

ROUNDTABLE



CRACKING DOWN ON CORPORATE FRAUD

Introductory paragraph Corporate fraud is an ever-present threat in the business world, but since the financial crisis broke, experts have warned of a probable increase. Whether this is down to more breaches of the law, better investigations, a lack of liquidity to hide behind, or a combination of all these elements, is difficult to say. Whatever the case, the power to avert fraud lies with companies. An effective risk-based anti-corruption program makes it possible to expose and eradicate any wrongdoing.

www.financierworldwide.com



THE PANELLISTS



Jerry Oldham

Chairman/CEO, 1stWEST Financial Corporation
T: +1 (303) 670 3443
E: joldham@1stWEST.com
www.1stWEST.com

Jerry Oldham is the co-founder, Chairman and CEO of 1stWEST Financial Corporation, a leader in providing background investigations, fraud investigations and asset searches to the corporate finance industry nationally and internationally. Mr Oldham received his B.S. Degree in Finance and Real Estate from The Pennsylvania State University and his M.S. Degree in Banking and Finance from Colorado State University. Mr Oldham also serves as Champaign Chair for the Board of Governors of The Education Foundation of the Commercial Finance Association.



David Gray

Partner, DLA Piper UK LLP
T: +44 (0)161 235 4524
E: david.gray@dlapiper.com
www.dlapiper.com

David Gray is UK Head of the Litigation & Regulatory Group at DLA Piper UK, one of the largest dispute resolution practices in the UK. For over 20 years, he has specialised in all aspects of dispute resolution, fraud and risk management, acting for a broad range of commercial organisations, focusing on plcs and larger limited liability companies, as both claimant and defendant.



Paul Doxey

Senior Managing Director, FTI Forensic Accounting
T: +44 (0)20 7979 7549
E: paul.doxey@fticonsulting.com
www.fticonsulting.com

Paul Doxey is a senior managing director in FTI Forensic Accounting's London office. His areas of expertise include forensic accounting, regulatory investigations and risk management. Mr Doxey was previously a partner in a leading global audit firm and his experience also covers compliance, audit and accounting. Mr Doxey has worked in the financial services sector for over 20 years. This includes a two and a half year secondment to the Bank of England's Special Investigations Unit and the Financial Services Authority's Bank Investigation Group.



Sam Eastwood

Partner, Norton Rose LLP
T: +44 (0)20 7444 2694
E: sam.eastwood@nortonrose.com
www.nortonrose.com

Sam Eastwood is a dispute resolution partner based in Norton Rose's London practice. In addition, he heads Norton Rose's business ethics and anti-corruption group. Mr Eastwood also specialises in fraud and corruption investigations, and has experience in a broad range of large commercial disputes for major corporates and financial institutions.



Joseph Jaffe

Managing Director, UHY Advisors FLVS, Inc.
T: +1 (646) 746 1300
E: jjaffe@uhy-us.com
www.uhyadvisors-us.com/flvs

Joseph Jaffe is a managing director of UHY Advisors FLVS, Inc. and leader of UHY's Global Business Intelligence and Investigations. He served as elected District Attorney of Sullivan County, New York and seven years in the US Attorney's Office for the Southern District of New York as Assistant United States Attorney. As a prosecutor, practicing attorney and consultant, he has conducted worldwide investigations for decades. He received his J.D. from the New York University School of Law, Cum Laude.



Keith D. Krakaur

Partner, Skadden, Arps, Slate, Meagher & Flom LLP
T: +1 (212) 735 2809
E: keith.krakaur@skadden.com
www.skadden.com

Keith Krakaur is a senior partner in Skadden's White Collar and Government Enforcement practice. A former federal prosecutor with more than 20 years of trial and appellate experience, he represents corporations and their directors and officers in criminal and regulatory investigations and at trial. He advises boards of directors and management of public companies in connection with compliance and internal controls issues relating to government investigations, and he assists boards and audit committees in conducting internal investigations.

There seems to be a perception that corporate fraud has increased since the onset of the financial crisis. Do you agree? If so, what are the underlying drivers?

Oldham: As is often said, “desperate people do desperate things”, and clearly, circumstance, opportunity and control are the primary drivers of fraud. The largest frauds are committed by executives that are motivated by a circumstance which they feel requires a financial solution that the current market won’t allow, so they take the opportunity to commit fraud. And they can, especially when they have enough financial control to commit the fraud undetected. Before the current financial crisis, the best example of this was the economic market circumstance in the US banking industry that led to the saving and loan crisis in the late 1980s. In some instances, desperate lenders at saving and loan institutions made business loans in proportions and in industries that were imprudent to borrowers that defrauded them from the get go.

