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EXPERT ANALYSIS

15 Years of Fraud — And the Government's Attempt to Restore Investor Confidence

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In the early 2000s, the U.S. corporate landscape was in the midst of an accounting fraud epidemic with no end in sight. Through creative accounting, many corporate executives and employees artificially inflated their companies' values and lined their own pockets. The U.S. government responded by forming the Corporate Fraud Task Force, an institution created under the Sarbanes-Oxley Act of 2002, 18 U.S.C.A. § 1514A, and initiating enforcement actions against corporate giants including Enron, Tyco and WorldCom. The litigation over this corporate criminal activity resulted in a monumental shift, both in terms of investor perception and the scope of corporate compliance efforts.

AFTER ENRON

In July 2002, President George W. Bush signed an executive order establishing the Corporate Fraud Task Force to prosecute the increasing number of corporate and accounting fraud cases under investigation. The stated goal of the task force was to "clean up corruption in the board room, restore investor confidence in our financial markets, and to send a loud and clear message that corporate wrongdoing will not be tolerated."[1]

A July 2004 report on the Corporate Fraud Task Force trumpeted the group's achievements over its first two years, including over 500 corporate fraud convictions or guilty pleas and charges against over 900 defendants. The victories included the massive Enron case, which saw 31 defendants charged and over $161 million seized for the benefit of injured parties — as well as a record-breaking $2.25 billion penalty against WorldCom.

THE SUBPRIME CRISIS

In 2009, in the wake of the subprime crisis, the Corporate Fraud Task Force was replaced by the Financial Fraud Task Force. Once again, investor confidence had sustained a devastating blow, this time at the hands of the mortgage banking industry. The newly formed (or perhaps just retitled) interagency task force sought to "hold accountable those who helped bring about the last financial meltdown [and] prevent another meltdown from happening."[2]

In both 2002 and 2009, the goals of enforcement policy shared the common theme of restoring investor confidence and combatting future occurrences of the accounting fraud that led to the crises.

One difference, however, related to whether the government prosecuted individuals and held them accountable for the fraud. Following the credit crisis of 2008, only one investment banker received jail time.[3] Some may argue that the credit crisis lacked the illegal activity present in early-2000s cases like Enron. However, even the savings-and-loan crisis of the 1980s led to significant convictions, with over 1,000 individuals prosecuted as a result.[4]

AN INCREASE IN INDIVIDUAL PROSECUTIONS

Fast-forward to 2015, and the portfolio of ongoing investigations by the Department of Justice and the Securities and Exchange Commission looks much different. The number of corporate prosecutions has dropped by 29 percent over a 10-year period, from 335 cases in 2004 to just 237 in 2014.[5] The government appears to be focusing its resources back on individual prosecutions rather than corporate criminal penalties.

This shift in enforcement approach raises several important questions. Is the change a result of an enhanced regulatory environment? Have the regulators successfully "disincentivized" most corporations and executives from committing accounting fraud? Or does the decrease in corporate prosecutions and lack of large-scale fraud investigations reflect a shift in government policy?

EMPHASIS ON FOREIGN CORRUPTION

A review of the past year's major enforcement cases provides a picture of the government's current focus. At the second annual Global Investigations Review Conference on Sept. 22, 2015, Assistant U.S. Attorney General Leslie Caldwell discussed major recent prosecutions. The highlighted cases included a number of enforcement actions under the Foreign Corrupt Practices Act, 15 U.S.C.A. § 1 78dd-1.

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In December 2014, French power company Alstom SA agreed to a penalty in excess of $772 million, which was the largest foreign bribery resolution ever attained by the Department of Justice. In addition to the corporate penalty, five individuals, including four corporate executives, faced criminal charges. Additionally, IAP Worldwide Services and Louis Berger International faced FCPA charges of their own, and in 2015 they paid penalties of $7.1 million and $17.1 million respectively. In both cases, one or more corporate executives also pleaded guilty to FCPA charges.[6]

Caldwell pointed out several common themes among these cases. First and most important was the DOJ's increased focus on individual criminal prosecutions. Caldwell stated that prosecuting the corporate entity alone "simply is not enough — in most instances — to fully punish and, more importantly, deter corporate misconduct."[7]

When determining corporate penalties, the DOJ has strongly considered companies' cooperation with internal investigations and proactive remediation efforts. While consistent cooperation can lead to a lighter penalty, failure to be forthright with investigators can lead to harsh punitive measures.

In addition to those prosecutions, the anticipated conclusion of the Wal-Mart FCPA investigation may be construed as the bellwether for the current state of enforcement policy. In December 2012, The New York Times published the results of its detailed investigation of Wal-Mart's Mexico division, which alleged a widespread system of bribery payments to government officials to obtain building permits throughout the country.[8] The investigation included the review of tens of thousands of permit-related documents and dozens of on-the-ground interviews.

Among others, the Times interviewed Sergio Cicero Zapata, a former Wal-Mart de Mexico lawyer who claimed to have been personally involved in orchestrating many of the bribes. Despite the laundry list of evidence uncovered and an ensuing investigation by the DOJ, a recent Wall Street Journal article states that (according to sources familiar with the probe and barring any last-minute discoveries), it now appears that the case will likely avoid formal prosecution or criminal charges through the ever-popular non-prosecution agreement or deferred prosecution agreement.[9]

The investigation has not been without cost to Wal-Mart, which has already paid over $650 million on the investigation and related compliance improvements.[10] Additionally, even as the probe of Wal-Mart's activities in Mexico draws to a conclusion, investigations of potential bribes in other foreign markets are ongoing. The Wal-Mart case illustrates the importance of conducting in-depth investigations and cooperating early and often with federal investigators.

