
Corporate Fraud Issues

In This Issue

May 2003
Volume 51
Number 3

United States
Department of Justice
Executive Office for
United States Attorneys
Office of Legal Education
Washington, DC
20535

Guy A. Lewis
Director

Contributors' opinions and
statements should not be
considered an endorsement by
EOUSA for any policy,
program, or service.

The United States Attorneys'
Bulletin is published pursuant
to 28 CFR § 0.22(b) .

The United States Attorneys'
Bulletin is published bi-
monthly by the Executive
Office for United States
Attorneys, Office of Legal
Education, 1620 Pendleton
Street, Columbia, South
Carolina 29201. Periodical
postage paid at Washington,
D.C. Postmaster: Send
address changes to Editor,
United States Attorneys'
Bulletin, Office of Legal
Education, 1620 Pendleton
Street, Columbia, South
Carolina 29201.

Managing Editor
Jim Donovan

Assistant Editor
Nancy Bowman

Internet Address
[www.usdoj.gov/usao/
reading_room/foiamanuals.
html](http://www.usdoj.gov/usao/reading_room/foiamanuals.html)

Send article submissions to
Managing Editor, United
States Attorneys' Bulletin,
National Advocacy Center,
Office of Legal Education,
1620 Pendleton Street,
Columbia, SC 29201.

The Deputy Attorney General's Introductory Letter

The President's Corporate Fraud Task Force 1
By Andrew Hruska

Overview of the Federal Securities Laws 5
By Randall R. Lee and Andrew G. Petillon

Sarbanes-Oxley: Broader Statutes—Bigger Penalties 13
By Tom Hanusik

Cooking the Books: Tricks of the Trade in Financial Fraud 19
By Joseph W. St. Denis

**Market Capitalization as the Measure of Loss in Corporate Fraud
Prosecutions** 27
By George S. Cardona and Gregory J. Weingart

Dispositions in Criminal Prosecutions of Business Organizations . . 33
By Miriam Miquelon

The President's Corporate Fraud Task Force

*Andrew Hruska
Assistant United States Attorney,
Eastern District of New York
Former Senior Counsel to the Deputy
Attorney General
Department of Justice*

The problem of financial crime is neither new nor, unfortunately, surprising. Given the liberty of our free market economy, the enormous wealth that American enterprise generates, and the temptation to defraud others, there will always be a small minority of businesspeople who use criminal means to obtain wealth that the vast majority of their colleagues earn through sweat and toil. As Deputy Attorney General Larry Thompson cautioned, "it is important not to tar with too broad a brush the overwhelming majority of corporations that operate morally and productively in the best and highest interest of their shareholders and the country. Yet, . . . the breadth and extent of these recent scandals do demonstrate intolerable legal and ethical misdeeds that require a comprehensive response." Deputy Attorney General Larry D. Thompson, *A Day with Justice* (October 28, 2002) *available at* <http://www.usdoj.gov/dag/speech/2002/102802adaywithjustice.htm>. The spate of fraud at some of our largest corporations, revealed over the course of the past year, has injured investor confidence and compelled an efficient, coordinated response by both the Department of Justice (Department) and our many allied law enforcement and regulatory agencies. The President has charged the Corporate Fraud Task Force with that mission.

On July 9, 2002, President Bush created the Corporate Fraud Task Force, under the leadership of Deputy Attorney General Larry Thompson, to oversee and direct all aspects of the Department's manifold efforts to investigate and prosecute corporate fraud. EXEC. ORDER NO. 13,271, 67 Fed. Reg. 46091 (2002), *available at*

<http://www.usdoj.gov/dag/cff/execorder.htm>. The Executive Order also instructed the Task Force to coordinate the response of the federal law enforcement and regulatory community to this challenge. As the President explained, "This broad effort is sending a clear warning and a clear message to every dishonest corporate leader: You will be exposed and you will be punished. No boardroom in America is above or beyond the law." President's message to Corporate Fraud Conference, 38 WEEKLY COMP. PRES. DOC. 1626 (Sept. 26, 2002) *available at* <http://www.whitehouse.gov/news/releases/2002/09/20020926-10.html>.

The President's July 9 order created a dual structure with a Department group and an inter-agency group. The Department's core group consists of the Assistant Attorneys General for the Criminal and Tax Divisions, the Director of the FBI, and the United States Attorneys for the Southern District of New York, the Eastern District of New York, the Eastern District of Pennsylvania, the Northern District of Illinois, the Southern District of Texas, the Northern District of California, and the Central District of California. These United States Attorneys were chosen as representatives of major business districts across the country. Although corporate fraud matters are aggressively prosecuted throughout the country, many times in conjunction with the Criminal or Tax Divisions, these U.S. Attorneys' offices represent the bulk of the Department's enforcement. In addition, the Deputy Attorney General has designated Principal Associate Deputy Attorney General Christopher Wray and this author as staff to the Task Force.

The interagency group is composed of the Secretary of the Treasury, the Secretary of Labor, the Chairman of the Securities and Exchange Commission (SEC), the Chairman of the Commodities Futures Trading Commission (CFTC), the Chairman of the Federal Energy

Regulatory Commission (FERC), the Chairman of the Federal Communications Commission (FCC), and the Chief Inspector of the United States Postal Inspection Service (USPIS). While Grand Jury secrecy concerns bar the interagency group from discussing certain operational matters, the group does consult on policy issues and serves as a forum for the discussion of pressing matters of broad application. Perhaps more importantly, members of the interagency group communicate frequently outside of Task Force meetings on policy and, where appropriate, operational matters as they arise.

The Corporate Fraud Task Force has led an extraordinarily successful campaign against corporate fraud both in the many investigations and prosecutions it oversees and in the policy initiatives it has promoted. The Task Force concentrates on marshaling the full resources of the Department, and our allied enforcement agencies, to bring prosecutions and launch civil actions as quickly as possible following the discovery of wrongdoing by a business.

The Task Force has met in full session six times since its inauguration and hosted a national conference in September 2002 that included addresses by the President, the Attorney General, the Deputy Attorney General, as well as remarks by all the Task Force members. That conference drew together virtually all of the United States Attorneys and Special Agents in Charge of the FBI, the agency and regional leadership of the SEC, CFTC, IRS, USPIS, FCC, and the enforcement section of the Labor Department. In addition, Task Force members have contributed to a comprehensive national training program to educate AUSAs, FBI Special Agents, and our colleagues in allied Task Force agencies, in our new approach, new tools, and renewed determination to combat corporate fraud.

One of the first challenges the Corporate Fraud Task Force faced was to define the problem that demands our concentration. Although many forms of financial crime remain serious issues that properly command the attention of our prosecutors, the Task Force resolved to focus on three types of specific conduct at the heart of the current spate of corporate fraud:

- falsification of financial information, including false accounting entries, bogus trades designed to inflate profits or hide losses, and false transactions designed to evade regulatory oversight;
- self-dealing by corporate insiders, including:
 - (a) insider trading,
 - (b) kickbacks,
 - (c) misuse of corporate property for personal gain (e.g., embezzlement, self-dealing transactions), or
 - (d) individual tax violations related to the self-dealing (e.g., failure to report forgiven loans, kickbacks or other income); and
- obstruction of justice designed to conceal either of these types of criminal conduct, particularly when that obstruction impedes the regulatory inquiries of the SEC or other agencies.

These types of crimes may occur in different kinds of business organizations, including partnerships and sole proprietorships, as well as corporations, and at many levels within the organization. They may involve securities from the NYSE-listed stock to private debt instruments. Some cases arise in Fortune 100 companies, and some from small entities unknown outside the locality. All of these crimes can have serious impact both on the direct victims of the fraud, as well as on the national confidence in the integrity of the economy.

The results of the Corporate Fraud Task Force's determination are printed on the front pages of the national press. In the past nine months, the Department, and most often our Task Force colleagues from the SEC or CFTC, have announced charges in the investigations concerning corporate fraud at WorldCom, Enron, Adelphia Communications, HealthSouth, Arthur Andersen LLC, Tyco International, Imclone, Homestore.com, Qwest, Dynegy, American Tissue Inc., El Paso Corporation, Mercury Finance, Anicom, Commercial Financial Services, Kmart, Peregrine Systems, Symbol Technologies, and many other companies. Many of the press

releases for these charges are *available at* <http://www.usdoj.gov/dag/cff/pubs.htm>. Investigations continue concerning most of these companies and many more. Overall, the Corporate Fraud Task Force is overseeing more than 150 corporate fraud investigations. Task Force staff and the Deputy Attorney General consult regularly with the prosecutors and investigators assigned to these matters to coordinate the overall scope and direction of the Department's effort to combat corporate fraud and to best coordinate with our Task Force colleagues outside the Department. These investigations have led to charges against more than 200 individuals and already resulted in more than 75 convictions. In addition, Task Force members have obtained the freezing of tens of millions in assets and are seeking the forfeiture of billions. See, especially, the forfeiture allegations in the indictment arising from the investigation of Adelphia Communications: *United States v. John J. Rigas, Timothy J. Rigas, Michael J. Rigas, James R. Brown and Michael C. Mulcahey* (S.D.N.Y. 2002), *available at* <http://10.173.2.12/usao/eousa/ole/tables/fraudsec/rigasind.wpd>, and arising from the investigation into Enron Corporation from the Complaint in *SEC v. Andrew S. Fastow* (S.D. Tex. 2002), *available at* <http://www.sec.gov/litigation/complaints/comp17762.htm>.

While painstaking efforts are, and must be, made to be fair and thorough in our approach, the guiding principle of the Task Force is that we can no longer afford to wait years before addressing significant criminal conduct that threatens to corrupt the sound foundation of the economy. This real-time enforcement has cut the time from discovery to prosecution decisions from the traditional two or three years down to months or even weeks, as the recent Department and SEC actions in WorldCom, Adelphia, and HealthSouth demonstrate. Resisting the desire to plumb every aspect of the criminal conduct to wrap up the "perfect case," Department and SEC attorneys and investigators focused on discrete conduct that could be immediately charged.

Using this aggressive approach, the Task Force has addressed the need to broaden the traditional scope of our investigations to include the conduct of professionals, such as lawyers, accountants, and investment bankers, both within and outside the corporation. Because it is not possible for significant corporate fraud to persist without the complicity or deception of these key professionals, the Task Force determined that it is imperative to make prosecutorial decisions about each of the professionals in contact with the fraudulent business practice under investigation. Sometimes, as in the Arthur Andersen matter, a professional firm itself can become so enmeshed in the fraud of its client that the entire entity may be criminally liable.

It is particularly disturbing when attorneys, the guardians of the law, participate or acquiesce in crimes. As the Deputy Attorney General observed:

The attorney's role is to take an independent look with some healthy skepticism at the corporation's conduct—where it is right to keep it right, and where it is not, to make it right. . . . [L]awyers have a responsibility to their clients, to the profession and to the public to view such practices in the cold light of reality with an eye toward how they may look splayed out on the front page in the unforgiving glare of unfavorable public attention.

Deputy Attorney General, Larry D. Thompson, A Day with Justice (October 28, 2002) *available at* <http://www.usdoj.gov/dag/speech/2002/102802adaywithjustice.htm>. To add force to this determination, the SEC has recently promulgated a set of attorney conduct rules that requires attorneys to report fraud within a corporation and to take active measures to disassociate themselves from such conduct. Implementation of Standards of Professional Conduct for Attorneys, Securities and Exchange Commission, 17 C.F.R. Part 205 [Release Nos. 33-8185; 34-47276; IC-25919; File No. S7-45-02] RIN 3235-AI72, *available at* <http://www.sec.gov/rules/final/33-8185.htm>.

The Task Force supervised the process of revising the Principles of Federal Prosecution of

Business Organizations that led to the Deputy Attorney General's promulgation of the new principles in January 2003. As the Deputy Attorney General stated in his directive to Department prosecutors:

The main focus of the revisions is increased emphasis on and scrutiny of the authenticity of a corporation's cooperation. Too often business organizations, while purporting to cooperate with a Department investigation, in fact take steps to impede the quick and effective exposure of the complete scope of wrongdoing under investigation. The revisions make clear that such conduct should weigh in favor of a corporate prosecution.

Memorandum of Deputy Attorney General Larry D. Thompson to Heads of Department Components and United States Attorneys (January 20, 2003), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm. The revisions also reemphasize the need to pursue individual as well as organizational crime. In addition, while the waiver of work product protection and attorney-client privilege by the corporation may be desirable and may be a factor in determining the extent and authenticity of cooperation, the principles make plain that, "The Department does *not* . . . consider waiver of a corporation's attorney-client and work product protection an absolute requirement." (Emphasis added.)
Memorandum of Deputy Attorney General Larry D. Thompson to Heads of Department Components and United States Attorneys (January 20, 2003), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

The Task Force has also played a crucial role in advocating the Department's position on the appropriate enhancement of fraud sentences to correspond to the dramatic increase in statutory maxima enacted by the Sarbanes-Oxley Act. Sarbanes-Oxley Act of 2002, PUB. L. No. 107-204, 116 Stat. 745 (2002), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_public_laws&docid=f:publ204.107.pdf. Congress increased statutory maxima from five years to twenty years for mail and wire

fraud (18 U.S.C. §§ 1341, 1343) and the newly enacted Title 18 Securities Fraud offense (18 U.S.C. §1348) from ten years (under the Title 15 offenses) to twenty-five years. Thus far, the United States Sentencing Commission has not made commensurate changes in the Fraud Loss Table of UNITED STATES SENTENCING GUIDELINES MANUAL § 2B1.1. The Task Force continues to coordinate the Department's efforts to address this problem through a variety of approaches, including sending an ex officio Commissioner to participate in the Sentencing Commission's procedures.