Jaffe: Studies have found that during economic downturns, instances of fraudulent schemes increase. There are a number of factors driving this trend, including mounting financial pressure on individuals and companies. While there will always be a segment of the population that commits theft and fraud during prosperous times, recessionary periods exert additional pressures on individuals and corporate executives in the form of tightening finances, fear of being laid off and unattainable revenue goals. These pressures cause some individuals who would not think of stealing or who would be easily dissuaded by the simplest of controls to be more willing to take the risk to secure something for themselves or to protect their positions in the company by manipulation of financials. In addition, as companies face budget pressures, compliance and internal audit departments, like all others, are stretched thin, allowing more holes in the system and far less scrutiny by compliance professionals.

Eastwood: Corporate fraud certainly appears to have increased since the onset of the financial crisis. The Financial Times, for example, reported on 1 July that UK corporations lost £960m to publicly reported fraud in the half year to 30 June 2009, the highest six month total since at least 2003. Moreover, given that the majority of fraud losses are not reported, the true figure is likely to be much higher. The key driver is human dynamics and behaviour – people will be more motivated to deceive if driven by a personal crisis, or a desire to retain a job or status. In addition, company crises or failures will often reveal conduct that might have gone unnoticed in better times.

Doxey: Fraud is always with us, but the nature, extent and detection of fraud fluctuate as economic conditions change. The credit crunch put a stop to and exposed certain frauds that fed off the excesses of the long asset bubble – for example, several Ponzi schemes and some types of mortgage fraud. But tough credit conditions also spur new frauds, for example, driving management to massage earnings or put their hand in the till. The sudden detection of old, long-running frauds together with an increase in other types of fraud gives an inflated impression of increased fraudulent activity.

Gray: One of the problems in testing this perception is that we do not have any sound baseline information. Typically, more fraudulent activity is unearthed during an economic downturn, and as far as the apparent correlation between recession and fraud is concerned, the current recession is no exception – witness, for

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KEITH D. KRAKAUR

example, the number of Ponzi schemes which have surfaced in the wake of the financial crisis. In a recession, corporate fraud becomes more difficult to hide in the absence of economic growth. Overstated asset values, irregular incentive payments, and significant contractual activity are all scrutinised more closely than might previously have been the case. Although fraud in these areas may always have been prevalent, it could remain undetected during a sustained period of economic growth and prosperity. In addition, recessionary conditions may put pressure on management to keep their businesses afloat and their own positions secure.

Krakaur: While it is difficult to know if the actual amount of corporate fraud has increased, that perception clearly exists. This is hardly surprising. In the past, whenever high profile frauds or investigations have been announced – such as those involving Enron and WorldCom at the beginning of the decade – the public perceives an increase in the overall amount of corporate fraud and the government responds by tightening regulations and adding resources to investigations and enforcement. Today is no different. The high profile prosecutions of executives, Wall Street traders and investment professionals have caused some to suggest that we live in a time of rank corporate criminality. Whether those sentiments are true or not, the government has responded to the public outcry by adding resources to the DOJ, FBI and SEC and focusing their attention on hot-button issues such as TARP and mortgage fraud.

In your experience, does this issue receive enough attention in the boardroom and at management level?

Krakaur: Most clients today are extremely sensitive to the issue of corporate fraud. Directors and management read the same newspapers as those in the white collar defence bar, and they recognise that corporate fraud can result in substantial financial and regulatory sanctions, as well as significant brand damage and personal exposure. Most also realise that the current financial climate, along with the increased resources that the government has allocated to identify and punish corporate fraud, has elevated the need to set the correct tone at the top regarding compliance issues.

Oldham: Historically, the issue does not receive enough attention at the top level. However, this has been changing to the positive side of the ledger recently, because of an increased consciousness among management and boards of directors. In general, however, there is much that can still be done by most companies to obviate the risk of being sabotaged by a corporate fraud.

Doxey: On the whole, management do pay attention to the risk of ►►

fraud against their companies. Sometimes, when there is a strong desire to do a deal or move into a new market, the fraud risk is overlooked. Where management need to give much more attention is to the risk that their people are engaged in illegal activity, perhaps unknowingly. Many companies are unaware of the rules on bribery, sanctions and money laundering. Regulators and law enforcement agencies are starting to enforce these rules much more vigorously.

Eastwood: The boards of corporates are broadly aware of the risks of fraud, but do not spend sufficient time focusing on their organisation's culture and employee engagement. New legislation and innovative approaches to investigation and prosecution are laudable but, realistically, financial crime will only decrease if it is tackled at source through a greater focus on business ethics and values. This has been underlined by the SFO in their latest guidance. The risk dynamic for management has heightened significantly and boards today need to focus on the systems and controls that might allow a fraud to occur. Furthermore, following the enactment of the Bribery Bill, directors will have civil and criminal exposures if they fail to implement 'adequate procedures'.

