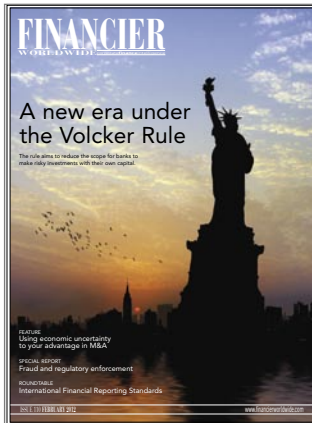


SPECIAL REPORT



FRAUD AND REGULATORY ENFORCEMENT



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Fraud and regulatory enforcement



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1STWEST FINANCIAL CORPORATION

SKADDEN, ARPS, SLATE, MEAGHER & FLOM (UK) LLP

FORUM

The regulatory fight against corporate wrongdoing

FW moderates a discussion on key trends in corporate fraud and corruption between Jerry Oldham at 1stWEST Financial Corporation, Christian Hay at Collas Crill, Simon Charlton at Deloitte Corporate Finance Limited, Lauren Reynolds at Gibson, Dunn & Crutcher LLP, and David B. Debenham at McMillan LLP.

THE PANELLISTS



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Jerry Oldham has an extensive background investigations and corporate due diligence background and a broad senior management resume in commercial banking, and corporate and real estate finance. He frequently serves as a consultant or expert witness in litigation and settlement negotiations involving complex corporate finance, real estate, banking, and lending practice issues, having assisted in the settlement of hundreds of lawsuits.



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Christian Hay is a partner and heads Collas Crill's Guernsey Dispute Resolution team. Mr Hay has acted on some of the most significant pieces of litigation to come before the Guernsey Courts and regularly advises banks, trust companies, other financial services and property/construction businesses on contentious issues.



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Simon Charlton leads Deloitte's Forensic and Dispute practice in the Middle East. Throughout his career Mr Charlton has focused on financial fraud and anti-corruption investigations, compliance activities, asset tracing and recovery, and dispute resolution. He has worked extensively on multi-jurisdictional investigations, liquidations and reorganisations, conducting investigations and assisting in the identification, freezing, and recovery of assets.



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Lauren Reynolds is a US-qualified attorney in the Munich office of Gibson, Dunn & Crutcher LLP. She is a member of the firm's White Collar Defense and Investigations Group and International Corporate Transactions Group. Ms Reynolds focuses on corporate compliance and on white collar criminal matters, in particular on issues related to the enforcement of the Foreign Corrupt Practices Act (FCPA).



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David Debenham is a partner in the commercial litigation group in the Ottawa office of McMillan LLP. He is a Certified Fraud Examiner and acquired his Diploma in Investigative and Forensic Accounting from the Rotman Business School's Graduate Program. He has published a text directed at fraud investigators and expert witnesses called The Law of Fraud and the Forensic Investigator, along with leading articles on detecting and reporting fraud in a law firm.



FW: Reflecting on the last 12 months, what major trends and developments have you witnessed in the fight against corporate fraud, bribery and corruption?

Oldham: In the US, the answer to this is simply an increased consciousness regarding the consistent assessment or detection of any issue in this area on the part of strategic acquisition firms and partners, private equity investors, and senior and sub-debt lenders, as far as the due diligence that they routinely perform on a prospective or portfolio company.

Charlton: Certainly the biggest global story of the last 12 months has been the Arab Spring, which is very much still ongoing. I think it is a cautionary tale about corruption, and perhaps it will lead to more active anti-corruption regimes in developing countries worldwide. In several Middle East countries, we've seen a boil-over in popular discontentment with rampant corruption on the part of kleptocrats and their hangers-on. Corruption drives all sorts of other inefficiencies – capital allocation, lack of competition, and base fraud within the country's public institutions and companies. This wasn't only limited to the public sector – the patronage networks extended straight into the private sector as well, and for these patronage networks to be effective required a subversion, or complete lack of internal controls at the organisations involved. However, in the end it was the corruption that led to the governments' fall. Consequently, wiser governments in the region are now starting to take notice that corruption is in fact a threat to their security. The recent establishment of Saudi Arabia's National Anti-Corruption Commission and Qatar's Administrative Control and Transparency Authority are two good examples of proactive moves by GCC countries to address corruption.

Reynolds: In the last year both US and UK regulators announced that they will focus on private equity in connection with anti-bribery

and anti-corruption. The US Securities and Exchange Commission (SEC) conducted an extensive probe into the financial services industry focusing on the relationships between certain banks and private equity firms and sovereign wealth funds. Notable targets included Citigroup Inc. and the private equity firm Blackstone Group LP. The SEC also for the first time investigated a large European insurer based on the conduct of a foreign private company in its portfolio. In 2012, there will likely be further enforcement actions against private equity firms and their dealings with sovereign wealth funds. Such actions can be expected to arise from the failure of private equity firms to conduct corruption focused due diligence and to implement compliance systems among their portfolio companies.