The Corporate Fraud Task Force will continue to press ahead on both the investigative and policy fronts. As the Attorney General stated in his address to the Corporate Fraud Task Force's national conference:

We cannot—we will not—surrender freedom for all to the tyranny of greed for the few. Just over a year ago, Americans were called to defend our freedom from assault from abroad. Today we are called to preserve our freedom from corruption from within. You are the answerers of this call; you are the defenders of this freedom. I am grateful to you all for your leadership, and I thank you for your sacrifice and your steadfast commitment to returning integrity to American markets through justice

Attorney General John Ashcroft, "Enforcing the Law, Restoring Trust, Defending Freedom," Corporate Fraud Task Force Conference, (September 27, 2002), *available at* http://www.usdoj.gov/ag/speeches/2002/092702a_gremarkscorporatefraudconference.htm. The support of the entire U.S. Attorney community is necessary for these efforts to continue with the great success we have all achieved to date.❖

ABOUT THE AUTHOR

□ **Andrew Hruska** is an Assistant United States Attorney in the Eastern District of New York. He was formerly the Senior Counsel to the Deputy Attorney General. He advised the Deputy Attorney General on a variety of matters, including Corporate Fraud, the work of the President's Corporate Fraud Task Force, which the Deputy Attorney General chairs, and white collar crime in general.

Mr. Hruska previously served as an Assistant District Attorney in the Frauds Bureau of the Manhattan District Attorney's Office where he prosecuted a wide range of financial crimes, including securities fraud, bank fraud and accounting fraud. Prior to that, Mr. Hruska was associated with the New York law firm of Sullivan & Cromwell. ☒

Overview of the Federal Securities Laws

Randall R. Lee
Regional Director, Pacific Region
U.S. Securities and Exchange Commission

Andrew G. Petillon
Branch Chief, Pacific Regional Office
U.S. Securities and Exchange Commission

I. Introduction

The "federal securities laws" consist of six statutes enacted by Congress from 1933 to 1940 to protect investors and restore confidence in the stock market following the Great Crash of 1929. Today, in the wake of corporate fraud scandals and investor uncertainty, the federal securities laws are as important as they were seventy years ago. The United States Securities and Exchange Commission (SEC) is the federal agency with primary responsibility for regulating the securities markets and bringing civil enforcement actions against securities violators. The federal securities laws also provide for criminal liability, and the Department of Justice (Department) and United States Attorneys' Offices (USAOs) around the country have been increasingly active in working with the SEC and bringing criminal actions against securities violators.

Recent legislation gives the SEC and criminal prosecutors unprecedented powers to enforce the federal securities laws, which should result in additional civil and criminal securities cases. In light of these developments, more Assistant United States Attorneys (AUSAs) and related criminal law enforcement personnel are devoting their efforts to prosecuting securities violators. This article gives a brief overview of the federal regulation of securities and attempts to provide some tips on working with the SEC and prosecuting securities fraud.

II. The SEC

The SEC was established in 1934 to administer and enforce the federal securities laws. The agency has about 3,100 employees who work in the headquarters in Washington, D.C., and in five regional and six district offices throughout the United States. The professional staff members are mostly attorneys, accountants, and examiners, but also include economists, financial analysts, and others. The agency has five Commissioners, including a Chairman, who are appointed by the President. William Donaldson became the SEC's Chairman in February 2003, following former Chairmen Harvey Pitt and Arthur Levitt. The five Commissioners meet in public sessions to consider and vote on proposed rules and policy issues that affect the securities markets. They also

meet in non-public sessions to consider and vote on whether to authorize enforcement actions recommended by the staff.

The SEC has four operating Divisions: Corporation Finance, which oversees the disclosure requirements of public companies; Market Regulation, which oversees broker-dealer firms, the stock exchanges, and other securities market participants; Investment Management, which oversees the \$15 trillion money management industry of mutual funds and investment advisers; and Enforcement, the SEC's largest division, which conducts investigations, recommends enforcement action when appropriate, and prosecutes civil enforcement actions in federal court and before administrative law judges. The Enforcement Division works closely with federal, state, and local criminal law enforcement agencies around the country when securities law violations warrant criminal prosecution.

The SEC has regional offices in Los Angeles, Denver, Chicago, New York, and Miami, and district offices in San Francisco, Salt Lake City, Fort Worth, Boston, Philadelphia, and Atlanta. Each field office operates enforcement programs within their geographic region, and cases are investigated and prosecuted by either a field office or by enforcement staff at headquarters in Washington, D.C. (commonly referred to as the home office). The enforcement staff consists of attorneys and accountants with extensive experience and expertise in investigating securities violations of all types.

The field offices (as well as the home office) also operate inspection programs, in which staff accountants, attorneys, and examiners conduct on-site examinations of regulated persons and entities—broker-dealers, transfer agents, clearing agencies, investment companies, investment advisers, and the self-regulatory organizations—to ensure compliance with the securities laws. When an examination reveals potentially serious violations, the examination staff may refer the matter to the enforcement staff for further investigation. Therefore, AUSAs who handle cases involving misconduct by a regulated person or entity may work closely with the SEC's

examination staff, who can also be a useful resource because of their in-depth knowledge of the regulated community.

We strongly encourage United States Attorneys and AUSAs to develop close and cooperative relationships with the SEC field office in your jurisdiction. That office is likely to be your most fruitful source of securities fraud cases and can be a tremendous source of experience and expertise. The more the SEC and the USAOs work cooperatively and coordinate their efforts, the more both agencies can leverage their scarce resources and bring swifter and more effective actions to prevent wrongdoing and prosecute the wrongdoers.

III. The six federal securities statutes and related rules

Six statutes comprise the federal securities laws: (1) the Securities Act of 1933; (2) the Securities Exchange Act of 1934; (3) the Public Utility Holding Company Act of 1935; (4) the Trust Indenture Act of 1939; (5) the Investment Advisers Act of 1940; and (6) the Investment Company Act of 1940. Each statute also authorizes the SEC to adopt rules and regulations (which are a group of rules relating to the same subject) to further define and interpret the specific statutory provisions. For example, Section 10(b) is the general antifraud statute of the Securities Exchange Act of 1934. 15 U.S.C. § 78j(b). Using its statutory authority, the SEC adopted Rule 10b-5, which sets forth conduct that the SEC considers to be fraudulent under Section 10(b). 17 C.F.R. § 240.10b-5. The core philosophy throughout the six statutes and related SEC rules and regulations is to protect investors by requiring companies to make full disclosure of all material facts about a security. A fact is material, and therefore must be disclosed, if a reasonable investor would consider the fact to be important to an investment decision. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

Each statute provides a basis for criminal prosecution for willful violations of any provision of the statute or rules and regulations thereunder, and for any knowing and willful material false statements in any report or document filed with

the SEC. Thus, although most criminal prosecutions are brought under the antifraud provisions of the securities laws, it is important to remember that any violation of the securities laws, rules, and regulations, can be the basis for a criminal action if the requisite *mens rea* is present. Below we provide a brief overview of four of the six statutes that are most commonly charged in SEC civil enforcement actions and criminal prosecutions.

IV. The Securities Act of 1933

The Securities Act of 1933 (commonly referred to as the Securities Act or the '33 Act) primarily regulates the offer and sale of securities by companies to the public. The statute seeks to protect investors in securities offerings by requiring companies to disclose adequate information to allow investors to make fully informed investment decisions about the security.

A key provision in achieving this goal is Section 5 of the Securities Act, which requires that every offer or sale of a security involving interstate commerce must either be registered or exempt from registration. 15 U.S.C. § 77e. This means that every time a company wants to raise money by selling securities to the public, the offering process must comply with the detailed registration or exemption provisions of the Securities Act and related rules. The SEC often charges Section 5 violations in cases involving the sale of unregistered stock by boiler rooms or by publicly traded shell companies. Criminal prosecutions are occasionally brought under Section 5, which does not require a showing of fraud. 15 U.S.C. §§ 77e, 77x. Because a Section 5 violation requires proof that the registration or exemption provisions have not been complied with (and because evidence of fraud tends to be more compelling to a jury), criminal Section 5 charges are more commonly brought in conjunction with securities fraud charges. The following briefly describes some Securities Act issues and provisions that can arise in a criminal case.

A. Is a security involved?

A threshold question applicable to all federal securities laws, but that frequently arises in the context of Securities Act registration issues, is whether an investment opportunity involves a security. If no security is involved, the federal securities laws do not apply. Because the federal securities laws typically provide the greatest range of civil and criminal sanctions for fraudulent investment activity, the SEC and USAOs often expend significant effort in determining whether conduct involves a security. For the same reason, sophisticated fraud perpetrators often attempt to structure their activities to try to avoid falling within the legal definition of a security.

A security is basically an intangible interest in a business. Each of the six securities statutes sets forth a detailed legal definition of a security, which is further defined by SEC rules and interpretations and court decisions. Section 2(1) of the Securities Act defines a security to include "any note, stock, treasury stock, bond, debenture . . . [or] investment contract . . ." 15 U.S.C. § 77b(a)(1). There often will be no question that a security is involved if the investment is described as a "stock" or "bond" and has the typical characteristics of these common securities. However, when the name or characteristics of an investment program do not make it obvious that a security is involved, a factual and legal analysis of the investment must be made.

The most common catch-all definition of a security in the federal securities laws is the term "investment contract" in Section 2(1) of the Securities Act. 15 U.S.C. § 77b(a)(1). This term was first interpreted by the Supreme Court in *SEC v. W.J. Howey*, 328 U.S. 293 (1946). In *Howey*, the Court held that the ostensible "sale" of orange groves to investors, under a contractual arrangement in which the seller would use proceeds from the sale to manage the groves and return a portion of the profits to the buyer, was in reality an investment contract and therefore a security. The Court defined "investment contract" in Section 2(1) of the Securities Act as a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is

led to expect profits solely from the efforts of the promoter or a third party." *Id.* at 301. This three-part "Howey test" is often used by the SEC to find that certain investment programs (e.g., earthworm breeding programs, pyramid sales, "prime bank" instruments, etc.) are, in fact, securities, and can be regulated as such.

B. Registered offerings under the Securities Act

If a business offers and sells its securities to the public and cannot rely on any exemption from registration (as discussed below), the offer and sale must be registered and comply with the Securities Act. Registration means that a registration statement must be filed with the SEC. The registration statement must include a prospectus, which is a disclosure document provided to prospective investors. The registration statement must include detailed information about the company and its management, including audited financial statements, as required by the SEC rules and forms.

The SEC may choose to review and comment on the registration statement, and the company cannot sell its securities to the public until the SEC has completed its review and indicated that it has no further comments. The primary objective of the review process is to ensure that the registration statement provides full and accurate disclosure of significant information about the securities. A knowing and willful false statement in a registration statement may be subject to criminal prosecution. 15 U.S.C. § 77x.

C. Exempt offerings under the Securities Act

Under narrowly defined circumstances set forth in the Securities Act and related rules, certain types of securities and transactions are exempt from the registration requirements (but not the antifraud provisions) of the Securities Act. For example, certain securities issued by federal, state, or local governments, such as municipal bonds, are exempt from registration. Certain securities transactions, often called private placements, are also exempt from registration. Section 4(2) of the Securities Act provides that transactions "not involving any public offering" are exempt from registration. 15 U.S.C. § 77d(2).

Because it was difficult to determine what transactions qualified for an exemption under the broad language of Section 4(2), the SEC adopted Regulation D to be a safe harbor for conducting certain transactions without registration. 17 C.F.R. §§ 230.500-230.508.

Regulation D is a set of rules that generally allows a company to offer and sell securities without registration when the money to be raised is limited (\$1 million or less in one type of Regulation D offering, and \$5 million or less in another) and/or when the offering is made primarily to institutions, individuals who meet certain income or net worth requirements, and corporate insiders. To qualify for an exemption from registration under most provisions of Regulation D, the securities may not be sold through any form of general solicitation or advertising. Rule 502, 17 C.F.R. § 230.502(c). This means that if securities are being sold by cold-calling or over the Internet, for example, they generally will not qualify for an exemption under Regulation D. Many fraudsters who claim to be selling private placements run afoul of the securities laws in the first instance because of the prohibition on general solicitations.

D. Antifraud provision under the Securities Act

Section 17(a) is the general antifraud provision of the Securities Act. 15 U.S.C. § 77q(a). The provision prohibits fraud by any person in the offer or sale of securities involving interstate commerce. Section 17(a) proscribes three types of fraud: first, "to employ any device, scheme, or artifice to defraud"; second, "to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading"; and third, "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." This provision is applicable even if the underlying security or transaction is exempt from registration.

Criminal violations of Section 17(a) are typically brought in a wide variety of cases, ranging from the sale of fraudulent investments through boiler rooms to accounting fraud cases in which securities are sold to the public by companies that have reported false financial information in their registration statements. 15 U.S.C. §§ 77q(a), 77x.

V. The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 (commonly referred to as the Exchange Act or the '34 Act) regulates the trading markets, that is, the secondary trading of securities by brokers and the public after the initial sale of the securities by a company. This is in contrast with the Securities Act, which regulates initial sales by a company to the public. The Exchange Act is an extensive and complex statute that regulates the trading markets in at least three ways: first, by requiring market participants, such as broker-dealer firms, transfer agents, stock exchanges, and Nasdaq, to register with and be regulated by the SEC; second, by imposing periodic disclosure obligations on companies with publicly-traded securities and on insiders of these companies (officers, directors, large shareholders); and third, by providing strong prohibitions against fraudulent or manipulative conduct that could harm the integrity of the markets.