Gray: Senior management spends far too little time on fraud prevention and generally only ever gives the issue attention when the fraud has been discovered, by which time it is often too late to repair the damage. Most companies do not have adequate anti-fraud procedures in place, even where it might be thought that the nature of their business is particularly susceptible to fraud – for example, where it has subsidiaries and operations in parts of the world where it is known that fraud and corruption are more prevalent. It should not be forgotten that the some of the more significant corporate fraud occurs at board and management level in times of recession. Financial statement fraud may be a means of disguising the true underlying financial health of the business and, in so doing, secure a pay rise or a bonus or just stay in gainful employment. The distinction between acting appropriately and acting unethically can become blurred when the pressure is mounting.

Jaffe: Too frequently, proactive fraud and anti-corruption programs are viewed as a cost or a negative, with no measurable benefits. More recently, with the economic downturn, companies have been looking to cut any expenses deemed to be discretionary – the end result being that compliance staff are being cut, and fraud related preventive or proactive initiatives are being postponed, downsized or eliminated. It is not uncommon for boards and management to neglect fraud prevention until after an incident occurs. The challenge is to convince those directing the company that the

funds spent on fraud prevention will end up saving the company money, as well as reputation, and help avoid administrative, civil and criminal ramifications.

There are widespread concerns in the market that trust has been damaged and there is a general lack of accountability within companies. What can officers and directors of a corporation do to reassure shareholders and creditors that the individuals who manage the affairs of their company and set company policies are operating with integrity?

Eastwood: Stakeholders are, in the current climate, rightly feeling aggrieved. It is my view that the role of independent assurance will become increasingly important in the years ahead and that non-financial risk will come to be critically reviewed in the same way as financial risk. Officers and directors will need to show that they have in place, or, at a minimum, are working towards implementing, an effective program of ethics and corporate conduct.

Jaffe: Restoring trust will not be easy. Transparency and disclosure are part of what is required. By publicly discussing the ways an entity is devoting its resources and efforts to reduce fraud and lower corruption risk within the company and to proactively front run the damaging activities, companies can begin to establish some credibility with the public. The issues must be perceived as problems that are being taken seriously by management, the board and the board committees charged with that responsibility. Establishing management's stance against fraud can be accomplished through the internal actions taken at the company, as well as by proper utilisation of the media with the public.

Gray: The lead must come from the top, and the board and senior management must set a tone which resonates throughout the business, making it clear that fraud of any nature will not be tolerated. A high profile and transparent anti-fraud program should provide reassurance, educating everybody in the organisation about the tell-tale signs of fraudulent activity, encouraging whistleblowing, and explaining the consequences to the individual of being embroiled in fraud. Whistleblowing must be taken seriously, and allegations investigated thoroughly and the board must encourage openness and respond fully to challenges from major shareholders and investors.

Krakaaur: The single most important message that senior management and boards of directors can send is that the entity has set a strong, positive tone at the top, especially when times are tough, as they are now. This requires more than a mere reference in a speech or an occasional email sent throughout the organisation. To set the right tone, senior management and the board need to establish a strong code of conduct and code of ethics, institute rigorous training programs and focus on hiring senior people with the right vision and approach to ethics and compliance-related issues. In short, the compliance drum needs to be beaten frequently and loudly, and when issues of non-compliance arise, a clear, firm and appropriate message must be sent throughout the organisation that such behaviour will not be tolerated.

Oldham: The first step is to actually set company policies in critical areas where frauds are most likely to manifest themselves. The second step is to make it known that these policies will be monitored and followed, without exception, and then actually follow them. The only thing worse than not establishing a meaningful standard, is to establish one and then not honour it. Those that ►►

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JOSEPH JAFFE

follow their own fraud policies by exception will usually be defrauded exceptionally, when it occurs.

Doxey: It is important for firms to have highly visible, ethical policies that are communicated to all employees and are seen to be enforced. Companies can send a very clear message that they do not tolerate unethical behaviour by conducting thorough, visible investigations of possible wrongdoing and by taking firm action against transgressors; for example, by having strong whistleblowing policies and procedures.

If a company suspects fraud within its walls, how should it proceed? What steps should it take, for example, when conducting internal investigations?

