Patriot Act and Office of Foreign Assets Control ("OFAC") rules. President Obama has pressed hard for passage of additional measures to protect consumers and prevent fraud at home and abroad. And the U.S. Justice Department recently announced that it would not tolerate payoffs to local officials by U.S. companies selling healthcare products in foreign markets.

"Today, public and private entities operating in Latin America face serious penalties if they violate U.S. laws — even if based in China, the Middle

East, or Europe. One example: Siemens recently paid more than $1.3 billion to settle corruption probes in the United States and Germany related to alleged bribery of Brazilian government officials. Clearly, the American government is willing to levy fines, freeze bank accounts, and take other steps to enforce its rules on doing business in Latin America — particularly for public companies regulated by the U.S. Securities and Exchange Commission (SEC).

"While U.S. pressure is leading to greater scrutiny of foreign investments in Latin America, it has not halted public entities and private corporations from seeking 'opportunities with impunity.' One reason is that Latino governments traditionally distrust their 'big brother' to the north, commonly complaining that the United States is interfering with Latin America's right to regulate its own business practices.

"In addition, Latin American nations often see U.S. antifraud and anticorruption regulations as hindrances to their economic growth — particularly during a recession when foreign investment from China and the Middle East comes as badly needed economic stimulus. For many Latin American governments, the creation of new jobs ranks far more important than abiding by U.S. anticorruption laws.

"Faced with these countervailing pressures, any company doing business in Latin America needs to analyze the risks associated with a new investment, acquisition, joint venture, or business transaction. There's no substitute for due diligence at every step, including a thorough investigation of potential partners in the region. Otherwise, the U.S. company could be exposed to significant legal, financial, and public relations risks if past bribery or corruption charges come to light.

"When drafting business and investment agreements, it's essential to include provisions that absolve a U.S. company from any corrupt practices committed by a foreign entity. That can make a dramatic difference if the government launches an anti-corruption, anti-money laundering, or fraud investigation.

"The bottom line: Know your customer, know your partner, and know the risks of operating in a region where 'opportunity with impunity' remains the guiding principle for doing business."

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Lawyer Michael Diaz, Jr., Says Financial Fraud Victims May Benefit from Swiss Bank's Disclosures[13]

Swiss banking giant UBS' decision to turn over information on 4,450 "secret" bank accounts to the U.S. Internal Revenue Service signals a major shift in accountability for the world's financial markets. We spoke about the impact of this with Michael Diaz, Jr., managing partner of the Miami-based international law firm Diaz, Reus & Targ, LLP (www.diazreus.com).

Financial Fraud Law Blog: What does the UBS settlement mean to fraud victims?

Mr. Diaz: That's good news for fraud victims in South Florida and throughout the country, because locating a criminal's bank accounts is the first, and perhaps most important, step toward freezing those assets. Then, if the victims prevail in court, those funds can be recovered to provide compensation for their losses.

Financial Fraud Law Blog: Can you tell us what international banks must be thinking about right now?

Mr. Diaz: Other international banks should now recognize the importance of opening their records and cooperating with investigators. In today's climate, banks in traditional tax-shelter jurisdictions from Switzerland to the Cayman Islands understand that they may no longer be able to ensure a customer's privacy in the face of a legitimate investigation. In the UBS dispute, Switzerland's Justice Minster Eveline Widmer-Schlumpf noted that UBS could have faced criminal prosecution had it not released its records to the IRS.

It's not just Swiss bankers who see that the world is changing. When fraud victims file suit, both U.S. and foreign courts today are more open-minded about the potential need for immediate remedies, such as freezing a defendant's assets without notification. Those types of extreme steps become necessary when a financial con artist can quickly transfer funds from one jurisdiction to another.

Of course, freezing a defendant's funds in an offshore bank account is only one step in the long and complex asset-recovery process. In order to prevail in court, fraud victims must build a solid case right from the start, such as conducting a thorough review of all fraud-related documents, including email messages, fund transfers and receipts.

Financial Fraud Law Blog: Realistically, what chance do fraud victims have of finding overseas accounts anyway?

M. Diaz: Before filing a lawsuit, a fraud victim may want to conduct a careful, private investigation in order to identify potential witnesses and determine where investors' money has been hidden. At the same time, the victim's legal team can begin preparing the lawsuits, which may need to be filed overseas as well as in the U.S. The overall strategy is to have a powerful case to present to the judge without alerting the defendant in advance. In my experience, the element of surprise is extremely important in any asset recovery case.

Based on the UBS action, global banks today are more likely to cooperate with investigators than they have been in the past. Otherwise, they run the risk of being accused of complicity with any criminal actions. For fraud victims, that's a clearly a change for the better.

Financial Fraud Law Blog: Thanks, Michael.