Hay: Since the start of the financial crisis, the Channel Islands have spent much of the last four years in and out of the spotlight. Guernsey's response to that increased scrutiny has been to ensure that its image remains positive by taking various steps including much more focus on new legislation dealing with money laundering, tax disclosure, and international cooperation, as well as the emergence of a much more powerful financial services regulator and the creation of a dedicated financial crime unit by the Guernsey authorities. In Guernsey, requests from foreign governments for disclosure of documents relating to certain individuals, companies, or other structures suspected of involvement in corporate crime, including fraud, bribery, and tax evasion, are taken seriously. The key issue for regulated businesses is how to act under the obvious authority of the disclosure request while not putting themselves at risk of being actioned by their client. With international authorities becoming more aggressive in their approach, the pressure on business is becoming intense.

Debenham: In Canada there has been a rush to ensure compliance with the UK's anti-brib-

ery legislation for our multinational companies, as our historic ties to the commonwealth market require many domestic companies to comply with this legislation.

FW: What types of fraud and corruption seem to be prevalent in the current market?

Charlton: We have seen a lot of cases of fraud that could probably have continued uninterrupted if not for the financial crisis. As credit became tighter, these started to unravel. This is especially the case in the Middle East, where deals were often done at the shake of a hand and name lending was the norm. As markets contracted and banks were forced to start paying closer attention to their balance sheets, poor quality loans were put in the spotlight. Specific to this geography, we also see a lot of management override of controls – or abuse of power and position. When you have companies that are owner-managed at the top level, but rely on imported labour to fulfil their operational functions, you often have an environment where people just keep their head down and don't dare to question the actions of their superiors. Whether or not it is wilful or simple ignorance, it makes it very easy for an unscrupulous manager to defraud their organisation.

Reynolds: Asset misappropriation and financial misrepresentation remain predominant business crimes in the current market. Corruption, especially 'supply-side' corruption, also is prevalent in many parts of the world, particularly for companies doing business in developing markets such as China, India, and Russia. Companies that participate in public tenders and procurement and that rely on government permits and licences also face an elevated risk of fraud and corruption. Large scale construction projects also present a heightened corruption risk as inflated material and supply costs can serve as a means to finance bribery.

Hay: The layman's view of savings accounts operated in offshore jurisdictions has traditionally been the idea that funds are being invested offshore as a means to evade paying tax on funds in the home jurisdiction. Guernsey has signed up to a raft of new Tax Information Exchange Agreements (TIEAs) in the last few years. This, alongside the European legislation on withholding tax, has closed off opportunities for this type of crime. That said, as the impact of 50 percent taxation in the UK really began to bite during 2011 we assisted several deposit taking institutions following the reporting of suspicions to the Financial Intelligence Service (FIS). It seems that third party nationals are still prepared to risk criminal prosecution in their home country ►►



by attempting to operate accounts offshore in fraudulent names.

Debenham: Title and mortgage fraud appears to be an epidemic given that our real estate market in Canada is booming.

Oldham: The leaders by category would seem to be accounting fraud, disclosure fraud, and failure to inform boards of directors and possible acquirers of past frauds committed that were adjudicated, for which a member of senior management of the prospective investment was charged and found guilty, or is currently being brought to trial with consequences pending. Our best example of a currently pending matter discovered in a background investigation for a lender is the discovery of a corporate CEO in jail for attempting to bribe his current lender that was not disclosed to the prospective lender.

FW: *On the legal front, could you outline the significant regulatory changes that have been implemented in various jurisdictions? In your opinion, do these moves have the potential to reduce corporate wrongdoing around the world?*

Reynolds: More countries are implementing new anti-corruption laws and more resources are being dedicated to enforcement. Notably, the newly enacted UK Bribery Act criminalises the giving and receiving of bribes in both public and private transactions and creates a strict liability offence where a commercial organisation has failed to implement adequate compliance measures to prevent bribery. Beyond the UK, China, India, Brazil, Russia, Morocco, Taiwan, Ukraine, Australia, India, Indonesia and Jordan have passed, or are considering, significant anti-corruption laws. As a result of these legislative developments, cross-border coordination and cooperation among domestic enforcement agencies and their foreign counterparts will likely increase, thereby

heightening the risk for companies engaged in corporate wrongdoing.