Doxey: The first step a company should take actually precedes any fraud: having an existing set of policies and procedures for dealing with suspected wrongdoing. This allows firms to proceed much more quickly and makes compliance with legal and ethical requirements easier. Speed and due process are absolutely key to many investigations. Setting appropriate objectives early on – often, within the first 24 hours – and assembling the right team with appropriate experience is vital. It is also important to document what has been done, in case actions are subsequently questioned.

Eastwood: Companies should develop an action plan which covers the key stages of an internal investigation as well as highlighting examples of red flags to spot in a company. These may include frequent disputes or insurance claims, poor regulatory relationships, or weak internal policies and procedures. In management, it may be a reluctance to provide information to auditors, a lack of communication or failure to address irregularities. In finance, it may include recording revenue before it is earned or unusual timing of transactions. And in employees, it could be abnormal expenses or a close relationship with suppliers, customers, etc. In short, when conducting an investigation it is essential to ensure compliance with applicable laws, regulations and internal policies; to ensure that the investigation is impartial and fair; to maintain discretion, confidentiality and privilege as appropriate; to discourage the proliferation of documentation; to secure cooperation from employees; and to ensure the protection of such employees.

Oldham: The company should proceed carefully, but deliberately, and with the support of expert advisers whose business it is to investigate the suspected fraudulent activity. The fraudster is often not who it was originally suspected to be. The best investigation is the first one, in my opinion. Proactively, the board of directors of a company should perform a background investigation on every member of the executive management team. We have found in so many situations that history repeats itself. We recently completed a background investigation for a lender and private equity firm wherein the CEO of the prospective platform acquisition was a convicted felon for arson, having torched his warehouse 18 years previous to attempt to collect on the insurance proceeds, desperate for a financial solution.

Gray: Should a company suspect that it has been the victim of a fraud or has become embroiled in one, it must resolve it without delay. More often than not, relevant experts should be consulted immediately. Difficult judgment calls may have to be made, and should be done so efficiently, effectively and openly. Even the most seasoned management teams will need to be guided through the complexities of balancing the competing expectations

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SAM EASTWOOD

of investors, shareholders, employees, the media, etc. Deciding whether to involve the Serious Fraud Office, the police or a regulatory body such as the FSA or OFT can be very difficult, particularly if the indications are that there is some inside involvement – and even more so where a senior employee is potentially implicated. If regulatory infringement is likely, very serious consideration should be given to arranging an independent investigation rather than attempting to undertake one internally.

Krakaur: Once internal fraud is suspected, companies need to recognise that every action they take will be subject to second guessing by the government. Accordingly, it is imperative for companies to hire experienced outside counsel to help assess the conduct at issue and the risks to the organisation. By hiring counsel, the company will be able to maintain the credibility of any review that is conducted, benefit from the expertise of a subject matter expert and ask questions and explore issues in a privileged setting. Once on the ground, experienced counsel will help the company identify the business lines and individuals involved in the issue, immediately preserve documents and emails, handle any whistleblowers in an appropriate manner and assess the company's strategic options for potentially interacting with the government. If the issues are at risk of otherwise becoming public, it is also important to coordinate promptly with the company's public relations and investor relations functions.

Jaffe: When a company is alerted to the possibility that fraud may be occurring, it needs to quickly gather facts to determine how to proceed. Usually, a limited initial investigation should be conducted to gather evidence and determine the extent of the problem. Frequently, this will lead to a conclusion that more investigation is necessary. At that juncture, the company should consult with outside counsel and discreetly develop a plan to address the issues. It is critical to restrict the number of people with knowledge of the situation to avoid compromising the investigation. Those involved in the fraud frequently attempt to destroy evidence or develop rationalisations for their behaviour, once they are alerted to the existence of an investigation. If there are several employees involved, advance notice of an investigation may afford them the opportunity to get their stories straight, which can further frustrate efforts to uncover any ongoing fraud.

What advice would you give to a company that has become embroiled in litigation linked to corporate fraud?

Gray: Identifying the most effective solution to fraud-related litigation is a complicated endeavour. Not only will the company have to respond and, in many situations, settle the litigation as early as ►►

possible, but it will also need to consider whether to report any suspected criminal activity and/or how it should discipline any implicated employees. The terms of any applicable insurance policies must be reviewed and an investigation undertaken into the likelihood of being able to obtain compensation for the company itself from those who have perpetrated the fraud in the first place. Similarly, weighing up the advantages and disadvantages of instigating a criminal investigation alongside civil litigation is far from straightforward. Involving the SFO or the police will not stop the civil litigation in its tracks nor will it readily result in financial recovery for the company. Criminal, civil, regulatory and disciplinary proceedings could all proceed in parallel, but this is likely to drain limited management resource and will inevitably confuse the issue over admissibility of evidence, self-incrimination, privilege and prejudice. Legal costs incurred in defending litigation and in pursuing fraud will mount quickly but the cost of failing to take appropriate action could far exceed these.