As noted above, the Exchange Act provides the SEC with broad authority over the stock exchanges and the National Association of Securities Dealers (NASD), which together are known as self-regulatory organizations (SROs). An SRO is a member organization that creates and enforces rules for its members based on the federal securities laws. Among other things, SROs discipline and sanction their members, and establish rules to ensure market integrity and investor protection, all under the oversight of the SEC. SROs are the first-line regulators of broker-dealers (as compared to investment advisers and investment companies, which do not presently have an SRO).

A. Reporting obligations of public companies

A company becomes "public" under the Exchange Act by, among other things, selling

securities to the public under a registration statement, or having more than \$10 million in assets and more than 500 shareholders. 15 U.S.C. § 781(g); 17 C.F.R. §§ 240.12g-1, 240.15d-1. Once a company becomes public, it must begin filing periodic reports as required by the Exchange Act and related SEC rules. 15 U.S.C. § 78m(a); 17 C.F.R. §§ 240.13a-1, 240.13a-11, 240.13a-13. The periodic reports require disclosures about the company, its management, and its financial condition.

Once the periodic reports are filed, they are available to the public through the SEC's online database called EDGAR. The accuracy of these reports is important because investors base investment decisions on information in the reports. Most of the recent high profile corporate and accounting fraud scandals involved allegations that the companies had misled investors by including inaccurate financial and other information in periodic reports.

When a public company files a periodic report that is later discovered to be materially inaccurate, the company generally must file the report again with restated (accurate) information. The SEC's enforcement staff looks carefully at these restated periodic reports because they are evidence that a prior report was inaccurate and can be an indication that fraud has occurred.

The three main periodic reports that public companies must file are the annual report on Form 10-K, the quarterly report on Form 10-Q, and the current report on Form 8-K. The annual report on Form 10-K must be filed within ninety days after the end of a company's fiscal year. (In 2004 and 2005, the filing deadline for the 10-K will be shortened to seventy-five and sixty days, respectively, after the end of the company's fiscal year.) The Form 10-K report is generally the most detailed of the periodic reports. It provides a comprehensive description of the company's business activities, plans, management, and financial condition. The Form 10-K requires financial statements audited by an independent public accountant. As noted above, knowing and willful false statements in any periodic report are subject to criminal prosecution. 15 U.S.C. § 78ff.

The quarterly report on Form 10-Q must be filed within forty-five days after the end of a company's first three quarters. (In 2004 and 2005, the filing deadline for the 10-Q will be shortened to forty and thirty-five days, respectively, after the end of the company's first three quarters.) The Form 10-Q provides quarterly updates of the company's business activities and financial condition and is typically much less detailed than the Form 10-K. The Form 10-Q requires financial statements that must be reviewed by an independent auditor, but do not need to be audited.

The current report on Form 8-K must be filed within five or fifteen days after the occurrence of certain events. The Form 8-K provides disclosures about important events or changes during the life of a company, such as bankruptcy, a merger, a major acquisition, a change in the company's independent auditor, or a director's resignation. Under proposed new rules, the filing deadline will be reduced to two days after the triggering event, and the list of triggering events will be significantly expanded. As with restated periodic reports, the SEC's enforcement staff looks carefully at certain Form 8-K reports because they can be an indication that fraud or other significant problems at a company have occurred. For example, a change in the company's independent auditor could indicate a material accounting problem.

In addition to the disclosure obligations of public companies, officers, directors, and large shareholders of public companies have their own disclosure obligations. 15 U.S.C. § 78m(d), 78p; 17 C.F.R. §§ 240-13d-1, 240.16a-2, 240.16a-3. For example, these public company insiders must report their beneficial ownership of the company's stock in public SEC filings and update the information if they buy or sell additional shares. Insiders sometimes seek to conceal their ownership or control of a company from the public by failing to file, or filing false or misleading SEC reports, regarding their stockholdings. In such cases, criminal charges may be brought if prosecutors can demonstrate that the insiders acted knowingly and willfully. 15 U.S.C. § 78ff.

B. Accounting obligations of public companies

The Exchange Act requires public companies to keep accurate books and records and maintain a system of internal controls to provide reasonable assurances that financial transactions are properly recorded. 15 U.S.C. 78m(b)(2)(A), 78m(b)(2)(B). Although simply the failure to have adequate books and records or internal controls is not a basis for criminal prosecution, prosecutors may bring criminal charges against persons who knowingly circumvent or fail to implement a system of internal controls, or knowingly falsify books and records. 15 U.S.C. §§ 78m(b)(5).

Rule 13b2-2 under the Exchange Act provides that civil and criminal charges may also be brought against a director or officer who makes a materially false or misleading statement to an auditor in connection with any audit or examination of the financial statements of a reporting company. 17 C.F.R. § 240.13b2; 15 U.S.C. § 78ff.

Another accounting-related provision is Section 30A of the Exchange Act. 15 U.S.C. 78dd-1. Adopted in 1977 as part of the Foreign Corrupt Practices Act, Section 30A prohibits public companies from making improper payments to foreign officials for the purpose of influencing their decisions. These payments constitute accounting fraud when the transactions are inaccurately reflected in the company's financial statements to conceal the improper nature of the payments.

C. Antifraud provisions of the Exchange Act

Section 10(b) and Rule 10b-5 are the general antifraud provisions of the Exchange Act. 15 U.S.C. § 78j(b); 17 C.F.R. § 240-10b-5. These sections prohibit fraud by any person in connection with the purchase or sale of securities involving interstate commerce (in contrast with the "offer or sale" language in Section 17(a) of the Securities Act). The language of Section 10(b) and Rule 10b-5 essentially mirrors the language of Section 17(a) of the Securities Act in proscribing the use of a device, scheme, or artifice to defraud; the making of an untrue statement of a material fact, or the omission of a material fact

that results in a misleading statement; and acts which would operate as a fraud or deceit.

Section 10(b) and Rule 10b-5 are undoubtedly the most commonly charged provisions in both civil and criminal securities fraud cases. 15 U.S.C. §§ 78j(b), 78ff; 17 C.F.R. § 240-10b-5. Because of their breadth, violations of those provisions are typically alleged in virtually every type of case brought by the SEC, including cases involving accounting fraud and other false financial reporting, offering frauds, insider trading, market manipulation, and misappropriations of funds by brokers.

D. Effects of the Sarbanes-Oxley Act

On July 30, 2002, legislation known as the Sarbanes-Oxley Act of 2002 became law. Sarbanes-Oxley has had, and will continue to have, profound effects on the federal securities laws and civil and criminal enforcement of the laws. Among other things, the Act created a new Public Company Accounting Oversight Board, added more rigorous disclosure requirements for public companies, established new corporate governance requirements, imposed new rules of conduct and professional responsibility on attorneys, and significantly strengthened the criminal penalties for securities fraud. Sarbanes-Oxley also added new weapons to the SEC's enforcement arsenal, including authority to seek officer and director bars in federal court and administrative cease and desist proceedings under a new, lower standard, the ability to freeze certain extraordinary payments before bringing an action, and authority to seek penny stock bars in federal court.

Sarbanes-Oxley also contains several provisions that may make it easier to bring criminal charges in certain securities fraud cases. First, the Act created a new criminal offense for securities fraud. Section 807 of the Act, codified at 18 U.S.C. § 1348, makes it a crime "to defraud any person in connection with any security. . . ." A person convicted under this new statute is subject to imprisonment for up to twenty-five years. This new securities fraud statute is similar to existing mail and wire fraud statutes and may make it easier for AUSAs to charge securities

fraud because the new statute is less technical than the reporting and accounting provisions under the Exchange Act.

Second, Sarbanes-Oxley added three new obstruction of justice crimes that eliminate some of the more restrictive provisions of the pre-Sarbanes-Oxley obstruction statutes. 18 U.S.C. §§ 1512, 1519, 1520.

Finally, Section 906 of Sarbanes-Oxley, codified at 18 U.S.C. § 1350, requires chief executive officers (CEOs) and chief financial officers (CFOs) of public companies to certify that their corporation's financial statements, filed in periodic reports, are accurate and comply with SEC reporting requirements. 18 U.S.C. § 1350. This new provision provides criminal liability for those who knowingly or willfully certify a report that does not comport with the requirements.

VI. The Investment Advisers Act of 1940 and Investment Company Act of 1940

The last two federal securities statutes were enacted in 1940 to regulate investment advisers and investment companies. Investment advisers are in the business of giving investment advice to others for compensation. Investment advisers have a fiduciary duty to their clients and must always act in the best interests of their clients.

An investment company is an entity in the business of buying and selling securities. Mutual funds are the most common type of investment company. Those who manage and control investment companies also have fiduciary duties to investors. Congress enacted the two 1940 Acts to address the unique business and fiduciary duties of investment advisers and investment companies. Under the 1940 Acts, all nonexempt investment companies and investment advisers must register with the SEC and submit to SEC regulatory inspections at any time.

Section 206 of the Investment Advisers Act of 1940 (the Advisers Act) is the general antifraud provision applicable to investment advisers. 15 U.S.C. § 80b-6. Section 206 prohibits any direct or indirect transaction that acts as a fraud or deceit on any client or prospective client (in contrast with the antifraud provisions of the

Exchange Act, which require that the fraud be in connection with the purchase or sale of securities). Although there is no antifraud provision applicable specifically to investment companies, most investment companies sell securities under the Securities Act, have securities traded under the Exchange Act, and are managed by an investment adviser subject to the Advisers Act, all of which have antifraud provisions. Any fraud by an investment company, therefore, would likely be actionable under one of the other securities statutes.

Criminal prosecutions under Section 206 of the Advisers Act may be brought in a wide range of cases where an investment adviser defrauds or deceives its clients. 15 U.S.C. §§ 80b-6, 80b-17. Examples include cases in which the adviser misappropriates client funds, deceives clients about the value of their investments, places its own interests above those of the clients (such as by allocating profitable trades to its own account and losing trades to the clients' accounts, a scheme known as "cherry-picking"), or engages in other types of self-dealing.

VII. Overview of the SEC's enforcement authority

While there are many similarities between the manner in which the SEC enforcement staff and AUSAs investigate potential securities law violations, there are certain key differences in both procedure and substance. This section provides a very brief summary of the SEC's enforcement authority.

The SEC enforcement staff conducts both informal and formal investigations. An informal investigation may entail interviewing witnesses, reviewing trading data and records that regulated entities are required to keep and produce, and obtaining and reviewing documents that various other third parties voluntarily produce. A formal investigation, which must be authorized by the Commission itself, gives the SEC staff the authority to issue subpoenas to compel sworn testimony and the production of documents. The SEC, however, does not present evidence to a grand jury, immunize witnesses, engage in covert investigative methods, or execute search warrants.

When the SEC staff is prepared to recommend an enforcement action, it presents a detailed memorandum to the Commission setting forth the applicable facts and legal analysis. The Commission must authorize any enforcement action.

Under the securities laws, the SEC can bring an enforcement action either in federal court or before an SEC administrative law judge. When the SEC brings a federal court action, it may seek an injunction (i.e., a federal court order prohibiting someone from violating specified provisions of the federal securities laws). Violations of an injunction can be addressed by either a civil or criminal contempt action. As part of an injunctive action, the SEC can also seek civil money penalties, disgorgement of ill-gotten gains received by the securities violator, and an order barring someone from serving as an officer or director of a public company, either permanently or for a fixed period. When the SEC brings a federal court action to halt an ongoing fraud, it often seeks emergency relief in the form of a temporary restraining order, an order freezing assets, and the appointment of a receiver.

The SEC can also bring an enforcement action in an administrative proceeding before one of the SEC's five administrative law judges. In an administrative action, the SEC staff may seek to suspend or revoke a person's registration as a broker-dealer or investment adviser, bar a person from association with the securities industry, suspend or prohibit attorneys and accountants from appearing or practicing before the SEC, suspend or bar a person from serving as an officer or director of a public company, obtain civil money penalties and disgorgement in the case of a regulated person or entity, and obtain a cease and desist order against future violations.

VIII. Resources

One good resource for learning more about the SEC and the federal securities laws is the SEC website at www.sec.gov. Among other things, the website provides a link to the six statutes and related rules that constitute the federal securities laws (under the subtitle "About the SEC"); information on recent SEC enforcement actions

(Litigation); access to the annual, quarterly, and other periodic reports of public companies (Filings & Forms [EDGAR]); recent speeches by the SEC Chairman, Commissioners, and staff (News & Public Statements); and telephone contact information for SEC headquarters and regional and district offices (About the SEC – Concise Directory). Finally, we encourage AUSAs with questions about the federal securities laws to contact your SEC counterparts in the regional and district offices and the home office.

IX. Conclusion

For seventy years, the federal securities laws have provided a comprehensive regulatory scheme to oversee the securities industry and provide civil and criminal remedies against those who violate the laws. While the SEC is the primary overseer and regulator of the U.S. securities markets, only the Department and USAOs can criminally prosecute those who violate the federal securities laws. It is essential, therefore, for AUSAs who handle securities cases to gain an understanding of the securities laws and of the SEC's role, responsibilities, and operations. At the same time, the SEC stands ready and willing to share its expertise and experience to assist you in our joint mission to enforce the federal securities laws.❖

ABOUT THE AUTHORS:

❑ **Randall R. Lee** is the Regional Director of the Pacific Region of the SEC. In that capacity, Mr. Lee oversees the SEC's enforcement and regulatory programs in nine Western states through offices in Los Angeles and San Francisco. Before joining the SEC in December 2001, Mr. Lee was an Assistant United States Attorney for the Central District of California for seven and one-half years, where he served as a Deputy Chief of the Major Frauds Section. He previously practiced corporate and securities law at Munger, Tolles & Olson in Los Angeles.