Hay: There is no doubt that many jurisdictions have managed to fight their way through the red tape, and enacted ambitious legislation aimed at tackling corporate wrongdoing. The UK's Bribery Act remains the most likely to affect individuals and corporations based in Guernsey because of its ambitious extra-territorial effect. Since the Act applies to British citizens wherever in the world they reside, many individuals working in the Channel Islands financial services industry are potentially within its reach. Question marks over how aggressively the Bribery Act, and particularly its extra-territorial elements, will be enforced remain largely unanswered. November 2011 saw the sentencing of the first individual to be convicted under the Act, with a respectable three years handed out for the bribery offence. With what enthusiasm the Act continues to gather pace in 2012 remains to be seen.

Debenham: The impact of the UK's Bribery Act is causing a stir in North America and around the world. It may be an overly strict law. The difficulty with laws that are difficult to comply with is that they spawn a 'legislation avoidance' mentality in which the cost of avoiding the law is less than the cost of complying with the law, such that companies hire consultants to avoid the legislation altogether – similar to the tax avoidance industry moving income offshore.

Oldham: While changes in laws and enforcement procedures can provide further disincentives for managers and employees to misbehave, I would offer that it is not the laws that bring down the bandits – it is the predisposition of companies, investors and lenders to perform proper due diligence and institute and coordinate proper incentives, and a corporate conscience to detect fraud that solves the issue. In the US, bank regulators are the best ex-

ample of a regulatory group that has put a serious emphasis on enforcing current regulations and newly enacted regulations or enforcement procedures.

Charlton: Internationally, two regulatory changes that are making some waves over the last year are the US Dodd-Frank Act, which is a trendsetter in terms of whistleblowing, and the UK Bribery Act. Dodd-Frank essentially offers a bounty to whistleblowers if they provide evidence that leads to a regulatory judgment (including FCPA) against the company they work for. The objective is to scare companies into really beefing up their own internal compliance and reporting functions. The pressure is now on them to encourage employees to report internally and then have those concerns appropriately dealt with. The pressure is also on them to be squeaky clean. It will be interesting to see if any other countries follow suit. It will also be interesting to see how effective the Dodd-Frank Act is, because there have been a few other tip-off programs in the US, but they have been very poorly implemented. As for the Bribery Act, we now have a commercial bribery equivalent to the US FCPA. The FCPA only prohibits bribery of the public sector, but the Bribery Act extends that to purely commercial bribery as well. However, the UK does not have a very strong track record of anti-corruption enforcement, so we will see how that changes.

FW: *What challenges face regulators when enforcing the law in this area? Do they have sufficient resources to manage the workload, especially on an international basis?*

Hay: Experience has taught us all that regulating legislation is only as effective as the resources dedicated to enforcing it. It is only once statistics on prosecutions become available, and businesses get a feel for effectiveness on the ground, that the potency of new legislation can really be judged. Not all changes have arrived to the fanfare of the Bribery Act. Guernsey's regulator, the Guernsey Financial Services Commission (GFSC), has notably stepped up its operations incrementally over the last few years, in particular with the founding of a dedicated enforcement team of in-house lawyers, becoming a much more significant influencing force for regulated businesses in the Island. In the summer of 2010 Guernsey was visited by representatives of the IMF who reported on Guernsey's framework for Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT). The report was positive, but Guernsey's regulator in collaboration with the States of Deliberation – Guernsey's law making body – put in considerable efforts to tighten up Guernsey's AML and CFT legisla- ►►



tive framework ahead of, during, and following recommendations from the visit.

Debenham: Regulators have to match the cost of enforcement with the benefits gained from enforcement. Having more anti-fraud legislation, without additional funding for enforcement, and a clear identification of the domestic cost of this corporate wrongdoing, is going to continue to leave regulators in a bind. My own view is that private remedies should be enhanced to allow the victims of wrongdoing access to the courts whenever there is an identifiable victim, so that private litigation can be used to reinforce the public interest wherever possible.

Oldham: US banking regulatory groups generally do have the capacity and a strong predisposition to enforce current regulations and systems, as do the accounting regulatory and security regulatory bodies, although certain legal jurisdictions may have somewhat less capacity in this area.

Charlton: Limited resources have been the biggest constraint to the US, and it will likely be the case for the Serious Fraud Office, too, who are tasked with enforcing the UK Bribery Act. In the case of the FCPA, the US has developed the rather ingenious tactic of getting the companies to investigate themselves and report back to the SEC/DOJ, in hopes of receiving some leniency if their investigation is deemed transparent and independent. The problem is that most companies settle without admitting or denying wrongdoing, a practice which is currently being questioned. As for the UK, the SFO is not a regulator and thus does not have the authority to settle. So, we will see if they can develop a similar means for passing the costs of enforcement on to the private sector as well.