Krakaur: It is a rare occurrence these days where an instance of corporate fraud does not sprout parallel regulatory/criminal and civil proceedings. When faced with such a situation, companies need to take a holistic approach to the proceedings, weighing how each action in one proceeding may affect the other. Particular attention should be paid to protecting against admissions and waivers of the attorney-client privilege, as civil plaintiffs often seek to benefit from internal investigations where facts are later shared with the government.

Jaffe: Once litigation has commenced there are a host of compounding issues that must be addressed. Ideally, the corporation will have pre-planned its actions and have a litigation risk control program in place to deal with the various contingencies presented by litigation. Fraud litigation frequently means parallel proceedings. The market will react to notice of an investigation, the fact that litigation has been filed, and to public statements by the company or others involved. There must be a coordinated single voice for the company, guided by counsel. A thorough and complete fact gathering must be undertaken to obtain all possible information relating to the alleged fraud and those implicated, bearing in mind privilege, work product and other considerations and when and whether they need to be or will be waived. Care must be taken to avoid spoliation or obstruction charges being brought. Dealings with employee witnesses, suspects or otherwise, must be exercised with considerations for the company's rights, as well as those of the employees.

Doxey: Where litigation is involved it is especially important not to

cut corners. Companies should use people who are experienced in dealing with both litigation and fraud issues. Assemble a team that knows how to avoid the pitfalls and how to obtain and present evidence that will stand up in court and support the company's case.

Oldham: Be sure that you have surrounded yourself with the best advisers. Hire a really smart PR firm, especially if you are a public company. Your shareholders deserve the best experts along the way – that is legal, investigative accounting, background and fraud investigators, and public relations.

Eastwood: The key consideration must be that litigation is public and that its course is often uncertain. Any number of faults, errors, omissions or failings of the company, all of which may have regulatory or criminal elements, may be exposed, however unlikely this may seem at the outset. Such negative publicity will undoubtedly have an effect on the company's reputation and may put at risk established relationships. The message therefore must be one of caution and that litigation should not be undertaken lightly.

Can you outline any recent regulatory developments related to corporate fraud, and their potential impact on the market going forward?

Jaffe: Countries around the world are constantly advancing both the language and the enforcement of their anti-corruption laws. Great Britain is in the process of updating its century old anti-corruption laws. China has increasingly focused on prosecuting public and private corruption, in hopes of drawing more foreign investment. Mexico has also been working on improving corruption for several years and recent activities, likely instigated by those efforts, have been accelerated. In addition, the US Department of Justice is increasingly looking to prosecute companies and management for Foreign Corrupt Practices Act violations. These recent trends increase exposure to risk for companies doing business in foreign jurisdictions, both legally and financially. It is important for management to keep a keen eye on not only changes in laws and regulations, but especially on enforcement efforts.

Doxey: In the UK there is a concerted move by regulators and law enforcement agencies to coordinate their efforts and choose the most appropriate weapons in their armoury. For example, the Serious Fraud Office is encouraging firms to self-report wrongdoing and co-operate with any investigation. They do this by offering the carrot of civil settlement instead of the stick of criminal prosecution. The SFO routinely liaises with the Financial Services Authority and City of London Police in making a joint decision on how to proceed.

Eastwood: In January of this year, the FSA fined Aon Limited £5.25m for failings in its anti-bribery and corruption systems and controls. This decision not only represents a clear message to the financial services industry that firms must have robust anti-bribery and corruption systems and controls in place, but also demonstrates the importance of companies giving their full cooperation to regulators. Indeed, the fine would have been £7.5m but for Aon's full cooperation. Reputational damage was also mitigated by Aon's proactive approach, with the FSA praising Aon's senior management for its determination to bring in changes to establish a "model of best practice that other firms may wish to adopt".

Gray: The Fraud Act 2006 will attach to dishonest conduct by way of false representation, abuse of a position of trust or failing ►►

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PAUL DOXEY

to reveal information. The Act has, in principle, made it easier to identify, prosecute and prove fraud. This is likely to be extensively tested in practice over the coming months. Many executives could be caught unaware since simply failing to disclose facts that have come to light, for instance following a merger or acquisition, is now sufficient to found criminal liability. The Bribery Bill, should it become law, will rationalise the law and make corruption easier to prosecute. The proposed corporate negligence offence will put additional pressure on companies to introduce measures to ensure that subsidiaries and agents overseas are not paying bribes. The ability to recover the proceeds of crime by civil means has added a new dimension, allowing prosecutors to seek recovery without bringing a prosecution.