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Stock Options Backdating Cases Go Out with a Whimper[14]

Late yesterday, Bruce Karatz, the former chief executive of KB Home, was sentenced to home detention and probation following his stock options backdating-related conviction. The court said the government's request for significant prison time was "mean-spirited and beneath this office." We spoke about the sentence with Christopher Clark, a partner at Dewey & LeBoeuf LLP and co-head of the firm's White Collar Defense and Investigations Practice Group; Clark also was a member of the Securities and Commodities Fraud Task Force during his six-year tenure as an Assistant U.S. Attorney in the Southern District of New York, and he has tried numerous white collar cases, including securities fraud and insider trading.

"The most intriguing aspect leading up to the sentencing was the split between the U.S. Probation Office and the U.S Attorney's Office on the size of the loss caused by Karatz. The Probation Office took the position that Karatz caused no loss, which meant that under the federal Sentencing Guidelines, he would serve no jail time. The U.S. Attorney's Office disagreed, arguing that KB Home 'lost' more than $6 million in stock options paid out to Karatz. The split was notable because the Probation Office, while organized under the authority of the federal courts rather than the DOJ, is nevertheless a law enforcement agency. Although it is supposed to provide an independent review of a defendant's potential sentence, too often its recommendations favor the government. Here, the Probation Office took a truly independent look at the facts and concluded there had been no loss. Judge Wright made the right decision by agreeing with that conclusion.

"Ultimately, the minimal sentence in this case is a fitting coda to the DOJ's string of stock option backdating prosecutions, which went out with a whimper rather than a bang. With few convictions and no substantial sentences, juries and the courts simply did not agree with the government's position that stock options backdating represented a serious financial crime."

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Expert Shirley Inscoe Cites "Billions Of Dollars" Disappearing Every Year Due to Internal Bank Fraud[15]

Shirley Inscoe took early retirement from Wachovia Bank at the end of

2007 to become Director, Financial Services Solutions, at Memento, Inc., which addresses fraud and compliance challenges of financial institutions of all sizes. During her 29 year tenure with Wachovia, Ms. Inscoe held a wide variety of positions, and she spent the last 13 years in strategic positions in enterprise loss management and payments strategy. Ms. Inscoe is very active with various industry groups and initiatives. She is a member of NACHA's Internet Council and is active with the Santa Fe Group. She has spoken at many BAI, ABA, BITS and NACHA conferences in recent years on a variety of topics related to fraud prevention and payments fraud, and recently co-authored the book *Insidious: How Bank Employees Steal Millions and Why It Is So Hard for Banks to Stop Them*. http://www.mementosecurity.com/insidious/. We spoke with Ms. Inscoe recently about internal bank fraud.

Financial Fraud Law Blog: How big of a problem is insider bank fraud?

Ms. Inscoe: It is impossible to say for sure — in large part that's because banks don't have established industry standards for measuring these losses, don't report this kind of information to any external governing body, and a great deal of employee fraud goes undetected.

Plus, the damage can be difficult to quantify. There are direct remediation costs from fraud incidents — reimbursing customers' stolen funds, closing accounts and opening new ones, issuing new debit cards, etc. — but there are also indirect costs from damaged reputation, reduced shareholder value and so on. What's clear and undeniable is that each and every year billions of dollars disappear due to internal bank fraud.

Financial Fraud Law Blog: What are some of the ways that employees commit fraud?

Ms. Inscoe: There are many ways bank employees can commit fraud. But, in simple terms there are four primary avenues for insiders to commit fraud. Insiders can:

- Steal money from the bank,
- Steal money from the bank's customers,
- Steal information from the bank, or
- Steal information from the bank's customers.

That being said, the method often depends on the employee's position inside the institution and his or her level of access to accounts and systems. Some of the more common approaches are well known, but difficult to detect, such as thefts from general ledger, loan lapping, selling confidential customer data, collusion, etc. Employees also can work directly with organized external crime rings to enable identity theft, on-us check fraud, new account fraud, credit card fraud, ACH fraud, deposit or payment fraud, debit card fraud, loan and/or mortgage fraud, online account hijacking, and various types of cross channel fraud.

Financial Fraud Law Blog: Why aren't banks doing more to stop this?

Ms. Inscoe: You have to understand that the very nature of the insider fraud problem makes it very difficult for banks to accept and detect. This crime — and make no mistake, insider fraud is a crime — is committed by the banks' employees, who are usually trusted co-workers and friends. People don't want to believe that their friends are crooks — so in many cases, banks are simply in denial about the problem. In our experience, once banks understand the scope of the problem, they start doing something about it. But even then, insider fraud is a difficult crime to detect.

Financial Fraud Law Blog: What can banks do to solve this problem?