Although Wal-Mart's fees related to the investigation have already exceeded $650 million, this amount pales in comparison to what it likely would have faced if it had not cooperated in the federal investigation.

For example, a 2014 FCPA case against Marubeni Corp., which had pleaded guilty and was charged an $88 million fine, specifically cites, "Marubeni's decision not to cooperate with the department's investigation when given the opportunity to do so, its lack of an effective compliance and ethics program at the time of the offense, its failure to properly remediate and the lack of its voluntary disclosure of the conduct as some of the factors considered by the department in reaching an appropriate resolution."[11]

Though the government appears to go out of its way to suggest Marubeni was charged because it did not cooperate, it does not indicate what the penalty would have been had the company cooperated.

Analysis of these recent trends in prosecution statistics shows that regulators believe their best course of action is to penalize the individual rather than the corporate entity. The decline in corporate prosecutions could also stem from a shift by the DOJ. DOJ officials have recently acknowledged that they are turning their focus toward "higher-impact" bribery cases, which take longer to investigate.[12]

Though U.S. regulatory and enforcement efforts still have room for improvement, the continued focus on FCPA prosecutions signals that the U.S. regulatory environment has made strides in the right direction. While many prosecutions of the early 2000s were a reaction to a system that had grown too lenient, FCPA prosecutions are more proactive. Unlike when the Sarbanes-Oxley Act was instituted in 2002, the FCPA has been in place since 1977. While other countries have recently issued stepped-up regulations, such as the U.K. Bribery Act of 2010, bribery and corruption in developing markets around the world have long been widely known. Having successfully performed damage control with regard to investor confidence domestically, the United States is moving forward with continued cooperation with foreign jurisdictions in an attempt to improve investor confidence globally.

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JAPAN'S ENRON

One area of the world currently under scrutiny is Japan, which has been rocked by two major accounting scandals in recent years. First, in October 2011, Japanese corporate giant Olympus was accused of perpetrating a 13-year loss-hiding scheme. The Japanese regulatory authorities commissioned a high-profile independent investigation of Olympus, ending in the criminal prosecution of three executives and a $7 million fine. On top of that, Olympus' stock price dropped precipitously, and it faced a number of civil lawsuits seeking additional damages to the tune of $273 million.[13]

The Olympus scandal turned from a single data point to the start of a trend when its biggest rival, Toshiba Corp., was found guilty of overstating operating profits over a multiyear period. Ongoing investigations of the company's books continue to unearth additional violations — what was previously thought to have been $780 million of misstatements over three years is now known to have been more than $2 billion over seven years. The company has already seen a change in management and is sure to face harsh sanctions from Japanese regulators. As with the Toshiba accounting scandal, poor corporate culture was cited as a factor in how these frauds began and were able to continue for so long.[14]

The nature of these two cases and the underlying corporate landscape of Japan is reminiscent of the accounting fraud scandals in the United States in the early 2000s. Despite Japan's internal control provisions outlined in the Financial Instruments and Exchange Act of June 2006 (also referred to as J-SOX), it is likely that we will see enhanced regulatory actions in the coming years as Japan attempts to alter a deeply embedded and broken corporate culture that fosters fraudulent accounting.

If the past experience of the U.S. is any indication, the situation in Japan is likely to get worse before it gets better — and investors in Japanese companies should take note.

RESTORING INVESTOR CONFIDENCE

While the decrease in large-scale domestic accounting fraud cases can be seen as an encouraging sign, U.S. regulators must stay vigilant against growing risks to domestic investor confidence. There will likely always be people who will try to commit fraud, so through enforcement and regulation we must limit the incentive and opportunity for fraud to occur.

This can be done through transparency, independence and accountability. To achieve transparency, regulators must promote an understanding of complex accounting and financial issues. This is especially important in the ever-developing realm of securities. Sarbanes-Oxley went a long way toward promoting truly independent third-party audits, but continued enforcement efforts are needed to ensure that these audits stay free from bias.

Further, board members and key employees must be held accountable to ensure that proper compliance measures are implemented and observed. With a greater focus on individual prosecutions, regulators aim to foster a greater culture of accountability among key players.

It appears clear that the enhanced regulatory environment of the DOJ and SEC over the past 15 years has had a significant impact on the number of accounting frauds committed in the U.S. The current enforcement policies of more individual accountability and the DOJ's focus on "higher-impact" bribery cases have had a positive effect on investor confidence in corporate America.

This confidence is bolstered as corporations see the benefits and incentives of having robust compliance programs that deter fraudulent activity. Though large fines may still be levied in cases of noncompliance, companies that self-disclose and cooperate in investigations may be able to avoid criminal prosecution — and enjoy Wall Street's continued support.

NOTES

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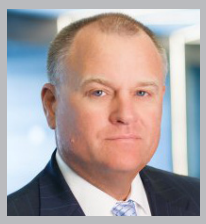

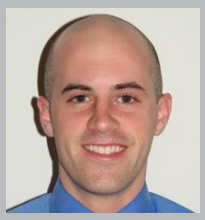

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