Krakaur: Invoking the clawback provision of Sarbanes-Oxley, the SEC recently filed a civil action against a CEO who was not accused of securities fraud or any other wrongdoing, seeking over \$4m in compensation the executive earned after his company filed financial statements that were subsequently restated. The provision, which previously had only been invoked against CEOs and CFOs alleged to have been involved in wrongdoing at the company, states that when issuers are “required to prepare an account restatement due to material non-compliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws,” the CEO and CFO shall reimburse the issuer for any incentive based compensation they received during the year following the restatement. The SEC’s suit was clearly designed to send a message to the US marketplace that the agency plans to hold senior executives responsible for corporate fraud by testing the limits of its regulatory powers, including seeking compensation disgorgement where there is no allegation of wrongdoing by the executive.

Have regulators stepped up their monitoring and enforcement activities? What kind of penalties are they issuing in relation to corporate fraud?

Oldham: It would seem that they have in the US. The Bernie Madoff Ponzi scheme was perpetrated on such a very large number of investors that it has brought to light the extremes that an undetected fraud can evolve into. Regulators were both embarrassed and motivated by this travesty. Madoff is in prison and, hopefully, regulators are stepping up their surveillance of such nefarious possibilities. It is interesting that the SEC and FINRA do not routinely proactively perform background investigations on the management teams or directors of US public companies, thus relying on both management and directors to self-manage the risk that these key individuals’ backgrounds could compromise the integrity of the company that they regulate.

Krakaur: Government regulators and prosecutors have clearly increased their focus on rooting out and prosecuting corporate fraud, and they have obtained additional resources and personnel to assist in that effort. Some regulators, such as the SEC, have also revamped their internal procedures to increase and improve their monitoring and enforcement activities. When corporate fraud is found, regulators and prosecutors are seeking severe financial penalties, as evidenced by the \$800m settlement in the Siemens FCPA matter, the \$350m settlement in the Lloyds sanctions compliance matter, the \$780m settlement in the UBS tax evasion matter and the \$2.3bn Pfizer settlement in the off-label marketing case. In addition, prosecutors are often seeking structural changes, such as the removal of executives, the appointment

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of independent directors and outside monitors and even, in the case of UBS, the closing of a specific business line.

Jaffe: In the US and around the world there is a growing effort to criminally charge individuals within companies who knew or should have known of the corrupt actions, as well as the corporations themselves. Whether the goal is to convince corporate executives and corporations that governments are serious about enforcement by threatening their personal freedoms and imposing extreme monetary punishment or whether the governments view it as a source of revenue, it is clear that the level of enforcement effort has been and continues to be increasing. The SEC’s recent charging of corporate officers with violations of the anti-fraud, issuer reporting, books and records, and internal controls provisions of the federal securities laws in their capacities as control persons appears to be a new direction. The costs of fines or settlements for these types of violations are staggeringly high.

Eastwood: Internationally, we have seen a huge step up in monitoring and enforcement by regulators in response to increased stakeholder pressure. There has also been an increased level of cooperation between the authorities. US enforcement actions led the way in this area and authorities in other jurisdictions have been pressed to follow suit. We are additionally seeing an increase in the level of penalties that regulators are issuing. The US is however adopting a more measured methodical approach to sentencing, which I anticipate seeing more of in the UK.

Gray: Enforcement activity, both regulatory and criminal, is definitely on the rise. The SFO recently announced a 50 percent increase in the number of investigators dedicated to bribery and corruption investigations. The Metropolitan Police has increased the number of officers in its Overseas Anti-Corruption unit by a third. A new National Strategic Fraud Authority has also been established. By way of example, in May, the FSA fined Morgan Stanley £1.4m, merely for failing to use existing controls effectively to measure trades in illiquid financial products.

Doxey: The Financial Services Authority has stated it will increase its fines for certain offences, and has recently issued record fines. The FSA and SFO are breaking new ground in criminal prosecutions and civil enforcement. The FSA and the SFO are increasing their monitoring and investigations activity – for example, the SFO has been developing ‘red flag’ systems for detecting possible fraud and the FSA has stated that regulation will become more intrusive. The FSA’s use of third party investigations by law firms and accountants tripled last year.

What can companies do to monitor, detect and mitigate the risk of corporate fraud? What systems and controls should they implement, for example? Also, are there any considerations that may lead senior management to preclude certain 'best practices' from their approach to identifying possible corporate fraud?