Ms. Inscoe: As is always the case, the first step toward a solution is to admit that there is a problem. Once they've gotten past the denial stage, banks need to look at fraud detection processes and solutions that can help them solve the problem. The good news is that there are effective solutions available today that can greatly improve banks' ability to detect fraud, without adding an inordinate amount of overhead to their operations.

Financial Fraud Law Blog: Do fraud losses get passed on to customers?

Ms. Inscoe: They certainly do. Losses get passed on in the form of higher interest rates charged on loans and credit cards, lower interest rates paid on savings, and higher fees overall. The other way consumers "pay" is in the case of stolen information. When your personal information is stolen due to insider fraud, there is no way to get that back, and, as anyone who has been the victim of identity theft knows, the cost in time and aggravation — not to mention real dollars — is very high. In addition, statistics show that once an individual has become an identity-theft victim, they are more likely to be re-victimized because their confidential personal information (Social Security number, date of birth, driver's license number, etc.) has been compromised.

Financial Fraud Law Blog: Thanks for your insights, Shirley.

Ms. Inscoe: Thank you.

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A Surprise in the Search for Financial Fraud: Owner-Manager Fraud[16]

Auditors and attorneys are diligent about ferreting out financial fraud but often miss a surprising kind: fraud committed by owner-managers against their own businesses.

"It seems unthinkable that an owner would raid his or her own business, but owners can have strong motives for doing just that," says John E. Barron, Director in the Litigation and Corporate Financial Advisory Services Group at New York accounting firm Marks Paneth & Shron LLP (MP&S). "Auditors and attorneys should be alert to the possibility of fraud committed by owner-managers," according to Barron. Barron has more to say about owner-manager financial fraud:

Financial Fraud Law Blog: Is owner-manager fraud a large problem?

Mr. Barron: Normally you'd expect that fraudulent financial reporting or misappropriation of assets would be committed by members of management who don't have a significant ownership stake. Auditors and attorneys rightfully place most of their attention on those non-owner managers, who are responsible for most frauds. But in privately held companies, owner-managers can be the perpetrators of fraud and it is a mistake to overlook them, especially when the owner-manager has direct involvement in (or influence over) the financial reporting process.

Financial Fraud Law Blog: Why do owner-managers commit fraud?

Mr. Barron: There are several ways an owner-manager can benefit from fraudulent financial reporting. They falsify financial reports to secure financing — third-party financing normally depends on the entity's reported financial results, and poor performance could lead to restrictions on credit. Also, private equity investment or joint venture agreements might be contingent on favorable financial results. Owner-managers might need to maintain compliance with debt covenants or regulatory requirements. Or they might be trying to secure contracts that require that the business is financially sound or profitable.

Finally, they might take a step beyond fraudulent financial reporting and actually misappropriate funds. In a case like that, they're not necessarily stealing from themselves — they could be stealing funds provided by lenders or from other owners who aren't directly involved in the management of the business and therefore aren't in a position to monitor it.

Financial Fraud Law Blog: How do owner-managers conceal their financial fraud?

Mr. Barron: Owner-managers cover their tracks in exactly the same way as other members of management. They intentionally misapply Generally Accepted Accounting Principles. They put pressure on staff to complete transactions such as those with side agreements that lead to misstated results — they'll say things like, "We need to make the numbers and I don't care how you do it." They make their own financial estimates or pressure others to overestimate the value of assets or underestimate liabilities.

Financial Fraud Law Blog: How is misappropriation of funds typically concealed?

Mr. Barron: In overstated assets or expenses or understated liabilities or revenues. The owner-manager may be in a position to authorize and record fraudulent transactions. The owner-manager may have unchecked access to cash receipts or the ability to authorize fraudulent expenditures and the source of the funds may be from other owners or lenders.

Financial Fraud Law Blog: Are there special considerations that lead to owner-manager financial fraud?

Mr. Barron: The owner-manager has power and authority that isn't available to non-owner managers. He or she can intimidate subordinates into "cooking the books" or going along with questionable accounting, perhaps by the implied threat of job loss. Coming from the owner, that's a very serious threat. What makes the situation more challenging is that in private, closely-held companies, there often aren't compensating controls, such as segregation of financial reporting or record-keeping duties that are typically employed in larger, public companies. And in closely held private businesses, federal whistleblower protection statutes normally don't apply.

Financial Fraud Law Blog: Doesn't the current auditing standard for fraud help to prevent owner-manager fraud?

Mr. Barron: The standard should be revised. The standard, expressed in SAS 99, Consideration of Fraud in a Financial Statement Audit, calls attention to the risk of ineffective monitoring when management is dominated by a single person or small group in a non-owner-managed business. That presumes that an owner-manager is likely to identify fraud committed by others. However, as we've seen, there are both incentives and opportunities for the owner-manager to commit fraud and this requires an appropriate audit response. The current standard seems to give owner-managers a pass; it allows auditors to ignore the risk of fraud committed by an owner-manager. That language should be changed and the "owner-manager exception" should be removed.