❑ **Andrew G. Petillon** is an enforcement branch chief in the SEC's Pacific Regional Office (PRO) in Los Angeles, where he supervises investigations of a wide range of securities law violations. He has been an SEC staff member for over seventeen years, as an enforcement staff attorney in the PRO, as an attorney in the PRO's investment adviser and investment company examination program, and as an attorney in the SEC's Division of Corporation Finance in Washington, D.C.✉

The SEC, as a matter of policy, disclaims responsibility for any private publication or statement of any of its employees. The views expressed herein are those of the authors and do not necessarily reflect the views of the Commission or any other staff members.

Sarbanes-Oxley: Broader Statutes— Bigger Penalties

*Tom Hanusik
Trial Attorney, Fraud Section
U.S. Department of Justice*

I. Introduction

The Sarbanes-Oxley Act of 2002 (the Act) became effective on July 30, 2002. PUB. L. NO.

107-204, 116 Stat. 745 (2002). The Act represents the legislative response to the recent wave of corporate scandals that have plagued our capital markets. This legislation supplies important new tools to federal prosecutors who enforce the nation's securities laws, while simultaneously increasing the SEC's ability to punish corporate

officers and recoup ill-gotten gains. In addition, recent amendments to the UNITED STATES SENTENCING GUIDELINES MANUAL (sentencing guidelines), adopted in response to the Act, make the prospect of lengthy jail terms a reality for high-ranking corporate criminals.

The purpose of this article is to review three aspects of the Act: (i) the new securities fraud criminal provisions contained in 18 U.S.C. §§ 1348, 1349, and 1350; (ii) the recent amendments to the sentencing guidelines for corporate criminals adopted in response to the Act; and (iii) the new regulatory powers conferred on the Securities and Exchange Commission (the SEC) by the Act. As explained below, the Act changes the landscape for securities fraud investigations and prosecutions by expanding the arsenal of weapons available to both criminal and civil prosecutors. These changes will make it easier for federal prosecutors to bring securities fraud charges. Furthermore, the Act's increased penalty provisions and concomitant amendments to the sentencing guidelines should serve as a significant deterrent to would-be corporate criminals.

II. New criminal securities fraud statutes

A. Securities fraud

The Act adds three new statutes to Title 18 relevant to the federal criminal securities laws. The first, a general securities fraud statute, provides:

Whoever knowingly executes, or attempts to execute, a scheme or artifice—

(1) to defraud any person in connection with any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (§ 15 U.S.C. 781) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (§ 15 U.S.C. 78o(d)); or

(2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of

any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (§ 15 U.S.C. 781) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (§ 15 U.S.C. 78o(d)); shall be fined under this title, or imprisoned not more than 25 years, or both.

18 U.S.C. § 1348 (2002).

Aside from omitting the mailing and interstate wire requirements found in 18 U.S.C. §§ 1341 and 1343 respectively, section 1348 goes a long way toward demystifying the formidable maze of statutes and regulations that constitute the Title 15 body of law under which securities fraud prosecutions are currently pursued. Practically speaking, the new statute makes it easier to bring these cases by omitting the willfulness requirement found in the criminal provisions of the Securities and Exchange Act of 1934 (the '34 Act), 15 U.S.C. § 78a, *et seq.* (1996). Requiring that securities fraud schemes be executed knowingly, rather than willfully, should make securities fraud charges more palatable to federal prosecutors who have extensive experience charging knowing violations in mail, wire, and bank fraud cases. In addition, eliminating the willfulness requirement also removes a potentially confusing jury instruction. Although section 1348 cites Title 15 for jurisdictional purposes, the bottom line is that it will apply to securities fraud in connection with the stock of companies that trade on the New York and American Stock Exchanges, as well as those that are required to file periodic reports with the SEC.

Another benefit of section 1348(1) is that it omits the '34 Act requirement that the fraud scheme occur "in connection with the purchase or sale" of a security. Section 1348(1) requires only that the scheme occur in connection with a security. In light of the Supreme Court's decision in *SEC v. Zandford*, which held that a scheme which coincides with a purchase or sale of a security satisfies the "in connection with" requirement, this change may amount to a distinction without a difference. *SEC v. Zandford*, 535 U.S. 813 (2002). Nonetheless, prosecutors

have one less hurdle to clear by eliminating the purchase or sale requirement. The broader language of section 1348(1) will also encompass a number of fraudulent and deceptive practices that utilize pledges of securities and hedging mechanisms, regardless of whether or not there is an actual purchase or sale of a security. In addition, by focusing on the scheme to defraud rather than some technical books and records or internal control violations, section 1348(1) should enable federal prosecutors to stay focused, and get juries focused, on the underlying fraud without being distracted by potential defenses to technical violations. Finally, for those cases where dishonest means are used to deprive investors of money and property in connection with securities transactions, section 1348(2) still retains the purchase or sale language.

Section 1348 also increases the statutory maximum for securities fraud to twenty-five years in jail. Prior to Sarbanes-Oxley, securities crimes prosecuted under Title 15 carried a statutory maximum of ten years. Although Sarbanes-Oxley increased the Title 15 maximum to twenty years, section 1348 provides the longest potential jail term for people convicted of securities fraud. 15 U.S.C. § 78ff.

B. Attempts and conspiracies

Another new fraud provision in Title 18 is the attempt and conspiracy statute that is codified at section 1349:

Any person who attempts or conspires to commit any offense under this chapter shall be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy.

18 U.S.C. § 1349 (2002).

Section 1349 is important in three respects. First, it does not contain an overt act requirement. Thus, there is one less element of proof than required by a conspiracy charge under 18 U.S.C. § 371. Second, conspiracies charged under section 1349 carry the maximum penalty for the underlying substantive offense, rather than the five-year maximum contained in section 371.

Notably, this applies to all conspiracies that violate Chapter 63 offenses. Thus, conspiracies charged under section 1349 now carry a twenty year term if they involve mail and wire fraud, a thirty year term if they involve bank fraud or affect a financial institution, and a twenty-five year term if they involve securities fraud under section 1348. Finally, section 1349 is important in that it does not displace section 371 entirely. Thus, in cases where the facts and circumstances warrant a five year cap on exposure to incarceration, section 371 conspiracies to violate any fraud statute can still be charged. In addition, section 371 will have to be used when one of the objects of the conspiracy is something other than a Chapter 63 offense, such as obstruction of justice.

C. False certifications of financial statements

The final new securities fraud provision added by Sarbanes-Oxley to Title 18 is found in section 1350 and addresses certifications of financial statements by CEOs, CFOs, and equivalent officers:

(a) Certification of periodic financial reports. –Each periodic report containing financial statements filed by an issuer with the Securities Exchange Commission pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934 (§ 15 U.S.C. 78m(a) or § 78o(d)) shall be accompanied by a written statement by the chief executive officer and chief financial officer (or equivalent thereof) of the issuer.

(b) Content. –The statement required under subsection (a) shall certify that the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

(c) Criminal penalties.– Whoever –

(1) certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$1,000,000 or imprisoned not more than 10 years, or both; or

(2) willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$5,000,000, or imprisoned not more than 20 years, or both.

18 U.S.C. § 1350 (2002). Aside from explicitly requiring that CEOs, CFOs, and similar officers certify the accuracy of financial statements of publicly traded companies, section 1350 is important in that it draws a distinction between knowing violations, which carry a \$1,000,000 fine and ten year jail terms, and willful violations, which carry a \$5,000,000 fine and twenty year jail term.

Although it is difficult to practically demonstrate the legal ramifications of section 1350's distinction between knowing violations and willful violations, the Supreme Court held that "willful" has different meanings and "its construction [is] often . . . influenced by its context." *Ratzlaf v. United States*, 510 U.S. 135, 141 (1994). In the context of section 1350, it is clear that Congress intended to draw a distinction between those who knowingly certify false financials and those who willfully do so—a distinction that has a difference of up to ten years in jail. In practice, this distinction will fall almost entirely into the realm of prosecutorial discretion. Federal prosecutors using section 1350 will have to exercise discretion when differentiating between corporate officers who act knowingly and willfully. That discretion should include consideration of the level of culpability and responsibility of the putative defendant. Since both provisions apply only to senior-level officers, the different exposure levels between sections 1350(c)(1) and 1350(c)(2) provide federal prosecutors an opportunity to distinguish

between the corporate officer who knows that a company's financial statements are misleading but nevertheless certifies them, and the corporate officer who causes the financial statements to be misleading and also certifies them.

III. Amendments to the United States Sentencing Guidelines

The most significant practical change in how corporate criminals will be treated under Sarbanes-Oxley can be found in the recent amendments to the sentencing guidelines. When Congress passed Sarbanes-Oxley, it directed the United States Sentencing Commission to develop modifications to, *inter alia*, the fraud guidelines within 180 days of the Act's enactment. In response, the United States Sentencing Commission adopted a series of temporary guideline modifications for fraud cases which became effective January 25, 2003. *See* U.S. SENTENCING COMMISSION SUPPLEMENT TO THE 2002 GUIDELINES MANUAL.

The net effect of these amendments is that a corporate officer or director who is convicted of securities fraud, in a case that has more than 250 victims and that jeopardizes the solvency of the issuer, is exposed to eight additional points for sentencing guideline calculation purposes. For example, consider the CEO who is convicted of securities fraud with a total loss to the company's 300 investors of \$500,000 in a case where the company filed for Chapter 11 bankruptcy protection following revelations of the misconduct. As demonstrated in the following chart, this corporate felon's exposure jumps from a 78-97 month range to a 188-235 month range under the amended guidelines. Both of these ranges increase proportionately if further adjustments apply under U.S. SENTENCING GUIDELINES MANUAL § 3B1.1 (2002) for aggravating role. Considering that \$500,000 losses in securities fraud cases are not infrequent, and that most public companies have well in excess of 300 investors (i.e., potential victims), these guideline amendments will have a significant impact on the ongoing effort to crack down on corporate crime. Pursuant to another amendment found in the U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 (2002), courts

should consider "[t]he reduction that resulted from the offense in the value of equity securities or other corporation assets" when making loss determinations at sentencing. *See* U.S. SENTENCING COMMISSION SUPPLEMENT TO THE 2002 GUIDELINES MANUAL § 2B1.1., cmt. n. 2(c)(iv) (2003).

The guideline amendment's first two-point adjustment, or upgrade, applies in cases where there are more than 250 victims. Under the old guidelines, cases with more than fifty victims would result in a four-point upward adjustment to the offense level. The amendments retain this four-point adjustment and add a new-six point adjustment for cases with more than 250 victims, for a net increase of two points in cases with more than 250 victims.

The next guideline amendment adds a specific

offense characteristic worth four points to the offense level in cases where the crime substantially endangers the solvency of: (i) a publicly traded company; or (ii) a private company with more than 1000 employees; or (iii) more than 100 victims. *See* U.S. SENTENCING COMMISSION SUPPLEMENT TO THE 2002 GUIDELINES MANUAL § 2B1.1(b)(12)(B) (2003). This amendment expands the existing adjustment for crimes which jeopardize the solvency of banks and applies it to all large and/or publicly traded companies. Notably, the nonexhaustive list of factors for courts to consider in determining whether financial solvency has been endangered includes: (i) whether the company has become insolvent or suffered a substantial reduction in the value of its assets; (ii) whether the company has filed for bankruptcy; (iii) whether the company's stock or retirement accounts have experienced a

Table
Impact of Sarbanes-Oxley on Sentencing

2002 Guidelines:		Sarbanes-Oxley Amendments:	
§ 2B1.1(a) base level	6	§ 2B1.1(a) base level	6
§ 2B1.1(b) (1) loss	+14	§ 2B1.1(b) (1) loss	+14
§ 2B1.1(b) (2)(B) >50 victims	+4	§ 2B1.1(b) (2)(C) >250 victims	+6
§ 2B1.1(b) (8) sophisticated means	+2	§ 2B1.1(b) (8) sophisticated means	+2
	--	§ 2B1.1(b)(12)(B) substantially endangers solvency of (i) a public company, (ii) a company with more than 1000 employees or (iii) more than 100 victims	+4
§ 3B1.3 abuse of position of trust	+2	§ 2B1.1(b)(13) securities fraud by officer/director	+4
Total Offense Level	28	Total Offense Level	36
Criminal History Category I = <u>78-97 months</u>		Criminal History Category I = <u>188-235 months</u>	

substantial reduction in value; (iv) whether the company has substantially reduced its workforce; (v) whether the company has substantially reduced pension benefits; and (vi) whether trading in the company's stock has been halted and/or the stock has been de-listed. U.S. SENTENCING COMMISSION SUPPLEMENT TO THE 2002 GUIDELINES MANUAL § 2B1.1(b)(12)(B), cmt. n. 10(B)(ii) (2003).

Finally, the Sentencing Commission added a new offense characteristic worth four points for offenses involving violations of the securities laws that are committed by officers and/or directors of publicly traded companies. U.S. SENTENCING COMMISSION SUPPLEMENT TO THE 2002 GUIDELINES MANUAL § 2B1.1(b)(13) (2003). Since this is a specific offense characteristic, the net effect for sentencing purposes will be two additional points since the two-point adjustment for abuse of trust found in U.S. SENTENCING GUIDELINES MANUAL § 3B1.1 (2002) will be mooted. U.S. SENTENCING COMMISSION SUPPLEMENT TO THE 2002 GUIDELINES MANUAL § 2B1.1(b)(12)(B), cmt. n. 11(C) (2003). However, this adjustment applies to all securities laws violations, including the aforementioned Title 18 statutes and the Title 15 violations of the SEC's rules and regulations. U.S. SENTENCING COMMISSION SUPPLEMENT TO THE 2002 GUIDELINES MANUAL § 2B1.1(b)(12)(B), cmt. n. 11(B) (2003). In addition, this adjustment will apply to an officer or director convicted under a general fraud statute whose conduct also violates the securities laws. *Id.* Thus, federal prosecutors should keep this adjustment in mind when negotiating plea agreements that contain guidelines stipulations since it can be used in mail and wire fraud cases and should be easier to prove at sentencing where the lower preponderance of the evidence standard applies.