Doxey: Companies may feel tempted not to look too hard for internal fraud, because of the management time, expense and possible publicity. There may also be a difficult decision as to whether to report illegal activities or control weaknesses. It can feel much easier not to know about it. But that approach is corrosive, and a sloppy culture can develop that allows problems to fester and multiply until they finally come out in the open, often with devastating legal and regulatory consequences. Companies should have clear, properly enforced policies and procedures, whistleblowing facilities, proper investigation of suspicions, regular staff training and awareness-raising on financial crime issues, self-review and external scrutiny.

Jaffe: Fraud is best prevented in a corporate culture of transparency and integrity, displayed by and bought into by all in a company. The corporate culture needs to be changed before efforts can be achieved. Clear guidelines and requirements must be established so that monitoring can be achieved. Internal audit and compliance needs a higher place in the corporate continuum and must be properly funded and staffed by appropriate personnel. Appropriate risk assessments and constant evaluations are a necessity. Whether outsourced or in-house, a compliance monitoring group should be employed to verify and update anti-fraud and anti-corruption efforts. This should be done on an annual basis and the team should be provided with access to sufficient data and personnel. As part of a consistent monitoring of the effectiveness of internal controls, selected site visits and personnel interviews are very important. Employee engagement is an imperative, including establishing and implementing whistleblower policies. Segregation of functions and board committees with responsibility for both operational and financial controls should be in place.

Krakaur: Companies should establish codes of conduct and codes of ethics that address all relevant aspects of their business so that employees in each business line understand how their actions can affect the entire entity. Companies should also consider implementing robust training and educational programs, whistleblower hotlines and an internal audit function with teeth. However, as the second question suggests, compliance programs are not 'one size fits all'. When evaluating best practices, each

company needs to assess honestly the nature and scope of its business, the strengths and weaknesses of its existing compliance programs and the available resources it can devote to improving its policies and practices.

Eastwood: Companies should have tailored systems and controls in place to monitor and detect fraud. These systems and controls will vary depending on the size and type of company in question. It is increasingly imperative that, once in place, companies complete regular independent reviews of these systems and controls to ensure that they are adequate to meet the ever increasing demands of the regulators. The role of independent internal audit in companies is also extremely important in detecting fraudulent activity. More generally, companies should ensure that they carry out effective due diligence on agents and intermediaries – particularly those which operate in high risk jurisdictions – as well as on all contracts that they enter into with third parties.

Oldham: An ounce of prevention is certainly worth way more than a pound of cure. This is absolutely true in the area of background investigations. I believe in a dual or crossover check and balance system, and that a background investigation should be proactively performed on all members of the executive management team and on the board of directors. Any of these critical positions could be compromised by unknown past frauds, financial malfeasance, misrepresentations or acts of indiscretion, and could result in an even larger compromise to the company's shareholders and lenders if, and when, it is discovered. I can think of no consideration that should preclude this 'best practice.' This best practice should be ongoing and followed during the hiring of all future high level executives, managers and directors.

Gray: A keen awareness of the risks is an obvious starting point. Staff should be vetted before being recruited. The business should be audited regularly and compliance programs must be in place. Employees should be trained and re-trained regularly and internal procedures and policies should be subject to regular assessment to ensure their continued effectiveness. Maintain effective whistleblowing procedures, which make it clear that employees who are aware of an offender but do not report them are to be regarded as having themselves offended and liable to disciplinary action. Such procedures must be handled with complete integrity and the whistleblower must trust management and know that his or her anonymity will be respected. Companies must always bear in mind the need to balance the pressure required to ensure that the business is performing well, against making profit as the be all and end all. An overbearing board can be sufficiently intimidating and its intolerance of financial underperformance so frightening that those responsible on the ground for financial performance may feel forced to resort to fraudulent practices either to create profit or disguise losses.

Companies must always bear in mind the need to balance the pressure required to ensure that the business is performing well, against making profit as the be all and end all.

How important is it to set the right tone at the top and build a company culture that renounces fraud? What conditions are necessary for individual employees to buy into this ethos?

Krakaur: Setting the right tone at the top is the critical step in building a culture of compliance. This cannot be an afterthought or achieved through half-measures. Senior management must take an active role in establishing the right policies and procedures, explain how compliance is critical to meeting the company's goals and show that proper conduct will be rewarded and misconduct punished.

DAVID GRAY



Oldham: This is extremely important – you reap what you sow. Nothing is more important to the prevention of fraud than for every employee to know that it is a critical aspect of the company's culture to renounce fraud at every level. Leading by example and establishing and following best practices that isolate and monitor consistently the areas of the greatest vulnerability are essential.