Financial Fraud Law Blog: What's the bottom line?

Mr. Barron: Being an owner-manager does not exempt you from human behavior. Attorneys and auditors need to remember that owner-managers have the same opportunity to commit fraud as any other senior manager, and often have as much or more incentive and the ability to do so. Businesses led by owner-managers need as much or more auditor vigilance as any other company.

Financial Fraud Law Blog: Thank you, Mr. Barron.

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What Will the STOCK Act Accomplish?[17]

On March 22, 2012, the U.S. Senate passed a diluted version, as amended by the House of Representatives, of Senate Bill 2038, a law entitled "Stop Trading on Congressional Knowledge Act" (the STOCK Act). The STOCK Act is intended to specifically prohibit Members of Congress, Congressional employees and others from using non-public information obtained from their official positions for personal benefit. With the President expected to sign the STOCK Act into law this week, we thought it particularly timely to speak about it with William J. Kelleher III, a partner in the Stamford, Connecticut, office of the law firm Robinson & Cole LLP and a member of the Board of Editors of the *Financial Fraud Law Report*.

Financial Fraud Law Blog: What is the essence of the STOCK Act?

Mr. Kelleher: The STOCK Act was re-introduced in late 2011 in the aftermath of news reports that several members of Congress perhaps used information gleaned from their positions and intimate knowledge of non-public events to make trades during the 2008 financial crisis, and make other fortuitous trades at other times. The STOCK Act prevents those in Congress and the executive and judicial branches from using what they learn on the job to trade the stock market.

Financial Fraud Law Blog: Didn't existing insider trading laws already prohibit that conduct?

Mr. Kelleher: Federal insider trading laws do not contain an exemption for members of Congress, nor do they specifically apply to them. However, many members of Congress evidently felt the need to clarify the issue given recent developments and the push for a new law. Under the STOCK Act, there is an affirmation that the covered employees are not exempt from insider trading laws under SEC Rule 10b-5 (used to police insider trading), and that there is "a duty arising from a relationship of trust and confidence owed by each Member of Congress and employee of Congress" to the Congress, the U.S. Government and U.S. citizens.

The law also bans insider trading for all executive branch employees who are required to file financial disclosure statements and it covers judicial officers, as well.

The Act makes it a violation for the covered employees and it so amends the securities and commodities laws to include its provisions.

Financial Fraud Law Blog: What else does the STOCK Act provide?

Mr. Kelleher: Among other provisions, the STOCK Act prevents Congress and executive and judicial branch employees from getting special access to IPOs in a manner not available to the general public. In addition, it requires that the Senate and House Ethics Committees issue guidance that includes rules on conflicts of interest and gifts, which incorporate the Act's ban on the use of non-public information. It also mandates that public reports of certain transactions be disclosed within either 30 days after the person was notified of the transaction in an account, but not later than 45 days after the transaction.

Financial Fraud Law Blog: And, of course, there is a significant provision that was not included in the bill.

Mr. Kelleher: Importantly, as passed, the law does not include one of the more controversial provisions in the proposed law. The Senate's tougher version of the law, which was part of an earlier version of the bill in the Senate, included a provision that would have required more disclosure from consultants and firms that gather information and work in the area of political intelligence. This provision was not included in the final bill.

Financial Fraud Law Blog: Does that mean that provision is dead?

Mr. Kelleher: Not necessarily. The STOCK Act requires that the Comptroller General of the U.S. submit a report, within one year of the law's enactment, "on the role of political intelligence in the financial markets," including what is known about its use, prevalence, effect on markets, the extent to which it is being sold and use, the legal and ethical issues raised by the sale of political intelligence, and the benefits that may be obtained from imposing disclosure requirements on those who engage in political intelligence activities. The Act defines "political intelligence" as information that is "derived from a person from direct communications with an executive branch employee, a Member of Congress, or an employee of Congress" and "provided in exchange for financial compensation to a client who intends, and who is known to intend, to use the information to inform investment decisions." Such information is generally used by institutional investors, including investment firms, hedge funds and financial services firms. It remains to be seen if this provision will be proposed again in the future either in other laws or as a stand-alone law.

Financial Fraud Law Blog: Thank you, Mr. Kelleher.

NOTES

1 03/14/2012.
2 03/14/2012.

[3] 04/05/2012.
[4] 05/16/2012.
[5] 03/28/2012.
[6] 02/13/2012.
[7] 03/28/2012.
[8] 03/16/2012.
[9] 02/02/2012.
[10] 01/30/2012.
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[12] 07/06/2010.
[13] 08/27/2009.
[14] 11/11/2010.
[15] 11/16/2009.
[16] 03/29/2012.
[17] 04/02/2012.