IV. New SEC enforcement powers

In addition to the new criminal provisions discussed above, the Act also provides significant new enforcement powers to the SEC—three of which are discussed herein. These new powers have the potential to significantly impact the direction and progress of a parallel SEC civil investigation, which can, in turn, influence the

pace and direction of a criminal case. The SEC's new powers fall into three areas: (i) lower standards for officer and director bars (O&D bars); (ii) the ability to request a freeze of extraordinary payments to officers and directors in certain circumstances; and (iii) new forfeiture powers in situations where earnings restatements result from misconduct.

Before the Act the SEC had the power to petition federal district courts to get officers and directors barred from serving in such capacities when they commit fraud violations under either Section 17(a)(1) of the Securities Act or Section 10(b) of the Exchange Act. The Act enhances the SEC's ability to seek O&D bars in two important respects. First, the SEC can now seek O&D bars in administrative proceedings, which means the administrative law judges who have specific expertise in securities fraud cases will be making these determinations. 15 U.S.C. §§ 77h-1, 78u-3. Second, the standard for an O&D bar has been lowered by the Act from "substantially unfit" to "unfit." 15 U.S.C. §§ 77t(e), 78u(d)(2). While the precise parameters of this new standard have not yet been litigated, it is clear that Congress has reduced the standard for an O&D bar.

The Act also enhances the SEC's power to preserve a company's assets for the benefit of defrauded shareholders. Under section 1103 of the Act, the SEC can, in certain circumstances, petition federal courts to freeze extraordinary payments to any director, officer, partner, controlling person, agent, or employee of a company during an investigation. 15 U.S.C. § 78u-3(c). The initial freeze order lasts for forty-five days and can be extended another forty-five days for good cause shown, or until the resolution of a case if the SEC files charges. *Id.*

Another enhancement of the SEC's enforcement powers is provided by Section 304 of the Act and applies in situations where a company restates financial results due to "material noncompliance" resulting from "misconduct." 15 U.S.C. § 7243. In these situations, which generally occur when a company restates financial results because of "accounting irregularities", the SEC can force the company's CEO and CFO to forfeit bonuses, as well as

profits from trading in the company's stock, that they received within twelve months of the filing that is being restated. *Id.* Notably, there is no requirement that the CEO and/or CFO be shown to have engaged in the misconduct at issue in order for the SEC to enforce this new power. *Id.*

While the SEC's new powers are not available to criminal prosecutors, the reality is that most securities fraud investigations proceed on parallel criminal and civil tracks, with a large amount of cooperation between the SEC and Department of Justice. Thus, an understanding of the SEC's powers will assist the cooperative law enforcement effort, especially when decisions are being made concerning attempts to freeze and forfeit fraud proceeds.

V. Conclusion

Sarbanes-Oxley has the potential to significantly enhance the federal prosecutor's efforts to combat corporate crime. Broader statutes like section 1348, which focuses on the scheme to defraud, go a long way toward demystifying an otherwise daunting maze of securities fraud statutes and regulations. Increased penalties in the statutes, and concomitant offense characteristic adjustments in the guidelines, should help deter illegal conduct and induce cooperation after illegal conduct occurs. In addition, new enforcement powers at the SEC will enhance the effectiveness of parallel investigations between civil and criminal authorities. Taken together, these changes represent important steps in the effort to protect our capital markets and restore investor confidence, by cracking down on corporate fraud. ❖

ABOUT THE AUTHOR

❑ **Tom Hanusik** is a Trial Attorney with the Fraud Section of the Criminal Division and a member of the Enron Task Force. Prior to joining the Department, he was Senior Counsel in the SEC's Division of Enforcement. ❖

Cooking the Books: Tricks of the Trade in Financial Fraud

Joseph W. St. Denis
Assistant Chief Accountant
United States Securities and Exchange
Commission, Division of Enforcement

I. Introduction

In December 2001, Enron declared bankruptcy as the many aspects of that scandal were beginning to come to light. In the Report of the Powers Committee and a series of televised congressional hearings throughout the spring and

summer of last year, the mind-boggling complexity of the Enron debacle was revealed to an incredulous and outraged public. As the Enron story unfolded, other formerly high-flying large capitalization public companies seemed to be collapsing under accounting scandals on a disturbingly regular basis.

High-profile corporate collapses during the last eighteen months have caused the public, and many in government and the financial services industry, to question the soundness of the

financial reporting system. Generally accepted accounting principles (GAAP), the principles which govern accountants in the preparation of financial statements, and generally accepted auditing standards (GAAS), which provide a framework for the conduct of audits, are under fire for their apparent failure to detect and prevent fraud. Some commentators have opined that Enron's allegedly fraudulent financial statements, for example, would have been in conformity with GAAP had certain related-party disclosures been more complete, or had an independent investor's ownership of a special purpose entity (SPE) been a few tenths of a percentage point higher. As recently as February 24, 2003, *NEW YORK TIMES* reporter Kurt Eichenwald told a national television audience that "Enron complied with the letter of the law" in its financial reporting. *See Kudlow and Kramer* (MSNBC television broadcast, February 24, 2003).

These assertions seem somewhat disconnected from real world events, given the pace and scale of criminal indictments and civil enforcement actions in the Enron matter and others. One possible explanation for this is that the conclusions drawn by some commentators seem to be based on the assumption that GAAP is a system of binary rules that provides a clear "yes or no" answer to any conceivable question arising in the preparation of financial statements, and that GAAS is essentially a compliance checklist. Nothing could be further from the truth. The presumption that GAAP and GAAS are purely rules-based systems is a questionable place to begin an assessment of the financial reporting system or a financial fraud investigation. In fact, although there are certain "bright line" rules, they are intended to provide minimum standards, not to function as hard and fast rules. In fact, GAAP and GAAS are essentially principles-based systems that require thousands of judgments to be made by human beings in the preparation and audit of financial statements, and the two processes are inseparable in providing relevant and reliable financial information to investors.

This suggests three topical areas of interest for prosecutors:

- GAAP and GAAS, being principles-based, must reflect the economic substance of transactions rather than their form; therefore, a defendant's use of a technical "rules" defense is not necessarily insurmountable in cases where there have been materially misstated financial statements.
- The audit process, being integral to financial reporting, is unlikely to exist in a free-floating state apart from or oblivious to fraud; therefore, large-scale financial fraud often requires the participation and cooperation of those parties who hold an interest. These "stakeholders" to financial fraud can include boards of directors, auditors, attorneys, customers, and suppliers, as well as management. Although this article deals primarily with the auditor's responsibility, other actors are often involved.
- Certain recurring fact patterns have established themselves over the years as dominant themes in financial fraud and these patterns can be expected to appear in the future.

II. Substance vs. form

In the post-Enron environment, the idea that a company can manipulate GAAP such that it does not engage in bright-line rule violations, but still presents materially misleading financial statements to its investors, has gained broad acceptance. Some prosecutors may feel this is a novel charging theory, but from an accountant's viewpoint, it is a return to the profession's roots. Form over substance arguments, while popular in the media and with the defense bar, do not cut much ice with the SEC or other law enforcement authorities these days. As far as the accounting and auditing profession is concerned, the argument was settled long ago.

In fact, the greatest advantage of the current system to financial statement users is its emphasis on substance over form. The accounting literature is replete with references to the importance of this concept. A couple of brief examples of this include the following:

- "Substance over form is an idea that also has its proponents, but it is not included because

it would be redundant. The quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form." QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION, Statement of Financial Accounting Concepts No. 2 ¶ 160 (Financial Accounting Standards Bd. 1980). ["Con 2"].

- "Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance. The auditor should consider whether the substance of transactions or events differs materially from their form." THE MEANING OF 'PRESENT FAIRLY IN CONFORMITY WITH GENERALLY ACCEPTED ACCOUNT PRINCIPLES', Statement on Auditing Standards No. 69, AU § 411.06 (American Inst. of Certified Pub. Accountants 1992). ["SAS 69"].
- "Because of developments such as new legislation or the evolution of a new type of business transaction, there sometimes are no established accounting principles for reporting a specific transaction or event. In those instances, it might be possible to report the event or transaction on the basis of its substance by selecting an accounting principle that appears appropriate when applied in a manner similar to the application of an established principle to an analogous transaction or event." *Id.*
- With respect to related party transactions: "In addition, the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form." RELATED PARTIES, Statement on Auditing Standards No. 45, AU § 334.02 (American Inst. of Certified Pub. Accountants 1983). ["SAS 45"].

Starting from the perspective that financial statements should fairly present the economic substance of a company's activities, consider a hypothetical situation in which a clever

accountant, attorney, or MBA, creates a set of financial statements that technically comply with every specific rule in the GAAP literature, but are not fairly presented and, therefore, not in conformity with GAAP. If investigators and prosecutors begin this case looking for bright-line rule violations, they will be met at every turn with an explanation of how each transaction complied with the letter of the law. Instead of starting an investigation looking for specific, tangible rule violations, prosecutors should seek to understand how the tools of financial fraud were employed in an overall scheme to enrich management and others. Consider how other parties to the fraud (auditors, customers, banks, etc.) may have participated or cooperated and what they stood to gain. Remember that cooperation can be active (a customer signs a false accounts receivable confirmation) or passive (auditors willfully ignore red flags or employ tortured logic to explain the unexplainable).

III. The audit process

The audit process includes more than the work performed by the auditing firm; it involves the whole corporate governance infrastructure—board of directors, audit committee, internal audit (if applicable), and any other compliance-related activities. The audit committee of the board of directors is ultimately responsible for the integrity of the audit process. However, there are specific standards within GAAS that compel auditors to assert themselves in situations where there are warning signs of financial fraud, in order to fulfill their legal and ethical obligations. Some in the auditing profession claim that audits are not designed to detect fraud. It is true that audits are not designed to detect activities such as embezzlement, forgery, and counterfeiting. However, in examining some of the major frauds of the recent past, it is apparent that the audit process was adequate to detect many of these schemes, and in many cases it did. The American Institute of Certified Public Accountants occasionally publishes statistics indicating that a small percentage of frauds are detected in the audit process. This seems at odds with the experience of the Securities and Exchange Commission (SEC) staff, which is that auditors were often aware at some level that fraud

was being perpetrated, but failed to take the proper steps to investigate and report it. If a financial fraud scheme, like those discussed below, is addressed by an auditing standard and yet continues undeterred, the prosecutor should ask why the auditors failed to act. Was it incompetence or inexperience? Were the auditors protecting a lucrative fee arrangement, or were compromised decisions made in the past to advance their careers?

GAAS and the securities laws require auditors to assess the risk of fraud and respond to red flags. Among the risk factors for financial reporting fraud cited in the auditing literature is the presence of:

- A significant portion of management's compensation represented by bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position, or cash flow;
- An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices;
- Domination of management by a single person or small group without compensating controls such as effective oversight by the board of directors or audit committee;
- Management setting unduly aggressive financial targets and expectations for operating personnel;
- Management displaying a significant disregard for regulatory authority;
- Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work;
- Inability to generate cash flows from operations while reporting earnings and earnings growth;
- Significant, unusual, or highly complex transactions, especially those close to year end, that pose difficult "substance over form" questions.

At the conclusion of the assessment, auditors are required to design appropriate procedures to address the risks. If auditors discover that there is possible material fraud, they are required to report it to senior management and the audit committee. *See* CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement on Auditing Standards No. 82, AU § 316.17 (American Institute of Certified Public Accountants 1997) ["SAS 82"]. Further, the securities laws compel auditors to report possible material fraud to the audit committee, which is then required to advise the SEC. *See Securities Exchange Act*, 15 U.S.C. 78b § 10A(b)1.

IV. There are a thousand ways to cook the books, but only a few basic ingredients

To employ a culinary metaphor, there is a practically unlimited variety of recipes for financial fraud, but they all contain the same basic ingredients. Howard Schillit has referred to these as "shenanigans," and they include recording bogus revenue, boosting income with one-time gains, and failure to record or disclose all liabilities. *See* HOWARD SCHILLIT, FINANCIAL SHENANIGANS AT X, (McGraw Hill, 1st ed. 1993). An earlier article, David L. Anderson & Joseph W. St. Denis, *Investigating Accounting Frauds*, USA Bulletin March 2002, at 3 includes a more complete discussion of these basic tools of financial fraud. All of the patterns in public company financial reporting fraud employ some combination of these basic tools. Following are some examples of common patterns.

A. Earnings management

The term earnings management refers to the intentional manipulation of a company's revenues and/or expenses through the use of accruals or reserve accounts. This involves some combination of shifting current expenses to future periods, shifting current income to future periods, and shifting future expenses to the current period. Some common examples of the accounts used are reserves for litigation, bad debts, returned product, and environmental remediation. Earnings management can also occur through manipulation of unearned revenue accounts and, one of the largest areas of past abuse, restructuring reserves. In the case of restructuring reserves, large reserve

increases are characterized as "one-time charges" and then later released to supplement reported income from operations. Improper manipulation of these accounts takes place because their balances are based on estimates, an area in which GAAP is perceived by many to be vague.