Jaffe: Tone at the top is of critical importance. Once the buy-in comes from the top, it has to be rolled out so that there is buy-in from the bottom, up. There must be demonstrable punishment for those who do not adhere and demonstrable rewards for those who do. Employees need to be shown that the culture is real; that the requirements apply to all in the entity, not just to those below management and the board. Cultural change requires constant reinforcement, more than reading a policy on a computer screen. Management involvement is an imperative.

Eastwood: It is vital to set the right tone at the top. There is no definitive list of drivers for employee engagement, but as a minimum, management should ensure that employees are kept well informed about the steps being taken to detect and mitigate fraud and give employees the opportunity to feed their views upwards on the issue. Employee input is important to help management recognise any personal conflicts that employees may face and understand any dynamics in a company that may impinge on the effectiveness of anti-corruption measures. Hotlines for employees for suspected fraud should be put in place. Further, the identification and mitigation of fraudulent activity and more generally ethical behaviour should be rewarded.

Doxey: Management at all levels must be observed to be intolerant of ethical breaches. Employees must not be seen to gain from cutting corners, either financially or in their promotion prospects.

Gray: It is the board that establishes the company's culture, and they must lead from the front when it comes to setting a tone of complete intolerance of fraudulent activity. Transparency is important so that employees are aware of what is expected of them, and so they can see that management is leading by example. Whistleblowing procedures must be safe and reliable and, just as non-compliance is dealt with by way of disciplinary action, compliance, integrity and ethical behaviour should also be rewarded. The manner in which the business responds to incidents which have been reported by employees should be transparent, consistent, robust, and include a public recognition of the value the management places in the employee having made the report in the first place. Transgressors must be seen to receive appropriate sanctions commensurate with the nature of the offence.

What can lenders and investors do to protect themselves from debtor-related corporate fraud during the term of the relationship?

Doxey: Lenders and investors can insist on forensic due diligence that is focused on fraud and integrity risks. This may include investigation of specific transactions and background checks on borrowers and their key stakeholders. They can review the design and practice of ethical policies.

Krakaur: Prospective lenders and investors normally perform due diligence and request various representations and warranties prior to entering into a lending or investment relationship. While

necessary first steps in any such business relationship, these actions, by themselves, cannot fully protect investors and lenders from unidentified or subsequent corporate fraud. Nevertheless, investors and lenders must remain proactive and diligently follow their investments. When potential yellow and red flags arise, they can use appropriate forums to explore the potential issues with the company, and to obtain assurances that the issues are being appropriately reviewed and addressed.

Eastwood: The role of intelligent and effective due diligence is vital in helping lenders and investors protect themselves from debtor-related corporate fraud. Lenders and investors have a key role in satisfying themselves that the systems, controls and culture that they have in place to detect and mitigate fraud meet with the increasingly demanding standards.

Oldham: Lenders and investors require the establishment of prudent policies and controls at every level of potential exposure, and require the business in which they are investing or providing financing for to follow them without exception. This is the only way to manage your business risk in this area. Consistency in this effort throughout the years of the relationship is vital to managing the risk of fraud.

Gray: As far as lenders are concerned, they will not generally be aware that a fraud has occurred until late in the day. The advice is fairly stark – if a significant level of pre-lending due diligence has not proved to be adequate, the lender will have to move rapidly to secure the debtor/defrauding company's assets when fraud is uncovered. As for investors, nothing can beat comprehensive due diligence of a scale that is appropriate to the specific risks that may apply to the organisation in which the investment is being made. Seeking assurances that a robust anti-fraud procedure is in active use in the business should provide some comfort and investors should not lose sight of the fact that their investment is not just in the business per se, but in a trusted management team which will run the business in an ethical fashion. Once the investment has been made, the extent of protection from corporate fraud may well be dictated by the nature and extent of the investment. Obviously an investor with board room presence is in a far better position to monitor matters than a minority investor who is remote from the business.

Jaffe: Lenders and investors need trustworthy information and adequate assurances that they can rely on the information provided. Requiring that borrowers maintain and enforce strict anti-fraud compliance policies, effective internal audit and compliance reviews, and perform periodic, unscheduled fraud reviews, can bolster this reliance. Ensuring such corporate governance can be achieved in part through board and board committee participation. Having the chief compliance officer reporting directly to the CEO and the audit or risk management committee will help ensure that the functions are fulfilled. Studies have shown that organisations with such reviews have lower losses than those that do not. Lenders can also protect themselves by conducting investigative and financial due diligence regarding debtors, their management teams and the systems of internal controls that are in place. Those who have committed fraud in the past or have financial pressures outside the office typically present a higher fraud risk than other employees. Additional controls should be considered if any member of the management team or employee with control over company funds exhibits any of these risk factors. ■