Reynolds: Although there have been a number of international anti-corruption en-

forcement actions in 2011 – Ferrostaal AG in Germany and Aon Corp. in Switzerland are notable examples – anti-corruption enforcement globally continues to face significant challenges. Despite the fact that the OECD anti-bribery convention has been in force since 1999, in 2010 only five of the 38 signatory nations imposed penalties on individuals and companies. In many countries, a lack of political will and insufficient resources contribute to under-enforcement. However, poor local infrastructure, insufficient investigative training of law enforcement, cultural resistance to reporting and insufficient reporting mechanisms, as well as domestic legislation and institutional frameworks also play a significant role. For example, laws in some countries that provide for a narrowly defined foreign bribery offence, a restrictive statute of limitations, and mild applicable sanctions prevent a more robust prosecution and sanctioning of companies in foreign bribery cases.

FW: *Broadly speaking, how should corporates respond to the enhanced scrutiny of regulators? How important is it to update internal governance policies to monitor and detect potential fraud and corruption?*

Debenham: Corporate compliance, with ‘tone from the top’ is critical for corporations to avoid the Enron effect and tumble into bankruptcy within days of a scandal as investors, lenders and other stakeholders jump ship.

Oldham: Simply put, corporations and other legal entities should establish a fraud consciousness. Trust but verify. You don’t know what you don’t know, so establish systems that consistently ‘trust but verify’ everything that could compromise the company’s financial status and reputation.

Charlton: It is essential to have strong governance policies, but policies alone don’t detect or deter fraud and corruption. The big challenge is

always in the operationalisation of those policies. Regulators may give a company credit for having strong policies in place. But those policies aren’t worth the paper they’re written on if it is shown that the company does not abide by them and has no mechanism in place to monitor their effectiveness or enforce compliance. Further, management must make it clear to everyone in the organisation that they, and everyone else, must take the policies seriously.

Reynolds: Given the current anti-corruption enforcement climate, companies are advised to undertake risk assessments aimed at ensuring that a company’s anti-corruption compliance program both comports with best practices and is tailored to the company’s greatest risks. Additionally, companies regularly should review their policies and procedures to make sure their compliance program is operating as intended and is compliant with newly enacted regulations. For example, internal compliance policies regarding facilitation payments should be examined to ensure compliance with the UK Bribery Act. Companies are strongly advised to document the review and updating of their internal compliance policies in order to demonstrate that the company took the proper preventative measures should a government enquiry ever arise.

Hay: Businesses must start to think about regulation as another cost of doing business, and like other costs, do all they can to minimise the direct and indirect drag on profits of interactions with regulations and regulators. The most important tool in meeting this objective is having a feel for how the regulator is thinking. Regulators will always be subject to their own competing external demands, whether they are political, financial, or other. Those demands will in turn affect the way in which the regulator manages its relationship with regulated businesses. It is vital for businesses to listen to their regulators to understand not only what the law says, but in what way the regulator is expecting you to comply with that law. That is something that could change over time and as a result of the regulator’s own external demands.

FW: *What advice would you give to companies on managing internal investigations and dealing with governmental enquiries, should the need arise?*

Oldham: First, assume that the need will arise or has already arisen. Be presumptuous about this condition. With regulators and enforcement agencies, give them access to people and records within the legal boundaries that exist in the jurisdiction in which the company is operating. Always have exemplary people, systems ►

and processes in place that would stand proud when put under a microscope. Constantly test and retest these elements.

Charlton: The first piece of advice is to not deal with anything ad hoc. A company should always have a well-crafted internal investigation policy and procedure that governs everything from who to involve in the investigation and their roles, to preservation of data and information, to reporting lines. It should also dictate when to involve external counsel or other assistance. We have seen plenty of companies attempt to conduct an internal investigation without having a clear game plan, and they often end up doing more harm than good. Even if they have good intentions, if they contaminate evidence or otherwise undermine the independence of their investigation, it will be difficult to convince the regulators that they did not intentionally manipulate the outcome.

Reynolds: Companies should take government enquiries seriously and respond proactively. At the very onset, companies need to take steps to ensure that all company documents and data are preserved and to designate a senior officer – ideally the chief compliance officer or an individual of an equal status within the organisation – to manage the company’s internal investigation and communicate with government regulators on the company’s behalf. In many cases, companies should consider retaining experienced outside counsel to advise them in conducting an internal investigation, particularly in situations where companies may face enquiries from national and foreign regulators. The company’s legal advisers can help ensure that the company asserts all of its rights in responding to a governmental enquiry. It is often the case that a company’s ability to provide certain requested information is restricted, inter alia, by legal privilege, corporate law provisions, data protection laws, and certain national laws, for example domestic blocking statutes.