Accounting for reserves, known in the accounting literature as "loss contingencies," is controlled by ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5 (Financial Accounting Standards Bd. 1975) [SFAS 5]. SFAS 5 states that in order for a loss contingency to be accrued, it must be probable that the loss has occurred at the date of the financial statements, and the amount of the loss must be reasonably estimable. *See* SFAS 5 ¶8. SFAS 5 says nothing about how to make or document estimates. Too often this has led to the conclusion that the lack of guidance in this area of the accounting literature meant that accounting estimates could be whatever was wanted or needed, and that the documentation could consist of a few stray thoughts or a conversation in the hallway. This approach is too easily manipulated and should never survive the audit process, yet it is disturbingly common.

Indeed, auditors are required by GAAS to obtain and document sufficient competent evidential matter to support their audit of the financial statements. *See* EVIDENTIAL MATTER, Statement on Auditing Standards No. 31, AU § 326.01 (American Inst. of Certified Pub. Accountants 1980) [SAS 31]. With respect to estimates, this means that auditors are required to obtain an understanding of how management develops estimates supporting reserve accounts and then apply one or more of the following tests:

- Review and test the process used by management to develop the estimate;
- Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate;
- Review subsequent events or transactions occurring prior to the completion of fieldwork.

See AUDITING ACCOUNTING ESTIMATES, Statement on Auditing Standards No. 57, AU

§ 342.10 (American Inst. of Pub. Accountants 1989).

Additionally, the federal securities laws require issuers to "make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." Securities Exchange Act of 1934 (Exchange Act); 15 U.S.C. 78b § 13(b)(2)(a). The SEC has pulled together the concepts of "probable and reasonably estimable" from SFAS 5 and "reasonable detail" from the Exchange Act in recent enforcement actions involving improper estimates. In June of 2002, the SEC found that Microsoft Corporation:

recorded and adjusted its reserve accounts in ways not permitted under GAAP in its quarterly and annual filings. To a material extent, these reserve accounts lacked factually substantiated bases, and were therefore improper. The limited and inadequate documentation that Microsoft created with respect to these reserve accounts either did not substantiate any permitted basis for the accounts or indicated that the accounts were impermissible under GAAP.

In the Matter of Microsoft Corporation, Accounting and Auditing Enforcement Release [AAER] No. 1563 at 9 ["Microsoft Action"]. The Microsoft Action made clear the SEC's position that undocumented reserve accounts that cannot be explained and audited at a reasonably detailed level are in violation of the federal securities laws. When unsupported reserves are used to make a failing company appear successful, that is fraud.

Here are a couple of other points about reserves. First, GAAP does not allow the accrual of reserves for future losses, no matter what the likelihood. A common example of this is where a company knows with absolute certainty that it will incur losses when a foreign government changes a currency exchange rate. Although it may be known with 100% certainty that the change will be made and how much it will affect the company's results, it has not happened yet and cannot be accrued until it is incurred. Second, judgments that are not reducible to paper cannot be reasonably estimable. Experienced managers

often feel that their undocumented judgment or gut feeling is the most accurate way to estimate reserves. They may be right. However, gut-level or purely intuitive estimates do not meet the GAAP standard of probable and reasonably estimable and are, therefore, improper. Further, GAAP requires that methods of estimation must be consistent and any material change in the method of calculation must be disclosed to investors. *See* QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION, Statement of Financial Accounting Concepts No. 2 (Financial Accounting Standards Bd. 1980).

B. Cherry picking

Cherry picking involves the creative application of boosting income with one-time gains and failing to record or disclose all liabilities. Wall Street investment banks and large accounting firms made billions of dollars during the last bull market selling structured finance devices to their clients. The world of structured finance is full of sophisticated vehicles such as synthetic leases, special-purpose entities, and unconsolidated subsidiaries. Most of these concepts come out of capital-intensive, regulated industries such as utilities, where they are used to increase access to capital. Structured finance also uses derivatives, such as options, futures, and interest rate swaps, to spread risk. When properly used, structured finance provides a valuable risk management tool that can reduce costs and provide stability. However, more recently these devices have become popular with companies of dubious intent, Enron being the most notorious.

In the 1980s, before the proliferation of structured finance, the energy industry was extremely innovative in the use of limited partnerships for tax avoidance. Oil and gas companies, in particular, set up hundreds and sometimes thousands of layered limited partnerships in a shell-game to disguise ownership and take advantage of tax loopholes. In the 1990s, companies like Enron combined structure finance with limited partnerships to allow them to present a highly engineered and extremely flattering view to investors. Enron had over 2,500 subsidiaries. Through a myriad of legal agreements, Enron arranged its assets,

liabilities, and income streams, such that debt and losses were placed in unconsolidated subsidiaries, and gains and income were placed in consolidated subsidiaries. For example, Enron used mark-to-market accounting to generate income on energy supply contracts in its consolidated wholesale division, while losses on its merchant investment portfolio were siphoned into the unconsolidated (off-balance sheet) Raptor structure. *See* William Powers, Jr., Chair, Report of Investigation by the Special Comm. of the Bd. of Directors (Feb. 1, 2001) (Powers Report). Therefore, Enron's financial statements presented only part of the picture. This is the essence of a cherry picking strategy.

Some of the more mundane schemes of cherry picking involve simply failing to properly classify and disclose bank loans. The last few years have seen an increase in the use of receivables factoring. This is a transfer of amounts due to a company to a bank or other third party, in exchange for cash. If the transaction is properly executed, i.e. the receivable is proper and the transferee assumes all of the risks associated with collection, the receivable can be removed from the balance sheet, and the cash received from the purchaser can be included in the cash flows from the operations section of the statement of cash flows. However, if there is any guarantee by the company selling the receivable that it will repurchase or otherwise "make whole" the purchaser, it should be presented on the balance sheet as a loan, and the receivable should remain on the books. *See* ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140, (Financial Accounting Standards Bd. 2000). Moreover, the statement of cash flows should present the proceeds in the cash flows from the financing activities section.

A good example of just such a scheme is that of Peregrine Systems, Inc. ("Peregrine"). The SEC filed a complaint against Peregrine's treasury manager on November 25, 2002, alleging "Peregrine management engaged in a myriad of deceptive sales and accounting practices to create the illusion of growth, including secretly adding material sales contingencies to what appeared on

their face to be binding contracts." *See Securities and Exchange Commission v. Ilse Cappel, C.A.*, No. 02 CV 2310 JM (LSP) (S.D. Cal. November 25, 2002). Peregrine allegedly sold some of these contingent receivables to banks in order to reduce its day sales outstanding (DSO), an important financial metric for analysts, and agreed to compensate the banks for any amounts that were not collectible. Effectively, Peregrine retained all of the risks associated with collecting the receivables. When the receivables were sold, Peregrine removed them from the accounts receivable line on its balance sheet, reducing DSO. Further, Peregrine did not recognize a liability for the amount received from the banks. In November of 2002, Peregrine's treasury manager pled guilty to bank fraud.

Auditors are almost always complicit in a cherry picking strategy because such schemes usually involve aggressive interpretations of GAAP, along with lack of disclosure. This, more than any other pattern, relies on form over substance. Although one would hope this is changing, companies found in recent years that they could often convince their auditors to accept a highly liberal, self-serving interpretation of GAAP for each individual transaction. Naturally, these transactions often accumulated into an unfair portrayal in the financial statements. In such cases, prosecutors should pay particularly close attention to the auditor's fraud risk assessment and compliance with SAS 82.

C. Channel stuffing

Channel stuffing refers to the practice of pushing inventory into the "channel," which generally consists of a network of distributors or resellers. By itself, channel stuffing is not necessarily fraudulent. In fact, there are circumstances in which loading up resellers with inventory makes good business sense. For example, when a company introduces a new product, it may be perfectly reasonable to flood the channel in order to make certain that there is plenty of inventory on the shelves in the event the product is popular with consumers. An example of this strategy was Microsoft's launch of Windows 95 in August of 1995. Microsoft knew it had a potential blockbuster, so it flooded the

channel with more inventory than it thought it could possibly sell. On the night before the release, customers lined up outside of stores around the country to get their hands on a copy. Microsoft's strategy was a response to the risk that they had underestimated demand and would lose revenue due to stock-outs.

However, when channel stuffing is used to improperly inflate a company's reported revenue, that is improper. One of the most common types of fraudulent channel stuffing occurs when revenue is recognized on a consignment sale. A consignment sale takes place when a seller places a product at a seller's location and collects when the reseller sells the product. In other words, the sale of the good from the seller to the reseller is contingent on resale to an end customer. GAAP prohibits recognition of revenue in the presence of a resale contingency. *See* REVENUE RECOGNITION WHEN RIGHT OF RETURN EXISTS, Statement of Financial Accounting Standards No. 48, ¶ 6b. (Financial Accounting Standards Bd. 1981). The consignment nature of the sale is generally hidden in a side agreement, but it is surprising how often the language of the contract indicates that there is a resale contingency. For example, without stating outright that payment is contingent on resale, there might be a cancellation clause that allows the reseller an out if they are unable to move the merchandise. Another example is a contractual right to bill-back the seller for unsold goods, i.e. a round-trip. The SEC has brought numerous channel stuffing cases in recent years, including Critical Path (AAER 1539), Informix (AAER 1215), and North Face (AAER 1713). More details can be found on the SEC's web site at www.sec.gov.

Improper channel stuffing can take place without the auditor's direct knowledge as it often involves conspiracy with customers to provide false audit confirmations. Where customers provide such fraudulent evidence, it is hard to fault the auditor, since ostensibly independent, third-party confirmation is considered to be the highest quality audit evidence. *See* SAS 31. However, consignment sales often create a collection problem, and the auditor has a responsibility to follow up. For example, if a company sells a block of software licenses to a

reseller on consignment, but obtains a fraudulent confirmation from the customer stating that there is no resale contingency, presumably the associated receivable will remain uncollected until the licenses are sold through to end users. After some period of time without collection, the auditor should become highly skeptical of the representations made at the time the sale was booked and consider whether the company's financial statements should be restated, regardless of whether the transaction was confirmed. *See THE CONFIRMATION PROCESS*, Statement of Auditing Standards No. 67, AU § 330 (American Inst. of Certified Pub. Accountants 1992).

D. Topsiders

This is one of the simplest and most blatant forms of fraud—making unsupported entries to a company's books. In June of 2002, the SEC filed a civil complaint against WorldCom alleging that the company had improperly capitalized billions of dollars in ordinary operating expenses. This caused WorldCom to appear to be a profitable company, when in fact it was losing money. The alleged fraud was accomplished through topside journal entries to reclassify line costs (fees paid by WorldCom to third-party telecommunication network providers for access rights) to capital expenditures. *See Securities and Exchange Commission v. WorldCom*, Civil Action No. 02-CV-04963 (JSR November 5, 2002).

A basic auditing procedure is designed to detect improper topside entries. It is known in the profession as "tying-out" the financial statements. This is where an auditor (usually an inexperienced auditor under the close supervision of more senior personnel) traces the amounts in the financial statements and related notes to the underlying audited accounting records. If topside entries have been made, they will be flushed out when the auditor attempts to tie the financial statements back to the underlying books and records. In fact, this is a procedure that is required by GAAS, which states that the audit working papers "should be sufficient to show that the accounting records agree or reconcile with the financial statements." *See WORKING PAPERS*, Statement of Auditing Standards No. 41, AU

339.06 (American Inst. of Certified Pub. Accountants 1982).

V. Conclusion

Accounting information, along with full and fair disclosure, should provide an accurate reflection of the economic substance of reported transactions. A system of specific, universally applicable rules that would provide such a reflection in all or nearly all cases is not attainable nor is it desirable, as the cost of compliance would be prohibitive. It is also undesirable for another, more compelling reason: it would emphasize form over substance. Such a system, if it did exist, would encourage poor economic outcomes because it would reward the financial engineer at the expense of the entrepreneur. The fall of Enron and its auditor, Arthur Andersen, provided useful insights into the risks inherent in such a rules-based system. ❖

ABOUT THE AUTHOR

□ **Joseph W. St. Denis** is an Assistant Chief Accountant in the United States Securities and Exchange Commission's Division of Enforcement. Mr. St. Denis joined the Staff in 1998 after working as an auditor with Coopers & Lybrand and as a Chief Financial Officer and controller in the high tech industry. Mr. St. Denis is a licensed Certified Public Accountant in Colorado.✉

The Securities and Exchange Commission, as a matter of policy, disclaims any responsibility for any private publication or speech by its members or staff. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or the author's colleagues on the staff of the Commission.

Market Capitalization as the Measure of Loss in Corporate Fraud Prosecutions

George S. Cardona
Chief Assistant United States Attorney
Central District of California

Gregory J. Weingart
Assistant United States Attorney
Chief, Major Frauds Section
Central District of California

Congratulations! You've navigated your way through complex business deals and opaque accounting literature, marshaled your facts, and convicted a defendant in a corporate accounting fraud case. Your reward is an equally daunting challenge—attempting to answer the question of what exactly is the loss caused by the defendant's conduct for purposes of calculating the sentence under the Sentencing Guidelines.

When the fraud victimizes a financial institution (for example, the manipulation of accounts receivable to draw down on credit lines), loss can be calculated in a fairly traditional manner by looking at how much the financial institutions actually lost. However, many corporate fraud cases, particularly those involving publicly traded companies, are premised on wrongdoing that results in a fraud on the market, (for example, a public exchange such as the New York Stock Exchange or Nasdaq). While alternate means such as the offender's gain (for example, insider trading profits made during the fraud) exist by which to calculate loss, measuring the loss caused to persons in the market is most appropriately done by comparing the difference between how the market priced the stock based on the fraudulent information with how the market would have priced the stock had the market had the correct information.

Frauds on the market typically take one of two forms, with distinctly different patterns in the effect on stock price. In the first type of case, the defendants conceal information that, if known, would decrease the stock price. An example would be where corporate officers of a pharmaceutical company conceal the FDA's issuance of a nonapproval letter for a drug on which the company has pinned significant hopes. Were this information known, investors would likely discount the future revenues of the company and bid down the company's shares. The effect of the fraud is typically to maintain the current stock price or, to be more specific, to maintain movement in the stock price consistent with market trends. When the correct information is ultimately discovered, be it through the corporation restating its prior guidance or actual earnings, the revelation of an SEC investigation, the filing of a civil securities actions, or the filing of criminal charges, it produces a sharp downward spike in stock price followed by a lesser rebound to what remains a significantly lower stock price. (Diagram A is an example of the stock price pattern typically resulting from this type of fraud.) Alternatively, where the concealed information renders the company essentially worthless, the discovery of the fraud may lead to a sharp downward spike in stock price followed by a cessation in trading and the liquidation of the company.

The second type of case involves the dissemination of false information that inflates the stock price. An example would be a "pump and dump" scheme, where an individual who has recently purchased or had issued to himself some significant number of shares in a company (generally one with a low price per share) generates an intentionally false rumor that the company has had a significant success (the

pump). For example, the pump could be that it is the target of a takeover by a larger company, or has developed a phenomenal new product with the expectation of selling his shares once the market has peaked based on the false information (the dump). The effect of the fraud is a significant upward spike in stock price, with the ultimate discovery that the information was false (whether as the result of the dump or otherwise) resulting in a sharp downward spike and rebound to the original lower stock value. (Diagram B is an example of the stock price pattern typically resulting from this type of fraud.) Alternatively, where the company was in dire straits at the time of the false pump, the discovery of the fraud may lead to a sharp downward spike in stock price followed by a cessation in trading and the liquidation of the company.

Other cases may represent a combination of these two types of fraud. An example would be a company that fraudulently inflates revenues by engaging in "round trip" transactions, that is, sales to other companies that are contingent on a quid pro quo that the payments from those companies will be returned to them, either directly or through intermediaries, for the purchase of their products. The concealment of the "round trip" nature of these transactions may serve not only to conceal the company's actual losses, but also to inflate its revenues above what would be expected in the absence of those losses. The effect of the fraud typically is a more muted upward spike in stock price (or alternatively, a more muted downward slide if the company's market sector as a whole is declining), with the ultimate discovery of the concealed fraud resulting in a sharp downward spike and rebound to a price significantly below what was the original lower stock price. (Diagram C is an example of the stock price pattern typically resulting from this type of fraud.) Alternatively, where the "round trip" transactions served to conceal the nonviability of the company, the discovery of the fraud may lead to a sharp downward spike in stock price followed by a cessation in trading and the liquidation of the company.

In any of these cases, determining the sentence will turn largely on the determination of

loss, as loss will almost always be the single biggest upward adjustment to the defendant's offense level. In this regard, the guidelines themselves provide only limited guidance. Assuming that the issue is the actual loss, the guidelines require the court to make a "reasonable estimate" of the "monetary" harm that the defendant "knew or, under the circumstances, reasonably should have known, was a potential result of the offense." U.S. SENTENCING GUIDELINES MANUAL § 2B1.1, cmt. n. 2(A)(i), (iii), (iv) & 2(C) (2002). Beyond this, the only helpful guidance is that in making this "reasonable estimate," the court should take into account "[t]he approximate number of victims multiplied by the average loss to each victim." U.S. SENTENCING GUIDELINES MANUAL § 2B1.1, cmt. n. 2(C)(iii) (2002).

The victims in a fraud on the market are the investors in that market, the shareholders. What the guidelines suggest, therefore, is that the loss is correctly determined by aggregating the losses suffered by these individual shareholders. These shareholders typically fall into two groups: those who owned shares prior to the fraud and either took or failed to take action with respect to their shares as a result of the fraud, and those who did not own shares prior to the fraud and purchased shares as a result of the fraud. The change in "market capitalization" resulting from the fraud provides a quick and reasonable estimate of the losses suffered by both groups of victims. The market capitalization of a company on any given date is the price per share of the stock multiplied by the total number of outstanding shares. Estimating loss using market capitalization entails taking the difference between the market capitalization immediately prior to the fraud and the market capitalization immediately (or shortly) after the revelation of the fraud.

In calculating damages in civil securities fraud cases, this general approach seems well accepted. Courts have adopted the fraud-on-the-market theory, with the consequence that in civil actions, as in criminal prosecutions, there is no need to demonstrate the existence or scope of an individual victim's reliance on the fraudulent conduct. The result is "the well-settled general

principle that damages in a securities fraud case are measured by the difference between the price at which a stock sold and the price at which the stock would have sold absent the alleged misrepresentations or omissions." *In re Executive Telecard Securities Litigation*, 979 F. Supp. 1021, 1025 (S.D.N.Y. 1997); *see also Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-55 (1972); *Flamm v. Eberstadt*, 814 F.2d 1169, 1179-80 (7th Cir. 1987); *Blackie v. Barrack*, 524 F.2d 891, 908-09 (9th Cir. 1975). Moreover, courts have accepted the efficient market hypothesis under which the price of a security will accurately reflect all publicly available information. *See Basic v. Levenson*, 485 U.S. 224, 246 (1988); *Flamm*, 814 F.2d at 1179. Thus, in civil cases, courts have agreed that the difference between market price at the time of purchase and market price after the revelation of the fraud can be used as a measure of damages. *See Executive Telecard*, 979 F. Supp. at 1028 ("In the absence of other influences, the price of a fraudulently inflated security and its 'true' value should converge on or shortly after the date the fraud or misrepresentation is disclosed.") Indeed, the focus in civil cases is often the propriety of differing expert opinions based on varying computer models that seek to account for market trends and other nonfraud influences on the changes in share price. *See, e.g., Id.* at 1024 (taking stock price after revelation of fraud as baseline, expert "used a proprietary computerized model—which reflects adjustments for such factors as inflation, float, volume, intra day trading, and short interest—to determine that total class damages were \$18.5 million").

In contrast to the fairly well-developed body of law arising out of damage calculations in civil securities fraud matters, there is sparse authority in the criminal law area. What law does exist, however, suggests that change in market capitalization of a company is the most appropriate measure.

If the company whose shares are manipulated is a total sham, such that the shares become worthless after the fraud, the calculation of loss under the guidelines is fairly straightforward. For example, in *United States v. Hedges*, 175 F.3d

1312 (11th Cir. 1999), the defendant conspired with several other individuals to manipulate the price of stock in a company called Cascade International. Cascade's business ventures generated almost no revenue, and the company was operating at an enormous loss. In a typical pump and dump scam, the conspirators bought up substantially all of Cascade's stock, and then disseminated false information about Cascade's operations and profitability. The stock price rose substantially based on the false information (the pump), and the conspirators secretly sold off the shares they owned before the fraudulent conduct came to light (the dump). When the fraud became known, the publicly held shares of Cascade immediately became worthless.

In calculating loss, the court noted that of the eighteen million Cascade shares outstanding, at the time the fraud came to light thirteen million shares traded at an average price of \$4 per share, and the remaining five million traded at an average price of \$5 per share. The total market capitalization of Cascade was thus \$77 million, all of which was lost when the fraud was uncovered and the shares became worthless. The Court also added in \$15 million which was lost by financial institutions who lent Cascade money based on the false financial information, and estimated the total loss at \$92 million.

When the shares of an otherwise legitimate company are inflated through accounting fraud, and the shares retain value after the fraud becomes publicly known and is factored into the share price, the calculation of loss becomes much more difficult. While numerous cases have been prosecuted involving such conduct, there is little case law given that such cases are often resolved by way of plea, and the parties negotiate what they believe to be the appropriate loss figure as part of the plea agreement.

To date, only the Second and Eleventh circuits have opined as to how loss should be calculated when the stock retains residual value after the fraud ends. Moreover, neither of the opinions definitively states the appropriate methodology for calculating loss under the guidelines. In *United States v. Moskowitz*, 215 F.3d 265 (2d Cir. 2000), the defendant also

engaged in a pump and dump. At sentencing, the government introduced evidence estimating the loss from between \$7.1 million to \$18.3 million based on the decline in the company's share price upon revelation of the fraud. A civil class action plaintiff's expert estimated the loss to shareholders to be \$30 million. The district court found the loss to be between \$5 and \$10 million under the former U.S. SENTENCING GUIDELINES MANUAL § 2F1.1 (2000). In light of the competing figures, the Second Circuit opined that because there was ample evidence that the loss was in fact higher than the district court found, the district court did not abuse its discretion in calculating loss.

In *United States v. Snyder*, 291 F.3d 1291 (11th Cir. 2002), two defendants who worked at and held substantial stock options in a publicly traded pharmaceutical company participated in a scheme to falsify and misrepresent data from clinical trials of one of the company's drugs. The prosecutors submitted an expert report calculating that shareholders lost over \$34 million from the fraud. The defendants, on the other hand, argued that there was no actual loss because the price of the company's stock was higher after the disclosure of the fraud than its average price during the life of the fraud. For many of the reasons noted at the beginning of this article, the district court found it was not feasible to make a reasonable estimate of the victims' losses, and instead calculated loss based on the intended or potential gain to the defendants. *Id.* at 1295. In reversing and remanding, the Eleventh Circuit noted that under the Sentencing Guidelines, substitution of defendant's gain is not the preferred method because it ordinarily underestimates loss. *See* U.S. SENTENCING GUIDELINES MANUAL § 2B1.1, cmt. n. 2(B) (2002); U.S. SENTENCING GUIDELINES MANUAL § 2F1.1, cmt. n. 9 (2000). Instead, the Eleventh Circuit suggested that the district court focus on the period between the false press release about the clinical trial and the days immediately following the announcement of the fraud to determine the amount that each share's price was fraudulently inflated. *Id.* at 1296 n.6. The panel further suggested that this per share loss then be

multiplied by the shares bought and sold during that time frame.

Picking up on the suggestion in the *Hedges* court, at least one district court judge has also adopted the market capitalization approach. In *United States v. Bakhit*, 218 F. Supp. 2d 1232 (C.D. Cal. 2002), the defendant engaged in various accounting frauds to falsely inflate his company's revenue. These frauds predated the company's initial public offering (IPO) (the financial statements were manipulated to defraud the company's lenders before the company went public), and continued after the IPO. In calculating loss, the district court first determined the average share price during the life of the fraud, and then subtracted the average selling price after disclosure of the fraud but before the next "significant intervening cause" affecting the stock price. *Id.* at 1241. To calculate loss, the court then multiplied that difference between the average selling price during the fraud and the average selling price after the fraud times the total number of shares outstanding (since all the shares were sold during the life of the fraud).

Defense attorneys have made a number of arguments against using the market capitalization approach. The arguments generally fall into three categories.

First, it has been argued that stock price is an inaccurate measure of the value of a company; thus the efficient market hypothesis should be rejected. As the citations above indicate, however, civil courts have repeatedly accepted the efficient market hypothesis, under which stock price is presumed to incorporate all publicly available information.

Second, it has been argued that using changes in market capitalization as a measure of loss results in arbitrary guideline calculations because it fails to account for irrational exuberance, irrational panic, and other psychological trends that might affect stock price in the relatively short term. Again, in a widely traded market, the efficient market hypothesis suggests that such trends will have limited impact. Moreover, to a certain extent, this can be addressed by adjusting the period used to measure the change in market

capitalization, such as waiting for the completion of the typical bounce back from the sharp drop occasioned by revealing the fraud. In the diagrams at the end of this article, this would mean using the differences between points A and C, rather than other points on the stock price curve.

Third, it has been argued that using changes in market capitalization fails to account for other factors that might also affect stock price during the period of a fraud, such as ordinary market trends or outside events such as a worldwide change in oil prices or the entry of a new competitor. In civil securities fraud cases, this is the subject of expert testimony, with dueling economists often attributing differing portions of the change in stock price to varying external factors. An argument can be made, however, that in the criminal context such precision is unnecessary. In civil cases, the goal is to return to the plaintiffs exactly what they lost, no more and no less. In criminal cases, however, the court is attempting simply to establish a rough measure of culpability. *See Bakhit*, 218 F. Supp. 2d at 1240 (noting prudential concerns with relying too heavily on expert testimony at sentencing). Not only do the guidelines explicitly require only a "reasonable estimate" of loss, but they also permit the court to adjust from that estimate by departing downward should the court determine that it "substantially overstates the seriousness of the offense." U.S. SENTENCING GUIDELINES MANUAL § 2B1.1, cmt. n. 15(B) (2002). Without any need for expert testimony, the court, therefore, can adjust the loss determined by the market capitalization approach to reflect any injustices resulting from that approach as the result of gross external factors.