Hay: The first step is to seek advice. An experienced advisory firm will work with the regulator on a day-to-day basis and know the traps that can befall the inexperienced business in trying to grapple with these issues. Dealing with investigations or enquiries without any kind of background as to the real drivers behind the questions can lead businesses dangerously astray. Again, the key objective is to minimise the costs and damage of the investigation – businesses must approach investigations strategically just like they would with any other challenge. The second, and more practical, piece of advice is to think carefully about privileged documents – those which you would not legally be obliged to disclose dur-

ing the investigation. It may be that little can be done about documents already in existence, but correspondence openly discussing the situation with colleagues, even by internal email, may become disclosable, depending on the nature of the investigation.

Debenham: The greatest difficulty for corporations is that a corporate ‘group think’ or cohesive culture can result in everyone internally seeing things one way, and thus they miss the invisible gorilla in the room that any outsider, and hence public opinion, can see immediately. Thus you need an outsider to first, see when an internal investigation is warranted; second, review the results of the internal investigation; and third, assist in addressing governmental enquiries. It is not that corporations don’t have the talent and ability to address all of these issues, it is that they don’t have the ‘naïve’ perspective of an outsider that is needed so that they can see what outsiders will perceive and address these concerns proactively.

FW: Do companies need to be proactive about preventing corruption wherever possible, such as checking the backgrounds of board members, senior level corporate officers and independent contractors before employing them?

Charlton: One ounce of proactive effort is worth five ounces of reactive effort, and costs far less. Integrity due diligence is critical for board members and corporate officers, and especially for staff in high-risk positions. One area that most companies fall down on is due diligence on third parties, such as the sales agents, distributors, or other service providers that act for them in some capacity with a client or government official. Due diligence should not be just a file-papering exercise, though; it should involve clear expression of responsibilities related to anticorruption, as well as confirmation of understanding the company’s policies, and commitment that those policies will not be violated. Further, they should be checked up on – transactions with, or expenses by, high risk individuals or third parties need to be closely monitored such that, should any problem arise, it is detected and dealt with swiftly.

Reynolds: Conducting compliance due diligence on a company’s board members, senior officers, and third party intermediaries, including sales representatives, distributors, resellers, freight forwarders, customs brokers, and logistics agents, is a best practice in mitigating fraud and corruption risk. The realisation that an individual has personally engaged in wrongdoing or has been associated with a company that has a shadowy track record should raise a red flag in any employment or

contracting decision. Additionally, in view of the risk that companies face of successor liability for pre-acquisition misconduct or for post-acquisition misconduct enabled by deficiencies in integrating the acquired company into the company’s compliance environment, companies are advised to perform anti-corruption due diligence in advance of any proposed corporate mergers, acquisitions, and joint ventures, and subsequently to review these entities to identify any corruption risks associated with such transactions.

Hay: A proactive approach to preventing corruption will assist a company’s public image, and will assist in defending against any sanctions or criminal or civil proceedings that may be brought against the company. To return to the example of the UK Bribery Act, the element of the Act which has attracted the most publicity is undoubtedly the new offence of ‘failure to prevent bribery’. There is a statutory defence for businesses that have ‘adequate procedures’ to prevent bribery. Checking the backgrounds of board members and senior level officers would certainly seem to be a useful step in satisfying the requirements of this defence. Guernsey’s Anti Money Laundering and Countering of Terrorist Financing Handbook also makes a requirement for employees of regulated businesses to be ‘screened’ to ensure a required standard of competence and probity. Such screening should include investigation into any regulatory action or criminal convictions.

Debenham: The steps suggested in the question are obvious, and for the most part are being taken now. The key is to ensure that there are outside advisers who can review steps that appear ‘normal’, or ‘innocuous’ from an internal perspective to suggest that the company may be headed into trouble – intentional wrongdoing by companies is largely mythology – what almost invariably happens is that steps taken to be ‘innovative’ or ‘sophisticated’ head the corporation off into unknown waters where an insider steers the company into misconduct, and it eventually becomes too late to detect and correct internally.

Oldham: There is no substitute for the best business practice of performing background investigations at all these levels. There should be no excuse for not knowing if a board member, management team member, or vital contractor has committed a previous fraud or serious act of personal indiscretion that would compromise the company’s financial status or reputation. As already stated, always ‘trust but verify’. You don’t know what you don’t know. The sooner you know all that you should know, the better. ■