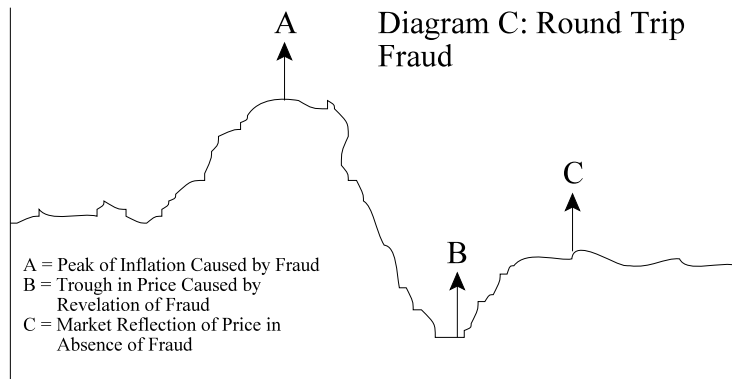
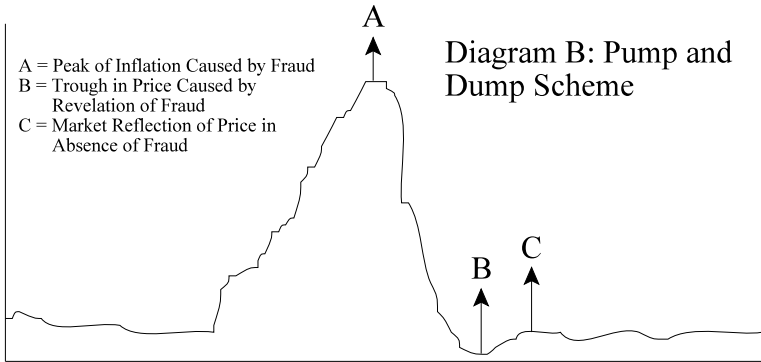
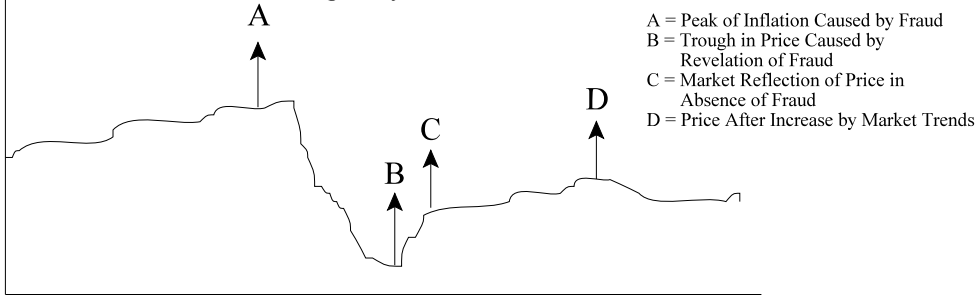
To streamline cases and speed investigations, prosecutors in corporate fraud cases quite often select only certain fraudulent transactions on which to indict, while foregoing other transactions that formed the basis of a restatement or other event that cast into doubt earlier representations about the company. In those cases, trying to separate the effect on the stock price of the transactions proven to be fraudulent from other suspect, but noncriminal, transactions can become complex. In such circumstances, expert testimony to establish what portion of the loss was caused by the transactions proven to be fraudulent may be unavoidable.❖

ABOUT THE AUTHOR

❑ **George S. Cardona** is the Chief Assistant United States Attorney in Los Angeles.

❑ **Gregory J. Weingart** is Chief of the Major Frauds Section in the U.S. Attorney's Office in Los Angeles, which prosecutes corporate and securities fraud matters.✉

**Diagram A: Accounting Fraud --
Concealment of Derogatory Information**



Dispositions in Criminal Prosecutions of Business Organizations

Miriam Miquelon
United States Attorney
Southern District of Illinois

In January of this year, the Deputy Attorney General (DAG) issued a memo entitled "Principles of Federal Prosecution of Business Organizations" which clarified the Department of Justice's policy considerations in prosecuting business organizations. Specifically, the memo tasked prosecutors to "assess the merits of seeking the conviction of a business entity itself" in the context of prosecuting business crimes. Memorandum from Larry D. Thompson, Deputy Attorney General 1 (January 20, 2003). The memo represents a considered approach in deciding whether an entity prosecution is appropriate, by balancing the harm to society as a result of a particular business crime against the potentially devastating effect on a corporation or partnership when a criminal charge is brought against it.

As prosecutions against accounting firms escalate, some consideration should be given to the impact on the firm as a whole, particularly since most accounting firms are partnerships and not corporations. The significance is apparent from the very form of the business organization. For example, the Southern District of Illinois recently prosecuted the accounting firm of BDO Seidman, LLP, a New York Limited Liability Partnership. BDO operates nationwide and is on the top fifteen list of accounting firms nationally. The BDO St. Louis office operated relatively independently from its other partners. While the partnership shared revenues and had common management policies, each office operated as its own autonomous cost center. There was relatively little communication between the various partners relative to local operations and clientele except for client conflict checks. Unfortunately, certain partners in the St. Louis office helped one of their

more lucrative clients unlawfully convert annuity funds held in trust for personal injury clients to acquire part of the National Tea grocery chain in St. Louis. Not surprisingly, the businessman knew nothing about operating grocery stores, the business failed, and the annuitants, most of whom were paraplegics, widows, and orphans, were left with nothing. The losses to the victims were catastrophic and in excess of \$60 million.

But for the assistance of the accounting firm in issuing reckless opinion letters and less than accurate financial statements, the businessman could not have succeeded. Indeed, there is no question that the accounting firm could have blown the whistle and advised authorities long before the losses increased to such monumental proportions. Under the first consideration of the Deputy Attorney General's memo—that the nature and seriousness of the offense, including the risk of harm to the public, be considered—there was no question that BDO had to be criminally prosecuted.

At the same time, the investigation revealed that the criminal conduct was confined to the St. Louis office, and when the conduct became known to management, the local office was disbanded by the remaining members of the partnership. In the case of a partnership, as opposed to a corporation, there is no other entity, such as a subsidiary, that can step forward and enter a guilty plea in an attempt to minimize the institutional damage suffered by the business organization.

Consideration number seven of the memo requires the prosecutor to review the "collateral consequences, including disproportionate harm to shareholders, pension holders and employees not proven personally culpable, and impact on the public arising from the prosecution." Larry D. Thompson Memorandum of January 20, 2003 at 3. The institutional damage to an accounting

partnership, particularly one that serves large national clients, is severe. Once the indictment is announced, the clients jump ship in an effort to avoid the perception that anything could be improper with their internal accounting practices or agency filings. Other accounting firms also take advantage of their colleague's misfortune and use the opportunity to shepherd the business to their own firms. The bottom line is that a criminal prosecution may contribute to insolvency for the business organization. Sometimes that collateral consequence is warranted, as the example in this article demonstrates. However, part of our job as prosecutors is to make that judgment call. In many respects that is a heavy burden. As a caveat, that burden can be shared by seeking advice and review from the Fraud Section of the Criminal Division at Main Justice.

In the BDO case, however, the victims were so vulnerable and the amount of the funds diversion so great, that the balance easily tipped in favor of prosecution. However, a prosecution technique was utilized that did tend to minimize, at least to some degree, the collateral consequences to the "innocent partners." First, a criminal information was filed with the court. At the same time, BDO entered into a pretrial diversion agreement which effectively suspended the prosecution of the crime during which time the partnership could make restitution to victims, engage in appropriate remedial actions to implement compliance programs, replace management, and provide full cooperation in the continuing prosecution of culpable individuals. The pretrial diversion agreement was also filed as a public document with the court, along with a stipulation of facts providing a factual basis for an admission of guilt in the event that the agreement was revoked and the government proceeded on the information.

Other salient features of the agreement include provisions governing the waiver of the applicable statute of limitations past the expiration date of the pretrial diversion, a waiver of the attorney-client privilege where such information is required to satisfy the cooperation provisions of the agreement, and a formal resolution authorizing the entry of the pretrial

diversion agreement and the stipulation of facts. Of course, this subjects the business organization to additional collateral consequences, including related civil actions that can be filed by the victims, unless the agreement specifically structures the payment as restitution requiring each victim to sign a release in order to receive their distributive share of the restitution.

From an evidentiary standpoint, there does not appear to be any reported decision ruling on the admissibility of a pretrial diversion agreement at a subsequent trial of an employee or other coconspirator. In an unrelated case, prosecutors successfully argued that the agreement was admissible during trial on the theory that it was tantamount to a prior conviction as a criminal information and stipulation of facts were filed, and that the pretrial diversion agreement was substantially similar to a plea agreement. These facts, however, were also considered in the context of the cross-examination of a corporate representative by the defense during the trial of the chief operating officer, in an apparent attempt to mislead the jury regarding the true consequences to the corporation. The implication of the cross-examination was that the corporation had escaped the punishment that was now being unfairly heaped upon the chief operating officer. In any case, the issue of admissibility at trial should be raised pretrial through an appropriate motion in limine.

The use of a pretrial diversion agreement may also be helpful when prosecuting a publicly traded corporation. The decision requires balancing competing interests and policies. Where upper management has effectively operated the company and/or increased profits through a scheme or artifice to defraud, management has breached its duty to provide loyal and faithful services to the shareholders. By putting the continued viability of the corporation at risk through the use of unlawful business practices as the "way of doing business," the shareholders' investments are also seriously placed at risk. On the other hand, in an effort to protect the interests of the shareholders, any prosecution of the corporation could affect its continuing viability in the marketplace and render it insolvent.

Additionally, it is important to distinguish between a corporation operated at the highest levels of upper management through fraud, and one where lower-level managers, in discrete operations, have engaged in fraudulent acts. The former may be seen as a pervasive corporate fraud, whereas the latter may be viewed as an employee fraud that requires a tighter corporate compliance program to avoid a repeat in the future. Again, the Deputy Attorney General's memo requires the prosecutor to consider the "collateral consequences, including disproportionate harm to the shareholders, pension holders and employees not proven personally culpable, and the impact on the public arising from the prosecution."

In a recent case prosecuted by the Southern District of Illinois against the Exide Corporation, the largest automotive battery manufacturer in the world, Exide supplied defective DieHard batteries to Sears, Roebuck and Co. Upper management employees of Exide used corporate money to pay bribes to the Sears battery buyer. Ultimately, Exide was required to plead guilty to a felony charge because the fraud pervaded the highest levels of management. All three of the chief executive officers, the CEO, president, and CFO, were prosecuted and found guilty. However, Sears was given the opportunity to enter into a formal pretrial diversion agreement, along with the filing of a criminal information and stipulation of facts, because the fraudulent conduct was confined to a discrete operating division. The fact that the fraud is confined to a particular operation of the company may still militate in favor of a felony prosecution where the fraud resulted in large profits or other substantial benefits to the company. It is important to consider all of these factors in evaluating the fairest disposition in the case. However, the DAG's memo also cautions against prosecuting a corporation based upon strict *respondeat superior* theory for the isolated acts of rogue employees. At the same time, "[f]ewer individuals need to be involved for a finding of pervasiveness if those individuals exercised a relatively high degree of authority. Pervasiveness can occur either within an organization as a whole or within a unit of an

organization." Larry D. Thompson Memorandum of January 20, 2003 at 5.

As a caveat, a pre-trial diversion agreement should not be offered as a means by which a corporation can "buy its way out" of criminal liability. It is also not to be employed as a means for the corporation to exact immunity from prosecution for corporate management or other employees who are culpable and should otherwise be prosecuted. The collateral consequences evaluation should control, along with a realistic assessment of the knowledge and participation of upper management and whether the fraud was the way of doing business at the company.

In this regard, disproportionate harm to a target corporation should also be considered. For example, some corporations have special licenses or government contracts that may be lost in the event of a prosecution. These are economic penalties that may be disproportionate when compared with punishment meted out to similarly situated corporations that do not have licenses or contracts at risk. One technique that can be employed to avoid disparity in corporate punishments is to allow a subsidiary of the target corporation to be named in the charging instrument so that the parent can continue to operate competitively in the marketplace, particularly where insolvency would harm the public and/or the shareholders.

Corporate cooperation is one of the key factors in evaluating the usefulness of a pretrial diversion agreement. It is imperative for the prosecutor to ensure that the cooperation is complete and truthful. It is entirely appropriate for the prosecutor to demand the waiver of attorney-client privilege and work product protection by the corporation, make employees and agents available for debriefing, disclose the results of internal investigations, file appropriate certified financial statements, agree to government or third-party audits, and take whatever other steps are necessary to ensure that the full scope of the corporate wrongdoing is disclosed.

The DAG memo further instructs that when prosecutors are considering pretrial diversion agreements, reference should be made to the

USAM § 9-27.600-650. The USAM principles permit a nonprosecution agreement in exchange for cooperation when a corporation's "timely cooperation appears to be necessary to the public interest and other means of obtaining the desired cooperation are unavailable or would not be effective." In the case of national or multi-national corporations, multidistrict or global agreements may also be necessary. *See* USAM §9-27.641.

The decision to utilize a pre-trial diversion agreement in the context of prosecuting a business entity has many dimensions. Reference should be made to the DAG memoranda referred to in this article, the USAM, and to the practical advantages and disadvantages to the case and to the public. Prosecutors may also consider contacting the Fraud Section of the Criminal Division at Main Justice for guidance and advice. ❖

ABOUT THE AUTHOR

❑ Miriam F. Miquelon is currently serving as the United States Attorney for the Southern District of Illinois. Ms. Miquelon is also on the adjunct law faculty at Washington University School of Law where she teaches Litigation Ethics and Trial Advocacy. While serving as an AUSA, Ms. Miquelon prosecuted white collar and public corruption cases. She was also detailed to the Office of Special Counsel during the Waco investigation. ❖

Notes







Request for Subscription Update

In an effort to provide the UNITED STATES ATTORNEYS' BULLETIN to all who wish to receive it, we are requesting that you e-mail Nancy Bowman (nancy.bowman@usdoj.gov) with the following information: Name, title, complete address, telephone number, number of copies desired, and e-mail address. If there is more than one person in your office receiving the BULLETIN, we ask that you have one receiving contact and make distribution within your organization. If you do not have access to e-mail, please call 803-544-5158. Your cooperation is appreciated.